

Economics

Department Alumni Newsletter

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New beginnings

We're in. Sunlight, *real* sunlight, streams across my desk while two plants, *real* plants, perch on my windowsill expecting to be watered. Spring breezes drift through my office, brushing occasional orphaned leaves against the window panes. Glancing up, Sutton's bell tower rises above oak trees tinged by the pink tips of pubescent buds. Windows are nice.

Not *only* windows. Bright new air-conditioned classrooms, complete with carpets, *padded* seats, and the latest technological gizmos to await our pearls of wisdom on a daily basis. We hold meetings in our *new* department library and pore over exchange rate data while lounging on our *new* matching sofas. For those concerned about physical fitness, the fifty stairs we climb to our penthouse suite are as effective as an in-house health spa. And, for the aerobically-challenged, an elevator is available.

And colors. Colors everywhere. Institutional off-white has given way to a rich array of earth tones. Offices and hallways are adorned with a warm palette of deep blues, copper browns and cactus yellows, with scattered accents of musky rose and dusty mauve. Oooooooh.

Of course, a few wrinkles remain. We're beset by a stream of workers flowing in and out, frantically trying to check those final items off their punch lists. Office temperatures oscillate between 65 to 90 degrees, and residual fumes from assorted adhesives, paints, chemical cleansers still haunt the hallways. But, it's a small price to pay. Morale is up. We come early; we stay late. We smile; we laugh. Some of us even suspect our hairlines are regenerating. *Life is good.*

Our old digs in Keith Hall? Gone the way of all flesh. Workers began gutting and stripping within a week to prepare the site for new School of Continuing Education offices. Walls were razed -- the Continuing Ed staff will have offices twice the size of ours -- and, get this, they're knocking holes in walls to install windows. Yes, windows! We spend twenty-seven years in the land of fluorescence and the new tenants fall into double-sized offices with natural light.

What do you think?

Veteran readers may notice a slight shift in content. Past editions delivered *short* articles; ones easily digested over an evening snack of cheese doodles and ice cream. This time you'll find a six-page (yes, count 'em) article on Social Security. A *heavy* read. But, it's a heavy subject; possibly the most thorny economic issue your generation will face. Is it too much?

A shorter article on out-of-wedlock births provides balance, but may prove contentious. I dismiss values and morality as irrelevant; I reduce the issue to amoral costs and benefits. Does my treatment

ignore important aspects of the controversy? Of course. Will it prompt you to think; to reconsider your opinions? *Maybe*. Replies and unsolicited articles are always welcome!

Bob Stonebraker, editor

Cinematic Sense

Life is filled with unexpected pleasures. I admit to a long-standing weakness for actress Kim Basinger's blonde curls, curves and pouty mouth. While leisurely clicking through the local cable channels last month, a glimpse of Ms. Basinger in a provocative pose caught my eye. I had stumbled upon a re-run of *My Stepmother is an Alien*, a modern classic in which Ms. Basinger portrays an alien sent to seduce a young earth scientist (played by Dan Ackyrod) who inadvertently holds the key to her home planet's survival.

After Ackyrod discovers the inter-galactic origin of his new love, he tries to learn more about her race. After explaining America's love of the beach, he asks Ms. Basinger, "What do you people do on vacation." She excitedly answers, "*Math*." "No, no," Ackyrod replies. "I mean, what do you do for *fun*?" "Oh," smiles Ms. Basinger, "*graphs!*"

Less discerning individuals might think Ms. Basinger was attempting humor. But, we economists know truth when we hear it.

Moral Decay

In 1960, fewer than one out ten births were to single mothers. By the early 1990's that number had rocketed to over 30 percent of all births. Among women under twenty years of age, 70 percent of all births are to single mothers. Yikes.

Should we care? Does it matter? *Yes!* A considerable body of evidence indicates that children born out of wedlock are more apt to suffer from a variety of ills. Out-of-wedlock birth seems to increase a child's propensity for ill health, for poverty, for criminal activity, for being a school drop-out, for being a welfare recipient, and for being a single parent him/herself. In short, out-of-wedlock births often create spillover costs for both society and for the children themselves.

