Transfer Payments: Welfare and Social Security Part II

The tyranny of a prince in an oligarchy is not so dangerous to the public welfare as the apathy of a citizen in a democracy.
Charles de Montesquieu

Incentives vs. Costs

- Although this new benefit calculation is an improvement, it stills offers a 67% marginal tax rate.
- If we don't impose a marginal tax rate at some point, everyone will be eligible for welfare benefits.

Incentives vs. Costs

- We must recognize a basic dilemma:
  - Low marginal tax rates encourage more work effort but make more people eligible for welfare.
  - High marginal tax rates discourage work effort but make fewer people eligible for welfare.

Incentives vs. Costs

The breakeven level of income is the income level at which welfare eligibility ceases.

$$\text{Breakeven level of income} = \frac{\text{Basic benefits}}{\text{marginal tax rate}}$$

Incentives vs. Costs

- There is a basic conflict between work incentives (low marginal tax rates) and welfare containment (smaller welfare rolls and outlays).
- Low marginal tax rates encourage work but make it hard to get completely off welfare.

Tax Elasticity of Labor Supply

The trade-off between more welfare and less work depends on how responsive people are to marginal tax rates.

Tax Elasticity of Labor Supply

The tax elasticity of labor supply is the percentage change in quantity of labor supplied by the percentage change in tax rates.

$$\text{Tax elasticity of labor supply} = \frac{\text{\% change in quantity of labor supplied}}{\text{\% change in tax rate}}$$

Tax Elasticity of Labor Supply

- If the tax elasticity of labor supply were zero, the marginal tax rate wouldn't matter– people would work for nothing.
- In reality, the tax elasticity of labor supply is more in the range of 0.2 to 0.4, so the marginal tax rates *do* affect work effort.

Time Limits

- TANF recipients must engage in some sort of employment-related activity within two years of receiving benefits.
- There is also a five-year lifetime limit on welfare eligibility.

Social Security

The Social Security program faces the same conflicts between compassion, incentives and costs.

Program Features

- The Social Security program is a mix of three separate income transfers.
  - retirement benefits
  - survivor benefits
  - disability benefits

Chart: Social Security Finances

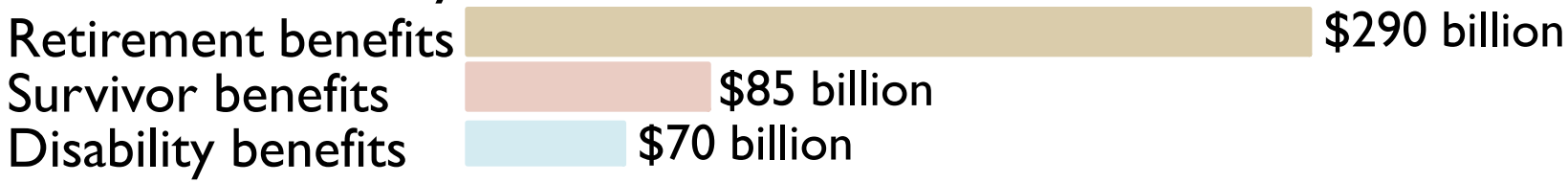
Where Tax Revenue Comes From

Payroll taxes

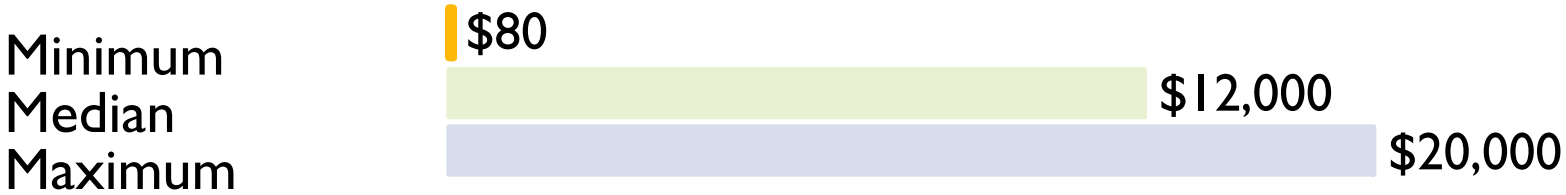
7.65% paid by workers

7.65% paid by employers

Where Transfer Payments Go



Annual Retirement Benefit



Retirement Age

- People born before 1940 can choose early retirement at age 62–64 and normal retirement at age 65-67.
- Those who choose early retirement do so with reduced benefits.

Retirement Age

- The age threshold for normal retirement is increasing each year.
- By the year 2022, the age threshold for normal retirement will be age 67.

Progressive Benefits

- Retirement benefits are based on an individual's wages.
- High-wage workers receive larger benefit checks than low-wage workers.

