

# Social Insurance Reform

## *Let's Just Do It*

**M**OST PEOPLE NOW RECOGNIZE THAT SOCIAL SECURITY AND MEDICARE, significant parts of our social insurance system, will have serious financial problems in the years ahead. The normal reaction is to say, "Let's identify the problems and fix them."

Following such reasoning, some people assert that benefits are too generous and should be reduced. Others insist that the benefits should be maintained—perhaps even expanded—and that we must simply find sources of money to pay for these benefits. Some people want to "privatize" all or part of Social Security and Medicare, or make other changes in an attempt to "take the politics out of the system."

All of these so-called solutions betray a fundamental misunderstanding of the basic nature of social insurance and its role in the nation's social and economic structure. In order to develop rational solutions to the putative problems of Social Security and Medicare—or more broadly, social insurance in general—we must step back and view these systems from a much wider perspective.

First, consider for a moment three basic economic questions that any society must answer in organizing its affairs and attempting to live and work together in harmony:

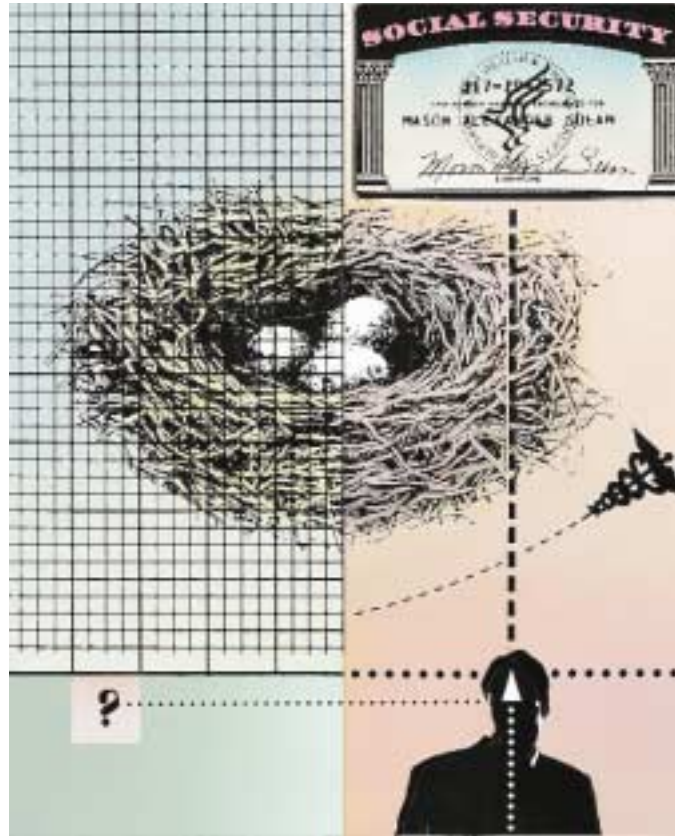
- What goods and services are to be produced?
- What segment of the population is going to produce these goods and services?
- How are these goods and services to be allocated among the population?

All societies answer these basic economic questions in a different way, depending on their particular political, social, and cultural makeup. A free-enterprise, capitalist society, for example, will answer these questions one way; a socialist society will answer them another way.

What does all this have to do with social insurance? Everything. The design of any particular social insurance system depends upon the answers to the above three questions, especially the last two.

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Ideally, society answers the questions first and then designs its social insurance system accordingly. Sometimes the social insurance system is designed without considering these basic questions carefully. When this happens, the social insurance system may implicitly answer the questions—but not necessarily in the same way had the questions been asked and answered directly.

In evaluating our social insurance system, therefore, we first need to address the three basic economic questions posed above. In short, how do we want to allocate the nation's resources among alternative uses to satisfy human wants? Implicit in this exercise, of course, is consideration of the extent to which our citizens should have freedom of choice instead of having their activities limited and regulated. Having answered these questions and thus having determined our objectives, we would then ascertain whether the present social insurance system is consistent with those objectives and, if not, how it should be changed.

If we performed this analytical exercise, we

would probably conclude that the retirement age patterns fostered by the present social insurance system won't give us a large enough work force in the early 21st century to produce all the goods and services our citizens will want. We would probably conclude that the nation's average retirement age should increase from the early 60s to the late 60s or early 70s within the next 10 to 20 years. This increase in retirement age would help reduce the future cost of our social insurance system, but that would only be a by-product of the primary achievement—establishing an appropriately sized work force. There would be less agreement on whether our present social insurance system offers the desired level of freedom of choice for our citizens—for the obvious reason that not everyone would agree on the “desired level.”

