ECO 225 - Social Security II

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First Beneficiary of the SS System

- Ida May Fuller (born 1874).
- Worked for only three years after the establishment of the SS system.
- Paid a total of $24.75 in SS taxes.
- First SS check issued to her in January 1940 for $22.54.
- Lived for 35 more years, died at 100 in 1975.
- Over those 35 years, she collected around $23K in SS benefits.

How Does SS Redistribute?

- SS can redistribute across generations.
- First generation - big winner
- Middle generation - rate of return determined by wage and population growth
- Final generation (if exists) - big loser
- Reality more complicated. Look at actual redistribution due to the SS system in the US.
- Q: which generations have won from the existence of this system, which have lost, and by how much?

Social Security Wealth (SSW)

- Compute this on board...

Consumption-Smoothing Benefits of Social Security

Two rationales offered for SS:

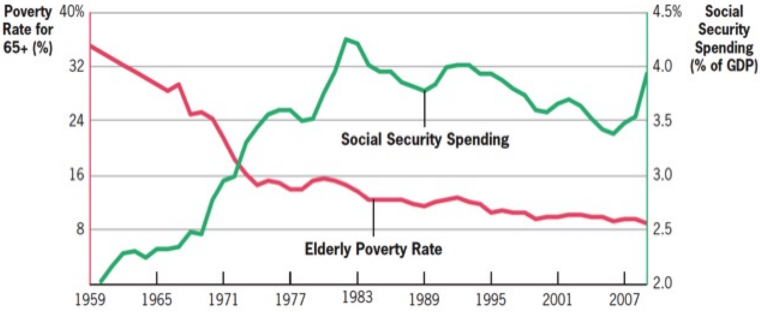
1. Market failures in the annuities market.
   - A pure annuity - contract pays some amount up front to insurance company and in return, insurance company pays the person a fixed payment until he/she dies.
   - Benefits from buying annuities?
   - Adverse selection - people who live long will buy annuities.
2. Paternalism
   - Policy makers concerned that people won't save enough for their own retirement.
   - 80% of married couples and 89% of college grads are prepared, but only 55% of singles and 70% of those without a high school diploma are prepared.

Does Social Security Smooth Consumption

- SS existence is motivated by the notion that individuals are not appropriately protected for their retirement consumption.
- Does government need to be involved? This is open (and normative).
- Once workers retire, they have many years of consumption to finance (large expense).
- On the other hand, retirement is very predictable.
- Unclear how important SS is for consumption smoothing.
- Maybe all SS does is crowd out private savings.

Research on SS and Consumption Smoothing

- Each dollar of SSW crowds out \$0.30 – \$0.40 per dollar of private savings (partial crowd-out).
- Living standard of the elderly:



Social Security and Retirement

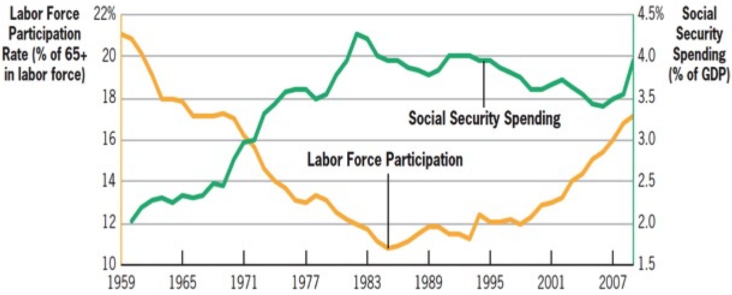
- Strong moral hazard problem with early retirement.
- Insuring against the adverse event of retirement may encourage that adverse event, lowering social efficiency and raising program costs (and associated taxes).