Progressive Benefits

- The Social Security benefits formula is progressive because the ratio of benefits to prior wages declines as wages increase.
- This declining wage-replacement rate ensures that low-wage workers receive proportionately greater benefits.

Progressive Benefits

The wage replacement rate is the percentage of base wages paid out in benefits.

The Earnings Test

The government imposes an earnings test to determine how much retirement benefits an older person can collect while still working.

$$\text{Benefit Amount} = \text{Maximum Award} - 0.5\left(\text{excess wages in ceiling}\right)$$

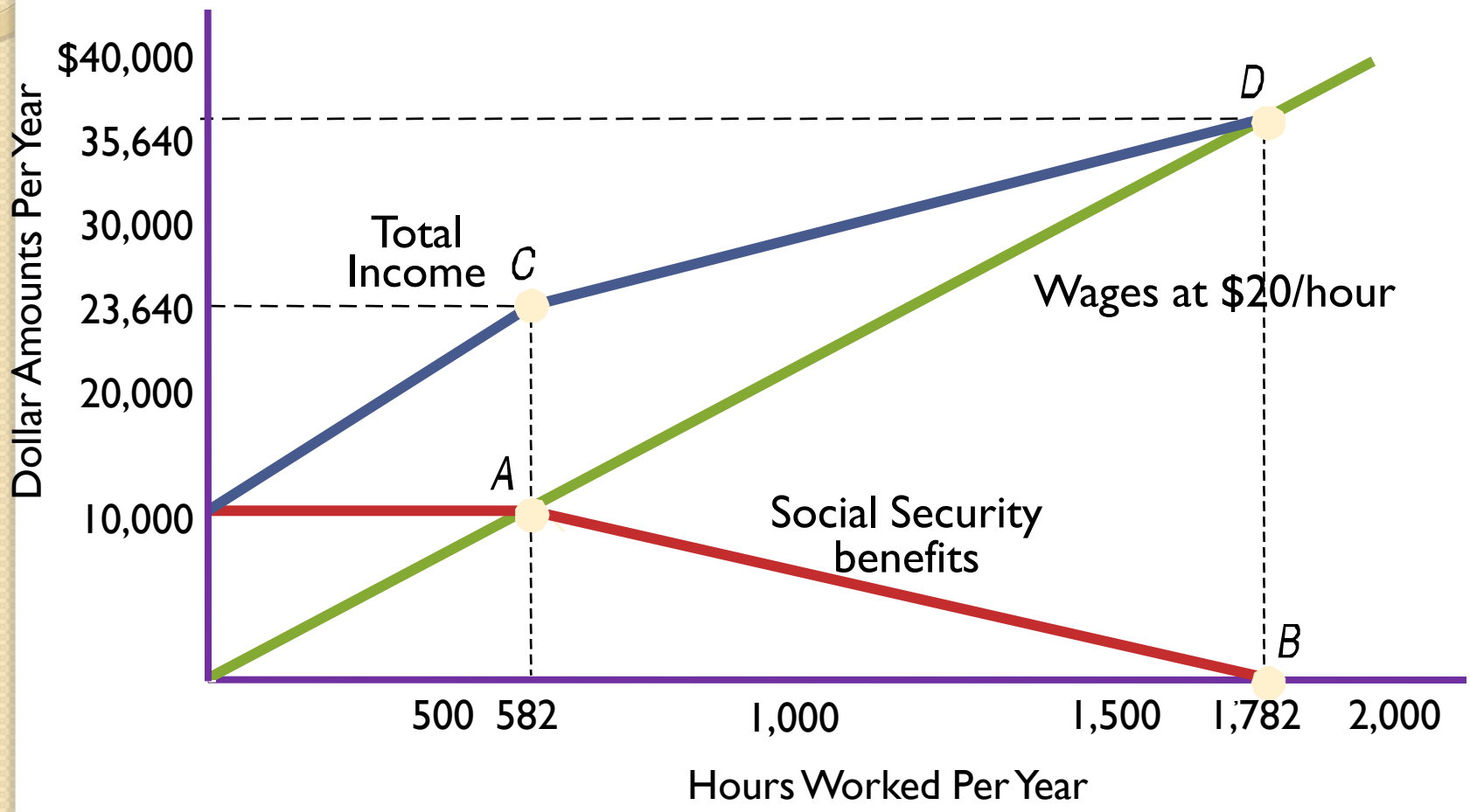
The Work Disincentive

- In 2004, a person could earn up $11,640 and get maximum retirement benefits.
- Earning over $11,640 results in a 50 cent reduction in benefits for each dollar earned.

The Work Disincentive

This 50% marginal tax rate creates a large disincentive for Social Security recipients to work.

