Social Security: Reform

Need for reform easy to see from the figure.

How has this come about?

1) Pay-as-you-go structure, "pure" from 1935-1983, now "mixed" because of the trust fund accumulations.
   Program began 1935, benefits began 1939.
   Allowed for some immediate relief, but created some costs.
   - Legacy debt. Passed off to each succeeding generation.
   - Ongoing pyramiding in the benefits side, esp. through the 1970s.

   All without associated ⇑ in costs. Until recently.
2) Growing life expectancy (without a growing "work life" expectation).
3) Falling birth rates.
   Because of pay-as-you-go, fewer workers/retiree.
4) Slow wage growth.
   So, workers who support retirees making less than expected.

[Question: When were these problems foreseeable?]

Incremental Reform

Diamond - Orszag

Peter Diamond — Brooking/CBO now.

1) Couple payroll tax increases to growing life expectancy, over time.

2010 :	12.4%	(current)
2050 :	13.85%	
2100 :	15.5%	

2) Increase taxable maximum income over time, ending at $115,200 instead of $91,000.

3) Additional payroll tax, on earnings above the max ($115,200). At 3% in 2010 and 4.03% in 2100.

4) Benefits reductions.

Current factors : 90%, 32%, 15%.

2050 : .794%, .283%, .088%

People with highest AIME get little additional PIA.

⇒ Create fiscal balance, and increase benefits for people with low lifetime earnings.

Bottom Line: Table

Fundamental Reform

A. Invest trust fund in Stocks rather Than Treasury securities. Get higher return.

-- What will happen to gov't expenditure/borrowing if This pot of money is off limits?

-- Government will become an owner of a lot of The private sector. Maybe not such a big problem.

-- If people aren't rationally diversified, maybe too much in real estate and company stock, a bond fund is what They need. Argues against This reform.

B Private accounts.

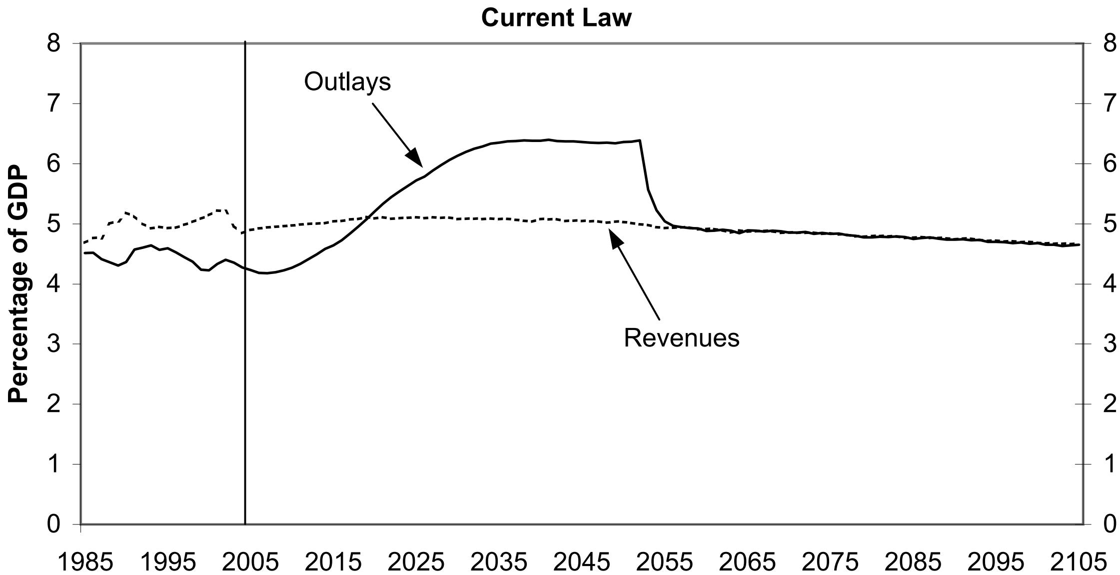
-- More you want in private acts. quickly, The more must be borrowed (So current retirees can still get benefits).

