

## SHOULD SOCIAL SECURITY AND MEDICARE BE MORE MARKET- BASED?

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*Contemporary political debate about Social Security and Medicare often conflates the issue of the programs' long-term fiscal sustainability with that of whether their design should be made more market-based, such as by transforming Social Security into a private accounts program and Medicare into a voucher-based program. In fact, the sustainability and design issues are fundamentally separate.*

*This Article assesses the case for making the programs more market-based by using two main vehicles: (1) a three-part model (from Daniel Shaviro, Making Sense of Social Security Reform (2000)) that views the program as mandating forced saving and limited portfolio choice while also executing various inter-group transfers, and (2) Paul Samuelson's classic description of Social Security as providing what we would now call an implicit financial instrument that reflects an intergenerational compact. In the end, the Article concludes that the programs should not be altered to use either private accounts or health insurance vouchers.*

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## I. Introduction

Just as Harvard has been called a giant hedge fund that also operates a university,<sup>1</sup> so the U.S. government's fiscal future increasingly looks like that of a giant insurance company, specializing in the retirement packages embodied in Social Security and Medicare, that also operates an army. Other federal outlays face the prospect of becoming increasingly trivial as a percentage of the whole, even if they are not crowded out all the way down to zero.<sup>2</sup> Social Security and Medicare, however, will face significant long-term budgetary pressure even if they prove exempt from the need to compete with other non-military spending priorities. Indeed, each is projected to be on an unsustainable long-term fiscal path—especially Medicare, which faces much more urgent budgetary pressures due to the steep growth rate of healthcare expenditures in general.<sup>3</sup>

The adverse long-term fiscal projections for Social Security and Medicare, by undermining the credibility of the status quo, have helped to encourage proposals to change the programs dramatically, in ways that might otherwise have been politically unthinkable. In particular, both the 2005 Bush Administration plan to replace traditional Social Security with a system of private accounts, and the 2012 House Budget Resolution (often called the Ryan plan), under which Medicare would eventually become a privatized voucher system, were commonly rationalized by their proponents as necessary responses to impending program insolvency.<sup>4</sup>

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1. See, e.g., Ron Unz, *Paying Tuition to a Giant Hedge Fund*, AM. CONSERVATIVE, Dec. 4, 2012, <http://www.theamericanconservative.com/articles/paying-tuition-to-a-giant-hedge-fund/>.

2. See, e.g., NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 12 (2010) ("By 2025 revenue will be able to finance only interest payments, Medicare, Medicaid, and Social Security. Every other federal government activity—from national defense and homeland security to transportation and energy—will have to be paid for with borrowed money.").

3. See, e.g., ALAN J. AUERBACH & WILLIAM G. GALE, THE FEDERAL BUDGET OUTLOOK: NO NEWS IS BAD NEWS 11–12 (2012) (describing Medicare's long-term unsustainability); NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, *supra*, note 2 at 49 (noting that the Social Security trust fund is projected as being fully drawn down by 2037, necessitating a 22% benefit cut under present law).

4. See, e.g., George W. Bush, President of the United States, State of the Union Address (Feb. 2, 2005) ("Social Security was a great moral success of the 20th century, and we must honor its great purposes in this new century. The system, however, on its current path, is headed toward bankruptcy. And so we must join together to strengthen and save Social Security."); Representative Paul D. Ryan, *A Roadmap for America's Future Version 2.0: A Plan to Solve America's Long-Term Eco-*

Oddly, however, the ensuing political debates have frequently been more about philosophy and design than long-term funding levels. The Bush Administration's proposed creation of Social Security private accounts concededly did nothing to address the system's projected long-term funding shortfall.<sup>5</sup> Instead, its claim to offer a superior program structure would have been equally strong or weak (as the case may be) had Social Security been projected to self-finance indefinitely. As for Medicare, in 2012 the competing Obama Administration and Ryan budget plans proposed "roughly the same rate of Medicare growth over the long run, which is a significant slowdown from the historical norm [suggesting that] . . . the fight over Medicare is not so much about the size of the program but instead about how the program looks . . . ."<sup>6</sup>

For both programs, the nub of the dispute is as follows. Under the traditional structure, neither Social Security nor Medicare is closely modeled on private insurance.<sup>7</sup> In particular, while there is dedicated financing for each program (albeit, for Medicare, only covering hospitalization benefits), participants' taxes and benefits are not actuarially linked in the manner that one would expect in the case of a private program.<sup>8</sup> Policy judgment plays a large role in benefit design, and individual consumer choice does not apply to certain key parameters. Replacing Social Security with private accounts, and/or Medicare with health insurance vouchers, would make the programs much more private insurance-like—for example, in the role played by consumer choice, the relationship between individuals' contributions and benefits, and/or the insurance industry's role in furnishing people's benefits.

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*nomic and Fiscal Crisis* 11 (2010) (describing the unfunded liabilities in Social Security and Medicare as key reasons for dramatically changing both programs).

5. Bush, *supra* note 4. The Bush Administration's claim, rather, was that using Social Security tax revenues to fund private accounts would not worsen the program's solvency, because it would be wholly funded by reducing traditional Social Security benefits.

6. David Kamin, *Are We There Yet?: On a Path to Closing America's Long-Run Deficit*, <http://ssrn.com/abstract=2157688> (last visited Apr. 8, 2013).

7. On the programs' main features, see DANIEL SHAVIRO, MAKING SENSE OF SOCIAL SECURITY REFORM 10–23 (2000) [hereinafter MAKING SENSE OF SOCIAL SECURITY REFORM]; DANIEL SHAVIRO, WHO SHOULD PAY FOR MEDICARE? 11–25 (2004) [hereinafter WHO SHOULD PAY FOR MEDICARE?].

8. *See id.*

In both cases, the term “privatization” would be apt. However, since Republicans in recent years have become so leery of this term,<sup>9</sup> I will instead describe the issue as that of whether the retirement programs should be made more market-based, with differences from privately offered insurance being mainly limited to the fact that the government mandates, regulates, and subsidizes retirees’ private coverage.

It would be tempting to depict this as a standard “governments versus markets” question, especially given the unsurprising fact that analysts’ general orientation along the conservative to liberal spectrum often predicts their views concerning Social Security and Medicare reform. In fact, however, thoughtful people from across the spectrum know that both market and government approaches vary in their appropriateness with the context. For example, one can be generally pro-market and yet oppose both (a) replacing local police with privately hired security firms, and (b) outsourcing tax collection to privatized “tax farmers” who would get to keep every extra dollar that they extracted.

What makes it non-obvious whether Social Security and Medicare should be more market-based, even if one generally likes markets and distrusts political processes, is the fact that these programs specifically address problems of market failure and defective consumer choice.<sup>10</sup> Accordingly, unless one wholly rejects the rationales for these programs—which few have done—one needs to assess the issue of more versus less market-based design in terms of how it would affect achieving the underlying objectives that one has already agreed markets do not provide. In addition, one has to ask how political choice problems would change within the new structure, rather than presuming that they would go away, given that the government will be heavily involved in any event.

The point is not just that proponents of more market-based approaches to Social Security and Medicare have already conceded that markets cannot entirely handle the core problems that make the pro-

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9. See, e.g., Matt Bai, *The Framing Wars*, N.Y. TIMES, July 17, 2005, [http://www.nytimes.com/2005/07/17/magazine/17DEMOCRATS.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2005/07/17/magazine/17DEMOCRATS.html?pagewanted=all&_r=0) (“Bush had tried to recast his proposed ‘private accounts’ as ‘personal accounts’ after it became clear to both sides that privatization, as a concept, frightened voters.”).

10. See MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 54–56; WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 57–65.

grams necessary—leaving them in a posture of merely “haggling about the price.” The concession also means that proponents must combine explaining why more market-based is better with respect to the specific design choices that are on the table, with explaining why it is worse with respect to making retirement policy more market-based still (at the limit, by repealing the programs altogether).

In assessing the degree to which Social Security and Medicare should be market-based, I believe that the analytical structure I used in my books, *Making Sense of Social Security Reform* and *Who Should Pay for Medicare?*, can be helpful.<sup>11</sup> These books, which were more concerned with developing a conceptual framework for thinking about the two programs than with advocating particular reform proposals, followed three main strategies. The first was conceptual decomposition of the programs into their component parts, reflecting that they serve multiple purposes, and that reform proposals typically are compound packages that could be mixed and matched in alternative ways.<sup>12</sup> The second was conceptual integration of Social Security and Medicare into the broader fiscal system, reflecting that the programs’ formal boundaries are ultimately of less interest than how the fiscal system affects people overall.<sup>13</sup> The third was to think about the programs’ social insurance functions by using the public economics framework for social insurance (posited as a response to market failure) that underlies the theory of optimal income taxation.<sup>14</sup> This framework conceptualizes the income tax and transfer systems as providing insurance against ability risk, a product that consumers would value, if commercially available, due to the declining marginal utility of money, but that requires government provision due to adverse selection, and that remains limited in its optimal scope by moral hazard.

In common parlance, Social Security and Medicare are the quintessential “social insurance” programs.<sup>15</sup> However, this partly reflects considerations of mere form, such as their use of earmarked taxes and trust fund accounting. In substance, while Social Security and Medicare have important insurance elements, they are also, to a considera-

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11. See *MAKING SENSE OF SOCIAL SECURITY REFORM*, *supra* note 7, at 8–9; *WHO SHOULD PAY FOR MEDICARE?*, *supra* note 7, at 10.

12. See *MAKING SENSE OF SOCIAL SECURITY REFORM*, *supra* note 7, at 2–4.

13. See *id.* at 5–7.

14. See *id.* at 44–75.

15. See *id.* at 48–50; *WHO SHOULD PAY FOR MEDICARE?*, *supra* note 7, at 56–62.

ble degree, something quite distinct. Unlike classic insurance, they are deliberately designed to limit people's ability to make their own choices—in particular, with regard to how much or little to save for retirement; how to invest these savings; and how to structure the eventual payout. While limiting choice may sound bad—not to mention, in tension with the rhetorical tenor of calling Social Security and Medicare “entitlements”—it turns out to be well-justified in this context. Both paternalism (however dubious an approach in many contexts) and externality problems provide convincing grounds for imposing the lifecycle planning equivalent of requiring people “to eat their spinach.”<sup>16</sup>

In some respects, the existing Social Security and Medicare programs are clearly flawed. For example, in Social Security, the opacity of the relationship between participants' taxes paid and benefits received creates needless economic inefficiency, while having mixed political economy effects.<sup>17</sup> Medicare, taking as given the overall value of the benefits that it offers, over-provides low-end or relatively routine insurance coverage relative to high-end catastrophic coverage.<sup>18</sup>

Yet proposals to make the programs more market-based often seem ill-matched to accomplishing the programs' core purposes. Thus, consider the fact that a private accounts plan would increase the extent to which one's Social Security retirement benefits depended on how particular financial assets had performed during one's working years (including right at the end). Such a structure arguably is made less appropriate than ever, not more, by the fact that private retirement plans have been shifting in the same direction.<sup>19</sup>

As for Medicare, its benefits in effect automatically correlate to the growth rate of the healthcare sector.<sup>20</sup> The Ryan plan would shift to something that came closer to resembling a fixed real life annuity in its annual growth pattern. I will show that, while the choice between the two approaches depends in large part on how one evaluates general healthcare sector market failure, there are reasons for considering

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16. WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 62–65.

17. See MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 30–32, 71–73.

18. WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 114–16.

19. See, e.g., Richard Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 62–63 (2004).

20. See WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 86–88.

the Ryan plan's relative disconnect from overall healthcare sector growth rates a design mistake from a social insurance standpoint.

The rest of this Article proceeds as follows. Section II offers a conceptual overview of Social Security and Medicare. Section III briefly describes the traditional and the more market-based alternative paths forward for the programs. Section IV discusses what we learn, in particular for Medicare reform, from what I call the "forced saving" rationale for the retirement programs. Section V discusses what we learn, in particular for Social Security reform, from the programs' rationale for limiting participants' portfolio choice with regard to the investment of their accumulating retirement savings. Section VI discusses certain distributional and efficiency issues that are raised by the current systems' lack of a clear relationship between individuals' taxes paid and benefits received. Section VII offers a brief conclusion.

## II. Conceptual Overview of the Programs

### A. Social Security

What is Social Security? More than just a set of rules, it has a widely accepted conceptual structure that reflects the deliberate linkage between its taxing wages and its offering retirement benefits, thus creating a sense of "earned entitlement" even if the taxes one pays are not present value-equivalent to the benefits one eventually receives. I find two very simple abstract models helpful, and complementarily so, in understanding the program conceptually. The first is Paul Samuelson's classic description of the program as providing what we would now call an implicit financial instrument that reflects an inter-generational compact.<sup>21</sup> The second I set forth previously in *Making Sense of Social Security Reform*.<sup>22</sup>

#### 1. THE SAMUELSON MODEL

Samuelson's Social Security model can be explained as follows.<sup>23</sup> Suppose everyone lives for two equal periods: a work period and a retirement period, and that there are successive age cohorts such that,

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21. See Paul A. Samuelson, *An Exact Consumption-Loan Model of Interest with or without the Social Contrivance of Money*, 66 J. POL. ECON. 467 (1958).

22. MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7.

23. For a similar description, see WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 80–81.

for example, Generation 2's work period coincides with Generation 1's retirement period, while its retirement period coincides with Generation 3's work period. Let's call the retirees when Social Security is first enacted "Generation 1."