What's causing this trend? The demagoguery of the day blames moral decay. The conservative *Wall Street Journal* recently dubbed the out-of-wedlock birth rate as the most accurate indicator of our nation's moral decay. (*Just ahead of high tax rates, no doubt.*) But, such explanations don't wash with economists. Moral decay, if it has occurred, is a symptom, not a cause. Economists assume people have *always* pursued self-interest. If people's behavioral patterns shift, there must be some underlying shift in costs and benefits that caused such a shift. Morals don't spontaneously combust.

Besides, the rise in out-of-wedlock births is not confined to Americans. It is a broad trend that has occurred across countries, across classes, across ages, and across religious and ethnic groups. While out-of-wedlock birth rates in some countries -- notably Japan -- are lower than ours, the rates in others are higher. For example, almost 50 percent of births in Sweden are out-of-wedlock while rates in Canada and Great Britain mirror our own. Moral decay furnishes great sound bites for the media, but is scientifically empty.

Possible causes

How about *welfare*? Can we pin the blame for out-of-wedlock births on handouts to the poor? The argument is plausible. Welfare payments *do* make it easier for unmarried women to support themselves and their children without marriage. But, the data do not cooperate. If welfare is the culprit we would expect changes in out-of-wedlock birth rates to mimic changes in the real value of welfare payments. They don't. The real value of welfare payments has been falling steadily since 1975; the same period in which out-of-wedlock birth rates have soared. More surprisingly, the greatest *rate* of increase in out-of-wedlock births has occurred among relatively affluent women, not among welfare recipients.

Interestingly, the increase in out-of-wedlock births is apparently *not* the result of increased births. The change is in marriage patterns, not fertility patterns. When single women found themselves pregnant in the past, they typically demanded -- and got -- a *shotgun wedding*. No more. Shotgun marriage rates for both whites and blacks have fallen quickly over the last three decades. According to economists George Akerlof, Janet Yellen and Michael Katz (AYK), nearly 2/3 of the increase in out-of-wedlock births are attributable to this decrease in shotgun marriages.

Why? One explanation is changing job opportunities for women. As the economy shifts from "muscle-power" to "brain-power" occupations, women have found more lucrative employment opportunities. With the ability to earn high wages and salaries themselves, women are less dependent upon men. They can afford to raise children without a husband. Similarly, knowing that their monetary contributions are less crucial, men are more apt to duck their responsibilities and skip out.

Although changing employment roles are a likely factor, AYK identify a different culprit: *technology*. Indeed, they finger contraception and abortion -- the very technologies that many hoped would *lower* the rates of out-of-wedlock births.

How can this be? How can technology designed to decrease the incidence of unwanted pregnancies and births paradoxically lead to more? In a word...*competition*. The ready availability of contraception and abortion transformed the competitive nature of the market for sex.

Competition and sex

Prior to the 1960's, most women refused to engage in pre-marital sex without a promise, explicit or implicit, of marriage in the event of pregnancy. With women presenting a united front, men were willing to make and hold to such promises of marriage; they had few competitive alternatives. Shotgun weddings were expected and were common.

Easily-available contraception and abortions on demand dramatically altered this process. With new technology to lessen the threat of unwanted children, the cost of pre-marital sex to women fell rapidly. Aha. When costs drop, prices should follow suit. And they did. Without the threat of unwanted children, many women no longer demanded promises of marriage in the event of pregnancy. In essence, they lowered the price charged to men for pre-marital sex. Not surprisingly, when the price went down, the quantity demanded by men went up.

What of those women who tried to cling to the earlier technology; those who wanted marriage and/or who opposed contraception or abortion? Just what an economist would predict in a competitive market -- they were undersold and driven out of business. Yes; they lost their bargaining power. With pre-marital sex readily available elsewhere, they could no longer extract promises of marriage in the event of pregnancy. Many responded exactly as any other competitor trying to protect market share; they lowered their prices to compete. When unplanned pregnancies did occur, they absorbed the loss. They bore children out of wedlock.

