POSTED: Jan 30, 2013

IN SEARCH OF RETIREMENT SECURITY

THE CHANGING MIX OF SOCIAL INSURANCE, EMPLOYEE BENEFITS, AND INDIVIDUAL RESPONSIBILITY

EDITED BY
Teresa Ghilarducci, Van Doorn Ooms,
John L. Palmer, and Catherine Hill

A CENTURY FOUNDATION BOOK
COSPONSORED BY THE
NATIONAL ACADEMY OF SOCIAL INSURANCE

The Century Foundation Press • New York
2004

SOCIAL SECURITY AND THE PRIVATE PENSION SYSTEM

John H. Langbein

This paper examines the policy justifications for Social Security from the perspective of the private pension system. Contrasting Social Security with the private system reveals much about the nature of the public program.

WHAT SOCIAL SECURITY DOES

The distinctive trait of the Social Security system is that it is compulsory. Government power is used to compel workers and employers to contribute. Failure to comply can result in jail time. Social Security entails, therefore, serious infringement of personal liberty. Whenever government interferes with anybody's liberty in a free society, it must be clear about the reasons why; there needs to be justification.

There are two fundamental reasons for the coercion of Social Security: one is paternalistic, the other is redistributive. The paternalistic impulse responds to the simple reality that, without government coercion, large numbers of people will fail to make adequate provision for themselves. Indeed, this was exactly the circumstance in which the Social Security system was born in the 1930s, when the depression left so many elderly people destitute. Even though life expectancies were shorter then and the need for retirement income correspondingly less, not enough people had displayed the foresight and discipline to save adequately for retirement.

The existing private pension system, which promotes personal saving for retirement, has many virtues, but it is a flop when it comes to securing retirement income for those who are least likely to provide for themselves. The private system embraces both traditional defined

benefit plans and a range of defined contribution plans or individual account plans: 401(k)s, 403(b)s, 457(b)s, IRAs, profit-sharing plans, and so forth. Although these private plans have assets presently valued at slightly less than $11 trillion, most of that wealth will be delivered to persons in the upper half of the workforce, as measured by income. For the lower half, Social Security will be the only significant source of retirement income.

Social Security can be understood as the successor to a much older "system" of old-age provision, rooted in the family. We all are quite familiar with the process of wealth transfer within the family, from parents to children. Those in the college-tuition-paying phase of life are particularly sensitive to this process. Of old, however, there also was a pattern of reverse wealth transfer, from children to parents, when parents outlived their productive years. Most workers did not live very long after leaving the workforce—they pretty much died with their boots on, so to speak. But when workers (more often their widows) outlived their employment income and had not saved adequately for retirement, they relied upon their children for support. That pattern continues today in less developed countries, where the family is the de facto social security system. Such countries commonly have very high birthrates, at least in part because parents want to have enough children to support them in old age.

The Social Security system effectively superseded this reverse transfer system by collectivizing it and making it mandatory. Government has appropriated the function from the family. Government now taxes the generation of the children to fund transfer payments to the generation of the parents. Intrafamilial wealth transfer now plays virtually no role in the retirement income of the elderly.

This collectivization has many advantages. Because the old system of reverse wealth transfer was limited to the family, persons who were childless, or whose children did not survive, or whose children were unable or unwilling to support them, could be left destitute. By making Social Security mandatory, the government harnessed the earning power of substantially the entire workforce to support the core retirement income needs of the nation's elderly. This attribute of Social Security, universal coverage, is why the program is understood as social insurance. Social Security funds a risk pool that covers persons who, in the days when old-age support was family-based, would not have had assistance. Social Security also has facilitated the growth

of our ever more mobile national labor market, freeing workers to locate at great remove from their elderly parents.

The redistributive character of Social Security is closely related to its mandatory nature. Social Security is bottom weighted, meaning that benefit levels as a fraction of earnings are greater for lower-income workers than for higher earners. Social Security benefit levels have largely eliminated poverty among the elderly: at present the poverty rate among the current retiree population at age 67 is only 8 percent. That is a stunning achievement, an important source of American political stability and social peace.

WHAT PRIVATE PENSIONS DO

Proposals to extend individual accounts from the private pension environment into Social Security should provoke concern. The private pension system serves fundamentally different purposes, which would make it difficult to introduce the principles of private retirement provision into Social Security.

