Angus Deaton

PrincetonUniversity 361 Wallace Hall Princeton, NJ 08544 Phone: 609.258.5967 Fax: 609.258.5974 Email: deaton@princeton.edu

HOME
PAPERS
MULTIMEDIA
LETTERS
POVERTY
HEALTH
SURVEYS
COURSES
CV
LINKS
CONTACT

Letter from America: On Social Security Reform

***from the Royal Economic Society Newsletter,
April 1997***

When I moved from Bristol to Princeton in 1983, the Dow Jones Industrial Average stood at 1,200, having not long passed 1,000. Early this year, the Dow broke 7,000, a 16 percent annual growth rate, about 13 percent a year in real terms. The majority of academics in the U. S. insure their consumption in retirement with defined-contribution pension plans, whereby they and their universities make tax-deferred contributions to TIAA/CREF, a fund which invests the money in bonds (TIAA) or stocks (CREF) in proportions determined by the investor. House prices in many parts of the U.S. have been more or less stagnant in the 90s, so that CREF has replaced housing equity as the engine of enrichment for professors. Academics are not the only middle-class Americans with a sharp interest in the market. American corporations have been systematically replacing the once-standard defined-benefit pension schemes with defined-contribution and employee-directed 401k plans (the name is after the section of the relevant tax code). As a result, a large fraction of white-collar workers now have an immediate and transparent interest in events on Wall Street. For the many Americans whose first experience of the market was a 401k plan in the 80s and 90s, the stock market has been a fairy godmother. Corporations and politicians are also reaping the benefits. Governor Christy Whitman of New Jersey, elected on a promise to reduce state income taxes, has done so using the stock-market gains on the (defined-benefit, and now over funded) pension funds of state employees, and her success has made her one of the rising stars of the Republican party.

As the market and private pensions boom, America's (almost) universal social security system is going bust. According to the recent report of an Advisory Council chaired by Edward Gramlich of the University of Michigan, payments to beneficiaries will exceed pay-as-you-go income in 2020, and the fund will be exhausted in 2030. Contrary to popular perception, the problem lies not in the aging of the baby-boomers, an event that has been anticipated for many years, but in more mundane events, such as the reduction in receipts from slower than expected productivity growth. The system could be made solvent for the next 75 years if the current social security payroll tax were raised from the current 12.4 percent to 14.6 percent, a solution that is about as likely as universal health insurance, gun control or the abolition of the death penalty. Instead, the council has recommended that social insurance adopt the same fairy godmother as private insurance, investing a component of social security on Wall Street. How, and the extent to which this should be done were issues that left the council hopelessly fractured. The smallest faction—the chairman and a supporter—adopted a middle of the road position, while the two other larger groups embraced the extremes. One group—largely union representatives, but also an ex-commissioner of the Social Security System and the Chairman of TIAA/CREF—regarded the stock market with deep suspicion, saw the current Social Security System as a great success, and proposed solving the financial shortfall partly by the government investing current surpluses in the market, but also by increasing taxes in 2045! If this proposal is a caricature of the sort of irresponsible and time-inconsistent planning that opponents of social security have always charged it with, the views of the opposite group are a similarly extreme endorsement of the ability of individuals to use the market to plan their own retirements. They recommend that up to a half of social security contributions be invested in personal saving accounts under individual control—privatization— without controls on the selection of assets, and with people allowed to withdraw all of their investments in a lump-sum at the date of retirement. James Tobin refers to this as a “madhouse” in which stock and bond salesmen compete “ for every old geezer’s Social Security fund.” One group emphasized the high mean returns in the market, while the other emphasized the high variance, both across time, and across people.

Until recently, professors were allowed control only over the allocation of their pensions between stocks and bonds, and only over the increments, not the accumulation. Today, we are presented with a much larger menu, including such exotica as “green” funds, as well as plain, old-fashioned cash (to allow us to play the market). As a result, Princeton and other participating universities have lost the assurance that faculty will be secure in their old age, an assurance that was surely one of the reasons for the universities’ participation. There once was no risk that the doorways of Nassau Hall would become shelters for homeless elderly Nobel Laureates, who thought that cash was the “safe” asset for long-term investment, or who believed that fairy godmothers always smile. But perhaps there would be no embarrassment, in the University or in the country as a whole. Judging by the Advisory Council’s report, many Americans believe that their incomes and stock market success are the result of their own efforts and are available to everyone, so that those who are successful on the market owe little to those who are not. The redistributional battleground between left and right has moved away from the old, largely static questions of tax-progressivity towards more dynamic issues, particularly insurance and the extent to which the lucky bear responsibility for the unlucky.

Angus Deaton's Letter from America appears every six months in the Royal Economic Society's Newsletter. For more information, visit http://www.res.org.uk/society/newsletters.asp.

Return to Angus' full list of *Letters from America*.

© 2004 Woodrow School of Public and International Affairs
Princeton University; Princeton, NJ 08544; USA
Phone: 609.258.6403; Fax: 609.258.5974