Men's reactions reinforced the trend. Many reasoned that they were not to blame for unwanted births. After all, the women had access to contraceptives and to abortions. If women *choose* not to avail themselves of contraceptives or abortions, they should bear the consequences of that choice. Many men felt absolved of guilt; absolved of responsibility. When pregnancies occurred, they walked away.

Of course, once a dam begins to leak, floods aren't far behind. As out-of-wedlock births began to increase, the social stigma associated with them started to ease. But, as the stigma eased, so did the cost to women of bearing children out of wedlock. Lower costs meant more such births, which meant less stigma, which meant more such births, *etcetera*.

What now? Should we roll back the technology? Probably not. The technology *has* increased choices and options for millions of men and women. At this point, denying access to it would probably increase the number of unwanted births significantly. Cuts in welfare benefits are not likely to have much impact either. Despite their political pizzazz, such cuts will do little other than to further impoverish the recipients.

A more appropriate policy would reverse the competitive position of men and women in the market for sex. If the new technology disadvantaged "women of virtue," policies which disadvantage men could restore balance in the market. For example, heavy taxes on men for fathering children and/or aggressive child-support programs might alter the terms of trade.

Any other ideas? Scarlet letters?

Social Security:

Apocalypse Soon?

*Will you still need me, will you still feed me,
When I'm sixty-four?
Beatles, 1967*

Social Security is back in the news. A recent report issued by President Clinton's bipartisan Advisory Committee on Social Security sparked the type of media madness normally reserved for sex scandals and airplane disasters. "Expert" analyses blanketed the news like dandelions in June. That few journalists had either read or understood the two-volume, 752-page report seemed of little consequence.

To economists, the issues are old hat. As proof, parts of this commentary appeared *verbatim* in a similar article in this newsletter seven years ago (*issue #12 for those of you who want to check your archive collections*). The names have changed, but the issues have not.

Social Security has always stirred intense passions. Although billed as old age "insurance" when signed into law in 1935, it has never been run as such. Instead of salting payments away in individual accounts to be repaid at retirement, the program has been financed on a *pay-as-you-go* basis. Payments from current workers are immediately recycled as benefit checks to retirees.

Moreover, benefits received have never been based on payments in any meaningful way. Congress has used the system to generate massive redistributions of income across generations and across income classes. Despite the official rhetoric, Social Security has been administered as a type of welfare program in which current workers (rich and poor alike) redistribute dollars to current retirees

and their spouses (rich and poor alike).

Is that bad? Not necessarily. The program has successfully shored up the incomes enjoyed by elderly citizens and has enjoyed enormous popular support. Not that many years ago, the elderly were a generally impoverished lot with average standards of living well below those of their younger counterparts. Now, thanks largely to Social Security, income levels of most elderly citizens have reached or surpassed national averages.

Despite its success, the system has come under increasing fire. Social Security and its associated medicare program are the largest item in the federal budget -- far surpassing the runner-up lines for national defense and interest on the national debt. As Congress struggles to balance the budget, escalating costs in Social Security have squeezed other federal programs into oblivion. Can we afford it?

The Issues:

1. The shrinking trust fund.

The early years were a piece of cake. In 1940 there were 159 workers paying into the system for each beneficiary drawing payments out. Tax rates were low and financing non-controversial. This allowed Congress to legislate benefits to early recipients that far exceeded the value of their contributions plus interest. Ida Fuller, the first American to draw a Social Security check, ultimately received \$20,940.85 from a system to which she had contributed a mere \$22.

Later recipients have enjoyed similar largesse. However, as the number of retirees grew, problems began to mount. By 1960, the number of workers per beneficiary had plunged to five. It currently stands at 3.3 and, by 2030 when the final baby boomers will hit the nursing homes in full force, we expect only 2.0 workers per beneficiary -- at most.

