

Sustainable Social Security: Four Options

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Abstract

Four policy options to make the social security sustainable under the coming demographic shift are presented; increase payroll taxes by 6 percentage points, reduce replacement rates by one-third, raise the normal retirement age to 73, or means-test the benefits and reduce them in income. While the four policies all achieve the same goal, economic outcomes differ significantly. Options to curtail benefits encourage own savings and capital accumulation. The payroll tax increase discourages work effort, but the means-test gives the worst labor disincentives. Future generations prefer options to reduce benefits, but current generations prefer to finance the transition with payroll taxes.

Keywords: Social security reform and sustainability, general equilibrium, labor force participation, retirement age, demographic shift, overlapping generations, transition and welfare effects

J.E.L. classification codes: E2, E6, H55, J2

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1 Introduction

The coming demographic shift will pose a significant fiscal challenge on the budget of the social security system in the U.S. The long-run sustainability of the pension system is in question unless some form of reform is undertaken to close the budget gap that is expected to grow.

Life-expectancy has grown dramatically during last decades to reach 82 years in 2000 and the current projection is that it will climb to 88 years by the end of the century. At the same time, the birth rate has declined sharply and the total fertility rate stands at about 2.0 in 2000. The dependency ratio is projected to rise rapidly from the current 22% and reach 38% in 2050 and 45% in 2100.¹ More retirees will receive benefits, while there will be fewer individuals at working ages who contribute to the system through payroll taxes. The policy debate and public concerns appear to be mostly focused on the insufficient fund of the pension system imputed from simple accounting exercises. Economic distortions, however, that would emanate from fiscal adjustments to maintain the pay-as-you-go system could exacerbate the sustainability problem. For example, if the general government budget would absorb the imbalance and income taxes were to rise, it may significantly discourage investment or work efforts, which reduces the level of economic activities and shrinks the tax base, requiring a further increase in taxes, and so on. To quantify the effects of the demographic shift and fiscal consequences, we develop an economic model in which individuals make decisions on consumption, savings, labor participation and work hours over a life-cycle in a competitive production economy.

The paper considers four policy options that would make the social security system self-financed and its budget balanced every year; (1) raise the payroll tax by 6 percentage points, (2) reduce the replacement rates of the benefit formula by one-third, (3) increase the normal retirement age from 66 to 73, or (4) make the system means-tested and let the benefits decline one-to-one with income. All of the four options are shown to achieve the same goal of making the system self-financed. The economies, however, implied by alternative policies differ significantly from each other in terms of aggregate economic activities as well as the behavior of individuals along the life-cycle. Reducing the spendings through scaling down the benefit replacement rates or raising the normal retirement age will provide strong incentives to increase savings to supplement retirement consumption and the capital stock will be significantly higher than in the other two options. The higher payroll

¹The dependency ratio is defined as the ratio of population above age 65 to that of age 20 to 64. Source: Bell and Miller (2005) for life expectancy and the Census for dependency ratio: <http://www.census.gov/population/www/projections/>.

taxes will have negative work incentives and the participation rates in the first option will be much lower than in the second and third options. The average years of work is 44.5 years in option 1, while it is 46.7 and 46.2 years in options 2 and 3, respectively. The worst option, however, in terms of work disincentives, is the last option of means testing the benefits. The policy significantly reduces the labor force participation among the elderly. The labor force participation will plummet once individuals reach the normal retirement age and only 4.3% of those at age 65-85 will participate, while about 12 to 19% of those individuals would remain in the labor force in other reforms.

We also compute transition dynamics and study welfare effects of alternative policy options. Policies to reduce benefits encourage economic activities, but there will be large welfare costs on the current generations. While future generations will prefer lower benefits and lower taxes, current generations would prefer to finance the demographic transition through taxes, especially the middle aged individuals who have already contributed to the program through payroll taxation.

This paper builds on the vast quantitative research on social security reforms and aging demographics in the tradition of general-equilibrium life-cycle models pioneered by Auerbach and Kotlikoff (1987).² Existing papers study effects of particular and often ad hoc reforms of the current social security system. This paper presents a set of policy options that make the social security self-financed as the economy faces the coming demographic shift. The set encompasses the range of possible and well debated reforms and we quantify the magnitude of changes in each option that would restore the long-run sustainability of the program, taking into account the responses to reforms in aggregate variables as well as life-cycle behavior of individuals.

Most papers in the quantitative general-equilibrium literature assume that labor supply is either exogenous or endogenous only in the intensive margin. Our model endogenizes labor supply in both intensive and extensive margins and examines the changes in participation as well as work hours in response to reforms. Recent exceptions are İmrohorođlu and Kitao (2011) and Díaz-Giménez and Díaz-Saavedra (2009). İmrohorođlu and Kitao (2011) incorporate endogenous participation as well as social security benefit claims and focuses on two particular reforms to change retirement ages. Díaz-Giménez and Díaz-Saavedra (2009) study the effects of reform of the Spanish pension system to raise the retirement age in a model with endogenous

²See, for example, Conesa and Krueger (1999), De Nardi et al. (1999), Kotlikoff et al. (1999), Altig et al. (2001), Kotlikoff et al. (2007), Nishiyama and Smetters (2007) and Attanasio et al. (2007).

retirement decisions. Reforms are shown to affect both margins in different ways and exhibit a considerable degree of heterogeneity in the responses across them.

The rest of the paper is organized as follows. Section 2 presents the model economy and the calibration of the model is discussed in Section 3. Section 4 presents the quantitative findings of the paper. Section 5 concludes.

2 Model

This section describes the details of the economic model and presents individuals' recursive problem and the definition of a stationary equilibrium.

2.1 Demographics

The economy is populated by overlapping generations of individuals. Individuals enter the economy at age j_0 and face lifespan uncertainty. The conditional probability of survival from age j to age $j + 1$ is denoted as s_j . The maximum possible age is $j = J$, with $s_J = 0$. The size of new cohort grows at a constant rate n . Individuals derive utility from leaving bequest at death, denoted as $u_B(b)$ for the amount of assets left b at death. Bequests are assumed to be collected and distributed as a lump-sum transfer to the entire population. Individuals enter the economy with no assets except for the transfer of the lump-sum bequests.

2.2 Endowments

Each individual can allocate one unit of disposable time to leisure or market work. Individuals' earnings are given by $y_L = \tilde{\omega}h$, where $\tilde{\omega}$ denotes the wage rate per work hour h of each individual and is determined as

$$\tilde{\omega} = \omega(j, h)\eta w.$$

$\omega(j, h)$ is the part of the wage that depends on the age and work hours of each individual and η denotes an idiosyncratic labor productivity that evolves stochastically. w is the wage rate determined in the market as discussed in section 2.4.

2.3 Preferences

Individuals order the sequence of consumption and labor supply over the life-cycle according to a time-separable utility function

$$E \left\{ \sum_{j=j_0}^J \beta^{j-j_0} u(c_j, h_j) \right\},$$

where β is the subjective discount factor and the expectation is with respect to the shocks associated with the time of death and idiosyncratic labor productivity. Consumption and labor supply at age j are denoted as c_j and h_j , respectively.

2.4 Technology

Firms are competitive and produce output according to a constant returns to scale technology of the form $Y = F(K, L) = K^\alpha (AL)^{1-\alpha}$, where K and L are aggregate capital and labor inputs and α is capital's share of output. A is the total factor productivity which we assume is constant. Capital depreciates at a constant rate $\delta \in (0, 1)$. The firm rents capital and hires labor from individuals in competitive markets, where factor prices r and w are equated to the marginal productivities as $r = F_K - \delta$ and $w = F_L$.

2.5 Social security

The government in the benchmark economy operates a pay-as-you-go pension system similar to the current U.S. system. A proportional tax τ^s is imposed on earnings of working individuals up to the maximum amount of y^s , above which the social security tax phases out to zero. Once reaching the normal retirement age j_R each retired agent starts to receive benefits ss . The amount of the benefits is determined as a concave function of an individual's average lifetime earnings. We will consider reforms of the social security system in section 4.