To help motivate the program's enactment, suppose that the saving of material resources from one period to the next is literally impossible—"[N]othing will keep at all. Thus, no intertemporal trade with Nature is possible . . . ." <sup>24</sup> Accordingly, retirees will die at the start of the retirement period unless current workers support them. "Formerly we used to support our parents in their old age. That is now out of fashion" <sup>25</sup> in the era of Generation 1. An alternative solution is therefore necessary, albeit impeded by inter-generational conflicts of interest. After all, why should Generation 2's workers agree to support retirees from Generation 1, who will never be able to pay them back? What is more, even if they set a good example, why should they expect this to help them when Generation 3 comes along?

Rather than despair, however, Generation 1 proposes to Generation 2 that it agree to the enactment of the following program. During each period, the members of the work cohort will face a permanently fixed, flat-rate payroll tax, the proceeds of which are handed over to the retirement cohort for their support. While this is bad for Generation 2 during the current period, it will solve their retirement problem so long as Generation 3 subsequently accepts it as well.

Samuelson posits that the members of Generation 2 have good reason to agree to this plan. After all, only with such a program in place can they hope for support from Generation 3, which may view the problem similarly based on Generation 4, and so on going forward indefinitely. Thus, the program may prove stable and benefit everyone until "the final young . . . [are] cheated by the demise of the human race." <sup>26</sup>

Three main lines of thought follow from the Samuelson model. The first concerns fiscal sustainability. Consider the free benefits that Generation 1 receives—mirroring actual Social Security's extremely generous treatment of early retirement cohorts, whose members generally got far more from the program than the value of what they had put in. Giving money to the first group that is never paid back under

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24. Samuelson, *supra* note 21, at 468.

25. *Id.*

26. *Id.* at 480 n.19.

pay-as-you-go financing may sound fiscally imprudent, and all the more so if one anticipates, as with actual Social Security, that total annual benefit payouts will keep on growing in real terms over time. Indeed, the phrase that may initially come to mind is “Ponzi scheme”—an epithet that is in fact extremely common among Social Security critics and skeptics.<sup>27</sup>

The Samuelson model helps to show, however, that offering free benefits up front that are never repaid, and that keep on growing without any advance accumulation of funds to pay for future benefits, can be fiscally prudent and indefinitely sustainable. True pay-as-you-go is perpetually sustainable by definition, given the requirement that each year’s tax collections fully fund its payouts. Even with actual Social Security, under which the law defines a payout scheme that does not explicitly depend on amounts contemporaneously collected, there is no Ponzi problem if the two sides of the ledger are kept in long-term equipoise.

What makes the Ponzi label applicable in a given case is not just free benefits for the early cohorts, and not just a particular level of promised benefits, but an “exploding” growth rate to fund such benefits that cannot realistically end up being sustained. To illustrate, consider my own childhood Ponzi experience, which involved a chain letter for picture postcards. One day I received such a letter from a friend, demanding that I send a picture postcard to the stranger whose name was at the top of a list, plus new chain letters to six other friends who were supposed to do the same. Failure to comply, I was told, would subject me to an ancient Egyptian curse. But if I continued the chain, within a short time I would get either 36, 216, or 1,296 picture postcards (I forget which). I seem to recall that I sheepishly and reluctantly complied, although I was far more concerned with avoiding the curse than with reaping a picture postcard cornucopia. Unfortunately, however, I never received a single picture postcard on the back end.

This was an exploding Ponzi scheme, doomed to fail in short order (although I might have gotten a few picture postcards first), because its projected exponential growth rate simply could not be sustained. Suppose, however, that its projected growth rate had been

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27. See, e.g., Jerry W. Markham, *Privatizing Social Security*, 38 SAN DIEGO L. REV. 747, 756 n.48 (noting descriptions of Social Security as a Ponzi or pyramid scheme).

zero, with letters going to just one friend at each stage, in the hope of getting just one postcard back in the next stage, and that the curse had been far more credible (or the other recipients far more credulous). Then, while the chain letter's founder, in the manner of Samuelson's Generation 1, would have gotten a postcard for free, nothing would have prevented this "unfunded" program from being sustainable for a very long time. In particular, its failure to "pre-fund" benefits, and its "pay-as-you-go" financing of benefits for those at the top of the chain, would have been unproblematic.

Returning to Samuelson's Social Security model, there is no reason why real benefit growth could not be indefinitely sustainable. After all, the payroll tax funding device keeps benefits constant relative to wage levels, thus ruling out an exploding-benefits scenario. Only if they grew faster than the economy, rather than being pegged to it, would sustainability concerns arise.

The second important point that one can derive from the Samuelson model of Social Security concerns how to think about it from the standpoint of a working-age participant. Although the Samuelson piece predated by several decades the era of modern financial innovation, it is rooted in the understanding that the use of a fixed-rate payroll tax to fund pay-as-you-go retirement support effectively creates a distinctive implicit financial instrument.

As Samuelson explains, with zero population growth and zero wage growth, workers from Generation 2 onwards would effectively be saving through the program at a zero percent rate of return<sup>28</sup> (just like that in the non-exploding version of the picture postcard chain letter). The amount of payroll taxes that a given generation paid during its work period would be exactly the same as what it later got, through payroll tax collections from the next age cohort, in its retirement period. However, population growth would lead to a positive rate of return, even with fixed per capita wages. For example, if your age cohort had 100 people while the next had 105, your group would get back 5% more per person at retirement than it had put in. Likewise, per capita wage growth would lead to a positive rate of return on the implicit financial instrument. For example, the same 5% rate of return would arise if the population remained at 100 people, but the younger generation earned 5% more per person, and thus paid that

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28. Samuelson, *supra* note 21, at 482.

extra amount under a fixed flat-rate payroll tax that was then handed to retirees.

One possible implication of thus viewing pay-as-you-go Social Security as creating an implicit financial instrument came up in an important 1966 follow-up to Samuelson's work, by the economist Henry Aaron.<sup>29</sup> Recall that Samuelson, to motivate adoption and continued worker support for the program, posited that saving, other than implicitly through the creation of successive commitments, was literally impossible in his hypothetical society.<sup>30</sup> This might have been a good way to express abstractly the motivation for adopting Social Security back in 1935, not long after numerous bank failures and the collapse of stock market prices had wiped out many people's savings and caused the basic enterprise of pre-funding one's own retirement to look hazardous. By the 1960s, however, such concerns may have appeared considerably less pertinent.

One might alternatively think of Samuelson's no-saving assumption as a proxy for the concern that people myopically fail to save enough for their own retirements<sup>31</sup>—in effect, acting as if it were impossible. Yet this would not necessarily motivate offering the Social Security implicit financial instrument, as distinct from simply requiring people to save and invest enough in conventional instruments through their own private savings accounts. Aaron noted, however, that Samuelson's implicit financial instrument, with its payoff that depended on the rates of population and wage growth, might conceivably offer a rate of return above that generally available (via prevailing interest rates) to savers in capital markets.<sup>32</sup> If so, Samuelson's conclusion that all age cohorts (until the last one) would benefit from the program, notwithstanding its offering ever-growing benefits that were not funded in advance, could continue to hold on alternative grounds.

This brings us to the third important conceptual point that one can derive from the Samuelson model, concerning political economy. As Samuelson noted, good programs will not always be adopted, especially if they have losers as well as winners. When addressing political feasibility, economists must "economize on . . . love or altruism,

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29. Henry J. Aaron, *The Social Insurance Paradox*, 32 CANAD. J. ECON. & POL. SCI. 371 (1966).

30. Samuelson, *supra* note 21, at 470.

31. See MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 47.

32. Aaron, *supra* note 29, at 372.

this being a scarce good in our imperfect world.”<sup>33</sup> However, while intergenerational conflict might seem inevitable in the context of a non-prefunded retirement program, the Social Security payroll tax instrument can be used to overcome “[t]he reluctance of the young to give to the old what the old can never themselves directly or indirectly repay.”<sup>34</sup>

Crucial to this conclusion, however, was the limited nature of the decision that each new age cohort of workers needed to make. Rather than having to evaluate any aspects of program design, such as considering whether taxes and/or benefits should rise or fall, all that each group needed to do was choose between a thumbs up and a thumbs down verdict for a program that was assumed to have fixed features (i.e., a pre-set payroll tax rate and a pure pay-as-you-go payout).

More than fifty years have passed since Samuelson introduced his Social Security model, and much has happened since. What is more, the program was never exactly as he described it, even allowing for schematic simplification. For example, Social Security benefits are now significantly pre-funded (i.e., current payroll tax receipts exceed current payouts), and yet the program is projected to face a long-term deficit.<sup>35</sup> Moreover, the program has never been literally pay-as-you-go. It separately establishes a payroll tax on the one side and a benefit formula on the other side. Accordingly, rather than being just a defined benefits (DB) program on the one hand, or just a defined contributions (DC) program, one could view it as in effect being both. Yet the two sides of the ledger will only be in balance, either for a given year or over the long term, if Congress adjusts them suitably and without undue lag, as demographic events alter the fiscal relationship between the two sides of the ledger.

Nonetheless, Samuelson’s model offers a potent framework for understanding the program, no less where the picture has darkened since 1958 than where it remains largely the same. Indeed, the difference between what his model assumed and what we now see only adds to its analytical usefulness, by offering a roadmap to where the problems lie. Thus, let’s see how each of the three main points that

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33. Samuelson, *supra* note 21, at 480.

34. *Id.*

35. *A Summary of the 2012 Annual Reports*, SOC. SEC. ADMIN., <http://www.ssa.gov/oact/trsum/index.html> (last visited Apr. 8, 2013).

can be derived from the Samuelson model helps us to understand the challenges that Social Security faces today.

*i. Fiscal Sustainability* Although actual Social Security, unlike the version in the Samuelson model, faces long-term sustainability issues, it remains the case that prefunding, in the sense of having payroll tax revenues on hand that will generate a sufficient return to fund current workers' benefits, is not a sustainability prerequisite. Instead, Social Security benefits can be funded indefinitely under the current program structure simply by increasing taxes relative to benefits over the long term. However, one thing that is necessary, in order to make the program indefinitely sustainable without placing undue pressure on the payroll tax financing, is that benefits not rise too fast relative to the size of the economy. While this is automatically assured under the Samuelson model, it can fail to hold where benefits are defined by law and the cost of providing them depends on demographic factors—such as rising life expectancies, which his two-period model rules out.

*ii. The Implicit Financial Instrument* Given the fiscal pressures that cause Social Security taxes and benefits to bear a long-term relationship to each other, there is good reason to view the program as creating an implicit financial instrument with payoffs that depend on relative age cohort sizes and on the rate of real wage growth. At the time when Samuelson and Aaron wrote, population growth and rising real wages made this instrument appear attractive. Since then, however, it has become considerably less so. Both the decline in U.S. birth rates in recent decades (sometimes called the baby bust)<sup>36</sup> and rising life expectancies, which are ruled out under the Samuelson model but in practice increase the ratio of living retirees to workers,<sup>37</sup> worsen the fiscal relationship between Social Security taxes and benefits even though the U.S. population continues to rise. In addition, real wage growth has slowed in recent decades, other than at the top of the in-

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36. See, e.g., Peter H. Schuck, *The Golden Age of Aging, and Its Discontents*, 18 *ELDER L.J.* 25, 35 (2010).

37. It is not entirely certain that U.S. life expectancies will continue increasing. See S. Jay Olshansky et al., *A Potential Decline in Life Expectancy in the United States in the 21st Century*, 352 *NEW ENG. J. MED.* 1138, 1143 (2005) (suggesting that rising obesity may halt the increase in U.S. life expectancies).

come distribution,<sup>38</sup> where Social Security gains nothing fiscally given the ceiling on taxable wages (\$113,700 for 2012).<sup>39</sup>

With the advantage of hindsight, we can now see Social Security's implicit financial instrument as involving risky bets on demography and real wage growth. The program's terms would have to get worse for someone, even if not current seniors, if the terms on which these risks were resolved proved not to be so good. However, there is no inherent reason why an adverse resolution of these bets would have to weaken the program's long-term fiscal sustainability, which could remain the same so long as the needed changes to taxes and/or benefits were adopted in a timely fashion. This, however, brings us to the political economy issues that Samuelson posited the program had favorably resolved.

*iii. The Political Economy Solution* Time has been perhaps least kind to the hope that Social Security could solve the political choice problems that are unavoidably implicated by zero-sum distributional choices between directing resources to current retirees or current workers. As an initial matter, while Samuelson viewed the core political choice problem as one of persuading workers to support impoverished retirees, the last few decades of generational politics have suggested that seniors' influence might, if anything, be too great rather than too small. Seniors generally vote at higher rates than younger people,<sup>40</sup> and often act like single-issue voters with respect to retirement benefits, which is why both Social Security and Medicare have often been called "third rails" in American politics.<sup>41</sup>

In addition, the realization of downside risk with respect to Social Security's implicit financial instrument, requiring ongoing adjustment of its taxes relative to its benefits if it was to be independently self-financing, has undermined the hope that the traditional program structure could serve to eliminate intergenerational political conflict. The question of how and when to adjust Social Security, so

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38. See, e.g., Harry Krashinsky, *The Effect of Labor Market Institutions on Salaried and Self-Employed Less-Educated Men in the 1980s*, 62 IND. & LAB. REL. REV. 73, 85 (2008).

39. See *2013 Social Security Changes*, SOC. SEC. ADMIN., <http://www.ssa.gov/pressoffice/factsheets/colafacts2013.htm> (last visited Apr. 8, 2013).