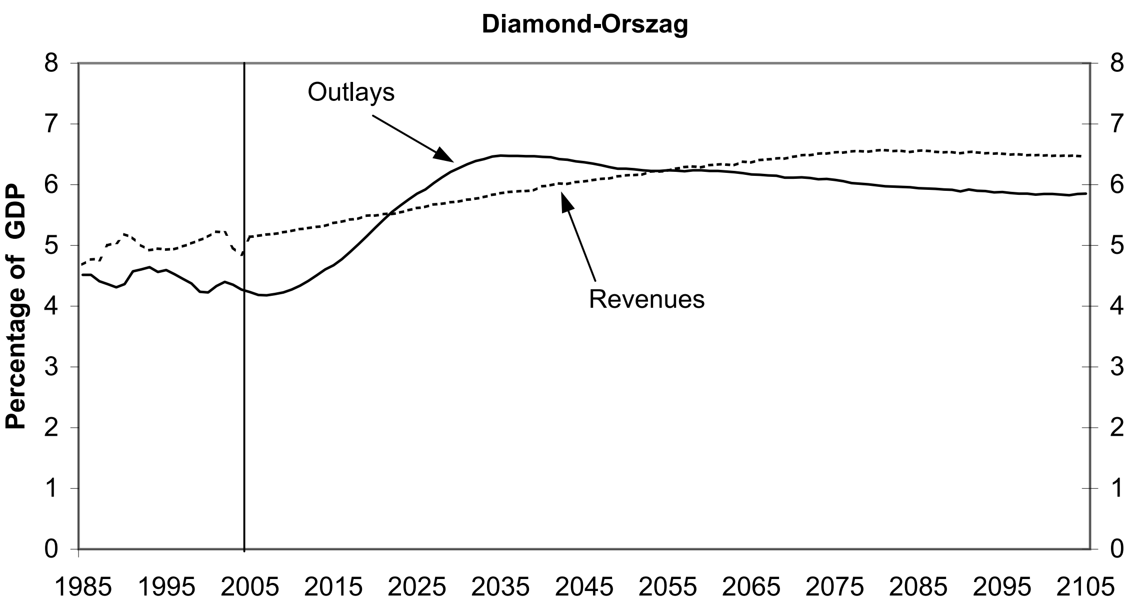
-- If truly privatize, must pay off legacy debt. No one to hand it off to anymore.

-- Not Consistent with vision of The plan, which really was paternalistic.

Figure 1B.

Social Security Revenues and Outlays as a Share of GDP Under the Trust-Fund-Financed Benefits Scenario, 1985 to 2105





Source: Congressional Budget Office

Note: Based on a single simulation using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's August 2004 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include trust-fund-financed Social Security benefits and administrative costs. Under current law, outlays begin to exceed revenues starting in 2020; starting in 2053 scheduled benefits cannot be paid. Under Diamond-Orszag, outlays begin to exceed revenues in 2022, but fall below revenues in 2056.

Table 2.

First-Year Annual Benefits for the Median Retired Worker If Benefits Are Claimed at Age 65, by Birth Cohort and Lifetime Earnings Level