2.6 Fiscal policy

The government spends an exogenous amount of G on public purchases of goods and services and issues one-period riskless debt D' , which pays the interest rate of r . Besides social security taxes, revenues are raised from taxation on labor income, capital income and consumption at proportional rates denoted as τ^l , τ^k and τ^c . The

labor income tax τ^l is determined in equilibrium so that the following consolidated government budget constraint is satisfied every period.

$$G + (1 + r)D + \sum_x ss(x)\mu(x) = \sum_x [\tau^l \tilde{\omega}h(x) + \tau^s \min\{\tilde{\omega}h(x), y^s\} + \tau^k r(a(x) + b) + \tau^c c(x)] \mu(x) + D', \quad (1)$$

where $\mu(x)$ denotes the measure of individuals in individual state x , D is the debt issued in the previous period and D' is the proceeds of the debt issued in the current period.³

2.7 Market structure

The markets are incomplete and there are no state contingent assets to insure against the idiosyncratic labor income and mortality risks. Individuals can, however, imperfectly self-insure against risks by accumulating one-period riskless assets. Individuals are not allowed to borrow against future income and transfers, i.e. $a_j \geq 0$ for all j .

2.8 Individuals' problem

The state vector of each individual is given as $x = \{j, a, \eta, e\}$, where j denotes age, a assets accumulated in the previous period, η the idiosyncratic labor productivity, and e the index of cumulated labor earnings that determine the social security benefit. Given the states, each individual optimally chooses consumption, saving and labor supply.

The problem is solved recursively and the value function $V(x)$ of an individual in state x is given as follows.

$$V(j, a, \eta, e) = \max_{c, h, a'} \{u(c, h) + \beta s_j E[V(j + 1, a', \eta', e')] + (1 - s_j)u_B(a')\}$$

subject to

$$\begin{aligned} c + a' &= (1 + r)(a + b) + \tilde{\omega}h + ss(x) - T(x), \\ a' &\geq 0, \\ e' &= e, \text{ for } j \geq j_R, \end{aligned}$$

³In stationary equilibrium, all aggregate variables grow at a constant rate n and $D' = (1 + n)D$.

where $T(x)$ denotes the taxes paid by an individual in state x .

$$T(x) = \tau^c c + \tau^k r(a + b) + \tau^l \tilde{\omega} h + \tau^s \min\{\tilde{\omega} h, y^s\}$$

The state e that represents cumulated labor earnings evolves according to the sequence of realized labor productivity shocks and endogenously chosen work hours.

2.9 Stationary competitive equilibrium

For a given set of exogenous demographic parameters $\{s_j\}_{j=1}^J$ and $\{n\}$ and government policy variables $\{G, D', ss, \tau^s, \tau^k, \tau^c\}$, a stationary competitive equilibrium consists of agents' decision rules $\{c(x), h(x), a(x)\}$ for each state x , factor prices $\{w, r\}$, labor income tax rate $\{\tau^l\}$, a lump-sum transfer of accidental bequests $\{b\}$ and the measure of individuals $\{\mu(x)\}$ that satisfy the following conditions:

1. Individuals' allocation rules solve their recursive optimization problems defined in section 2.8.
2. Factor prices are determined competitively.
3. The lump-sum bequest transfer is equal to the amount of assets left by the deceased.

$$b = \sum_x a(x)(1 - s_{j-1})\mu(x). \quad (2)$$

4. The labor and capital markets clear.

$$L = \sum_x \omega(j, h)\eta h(x)\mu(x), \quad (3)$$

$$K = \sum_x (a(x) + b)\mu(x) - D. \quad (4)$$

5. The labor income tax satisfies the government budget constraint defined in equation (1).
6. The goods market clears.

$$\sum_x c(x)\mu(x) + K' + G = Y + (1 - \delta)K. \quad (5)$$

7. The distribution of individuals across states is stationary. $\mu(x) = R_\mu[\mu(x)]$, where R_μ is a one-period transition operator on the distribution.

3 Calibration

This section presents the parametrization of the model. The model period corresponds to a year. The unit of the agents in the model is an individual. For the data that is used to derive the target moments of calibration, we use male and female individual data except for the asset data as we discuss below. More details about the sample selection for each moment are discussed below. The parameters are summarized in Table 1.⁴

3.1 Demographics

The conditional survival rates s_j are calibrated based on the life-tables of Bell and Miller (2005). We use the estimates for the age-dependent survival rates of 2010 and take the average of the male and female figures. The growth rate n of the new entrants is set at 1.2%, the long-run average in the U.S. We assume that 20% of “new-borns” enter the labor force at each age between 20 and 24 every period. Individuals live up to the maximum age of 100 ($J = 81$).

When we simulate the economy under alternative demographics (which we call an “economy with aging”) in section 4, we use the projected survival rates of 2100 from Bell and Miller (2005) and the population growth rate of 0.5%, based on the projections of the U.S. Census Bureau.⁵ Figure 1 shows the unconditional survival rates for both economies.

⁴The dollar amounts in the calibration are normalized in terms of the average earnings based on the average earnings of workers in our PSID samples (\$48,000 in 2006 dollars or \$52,000 in 2010 dollars). Outcomes of the model in various figures in section 4 are expressed in 2010 dollars.

⁵<http://www.census.gov/population/www/projections/natdet-D1A.html>

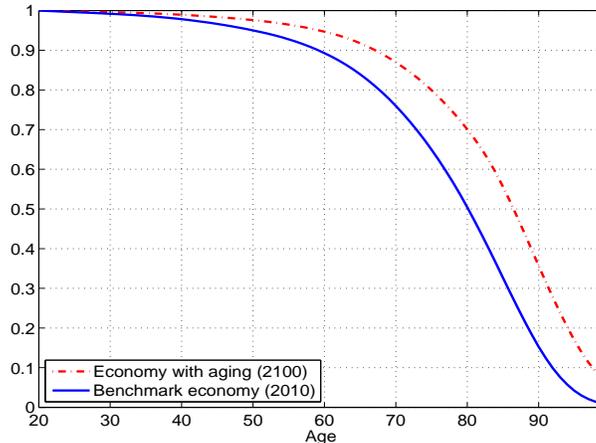


Figure 1: Survival rates (unconditional): For each age j , the unconditional survival rates are computed as $\prod_{i=1}^j s_{i-1}$ with $s_0 = 1.0$.

3.2 Endowments, preferences, and technology

To obtain the life-cycle profile of labor market variables such as labor force participation, work hours and wage rates, we use the Panel Study of Income Dynamics (PSID) and its individual data for male and female heads of households.

Endowments: The idiosyncratic component η of a worker's wage is specified as a first-order autoregressive process in log with a persistence parameter $\rho = 0.97$ and the variance of the white noise $\sigma^2 = 0.02$, which lie in the range of estimates in the literature (see, for example, Heathcote, et al, 2010). We approximate this continuous process with a five-state, first-order discrete Markov process.

The component $\omega(j, h)$ is a function of age and hours worked given as

$$\ln \omega(j, h) = \xi \ln h + \psi_j.$$

The coefficient ξ represents the part-time wage penalty and the value is set at 0.415, which implies that individuals who work 1000 hours per year earn 25% less per hour than those who work 2000 hours per year, as estimated by Aaronson and French (2004). We use work hour and wage data in the PSID data in 2007 to derive the age-specific profile of ψ_j as a residual wage net of the hours effect, $\{\ln \omega(j, h) - \xi \ln h\}$, using the life-cycle profile of average work hours.

Figure 2 shows the profile of age-dependent productivity ψ_j .

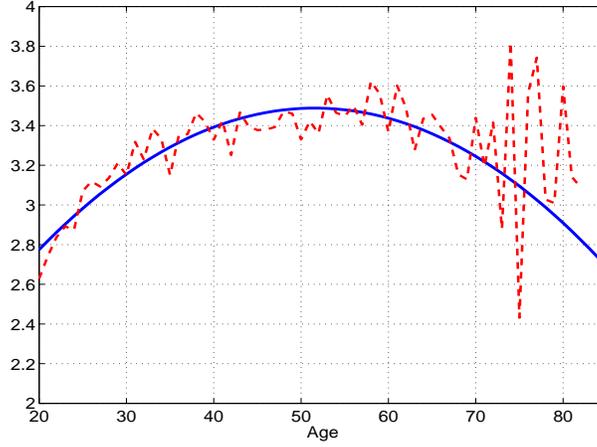


Figure 2: Age-dependent labor productivity ψ_j : The dashed curve represents the log wage net of the hours effect from the PSID data and the solid line represents a fitted line using a polynomial.

Preferences: The instantaneous utility function takes the following specification.

$$u(c, h) = \frac{c^{1-\sigma}}{1-\sigma} + \chi \frac{(1-h-\theta_j \cdot i_p)^{1-\gamma}}{1-\gamma} \quad (6)$$

The parameter χ represents the weight on utility from leisure relative to consumption. i_p is an indicator that takes a value 0 when $h = 0$ and 1 otherwise. θ_j represents the disutility associated with the participation in the labor market. We assume that the fixed cost of participation is measured in terms of lost time for leisure and varies by age.

