Chapter 13

Basic things you need to know about SS.

SS is essentially a public annuity, it gives insurance against low income in old age.

Because there is forced participation in SS, it removes the adverse selection problem involved in private annuities.

With private pensions, there seems to be more uncertainty than with SS: The risk that the firm a pension holder works for would go bankrupt and pay less than it promised is much higher than the risk govt will renge as substantially on its promised SS benefits.

When there is sufficiently high population growth, a pay as you go system can give higher benefits than a funded system. If pop growth is 100% (each couple has four children), each old person can get 2 times what they put into the system in the time of one generation (25 years). This gives more than a fully funded system with real growth rate of 2% a year, which would double what was put in over about 35 years. (But if real growth was 3% a year, it would take only 23 years for money put in to double). For a fully funded system, the relevant growth rate would be the rate of return on stocks that these people could get. This can’t deviate very much from the real growth rate of the economy.

Continuation of the notes from last lecture.

By allowing people to count on government transfer in old age, SS might lead to less savings. Research suggests that each dollar of SS wealth (present discounted value of the net benefit) crowds out 0.30 to 0.40 dollars of private savings.

What is the difference between having SS saving versus private saving? SS saving buys gov bonds, whereas private saving can be in both bonds and stocks. Can SS saving be productive?

The long-run effect of SS on average consumption depends on the population growth rate, on the depreciation rate of capital, and on productivity growth and how that depends on capital investment. A higher population growth rate leads to SS raising average consumption. A lower depreciation rate leads to SS raising average consumption. A more positive effect of capital investment on productivity growth tends to make SS reduce average consumption, due to social security reducing private saving.

Other evidence on SS’s effect - poverty rates of elderly

Poverty rate is percentage of a population whose income is below poverty level, which is amount of income needed to buy a “minimum acceptable” bundle of food, housing, other goods. Was $18850 for family of four in 2004. In 1960, 35% of elderly lived in poverty, compared to 21% of non-elderly.
In 2001 only 10% of elderly lived in poverty, compared to 12% of non-elderly. This change corresponds to expansion of SS system. In the years when SS was growing the fastest- 1960s and 70s (total benefits paid increased), observe steepest reduction in poverty of elderly. Engelhardt and Gruber (2004) found that poverty fell for birth cohorts that benefited from expansion of SS relative to those who didn’t, concluded that expansion of SS can explain entire reduction of poverty among elderly over this period. Shows that individuals were not protecting themselves enough by saving.

Effect of SS on retirement decisions

2 effects theoretically of SS on retirement decisions.

1. the value of SS benefits can be reduced if one retires at an older age (because one gets them for a shorter time, assuming date of death is fixed). Gruber and Wise define implicit tax from SS as reduction in SSW if one continues working another year divided by wage that could be earned by working that year. Numerator found by finding SSW at a possible age of retirement, then measuring how it changes if the person works another year.

If a 62-year-old worker decides to work until 63 instead of retiring now,

a. She pays an extra year of payroll taxes on earnings
b. She receives one year less of SS benefits
c. She gets a higher level of SS benefit through actuarial adjustment - the increase in benefits calculated to account for getting fewer years of SS benefits.
d. Gets to replace a low-earnings year with high-earnings year in calculation of 35-year average.

a. and b. are negative, c. and d. are positive. In most countries, the first two dominate, so there is an implicit tax on working longer.

2. Slight redistribution from rich to poor, from men to women, from single to married through SS. These changes in wealth have income effects on retirement. The groups that become richer can buy themselves more retirement and the groups that are poorer would tend to work longer.

Social Security Reform

SS will soon have important fiscal imbalance. In 1950, 12 people over 65 for every 100 people under 65 (of working age). In 2050, more than 35 people over 65 for 100 working age people. Aging of large baby boom generation and rising life expectation. Over next 75 years PDV of SS’s obligations exceeds PDV of taxes collected by 4.6 trillion.

Factors- rise in life expectations with no corresponding rise in retirement age. Decrease in birth rates. Slower growth in real wages. Continuation of the legacy debt.
Reform round I: Greenspan Commission recommended that SS system be funded to earn more money. Commission cut some benefits and sped up payroll taxes scheduled to rise in future.

