From social insecurity to social security: the genius of democratic politics

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Abstract: Modern attempts to 'save' the US Social Security System are futile. Any such unfunded system has already provided an intergenerational redistribution to the founding elders from subsequent generations. Starting from an initial perfectly competitive equilibrium, these later generations cannot rationally expect to be fully compensated. The numerous economists who have been arguing for financial reforms to prevent such systems from damaging anyone have thus been participating in a widespread deception of the working public. Nevertheless, the democratic political representatives who created and maintain this unsteady sequence of redistributions have been ingenious, not only for selling a system of insecurity-inducing intergenerational redistributions as a system of 'social security' but also for choosing a method of redistribution that, despite the misdirected objections of economists, minimises the losses of the subsequent generations by successfully eliminating an important parental malincentive that had, prior to social security, led most parents to educationally exploit their children.

Keywords: social security; intergenerational redistribution; parental malincentives; infinite horizon; Pareto optimality; educational inefficiency; excessive consumption; wealthy parents; excessive risk-taking; privatised social-security payments.

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Biographical notes: Professor Thompson, BA, UCLA, 1959 and PhD, Harvard, 1961, was an Assistant Professor of Economics at Stanford University from 1962 to 1965 and has been an Assistant, Associate and then Full Professor of Economics at UCLA from 1965 to the present. He is the inventor of: the first demand-revealing process for collective goods (1966); an infinite horizon laissez-faire optimality theorem without a transversality assumption (1967); a pure theory of competitive value for collective goods (1968); a theory of value with competitively supplied money (1974) and subsequent reinterpretation of the gold standard (1995); optimal intertemporal governmental policy commitments with several national defense applications (1974, 1979); and a characterisation theorem for worlds with rational strategic communication, 1980, followed by numerous social-theory-based reinterpretations of economic history. (This above-cited works are available at http://www.econ.ucla.edu/thompson/).

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1 The basic economics of social security

1.1 Background

Social security is one of the least understood of all government policies. People widely consider observed social security [*i.e.*, any governmentally imposed, unfunded (or 'pay-as-you-go'), retirement system] to be a type of forced-savings policy designed to protect working adults from their myopic consumption decisions. (See, *e.g.*, Feldstein, 2005, for a recent review of the conventional arguments for social security.) They correspondingly believe that social security, like most other governmental regulations, expands or contracts according to the institution's perceived net social benefits.[1] This is a substantially false belief.

Social security payments, like any public expenditure benefiting for the elderly that the government finances with long-term public borrowing, are thinly veiled redistributions from younger to older generations. Such payments arise when an initiating older generation suddenly gains sufficient political power to acquire a net public transfer from existing younger generations. If this political shock were temporary and hence only applied to the initiating older generation, the return on the 'investments' of the younger generations would be – 100%. It would be pointless for economists to attempt to 'reform' this essentially redistributional programme. Politicians base their distribution-determining decisions almost entirely on the political payoffs offered by various special interest groups rather than the distributional advice of economists. That's just the way a distributional system works in a democracy, wherein raw political power is the only significant reason for unconditional governmental transfer programmes.

Because the increase in political power of retired relative to younger workers accompanying the introduction of social security in the USA from the late 1930s through the 1950s was apparently quite durable, the initially victimised younger generations benefitted from the same sort of transfers when they became old. Nevertheless, some subsequent generations must correspondingly lose. In a finite-horizon economy, the last younger generation contributing to social security suffers losses (which correspond to the net cumulative gains of prior generations). In an infinite-horizon economy, initiating such a redistributional programme in a full competitive equilibrium eventually creates corresponding redistributional losses to future generations because the growth rates in the output of the working younger generations, from which future social security contributions come, must eventually fall short of the competitive interest rate available on private investments. For, in a genuine competitive equilibrium, private pension funds and interest rates would increase to eliminate any excess of expected long-term growth over interest rates (Thompson, 1967). Not only do economists lack any substantial impact on purely redistributional political decisions, but there is nothing in economic theory enabling economists to evaluate such pure redistributions. It follows that the recent pleas of a large number of economists for reform in order to give future contributors of a normal or super-normal expected return on their social security payments (*e.g.*, Diamond and Orszag, 2003) are entirely misplaced. The substantial net gains to previous social security recipients assure us that there are corresponding expected losses to subsequent social security 'investors'.[2]

Some of the involved economists may be aware of the negative expected net returns to workers' social security contributions; their numerous recent fiscal suggestions have been designed mainly to merely maintain the same, abnormally low, rate-of-return to social security contributions to future retirees as has been paid to recent-past retirees. Again, however, while intergenerational equity may be an acceptable goal to economists, bureaucrats, and journalists, it is not part of our political system, one which may well entail increasing social security taxes based on an increasing political power of relatively elderly citizens.