	Current Law		Diamond-Orszag		
10-Year Birth Cohort Starting in Year	Scheduled Benefits A	Trust-Fund-Financed Benefits /a B	Proposed Benefits A	Trust-Fund-Financed Benefits B	Benefits Financed with Intragovernmental Transfers /b
	Median in Lowest Household Earnings Quintile				
1940	7,500	7,500	7,500	7,500	na
1950	8,200	8,200	8,600	8,600	na
1960	8,900	8,900	9,100	9,100	na
1970	9,700	9,700	9,700	9,700	na
1980	10,500	10,200	10,200	10,200	na
1990	12,200	9,400	11,300	11,300	na
2000	13,600	10,200	11,900	11,900	na
	Median in Middle Household Earnings Quintile				
1940	15,500	15,500	15,500	15,500	na
1950	15,700	15,700	15,600	15,600	na
1960	16,000	16,000	15,700	15,700	na
1970	18,400	18,400	17,400	17,400	na
1980	21,100	20,400	19,200	19,200	na
1990	24,100	18,600	21,000	21,000	na
2000	27,300	20,400	22,600	22,600	na
	Median in Highest Household Earnings Quintile				
1940	20,100	20,100	20,100	20,100	na
1950	22,100	22,100	21,700	21,700	na
1960	23,000	23,000	21,900	21,900	na
1970	26,000	26,000	23,600	23,600	na
1980	30,100	29,000	26,300	26,300	na
1990	34,200	26,400	28,700	28,700	na
2000	38,700	29,100	31,500	31,500	na

Source: Congressional Budget Office

Note: Based on a single simulation using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's August 2004 economic assumptions. First-year annual benefits have been adjusted for inflation to put them into 2004 dollars. All workers are assumed to have claimed benefits at age 65. All values are net of income taxes paid on benefits and credited to the Social Security trust funds.

a. The trust-fund-financed baseline subjects all beneficiaries to an across-the-board cut in benefits each year such that total projected benefits equal projected revenues once the Social Security trust funds have been exhausted, including any specified transfers into the trust funds. Current-law trust-fund-financed benefits are reduced starting in 2053; trust-fund-financed benefits under Diamond-Orszag are not reduced.

b. No intragovernmental transfers are necessary to finance benefits under Diamond-Orszag.

Unemployment Insurance (UI)
Disability Insurance (DI)
Worker's Compensation (WC)

-- Is there an adverse selection problem?
-- Does the program smooth consumption?
-- Does it crowd out private savings?
-- Is moral hazard a problem, how is it managed?

Unemployment Insurance

- Limited time, layoff, not quit or fired for cause.
- Average after-tax replacement rate $= 47\%$ $\left(\dfrac{\text{Benefit net of tax}}{\text{Income net of tax}}\right)$

Risk: of being unemployed, (ideally) for reasons beyond your control.

Adverse selection: Problems for private insurers? Some people (with certain characteristics an insurer cannot observe?) are more subject to layoff than others? Cannot determine a true layoff from other reasons?

* Maybe private company with bad news would tell workers, they would go buy insurance.

Moral Hazard: People stay unemployed longer than otherwise.

Figure 14.3, and 10% ↑ benefits leads to 8% ↑ in unemployment duration.

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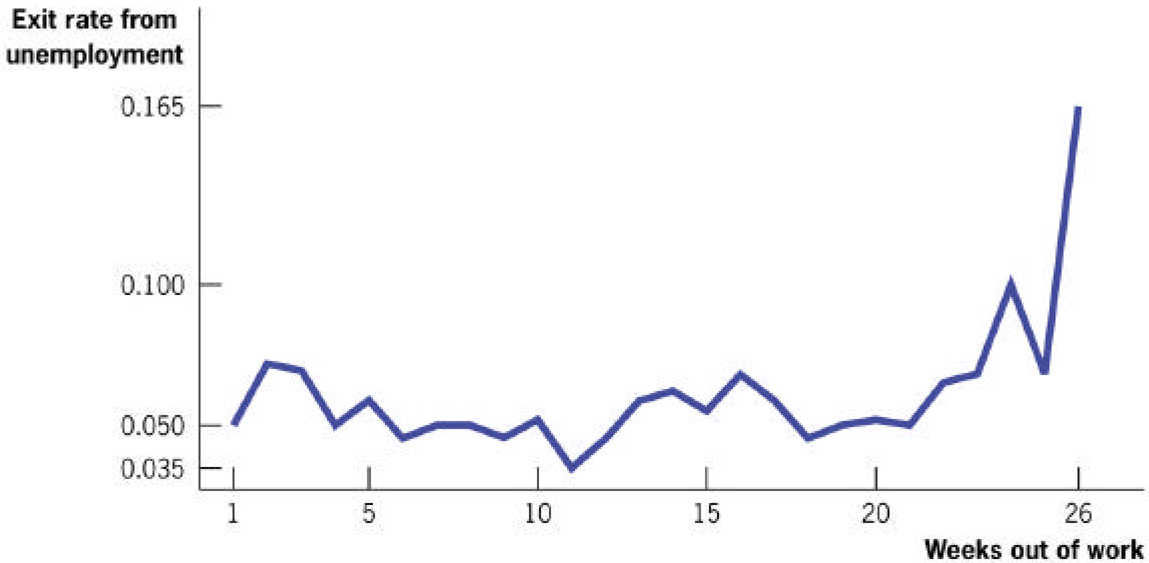