Reforms - incremental and fundamental

Increasing payroll tax to 14.4% from 12.4% without increasing benefits would solve financing problem for next 75 years. Increasing it to 18.1% is projected to solve the problem forever.

Increase the tax base - try to increase the number of young paying into system. Currently many state and local gov workers are excluded from SS, given option to enroll instead in state or local pension plan. Or, ease immigration restrictions on young workers.

Increase maximum income on which payroll tax is paid. That would make richer people pay a bigger share of the legacy debt, the amount that went to the first few generations of recipients of SS who got positive net SSW.

Raise retirement age, for instance raise the Early Entitlement Age (EEA) past the age of 62. This is happening gradually as the optimal age to retire is becoming higher. The expected PDV of benefits is now lower when you retire at 62 than when you retire at 67, which is the optimal age to retire in terms of net benefits received.

Lower benefits, or benefits that are tied more to income. For example, count total benefits as taxable income. Those people who are living off only SS would not be taxed much; those who have both SS income and other forms of income would see their taxes increase.

Reduce benefits for higher income groups. 1/3 of benefits paid to recipients in families with incomes of over 50,000 per year. Current law taxes SS income only if other income plus SS benefits exceeds 25,000. Only 25% recipients are taxed on benefits. Alternative: progressive price indexing due to Pozen (2005). For higher income workers earnings could be inflated using the rate of price level increase instead of the rate of real wage growth. The rate at which prices increase is typically below the rate at which wage levels increase, thus the higher-earning workers would get less in benefits.

Opponents of this kind of idea (making benefits lower for the higher earners) fear that it could lose support among wealthier SS beneficiaries. As it is, SS has the widespread support of elderly voters. This would not be the case if it were viewed as a program for the poor.

Fundamental reforms

Invest trust fund in stocks (rather than government bonds). While stocks are riskier in short-run, they consistently yield higher rate of return over long run. Most experts recommend that individuals saving for retirement keep majority of assets in stocks when young. It would be as if investors shifted their portfolio towards riskier, but higher-average returns. If this happens, there will be a
lower price of bonds, meaning that the gov has to pay a higher interest rate to get people to buy bonds.

Shifting the trust fund towards stocks would tend to lower the return on stocks. So we can’t expect the return in the future to equal the historical return.

Concerns with this:

If government invests in private stock market, there are incentives for corruption. Government could invest in preferred firms for some corrupt reason. Investing half the SS trust money in stocks would lead to the gov owning 6% of the stock market. The NYS pension for gov employees, which bought stocks, had a corruption problem in which some officials got kickbacks for hiring managers of the funds, and there were probably kickbacks from businesses in whose stock the fund was invested.

Privatization

SS would become like a private pension. Individuals would invest their payroll taxes and earn interest on the investments when they retire.

Advantages: Funded system would increase capital and thus long-run GDP. Individuals could choose investments to match their personal level of risk-aversion. But this is also a problem – people who took too much risk with their pension investments could end up with nothing.

Problems: Existing generation of retirees who paid into SS still have to be funded. How can the SS program be ended? Legacy debt must be paid off.

privatization - advantages and disadvantages

The system would be fully funded. Everyone would invest in individually controlled accounts. Benefit is that system would be funded, increasing capital and long-run GDP. Furthermore, stocks have had a historical real return of 7%, while the return on SS is now only about 2%. The rate of return to SS is the sum of population growth and wage growth effects in steady state (the return is also equal to the return on the gov bonds in which the SS money is invested).

Counterarguments: Geanakoplos, Mitchell and Zeldes argued that once legacy debt is paid, privatized SS would not provide higher rate of return than current system. Considered moving to a privatized system where all future generations pay additional tax to pay off legacy debt. They show that this tax will be large enough to offset the higher returns from private investment.

Explain about the legacy debt: the benefits of people who were already promised benefits will have to be paid. Young people will have to pay both for the benefits of those who were already promised benefits, and for their own saving.

Privatization could have much higher administrative costs. SS has low administrative costs (0.2% of program’s asset balances), both from investing - since everything is invested in bonds - and from annuitization (paying benefits over lifetime) - since there are many recipients over which fixed costs of annuitization
can be spread. With privatization, there will be more costs due to advertisement (competition among funds), designing of contracts to cream-skim.