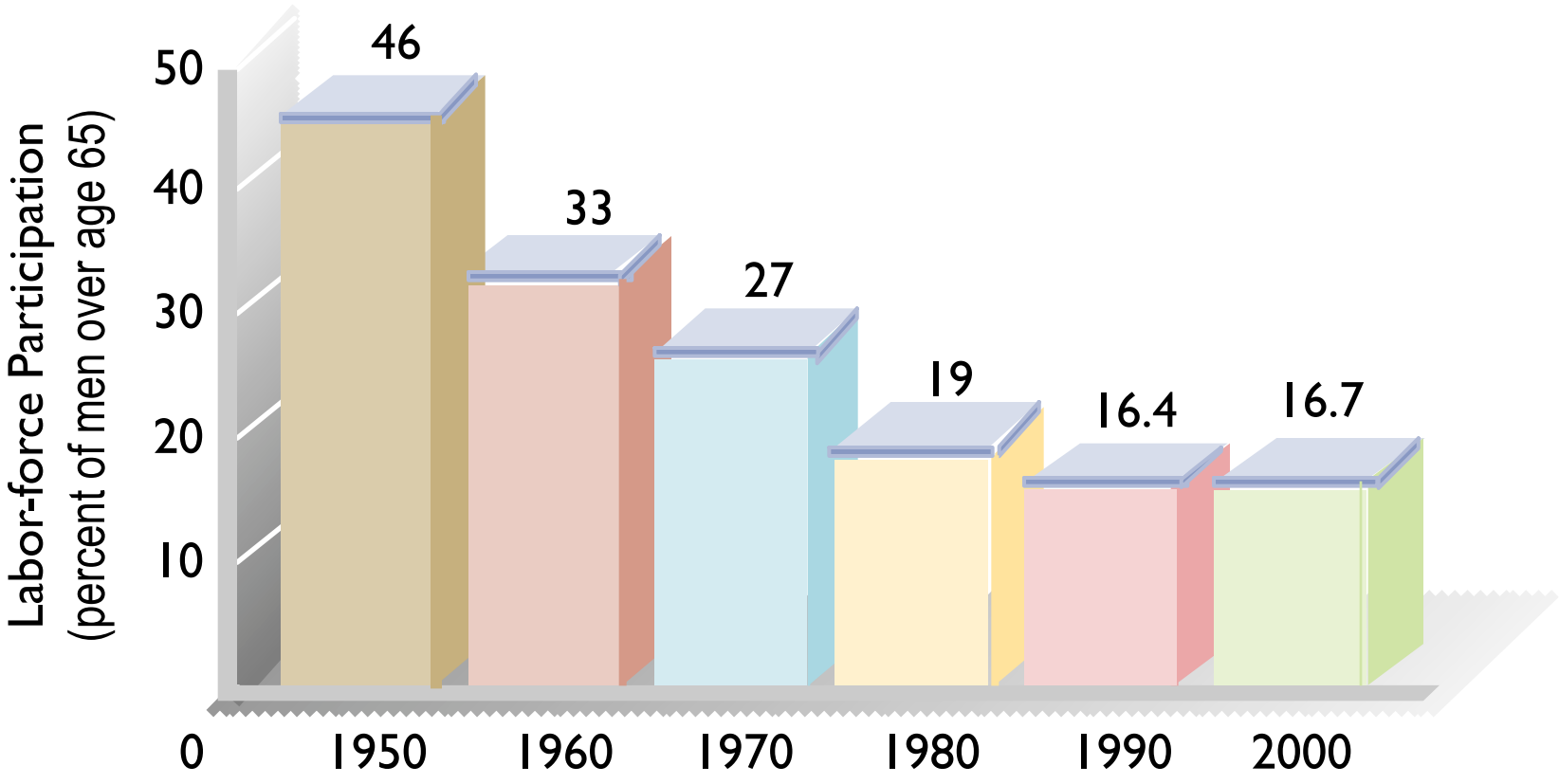
Chart: Social Security Work Test



Declining Labor Supply

- The labor force participation rate for the over-65 has declined dramatically in the US since the 1950s.
  - Labor-force participation rate - a measure of the percentage of the population that is either employed or actively seeking a job

Chart: Declining Labor-Force Participation Rate



Compassion, Incentives, and Cost

- The primary economic cost of the Social Security program isn't the benefits it pays, but the reduction in total output that occurs when workers retire early.
- The economic cost of Social Security is increased further by a labor supply reduction among *younger* workers.

Compassion, Incentives, and Cost

As the behavior of both older and younger workers changes, the economic pie shrinks as we try to redistribute it from younger to older workers.

Trade-Offs

Like any other program, the social security program faces trade-offs between work incentives, budgetary costs and equity.