Social insurance plays an obvious role in satisfying the population's economic

security needs. At the same time, it's a reflection of our nation's existing social and economic structure. Less obvious—and perhaps more important—social insurance is a significant *determinant* of the nation's emerging social and economic structure as we move into the future.

We must also keep in mind that the government doesn't pay for social insurance. Social insurance is simply an agreement among the citizens that one segment of the population will receive certain benefits and another segment of the population will pay for such benefits. The government may administer and enforce compliance with a social insurance system, but in the final analysis it's paid for by—and is for the benefit of—the people of the nation. The government is simply the intermediary that carries out the wishes of the people.

Not only does the government not pay for social insurance benefits; it doesn't *guarantee* them, either. The payment of

future social insurance benefits is the responsibility of future taxpayers; they provide the guarantee.

The government does, however, define the nature and extent of the future benefits to be paid and thus the nature of the guarantee burden imposed upon future taxpayers. Today's citizens and taxpayers should do all they can to ensure that the guarantee expected of tomorrow's citizens and taxpayers will be acceptable to them so it will continue to be honored.

In studying social insurance reform, it's important to acknowledge that a retired person aged 65 or older receives monthly benefits made up of two parts:

- A cash annuity, payable monthly for life, adjusted explicitly to reflect increases in the Consumer Price Index;
- A medical care annuity, payable monthly for life, which increases implicitly as the cost of medical care increases.

The medical care annuity is not paid in cash, of course; it's paid in the form of medical care insurance protection through Medicare, under the Hospital Insurance and Supplementary Medical Insurance programs.

The medical care annuities represent, on average, about 40 percent of the combined value of the cash annuities and medical care annuities. If one type of annuity is decreased, there will be pressure to increase the other type—and vice versa. From the viewpoint of the retiree, it's the value of the total *annuity* that's important. From the viewpoint of the national government's budget, it's the cost of the *total annuity* that's important.

### **A Plea for Honest Debate**

Another example of the fundamentally flawed debate over Social Security reform is the pervasive focus on the “*rate of return*”—a convenient way to compare what you put in with what you take out of a system. It's popular to imply that the present system provides a low rate of return because of low interest rates paid on government bonds or even government ineptitude in managing the system.

But this argument misses the point.

The reason a funded individual retirement account system would produce higher rates of return than the present system for today's young participants is that money is saved and invested in advance of retirement; and all income redistribution is eliminated, thus each generation pays its own way. It should be noted that *prior generations* received very high rates of return under the present system.

For a funded individual retirement account system, the rate of return is based solely on investment returns, net of administration and investment expenses. But for the current Social Security system—essentially a pay-as-you-go system—the rate of return is based primarily on (1) the payroll taxes paid in earlier years when the beneficiaries being studied were paying taxes (which, in turn, were based on the ratio of total benefit payments to total taxable payroll in such years), and (2) for individual beneficiaries, the degree

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of income redistribution built into the system; for example, to favor lower-paid workers.

Virtually nothing is saved in advance and invested; therefore, there is *no investment return*, no investment expense, and very little administrative expense. The components of the rate of return are one thing when applied to the present system, and an entirely different thing when applied to an investment-based system.

While the rate of return may be low for future generations of participants, it was very high for past generations. Furthermore, for participants within a given generation, the rate of return will be generous for some and meager for others. But this has nothing to do with good or bad investment performance, or government administration. It has everything to do with the design of the system, including the funding method employed, and the system's stage of maturity.

A change to a funded individual retirement account system would eliminate future income redistribution within generations as well as among generations. It would also eliminate the Ponzi-like pay-as-you-go financing system that facilitates making fiscally irresponsible benefit promises for the future.

Personally, I am in favor of a funded individual retirement account system for a large part of Social Security, relying on welfare or income redistribution only for a "safety net." However, justification for revising the Social Security system should be based on forthright and proper arguments, not on misleading statements about rates of return.

There is no reason for this country to continue with a social insurance system that is so controversial and unpopular and whose financial status must constantly be debated. Living with such a system is an unnecessary drain on our collective productivity and psyche. It's eminently more sensible for us to design a social insurance system that the majority of the citizens can understand and perceive as fair and reasonable—one that will support rather than hinder the attainment of a healthy and productive national economy.

The national debate about Social Security and Medicare reform has begun in earnest. All of us in the employee benefit community have the background, the interest, and the ability to bring the broad perspective to this debate needed to develop sound and meaningful reform. Furthermore, as responsible and concerned citizens, we have the obligation to do so.

*Let's just do it.*