

Redistribution, distortions, and the welfare effects of Social Security*

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Abstract

How should the funding problems of Social Security be addressed? Academic literature offers diverging advice. There is a well-known result that the optimal size of Social Security is zero, implying it is best to phase the program out. Other studies argue that much can be gained by re-designing the program given its current size. We provide a unified analysis by asking how the optimal size of Social Security depends on the key features of its design? We first do a theoretical decomposition tracing welfare effects of the program to (i) income redistribution, (ii) distortions on the optimal annuitization level; (iii) intertemporal distortion. We then quantitatively assess the role of these channels. We show that the zero-optimal-size result is due to the fact that Social Security is too distortive and not redistributive enough. Once these design flaws are corrected, it is even optimal to increase the size of the program.

Keywords: Social Security, Pensions, Annuities, Consumption and Saving, Life-Cycle Models

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