In contrast to Social Security's redistributive dynamic, the private system is top weighted; it is skewed to the affluent because its central mechanism is deferral and abatement of income taxes. Three great tax breaks drive the private system. First, taxation of contributions is deferred. The employee does not pay current taxes on sums contributed to his or her pension account, even though these sums are functionally compensation. Rather, the tax bill is deferred for decades, until the worker enters the distribution phase, theoretically in retirement.

Second and even more important is the deferral of income taxes on the investment activity in the account, the so-called buildup. In effect, the pension plan or account receives an interest-free loan from the government in the amount of the deferred taxes on the investment gains. These "borrowed" proceeds compound tax deferred until distribution. This enormous tax benefit is the single most costly subsidy in the entire tax expenditure budget.

The third pension tax break is that when distribution commences upon retirement, the retiree may be in a lower tax bracket than when he or she was employed. The replacement ratio needed to maintain preretirement living standards is usually reckoned at around 70 percent of preretirement income. There are various reasons why: retirees do not pay Social Security and other employment taxes on pension

income; they often own their homes free of mortgage; they do not have child-rearing and household-formation expenses; they have a larger personal exemption from the income tax; and much of their health care is publicly provided.

These three pension tax breaks—deferral on contributions, deferral on investment gains, and rate reduction upon distribution—drive the private system. The deep reason why the private system matters so little for the bottom half of the workforce is that those workers have such limited exposure to the income tax. Earners in the bottom half pay Social Security taxes and other employment taxes, and they pay sales and excise taxes, all of which are first-dollar taxes not adjusted to income levels, but they earn so little that the income tax touches them only barely or not at all.

A great maxim would be, "Paupers do not need tax shelters." Therein lies the explanation for why the private pension system as we know it provides virtually no benefits to the poorer half of the workforce.

The private pension system is only incidentally about retirement income. To be sure, private pension plans do and will deliver retirement income to many participants, but in its larger dimension the system is best understood as part of a group of tax shelters that are designed to abate the progressivity of the income tax for the affluent. These shelters include the home mortgage deduction, the exclusion of capital gains on residential housing, the exclusion of employer-paid health insurance, and the favorable treatment of many forms of investment income, including the capital gains rate, forgiveness of capital gains taxation on assets held until death (the so-called stepped-up basis), the exclusion of interest on state and local bonds, and now the lower rate on dividend income.

The net effect of these middle- and upper-middle-class tax shelters is to give the pretense of a moderately progressive tax system but the reality of a flat tax. We Americans do not admit to a flat tax, but in fact most taxpayers pay about a quarter of their income. The status quo serves various interests. It lets politicians on the left brag about having imposed progressive income taxes, and it allows a variety of service providers—lawyers, accountants, actuaries, investment professionals—to enjoy fine incomes from arranging for the affluent to escape much of the bite of these taxes.

This paper spoke earlier of Social Security as the successor to an older pattern of intrafamilial wealth transfer from children to parents.

In this regard, the private pension system offers another striking contrast. More and more of the wealth that is channeled through private pension accounts is being accumulated not for the purpose of providing retirement income but for discretionary savings and for intergenerational wealth transfer to children and grandchildren. The use of pension accounts as tax-favored savings, investment, and wealth transmission devices is possible only in the defined contribution system, in which the participant builds an individual account, whose unexpended proceeds can be accessed for nonretirement purposes or left to transferees. In a 401(k) or 403(b) plan or an IRA, the participant can cash out in whole or in part at any time (free of penalty after age fifty-nine and a half). If the participant or spouse leaves unexpended proceeds at death, the minimum distribution rules allow heirs or other transferees to perpetuate the tax shelter for many years as they draw down the account. These attributes of individual account plans have been a major attraction in the notable shift from defined benefit to defined contribution plans that has been going on in the private system over the past two decades. Defined benefit plans typically pay retirement income only, and only for the participant and spouse. If they die early, the shortening of the payment obligation benefits the plan sponsor, not their heirs.

The very term "pension plan" is increasingly a misnomer for defined contribution plans. They are in truth multipurpose savings, investment, and wealth transmission vehicles for the tax-sensitive classes.

SUMMARY

The differences in purpose between Social Security and the private system, especially the individual account plans that are now so prevalent, are profound. Whereas Social Security is compulsory and redistributive, participation in the private system is largely voluntary and wholly devoid of any redistributive component. Whereas Social Security is bottom weighted, favoring those less well-off, the private system is top weighted, delivering most of its benefit in the form of tax advantages attractive only to upper-bracket taxpayers. In view of these stark functional differences, the likelihood that the private system could be a model for the reform of Social Security seems remote.