As the number of workers per beneficiary falls, a pay-as-you-go Social Security system becomes increasingly untenable. Early retirees reaped exorbitant rates of return from the Social Security system. Current workers will not; negative rates of return are likely. It was relatively easy for past retirees to live off of the contributions of the huge baby-boom generation. The boomers will find living off their less numerous children far more difficult.

Realizing the dilemma, Congress phased in several tax increases to build a trust fund and return the system to a sound actuarial footing. Even though these increases have created a large and growing trust fund, it's not enough. As the baby boomers begin to retire, the current annual surpluses will turn to deficits sometime around 2015. By 2030, the trust fund will be empty and system will be bankrupt.

Or, so goes the rhetoric. But, it's all a ruse; a red herring. There is no *real* trust fund to deplete. Oh, it does exist on paper; but the trust fund is only an accounting artifice, an illusion. By law, all trust fund monies are invested in special non-marketable government bonds. In effect, the current Social Security surpluses are given back to the Treasury Department each year for bonds -- bonds which are merely interest-bearing IOU's with no tangible assets or collateral to back them. In other words, the current surpluses are not being squirreled away in a protected account somewhere; they are simply loaned back to Congress which, in turn, spends the monies to finance ongoing government operations.

When the annual surpluses become deficits down the road, the trust fund will begin cashing in its bonds and ask Congress to fork over the needed dollars. But, where will Congress *get* the dollars? It has no storeroom of tangible assets to tap into; no *real* reserve exists. With no tangible asset -- only

government IOU's -- the fund is an illusion. When the trust fund tries to redeem its bonds, Congress must either raise taxes or borrow the needed funds. Of course, Congress could always renege and not pay the promised benefits. But as the number of retirees and their political clout grows, this becomes less and less likely.

We can build a bigger trust fund, but it would not solve the problem. It does not matter if we have a \$10 trillion trust fund or a \$0 trust fund. As soon as annual outlays begin to exceed annual tax receipts, Congress must either raise taxes, cut benefits, or borrow the additional monies. The size of the trust fund is irrelevant. The "expert" wringing his/her hands over the vanishing trust fund is an "expert" to ignore.

2. *Economic Growth*

The claims of retirees are ultimately claims on the output being produced by current workers. If retirees claim an increasing share of the pie, current workers necessarily inherit a smaller share. And, no conceivable financial arrangement can alter that fact. Fundamentally, the problem is that of economic growth. If productivity rises and economic growth is robust, disaster will be averted. With a rapidly rising GDP, "baby busters" could enjoy a higher *absolute* standard of living despite consuming a smaller *share* of output. The best way to "fix" Social Security is to generate more economic growth.

How? Most macroeconomists insist increased saving is the key. The more we save, the more resources we can plow into new technology and productivity-enhancing investments. More savings translates into more productive capacity for future generations; more capital per worker. In general, countries with the highest savings rates have the highest standards of living. A recent estimate by economists at the respected Brookings Institution pegs the needed increase in national savings at an extra five percent of GDP per year. That amount of new savings should generate enough new growth to finance the projected increase in spending on the elderly.

Alas. We're not moving forward; we're backpeddling. Savings rates have fallen well below historical levels and show no sign of recovery. As expected, productivity growth has suffered a similar fate. Although the causes are still hotly debated, it appears that the Social Security system itself has been a major offender. Guaranteeing elderly citizens a minimum standard of living has reduced the needs of workers to save for retirement. More importantly, the system has reallocated massive amounts of dollars from middle-aged workers, *whose savings rates are relatively high, to retirees, whose savings rates are very low*. Ironically, Social Security has undermined the very behavior needed to insure its long-run success. Rats.

Can we reverse the trend? Conservatives expected the tax cuts and Individual Retirement Accounts of the 1980's to unleash new torrents of private saving. They were wrong. Attempts to prompt more private savings by tweaking the tax code have been a resounding flop.

But, all is not lost. Government savings can substitute for private savings. When the Treasury Department borrows to cover the federal deficits it absorbs scarce private funds that might otherwise be invested in new technology and capital. Smaller deficits or even, *gasp*, federal surpluses could reverse this drain and pump more dollars back into investment markets.