40. Schuck, *supra* note 36, at 39.

41. See, e.g., Peter D. Jacobson & Johanna R. Lauer, *Health Reform 2010: Incremental Advance or Radical Transformation?*, 42 ARIZ. ST. L.J. 1277, 1294 (2010).

that it can remain on an indefinitely sustainable fiscal path, is not one that the U.S. political system (or any other) is well-equipped to handle. It unavoidably features the zero-sum question of which age cohorts should bear the burden of paying for the needed adjustments.

## 2. SOCIAL SECURITY AS A THREE-PART PROGRAM

While the Samuelson model takes a system-wide perspective on Social Security, the approach that I deployed in *Making Sense of Social Security Reform* looks instead at how the system acts on a given participant. My underlying motivation was as follows. There is a maxim in public economics, going back at least to Milton Friedman's classic 1962 book, *Capitalism and Freedom*, that the fiscal system, when making transfers to needy individuals, often should give them cash rather than in-kind benefits.<sup>42</sup> After all, if the recipient knows her own preferences best and there are no externalities, giving her in-kind support that costs \$X— in a case where she would have chosen something different if handed \$X in cash—makes her worse-off without benefiting anyone else. Only where we think either that she might choose wrongly from the standpoint of her own self-interest, or that there are positive externalities to constraining her choice, does the use of in-kind support rather than cash generally make sense.<sup>43</sup>

Thus, consider the Supplemental Nutrition Assistance Program, commonly known as Food Stamps. Why offer them instead of cash, if they are non-cash equivalent in practice (i.e., if they actually induce recipients to spend more on food and less on other things than if they had been given unrestricted cash)?<sup>44</sup> One reason might be paternalism, if we believe that the recipients would otherwise mistakenly spend too little of their budgets on food. A second might be altruistic

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42. MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 191–92 (1962).

43. See generally David F. Bradford & Daniel N. Shaviro, *The Economics of Vouchers*, in *VOUCHERS AND THE PROVISION OF PUBLIC SERVICES* 40, 40–41 (C. Eugene Steuerle et al. eds., 2000). A further case for in-kind benefits may arise if their provision is related to measuring underlying need. Thus, suppose we want to give cash support to sick people, but all we can observe is medical expenditure rather than underlying health status. Paying for people's medical expenses is the closest we can come to directing unrestricted cash (without requiring that it be used on healthcare) to those who happen to be sick. See *id.* at 41.

44. There might be political reasons for offering Food Stamps instead of cash. For example, offering Food Stamps instead of cash might win political support for the transfer from farmers and grocers. See Burdett Loomis, *The Politics of Vouchers*, in *VOUCHERS AND THE PROVISION OF PUBLIC SERVICES* 92, 108 (C. Eugene Steuerle et al. eds., 2000).

externalities, if the people funding the transfers get greater satisfaction from paying for food than other consumption goods. A third might be financial externalities, if poor people who spend their limited budgets on other things will end up getting fed as well. So the bottom line is not that one should always give unrestricted cash, but rather that the use of non-cash programs raises a distinctive set of issues.

Social Security, of course, gives retirees cash. Nonetheless, because it restricts *when* participants get and can use the cash—they must pay taxes during the working years, and only get retirement benefits on the backend—it requires the same mode of analysis as in-kind benefits. That is, one needs to ask why, given Social Security's net effect on one's after-taxes-and-transfers lifetime income, it deliberately restricts what they can do and when. As it happens, there are perfectly good answers to this question, but I viewed the idea of deliberate restriction as offering a useful vantage point for analyzing and decomposing what Social Security actually does with respect to a given participant.

With this background in mind, *Making Sense of Social Security Reform* stated that:

[e]ach individual's Social Security benefits ( $B$ ) can be described as the sum of the following amounts: (1)  $T$ , or the Social Security taxes he paid, plus (2)  $r$  times  $T$  (henceforth  $rT$ ), or the return on these taxes paid—I . . . assume [for now] that there is one all-purpose interest rate—plus or minus (3) the extra amount that the system gives him or takes away from him. Let us call that amount " $X$ " and describe it as the amount by which  $T + rT$  needs to be adjusted in order to equal  $B$ . It is negative if the sum of  $T + rT$  is greater than  $B$ .

We thus can use the following formula to describe Social Security's benefit payments to any individual:

$$B = T + rT + X$$

This is a pure tautology. It holds in all cases simply because we define  $X$  as the amount needed to balance the equation.<sup>45</sup>

What made it a tautology worth exploring, I suggested, was its teasing out conceptually distinct elements, and showing that Social Security could reasonably be viewed as several distinct programs that all were wrapped together. In particular:

(1) As represented by  $T$ , Social Security is a *forced saving* program that compels participants to save some of their lifetime income, net of Social Security (and other) taxes and transfers, for their retirement

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45. MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 28–29.

years. Indeed, not just the taxes paid and the periodic rate of return that one could impute to those taxes, but also any net positive transfer that one receives from Social Security must be saved for one's retirement years. And even once one reaches retirement, its offering only a fixed real life annuity means that one cannot accelerate one's retirement-period spending of benefits from the program relative to a constant annual path.

As I noted, the fact that Social Security creates a minimum amount of forced saving by the individual (unless she can reverse it out by borrowing against expected future benefits) does not mean that it is increasing national saving. Indeed, "prominent analysts . . . argue that Social Security actually *reduces* national saving, by transferring money from people more inclined to save (workers) to those more inclined to consume (retirees)."<sup>46</sup> However, the question of how government policy should affect the level of national saving, while important, is distinct from that of limiting people's range of discretion during their own lives by requiring them to save some minimum portion of what they end up with for the retirement years.

(2) As represented by  $rT$ , Social Security deliberately creates *restricted portfolio choice* with respect to participants' forced saving. At the time I wrote the book, private accounts in lieu of traditional Social Security were being much discussed. One claimed advantage of this approach, apart from the assertion that this would increase people's returns and, thus, their retirement income (an assertion that relied in part on ignoring the legacy debt), was its offering the classic individual autonomy advantage of getting to decide on one's own preferred investment strategy with respect to accruing benefits. Suppose Alice likes stocks while Bert likes bonds, reflecting either different predictions about future financial asset performance or different preferences regarding the relationship between risk and expected return. In a private accounts world, Alice and Bert can indeed invest differently, meaning that they may end up with different retirement benefits even if the amounts they contribute are the same. At least judged *ex ante*, this could be viewed as making both of them better off, if we assume both that they are choosing rationally given their underlying consumption preferences and that there are no negative externalities. However, traditional Social Security does not permit people to do this

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46. *Id.* at 30.

with regard to the accruing expected value of their retirement benefits through the program.

(3) As represented by X, Social Security transfers net lifetime resources between different program participants. For example, it has transferred resources from younger to older age cohorts, it generally is modestly progressive within a given age cohort, and it favors one-earner married couples, who get spousal coverage without needing to pay more, at the expense of two-earner couples and single individuals.<sup>47</sup>

One question raised by these transfers is whether we consider them good policy. A second is whether they should be done inside rather than outside Social Security. A third question, given that they are somewhat obscured from public view by the murky relationship between the Social Security taxes one pays (including via the employer contribution) and the retirement benefits that one ultimately receives, is whether they should be more straightforward and easier to observe. This is a question both of political economy and of economic efficiency—the latter, given assertions that the program structure causes workers to “err in the direction of regarding Social Security as a ‘pure tax’ on work . . . rather than as a wage tax followed by a wage subsidy.”<sup>48</sup>

## B. Medicare

The analysis thus far has only addressed Social Security. What happens when we shift our focus to Medicare? In this respect, two complementary (although in each case incomplete) perspectives on Medicare are worth keeping in mind. The first is that it is a government health insurance plan, applying universally except that it happens to be limited to seniors (along with people with disabilities), thus raising issues about healthcare provision generally. The second is that it is simply Social Security all over again, albeit with a retirement benefit that happens to be health insurance coverage, thus raising the very same issues as those discussed above.

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47. See *id.* at 69–73. In addition, given Social Security’s fixed real life annuity, it ends up on an *ex post* basis transferring net lifetime resources from people who end up dying younger to those who end up living longer. There is also an *ex ante* expected transfer from people with short life expectancies to those with long ones.

48. *Id.* at 105 (citing Laurence J. Kotlikoff & Jeffrey Sachs, *It’s High Time to Privatize*, BROOKINGS REV., Summer 1997, at 16, 17 (1997)).

While both perspectives should be kept in mind, the second one supports applying Samuelson's and my analysis to Medicare, albeit with adjustments that take into account the program's distinctive elements. Thus, in Samuelson terms, the implicit financial instrument's risky payoff depends, not only on demographics and wage growth, but also on the path of covered healthcare expenditure over time. Likewise, in terms of my tripartite decomposition of Social Security, Medicare requires that a portion of one's forced retirement saving be used to provide health insurance coverage. While the forced saving here, like that in Social Security, has to be spread over one's entire remaining lifespan, it is not necessarily fixed in real terms like the annuity, since its value depends on what happens to healthcare during one's retirement period. This will turn out to be important in evaluating alternative approaches to Medicare reform.

### III. Overview of Social Security and Medicare Reform Options

#### A. Social Security

##### 1. PLANS THAT WOULD RETAIN THE TRADITIONAL STRUCTURE

Making Social Security indefinitely self-financing, if that is one's aim, is simply a matter of arithmetic. All it takes is some combination of increasing its tax financing and/or reducing projected future benefits. One of the most important issues raised here is what mix between changes to these two sides of the ledger should be utilized.

The most widely discussed recent proposal to put Social Security on a sustainable long-term course, promulgated in 2010 by the Bowles-Simpson National Commission on Fiscal Responsibility and Reform, would rely on gradually increasing the cap on taxable earnings to produce slightly less than half of the overall budgetary improvement. The rest would come from such reductions in projected benefits as the following:

- (1) Increasing the normal Social Security retirement age,<sup>49</sup> which then would be automatically indexed to rising life expectancies,

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49. This is relative to the slow increase in Social Security normal retirement age that is already on the books.

- (2) Gradually changing the benefit computation formula to be less generous to higher earners, although benefits at the bottom of the distribution would increase; and
- (3) Changing the computation of retirees' inflation adjustment to use a revised Bureau of Labor Statistics (BLS) measure that ends up being less generous because it incorporates more frequent adjustments to representative market baskets as consumers shift from higher-priced to lower-priced goods.

Not surprisingly, those who are significantly to the right of the centrist territory sought by the Bowles-Simpson Commission favor using just benefit cuts. For example, proposed legislation by Republican Senators Lindsey Graham, Rand Paul, and Mike Lee would entirely eliminate Social Security's projected seventy-five year budget shortfall, under the Social Security Administration's intermediate assumptions, purely through a more rapid increase in retirement ages, plus adjustment to the benefit formula.<sup>50</sup> Likewise, those who are significantly to the left of Bowles-Simpson note that most or all of the funding shortfall could be addressed purely on the tax side. For example, raising the Social Security portion of the payroll tax from 12.4% to about 15.2% would close the projected seventy-five year shortfall.<sup>51</sup> Retaining the current rate but eliminating the cap on taxable earnings (\$110,100 for 2012) would eliminate an estimated 87% of the seventy-five year shortfall.<sup>52</sup>

In assessing the choice or balance between benefit-side and tax-side changes, along with a revised Social Security's broader distributional effects, the following points are worth noting:

- (1) Whatever the mix of tax changes to benefit changes, it should be possible to make the system more progressive, such as by sharply reducing high-earners' benefits relative to their tax contributions, without incurring the efficiency costs that we normally associate with progressive redistribution. If workers do indeed regard Social Security as a pure tax on work, rather than as a wage tax followed by a wage subsidy, then giving them back less of their taxes paid does not in-

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50. See *Social Security Solvency and Sustainability Act*, S. 804, 112th Cong. (2011).

51. Monique Morrissey, *The Social Security Trustees' Report: Now What?*, WORKING ECONOMICS (Apr. 26, 2012), <http://www.epi.org/blog/social-security-trustees-report/>.

52. *Id.* The 87% estimate assumes that high-earners' retirement benefits were not increased to reflect the increase in their earnings that were subject to the Social Security tax.

crease labor supply discouragement, even where it “should” based on a correct understanding of the program’s marginal effects. This does, however, reflect what one might consider the needless inefficiency of the program’s making the marginal tax-benefit relationship both complex and obscure.

While making the system sharply more progressive might escape having the usual efficiency cost, it could have significant political economy effects. Social Security’s architects, such as Wilbur Cohen and Robert M. Ball, famously argued that “a program for the poor will end up being a poor program,”<sup>53</sup> and that universality was therefore needed to keep the program politically strong. If this is correct, a more progressive benefit skew might endanger poorer retirees’ benefits over time. However, critics of this approach may argue that, even if it is true within Social Security, the program’s overall effects on the progressivity of the fiscal system are more ambiguous because it may compete for budgetary dollars with programs that focus directly on the poor, and that thus would be more progressive still.

(2) The choice between payroll tax increases and Social Security benefit cuts implicates issues of intergenerational distribution, given that current retirees only can be affected on the benefit side. The picture is murkier, however, if any benefit cuts would be deferred anyway. Under the Bowles-Simpson plan, while reduced inflation indexing would take effect immediately (reflecting the view that the revised BLS methodology is more accurate), other benefit cuts would generally be deferred. For example, the provision newly raising the retirement age would not start operating until 2022, while the benefit reduction for high-earners would be slowly phased in from 2017 through 2050. Current seniors therefore would avoid much of the impact, even insofar as it arises on the benefit side.

