ECO 450G Notes
Fall 2006 Semester
University of Kentucky


Chapter 13 – Social Insurance Programs

## I. Social Security
## II. Medicare
## III. Unemployment Insurance
## IV. Child Support

### I. Social Security

Social Security provides retirement income to the elderly, as well as survivors insurance and disability insurance. More than 50 million individuals receive $500 billion in annual payments.

*Three programs*

- Old Age Assistance - Created in 1935, retirement income to elderly.
- Survivors Insurance - Created in 1939, payments of benefits to survivors and dependents of workers who died.
- Disability Insurance - Created in 1956, payments to disabled.

*Taxes and benefits*

The programs are financed by a payroll tax on workers and employers. Each pays 7.65% of payroll, up to a cap, which will be $97,500 in 2007. After the cap, a tax of 1.45% is paid on both sides (for Medicare). See Table 13.1.

- The *statutory and economic* incidence of the tax are likely different, meaning the worker "pays" the employer-side of the tax in the form of lower wages.
- In one sense, the payroll tax is regressive – richer individuals do not pay more taxes than somewhat poorer individuals. On the other hand, Social Security is a program with a *tax-benefit linkage* – meaning that taxes paid translate into benefit levels. Schiller notes that the benefit formula itself is progressive, which should be accounted for in making judgements about the regressivity of Social Security.

Benefits are based on a number of factors, like the age at which you retire. If you retire "early" and choose to collect benefits, your monthly amount is scaled down. If you retire "late," your benefit would be scaled up. The "normal" retirement age is being phased up from 65 to 67.

The benefit formula "replaces" 90% of averaged indexed monthly earnings at low levels, then 32%, and then 15%. There is a cap on payment levels – which reflects the cap on tax payments on earnings. Real benefit levels increased in the 1960s and 1970s.

*Poverty impact*
Table 13.2 shows median benefit levels by income group. Schiller notes that "Although the Social Security benefit formula is progressive, it clearly doesn't equalize retirement benefits."

- Progressive doesn't mean equal incomes.
- The table shows median Social Security benefits. Several things stand out. First, the table includes the population aged 55 and over. Although this group includes the elderly, many will not yet be on Social Security. It could be the case that the younger households in this group are working more and not collecting Social Security, which could drag down the median benefit level.
- It would be better to focus on those aged 62-plus or 65-plus, or better yet, Social Security recipients.

Figure 13.1 shows that a large share of total incomes comes from Social Security, especially as one ages. Assuming *no behavioral response*, nearly 12 million individuals are kept out of poverty due to these payments (Table 13.3). Of course, labor supply, living arrangement and savings are all affected by Social Security rules.

*Reforms*

Surprisingly, the biggest issue confronting Social Security (and Medicare) is virtually ignored by Schiller. Both programs face large fiscal imbalances in the future. For example, the fiscal imbalance in Social Security over the next 75 years is *$3.7 trillion*.

As such, Schiller's discussions about more progressivity (e.g., higher benefits for lower wage workers) is truly irrelevant. The discussion about means-testing benefits for older workers is relevant, but as he correctly notes, means-testing reduces the tax-benefit linkage and undermines political support for the program.

The work incentives discussion is wrong. Or a person can work in their sixties, take up benefits, but rather than them being "taxed away" as Schiller represents, the money is credited later. See Gruber and Orzag, http://econ-www.mit.edu/faculty/download_pdf.php?id=110 , who state on page 2 about the retirement earnings test:

> "But many appear unaware that this reduction triggers an increase in subsequent benefits. The increase is based on an actuarial adjustment and is intended to ensure that, on average, the subsequent benefit increase roughly offsets the benefit reduction."

The privatization debate is an interesting one that was much discussed after the 2004 election, but appears to have little chance of succeeding.

## II. Medicare

Medicare provides mandatory hospital insurance (although it doesn't cover long-term nursing homes), as well as supplemental medical insurance (for physicians) that almost all elderly take up. More recently, it also provides a highly-taxpayer-subsidized prescription drug benefit.

Medicare is expensive, and as Schiller notes, if it were counted as income, would be worth around $5,000 per year per elderly person (which would remove many elderly from poverty).

As with Social Security, Medicare has a severe financing problem because of its pay-as-you-go nature, where most of the program is financed by current workers supporting current retirees. With slowing population growth and wage growth (and rapidly rising medical inflation), severe fiscal problems lie ahead.

## III. Unemployment Insurance

UI and worker's compensation are major programs for workers (see Table 13.4). Workers are eligible for UI if (a) they have a work history, (b) are seeking work, (c) have lost their jobs through no fault of their own (e.g., no quits or firings).

UI benefits are taxed (WC benefits are not), and the after-tax "replacement rate" (e.g. current benefits divided by previous earnings) are around 50%. There is a great deal of inter-state variation in weekly benefit levels, although the *duration* of benefits is often set at 26 weeks.

UI has less impact on poverty than some other programs, in part because spells are short (and some are in "predicable" industries like construction).

## IV. Child Support

During the 1970s, 1980, and moving forward, child support enforcement has become more vigilant. In part this is in response to trends in family structure – such as the fact that nearly 30% of children currently live in single parent households – and due to the view that absent parents (rather than the government) should be responsible for the financial well-being of their children.

Table 13.6 shows percentages of *poor* mother that are entitled to, and collecting, child support. One surprising thing seems to be that *half* are not *entitled* to support. This is likely because those mother have not actively tried to get a court-order getting child support. Why?

- Perhaps the father is a low-earner so it isn't worth the time.
- Perhaps the father is violent, so collecting support isn't worth the risk.
- Perhaps the mother and father might get back together, and such legal battles would undermine that goal.
- Incentives from the welfare system – after the first $50 per month, cash welfare taxes child support payments at 100%. If this is the case, the mother

very well may prefer the father to not pay (at least through formal mechanisms).

The average amount collected is fairly small for poor mothers, but that is in part mechanically due to having “poor” in there. If a mother was collecting $35,000 from the absent father for child support, she wouldn’t be a poor mother! Hence, Schiller’s discussion on page 250 – “Yet, even if full payment had been made on those awards, only 200,000 of those families – one out of nine – would have had incomes above the poverty threshold. Hence, child-support enforcement is a fairly ineffective mechanism for reducing poverty.”

- A more convincing analysis would look at total cash income *excluding* child support awards.