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The Missing Piece of Entitlement Reform

If there is one point of broad agreement in Washington, a town defined by discord, it is that our nation's entitlement programs are in need of reform and that there are serious consequences in the absence of reform. Last Friday we got a reminder of the problem. Social Security will become insolvent in 2033 and Medicare in 2026. The good news is that with the debt growing more slowly, there may be an opportunity to refocus on long term sound policy. The bad news is that the tax hikes and spending cuts on the table (the two primary policy proposals out there) only fix part of the problem.

What's missing from the current debate is a basic understanding of how these programs are actually funded. While it is technically true that these programs are funded by payroll taxes, it is more instructive to think of these programs as an intergenerational wealth transfer.

> There is a fundamental difference between the mechanism for funding the program and the formula for paying out benefits.

In an intergenerational wealth transfer, the workers of today pay for the retirees of today. And when the workers of today retire tomorrow, they will be counting on the workers of tomorrow to pay for them (Exhibit 1). This is true for both Social Security and Medicare, but for the purposes of this paper, we will focus solely on Social Security, since health care introduces a whole host of other variables and complexities, though the central insight still applies.

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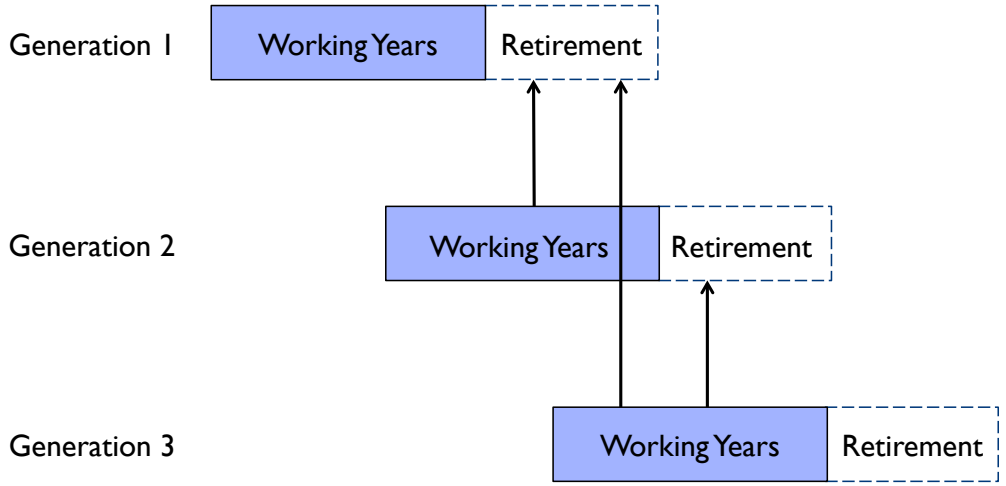
The Contradiction

There are several basic factors that keep Social Security funded: payroll taxes, productivity growth, and population growth. But not all these factors are accounted for in the benefit formula.

Simply stated: we calculate our benefits based on how much we earn, but our ability to fund Social Security benefits relies, in large part, on how many children we have (the program funders of tomorrow). There is a fundamental disconnect between the mechanism for funding the program and the formula for paying out benefits.

Exhibit 1

Intergenerational Wealth Transfer



This fundamental difference leads to an inherent tension. Kids are expensive, and if you were to approach Social Security from a purely utilitarian perspective, the best strategy to get the most out of our current system would be to not have kids and, obviously, maximize your income. Yet your ability to cash out during retirement would depend on the kids you're not having to be working and paying into the system. If everyone approached our entitlements this way, the challenges these programs are facing would be much more acute.

An analogous situation is the way pension funds are managed. Pension managers can have a lot of money invested, but if it isn't accessible to write benefit checks when they need to, they have a big problem. The way they deal with this problem

is through asset-liability duration matching, a technique used to match up the timing of their investments and their benefits. Quite simply, this is a step taken to keep the promises that a particular fund has made to its investors.

Aligning Funding With Benefits

As a thought experiment, what if there was a solution to entitlements that, instead of focusing on taxes or spending, more accurately aligned the funding mechanism and benefit formula? This way, you could guarantee benefits in the future, regardless of demographic or economic change.

In 2005, President George W. Bush tried to take a step toward reconciling this fundamental problem by introducing an element of forward funding to the program. Rather than paying for current retirees, a portion of payroll taxes would have been set aside for the individual who actually paid the taxes. Importantly, this policy would've aligned a portion of the funding mechanism with a portion of the benefits.

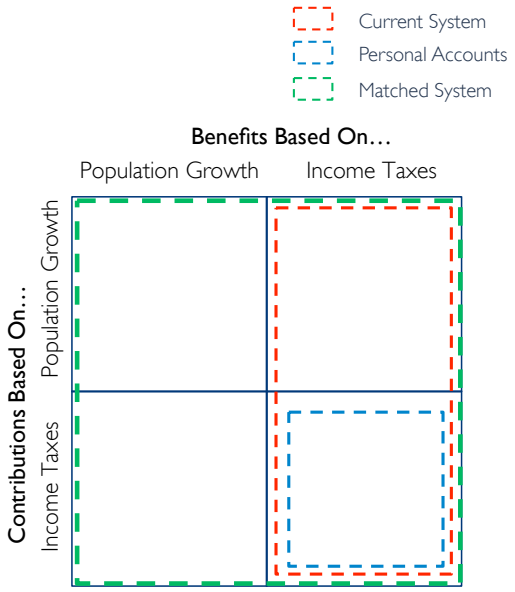
This proposal was rejected in 2005. But is there another way to match funding and benefits? What if there was an alternative that did the reverse: instead of aligning the funding mechanism with the benefits, it aligned the benefits with the funding mechanism. In this case, the policy could tie your benefits to the number of children you have rather than just the amount of your income (Exhibit 2).

