PERSPECTIVE

Social Insurance And Elderly Entitlement Reform: Are They Compatible?

We must find a way for the working generation to pay for some or most of their retirement consumption, including health care.

by Thomas R. Saving

ABSTRACT: There is no inconsistency between Social Security and Medicare reform and a firm commitment to the concept of social insurance. The retirement benefit components of these programs are not part of social insurance. Social insurance allows for people who experience low-probability random bad events to be compensated by others. An event, such as reaching retirement age, is a high-probability event and not a candidate for social insurance. [*Health Affairs* 25 (2006): w138–w140 (published online 21 March 2006; 10.1377/hlthaff.25.w138)]

THERE IS NO QUESTION that something must be done if current elderly entitlement programs are to continue. To put the issue in perspective, consider that in 2020—in less than fifteen years—covering the Social Security and Medicare shortfalls will consume almost 30 percent of projected federal income tax revenues. Just ten years later, in 2030, the transfers required to pay benefits will require more than 50 percent of projected federal income tax revenues. Anyone looking to providing for the continuation of Social Security and Medicare must deal with this growing funding gap.[1] The projected gap is not an illusion made up by those who favor one type of reform over another, but a real gap that must and will be dealt with by the present or some future Congress.

The Social Security and Medicare reform debate is really about how to close this gap—essentially, how to provide retirement benefits to current retirees as they age and to provide benefits to new retirees in the very near future. How future benefits are funded, through future tax increases or through additional savings today, determines who bears the burden of closing the funding gap and when that burden is borne. Given that these programs must be changed, must we give up social insurance in the process?

■ Social insurance: what does it mean?

The notion of "social insurance" is essentially general agreement among members of a generation that when a pitfall occurs to an individual, others will absorb all or some part of the individual's loss. Such insurance works best when the probability of a loss is low and independent across individual participants in the contract. Given this form of social insurance, should provision for retirement consumption for all be part of a social contract? The probability that a member of the cohort born in 2006 will live to retirement age is 0.87. Thus, cohort members cannot insure themselves against the remote chance they will survive to retirement, since reaching retirement age is

Thomas Saving (t-saving@tamu.edu) is a professor of economics and director of the Private Enterprise Research Center, Texas A&M University, in College Station.

DOI 10.1377/hlthaff.25.w138

expected.

What a cohort can insure against is the likelihood that members or their families will suffer income losses during their work years as a result of premature death or disability—where there is a clear role for social insurance—or that they will reach retirement age and not have sufficient resources for retirement consumption—another clear role for social insurance. Social insurance would then have each member of the cohort placing resources in a common account and using these resources to compensate the families of those unfortunate enough to have died young or those who have become disabled or have too little for retirement consumption.

Social insurance loses its meaning when one crosses generations. In fact, intergenerational social insurance is at best inefficient and at worst unworkable. Much of the current financial problems of Social Security and Medicare are the result of retired and older working cohorts pressuring Congress to give them benefits to be paid for by a combination of current young and unborn generations without regard for generational equity. Social Security reform is primarily about generations prepaying their retirement benefits. Such prepayment does not preclude social insurance and in fact provides the funds for such insurance. Thus, retirement funding reform and social insurance are not mutually exclusive.

■ **Social Security.** Let me begin by challenging the notion that Social Security is safe until at least 2042 or perhaps 2052 because it has been accumulating surpluses since the 1983 reform. The Social Security Trust Fund provides no income to the Treasury and will provide no resources when the revenue shortfalls begin in 2017. This relation of the Trust Fund to the overall budget has been well understood, as the following statement from the Budget of the United States Government made during President Clinton's administration shows:

> These [Trust Fund] balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits.[2]

The mere fact that we have been able to change Social Security whenever it got into trouble supports reformers' argument that government promises are not secure. Participants have a contract with their congressman or congresswoman, whose terms give members of Congress the right to change the contract whenever they like and participants have to accept whatever terms Congress sets.