Naturally, conservatives and liberals disagree on the proper approach. Conservatives advocate deep cuts in government spending. The resources no longer needed to support government spending could be released for private investment. Liberals counter that public, not private spending is needed to enhance productivity and growth. Government-funded education is needed to generate new ideas and to equip workers with the skills needed in a technological world. Government-funded highways, bridges, and ports are needed to provide the infrastructure on which growth must be based. In this scenario,

Congress should raise taxes and plow the monies back into education, research, and public investments.

The Proposals:

The Clinton Advisory Committee jumped into the middle of this fray with abandon. Unfortunately, panel members proved far more adept at suggesting options than making clear recommendations. Hopelessly deadlocked, the group's final document consists of little more than three minority reports, each pointing in a different direction.

Proposal #1: Minor Tinkering (MT)

Favored by six of the panel's thirteen members (including all three labor representatives), the MT plan opts against any radical reform of the system. Benefit cuts are rejected and a pair of minor tax hikes are proposed to generate new revenues. The tax hikes are an immediate increase in the percentage of Social Security benefits subject to taxation and an 1.6 percentage point increase in Social Security taxes *to be implemented in the year 2045*. But, with no cuts in benefits, the proposed tax changes will close only a small part of the system's looming financial shortfall. How will the other needed monies be generated?

Corporate stocks. To close the rest of the gap, the MT group advocates plowing 40 percent of the Social Security trust fund into the stock market rather than government bonds. By assuming the fund can earn 4.7 percent more on stocks than on bonds, the financial flows balance.

Will it work? Maybe. But, it smacks of hand-waving and deception to dissidents. Many stock analysts claim the MT proposal is overly optimistic about the long-run return on stocks. And, the plan injects a new element of risk into the system. What if the stock market takes a dive? Will Congress ante up the extra money? Where will Congress *get* the extra money? Moreover, the plan smells of what was once called socialism. If the government controls \$ trillions of corporate stock, might Congress be tempted to coerce firms to further its own political ends? Although the MT proposal would place the system's stock portfolio in passive index funds managed by an independent board, the potential for abuse is there.

In general, the plan is more concerned about fiscal balance in the trust fund (which is largely irrelevant) than economic growth (which is not). The plan does inject new dollars into the stock market, but the net impact will be small. If \$1 trillion of Social Security funds are transferred from government bonds to corporate stocks, the Treasury Department must replace the \$1 trillion. Without other changes in government spending or taxes, the need to finance government debt and deficits continue. Dollars not borrowed from Social Security must be borrowed from someone else.

To attract new monies, the Treasury Department will have to offer higher rates of return on government bonds. These higher rates, in turn, will coax current stockholders to switch dollars into government bonds. In other words, as Social Security puts an extra \$1 trillion into the stock market, the Treasury Department will raise interest rates to induce other investors to pull \$1 trillion out of the stock market. The result? No significant new monies in the stock market, and increased federal deficits to cover the higher interest rates on government bonds. Exciting? *Proposal #2: Personal Security Accounts (PSA)*

Five panel members (the Republican wing) endorsed the far more radical PSA proposal. Personal Security Accounts move Social Security from a *defined benefit plan* in which benefits are guaranteed, to a *defined contribution plan* in which contributions are fixed, but the benefits vary with the return on pension investments. PSA's are a step toward privatization of Social Security.

Current benefits would be reduced by 50 percent -- down to about 2/3 of the poverty line. Workers will supplement this *safety-net pension* by dumping five percent of their income each pay into a PSA. These PSA's would be managed by registered investment firms offering a smorgasbord of portfolio options for their individual clients. The PSA becomes a private pension arrangement much like current 401 (k) plans.