Social Security and Retirement

- In theory, two effects of SS on retirement decisions.
  1. Implicit taxation that SS may levy on work at older ages by reducing the value of SS benefits if retirement is delayed. Consider 62-year old worker who works until 63.
     1. She pays an extra year of payroll taxes on her earnings. (Reduce return to working)
     2. She receives one year less of SS benefits. (Reduce)
     3. She gets a higher SS benefit level through actuarial adjustments. (Increase)
     4. Earnings rise with age: replaces a low-earnings year with a high-earnings year in the 35-year benefit averaging. (Increase)
  2. Wealth redistribution.
     1. Rich buy more retirement, poor work longer.

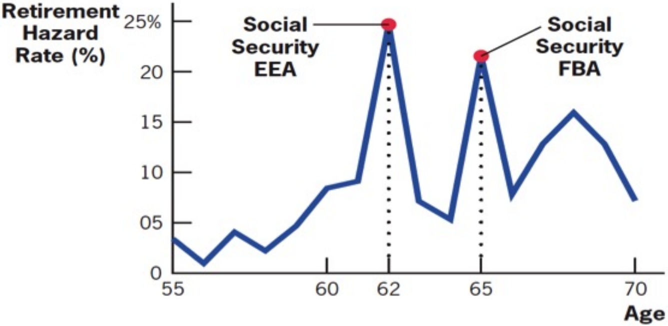
3 Types of Evidence Suggesting SS Determines Retirement Decisions

1. Labor-force participation (LFP) rates - percentage of the elderly population that is either working or looking for work.



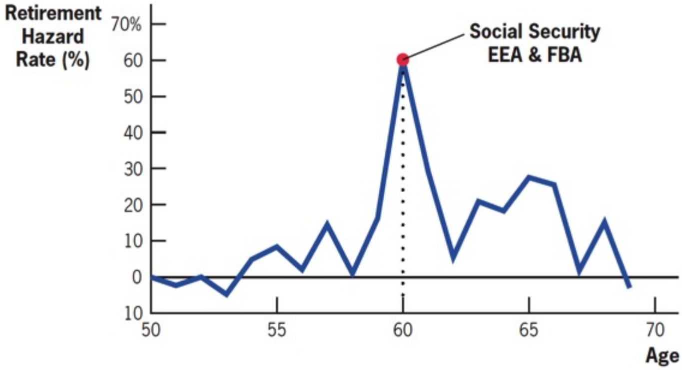
3 Types of Evidence Suggesting SS Determines Retirement Decisions

2. Retirement hazard rate - rate at which workers of a certain age retire.



3 Types of Evidence Suggesting SS Determines Retirement Decisions

3. International comparisons (France)



Implications

- Designing SS systems that penalize additional work beyond the retirement age is very costly.
- European systems that do not increase benefits for additional years of work appear to have led to a mass exodus from the labor force at retirement age.
- Adjusting systems to reward work at old age can mitigate much of the moral hazard problems.

Social Security Reforms

- Major fiscal imbalance due to - dramatic improvement in life expectancy, reduction in birthrates, dramatic decrease in wage growth.
- Reform Round I: The Alan Greenspan Commission.
  - 1983 - SS trust fund money would run out of money to pay claims in July of same year.
  - SS should move away from unfunded system to some extent, accumulate savings in the SS trust fund, speed up increases in payroll taxes, cutting benefits.

Incremental Reforms

1. Raise taxes further.
2. Extend the base of taxable wages.
3. Raise the retirement age.
4. Lower benefits.
5. Reduce benefits for higher income groups.

Fundamental Reforms

1. Invest the trust fund in stocks instead of all in bonds
   - Any private pension manager that had invested his private pension 100% in government bonds would be fired! Inefficient.
   - Stocks provide higher returns.
   - 40% at most funds in stock market would cover at least half of the 75-year projected deficit.
   - Two problems: trust fund used for other government projects, government manipulating capital markets for own good.
2. Radical: privatize - fully funded system with individually controlled accounts.
   - Advantages - increasing capital stock and well-being, government would not have to deal with budget, respect consumer sovereignty.
   - Disadvantages - How to deal with legacy debt, higher administrative costs, government may not trust people to save enough (complicated).