It is often assumed that reducing current seniors’ retirement benefits would be unfair, since they paid payroll taxes under the premise that these benefits would be maintained, and/or unduly burdensome on them because they planned their retirements under the current set of rules. However, while protecting their benefits may be politically necessary, one should not exaggerate its normative persuasiveness. Tax and spending programs across the entire budget change

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53. See, e.g., EDWARD D. BERKOWITZ, ROBERT BALL AND THE POLITICS OF SOCIAL SECURITY 4 (2005).

all the time, and well-off seniors may not be threatened with hardship if their benefits are cut.

Moreover, while retirement programs inherently should have some degree of stability over time, so that people can anticipate and rely on them, Social Security benefits have quite deliberately not been turned into binding legal commitments, like explicit public debt. Instead, they are merely “entitlements,” standing both rhetorically and procedurally on stronger ground than expectations regarding annual appropriations, but weaker ground than that associated with the issuance of formal debt obligations.

(3) For younger current and future workers, the choice between raising payroll taxes and cutting benefits need not have any particular distributional implications, since that depends on the particulars for each side of the ledger (and on how they relate), rather than on the high versus low question for one side considered in isolation. For example, raising my lifetime payroll taxes by \$X, in present value at the time of enactment, has the same overall distributional effect on me as reducing my lifetime retirement benefits by \$X in present value. However, raising my taxes, rather than cutting my benefits, increases my forced saving for retirement through Social Security, albeit at the cost of increasing Social Security’s discouragement of labor supply. Thus, rather than turning on standard bromides about big versus small government and the like, the question really is how one evaluates the particular forced saving and labor supply effects of the choice.

(4) The Social Security tax, considered independently of the benefits that it funds, has an unusual rate structure, given that it is a flat 12.4% levy that applies from the very first dollar of earnings until one reaches the annual ceiling, at which point the marginal rate becomes zero. Obviously, this reflects the forced saving rationale and consequent assumed overall (even if not marginal) link between taxes and benefits. High-earners do not pay additional taxes because they are assumed not to need additional retirement income, and indeed are not accruing it under the benefit formula given its limitation to wages up to the ceiling.

This rate structure has an important efficiency benefit. It makes the tax entirely inframarginal for people who know that they will be above the ceiling in any event. But since we normally would not choose such a rate structure despite its efficiency benefits, the case for maintaining it—and thus, for example, favoring tax rate increases rel-

ative to increasing the ceiling—would seem to require placing a high value on the political economy value of limiting both actual and apparent redistribution through the program.

(5) In assessing a given Social Security plan's mix between tax increases and spending cuts, it is important to keep in mind the difference between mere labeling and actual substance. As case in point, consider the Social Security reform plan set forth in Congressman Paul Ryan's 2010 document, "A Roadmap for America's Future."<sup>54</sup> While this is a private accounts plan, as I discuss next, that shift concededly does not improve the system's long-term fiscal sustainability. Thus, the Ryan plan also includes a number of generally Bowles-Simpson-like features to reduce Social Security's remaining traditional benefits. On the revenue side, however, rather than increasing either the payroll tax rate or the annual ceiling, the Ryan plan would make the value of employer-provided health insurance newly taxable for payroll tax purposes. It thus would increase payroll tax liability solely for those whose earnings are otherwise below the annual ceiling. Among that group, the Ryan plan would increase payroll tax liability the most for workers who, while they are getting significant health insurance benefits, do not get pushed above the ceiling by the inclusion.

Suppose one considers the payroll tax exclusion for employer-provided health insurance (as well as the matching income tax exclusion) a "tax expenditure"—that is, as an instance of government spending, in the form of a subsidy for the insurance, that happens to be administered through the tax code.<sup>55</sup> After all, no one could seriously question that employer-provided health insurance is valuable compensation, excluded from the payroll tax base merely as a device to encourage employers to offer the coverage and employees to want it. Thus, one could argue that, in economic substance, the Ryan plan, unlike Bowles-Simpson, does indeed restore Social Security's fiscal

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54. The fullest description of the 2010 Ryan Social Security plan is set forth in Letter from Stephen Goss, Chief Actuary, Soc. Sec. Admin., to the Honorable Paul D. Ryan, House of Representatives (Apr. 27, 2010), available at [http://www.ssa.gov/oact/solvency/PRyan\\_20100427.pdf](http://www.ssa.gov/oact/solvency/PRyan_20100427.pdf) [hereinafter SSA Ryan Letter]. There have also been more politically centrist private accounts plans for Social Security, such as JEFFREY LIEBMAN ET AL., NONPARTISAN SOCIAL SECURITY REFORM PLAN (2005), [http://www.dartmouth.edu/~samwick/ms\\_nonpartisan\\_plan\\_description.pdf](http://www.dartmouth.edu/~samwick/ms_nonpartisan_plan_description.pdf).

55. See, e.g., Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX. 1, 12 (2011).

balance purely through spending cuts, even though observed payroll tax revenues would increase if the plan were adopted.<sup>56</sup>

## 2. SHIFTING TO PRIVATE ACCOUNTS

Creating private accounts within Social Security, as a replacement for part or all of the traditional program, has been a frequent Republican and conservative project for more than a decade. A recent example is the 2010 Ryan plan, which combines the above-noted benefit cuts and payroll tax increase (if that is what one wants to call it) with an elective private accounts feature.

Under this feature, starting when the plan was implemented, all workers who were at least age fifty-five could elect to redirect a portion of their payroll taxes to fund private savings accounts (PSAs).<sup>57</sup> The amount of payroll tax diversion to PSAs for those so electing would rise with covered earnings for the year, and also over time, as the new system was more fully implemented; but payroll taxes above the diverted amounts would continue to help fund the traditional system (and in particular the legacy debt). The price of electing a PSA is losing benefits one would receive under the traditional system.<sup>58</sup> Choosing the election is thus effectively equivalent to selling or borrowing against the value of one's expected traditional benefits in order to fund the investments that one makes through the PSA.

Individuals would have some investment choice with regard to the funds deposited in their PSAs. The default choice would be Treasury bonds, but they could also choose to direct PSA amounts to a government securities fund, an index fund based on bonds, and/or any of three different types of stock index funds.<sup>59</sup> Given the fund

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56. On the issues raised by tax expenditure analysis, see generally Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187 (2004).

57. Under the Liebman-MacGuineas-Samwick plan, by contrast, the PSA feature would be mandatory, but also partial, as traditional Social Security would remain in place with benefits merely being reduced to help finance the PSAs.

58. For people who participated in the traditional system before electing into the PSA system, whether because they were already working when it first took effect, or because they didn't elect into it right away, the forfeiture of traditional benefits would be partial, to reflect that they had spent time participating in both systems. People's ability to elect back out of the PSA system would be limited. See Shaviro, *supra* note 56, at 8-10.

59. See *id.* at 9; Ryan, *supra* note 4, at 54 (noting that the options would resemble those under the government's Thrift Savings Plan for government workers).

services, participants would incur annual administrative fees, which might be something like 0.25% of the value of one's account.<sup>60</sup>

The range of choice allowed would result in a "relatively wide distribution of achieved life-time investment outcomes among individuals."<sup>61</sup> However, the government would guarantee that people's PSA balances at retirement could not be less than their contributions accumulated at the rate of inflation.<sup>62</sup> Thus, participants would be guaranteed a real rate of return of zero percent. The guarantee would not, however, kick in merely because PSA balances declined sharply at some point in midstream. Thus, suppose for descriptive convenience that the inflation rate was zero throughout a given participant's working life, and that this individual put her money entirely in stock index funds. Even if her account lost 80% or 90% of its value in the last year before retirement by reason of a catastrophic stock market crash, she would receive no compensation under the guarantee if the value that remained was at least equal to her total lifetime PSA contributions.

At retirement, participants would be required to purchase fixed real life annuities that funded monthly payments equal to at least 150% of the federal poverty level. Any remaining balance could either remain in the PSA, continuing to earn tax-free investment returns, or be withdrawn. The annuity's payouts would be computed by assuming that it was invested 65% in a broad equity index and 35% in a broad corporate bond index. The payouts then would be projected to earn "the assumed long-term future returns on equities and corporate bonds as determined by the Annuity Issuance Authority at the time of annuitization."<sup>63</sup> Thus, participants' portfolio choice would disappear at retirement—apart from the option to buy a larger-than-required annuity—and the Annuity Issuance Authority would bear all subsequent upside and downside risk regarding the actual performance of the stock and bond markets.

A final feature worth noting is that PSAs would be inheritable if the holder died before purchasing a retirement annuity (or if the PSA had a positive balance remaining). In current Social Security, by contrast, the payroll tax revenues received from people who die before

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60. SSA Ryan Letter, *supra* note 54, at 9.

61. *Id.*

62. *Id.* at 11.

63. *Id.* at 10.

reaching retirement age effectively help fund benefits for everyone else, leaving aside survivors' benefits. In principle, one could replicate this feature in a PSA plan by having, in lieu of inheritability, a rule whereby the PSA balances of people who died before retirement were somehow used to help purchase retirement annuities for everyone else. This rule would either permit mandatory contributions to be lower than those under the Ryan plan without impairing survivors' annuity levels, or else permit such annuity levels to be higher.

Obviously, if a private accounts plan for Social Security were adopted, it would not have to conform to the Ryan plan or any other existing model. However, in assessing the merits of any such plan—as well as the design issues that would arise if Congress went forward with Social Security private accounts—relevant considerations include the following:

(1) Allowing people to use their own payroll taxes to fund PSAs, rather than to help finance present-law Social Security benefits, has a negative effect on Social Security's long-term fiscal posture, while reducing their present-law benefits has a positive effect. The net effect is zero if the two offsetting changes have equal present value, a determination that actuaries for the Social Security Administration make by using the Treasury bond rate. This rate generally is lower than the historical rates of return on diversified stock portfolios and bond portfolios. Thus, a given amount (say, \$100) invested in Treasury bonds generally has a lower expected return than the same amount invested in stocks or bonds. Nonetheless, all three of these alternatively invested amounts have the same market value (such as \$100), reflecting that such values reflect risk considerations, not just the expected return. In particular, if the market is correct in viewing Treasury bonds as equally valuable, there must be downside risk that the stock and bond funds will end up earning less.

Given this point, which shows that the marginal investor regards the alternative portfolios as equal in value, one cannot simply assume that the higher expected return from stock and bond funds makes them preferable to a fixed investment at the Treasury bond rate (which is how one might think of existing Social Security, albeit plus or minus a conceptually distinct transfer, under my "T + rT + X" formulation). Rather, one needs some further basis for concluding that a riskier portfolio is better, at least in cases where the participant would choose it.

If one considers the riskier but higher-expected-yield portfolio generally better for Social Security participants—as distinct from better just for those who would choose it—then private accounts are not needed to get there. Instead, one could simply have the Social Security Trust Fund hold diversified stock and bond portfolios (or index funds) in lieu of Treasury bonds. Under this approach, the federal government as a whole would issue more bonds to the general public to hold the privately issued financial assets. Gains or losses from the portfolio could then be passed on to Social Security participants through benefit changes. This approach was indeed widely discussed in the late 1990s, when the stock market run-up (including the Internet bubble) made stocks look artificially reliable. Stock market performance in the years since has decidedly dampened enthusiasm for this approach.

(2) A central rationale for creating private accounts is to offer participants portfolio choice, which traditional Social Security generally denies. Thus, suppose that a given participant either believes that stocks are undervalued, or prefers their risk-return profile to that offered by Treasury bonds. A conventional economic view of consumer choice suggests that she is better-off, at least *ex ante*, if she can make the choice that she prefers—although in the case of believing that stocks are undervalued, it matters whether she is actually correct. Additionally, no one else is worse-off if she gets to choose the equal-value alternative that she prefers (leaving aside the scenario where, because her chosen portfolio has performed poorly, others end up providing her with more retirement support).

If this logic holds in this setting, however, it is hard to see why it should stop here. Why not also, unlike the Ryan plan, permit people to keep on making risky investment choices after the retirement payment starts that will affect their ongoing annuity payments? For that matter, why limit the PSA investment choices? Such features in the Ryan plan, which generally are shared by all other prominently discussed private accounts plans for Social Security, evince a general agreement that increasing portfolio choice is not desirable in all cases. In effect, proponents have conceded the principle that such choice should be limited or even denied in some respects, and all that remains is “haggling over the price.” So the merits of greater portfolio choice cannot simply be assumed here, even if we favor it in many

other settings. Rather, they need to be specifically demonstrated in relation to Social Security's accepted purposes.

(3) While the PSA approach eliminates an aspect of progressive redistribution between participants that the current system has, this need not affect the overall amount of progressive redistribution if other changes are made. These offsetting changes could be made entirely outside Social Security, but also can relate to how the system's legacy debt is financed.<sup>64</sup> In addition, if one wanted to combine increased portfolio choice with retaining progressive redistribution within the program, this would be easy to do. For example, as I noted in *Making Sense of Social Security Reform*, one could offer what I called a "progressive privatization" system, in which amounts effectively were transferred from high-earners' accounts to those of low earners.<sup>65</sup>

(4) One likely advantage of a private accounts plan is it creates a clearer relationship between Social Security's wage tax and its wage subsidy. Workers' labor supply decisions presumably would tend to reflect an understanding that the payroll taxes deposited in one's PSA, even if not expressly relabeled as "contributions," were not actually pure taxes. To be sure, the system would still discourage work to a degree, insofar as the workers would have preferred immediate access to the cash, and thus would not have voluntarily saved as much for retirement. But making the marginal relationship between taxes and benefits both actually stronger and easier to perceive could be a significant change.

Of course, such a change does not require offering portfolio choice to participants. It also can be reconciled with retaining a degree of progressive redistribution inside the system. Moreover, as discussed later, one could advance it within traditional Social Security, such as by changing the benefit formula to strengthen (and clarify) the dollar-for-dollar marginal relationship between taxes paid and benefits received.

