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An Overview

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The purpose of this chapter is to comment on and give the general flavor of the papers presented in the seminar on the Economics of Aging given by the Department of Economics of Western Michigan University during the academic year 1983-84.

Munnell-Schulz

Alicia Munnell provides an excellent account of the financial outlook for the social security system over the next 75 years. In retrospect she notes that the present day financial problems of the system have come about because of forecasting errors with regard to demographics and the economy.

Munnell emphasizes that the key relationship is the growth of nominal wages relative to the growth of the price level, i.e., the growth of real wages. Taxes depend mainly on the nominal wage level and social security benefits depend mainly on the price level because benefits are indexed. Thus, if nominal wages grow faster than the price level, taxes will grow relative to benefits.

In addition, Munnell underscores the fact that small errors in forecasting can have significant effects on how one views the viability of the social security system. In general, she finds that for the next 75 years the system will run surpluses. Munnell summarizes matters by asserting:

During the period 1990-2020, almost no uncertainties exist about the adequacy of social security

financing. Even under the pessimistic mortality and economic assumptions the system will run surpluses until 2013 and have positive fund balances until 2020.

She notes that even if the economy performs more poorly than anticipated under the pessimistic assumption that real wages grow less than 1 percent, revenues will still be adequate to cover benefits.

Could there be problems of managing this surplus? Munnell indicates that Congress has three alternatives:

- (1) reduce social security tax rates.
- (2) divert these surpluses to finance other programs.
- (3) let tax rate increases planned in 1990 take effect.

Suppose surpluses are generated in excess of expectations and Congress does *not* reduce social security taxes or divert surpluses to finance other programs. It is possible that the surpluses generated may be so large that the trustees of the system (the Secretaries of Health and Human Services, Labor and Treasury) may be compelled to invest these funds in private securities, rather than public securities. Whichever alternative is chosen, there are potential problems.

If the trustees were to invest in privately held securities, it can be asked how the trustees will do this without destroying the traditional boundary between the private and public sectors. It is not out of the question that such a policy might result in cabinet officers deciding which large corporations to take over.

To give a rough order of magnitudes involved, for 1984 benefits from OASI, DI, and HI totaled \$221.3 billion. Suppose, not unrealistically, the trust fund were double benefits, or \$442.6 billion. The trustees could then purchase about 15 percent of the \$3 trillion publicly held stock on the New York

Stock Exchange. By concentrating purchases of stock, the trustees could obtain a controlling interest in some corporations. If the trustees alternatively invested the surplus in the private bond market, the trustees may find that they have a controlling interest in corporations that end up in bankruptcy, as the bondholders are converted to stockholders.¹

If the annual surplus of \$442.6 billion were totally invested in U.S. Treasury securities, the trustees would be holding about 28 percent of the national debt. With a smaller percentage of the national debt held by the public and the banking system, it would probably significantly diminish the power of the Federal Reserve to control bank reserves via open market operations. In any event, the prospect of larger social security fund surpluses will not only change the social security system, but will also have a significant effect on the functioning of the economy.

In essence Munnell holds that the “crisis” in financing the social security system is almost entirely due to unforeseen circumstances—particularly the economic malaise of the last decade, with its low and declining growth rates, reduced productivity levels and high unemployment rates.

Schulz emphasizes that there is little payoff if we merely shift from social security to private pensions. He emphasizes that social security developed as a result of the failure of alternatives. In one sense, the development of social security was hardly revolutionary, since prior to World War II we already had an informal pay-as-you-go system whereby family members took care of the elderly. This informal private system, because of its shortcomings, gave way to the present social security system.

There is reason to believe that we need diversity of old age provisions, private as well as public. If we think of the provision for old age as an investment problem, then our aim is to

minimize risk by minimizing the variance around the mean retirement income, for a given return. This would call for diversification. That is, the variance for (say) a single public system of social security would be higher than a combined public and private system, as long as the returns from the two systems are independent. If the returns from private and public pension plans are negatively correlated, then the overall variance will be reduced further. Perhaps this negative relationship may have held during the last decade. With high rates of inflation the public social security benefits improved because of the upward bias in the consumer price index, while the private pension benefits worsened because of the lack of indexing. Thus in real terms the returns from private and public benefits appear to have moved in opposite directions.

This relationship may be changed if the U.S. Treasury were to issue (as the British Treasury does) a fully indexed bond. This would protect the individual against inflation and put private pensions on a par with public pensions when it comes to indexing.

Clark-Quinn

Clark makes the fundamental point that the elderly are no more vulnerable to inflation than the rest of the population. The converse is a common and erroneous conclusion based on the argument that the elderly live on fixed incomes. Clark puts the problem in perspective when he says,

Real income from current assets depends on the rate of return compared with the change in prices. The elderly experience inflation effects different from others only if the makeup of their portfolios differs.

Empirical support for Clark's conclusion is found in the fact that in 1982, coming after years of double-digit inflation, the

percentage of the elderly poor was less than the percentage of the general population which were poor.

These results must be handled cautiously, because Clark depends on the consumer price index to deflate incomes. Clark recognizes that the CPI has an upward bias, though there is considerable controversy as to the magnitude of the upward bias. Not only is the CPI biased upward because it is a Laspeyre index, but it also fails to take into account the fact that the elderly receive a wide range of discounts in many restaurants, motels, movies, pharmacies, etc. In fact, one of the most important discounts is given by the tax collector, with the federal government providing for a double exemption under the personal income tax regulations. In addition, many states, such as Michigan, have a “circuit breaker” which limits the increase in property taxes.