1.2 The question

The susceptibility of democracies to substantial intergenerational transfers creates an additional element of insecurity to their younger workers, who never know whether their future generational cohorts are going to be relatively politically weak or strong compared to their predecessors. Polities generating such uncertain future redistributions should thus be said to impose a system of *social insecurity* on their citizens. How then have the redistributions come to be called something as benevolent-sounding as 'social security?'

2 The political economy of social security

To minimise the objections of the victims of social security transfers, the promoters for the elderly in every generation rationally portray the redistributions as 'investments' or 'insurance contributions', by their tax-paying younger generations. In fact, however, the sacrificing younger generations would, when they became old, be able to redistribute from the immediately succeeding younger generations even if they paid no social security taxes! Mislabelling a negative transfer an 'investment', or an 'insurance contribution', is, however, ingenious only in a broad sense of the word that flatters cleverly deceptive advertising.

The genuine, socially quite impressive, genius of democracies lies in the abilities of political promoters to minimise the *actual* losses that they impose on their political opponents (Thompson, 1979, Section III.i). To the extent that there exist initial economic inefficiencies that concentrate at the intergenerational level, redistributional policies are thus adopted that eliminate them through a minimisation of the costs that the redistributions impose on younger generations for given returns to the older ones.

If there were no laissez-faire intergenerational inefficiencies, optimal and actual social security payments would be lump-sum asset accumulations that would not distort the intertemporal *laissez faire* optimum. However, observed social security income payments are far from lump-sums. Rather than receiving a lump-sum accumulation at a predetermined future date, at which point recipients would be free to spend the accumulation as they see fit, actual social security recipients receive survival-contingent, monthly cash annuities. For those relatively low-endowment individuals whose planned *laissez faire* wealth would fall short of their social security wealth at the commencement of their social security annuity, there is a forced-savings effect in that they cannot pre-spend their annuities. Nor can they borrow-and-spend prior to retirement in order to offset their social-security-induced savings: pre-retirement borrowing on the basis of future social security income flows is infeasible because social security payments, being essentially subsistence payments, cannot be taken in a bankruptcy. In contrast, individuals planning to leave substantial bequests, and thereby to own wealth substantially in excess of their social security wealth at the commencement of their social security income, are unaffected by social security's anomalous annuity structure because they will simply reduce their private asset accumulations in order to defeat the government's ostensible attempt to increase their savings. In particular, workers who save to make substantial bequests to their children reduce their pre-retirement private savings to fully offset their forced social security savings and thereby maintain the same consumption and wealth streams regardless of the timing of social security payments.

Note that if myopia were the market failure rationalising the existence of forced savings policies (*e.g.*, Thaler and Shefrin, 1981; Diamond, 2005), it would be perverse and cruel for the government to adopt a policy that allows high-endowment individuals to continue to carelessly misallocate their substantial resources while imposing greater savings only on low-endowment workers, who are typically forced by their circumstances to be abnormally consumptively careful and to respond to social security taxes by partial borrowing at very high transactions costs in order to barely survive. A second anomaly in existing social-security payments is that workers who would like the government to invest their anticipated future transfers in assets fitting their particular risk profiles are simply not given the choice.

How are we to explain these anomalous payment systems?

3 Parental malincentives

Parents are universally entitled to no legal compensation for the sacrifices they make for their young children. Since the time of Marshall, economists have been well-aware of the resulting tendency of parents to provide insufficient benefits for their children under laissez faire. More specifically, using a model simultaneously including several dimensions of parental exploitation of their children, Thompson and Ruhter (1979) rationalised a large, complementary, set of efficient institutions evolved by various modern democracies to protect the welfare of children against these parental malincentives. These governmental institutions include anti-child-labour and minimum-wage laws, anti-child-abuse laws, compulsory education, and welfare payments to support the children of poor or insufficiently benevolent parents. Each institution works to eliminate a well-defined parental malincentive for parents who are insufficiently wealthy or benevolent to grant lump-sum transfers to their grown children. However, even with all of these child-supporting institutions in place, these parents are motivated to teach their children values that lead them as adults to work too hard, save too much, and be unnaturally grateful to their parents. Competing private schools for the children of parents who are neither rich nor benevolent enough to plan to grant lump-sum transfers to their young-adult children – typically religious schools – teach their young children excessive work ethics, excessive thrift, and excessive filial loyalty. While freely provided public schools work against this inefficient form of education:

- the absence of public lump-sum transfers to young adults implies an insufficiency in the society's collective extra-familial benevolence (such benevolence being the political source of these governmental programmes) and thereby implies an insufficient quality of public education
- parents themselves participate in the education of their children.

Hence, in the absence of social security, there is still an educational bias towards excessive work and savings ethics and excessive filial loyalty. Of course, the reason that parents bias the quality of their childrens' education is to gain the financial support of their children when they are grown and the parents are retired.

At the same time, to the extent that these insufficiently wealthy or benevolent working parents save at all in the absence of social security, they would purchase excessively risky assets because the possibly negative returns would be substantially borne by their morally miseducated children.