(5) Actuarial estimating conventions tend to make PSA plans look better from a financing standpoint than they actually are, for two

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64. The Ryan plan also addresses overall progressivity by making the relationship between taxes and benefits in what remains of traditional Social Security more progressive than it is under present law, but the likely effect on overall progressive redistribution within Social Security is reduced by the possibility that high-earners will respond by disproportionately opting out of the traditional system.

65. See MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 152–56.

reasons that can be illustrated with reference to the 2010 Ryan plan. First, consider its creating property rights in individual accounts, which the Roadmap lauds as “contrast[ing] with current government Social Security benefits, which are subject to reductions or other changes by Congress.”<sup>66</sup> In other words, merely implicit and revocable commitments under present law are exchanged for those that are explicit and at least putatively irrevocable.<sup>67</sup> This feature could potentially end up having a significant cost, but it shows up as fiscally neutral under actuarial conventions for evaluating Social Security’s finances.

Second, the cost of implicitly guaranteeing future benefit levels may be very real as a political matter, but the estimates only address express commitments. Thus, consider that the 2010 Ryan plan guarantees only a zero real rate of return on one’s PSA contributions. This helps to keep the estimated fiscal cost of the guarantee very low (i.e., to only 0.01% of taxable payroll).<sup>68</sup> However, in a scenario where adverse price movements in the stock and bonds markets caused huge declines in the PSA balances of people who were near retirement, it is highly plausible that Congress would act to offset the sudden reduction in people’s expected retirement support. While this prospect may reduce the downside economic risk to retirees that otherwise is associated with PSAs, it both worsens the expected fiscal picture and potentially creates asymmetric “heads I win, tails you lose” investment incentives through the accounts.

(6) A well-known political economy rationale for adopting private accounts holds that their adoption would eliminate the current practice whereby Congress ostensibly “raids” the Social Security Trust Fund in order to fund deficit spending on programs other than Social Security.<sup>69</sup> An initial problem with this argument is that, since the Social Security Trust Fund is just a set of accounting entries describing the historical net balance between certain of the federal government’s actual or deemed cash inflows and outflows, there is nothing literally

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66. Ryan, *supra* note 4, at 54.

67. Even assuming the technical creation of irrevocable property rights with respect to PSAs, however, Congress could subject their distributions to high tax rates. Under the 2010 Ryan plan, PSA distributions, unlike Social Security benefits, would be entirely exempt from the U.S. federal income tax, but this feature would clearly be revocable.

68. See SSA Ryan Letter, *supra* note 54, at 12.

69. See, e.g., Gordon T. Butler, *The One-Fund Solution: “It’s My Money and I Need It Now!”*, 11 HOUS. BUS. & TAX L.J. 262, 287 (2011).

to be “raided.” Thus, running a unified budget deficit (a measure that includes Social Security cash flows) while the program is experiencing annual cash flow surpluses is not identical to a scenario in which an individual abuses her beneficial obligations as a trustee with respect to someone else’s bank account by diverting the funds to her own pocket. It also is not the case that the U.S. government would be unable to finance contemporary budget deficits through increased third-party borrowing on world capital markets if current Social Security surpluses were not reducing its overall third-party borrowing needs.

The anti-“raiding” rationale for adopting private accounts must therefore be reinterpreted. One way of doing so would be to argue that Congress’s willingness to run budget deficits is subject to a political constraint that depends on the unified measure, but that would change to exclude Social Security cash flows if the program used private accounts. This argument may indeed have empirical support.<sup>70</sup> However, it might cease to hold when Social Security starts running annual cash flow deficits, which is currently projected to happen during the 2020s. In addition, it offers no ground for supporting (or opposing) the real changes to Social Security that a private accounts plan would involve.

## B. Medicare

As noted earlier, the competing Medicare plans that were promulgated in 2012 by the Obama Administration and Congressman Ryan feature similar long-term projected growth rates for government financing of healthcare. However, they would get there by very different means—reflecting, just as in the debate over Social Security reform, the question of whether the existing system should be made significantly more market-based.

Consider first the Obama Administration’s plans (from its 2012 budget) for improving Medicare’s financing, through the ongoing implementation of features of the Affordable Care Act,<sup>71</sup> along with new proposed enactments. A number of different initiatives would attempt to address overpayment at the behest of providers, along with

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70. See, e.g., Sita Nataraj & John B. Shoven, *Has the Unified Budget Undermined the Federal Government Trust Funds?* 14–15 (Nat’l Bureau of Econ. Research, Working Paper No. 10953, 2004).

71. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

ineffective or non-cost-effective treatments, through a combination of federal oversight with measures affecting incentives. For example, healthcare reform created the Independent Payment Advisory Board (IPAB), an independent panel of medical experts that is empowered to devise changes to Medicare's payment system, with the aim of limiting spending growth to the rate of inflation plus one percent.<sup>72</sup> Measures to improve private sector incentives include the upcoming surtax on unusually expensive or "Cadillac" private health insurance plans, and the proposed creation of a premium surcharge for new Medicare participants who use supplementary private sector "Medigap" coverage to reduce their exposure to liability for copayments.<sup>73</sup> In addition to these initiatives, Medicare would use explicitly income-related premiums for its basic coverage.<sup>74</sup> While the impact of such measures, even if fully enacted and allowed to remain in place, is hard to predict, proponents assert that it would "bend the cost curve" regarding Medicare growth, and thus substantially enhance the program's long-term sustainability.<sup>75</sup>

The Ryan approach is quite different. Initially, he proposed entirely replacing traditional Medicare, for people under age fifty-five at the time of enactment, with a system in which seniors would simply get federal vouchers to help pay for mandated private health insurance coverage as offered by competing providers.<sup>76</sup> However, the Congressional Budget Office found that providing the same benefits as traditional Medicare would be much more expensive under the Ryan approach,<sup>77</sup> reflect higher administrative costs, and that "the private plans wouldn't be large enough to enjoy Medicare's leverage

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72. See, e.g., Peter R. Orszag & Ezekiel J. Emanuel, *Health Care Reform and Cost Control*, 363 NEW ENG. J. MED. 601, 603 (2010).

73. Regarding the surtax on Cadillac plans, see, e.g., DAVID M. CUTLER ET AL., THE IMPACT OF HEALTH REFORM ON HEALTH SYSTEM SPENDING, CTR. FOR AM. PROGRESS 6-7 (2010). For the proposed premium surcharge, see OFFICE OF MGMT. & BUDGET, LIVING WITHIN OUR MEANS AND INVESTING IN THE FUTURE: THE PRESIDENT'S PLAN FOR ECONOMIC GROWTH AND DEFICIT REDUCTION 39 (2011). For a discussion of the Medigap problem, see, e.g., WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 15-16.

74. See LIVING WITHIN OUR MEANS, *supra* note 73, at 38-39.

75. See, e.g., Orszag & Emanuel, *supra* note 72, at 602; Cutler et al., *supra* note 73, at 9.

76. See Ryan, *supra* note 4, at 43-49. A great irony, of course, is that this approach has a lot in common with the approach taken by healthcare reform, and much detested by Republicans, for people under retirement age.

77. See Letter from Douglas Elmendorf, Director, Cong. Budget Office, to Paul Ryan, Chairman, Comm. On the Budget (Apr. 5, 2011).

in negotiating prices with hospitals and other large providers.”<sup>78</sup> In other words, the private plans would lack the monopsony power that traditional Medicare can and does use to hold down payments without losing provider participation in the program. While the revised Ryan plan keeps traditional Medicare in place as an option,<sup>79</sup> critics argue that the same critique would continue to apply. That is, its bargaining power would decline if enough people elected to enroll in one of the competing private plans instead.<sup>80</sup>

In lieu of monopsony power, the Ryan plan relies on private market competition to reduce the rate of healthcare sector expenditure growth. Seniors would be cost-conscious with respect to healthcare and health insurance costs that exceeded the value of the voucher. Thus, providers would have an incentive to attract customers via lower prices or greater coverage. However, whether the societal growth rate for health insurance coverage slowed or not, the annual growth rate for retiree vouchers would be capped—if future Congresses kept to the plan—at an amount equal to the annual growth rate for gross domestic product (GDP) plus 0.5%.<sup>81</sup>

Relevant considerations in assessing the two alternative approaches include the following:

(1) A core dispute underlying the choice between Medicare approaches is how well private markets can and do work with respect to healthcare. Healthcare expenditure in the United States is more than twice as high per capita than in peer countries, and also is much higher as a percentage of GDP, yet “there is almost no evidence U.S. health outcomes are better than those in other rich countries.”<sup>82</sup> Many commentators, especially those who are more on the left, view this evidence as suggesting that private markets simply cannot function as

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78. Peter Orszag, *Ryan's Proposal Would Shrink Medicare's Doctor Pool*, BLOOMBERG Sept. 18, 2012, <http://www.bloomberg.com/news/print/2012-09-18/ryan-s-proposal-would-shrink-medicare-s-doctor-pool.html>.

79. See Paul Ryan, H. BUDGET COMM., *THE PATH TO PROSPERITY* 52–53 (Comm. Print 2012).

80. See Orszag, *supra* note 78 (arguing that traditional Medicare's loss of leverage, if seniors could elect to use private plans instead, would cause it to lose substantial participation from providers unless it significantly increased payment levels).

81. See Ryan, *supra* note 79, at 52–53.

82. Gary Burtless, *With Health Care Costs, the U.S. Is a Large Outlier*, BROOKINGS, Aug. 7, 2012, <http://www.brookings.edu/research/opinions/2012/08/07-healthcare-costs-burtless>.

well in the healthcare sector as in many other areas.<sup>83</sup> For example, consumers may lack sufficient information and experience to be able to make good choices, instead they must rely on professionals who may have incentives to provide too much care even when it is medically counterproductive, and our strong commitment to providing at least emergency care to everyone can affect consumers' cost-consciousness.<sup>84</sup> On the other hand, as commentators (often more on the right) who are more optimistic about market-based healthcare provision note, there is empirical evidence supporting the view that healthcare consumers, when made more cost-conscious, will respond by economizing in ways that do not worsen their health outcomes.<sup>85</sup> This underlying dispute, which I will not try to resolve here, can obviously have an enormous impact on one's policy preferences as between traditional Medicare and a voucher approach.

(2) The exercise of monopsony power, which traditional Medicare uses to hold down provider payments, is often thought to be economically undesirable. As conventional supply and demand curves can help show, the buyer-side exercise of monopsony power, like the seller-side exercise of monopoly power, results not only in a wealth transfer between buyers and sellers, but also in deadweight loss from the non-occurrence of transactions that would otherwise have taken place. Thus, suppose that the price of widgets would have been \$50, but for the existence of a consumer cartel that lowers it to \$40. For every transaction that still takes place, this outcome transfers \$10 from the seller to the buyer, relative to the non-monopsony case. However, there is lost social surplus from all of the transactions that end up *not* occurring, in which a consumer would have been willing to pay more than \$40 to a seller who would have been willing to transact at such a price.

The argument against monopsony does not necessarily apply strongly to healthcare, however. For one thing, the sector is highly subsidized to begin with, arguably leading to oversupply which may then be partly offset when monopsony induces under-supply. For another, insofar as healthcare providers extract economic rents, or extra-normal returns "that exceed those necessary to employ the re-

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83. Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 141 (1963).

84. See WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 30–32.

85. See *id.* at 29 (discussing the famous RAND study from the 1970s).

source,"<sup>86</sup> the reduction in efficient supply is not realized. And finally, if one regards private healthcare markets as malfunctioning because consumers have difficulty judging how proposed treatments would affect their welfare, then departing from the outcomes that an unrestricted market would yield is not necessarily socially costly.

(3) For both the Obama Administration's approach to Medicare and the Ryan plan, there is a question of political sustainability even if one agrees that it has the capacity to put both government and private healthcare expenditure on a feasible long-term path. For example, IPAB proposals could face political opposition in Congress, whether from economic interests in the healthcare sector or politicians' incentives to denounce "Medicare cuts" and "death panels," even if experts agreed that they were meritorious. Under the Ryan plan, if private health insurance costs are growing faster than the vouchers, Congress will face political pressure from seniors to keep pace. Thus, difficult questions not just of healthcare economics but also of political economy may be important to evaluating the alternative paths.

(4) Suppose the Ryan plan were adopted and proved politically sustainable, and that healthcare spending grew fast enough for healthcare voucher amounts to rise annually by the full cap amount of the rate of GDP growth plus 0.5%. In this scenario, seniors would in effect be getting two life annuities from government retirement programs. The first would be the fixed real life annuity from Social Security, which would grow annually at just the inflation rate under both the traditional and PSA-based approaches.

The second life annuity would be the Medicare voucher, likewise a life annuity (albeit that it had to be spent purchasing health insurance), but with an annual growth rate, relative to inflation, that was pegged to real GDP growth plus 0.5%. By contrast, the implicit voucher that traditional Medicare could be viewed as offering grows at a rate that depends on the uncapped annual change in the cost of its coverage. Thus, in assessing the choice between the traditional and more market-based approaches to Medicare, it is important to examine (as I will below), from a social insurance standpoint, how one should think about these two alternative growth patterns for life annuities to seniors that have to be spent on health insurance.

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86. DANIEL SHAVIRO, *DECODING THE U.S. CORPORATE TAX* 22 (2009) (quoting Gruber 2007, 205).

