Economic Viewpoint

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DON'T TINKER WITH SOCIAL SECURITY, REINVENT IT

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PRIVATIZE: The present setup causes distortions of work decisions and savings plans. We need to shift as rapidly as possible to a private system

If one takes a fresh perspective, then the U. S. Social Security retirement program is a really strange idea. We presently raise tax revenues equal to 6% to 7% of the gross domestic product just to make transfers from young people to old people. The program produces nothing, and most of the transfers are not from the rich to the poor (which is one reason the program is so popular). Many of the transfers are between members of the same extended family; for example, my mother receives about $7,600 per year, and my brother and I together pay in around $16,000 per year. It's not a great deal, even for my mother. She would probably get more if it came directly from her sons.

The Social Security program requires a vast amount of public finance-nearly equal in magnitude to that of the individual income ax-and thereby causes distortions of work decisions and savings plans. Of course, the U.S. is not alone in these problems.

World. Bank data (from *Averting the Old Age Crisis*, Oxford University Press, 1994) can be used to compare the U. S. public pension program to those of other nations. U.S. outlays of 6.5% of gross domestic product are well above the median for 92 countries of 1.5%, but below the median of 9.8% for 24 Organization for Economic Cooperation & Development countries. The U.S. ratio of public pension spending to GDP is very close to the value predicted by its old-age population and its levels of per capita GDP and schooling. Thus, we can take a bit of comfort in knowing that U. S. political decisions on Social Security are similar to the world's decisions.

DEFAULTS? Some European countries that have much more generous public pensions than would be predicted are Italy, Austria Greece, Poland, and France. These countries even more than the U.S.. are headed for real disasters, including either a default on promises or payroll tax rates above 30% to pay the overly generous public pensions.

Many economists think that pay-as-you-go social security (in which pension benefits to the old are paid by current taxes on the young) lowers national savings. This argument is, however, ambiguous in theory and isn't well supported empirically. In any case. this problem likely cannot be fixed by a shift to a funded public system tin which pension benefits are paid from the earnings and principal of accumulated reserves). Such a program implies massive accumulations of reserves with a consequent extreme political temptation to raise current benefits by spending the reserves. That is, unless a country has the discipline of Singapore, it is likely that a 'left-winger' like Franklin D. Roosevelt or Richard M. Nixon will raise benefits for elderly people who did not make comparable prior contributions.

The best reason to have a Social Security retirement system is that it can provide an income floor for old people. In this respect, Social Security is similar to other welfare programs. One special feature of Social Security is that the private resources that individuals have available during retirement depend largely on past saving choices, and people may save too little if they anticipate that the government will bail them out. Hence, there is some justification for the government to mandate, as the Chilean government does in its privatized system, sufficient saving during working years so that most people will have a privately provided old-age income that exceeds the designated income floor. The size of the mandate should be set so that the typical individual would not require a public bailout during retirement.

LIMITED RISKS. Individual incentives to work save, and incur risks are least distorted if the mandated saving flows into privately managed accounts. That is, the program should be private and funded as much as possible. There is, however, some basis for limiting the risks that an individual can incur in pension accounts in order to reduce the chance that the individual will end up on the dole.

A change to a private, funded program does not escape the problem of honoring existing commitments on pension payments to the current elderly. These promises ought to be kept, although there are questions about quantifying the degree of commitment for people who are currently below retirement age. This honoring of past promises inevitably requires taxes of some sort on current and future generations. These levies should be viewed as costs created by the past mistakes in giving old people retirement benefits that greatly overmatched their payroll taxes. But these costs are basically sunk and ought not to influence decisions about a desirable form of Social Security for the future. In particular, we should start now on a transition to a system that is mainly private and funded.

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