Upon retirement, employees would receive the skimpy safety-net benefit given to all, plus an annuity based upon the success of their PSA. The proposal reduces the role of the federal government to running the safety-net fund and allows individuals the freedom to invest the other monies as they see fit. Like the MT plan, the net effect of PSA's will be to move massive amounts of Social Security funds out of government bonds and into the stock market. But, unlike the MT plan, PSA's move management of those funds out of the federal government into private hands; a prospect that has brokerage firms and mutual funds salivating in anticipation.

While conservatives have rallied behind the privatization PSA's promise, others recoil in horror at their prospects. Defined contribution plans like PSA's shift investment risks to employees. Will employees -- especially unskilled, uneducated employees be able to make intelligent investment decisions? Or, will many be taken to the cleaners by unscrupulous money managers? Well-to-do clients with large PSA's can easily absorb the management fees investment firms will charge. What about low-income workers with much smaller accounts? Might management fees eat away large percentages of their funds?

Transition issues are even more problematic. Workers in my generation have already paid for our parents' retirements. In this scenario our children will be paying for their own retirements via PSA's. The problem.....who will foot the nearly \$2 trillion bill to finance ours? PSA supporters advocate a "temporary" [i.e. seventy year] tax to raise the necessary monies.

Proposal #3: Individual Accounts (IA)

Two members, including the lone academic economists on the panel, proved more willing to slash benefits. Under the IA plan, the normal retirement age would rise and eventually be indexed to changes in life expectancies. Benefits would be taxed more heavily, spousal benefits would be reduced, and payments to wealthier recipients would be lowered.

To supplement reduced Social Security benefits, workers would be required to pay an additional 1.6 percent of income into Individual Accounts. Like PSA's, these IA's will be defined contribution accounts that supplement reduced Social Security benefits. However, under the IA proposal, basic Social Security payments will be higher and personal accounts smaller than in the PSA plan. More importantly, the IA's will be managed by a government board rather than the employees themselves through private investment firms. The government board would allow employees to choose the percent of monies allocated to broadly-indexed stock funds versus more conservative government bonds.

Proponents argue that IA's combine the best features of the other alternatives. Individuals have the option of shifting some funds into higher-yielding stocks while the government board protects them from falling prey to ill-advised investment strategies pushed by unscrupulous money managers. Critics contend that we are stuck instead with the *worst* features of the other plans. Conservative fear the power of a government board that could become the largest corporate stockholder in the world and liberals fear the increased system risk as retirement dollars shift from government bonds to corporate stocks.

What Does it All Mean?

Who knows. All three plans are complex and controversial; none are easily explained through commercial sound bites to the electorate. Don't hold your breath. Given that Congress tends to dodge complex and controversial issues as long as possible, quick action is unlikely.

More importantly, none of the three plans aims directly at increasing economic growth -- the only sure-fire solution. We cannot pay Social Security benefits to larger number of retirees. without a larger pool of resources and output. Growth is the key. Growth requires *more* saving, more investment, more productivity growth. And, that means *sacrifice*. Ouch; what an ugly word. But, it's a necessary word. We cannot save more unless we are willing to consume less. Proposals that ignore the need to sacrifice are both dishonest and useless.

Who must sacrifice? Proposals to limit benefits push the sacrifice onto retirees. The IA plan goes the farthest in this direction, but also reserves most of the cuts for upper-income recipients who have less need for the benefits. This year alone, over \$15 billion in Social Security benefits will flow to families with incomes in excess of \$100,000. Should we cut them out? Or, will making the program more progressive erode its political support among the well-to-do?

The alternative is to ask non-recipients to sacrifice. Higher private saving rates would work. The IA proposal does mandate an extra 1.6 percent savings, but the effects of this are unclear. This 1.6 percent increase in *forced* savings might be offset by a similar decrease in *voluntary* savings. If so, overall savings, investment and economic growth will remain unchanged. An increase in income tax that is directly plowed back into productivity-enhancing investments by the government might be more effective, but is a political pariah.

Whatever the solution, the stakes are high. If we expect to avoid intergenerational warfare, we must do what we can to ensure that baby-buster incomes will be high enough to afford the tab they will be asked to pay.

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