As we have seen, the anomalous, yet efficient, aspect of social security is that it substantially increases the basic old-age consumption of parents who are neither wealthy nor benevolent enough to plan to leave their children substantial bequests. By forcing up the regular annual consumption levels of the retired to where they approximate their pre-retirement consumption levels, social security substantially eliminates the parents' return to providing their children with an early education biased towards work and savings ethics and filial piety. With the complementary policy of Medicare covering unexpected financial hardships, working parents no longer see any future profit from such exploitative child-rearing.

Also, since it would defeat the purpose of these subsistence-based annuity payments for social security systems to allow workers to invest their expected social security wealths in a risky form, in which case parents would over-risk their savings and again resort to the miseducation of their children, the relative social-security wealths among any given cohort of retirees are fixed by the government according to their relative pre-retirement incomes.

Parents who are sufficiently wealthy or benevolent to plan to leave bequests to their grown children are, as we have seen, allocationally unaffected by social security. Social security's anomalous, annuitised, payment system does not affect the real decisions of such parents. And this is as it should be, for such parents have no incentive to miseducate their children. Here then is clear evidence for the genius of the social security system: *It finds, through its annuitised payment system, a way to affect only those parents who should be affected. Parents who are sufficiently wealthy or benevolent to plan bequests and therefore choose Pareto optimal educations for their children, and only such parents, remain unaffected by social security's annuitised payment system.*

4 Conclusion: should we privatise social security payments?

Post WWII economic reform has been largely inspired by an economic theory that assumes away the market imperfections that are at the heart of the policies being reformed. US airlines and telephone deregulation thus assumed away the real capacity to monopolise in these industries and thus created problems of monopolistic price discrimination that appear to be more serious than the problems it solved. Were it not for the good judgement of the public and their elected representatives, the same might be happening to the ingenious character of our historic social security payment system.

In particular, the proposed, Chile-like, reforms (*e.g.*, Diamond and Valdes-Prieto, 1994; Kotlikoff, 1995; Mitchell and Zeldes, 1996; Ferrara, 1997) aim at replacing at least part of the government's fixed annuity payments of the existing system with voluntarily chosen worker-savings and investment plans. The underlying economic theory is sufficiently transparent to persuade many contemporary governmental leaders. However, it is a theory that fails to acknowledge the parental malincentive problem. It thereby fails to appreciate the ingenious character of a system that isolates relatively poor or ungenerous parents and prevents their excessive working-age consumption and risk-taking at the cost of their children, who would otherwise be trained to adopt values biased away from their own utilitarian interests and towards the excessive work, savings, and gratitude ethics that serve the long-term financial interests of their overconsuming and excessively risk-taking parents.

It is thus a theory that fails to appreciate the freeing-effect that social security has had on the excessively puritanical values of Pre-WWII USA, and presumably many other countries as well.

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Notes

1 Another common argument is that social security, along with Medicare, is part of a larger set of governmental institutions that arises from a purported free-market underprovision of insurance. (This, for example, is the argument favoured by Feldstein). The alleged market failure stems from the hypothesis that adverse selection forces private insurers to charge socially unjustifiably high rates to individuals who are not abnormally high risks. Bad insurance customers are thus presumed to drive out the good. However, this popular hypothesis is far from persuasive because insurers can and do offer non-linear rates when they suspect significant adverse selection. High-risk individuals reveal themselves through their desire for relatively extensive coverage. In other words, an equilibrium degree of rate progression will both reveal the high-risk insurance customers and substantially work towards efficiently discriminatory insurance rates. Although this imposes excessively high insurance

costs on unusually risk-averse individuals, and a tax-subsidy system is correspondingly required for a second-best optimum, the inclusion of significant moral hazard costs assures us of optimal low-old-age-income insurance policies that are both highly incomplete and more extensive for relatively risk-averse low-wage workers individuals. Hence, there is no insurance-specific argument implying the efficiency of the governmental provision of the essentially complete and non-discriminatory-among-low-old-wage-workers "insurance policies" that the government has imposed on the public.

It may well be true that certain people invest in assets that are too risky in view of the possibility of old-age poverty. In this case, social security and medicare may be viewed as forcing these people into relatively safe investments. However, as we are about to see, this excessive laissez-faire risk-taking is itself a consequence of a special market failure, one not contained in standard insurance or social security arguments.

2 In particular, the 22-year old US formula tying average benefits to the average wage rate reduced the average real return to Social Security contributions to the growth rate of real wages, a number that is theoretically less than the real interest rate in long-run equilibrium in an economy with a non-negative rate of population growth (Thompson, 1967). Hence, even if we could somehow maintain our existing Social Security tax and payment rates and population continued to expand, expected US Social Security benefits would eventually fail to justify their 'investment' costs, and indeed have been doing so for over three decades now.