Exit rate from unemployment
0.165
0.100
0.050
0.035
1
5
10
15
20
26
Weeks out of work

Disability Insurance

Part of social security
(must have work history).
Federal program.
Total disability.
Half who apply ultimately receive it.
Benefit is indefinite

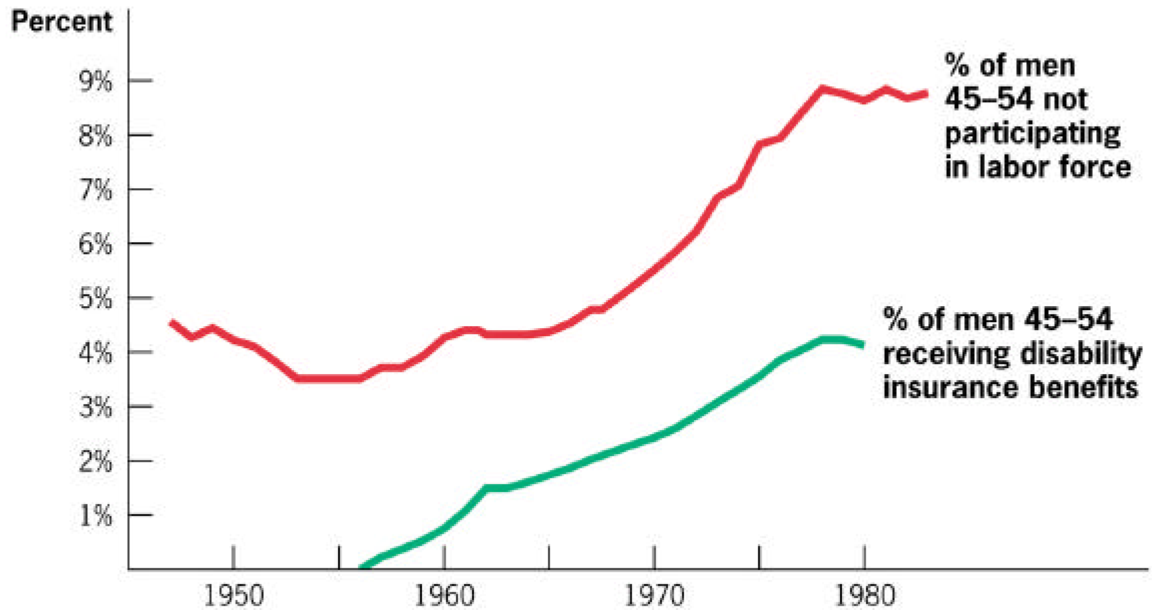
Risk: Any kind of disability.

Adverse selection: Big employers typically offer some private disability insurance. Still expect asymmetric info., about family history
Doctor gives you bad news, Then go buy insurance? Insurers can't screen This out?

Moral Hazard:

Don't expect actual self-injury, but many problems can be faked.
Back injury?

Every 10% ↑ in DI benefits leads to 3% ↓ of older workers in labor force.


Percent
9%
8%
7%
6%
5%
4%
3%
2%
1%
1950
1960
1970
1980
% of men 45–54 not participating in labor force
% of men 45–54 receiving disability insurance benefits