Figure 3 shows the life-cycle profile of labor force participation rate in the PSID data, in which we define participation as working at least 300 hours in a given year.

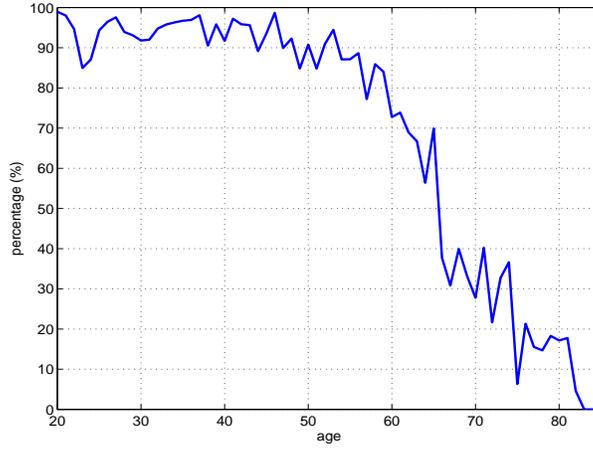


Figure 3: Life-cycle profile of labor force participation rate: data

Until individuals reach mid-50s, the profile is flat and a great majority of individuals participate in the labor force. The participation rate declines to about 70% by age 60 and falls sharply thereafter, reaching almost 0% in early-80s. Conditional on surviving, individuals who enter the labor market at age 20 spend about 44 years of their life participating in the labor market. We assume the functional form of $\theta_j = \kappa_1 + \kappa_2 j^{\kappa_3}$ for the age-dependent fixed cost of participation and calibrate the three parameters of the function to match these three targets, average participation rate at age 60 and in early 80s, and average work years over the life-cycle.⁶ The profile of the participation cost θ_j is shown in Figure 4.

⁶For normalization, the age j in the formula is expressed as the years since age 20 as a fraction of workable years, that is, 66 years.

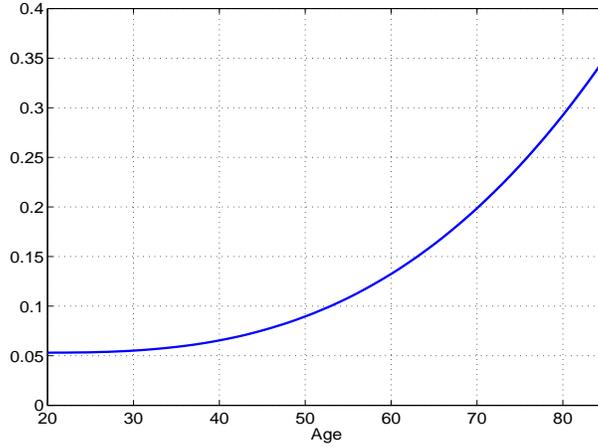


Figure 4: Fixed cost of participation by age θ_j

We assume that individuals make the participation decision between the ages of 20 and 85 and everyone withdraws from the labor market at 86 permanently.

The utility from bequest is assumed to be linear as in Kopczuk and Lupton (2007) and defined as $u_B(b) = \phi_B b$. The coefficient ϕ_B determines the relative weight on the bequest utility. According to the SCF, the ratio of the average wealth held by households above age 65 to those between age 20 and 64 is 1.5. Studies find many elderly keep large amounts of assets until very late in life. According to the SCF, households at age 65 and beyond hold 50% more assets than younger households of age 20-64 on average and we calibrate the value of ϕ_B to match the ratio.⁷

The subjective discount factor β is set so that the model has a capital-output ratio of 3.0 in the initial steady state.⁸ The parameter χ is chosen so that the average work hours of working individuals equal to 38% of disposable time as in the PSID data. Figure 5 shows the hours profile over the life-cycle from the PSID samples.⁹

⁷Ideally we would like to have the profile of wealth for individuals in a household, to be consistent with the calibration of other variables. Given the difficulty in distinguishing assets of spouses and individuals in a household, we assume that the life-cycle profile of households wealth approximates that of individuals and use the household data.

⁸The capital stock is assumed to consist of private fixed capital, government capital and the stock of durables. Imputed income flows from the last two components of capital stock are added to measured GNP so that the measurements are consistent.

⁹The hours are expressed as a fraction of disposable time, based on 15 hours per day times 365 days.

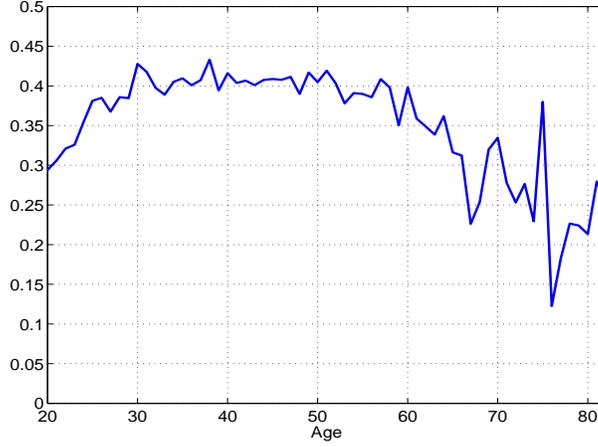


Figure 5: Work hours over the life-cycle: data

We set the risk-aversion parameter σ at 2. The parameter γ is set at 4.0, which implies the intertemporal labor supply elasticity of about 0.32 on average, in line with the estimates using the micro data, as surveyed in Browning, Hansen, and Heckman (1999).¹⁰

Technology: The income share of capital α is set at 0.40, based on private and public fixed capital including the stock of durables. The depreciation rate δ is $0.082 = \frac{X/Y}{K/Y} - n$, which is implied by the equilibrium law of motion for the capital in the steady state, where we target an investment-output ratio X/Y of 0.28 and a capital-output ratio K/Y of 3.0.¹¹ The TFP parameter A is set to normalize the unit of the model and to achieve the average earnings is 1.0 in the model's equilibrium.

¹⁰Note that the actual elasticity depends on the age and work hours of each individual. The average elasticity is computed based on the average work hours of 0.38 and the average participation cost of 0.13, $(1/\gamma) * (1 - 0.38 - 0.13)/0.38$ with $\gamma = 4$. The elasticity is higher for individuals who work less and are older.

¹¹Note that we abstract from technological growth since we also consider preference specifications that are not consistent with a balanced growth path. This allows us to implement utility functions with alternative values of the coefficient of relative aversion and labor supply elasticity separately that are considered in the literature.

3.3 Government

Social security: In the benchmark economy, the government runs a pay-as-you-go social security program that captures the features of the system in the U.S. We set the social security tax rate τ^s at 10.6% with the maximum taxable amount of $y^s = \$106,800$ as it is in the U.S. in 2009-11. The benefit, or the Primary Insurance Amount (“PIA”), is determined as a concave piecewise linear function of the career-average earnings (“AIME”), which we capture through the state variable e . In 2010, the marginal replacement rate is 90% for the average earnings up to \$9,132, above which the replacement rate falls to 32%. For earnings above \$55,032, the replacement rate is 15%.¹² See Appendix A for more details about the computation of the AIME and PIA.

The social security’s replacement rate, defined as the ratio of the average benefits to the average earnings of workers, is 40% in the benchmark model.

Government expenditures, public debt and taxes: In the benchmark economy, we set the government spending G at 20% of output, which is the average ratio of government consumption expenditures and investment to GDP in the post-war period. The ratio of federal debt held by the public to GDP is set at 40%. We assume a consumption tax rate of 5% and a capital income tax rate of 30%. The labor income tax is set so that the overall government budget constraint is satisfied.

¹²The bend points for the PIA formula are adjusted every year. The maximum monthly benefit is determined as the PIA that corresponds to the maximum taxable earnings.

Table 1: Parameters of the model

Parameter	Description	Values/source
<i>Demographics</i>		
n	population growth rate	1.2%
$\{s_j\}_{j=1}^J$	conditional survival probabilities	Bell and Miller (2005)
J	maximum age	81 (100 years old)
<i>Preference</i>		
β	subjective discount factor	0.9815
χ	weight on leisure	0.5123
γ	leisure utility curvature	4.0
$\{\kappa_i\}_{i=1}^3$	cost of labor force participation	{0.0531, 0.298, 2.780}
ϕ_B	weight on bequest utility	0.4386
<i>Labor productivity process</i>		
ρ_η	persistence parameter	0.97
σ_η^2	variance	0.02
ψ_j	age-dependent productivity	see text
<i>Technology and production</i>		
α	capital share of output	0.4
δ	depreciation rate of capital	8.2%
A	scale parameter	normalization
<i>Government</i>		
τ^k	capital income tax	30.0%
τ^c	consumption tax rate	5.0%
τ^l	labor income tax rate	22.1%
G	government purchases	20% of GDP
D	government debt	40% of GDP
τ^s	social security tax rate	10.6%
j_R	normal retirement age (benefit eligibility)	47 (66 years old)
y^s	social security maximum taxable earnings	\$106,800

4 Numerical results

In this section, we will first present the outcome of the benchmark economy, focusing on the life-cycle profile of individual decision variables. We will then simulate the model with the shift in demographics, which is financed by four different policy options and assess the economic effects of alternative policies. Finally, we compute

the transition dynamics from the calibrated benchmark economy to a new economy under an alternative policy and analyze the welfare effects from the transition.