Countries that have privatized all or part of social insurance systems have higher administrative costs. UK - cost of administering investment accounts alone is 1.24% of total program’s asset balances each year. Additional costs of annuitization are 15% of account balances.

Can individuals be trusted to make best investment decisions?

401(k) plans - plans that allow people to save through their employer in an account set up by their employer. They are allowed to save tax-free up to a limit, meaning that income from returns on saving are not taxed. A problem with 401(k) plans is that 1/6 of aggregate 401(k) stock assets is invested in the own company. This can lead to a bad outcome if the company loses value or goes bankrupt - the worker will then be left without a job or savings - Enron.

Chapter 17, Income distribution and Welfare programs

Welfare policy in the United States

Motivations - relative income inequality, income distribution: The evolution of income inequality over time in the US. From late 1960s to late 1970s, income inequality was falling. The share of income to the bottom quintile grew and the share to the top income quintile fell. Gini coefficient: another measure of income inequality. Define it. From 1980 to now income inequality has been rising. Share of income to bottom quintile fallen more than 20%, share of income to top quintile risen by 15%. Now more than half income goes to top 20%. Mostly due to increases in income at very top of income distribution. This relative income inequality is higher than in other developed nations.

Programs that redistribute income to low-income groups. Categorical and means-tested. Categorical welfare programs are aimed at people with some demographic characteristic, such as single mothers, disabled. Mean-tested welfare programs give benefits based on income level and asset level. For instance available only to those with income below poverty line. Most income redistribution programs are both means-tested and categorical.

Cash welfare programs provide cash benefits to recipients. In-kind welfare programs give goods such as medical care or public housing.

This chapter discusses Temporary Assistance for Needy Families (TANF) and Supplemental Security Income (SSI). There is a third income redistribution program, Earned Income Tax Credit (EITC), which will be discussed in Chapter 21.

TANF is funded jointly by federal gov and by states. Gives support to low-income families where one biological parent absent. Replaced Aid to Families with Dependent Children (AFDC) started in 1935 aimed at widows and orphans.

To be eligible for TANF, must have sufficiently low income. States are allowed
to use TANF funds for either single-parent families or two-parent families. Only 3.5% of recipient families have two parents present.

TANF is relatively small: 25.8 billion expenditures in 2004, compared to 529.9 billion benefit payments for SS.

A family becomes eligible for TANF due to sufficiently low income. Then they qualify for a benefit guarantee - cash payment from state. This benefit is not so high as to lift a family above the poverty line.

Benefit is means-tested. Payment is reduced as income from other sources grows. Federal gov gives block grants to states to finance their TANF programs. Federal gov also puts requirements on who can get benefits: time limits and work requirements. Can’t receive TANF for more than 5 years in lifetime. Must work after receiving at most 24 months of TANF benefits (states can have shorter deadlines).

Half a state’s TANF recipients must be working at any time. 30% of recipients can count education or job-skills training as work.

Supplemental Security Income (SSI)
Cash welfare to blind, elderly and disabled. Meant to fill gaps left in SS and disability insurance (DI). To get disability insurance, must have worked in the past. A young person who has never worked, disabled in car accident can’t qualify for DI, but can for SSI. SSI has larger expenditures than TANF: $36 billion in 2004.

In-kind programs: Foods stamps - like debit card system. If household has only TANF, SSI or state cash welfare recipients, it is eligible for food stamps. Otherwise, households without elderly or disabled members must have income below 130% of poverty line to get food stamps. Amount of benefit falls as income rises.

If not disabled or elderly,must be willing to take any job offered, otherwise benefits may be discontinued. Permanent residents must have been in US for 5 years to get food stamps.

Public housing - 2 programs. First is housing in public projects. Second is “section 8 vouchers” - can be used to subsidize private rent from landlords who participate in program. To be eligible, must usually have income below 50% of median income in metropolitan area. Of spending, 2/3 on private vouchers, 1/3 on public housing projects.

Additional nutritional programs. Special Supplemental Nutrition Program for Women, Infants and Children (WIC). Pregnant, recent mothers, children under 5 eligible if on welfare, Medicaid, or have incomes below 185% of poverty line.

School lunch and breakfast program - in families with income below 130% of fed poverty line get free meals in school, between 130 and 185% get meals for no more than 40c.