

## ***Social Security or Private Security***

Social security reform remains an important, controversial topic. This short essay provides a primer about the current social security system and its primary alternative a fully funded retirement system, either public or private.

### *Current system operates on the “pay-as-you-go” principle*

The current social security system taxes workers to pay benefits to retirees. As such, the system belongs among the transfer programs administered by the federal government, including Medicare and Medicaid, food stamps, and so on. No one's retirement benefit comes from an account set up in his/her name. That is, retirees do not draw from moneys that they paid into the system. That money paid the benefits of former retirees. In sum, current workers fund current retirees, a pay-as-you-go system.

### *Income growth defines the return within a pay-as-you-go system*

Social security revenue increases with income growth in a pay-as-you-go system. That is, if worker income grows by 10 percent, then the funds to support social security benefits increase by 10 percent for a fixed social security tax rate. Moreover, if the ratio of retirees to workers remains constant along with the social security tax rate, then the ratio of social security transfers received by one generation of retirees to the taxes paid by that generation equals the income growth rate.

### *Implementing a fully funded system entails a one-time transition cost*

Adopting a fully funded retirement system -- whether administered by the government or not -- imposes a one-time transition cost, reflecting the cost of supporting the retirement of those currently in the pay-as-you-go system. No way exists to avoid this transition cost, assuming that the government honors its pay-as-you-go promise. Estimates of this transition cost (i.e., the unfunded liability of the social security system) vary, but fall in the neighborhood of \$10 trillion. That transition cost represents the largest stumbling block to social security reform.

### *The interest rate, not income growth, provides the return within a fully funded system*

A fully funded retirement system allows (or government forces) workers to save for their own retirement. Thus, workers provide their own retirement income based on the accumulated saving during their working years. Their saving grows over time, reflecting the combination of returns on the saving instruments that exist – savings accounts, stocks,

bonds, mutual funds, real estate, and so on. For simplicity, call the average rate of return on total saving, the interest rate. The current discussion considers the average return over the long run, ignoring differences in risk associated with different forms of saving.

Whether individuals benefit more from fully funded or pay-as-you-go systems depends on income growth relative to the interest rate. If income grows at a rate higher than the interest rate, then a pay-as-you-go system provides higher retirement income than a fully funded system.

The existing evidence suggests that although income growth can exceed the interest rate for short periods of time, the interest rate generally exceeds income growth in the long run. Thus, a fully funded retirement system should provide higher benefits than a pay-as-you-go system.

But society still faces the transition cost of getting from here to there. That transition cost makes the adoption of a fully funded system politically difficult, if not impossible.

#### *Recent demographic trends exacerbate the current system's problems*

The prior discussion assumes a fixed ratio of retirees to workers. That assumption does not hold in the U.S., given several demographic trends.

First, the average life expectancy has increased with little adjustment in the retirement age. Thus, the ratio of retirees to workers has risen and will continue to rise in the foreseeable future, placing additional strain on the current system.

Second, a lower birth rate has reduced the number of workers entering the work force, further worsening the problem of a rising ratio of retirees to workers.

Finally, the post-WWII baby-boom generation has just begun to retire, creating a bulge in the age profile that adds more pressure to the viability of the current system.

In sum, increases in the ratio of retirees to workers inflate the already huge transition cost.

#### *There ain't no free lunch*

As noted above, when the interest rate exceeds income growth as it has in the U.S., everyone should prefer a fully funded retirement system, if we could start from scratch. But we cannot begin again, since we already have a pay-as-you-go system. Thus, current workers will experience a reduction in their lifetime standard of living, if we adopt a fully

funded system. That is, current workers must set aside money for their own retirement while they continue to pay taxes to fund the pay-as-you-go system until it is retired. Policy makers can reduce the burden on the current generation of workers by phasing the transition over several generations of workers. But that will only reduce the burden on current workers and impose some burden on future workers until the transition ends. But, someone must bear the transition cost; there ain't no free lunch.

Should we adopt a fully funded system? Perhaps. Is its adoption politically feasible? Perhaps not.

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