4.1 Benchmark economy

Figure 6 shows the labor force participation of individuals along the life-cycle in the benchmark model. As we saw in the calibration section and in Figure 3, in the data the labor force participation lies in the range of 90-100% until mid 50s and the profile is very flat in this age range. Thereafter, the participation starts to decline gradually and then sharply in mid to late 60s, eventually reaching below 20% by age 70 or so. Our model generates this pattern although we do not capture the relatively small fraction of young individuals who do not participate in the labor market, partly because our model is not rich enough to incorporate various possible reasons for non-participation such as time for human capital investment or child-bearing, and unemployment among other factors. The model generates a gradual decline in labor force participation starting in 50s and more sharply in 60s. The pattern of the withdrawal from the labor market in the model is explained by the combination of the rising participation cost, a decline in the labor productivity and wages at mid to old ages and the income effect that is strengthened through the rise in wealth and consumption as they age.

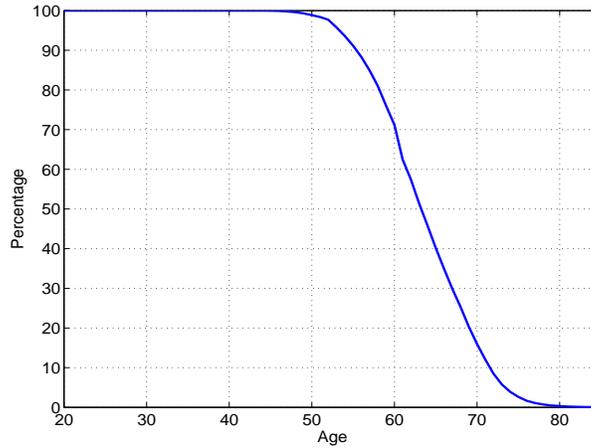


Figure 6: Life-cycle profile of labor force participation rate

Figure 7 shows the profile of work hours in the benchmark model. Hours are fairly flat initially and lies in the range of 0.35 and 0.45 between ages 20 and 50,

while trending down as they age. Hours are much lower at very old ages, falling to about one quarter of disposable time by age 70 and continuing to decline thereafter. The overall pattern of hours profile is consistent with the data as shown in Figure 5, although the model does not capture the mildly hump-shaped profile in the data, in which hours start low in early 20s and rise during the first 10 years. Incorporating the time set aside for human capital investment or short-term or part-time jobs that a relatively large number of younger individuals undertake during the years of ‘job churning’ is likely to improve the fit.

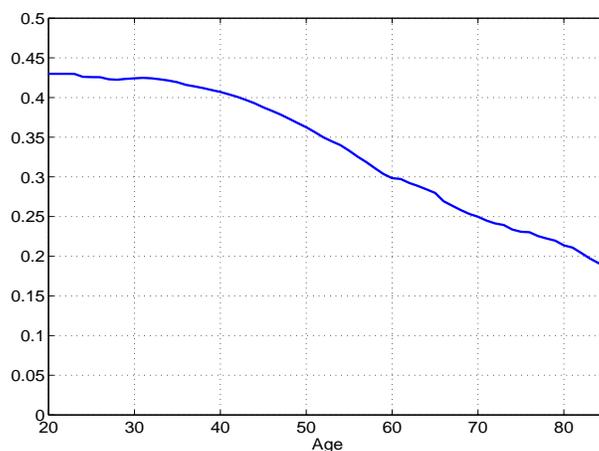


Figure 7: Life-cycle profile of work hours

Figure 8 shows the life-cycle profile of average assets by age. Individuals in the model save and accumulate wealth for three reasons; precautionary savings to insure against idiosyncratic income and mortality risks, retirement savings to supplement consumption after withdrawing from the labor force and savings to leave bequests. The profile exhibits a hump-shape as in the data (see, for example, Gourinchas and Parker, 2002). Individuals start to accumulate wealth at young ages to build a buffer stock of savings to insure against earnings risks and they maintain a significant amount of wealth even at very old ages to insure against the risk of outliving and to leave the optimal amount of bequests.

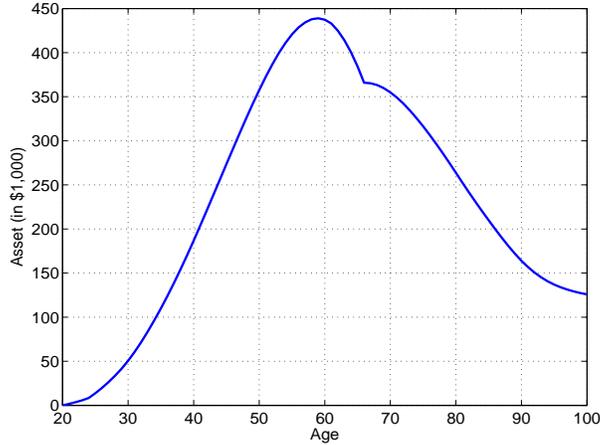


Figure 8: Life-cycle profile of wealth

The social security system currently runs a surplus and the revenues from the payroll taxes exceed the spendings on the benefits. In our benchmark model, the program runs a surplus in the magnitude of 0.44% of GDP every year, corresponding to the current magnitude of the surplus in the U.S. social security system. With the projected shifts in demographics, the spendings will significantly exceed the revenues if there is no reform. If we were to make the program sustainable, the budget gap needs to be filled by some form of taxation or reduction in benefits. We will explore the reform options in the next section.

4.2 Policy options

In this section, we study policy options to deal with the change in demographics and balance the budget of the social security program. As mentioned above, we assume the demographics implied by the projected survival rates and population growth rates for 2100 in this “economy with aging.”¹³ The implied old-age dependency ratio, which is defined as the ratio of individuals above age 65 to those at age 20-64, nearly doubles from 23.7% in the benchmark economy to 39.8% in the economy with aging. The life-expectancy at birth implied by the survival rates are 76.8 years and 83.2 years in the two economies, respectively.

¹³The survival rates are based on the estimates of Bell and Miller (2005) in 2100 and the population growth rate is based on the growth rate of the number of individuals at age 20 in 2100 according to the Census projections.

In what follows, we study policy options to fill the budget gap associated with the social security and to make the program self-financed. Differently from the benchmark economy, in which we imposed a consolidated budget constraint of equation (1) and backed out the labor tax rate that satisfies it, we assume an independent budget equation for the social security program as in (7) below, separately from the general government budget in (8), which excludes cash flows associated with the social security program. As in the benchmark economy, we adjust τ^l to satisfy the general government budget (8).

$$\sum_x ss(x)\mu(x) = \sum_x \tau^s \min\{\tilde{\omega}h(x), y^s\}\mu(x) \quad (7)$$

$$G + (1 + r)D = \sum_x [\tau^l \tilde{\omega}h(x) + \tau^k r(a(x) + b) + \tau^c c(x)] \mu(x) + D' \quad (8)$$

When we simulate alternative policy options in the economy with aging, we assume that per-capita government expenditures and debt are fixed at the levels in the initial benchmark economy. We keep them at the same level across experiments in order to control for the level of revenues needed to finance them and focus on the effects of alternative social security reforms.

We will consider following four policy options.

- Option 1.** Raise the payroll tax.
- Option 2.** Reduce the benefit replacement rates.
- Option 3.** Increase the normal retirement age from 66.
- Option 4.** Means test the benefits.

In each of the policy options, we solve for the value of a policy parameter to make the social security program self-financed and satisfy the program's budget equation (7) with equality. The parameter will be the payroll tax rate (option 1), the proportional rate for the benefit reduction (option 2), retirement age (option 3), and the level of income where the benefits start to phase out (option 4).

In order to facilitate comparison with the benchmark and across four policy options, we will first focus on the first option and contrast the results with those in the benchmark economy. The first option is essentially a “do-nothing” policy, which keeps the benefits intact in terms of replacement rates and eligibility. We will then use the first option as a reference point and compare three other options

in terms of deviations in various economic variables from the first option. These steps will help distinguish between the effects of the demographic shift and those of alternative fiscal adjustments.

