Published by Business Week on AUGUST 8, 2005 • Editions: N. America | Europe | Asia

ECONOMIC VIEWPOINT
By Glenn Hubbard

Happy 70th, Social Security; It's a great program, but it must adapt to today's economic realities

An acquaintance just turned 70 and bought an iPod. She has always loved music but finds she can indulge her passion of a lifetime in a new and more gratifying way. On Aug. 14, Social Security turns 70. As with my friend, this milestone birthday offers an opportunity for reflecting on how better to accomplish goals we hold dear.

Social Security was originally proposed by Franklin D. Roosevelt as a way to ensure economic security -- hardly surprising because substantial wealth was destroyed during the 1930s Great Depression, and many households lacked the means to finance old age. The law also authorized assistance to low-income individuals unable to work and set unemployment insurance standards.

The 1935 Social Security agenda ushered in a new role for social insurance in the U.S. In 1965 this role was extended to health care for the elderly and low-income individuals with the introduction of Medicare and Medicaid. Rationales for government intervention included paternalism (many individuals wouldn't save for their own retirement or health care) and market failure (private markets for old-age annuities or health insurance worked poorly).

SOCIAL SECURITY REMAINS an important subject in 2005. But key aspects of the economic environment have changed radically since 1935 or even 1965. Longer life spans raise the need to think about governmental incentives for work in old age and to build substantial retirement savings. Absent reform, the financial integrity of traditional defined-benefit pension plans in the private sector and even Social Security are called into question. Unemployment insurance, designed to sustain spending in the face of temporary layoffs, offers only a partial solution in a world in which extensive retraining may be required for changes in jobs or careers. And growing costs of Medicare and Medicaid reflect in part a health-care market in which consumers lack incentives to minimize cost and maximize value.

Also, financial innovation has made possible mechanisms for saving and risk sharing unheard of 70 years ago. The U.S. economy has been the world's leading growth juggernaut over the past decade because of its flexibility to adapt to changes in technology, finance, and international trade. Success in the contemporary U.S. and global economies lies not in preserving the status quo but in seizing opportunity. Basing Social Security on a long-vanished economic environment is self-defeating.

Public policy on economic security should be designed around present realities. In our dynamic economy, that means greater individual control of savings for retirement, health insurance, and funds for training and income support. Government should focus its support on low-income workers in retirement, health care, and job training. Proponents of Social Security reform have embraced personal accounts owned by individual workers, stronger traditional benefits for low-income workers, and slower benefit growth for higher-income workers. This more progressive plan should also include reforms to beef up defined-benefit pensions and build private savings for all workers.

Proposals that build on newly enacted Health Savings Accounts seek to enable individuals to save for medical expenses in retirement and to become more cost-conscious consumers of health care. President Bush's proposal for Personal Reemployment Accounts would supplement traditional unemployment insurance with an individually controlled account to fund training or provide income when an individual changes jobs. These proposals embrace modern economic security.

The celebration in recent years of the U.S. economy's resilience must be accompanied by a rethinking of economic security to maintain growth. A growth consensus has been seriously challenged by an alternative view that the U.S. needs to maintain the status quo in economic security policy. This antiquated view embraces labor market and trade restrictions and higher taxes to finance current Social Security and health plans. But such economic limits and tax hikes would sap true economic security by reducing entrepreneurship, economic flexibility, and growth.

After some initial grumbling, my friend enjoys the convenience of listening to music on her iPod. And U.S. economic security programs can adapt to today's reality, too. Let's keep economic security healthy for many happy returns.