

Saving Social Security

2037

Three Options

- Do Nothing
- Cut Benefits
- Raise Social Security Taxes

Do Nothing

- The Social Security Trust Fund is essentially a legal fiction.
- We could simply keep taxes and benefits as is, and just ignore accumulated deficits in the trust fund.

Do Nothing

- The Social Security Trust Fund is essentially a legal fiction.
- We could simply keep taxes and benefits as is, and just ignore accumulated deficits in the trust fund. **The deficit would grow, and put pressure on other government spending or force other taxes (income, sales) to be raised.**

Do Nothing

- **Query: would the deficit act as a brake on other government spending?**
- We could simply keep taxes and benefits as is, and just ignore accumulated deficits in the trust fund. **The deficit would grow, and put pressure on other government spending or force other taxes (income, sales) to be raised.**

Cut Benefits

- Two proposals for cutting benefits:
 - Raise the retirement age from 67 to (say) 70.
 - Cut the replacement ratio (an option buried in the Bush retirement plan).

The Replacement Ratio

- Someone earning the median income all his working life will get Social Security benefits equal to 40% of his last paycheck.
- In terms of the formula, it is the ratio of earnings to median income each year that counts, not the level of earnings.

The Replacement Ratio

- Someone earning the median income all his working life will get Social Security benefits equal to 40% of his last paycheck.
 - In terms of the formula, it is the ratio of earnings to median income each year that counts, not the level of earnings.
- If we change to a formula that bases social security earnings on actual earnings not earning as a percent of median income, we will slowly reduce social security benefits.

The Replacement Ratio

- Someone earning the median income all his working life will get Social Security benefits equal to 40% of his last paycheck.
 - In terms of the formula, it is the ratio of earnings to median income each year that counts, not the level of earnings.
- Hence, it will not impact persons currently retired or persons planning to retire soon, but it will affect persons currently in their 20's and 30's.
- If we change to a formula that bases social security earnings on actual earnings not earning as a percent of median income, we will slowly reduce social security benefits.

Raise Social Security Taxes

- We could raise social security taxes.
- Two issues:

Raise Social Security Taxes

- We could raise social security taxes.
- Two issues:
 - The Prescott problem – higher taxes are a disincentive to work.

Raise Social Security Taxes

- We could raise social security taxes.
- Two issues:
 - The Prescott problem – higher taxes are a disincentive to work.
 - If we raise them now, to build up a surplus, won't the funds simply be used to fund additional government programs now? Remember the Unified Budget.

Privatization

- For many people the social security program represents a significant portion of their retirement; if we eliminated the program, they would simply save the money for retirement.
- There is no good reason why this function should be in the public sector, hence the calls for privatization.

Two Other Issues

- Income distribution
- Moral Hazard

Income Distribution

- For low income workers
- $$PV_{\text{benefits}} > PV_{\text{tax}}$$
- There is an income redistribution

Moral Hazard

- We are not prepared to let people starve in old age.

Moral Hazard

- We are not prepared to let people starve in old age.
- There is a moral hazard problem; people have a disincentive to save for their old age and rely on public support.

Moral Hazard

- We are not prepared to let people starve in old age.
- There is a moral hazard problem; people have a disincentive to save for their old age and rely on public support.
- And, since we are going to be “stuck” with the cost of such people in their old age, why not require they save for their old age.

Solutions

- We can take care of the moral hazard problem with a mandatory private scheme, but we cannot take care of the redistribution this way.
- And, the argument goes, if we privatized social security, our interest in doing redistribution would decline.

Why People Act as they Do

- Everyone knows Social Security must be fixed eventually. But there are two solutions:
 - Cut benefits
 - Raise taxes

Why People Act as they Do

- Everyone knows Social Security must be fixed eventually. But there are two solutions:
 - Cut benefits
 - Raise taxes
- Would you rather fix the problem now or in 2037?

Cutting Benefits

- If you want to fix the problem by cutting benefits, this is the time to act.
- Persons adversely affected have decades before retirement, and the effects will be minimized.

Raising Taxes

- If you want to fix the problem by raising taxes, delay is not that big an issue.
 - Raise taxes now and you have more money to spend on other government programs now.

Raising Taxes

- If you want to fix the problem by raising taxes, delay is not that big an issue.
 - Raise taxes now and you have more money to spend on other government programs now.
 - Wait, and in 2037, the option of cutting benefits will be very difficult politically.

End

©2004 Charles W. Upton.
All rights reserved