Option 1. payroll tax increase (“do-nothing” on benefits): Table 2 compares the benchmark economy and the first option, in which the demographic shift is financed through an increase in payroll taxes. Since the demographics differ in two economies and the relative size of the population is indeterminate, the changes in aggregate variables (capital, labor, consumption and social security benefit spending) are expressed in terms of changes in per capita levels.

The payroll tax needs to increase by 5.7 percentage points and the total taxes on earnings (sum of labor income tax and payroll tax) rise by 9.3 percentage points, from 32.7% to 42.0%. The tax has to increase significantly to finance the rise in the social security benefits for retirees, which grows by more than 50% compared to the benchmark economy.

Table 2: Benchmark and demographic shift financed by payroll tax increase (Option 1)

	Benchmark	Economy w/ aging Option 1
Capital (per capita)	–	–5.3%
Labor (per capita)	–	–7.0%
Average work hours	–	+2.1%
Consumption (per capita)	–	–5.5%
Wage	–	+0.7%
Interest rate	5.19%	5.04%
Total labor taxes $\tau^y + \tau^s$	32.7%	42.0%
– Labor income tax τ^y	22.1%	25.7%
– Social security tax τ^s	10.6%	16.4%
Social security		
Benefit spending (per capita)	–	+53.8%
Avg replacement rate	39.6%	38.8%
Labor force participation		
Age 20-49	100.0%	100.0%
Age 50-64	81.0%	82.3%
Age 65-85	12.9%	12.4%
Avg work years	44.0	44.5

Despite the increase in labor taxes, individuals work more than in the benchmark economy, both in intensive and extensive margins, in order to supplement the retirement consumption for longer expected periods. The average work hours increase by 2.1% and the average number of years to work rises from 44.0 to 44.5 years. Figure 9 shows the changes in labor force participation rates and average work hours over the life-cycle. Labor supply in both margins increase across all ages.¹⁴ Although individuals work more, the average after-tax earnings will decline since the rise in labor supply and wage rate is not large enough to offset the increase in taxes. As

¹⁴Note that the average labor force participation of agents at age 65-85 declines slight as shown in the table. This is due to the change in the decomposition, that is, in the economy with aging the average age is higher and there is a greater fraction of older individuals who participate less.

a result, disposable income falls and both assets and consumption decline with the demographic shift financed by the tax increase. Capital per capita falls by 5.3% and consumption declines by 5.5%, as shown in Table 2. Note that per-capita labor declines since there will be relatively more old-age individuals that are not in the labor force and the labor supply from a smaller fraction of the population is used for the production of the economy.¹⁵

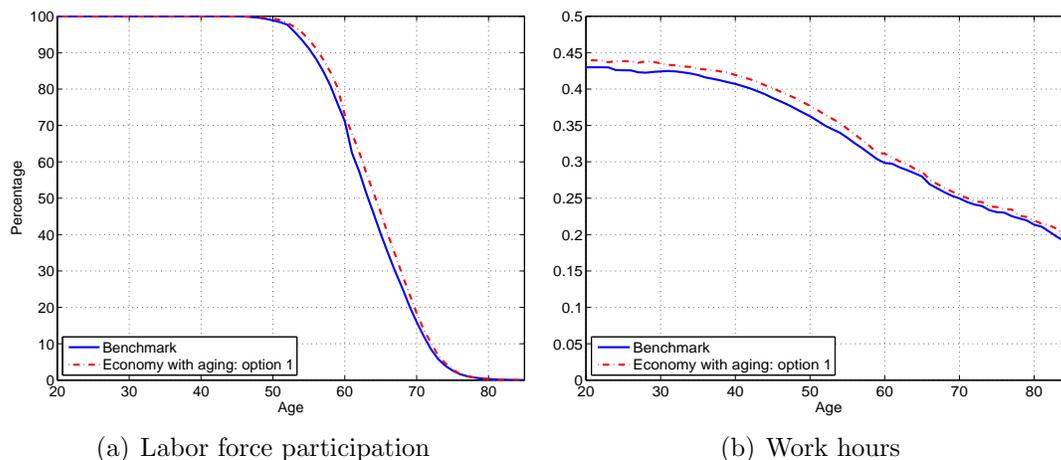


Figure 9: Labor supply in benchmark and option 1

Next we will compare four alternative policies to sustain the social security budget. We use the first option of raising the payroll taxes as a reference point of comparison. The results are summarized in Table 3. Changes are expressed as a deviation from the economy that implements the first policy option.

¹⁵If we compute labor per ‘working-age’ individual of age 20-64, it is higher by 5.4% under option 1 than in the benchmark economy.

Table 3: Comparison of alternative reforms

	Option 1 Tax increase	Option 2 Benefit cut	Option 3 Retire. age	Option 4 Means test
Aggregate variables				
Capital	–	+15.5%	+11.0%	–2.3%
Labor	–	+0.7%	+0.9%	–0.9%
Average work hours	–	–2.5%	–1.6%	+1.5%
Consumption	–	+4.4%	+3.7%	–1.6%
Wage	–	+5.6%	+3.9%	–0.6%
Interest rate	5.0%	4.0%	4.3%	5.2%
Tax rates				
Total labor taxes $\tau^y + \tau^s$	42.0%	34.7%	35.1%	36.8%
– Labor income tax τ^y	25.7%	24.1%	24.5%	26.2%
– Social security tax τ^s	16.4%	10.6%	10.6%	10.6%
Social security				
Benefit spending	–	–31.2%	–31.2%	–35.8%
Avg replacement rate	38.8%	26.2%	38.9%	24.5%
Labor force participation				
Age 20-49	100.0%	100.0%	100.0%	100.0%
Age 50-64	82.3%	87.9%	86.9%	81.5%
Age 65-85	12.4%	19.4%	17.6%	4.3%
Avg work years	44.5	46.7	46.2	42.9

Option 2. replacement rate cut: In option 2, we reduce benefit replacement rates by shifting down the benefit formula proportionally for given level of past earnings e , that represents past earnings of individuals. The payroll tax rate τ^s remains at 10.6% as in the benchmark economy. For the program’s budget to balance, the benefit scale must decline by about one-third (32.6%). The social security’s average replacement rate declines sharply from 38.8% under option 1 to 26.2%.

With lower benefits provided by the government, individuals save and accumulate wealth more aggressively to supplement retirement consumption. The aggregate stock of capital will be 15.5% higher than in option 1. The significant rise in capital

will raise the capital-labor ratio and the interest rate declines from 5.0% under option 1 to 4.0%.

Individuals work longer and the participation rate at age 50-64 and 65-85 will rise by 5.6 and 7.0 percentage points, respectively. The average number of years that individuals work along the life-cycle increases by more than two years, from 44.5 to 46.7 years. Since the age decomposition of workers changes and there are relatively more of old-age individuals, who work fewer hours than the young, the average work hours decline by 2.5%. The aggregate labor supply increases but only by 0.7%. Given the sizeable decline in the interest rate, the consumption and labor supply profiles become flatter. As a result, individuals work relatively more at older ages and the average work hours of younger individuals decline slightly, which contribute to a muted change in the aggregate labor supply.

Option 3. normal retirement age increase: In the third option, the normal retirement age is raised to reduce the benefit spendings and balance the budget of the social security. As in option 2, the payroll tax rate remains the same at 10.6%. The retirement age will have to rise by 7 years from 66 to 73 years old to close the budget gap.¹⁶

As shown in Table 3, effects on aggregate variables are very similar to those under the option 2 studied above, not only qualitatively but also quantitatively. Individuals increase savings for retirement and aggregate capital stock is 11% higher than in the economy under option 1. As shown in Figure 10, the life-cycle patterns of saving are somewhat different in options 2 and 3. In option 3, individuals start to decumulate wealth more quickly after the peak is reached at around age 60 to finance their consumption, while the pace of decumulation is much slower under option 2. Once individuals reach the retirement age of 73, they are entitled to higher benefits than in option 2 (note the replacement rate of 38.9% vs 26.2%) and the assets will decline more slowly.

¹⁶The exact budget balance of the social security program is a small deficit that corresponds to 0.07% of the GDP, since we assume the retirement age to be in integers. This small deficit is covered by the general government budget through the adjustment of labor income taxes.