The real question is: How can we restructure Social Security so that participants have a real deal where, when the deal is violated, participants have standing in a court of law? An answer, and perhaps the only answer, is personal accounts, in which each participant has the funds in an account that they fully own. This ownership must not be at the whim of Congress, even though the use of the funds before retirement or death may be restricted; once retirement or death occurs, the funds become exactly as any other property. In effect, we would make Social Security subject to the Employee Retirement Income Security Act (ERISA). Such private accounts are perfectly consistent with the social insurance concept if we view the social insurance contract as one that guarantees retirees a minimum level of retirement consumption.

■ **Medicare.** Medicare's problems stem from two factors: demographics and a growing demand for health care, neither of which are reflections of "a problem of U.S. medicine," unless freedom of choice is the problem. The demographic problem is a combination of decreasing fertility and mortality, both of which in the long run worsen the dependency ratio. Moreover, it is not the case that even in the short run the decrease in fertility offsets the decrease in mortality to leave the dependency ratio unchanged. In fact, the dependency ratio

is rising and is expected to rise for at least the next seventy-five years.

Medicare's second problem stems from the fact that the share of total earned income in the preretirement ages that people choose to spend on health care is increasing. Since Medicare is an in-kind benefit, it is a commitment to provide as much health care as retirees choose. Thus, the combination of Social Security and Medicare benefits form an increasing share of preretirement consumption that threatens to reach 80 percent of that consumption. Assuming two workers per retiree, a level that the trustees project will occur in 2040, replacing 80 percent of preretirement consumption will require that two workers each give up 40 percent of their consumption. Clearly, this level of taxation is not a sustainable equilibrium.

"All Social Security and Medicare reforms must deal with the fact that benefits, as currently scheduled, cannot be paid with the current tax rate."

The fundamental question is: Are the issues associated with the provision of retirement health care consumption different from the issues of providing for other retirement consumption? Is there more uncertainty in providing health care? Does the fact that health risks vary from retiree to retiree and that most health care spending is concentrated on people experiencing a major health shock or who are in the last years of life necessitate that the risks be borne by a social insurance compact?

Consider again the concept of cohort-based insurance in which new entrants to the labor force agree to finance their health care in retirement. Members of the cohort do know that almost all will survive to retirement, but they do not know how long any one member will live and how much health care he or she will consume. It is conceivable that cohorts could prepay their retirement health insurance through premium payments throughout their lifetime. Some will argue that such insurance would be too expensive for a cohort, but this is really an argument that a future cohort can afford these expenses.

■ **Some concluding remarks.** All Social Security and Medicare reforms must deal with the fact that benefits, as currently scheduled, cannot be paid with the current tax rate—or, for that matter, with any conceivable tax rate. Those who favor the current financing arrangement must explicitly detail whose taxes will be raised and whose benefits will be cut. Prepayment with personal retirement accounts has two other collateral benefits. Workers become the owners of their retirement accounts, and increased savings will increase the nation's income relative to the current financing arrangement. For these reasons, such reforms offer a promising alternative in the current policy discussion.

We must find a way for the working generation to pay for some or most of their retirement consumption while they are working. If we pay current-law benefits for Social Security and Medicare and only collect current-law taxes and premiums, the shortfalls will use up large parts of future federal income tax revenues. Transfers of the magnitude necessary to pay projected benefits cannot and will not happen. The real issue is not whether but how these programs will be changed. The current working population must be part of the solution. They can accept lower benefits, pay higher taxes, or preferably, set aside funds during their working years to pay for future benefits.

The author is indebted to Andrew Rettenmaier for his insights on the social insurance issue.

NOTES

1. This paper was written in response to T.R. Marmor and J.L Mashaw, "Understanding Social Insurance: Fairness, Affordability, and the 'Modernization' of Social Security and Medicare," *Health Affairs* 25 (2006): w114–w134 (published online 21 March 2006; 10.1377/hlthaff.25.w114).
2. "Analytical Perspectives," Budget of the United States Government, Fiscal Year 2000 (Washington: U.S. Government Printing Office, 1999), 337.