Privatize Social Security?

Private retirement programs are advanced-funded while Social Security is a pay-as-you-go program.

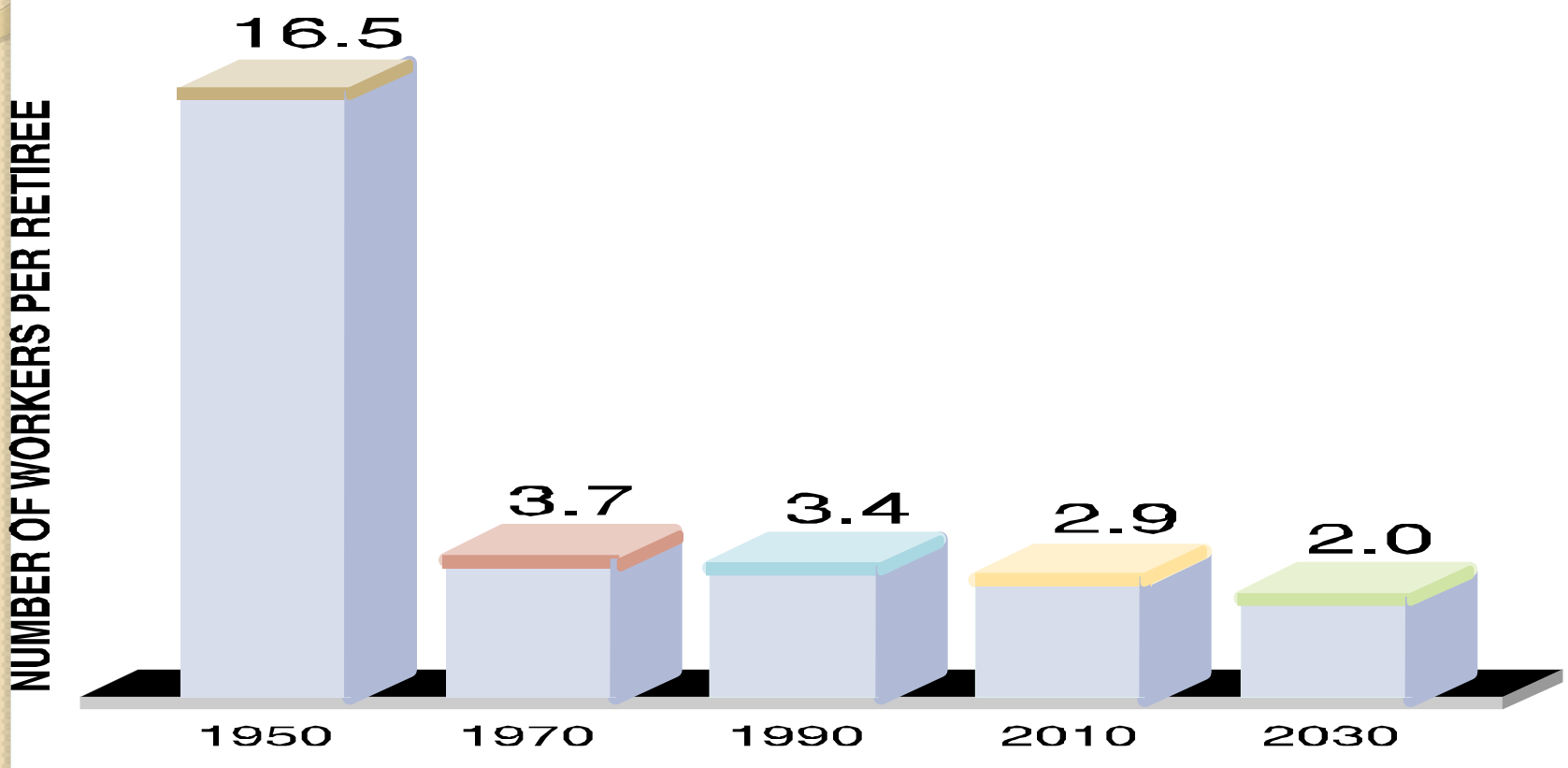
Privatize Social Security?

- Many people believe the Social Security system should be privatized.
- Instead of paying payroll taxes to fund someone else's benefits, you'd make a contribution to your own pension fund.

Privatize Social Security?

- The case for privatization is based on both efficiency and equity:
  - Individuals would determine their own saving/consumption choices and eliminate work disincentives.
  - The existing program is unfair to younger workers.

Chart: A Declining Tax Base



Privatize Social Security?

- Privatization would foster inequities:
  - Low-income workers and other people who saved little while working would end up poor in their golden years.
  - Even in a privatized system, some high earners and savers might end up poor if their investments turned sour.

THE END