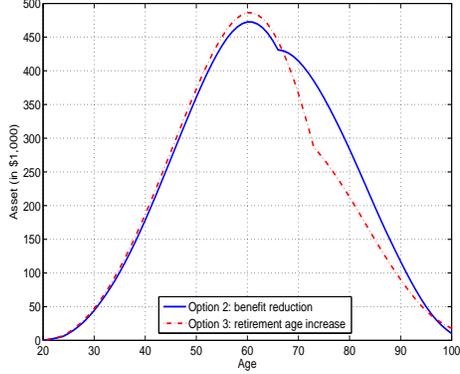


Figure 10: Assets over the life-cycle in options 2 and 3

Option 4. means-tested benefits: Lastly, we introduce means test in the determination of the social security benefits. This option appears to be less commonly debated than the previous three options. Many countries including Australia, Denmark and France have at least a component of the social security system that are means-tested. Australia is a notable example, in which is the pillar of the basic pension system known as the “Age Pension” is subject to both asset and income test.¹⁷ We assume a simple form of means testing, which allows the benefits to fall one-to-one with income above a threshold level.

Denote by \bar{s} the social security benefits without the means test, and the actual benefit after the test would be

$$ss = \max\{\bar{s} - \max(y - \bar{y}, 0), 0\}, \quad (9)$$

where y is the total income of each individual. \bar{y} is the cutoff level of income above which the benefits decline one-to-one until they reach zero and it is the policy parameter that is determined so that the social security program is self-financed. The max operator inside the bracket guarantees that the benefits do not exceed the upper limit of \bar{s} . The value of \bar{y} that makes the social security budget in equation (7) holds with equality is almost zero, -0.0068 in model units (or $-\$350$). To illustrate the benefit adjustment by the means test, Figure 11 shows the benefit as a function of total income, for two types of individuals with different past earnings and maximum benefit entitlement \bar{s} of $\$15,000$ and $\$10,000$. When the income exceeds

¹⁷http://www.centrelink.gov.au/internet/internet.nsf/payments/age_pension.htm provides details about the Age Pension.

certain levels (slightly less than \$15,000 and \$10,000, respectively), the benefits will be completely exhausted through the means test. The benefits will vary with income of each individual in a given year.

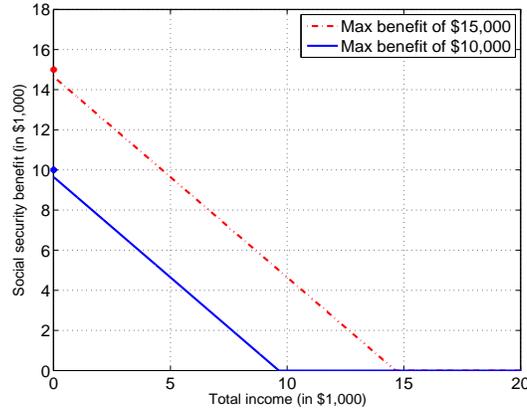


Figure 11: Means-tested social security benefit under option 4: examples

As shown in the last column of Table 3, means-testing the social security benefits will reduce both the savings and labor supply, a result that is in stark contrast from options 2 and 3, although all of the three options aim to control the spending side of the equation through different ways to cut down the benefits. In particular, the labor participation of older individuals will decline significantly under the means test. The participation rates for individuals of ages 50-64 and 65-85 are 81.5% and 4.3% respectively, 0.8 and 8.1 percentage points lower than in option 1. The participation rates are significantly lower than under the previous two options, which gave individuals strong incentives to work longer to supplement retirement consumption. The average work years is 42.9 years, more than 3 years shorter than in options 2 and 3. Figure 12 shows the life-cycle profile of labor supply in options 1 and 4, which exhibits strong disincentives on participation from the means-testing once individuals reach the retirement age of 66. The small number of individuals who remain in the labor force are the ones with very high productivity and they work longer hours to exploit the high wage, with most of them making earnings well beyond the point where the social security benefits are exhausted due to the means-test. Assets decline more sharply as well since the test is on the total income including returns from savings.

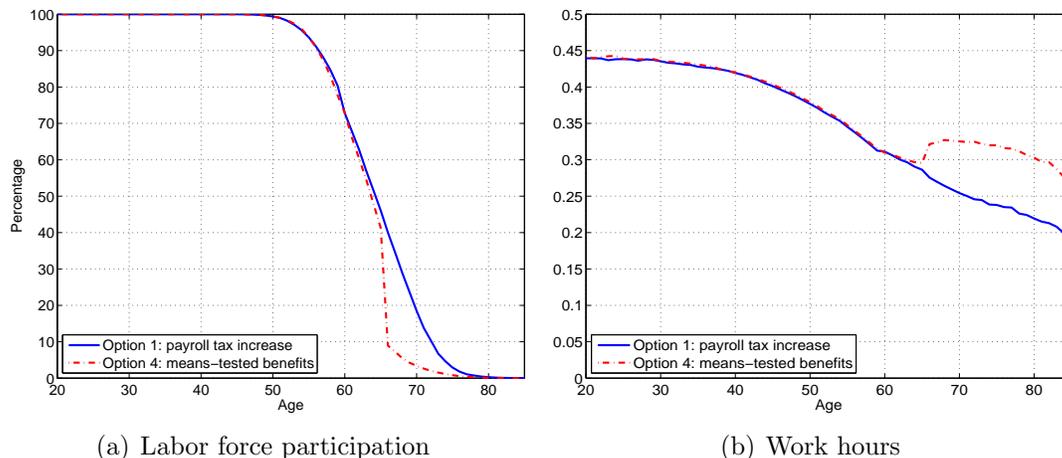


Figure 12: Labor supply over the life-cycle in options 1 and 4

4.3 Transition dynamics and welfare analysis

In this section we will analyze transition dynamics triggered by social security reform and study welfare effects from the transition. We will focus on the first three options that we considered above, the options to raise payroll taxes, to reduce replacement rates and to increase the normal retirement age.¹⁸ We assume that the economy starts in the steady state implied by the benchmark model that we calibrated and analyzed in section 4.1, which we call “initial steady state.” At the beginning of period 1, a new policy is announced and implemented. The economy will then start to make a transition to a new steady state which is implied by the new social security policy, and we call this economy as “final steady state.” The economies in the final steady state implied by alternative policies are the ones that we studied in section 4.2.

The economy will also experience demographic transitions, starting in period 1. The mortality risks will improve gradually over time and the survival rates increase linearly over 90 years from the rates of 2010 that we used in the benchmark economy to the projected survival rates of 2100.¹⁹

¹⁸We do not discuss in the paper the transition analysis for option 4 of meas-testing benefits, but computational results are available upon request from the author. Given the large negative effects on economic activities and fiscal burden, it is unlikely to be a viable option for the social security reform. Our results also suggest large negative welfare effects on current and many future generations through the transition.

¹⁹Note that the complete convergence of demographics will take more years after the survival

As in section 4.2, we will first study the results of option 1, which is a policy to adjust the tax and “do nothing” about the benefits. We will then use the transition path of option 1 as a benchmark and compare the paths of other options relative to the benchmark. For each policy option, a transition path is computed. There are many possible ways to introduce the new policy and we assume that the adjustment will be gradual and the policy variable in each option will adjust over 50 periods and converge to the level in the final steady state. In option 1, the payroll tax increases linearly over 50 periods from the benchmark level of 10.6% to 16.4% in the final steady state. In option 2, the benefit scale (replacement rates for given past earnings) shifts down linearly every period and declines by a total of about one-third (32.6%) over 50 periods. In option 3, the normal retirement age is raised by one year every 7 periods starting in period 2 so that the retirement age will reach 73 in 50 periods, which we found will almost balance the social security budget in the long-run. More detailed description of the computation is provided in Appendix B.

Figure 13 shows the transition dynamics of capital and labor supply per capita, interest rate and labor income tax rate when the option 1 is implemented. It is a policy to raise the payroll taxes to make the social security program sustainable without making any changes about the benefit schedule or the retirement age. Figure 13(a) shows the transition of capital over time. Capital stock rises initially as the survival rates increase and agents increase saving for retirement. Over time, however, the decrease in the labor supply and earnings will reduce the disposable income and the level of the saving will start to decline. The sharp increase in capital while the demographic change takes place implies a decline in the rental rate of capital and the interest rate falls from above 5.2% to 4.5%, which bounces back to around 5% as the capital starts to decline in later periods.

As shown in Figure 13(b), the demographic transition implies a significant decline in the labor supply of the economy, with the average labor supply per person in the economy falling by 7 percentage points through the transition. The sharp increase in labor income taxes, as shown in Figure 13(d), will add to the decline in labor supply, as we also studied in section 4.2. Without any change in the benefits, the demographic transition will imply a steady increase in the labor income taxes from slightly above 32% to about 42%.

rates converge in 90 years. We also assume that the growth rate of new cohorts declines linearly over 90 years from 1.2% in the benchmark economy to 0.5%, the projection of the U.S. Census Bureau.

