

LECTURE VII

Social Security

What is Social Security?

- A government program that taxes workers to provide income support to the elderly.
- Social Security is currently the largest program of most EU governments.

- “Social benefits” are expenditures made for the functions listed above. In other words, this refers to the money spent by the state directly received by the beneficiaries (families, retirees, unemployed people, etc.).
- In contrast, “social protection” refers to the total revenues and expenditures for social security in EU member nations. It consists of social benefits as well as administrative costs and other expenditures, and is basically funded by contributions from employees, employers and the state.

The share of old-age pension payments in total social security expenditures clearly mirror this trend: In 2012, almost half (46.24 percent) of social expenditures in the 28 EU member states fell to old age provision and surviving dependant pensions. The share for old age alone amounted to around 40.62 percent. Latvia has the highest share in old age pensions (54.55 percent), closely followed by Italy (52.68 percent), Romania (49.41 percent) and Poland (49.19 percent). Ireland (20.58 percent) spends by far the smallest amount on its pensioners. In 2012, EU-wide per capita expenditure amounted to an average €3,027.

- Despite the differences in their pension structures, the EU member states face one and the same challenge: to provide people in an increasingly ageing society with a reliable level of social security when they retire from working life. This is a difficult task given the demographic change seen across the EU, which results in fewer insured paying contributions into the system and growing numbers of ageing pensioners.

Social Security Systems

- **Funded:** Refers to retirement plans in which today's savings are invested in various assets in order to pay future benefits.
- **Unfunded:** Refers to retirement plans in which payments collected from today's workers go directly to today's retirees, instead of being invested in order to pay future benefits.
- In practice, most countries have a social security system that is a combination of the above two systems.

- **Legacy debt:** The debt incurred by the government because early generations of beneficiaries received much more in benefits than they paid in taxes.

Rationales for Social Security

- The fundamental motivation for Social Security is the notion that the elderly will not have sufficient income to support themselves in retirement or to support their dependents when they die. As a result, the government needs to force workers to provide for their retirement years by paying taxes when working that entitle them to benefits when retired.
- Failures in annuities markets (adverse selection, paternalism)
- Social security and private savings crowding out.
- Social security and elderly poverty rate

Social security and retirement

- Moral hazard problem
- Social security has a big effect on retirement

Social security reform (demographic problem)

- Incremental reforms:
 - (i) raise taxes further
 - (ii) extend the base of taxable wages
 - (iii) raise the retirement age
 - (iv) lower benefits
 - (v) reduce benefits for higher income groups

- Fundamental Reforms:

- (i) Invest the trust fund in stocks

- (ii) Privatization (private funds)

- (iii) Mixed plans (social security, professional or company funds, private funds)