In sum, choosing between the traditional approaches and more market-based approaches to Social Security and Medicare reform raises a host of issues, well beyond the scope of what I could hope to cover in this Article. Rather than attempt to span the entire waterfront, I will focus, for the remainder, on three issues. The first is how the rationale for forced retirement saving illuminates the issue of implicit voucher growth rates that arises in Medicare reform. The second is how the rationale for limiting portfolio choice illuminates the issues in Social Security reform. The third is how tax-benefit relationships for particular individuals who are participating in Social Security and Medicare can affect the programs' distributional and efficiency effects.

#### **IV. Forced Retirement Saving and Medicare Reform**

##### **A. Why Impose Forced Saving?**

Social Security and Medicare impose taxes on people's earnings during their working years, and then give them retirement benefits that continue through death, and that cannot be cashed in sooner (other than in the case of disability). The programs thus take a portion of lifetime income (net of taxes and transfers), and prevent it from being used before retirement or frontloaded during retirement. They thereby establish a floor on people's overall personal saving both for and during retirement. Anyone who wants to save more through her own efforts can do so, and thus is not constrained by the floor as such.<sup>87</sup> Indeed, forced Social Security and Medicare saving can effectively crowd out the saving that one would otherwise have done on the side without contradicting this rationale. However, those who would have preferred to save less, rather than more, are out of luck unless they can find a way to borrow against the expected value of their future benefits.

Why would one do this, rather than letting people spend their money (net of taxes and transfers) whenever and however they like? Again, the Milton Friedman point that people usually have the best knowledge and incentives regarding their own self-interest would seem to indicate not thus restricting consumer choice. In fact, howev-

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87. The entitlements' features of limiting portfolio choice and transferring resources between participants may, however, affect the amount that one chooses to save for and during retirement.

er, there are three strong grounds for favoring forced-saving retirement programs: paternalism, market failure, and externalities.

#### 1. PATERNALISM

No one could reasonably deny that people make mistakes. The Friedman point is really about background assumptions. For paternalistically motivated second-guessing to be persuasive in a given context despite the Friedman view, one needs strong grounds for concluding that people who depart from the recommended behavior pattern are probably making a mistake, rather than optimizing given their own, perhaps distinctive, preferences or circumstances.

In the case of forced saving through Social Security and Medicare, these grounds are easy to supply. With regard to identifying the right choice, we have a strong descriptive theory of optimal lifetime behavior, suggesting that people generally should save for (and throughout) retirement from the standpoint of their own self-interest. With regard to explaining why some people might nonetheless end up saving less than the floor in the absence of forced-saving entitlements programs, we have a set of theories apart from rational self-interest that suggest why they might be error-prone.

The descriptive theory, formalizing what is also plain common sense, is the permanent income hypothesis (advanced by none other than Milton Friedman),<sup>88</sup> along with the closely related theory of lifetime consumption smoothing.<sup>89</sup> In both models, the basic idea is that people's consumption has period-specific declining marginal utility. For example, suppose one is considering one's food budget both for this month and for the month that will start a year from now. It is probably better to have one dinner and a roof over one's head, both tonight and in a year from now, than to have two dinners and two roofs tonight but none in a year.

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88. See MILTON FRIEDMAN, A THEORY OF THE CONSUMPTION FUNCTION 20-37 (1957).

89. See Franco Modigliani & Richard Brumberg, *Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data*, in POST KEYNESIAN ECONOMICS 388 (Kenneth K. Kurihara ed. 1954); see also ANGUS DEATON, UNDERSTANDING CONSUMPTION 214 (1992) (describing the permanent income and life cycle hypotheses as "well-defined special cases of the general theory of intertemporal choice"); Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 763-66 (2007) (discussing the permanent income tax hypothesis and lifetime consumption smoothing).

How much retirement saving, relative to lifetime income, do the theories predict is optimal? If all periods are the same and (just for simplicity) the appropriate discount rate between periods is zero, the assumption of within-period declining marginal utility from consumption leads to the result of perfect consumption smoothing. That is, no matter how much or little you earn in one period as compared to another, you should aim to save whatever amounts will enable you to consume exactly the same amount in every period. After all, if you would otherwise be consuming a dollar more in Period X than Period Y, the above assumptions indicate that you would achieve a greater utility gain in Y than the utility loss in X if you shifted fifty cents' worth in order to equalize them.

Obviously, it need not be the case that all periods are the same. Thus, there may in fact be rational reasons for preferring higher consumption in some periods than others. Even so, however, given the fact that sufficiently long-lived people ultimately retire but still have consumption needs in retirement, the optimal lifetime consumption path is likely to be significantly flatter than the lifetime earnings path—suggesting the need for retirement saving, and indeed for during-retirement saving. The latter can involve a life annuity, which hedges against the risk of living “too long” without the need to self-insure through precautionary saving (which goes to waste, bequest motives aside, if one ends up dying “too soon”). And some of this life annuity would presumably be spent on lifelong health insurance.

If all periods, until the moment one dies, are the same, this line of reasoning suggests that people who do not have bequest motives should want to convert *all* of their available wealth into fixed life annuities. (This would include borrowing against expected future earnings to fund the fixed life annuity up front, if feasible.) Now suppose we add in inflation, assuming for the moment that this is a uniform phenomenon in which the rate of price increase for all commodities is exactly the same. This yields the prescription of buying a fixed real life annuity, thus keeping the real value of consumption the same in all periods.

While the prior discussion helps explain forced retirement saving through Social Security, what about Medicare, which requires that this saving take the form of having health insurance throughout one's retirement years? The added question here is why having health insurance might be considered rational for *any* period during one's life,

not just retirement, in the scenario where free healthcare (such as treatment in an emergency room when you are having a heart attack) is wholly unavailable.<sup>90</sup> The answer is that healthcare outlays, when you have a medical problem for which there is treatment, not only are potentially quite large yet unpredictable, but can have a huge marginal impact on your overall utility. Thus, arguably everyone should want health insurance, if available at an actuarially fair price, unless their overall resources are so low that other, even more desperately important priorities (such as having enough food to eat) are being forced to compete with finding room in one's budget for health insurance. Even in that case, however, if one is giving cash transfers to people with sufficiently desperate consumption needs (and thus presumed high marginal utility for a dollar), at some point one would expect them to prefer having at least some minimum amount of health insurance.

Under the fixed real life annuity scenario, the amount spent on healthcare would be the same in all periods, just like the amount spent on all other consumption. Even if we allow actual healthcare needs to vary unpredictably between periods, the underlying assumptions would support keeping the value of one's health insurance coverage constant in real terms, albeit growing nominally at the inflation rate. As we will see shortly, however, this set of assumptions may be especially inapplicable to healthcare.

Suppose that, in the real world, we observe that people are saving far too little for and through retirement to achieve equal consumption in all periods. There are too many assumptions in our model, many of them plainly unrealistic (such as assuming that all periods are the same), for this to lead right away to the conclusion that they are making a mistake. However, the steeper the decline we observe in attainable consumption levels, the stronger the inference that error may be playing a role.

Adding to the strength of this inference is the fact that we have theories of consumer failure to explain why people might have undersaved from the standpoint of their own lifelong self-interest. There is considerable evidence that low retirement saving often reflects myopia, rather than a consistent preference for concentrating consumption

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90. With free healthcare for the uninsured that is of sufficiently good quality, being under-insured can be rational because it eliminates the need to pay for the expected cost of care that one can thereby get for free.

in one's working years.<sup>91</sup> Psychological explanations differ, but one prominent version holds that people engage in hyperbolic discounting, or the application of a much higher discount rate between the current time and any future time than between alternative future times. People who are subject to hyperbolic discounting cannot hold consistent preferences. For example, at Time 1 a hyperbolic discounter will want to apply a normal discount rate in dividing consumption between Times 2 and 3. Once Time 2 arrives, however, she will be much more inclined to concentrate her consumption in Time 2.<sup>92</sup>

Paternalism thus reasonably supports requiring some minimum level of saving for and through retirement. For people who, rather than having extensive savings outside the entitlements programs, generally fund consumption during their working years out of current income, it may be logical to think specifically in terms of a "replacement rate" for their late-career salaries when they retire, on the view that this relates closely to how much their annual consumption might be expected to decline. Social Security replacement rates typically are around the 40% to 70% level,<sup>93</sup> arguably a plausible minimum level—and perhaps more likely to be too low than too high—even if one believes that retirement consumption would be lower than that for previous periods, even with perfect foresight and self-control.

## 2. MARKET FAILURE

A second explanation for forced saving for and through retirement applies even if all workers rationally optimize when planning for retirement. It posits that market failure can create gaps in the availability, at least for an actuarially fair price, of savings vehicles that people would want. If the government can do a better job than private firms of addressing the causes of market failure, then it can improve people's welfare by offering the otherwise undersupplied products.

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91. See, e.g., Robert J. Shiller, *Social Security and Institutions for Intergenerational, Intragenerational, and International Risk Sharing* 42 (Nat'l Bureau of Econ. Research, Working Paper No. 6641, 1998) (noting the frequency of reduced consumption at retirement, suggesting that people act as if reaching retirement age is a surprise).

92. This discussion is taken from Shaviro, *supra* note 89, at 774–75.

93. See Olivia S. Mitchell & John W.R. Phillips, *Social Security Replacement Rates for Alternative Earnings Benchmarks* (Univ. of Mich. Ret. Research Ctr., Working Paper No. 116, 2006).

A classic example where the government can improve people's welfare by addressing market failure is the existence of the income tax and transfer systems. Since, under these systems, the more you earn the more you pay, and if you earn little enough the government pays you, one could think of them as offering people insurance against income risk that reflects underlying "ability risk."<sup>94</sup> This product is valuable due to the declining marginal utility of money, which suggests that the utility you will gain, when you "win" the insurance bet by having low ability, is likely to exceed that which you will sacrifice when you lose the "bet."

In theory, private firms could offer insurance against having a low income rather than a high one. However, they would face two classic insurance problems. The first is moral hazard. People would tend to earn less, given the contracts, than they would have otherwise, reflecting that ability (the attribute that is actually worth insuring, as distinct from self-determined effort) is hard to observe. This problem, however, can be addressed by setting the insurance rate (i.e., the tax rate on income) well below 100%.

The second problem is adverse selection. Since it is impossible to enter into private insurance contracts regarding ability risk behind a veil of ignorance concerning one's own reasonable expectations, people who expected to have low income would disproportionately be the ones to sign up for the coverage. However, so long as people's country of residence is sufficiently fixed, national governments can address this problem, as private firms cannot, by requiring all residents to "enroll" by paying income taxes in good years.

In the context of retirement saving, the Samuelson model suggests one set of reasons why the government might have a role to play.<sup>95</sup> If saving securely for retirement is difficult because no private counterparty or financial instrument is sufficiently safe, the government (if solvent and politically stable) can offer a superior guarantee. Likewise, the government might be better able than any private firm to offer Social Security's implicit financial instrument, if the payoff

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94. A second source of income risk is under-diversified human capital. People typically must specialize in their careers, and this leaves them at risk of a change in market conditions that devalues the skills they have acquired. See, e.g., Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377, 396 n.57 (1992).

95. See Samuelson, *supra* note 21, at 467-82.

from demographic and wage-level risk seems sufficiently likely to compare favorably to otherwise available returns. However, there also are two more particular reasons, one applying to Social Security and the other to Medicare, why a government role may be valuable here.

Under Social Security, the problem relates to annuitization. In the market for life annuities, adverse selection can be a problem if prospective purchasers have better information than the insurance company about their actual life expectancies. A life annuity is a bet by the annuitant on living for a longer period, rather than a shorter one. If prospective purchasers can disproportionately place the bet in cases where they know they have favorable odds, given the life expectancy assumed by the company in pricing the policy, a well-functioning market is hard to maintain. Even short of the worst-case scenario, in which the market collapses and life annuities cannot be offered, firms may be unable to offer actuarially fair pricing to people who lack (but cannot prove that they lack) special inside information.

In the United States, there is evidence that the life annuities available from insurers do not offer actuarially fair terms, but rather have a poor expected payoff, supporting an inference that insurers may be struggling with adverse selection.<sup>96</sup> This suggests that Social Security can play a role, since the government can address adverse selection by requiring all residents to participate in the program. On the other hand, it is conceivable that, in the absence of Social Security, the private market for life annuities would have sufficiently increased demand from people who lack inside information about their life expectancies to make adverse selection less of a problem.

In the case of Medicare, adverse selection is well known to be an important problem for private health insurance markets. Even with fully individualized pricing, firms will have difficulty staying in business if they offer actuarially fair terms, as judged from their state of knowledge, if consumers know more about their own likely healthcare needs. In the United States, the tax-favored status of employer-provided health insurance makes things worse still for people who do have such coverage, by thinning the pool of people who are participating in this market sector.

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96. See Jeffrey R. Brown et al., *Mortality Risk, Inflation Risk, and Annuity Products*, (Nat'l Bureau of Econ. Research Working Paper No. 7812, 2000).

Medicare largely solves the adverse selection problem for seniors. The Ryan plan seeks to avoid re-creating it, despite the proposed shift to private insurance, by requiring participating companies to offer a standardized package. Opinions in the United States sharply differ regarding whether an approach like that in traditional Medicare should also apply to people who are below retirement age, as well as on the question of how effectively and desirably, and at what cost, the Affordable Care Act addresses adverse selection in pre-retirement cohorts. For seniors, however, no prominent Medicare proposal has sought to do away entirely with the traditional program's role in addressing adverse selection.

