



Fiscal Policy and Social Security:
Lessons from Economic Research

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- Counter-cyclical discretionary fiscal policy
- Long-run effects of deficits
- Impact of pay-as-you-go retirement programs

Counter-cyclical discretionary fiscal policy: three strategies

- GOVERNMENT PURCHASES
- INCENT CONSUMPTION, INVESTMENT
- Temporary expensing or ITC (JCWA Act, adopted March 9, 2002)
- Sales-tax holiday
- BOOST DISPOSABLE INCOME TO INCREASE CONSUMPTION
- Tax cuts
- Transfer payments

General difficulties

- Recognition, implementation lags
- Slope of aggregate-supply curve - does boosting aggregate demand raise output or prices?

Lessons about second strategy

- Powerful effect during incentive period
- “Payback” before anticipated temporary incentive
- “Payback” after unanticipated temporary incentive
- Greatest impact at end of incentive period
- See Lucas (CarnRoch Conf Series, 1976), Cohen, Hansen, and Hassett (NTJ, Sept. 2002)

Lessons about third strategy

- PERMANENT INCOME HYPOTHESIS
- Temporary boost to disposable income may do little to boost consumption (EGTRRA rebates)
- But, some consumers may follow “rule-of-thumb” - Campbell and Mankiw (NBER Macro Annual, 1989; J Bus Econ Stat, 1990; Eur Econ Rev, 1991)

Long-term effects of deficits

- RICARDIAN EQUIVALENCE
- Barro (J Pol Econ, 1974)
- Even sustained deficits may have no real effects if generations altruistically linked
- Without altruistic linkage, may be real effects from intergenerational redistribution

Intergenerational redistribution

- Conventional deficit measure may be uninformative or misleading
- Need to use generational accounting
- Size of pay-as-you-go retirement systems may be more important than deficits
- See Kotlikoff, *Generational Accounting* (1992)

Constructing simple example of pay-as-you-go system

- Two-period OLG model
- National labor income triples each period
- Pretax payoff to capital per period is principal plus 400 percent return
- Viard, forthcoming Federal Reserve Bank of Dallas *Economic and Financial Policy Review*, 1(4), 2002,
<http://www.dallasfedreview.org/>

Example of pay-as-you-go system

	Gen. 0	Gen. 1	Gen. 2	Gen. 3
Period 1	+1000	-1000		
Period 2		+3000	-3000	
Period 3			+9000	-9000
Net PDV	+1000	-400	-1200	-3600

Pay-as-you-go retirement systems

- No impact on measured deficit (for pure pay-as-you-go system)
- Early participants receive start-up bonus
- Later participants receive return equal to growth rate of national labor income, below-market
- Unfunded liability
- Zero-present-value result, no inefficiency
- Value judgement

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Abolishing mature pay-as-you-go system

- Transition cost to retire unfunded liability
- Removes burdens on future generations
- Zero-present-value result, no efficiency gain
- Easing the transition
- Value judgement

Prefunded retirement systems

- Likely to replace pay-as-you-go system
- Maintain some or all social protections provided by pay-as-you-go system
- Contributions invested at market rates
- No unfunded liability

Doesn't change intergenerational trade-off

- Transition cost still exists
- Future generations still gain - no unfunded liability, due to market returns
- Cost and gains arise from abolition of pay-as-you-go system, not creation of prefunded system

Privatized and public systems

- Privatized prefunded system - each worker owns contributions
- Public prefunded system - government owns workers' contributions
- Public system may offer more social protections, may create more economic distortions

Privatized and public systems (continued)

- Privatized system may be more politically sustainable - temptation for asset diversion in public system
- Privatized system may avoid political interference in portfolio decisions
- Institutional safeguards may address these concerns
- Public system may have lower administrative costs

Setting record straight on privatization

- Doesn't raise returns without transition cost - if cost not paid, system still pay-as-you-go
- Doesn't change intergenerational trade-off
- Doesn't avoid (and isn't alternative to) tax increases or spending cuts

Conclusion

- Lessons from economic research have (sometimes) shaped counter-cyclical fiscal policy
- Long-term effects of conventionally measured deficits still over-emphasized relative to effects of pay-as-you-go systems
- Effects of Social Security prefunding and privatization not always well understood