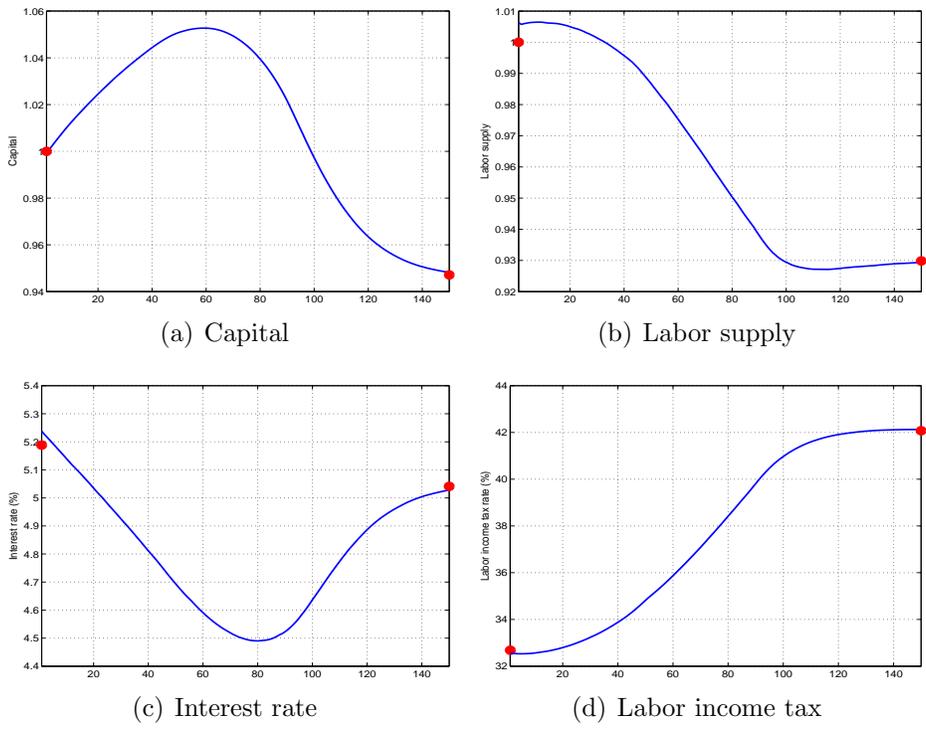


Figure 13: Transition dynamics: option 1: payroll tax increase. Two circles in each plot at the first and last periods indicate the levels in the initial and final steady states. The levels of capital and labor supply are normalized so that they take the value of one in the initial steady state. On horizontal axes are the number of years elapsed since the announcement of the new policy.

Figure 14 compares the transition dynamics of variables under options 2 and 3 to those of option 1 that we just studied. Given the gradual decline in the benefits or the increase in the normal retirement age, agents have stronger incentives to accumulate wealth for retirement and capital starts to rise even more sharply than in option 1. Labor supply will jump up by about one percentage points in both option 2 and 3, as some agents will try to make up for a decline in social security benefits by working longer.

The rise in earnings will expand the tax base and the labor income tax will decline by a few percentage points during initial decades of the policy change but start to rise as the labor supply falls sharply thereafter. Under option 3, the path of labor income taxes non-smooth since the retirement age will be raised every seven years in a discrete fashion and there is a discrete improvement in the government

budget, which makes the labor tax decline in the year of raising the retirement age.²⁰

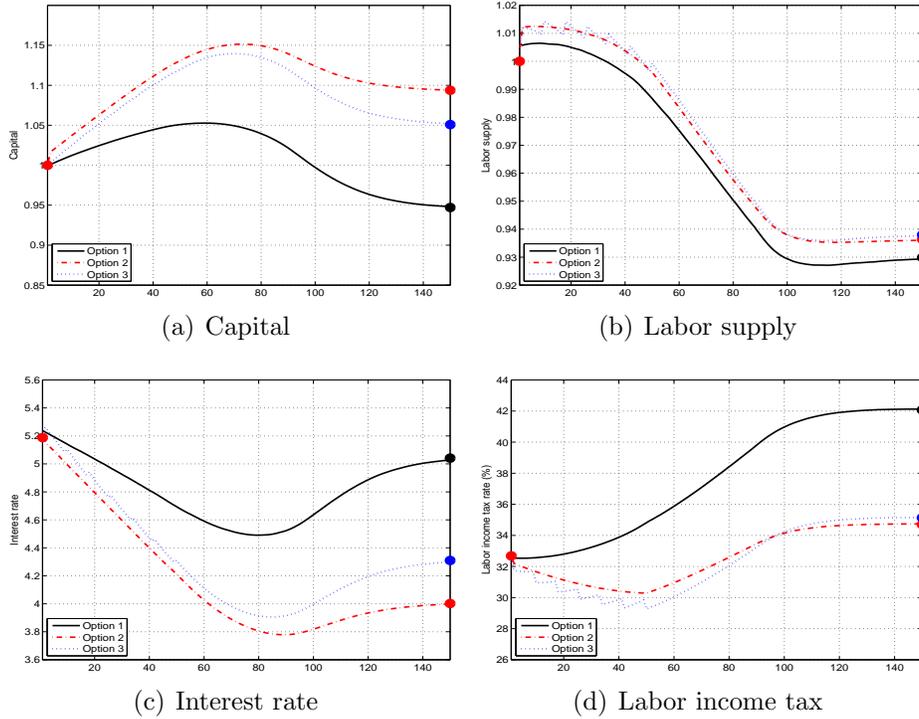


Figure 14: Transition dynamics of capital and interest rates: comparison of options. Two circles in each plot at the first and last periods indicate the levels in the initial steady state and final steady state for each option. The levels of capital and labor supply are normalized so that they take the value of one in the initial steady state. On horizontal axes are the number of years elapsed since the announcement of the new policy.

Welfare analysis: In order to evaluate and compare the welfare effects of a reform, we will use the transition path implied by option 1 as the benchmark and ask whether agents will prefer another option, for example option 2, versus option 1 and quantify the magnitude of welfare gains or losses between the two options. More precisely, we compute a one-time positive transfer to agents in each state in

²⁰The paths of the tax rates would be smooth if the retirement age is adjusted more gradually and the model is in a higher frequency, for example in a monthly frequency. The path of labor supply is also non-monotonic induced by the movements in the labor income tax rates.

period 0 that will make them indifferent between the benchmark (option 1) and the alternative. Depending on which option the agent prefers, the transfer can be either to an agent who would be in the benchmark or to an agent in an economy with a different option.

We will also study welfare effects for future generations. The amount of transfer is computed that will make a new-born agent indifferent between being born into the economy that is transitioning under option 1 and another economy that had implemented another option.

Figures 15 and 16 show the welfare effects of option 2 and 3, respectively, relative to option 1. A positive amount of transfer, for example \$10,000 in option 2, indicates that agents in that particular state prefer option 2 to option 1. The magnitude of the gain under option 2 is equivalent to a one-time transfer of \$10,000, for example. Similarly, a negative number indicates that agents will be worse off in option 2 than in option 1.

The figures suggest that almost everyone in the current generations would prefer the “do-nothing” policy of option 1, which would preserve social security benefits while allowing the payroll tax rate to rise to absorb the cost of demographic transitions. In the long-run, however, agents born in future will prefer the benefit reduction either by a cut in replacement rates or an increase in the normal retirement age, rather than facing high payroll taxes to sustain the current benefit schedule.

The leftmost plot in each figure indicates welfare effects on agents that are alive at the time of the reform announcement by the level of wealth for four age groups, 35, 50, 65 and 80, as examples. Within each age group, wealthier agents are worse off under both options to reduce benefits. As we saw in Figure 14, the interest rate falls much more rapidly in options 2 and 3 than in option 1 since agents accumulate more savings in anticipation of the lower retirement benefits. The fall in interest rate will hurt the wealthy more as the return on their wealth declines rapidly. The younger rich will suffer more as they will also face a prolonged period of low interest rates during the transition. However, the average welfare effects for young agents in 20s and 30s are not as severe as those for the middle aged in 40s and 50s since they do not much wealth. The middle plot in each Figure shows the average welfare effect by age. Note that the effects are not monotonic for option 3, since the normal retirement age is raised every 7 years in a discrete fashion.²¹ Those who are already retired are impacted much from options 1 or 3, as reflected in small welfare effects

²¹Agents who are right behind the threshold (hence need to wait two more years after agents that are older by just one year have retired) can be much worse off than agents who are one year older than them. The profile would be smooth if the model employs a higher frequency and the retirement age is raised more smoothly.

shown in Figure 16(b). In option 2, however, retirees at the time of the policy announcement will also face a gradual decline in benefits and the welfare effects are more negative.