### 3. FISCAL AND ALTRUISTIC EXTERNALITIES

A final rationale for imposing forced retirement saving through Social Security and Medicare pertains to what might happen if seniors were permitted to under-save and under-insure. If entirely destitute, they presumably would be offered at least minimal public support. If uninsured, they presumably would receive free emergency room healthcare, at least upon the onset of a severe health crisis. While much of the resulting cost might end up being borne by state and local governments, specific federal programs, such as Food Stamps and Medicaid, would also be implicated.

The fact that people can count on receiving at least minimal retirement support if they sufficiently under-save or lack health insurance creates a direct fiscal motivation for requiring them to save on their own, towards having adequate resources. However, even if all government support for sick and needy seniors were eliminated, there would still be what David Bradford and I, in assessing the economic issues raised in general by giving people in-kind vouchers instead of cash, called an altruistic externality.<sup>97</sup> Even if a given senior acted rationally, from her own perspective, in using her available lifetime resources in such a manner that she ended up having under-saved or under-insured, this might be more distressing to other people in the society than if she had instead sacrificed some other type of consumption that did not similarly grip their sympathies. For example, even if I would rationally prefer a great vacation today to having adequate savings on hand when I am very old and feeble, it arguably matters to

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97. Bradford & Shaviro, *supra* note 43, at 49–50.

social welfare if others would be unmoved by the former deprivation, and yet would mind very much if they saw me suffering near the end of my life. Thus, there may be an argument for forced saving that forestalls this eventuality, even if the society resolves to forestall the fiscal externality by withholding retirement-period support.

In sum, there are strong rationales for imposing a floor on people's saving for and through retirement, as current Social Security and Medicare do. For alternative reform plans, a question of particular interest is how these rationales should affect our thinking about the choice between traditional and more market-based reform approaches. In the next section, I consider how the rationales for forced saving should affect the choice presented by attempting to restrain the rate of Medicare growth either within the traditional system's contours, or by converting it into a voucher system with a fixed annual growth rate.

## **B. Applying the Rationales for Forced Saving to Medicare Reform**

As noted above, the Obama Administration and Ryan plans would take very different approaches to slowing down the projected rate of Medicare growth. Two of the differences are especially pertinent here. First, the Obama Administration plan would use what I call a "soft cap," while the Ryan plan would use a "hard cap." Second, cost-saving efforts would be more directed at the provider side, as distinct from the consumer side, under the Obama Administration plan than the Ryan plan. The reasons for imposing forced retirement saving through Social Security and Medicare can help in analyzing both differences.

### **1. SOFT CAP VERSUS HARD CAP**

Again, under present law the IPAB is tasked with devising changes to Medicare's payment system that would help limit annual spending growth to the inflation rate plus 1%, whereas the 2012 Ryan plan would restrict the rate of annual voucher growth to that of GDP plus 0.5%. Obviously, either could adopt the other's baseline and/or its currently targeted annual growth rate. However, other differences between them go more to the essence of each approach. The IPAB-based approach applies more of a soft cap on the annual growth rate of the annuity that must be spent on healthcare, since it merely involves trying to flatten the cost curve over time, whereas the Ryan plan offers a hard cap that is supposed to apply annually in all events.

In principle, this distinction between hard and soft caps could apply even if the two plans' methodologies were reversed. For example, under a privatized voucher system that was pegged to the market price of traditional Medicare coverage, Congress could task an independent panel of medical experts with finding ways to constrain its annual growth by suitably modifying the covered package over time. Likewise, under traditional Medicare, the IPAB could either impose end-of-year payment modifications to comply with a hard ceiling, or could adjust payment rules prospectively with an eye to keeping costs on a firmly constrained path.

One of the relevant differences between soft and hard caps is how likely they are to succeed in placing Medicare expenditure growth on a sustainable long-term path without serious disruption, such as a U.S. budget catastrophe.<sup>98</sup> Obviously, on the face of things, a hard cap automatically works if it is set low enough, whereas a soft cap merely offers hope. This may help explain why Washington "budget hawks," in my experience, tend to prefer harder caps to softer ones, all else equal.

However, the real question of interest is which approach would be more likely to yield sustainable policies that the U.S. government actually followed over time. The Ryan plan's hard budget cap cannot work in practice unless future Congresses prove willing to restrict annual voucher growth even in the face of complaints or hardship. By the same token, IPAB-endorsed spending changes could end up failing to do the job because adversely affected healthcare providers appealed successfully against them to Congress. And it is certainly conceivable that "hardness" could boomerang, by increasing the immediate public outcry and thus the political pressure on Congress to intervene and prevent the realization of slowed growth in outlays.

The underlying political economy analysis that this comparative assessment would require is difficult and uncertain. It would depend on one's assessment of factors other than just the alternative schemes' merits if they operate as intended, which is my focus here. Thus, despite its importance, I will leave it for others to attempt.

Without such an assessment, the analysis risks being unduly slanted against a "hard cap" approach. After all, greater flexibility is

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98. On the risk of a U.S. budget catastrophe, see Daniel Shaviro, *Tax Reform Implications of the Risk of a U.S. Budget Catastrophe*, 50 U. LOUISVILLE L. REV. 577 (2012).

always good, so long as it is appropriately exercised. One ties oneself to the mast (in the case where one actually is able to stay tied) only to prevent worse things from happening, not because it is a first best strategy. Nonetheless, I believe there is something to be learned from asking how one ought to think about the optimal growth rate of Medicare's effective life annuity for the purchase of health insurance. Specifically, if the cost of the standard healthcare treatment package, or that which Medicare (under current policy) would be expected to cover, grows relatively fast, rather than relatively slowly, within parameters that are generally feasible, should the annuity keep growing faster as well?

In advancing this analysis, recall the earlier observation that, if all periods are the same, then the declining marginal utility of within-period consumption would suggest spending the same amount in each period.<sup>99</sup> Likewise, if the assumption that all periods are the same is modified solely by adding in a uniform inflation rate for all commodities, then a fixed real life annuity, like that in Social Security, is optimal. As it happens, however, both the Obama Administration plan and the Ryan plan contemplate that the retirement annuity for health insurance coverage would actually grow faster than that, and indeed perhaps faster than GDP. This reflects important respects in which, for healthcare, all periods clearly are not the same—and not just for particular individuals who are aging, but also for the society as a whole.

In particular, consider the fact that healthcare expenditures (both inside and outside of Medicare) have been growing faster than GDP over a very long period, which is widely expected to continue indefinitely absent some shock to the process.<sup>100</sup> Indeed, if one simply projected forward current trends, one might end up predicting that overall healthcare expenditures eventually will exceed 100% of GDP, a scenario that clearly is impossible.

Suppose initially that healthcare technology was entirely static, and that rising healthcare costs were being driven purely by relative price inflation. (This might happen, for example, because key productive inputs, such as depleting natural resources and skilled human

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99. See *supra* Part IV.A.1.

100. See, e.g., JOHN HOLAHAN ET AL., CONTAINING THE GROWTH OF SPENDING IN THE U.S. HEALTH SYSTEM, URBAN INSTITUTE, HEALTH POLICY CENTER (2011), available at <http://www.urban.org/uploadedpdf/412419-Containing-the-Growth-of-Spending-in-the-US-Health-System.pdf>.

capital, were growing costlier over time.) For a given consumer, the fixed real life annuity that is optimal if all years are the same (price levels aside) is the one determined by keying it to *her* market basket, not the one that is used in calculating an overall inflation rate. And if her market basket shifts over time, then price increases in later-years' consumption items would have extra weight in the calculus for those years.

Clearly, seniors can generally expect to have greater healthcare consumption, relative to other consumption, than younger people. Thus, even if healthcare was not improving over time but merely becoming relatively costlier, seniors' optimal annuities would rise faster than the general inflation rate in response to this trend. Indeed, for any fixed real-life annuity that failed to take this factor into account, seniors who could not save between periods would generally benefit from trading it in for a present value-equivalent life annuity that started lower but rose faster in response to healthcare's relative price inflation.

Now suppose we add in real improvement in healthcare outcomes due to technological innovation.<sup>101</sup> This makes the implication stronger still that one benefits from being able to spend more on healthcare as its relative cost rises. In effect, the marginal utility of a dollar spent on healthcare potentially increases over time, as distinct from the model where consumption in all periods is the same. Once again, the implication is that rising healthcare costs imply that the life annuity for purchasing healthcare should grow faster than the inflation rate.

While the inputs here are too amorphous to permit specifying the optimal annual growth rate, it is plausible that the rate of cost increase for a standardized healthcare package (which in fact changes over time to reflect newly available treatments) would be used, absent anything more germane. This, of course, is effectively what current Medicare provides. Thus, even if it is on an unsustainable fiscal path, there is a case for reducing its capacity to provide state-of-the-art treatment in a comparable fashion for all periods, rather than effectively back-loading its departures from offering such treatment via a hard cap on annual growth.

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101. See WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 86–88.

In contrast to this approach, the Ryan plan potentially offers a scenario in which non-wealthy seniors' healthcare gets ever worse over time, relative to what is available and to what wealthy seniors are getting. This is potentially troubling even if such individuals' care is steadily improving in absolute terms due to technological progress. In terms of the reasons for having government-supplied retirement health insurance, the package that was offered might be inferior (from the beneficiary's standpoint) to one that was present value-equivalent but less growth-constrained. The increasingly limited scope of the basic package, relative to treatments that were available and potentially helpful, might also lead to worsened adverse selection for additional coverage and to fiscal or altruistic externalities from the denial or free provision of additional care.

Two caveats regarding this criticism should be noted. First, if consumers lack the information and expertise that are needed to make good healthcare choices, whereas providers have incentives to provide costly care even when it is not beneficial, the utility effects of limiting care become harder to judge. Second, if the alternative to the Ryan approach is imposing cost controls through IPAB mandates and the like, with overall healthcare expenditure to be about the same either way, then there are tradeoffs to consider, rather than simply a choice between less care and more. Suppose, for example, that centralized cost controls slowed the path of technological change, thus reducing the rate of improvement for state-of-the-art healthcare. However, this possibility brings us to the second important difference between the Obama Administration and Ryan approaches, which is that the former devotes a greater proportion of its direct cost-saving effort than the latter does to the provider side of healthcare transactions.

## 2. DIRECTING COST-SAVING EFFORTS AT THE PROVIDER SIDE

As we saw in Section III, in a well-functioning private market, where consumers can make informed choices given their preferences, there is a strong case for limiting subsidies (such as vouchers or other dedicated financing) in such a way as to ensure that people do in fact pay at the margin for what they get. In that scenario, expert panels such as the IPAB are unlikely to perform as well as consumers facing true market prices. Moreover, relying on monopsony power to hold

down costs is potentially short-sighted given its discouragement of provision for more than the imposed price.

In the case of healthcare, however, the validity of these standard assumptions is a core issue in dispute, even among those who generally favor market provision of goods and services. Thus, general pro-market assumptions cannot reasonably be relied on here, without further inquiry into the functioning of healthcare markets and regulation in particular, which I will leave to specialists in the area.

Even if the healthcare market could work well in the absence of any government intervention, the fact that it is highly subsidized must be kept in mind when we are considering the desirability of exercising monopsony power to hold down costs. As noted above, even if one generally views the exercise of such power as unduly inefficient, there are reasons for believing that the healthcare market is different.

## V. Limited Portfolio Choice and Social Security Reform

### A. Why Limit Portfolio Choice?

The rationale for limiting people's portfolio choice with respect to the accruing expected value of their government retirement benefits, like that for imposing forced retirement saving, rests on two main inputs. The first is an account of optimal investor behavior. The second is an account of why departures from such behavior might either represent investor error, which paternalism would suggest preventing, or else impose negative externalities on others.

A common and reasonable starting point with respect to rational investor behavior is to assume some degree of risk aversion, based on the declining marginal utility of money. While this may sound as if it is merely a particular consumer preference, it has a very clear and general rationale. As I noted in *Making Sense of Social Security Reform*:

If you satisfy your most urgent needs first, then each extra dollar may provide you with less subjective benefit than the one before. Thus, you may reasonably be reluctant to bet, say, \$10,000 on the toss of a coin that is slightly biased in your favor. Risk aversion is what makes insurance a profitable business. You may be happy, for example, to increase your expected cost of driving a car in exchange for making the downside (from an accident) less dire.<sup>102</sup>

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102. MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 36.

Risk aversion is not absolute. The question is simply how much of an extra expected return one demands from a riskier investment in order to be indifferent as between it and a safer investment.<sup>103</sup> In this regard, tastes may differ. In addition, however, the extra return that one would demand in order to be indifferent as between riskier and safer choices should depend on one's overall circumstances. For example, the richer you are (holding your preferences constant), the smaller the positive expected payoff that we would expect you to demand before agreeing to bet \$10,000 on the toss of a coin that was biased in your favor. One presumably would embrace the risk far less reluctantly if one would still have one million dollars in the bank than if one were betting rent and food money for the next month.

One clear implication of investor risk aversion is the counsel that one should diversify one's holdings, thus effectively substituting numerous smaller bets that one hopes are uncorrelated for fewer bets that are individually larger.<sup>104</sup> Diversification permits one to reduce overall variance, without necessarily reducing one's expected return, by reason of the law of large numbers.

The extent to which one is truly diversified depends on one's overall portfolio, rather than being a relevant attribute of particular holdings within the portfolio. Even car insurance, after all, is (in isolation) a risky bet that one will have an accident. What makes it a hedge, rather than a bet, is that one is also, by driving, betting against having an accident. Likewise, the fact that one cannot bet on the stock market through traditional Social Security is only a potential criticism if one cannot otherwise bet as much as one would reasonably like on future stock prices.