Exhibit 2

Applying Asset-Liability Matching To Entitlements

A fundamental aspect of portfolio theory (especially pension fund management) is the principle of duration matching: making sure that your liabilities come due at the same time as your investments.

A similar concept for government benefits would be to make sure that the benefit calculation is based on a similar set of factors as the funding mechanism; the goal being that if funding declines, so too does the obligated benefit.



This is provactive for a host of reasons, but to see how it could work in practice, let's look at a simplified society over three generations and how it might function.

Let's assume the first generation consists of 100 people, all born at the same time and all beginning work at age 20. They work for 40 years, making $40,000 per year (without inflation) and have 20 years of retirement. Both Generation 1 and Generation 2 have an average of 2.5 children per family, so Generation 3 now has 156 people.

Say that the society has determined that $10,000 per year in retirement is the basic benefit that needs to be provided, and a tax rate of 9% on the two generations working is sufficient to provide that for the generation just retired. If this scenario continued, it would be a sustainable program.

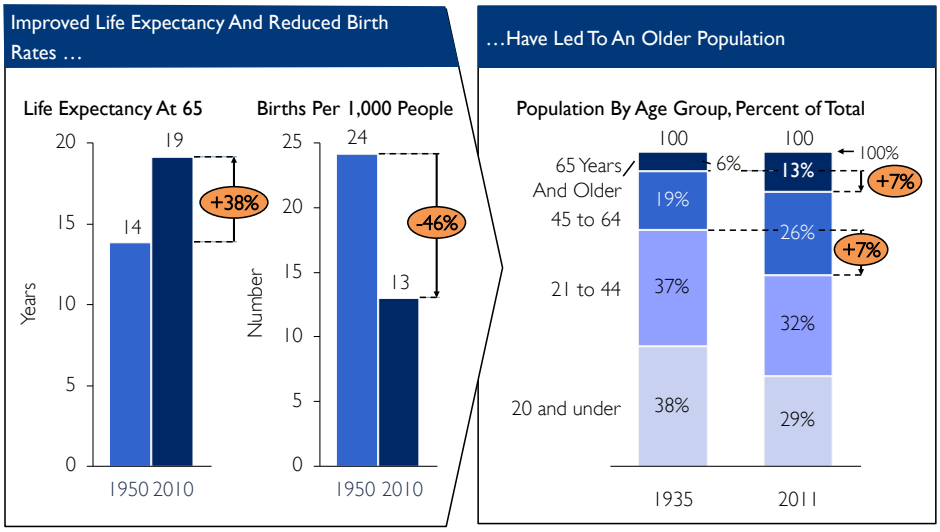
Now assume beginning with Generation 3, the children per family drops to 2.4. Even though the people are still making $40,000 a year and paying their 9%, the program no longer can provide the promised $10,000 per year to Generation 2.

In this scenario, the fundamental problem is not that the tax rates are too low, or that the benefits are too high; the problem is that there are too few of the next generation's workers to support the intergenerational payments for the next generation's retirees. While raising taxes or cutting benefits might extend the solvency of the problem, neither solution can guarantee it.

This is one of the trends that has been impacting our own Social Security system. When you add in increased lifespans (meaning the number of years of retirement effectively go up every year) and changing demographics, the pressures on the system are considerable (Exhibit 3). As we raise taxes to keep our benefit promises, we make it incrementally more expensive to raise the children who fund it.

Exhibit 3

The U.S. Population Continues To Get Older And Live Longer



Source: Center for Disease Control, Census U.S. Bureau

Now, to take this thought experiment even further, let's say that parents with three or more children are promised the same benefit of $10,000 per year; parents of two children are promised a benefit of $7,500 per year, and those parents who have one child or no children are given a benefit of $5,000. Under this alternative scenario, even if the birth rate declines from 2.5 to 2.0 children per family, our imaginary society can still keep all the benefits it has promised, because the benefits are actually connected in part to the funding mechanism.

Our imaginary society still runs into problems if the birth rate drops below the replacement rate (in this case 2.0 children per family). This is due to some of the choices made in the benefit structure. But in this situation, because the society has more aligned the incentives with the program, it actually makes sense to have more children under this alternative program.

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Of course, this alternative hypothetical introduces another set of issues fraught with societal complications: What about the expense of adoptions? What impact would this have on mothers who work outside the home? What role does this imply for education and immigration policy? The irony is that we already fund our entitlement programs without answering any of these questions, all of which could be applied to our current system. Indeed, one of the attractive parts of personal accounts is that it matches the funding mechanism with the benefits formula while at the same time sidestepping many of the complex moral and societal questions raised by this hypothetical.

It should be added that there are a host of other factors beyond those addressed here. While longevity and demographics have been putting negative pressure on the system, productivity increases are a factor that helps support the system, and significant increases there would have a positive impact on solvency. Conversely, if you believe that the "low hanging fruit" of productivity gains are behind us, this will be another challenge for entitlements in the future.

Conclusion

The main takeaway from this admittedly simplified thought experiment is that if we want to stop revisiting our real-world entitlement problems, we need to more closely align the benefits we receive from the programs with how they are actually funded. If we don't, we are likely to bounce from one fix to another as societal trends change. One fix might work for 10 years, another might work for 50, but a permanent solution has to more effectively match funding mechanisms with benefit formulas, much like private pensions. Without a match between the funding and the promise, neither are really guaranteed.