The rightmost plot in each figure represents the welfare effect on future generations, indexed by the birth year expressed as the number of years elapsed since the new policy was announced. Although almost all in the current generations and future generations born during the first several years suffer from the policy change and they would prefer option 1 that preserve the benefits, future generations will gain significantly more from the benefit reduction options. As we saw in Figure 14, reforms of option 2 and 3 imply much lower taxes than in option 1 and both capital and labor are higher. The output will be significantly greater than in option 1 and agents will enjoy a higher level of consumption in the long-run. In the final steady state, the welfare gain of option 2 and 3 on new-born agents is equivalent to a one-time transfer of \$58,000 and \$41,000, respectively, relative to the welfare under option 1.

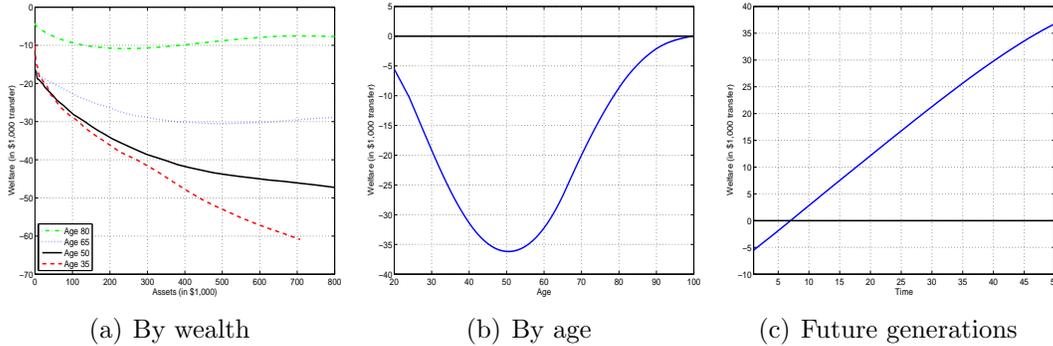


Figure 15: Welfare effect: option 2: replacement rate cut

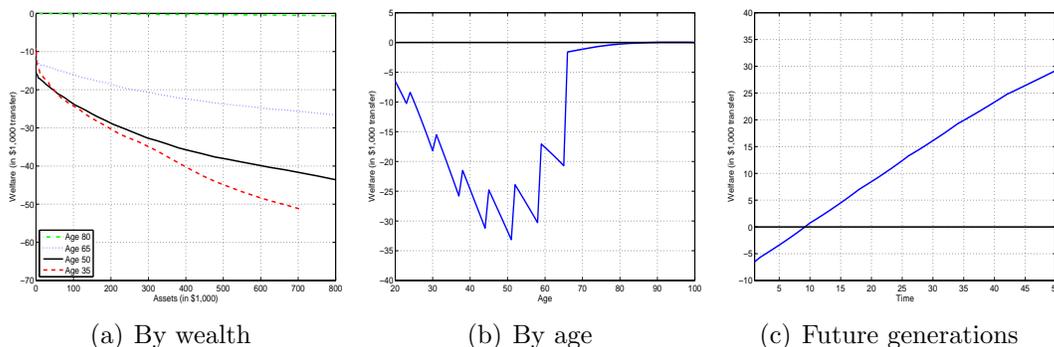


Figure 16: Welfare effect: option 3: normal retirement age increase

In summary, we find that it is much more efficient in the long-run if the government deals with the demographic transition with the benefit reduction. This can be done either through reduction in the replacement rates or an increase in the normal retirement age. In the short-run, however, these options will severely hurt current generations, especially the middle-aged agents who face much lower benefits despite all the contribution they have made through payroll taxation. They would prefer a transition financed through an increase in payroll taxes.

5 Conclusion

The social security is not sustainable as it is. The Trust Funds will start to decline soon and be exhausted eventually. The solution is to restore the balance, either by reducing benefits or by raising taxes. The question is what the options are, how big the adjustment has to be under each option, and what the economic consequences and welfare effects are.

We present four policy options to make the social security self-financed and sustainable in light of the coming demographic aging. The options are motivated by recent policy debate and some experience in other countries. We show that the program's budget will balance each year if we take one of the four options; (1) raise the payroll tax by 6 percentage points, (2) reduce the benefit replacement rates by one-third, (3) increase the normal retirement age from 66 to 73, or (4) make the system means-tested and benefits decline one-to-one with income. Although all of these options achieve the same goal of balancing the social security budget, economic and welfare consequences differ significantly across them.

We developed a rich model that approximates key macro and micro features of

the U.S. economy, in which individuals make life-cycle decisions of consumption, saving and labor supply in both intensive and extensive margins in a competitive production economy. In particular, the model allows endogenous timing of withdrawing from the labor market and we have shown that options have very different effects on labor force participation and retirement decisions of individuals. The paper suggests that fiscal policy can have significant effects on the pattern of individual labor supply over the life-cycle.

Although our model captures key dimensions of heterogeneity across individuals in age, financial and social security wealth and labor productivity, we abstract from other dimensions of potential interest such as unemployment, health status or other sources of expenditures. There are public programs other than social security that pose similar or possibly greater sustainability risks such as Medicaid and Medicare. These extensions are left to be explored in future research.

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A Social security benefit formula

Social security benefits are determined as a concave piece-wise linear function of the Average Indexed Monthly Earnings (“AIME”). The AIME measures the worker’s career-average earnings and it is computed as the average of a beneficiary’s 35 highest annual earnings.²²

In the model, we are not able to keep track of the entire history of earnings due to the limitation in the computation capacity. To approximate the AIME formula, we take the following strategy, which follows French (2005). The state variable e summarizes the average earnings and approximate the role of the AIME. We assume that during the first 35 years after individuals enter the economy, the state variable e is updated recursively as

$$e_{t+1} = e_t + \frac{y_{L,t}}{35}$$

where y_L is the covered earnings, that is, $y_L = \min\{\tilde{\omega}h, y^s\}$. Since we cannot store the information of 35 highest earnings for each individual in the computation, we assume that after 35 years the state is updated only if the new earnings exceed the current state of e_t ;

$$e_{t+1} = e_t + \max\left\{0, \frac{y_{L,t} - e_t}{35}\right\}.$$

The Primary Insurance Amount (“PIA”) is based on the AIME as

$$PIA_t = \begin{cases} 0.9 \times AIME_t & \text{if } AIME_t \leq \$9,132 \\ \$8,219 + 0.32 \times (AIME_t - \$9,132) & \text{if } \$9,132 < AIME_t \leq \$55,032 \\ \$22,907 + 0.15 \times (AIME_t - \$55,032) & \text{if } AIME_t > \$55,032 \end{cases}$$

The social security benefit ss in the model corresponds to the PIA and determined as a function of the state variable e , which corresponds to $AIME$ in the above formula.

B Computation methods

B.1 Computation of steady state

We summarize the steps to compute the stationary equilibrium of the model.

²²The AIME considers earnings only up to the maximum earnings cap, which is \$106,800 in 2009-11.

- Step 1:** Guess a set of equilibrium variables, which consist of aggregate capital K , labor supply L , labor income tax τ^l and bequest b .
- Step 2:** Solve individuals' problems and derive policy functions at each state.
- Step 3:** Compute the distribution of individuals across states.
- Step 4:** Compute aggregate moments implied by the distribution and verify if equilibrium conditions are satisfied. If not, update guesses for the equilibrium variables and return to step 2.

B.2 Computation of transition dynamics

We assume that the economy is in the initial steady state in period 0 and the new policy is announced and implemented in period 1. The economy makes a transition to reach the final steady state in period T . Choose T large enough so that the transition path is not affected by increasing T . We set T at 200, which satisfies the criteria.

- Step 1:** Guess the path of equilibrium variables, which consists of aggregate capital K , labor supply L , labor income tax rate τ^l and bequest b .
- Step 2:** Use the value functions of the final steady state as the values in period T and solve agents' problem backwards from period $T - 1$.
- Step 3:** Use the distribution of agents the initial steady state as the distribution in period 0 and compute the path of the distribution using the policy functions derived from Step 2.
- Step 4:** Compute the path of aggregate capital, labor supply and bequests using the distribution derived in Step 3. Check if they are the same as the guesses. Also check if the government budget constraint is satisfied in each period. If equilibrium conditions are not satisfied, adjust the values of the equilibrium variables and go back to Step 2.