If these discounts in favor of the elderly developed in a short period of time, they would have no effect on *changes* in the relative status of the elderly. However, if the discounts developed gradually—and this seems to be the case—they would bias the year-to-year changes in the relative status of the elderly.

The red thread running through Quinn’s presentation is that incentives to retire at age 65 are quite strong. If a worker does not retire at age 65, “social security and employer pensions impose pay cuts. . . . Many older workers respond exactly how you might expect to pay cuts—they stop working and retire.” These paycuts are not direct reductions of the paycheck. Rather, the paycuts involve a reduction in the wealth of the worker.

Quinn believes that workers’ perceptions with regard to how the social security system operates are reasonably accurate. Workers’ behavior suggests that they have calculated the benefit-cost ratio of retiring. By taking the net present value of future income streams, Quinn demonstrates that it

pays to retire. The cost is the loss of social security benefits for one year; the benefits are the increase in future benefits associated with delayed retirement. Put differently, the individual has a choice between two income streams, one that begins immediately to pay social security benefits and another which is delayed for one year. Most frequently, the former stream is preferred to the latter stream, and workers behave rationally by retiring.

Quinn notes that because the actuarial adjustment in benefits is to increase from the current 1 percent to 7 percent, beginning in 1990, for each year of delayed retirement, the disincentives for working will be significantly diminished, and later retirement should occur.

Berkowitz

Berkowitz raises in bold relief the difference between chronological age and functional age. Since functional age is more difficult to determine than chronological—even though the former is more important than the latter—there is “statistical” age discrimination when firms assume a close correlation between functional and chronological age. Firms are inclined to use chronological age as a proxy for determining functional age.

But if we discard the use of chronological age—which is definite and objective—what alternative criteria are there? Berkowitz spells out the many difficulties involved in determining functional age in workers’ compensation cases and in the disability program under social security. He notes that “. . . nothing in the disability experience provides any aid or comfort to those who allege that we should eliminate compulsory retirement and judge persons by their ability to do the job.”

Berkowitz cites experience with workers’ compensation in Florida and Michigan. The Michigan experience is par-

ticularly illuminating. In Michigan, many workers who retired from automobile plants simultaneously filed a claim for workers' compensation. Berkowitz makes it clear that no state program has a perfect solution to the workers' compensation problem.

Other problems in determining functional age are illustrated by the operation of the disability program under the social security system. For one thing, the law is written so that a worker is considered either disabled or not disabled. No allowance is made for partial disability. This problem is particularly acute in the case of disability resulting from mental illness. Diagnosis of mental disability is difficult and the worker may often appear able for an extended period of time and yet suffer severe mental problems at other times.

Berkowitz points out that we are uncertain whether the increase in mortality increases morbidity or whether increase in mortality decreases morbidity. Thus at the present time we have no firm empirical evidence regarding the link between mortality and morbidity. Finally, if we were to abolish compulsory retirement, we would need, according to Berkowitz, a better measure of functional limitation. He concludes:

. . . the argument for abolition of compulsory retirement centers around the notion that chronological age is irrelevant. The sword cuts both ways. Some older people are competent past the age of retirement and some younger people are incompetent prior to the age of retirement. Eliminating compulsory retirement means that we have to get serious about tests of performance for younger workers.

A general comment should be made in conclusion. In much of the discussion and analysis of the social security system during the seminar and at other times, it is recognized that changes in the economy will have a significant impact on

the social security system. However, it is not always recognized (or at least it is poorly recognized) that changes in the social security system's functioning will have an impact on the economy. The social security system is not *akin* to Alfred Marshall's fish market, because income effects loom large. To get some perspective on this problem of mutual causation, let us examine a fairly simple illustration.

What is the impact of an increase in social security benefits on the surplus of the social security system? To answer this question it is necessary to utilize a standard macro model. The surplus (S) is the difference between tax revenues and benefits paid out. Tax revenues are endogenous, equaling the product of the social security tax rate and the level of real national income (tY). Benefits (B) are considered to be exogenous. Thus we have,

$$S = tY - B$$

$$dS/dB = t(dY/dB) - 1$$

If there is significant unemployment, the benefit multiplier, dY/dB , might be as high as two, i.e., a one dollar increase in benefits will be associated with a two dollar increase in national income. This also signifies that the surplus in the social security system will *not* fall by one dollar for every dollar increase in benefits. Rather, assuming a tax rate of 0.10 and using the above equation, the surplus will decrease by eighty cents for a dollar increase in benefits. Thus,

$$dS/dB = .10(2) - 1 = -0.8$$

Some qualifications to this result should be noted. With the economy operating close to full employment, much of the increase in benefits will tend to crowd out other expenditures, or may be spent in price level increases rather than increases in real income. The dY/dB would then be in the neighborhood of zero and dS/dB would be equal to minus

one. At the other extreme it should be noted that it is possible to postulate a reasonable model where dS/dB is positive. By "reasonable" it is meant that the model is stable, and investment is not only a function of the interest rate, but also the income level. By the same reasoning, it may be concluded that a one dollar increase in social security taxes will not increase the surplus by one dollar, since the tax increase will tend to decrease real national income.

There are many other problems which focus upon the mutual causation of social security and the economy. For example, to take a long run problem, does a change in social security taxes change the growth rate of national income, or does it change the *level* of national income. The conclusions will vary depending upon what growth model is considered relevant. These questions, however, are topics for another seminar.

NOTE

1. Some of these issues are raised by Stuart Street, "A Looming Federal Surplus," *Wall Street Journal*, March 28, 1984, p. 23. Peter Drucker also discusses similar problems with regard to private pension funds in *The Unseen Revolution* (Harper and Row, 1976).