

The Virtues of Personal Accounts for Social Security: A Comment to Lazear¹

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The objective of this short note is to show that Edward P. Lazear's thesis that "personal accounts are more consistent with economic principles, avoid government moral hazard, and provide more security than government Social Security" is unsound. The same applies to a number of other statements that are put forward in the process of expounding the main thesis.

Let us consider in turn the different controversial points that the author raises in his paper:

On p. 2 Lazear criticizes the redistributive aspects of Social Security: "Other things equal, groups with short life expectancies transfer income to groups with long life expectancies through the Social Security System. Additionally, caps on benefits provide redistribution from the rich to the poor, but caps on contributions imply redistribution from the middle to the rich. The net redistributive flows depend on the actual history of contributions and benefit payments, but many of these transfers are secondary consequences of the system and some are adverse from a social equity point of view." Parts of the distributional effects of the social security system such that "groups with short life expectancies transfer income to groups with long life expectancies" is the outcome of retirement insurance as such, it does not depend whether the insurance system is private or public. Such an outcome can be reduced by differentiating contributions according to the different life expectancy of the different groups one belongs to (for instance, given the same benefit payments, contributions should be lower from men than from women, from blacks than from whites, from non smokers than from smokers, from overweight individuals than from the rest), but this kind of experience rating has some limitations. This would take place spontaneously in a private system, if legal constraints and transaction costs are not getting in the way, but provisions of the kind suggested can be in theory introduced in any retirement insurance system, be it private or public. As to the other lamented distributional consequences, these can be eliminated from the

¹ Comment to Edward P. Lazear "The Virtues of Personal Accounts for Social Security", *The Economists' Voice*, Vol. 2: No. 1, 2005, Article 4. http://www.bepress.com/ev/vol2/iss1/art4_1_2005. The comment was sent to *The Economists' Voice* on 12/4/2005, but the submission was rejected without comments.

Social Security System, if they are adversely perceived, by correspondingly restructuring benefits and contributions. Thus the argument at most may imply some reform of the Social Security System, not necessarily its change to a system of private accounts. Moreover, if one considers some redistribution of income (or rather welfare) as advisable (which may not be the case of Lazear), the social security system could well be quite useful as an additional means of redistribution (alongside the tax and public expenditure system), provided its redistributive impact is suitably adjusted.

P. 2: “To begin, the legitimate goal of Social Security is to ensure that everyone has sufficient income to support some basic standard of living throughout retirement. Thus, forced saving is at the heart of the system.” After having mentioned in the second section of the paper the social insurance aspect of the Social Security system, the author forgets about it and does not mention it any further. On the other hand this function can greatly diminish the amount of forced savings needed for ensuring a certain income during all the possible length of the retirement period, and this, because it reduces the extent of the required forced saving, increases in the end consumer’s sovereignty. It is the insurance function of Social Security that gives the certainty, with a minimum sacrifice of forced savings, to be provided for in later age whatever the possible (but unpredictable) effective length span of life.

P. 2: “Were individuals not forced to save, some would engage in moral hazard, over-consuming when young and allowing themselves to be destitute when old, knowing that they could then count on relatives, churches or communities to care for them. Others would be less strategic, but might end up in the same situation simply for lack of foresight.” There is an omission here: those with foresight but bad luck, since some degree of risk is always involved in portfolio management (consider for instance, as an extreme case, those who invested their life savings in the Stock Exchange and/or in savings accounts in the banks that later defaulted, before the 1929 Wall Street crash). One should also consider that probably only a (possibly small) minority of the population is able to grasp the different characteristics of the various assets in which they can invest their savings. Thus consumer sovereignty in this respect is only illusory (see below).

p. 3: “First, private accounts are more consistent than the government program with fundamental economic principles — namely, the principle that we ought to honor consumer sovereignty, and keep the market free of significant distortions.” The author does not elaborate on the way in which “private accounts are more consistent...with...consumer sovereignty”. I understand that what the author hints

to is the possibility to hold private accounts in different assets, characterized by different maturity and riskiness. But if the accounts are hold in risky assets the whole purpose of the system (“to ensure that everyone has sufficient income to support some basic standard of living throughout retirement”) is put into jeopardy. As to “keep the market free of significant distortions”, the market is an efficient allocative engine if choices are informed. But how many of the addressees of the Social Security system are capable to make conscious and informed decisions as to asset management? How many savers are able to read, say, the budget of a corporation or, even if they are, how many have the time to do it? To think that the market for assets can work “free of significant distortions” is simply day-dreaming. (Of course this is not an argument against the market for assets as such, as the world is not perfect anyway, outside of the realm of ideology, at least).

p. 3: “Third, private accounts reduce government moral hazard and do not sacrifice any of the benefits associated with a government run Social Security program. Moving pension funds to the private sector removes another source of revenues that government officials have not been able to resist spending.” This risk can be avoided by making the managements of the funds of the Social Security a separate administration, whose resources cannot be used but for the statutory and legally binding Social Security purposes.

P. 4: “most economists believe that the market does a better job than politicians of allocating resources in an efficient manner.” Very generic. What kind of resources? It is also true that practically *all* economists believe that politicians make a better job than the market for allocating in an efficient manner some types of resources: after all no economist in his right mind has ever advocated the abolition of the allocative function of the state in some areas, and thus of public expenditure and taxation. Generic statements of this sort are not really helpful for considering whether a particular task should be performed by the state or by the market. In particular, there are many economists who think that there are good economic motives why a Social Security system based on a state-run system of compulsory insurance could be advisable.

P. 5: “Individuals who buy treasuries privately can be virtually assured that the return they receive is that promised: the bonds’ face value.” Indeed, but not the *real* value (unless the treasuries are fully indexed, which mostly are not). What a pensioner needs is not the face value or the nominal returns, but the purchasing power. There are many instances in the world where treasuries have defaulted, either outright (see recently the case of Argentina), or, what is mostly the case, in real term, through inflation. The same applies to the real purchasing power of future money returns.

P. 5 (similar concepts are repeated on p. 6): “There is no guarantee in a pay-as-you-go Social Security system that the benefits, even on average, will reflect the market rate of interest on treasuries. After all, benefits and contributions are politically determined and Congress has the power to change benefits.” Indeed, in this lies the superiority of a public Social Security system. First of all, it is the power of parliaments and governments to enact inflationary economic policies resulting in a debasement of the currency and in negative real returns to treasury bonds. Secondly, the political dimension is precisely the guarantee that the interests of the pensioners would not be unduly sacrificed. Elder citizens, those who are either pensioners or are close to pension age, represent an important section of the electorate and they may even more be in the future. In post-war Europe the pay-as-you go system was introduced precisely as a political act aiming to safeguard the interests of pensioners in face of the destruction of the purchasing power of nominal Social Security funds, previously accumulated on a contributory basis. And certainly the ruling majority would pay a particularly politically high price in case they would arbitrarily change the rules to the disadvantage of pensioners. Indeed, the contrary problem may be possibly true: experience has shown, in Europe, at least, that once the laws that regulate the pension system are set, it is very difficult to change them to the disadvantage of pensioners, even if the economic situation can be hardly compatible with the maintenance of previous commitments. Finally, if the safe alternative to the public social security system is just private accounts held in treasury bills, where is the advantage of private accounts, as far as the assumed sovereignty of the saver goes? On the other hand if some more risky assets are contemplated, the possibility, because of bad choice or bad luck, to lose one's retirement savings remains.