In addition to having a theory of correct investor choice (subject to varying tastes for risk), we also have grounds for expecting error. For example, investors may be overconfident about particular hunches regarding profitable strategies, may overreact to recent trends that are salient to them, and do not always understand core principles such as diversification and hedging.<sup>105</sup> They also may underappreciate the significance of transaction costs, such as annual fees, that have a compounding effect on the long-term returns that they can expect. And if they judge wrongly, they end up on average worse-off. The

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103. *See id.*

104. *See, e.g.,* WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 66.

105. *See id.* at 67.

main aim of investing, after all, is to achieve good results, whereas, say, picking an unhealthy breakfast cereal cannot be called a mistake if one enjoys it enough. In addition, bad investment choices that lead, on average, to bad outcomes can result in negative fiscal and altruistic externalities, if they cause one to have inadequate resources during one's retirement years.

All this presumably helps to explain why PSA proposals such as the 2010 Ryan plan, while offering some elements of portfolio choice that are not in the traditional system, stop far short of fully embracing investor discretion. Again, one is just haggling over the price, rather than striking a fundamental blow for consumer and investor sovereignty, when one argues that Social Security participants should be allowed to select from among a handful of diversified investment funds, and then at retirement should be locked in even if they would prefer to continue betting through the system on financial asset prices. A question of interest is how to evaluate the marginal increase in portfolio choice that PSA plans do indeed contemplate.

#### **B. Applying the Rationale for Limiting Portfolio Choice to Social Security Reform**

Evaluation of the case for changing Social Security to offer PSAs should depend on an actuarially fair comparison. Under the current system, taking as given a particular stream of lifetime earnings, one has a relatively fixed level of expected Social Security retirement benefits. And while it is true that benefits may be cut in response to Social Security's long-term funding shortfall, the need to make the program sustainable over the long run is unrelated to the choice between a PSA-based and a traditional system.

Given that one can make Social Security indefinitely sustainable with relatively fixed benefits, even if they should prove less generous than those offered under present law, the question is whether we should favor actuarially fair trades of such benefits for the sorts of investment opportunities that a PSA system might offer. Should Social Security participants be allowed, in effect, to cash in their expected future benefits at present value, in order to fund PSA investments in diversified stock and bond funds that might offer higher expected returns but at the price of a lower downside?

There are three main arguments that Social Security participants should be allowed to make this trade. In my view, however, each is unpersuasive.

**1. OFFERING MORE PORTFOLIO CHOICE IS GENERALLY A GOOD THING**

No one doubts that, despite the potential problems with investors' exercise of portfolio choice, they should be allowed considerable discretion to do what they want. After all, they know their own risk preferences best, and allowing them the choices they prefer, holding constant the amount invested, can make them better-off (at least in expectation) without adversely affecting others.

The question presented here, however, is not whether portfolio choice is good in general. Rather, it concerns the bedrock, irreducible tier of one's retirement saving, at the level one is not permitted to go below, in light of the absence any restriction on one's saving more and investing it as one likes.

Given that almost anyone would be expected to exhibit significant risk aversion when betting the rent money, even if not with a million dollars in the bank, it is hard to see any serious objection to barring risky bets with the bottom-most tier of one's retirement saving. If Social Security saving is most or all of one's total retirement saving, then betting it riskily may well be a mistake (and one whose downside others might partly bear). As for people who have significant other retirement saving, while betting the Social Security piece on financial asset prices might be harmless if they anticipate having enough of a downside cushion in any event, limiting them in this respect does little obvious harm. They can always respond by investing the rest of their savings a shade more riskily than would have been optimal if the Social Security piece was variable as well.

**2. DEFINED BENEFITS (DB) PLANS VERSUS DEFINED CONTRIBUTIONS (DC) PLANS**

In recent years, private sector DB plans have increasingly been converted into DC plans such as 401(k) plans, in which participants' retirement benefits depend on investment outcomes rather than being

a fixed pension.<sup>106</sup> This trend is often cited in support of the proposition that the public sector, including Social Security, should follow suit.<sup>107</sup> One might argue, for example, that DC plans are a modern improvement on traditional DB plans, and/or that workers prefer the DC structure—although the latter claim is in some tension with the facts that employers have spearheaded the shift and that unionized industries (such as the public sector), in which workers can use collective bargaining to advance their preferences, have seen much less of it.<sup>108</sup>

Whatever one makes of the private sector DB to DC shift, however, its implications for Social Security design are opposite to what is often claimed. As Jacob Hacker noted in his Baum Lecture two years ago, the private sector shift makes retirement saving for millions of people riskier, and more dependent on the performance of financial markets, than it used to be (at least, assuming that their DB plans were adequately funded).<sup>109</sup> Under widely accepted principles of diversification, the case for fixed benefits in Social Security that will not directly depend on how financial markets perform during one's working years is made stronger, not weaker, by the private sector's shift to a DC approach.

### 3. STOCKS OFFER ABOVE-NORMAL RETURNS, EVEN TAKING ACCOUNT OF RISK

When Social Security private accounts were being actively considered in Washington, from the late 1990s through the unsuccessful Bush Administration initiative in 2005, a core argument was that they are simply an extraordinarily good investment, the benefits from which should be spread more broadly. Proponents of the view that there is a persistent and mysterious "equity premium" in financial markets asserted that "the measured risk associated with equity re-

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106. See, e.g., Jacob S. Hacker, *Restoring Retirement Security: The Market Crisis, the "Great Risk Shift," and the Challenge for Our Nation*, 19 ELDER L.J. 1, 6–10 (2011); Kaplan, *supra* note 19; Schuck, *supra* note 36, at 38.

107. See, e.g., Hacker, *supra* note 106, at 10 (noting that, in politics, "[a]s private defined-benefit pensions have disappeared, the argument that the public sector should follow suit becomes increasingly powerful.").

108. See *id.* at 7–9.

109. Illinois College of Law, *Ann Baum Lecture ft. Jacob S. Hacker*, YOUTUBE (Mar. 11, 2011), <http://www.youtube.com/watch?v=2Lfd-GBsAeI> (providing a video recording of Jacob Hacker's Baum Lecture).

turns is not high enough to justify the observed high returns.”<sup>110</sup> There were even books asserting that stock prices should (and ostensibly soon would) rise to more than three times their observed level, making them an incredible bargain so long as one got in the front door before the inevitable adjustment occurred.<sup>111</sup>

After the stock market events of more recent years, however, these arguments are not as much heard. Stock market (and also bond market) volatility is very real, and our history of observing it is still actually not that long. One is probably best off assuming, as a default proposition, that stocks and bonds both are worth about what the market says they are (or, in any event, are just as likely to be overvalued as undervalued), keeping in mind that market prices presumably reflect the risk preferences of the marginal investor, as distinct from the average Social Security participant.

Another version of the argument for letting people make stock investments through Social Security holds that, for people without independent savings, it would constitute desirable diversification. More than half of the public does not hold any stock,<sup>112</sup> and ostensibly they should, even if their overall savings are low.

The problems with this argument are twofold. First, the relative risk aversion point suggests that, despite diversification’s general merits, one should not own any stock until one has passed a minimum threshold of safe retirement saving. Second, even people who do not own stocks already effectively bear risks that are significantly correlated with those that affect stock prices. Even apart from the fact that the performance of the U.S. macro-economy strongly affects both U.S. stock prices and U.S. individuals’ direct economic fortunes, the U.S. government in effect holds a quasi-stock ownership position in U.S. companies via its claim on a share of corporate profits through the corporate income tax system. The economics of this quasi-ownership stake may, at least to a degree, be passed through to non-stockholding U.S. individuals, insofar as corporate tax receipts affect their own likely taxes and benefits.<sup>113</sup> Thus, U.S. stocks are not high

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110. Jeremy J. Siegel & Richard H. Thaler, *Anomalies: The Equity Premium Puzzle*, 11 J. ECON. PERSP. 191, 194 (1997).

111. See, e.g., JAMES K. GLASSMAN & KEVIN A. HASSETT, *DOW 36,000: THE NEW STRATEGY FOR PROFITING FROM THE COMING RISE IN THE STOCK MARKET* (1999).

112. See MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 117.

113. See *id.*

on the list of the assets that we might urge people with low savings to choose purely on diversification grounds.

In sum, I find the argument for offering greater portfolio choice through Social Security, such as via the use of PSAs in the 2010 Ryan plan, remarkably weak. It appears to rest on rote invocation of arguments that are often persuasive in other settings regarding the virtues of consumer choice, without regard to the reasons why all agree that it should be limited by having a Social Security system (with limited portfolio choice if any) to begin with. It also appears to ignore the distinctive role that Social Security plays in people's overall retirement portfolios, as the irreducible bottom tier of legally and economically required retirement saving.

## **VI. Distributional and Efficiency Issues Raised by the Programs' Tax-Benefit Relationship**

The possible reasons for favoring a PSA structure for Social Security are not limited to facilitating the provision of portfolio choice inside the program. In addition, one may favor the structure as a device for reducing the extent to which the program transfers resources between participants—or, at least, for making the transfers more visible. The relevant issues here may pertain both to Social Security and Medicare, and may involve both efficiency and distributional concerns.

### **A. Social Security Versus Medicare**

The historical reason for Social Security's dedicated payroll tax financing is well-known. As President Franklin Delano Roosevelt famously explained: "We put those payroll tax contributions there so as to give the contributors a legal, moral, and political right to collect their pensions. . . . With those taxes in there, no damn politician can ever scrap my social security program."<sup>114</sup>

Arguably, the impression created by this use of dedicated financing is a bit deceptive. Insofar as people conclude "I paid for all of my benefits," they may be misunderstanding the program's actual distributional effects. Equating Social Security payroll taxes to benefits received (or expected at retirement) on an actuarially fair individ-

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114. *Id.* at 90.

ual basis would require significant program changes, perhaps most easily and straightforwardly accomplished by adopting a PSA structure.

Yet there is an important sense in which the existing Social Security program design is already very roughly PSA-like. Covered earnings, or those up to the annual payroll tax ceiling, not only generate Social Security tax liability, but increase the measure of covered earnings that eventually helps to determine one's retirement benefits. Thus, even if one does not in general get an extra dollar of expected benefits (in present value terms) by reason of contributing an extra dollar to the system, the two sides of the ledger do indeed generally travel together.

Now consider Medicare. Not just the goal of making its benefits similarly politically inviolate, but also the specific popularity of Social Security's program design, contributed to the decision, at Medicare's enactment in 1965, to use payroll tax financing for the new program as well.<sup>115</sup> However, no similar ongoing marginal relationship between taxes and benefits was ever contemplated. Instead, everyone who pays Medicare payroll taxes during at least forty quarters of his or her working career ends up qualifying for the program's general benefit package. Even before Congress, in 1993, eliminated the applicability to Medicare of the annual payroll tax ceiling, the program did not similarly use Social Security's concept of covered earnings on the benefit side. Thus, by earning more, one would pay more, but one would not get more,<sup>116</sup> rendering the use of payroll tax financing a purely distributional tool that does not (as in Social Security) serve a PSA-like function of associating increased taxes with increased benefits.

Why should Social Security, but not Medicare, be deliberately designed to offer high-earners not only higher taxes but also greater

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115. In Medicare, however, only Part A's hospitalization benefits, and not Part B's outpatient benefits, were given payroll tax financing, with the latter relying instead on general revenues. See *WHO SHOULD PAY FOR MEDICARE?*, *supra* note 7, at 20–22. Arguably, this distinction is sufficiently obscure to the general public for the halo of dedicated financing to offer comparable political protection to both sets of benefits.

116. In practice, people with higher career earnings actually do tend to get greater Medicare benefits, reflecting that on average they live longer, live in higher-cost areas, are more willing to pay out-of-pocket for their share of treatment expenses, and have greater Medigap coinsurance coverage on the side. See *id.* at 34–36. However, high earnings merely correlate in practice with receiving greater benefits, as distinct from the case (from Social Security) where this is an express feature of the program design.

retirement benefits? The answer to this question reflects a distinction between the two programs' forced-saving rationales. In Social Security, the idea is that one should save for retirement at least some minimum proportion of one's career earnings. However, the minimum amount that one could rationally save does indeed rise with one's earnings, as suggested by the "replacement rate" concept.<sup>117</sup> In Medicare, by contrast, while it is not illogical to surmise that the amount one would rationally want to reserve for retirement healthcare coverage is likely to grow with lifetime earnings, one could argue that a view of healthcare expenditures as yielding high marginal utility (including from altruistic externalities) applies much more forcefully to a basic medical treatment package, than to increments above that level.<sup>118</sup>

Given this difference between the two programs, Social Security is a more obvious candidate for tightening the link between taxes paid and benefits received (a move that even the Ryan plan does not attempt with respect to Medicare). However, two different respects in which the two sides of the ledger could be brought closer together require separate consideration. Increasing Social Security tax and benefit equivalence at the margin (such as when one earns an additional dollar) would primarily raise issues of efficiency. Increasing equivalence in the overall lifetime value of taxes paid and benefits received would primarily raise distributional issues.

#### **B. Can Social Security Be Made More Efficient?**

As we saw earlier, if Social Security were revised to require mandatory contributions into people's own PSAs, the program's deadweight loss with respect to labor supply would be expected to decline. Its imposing forced saving implies that there would still be some reduction in work incentives among people who preferred current cash in hand, even if they were not myopic but simply preferred additional current consumption. However, the scenario under pre-

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117. Even the idea of an annual ceiling on the earnings to which the forced saving rationale applies can be defended on either of two grounds: that the case for inferring rationality grows weaker as the size of one's mandated retirement nest egg increases, or that high-earners are considered empirically less likely to under-save in practice.

118. In addition, while poorer seniors do not receive greater Medicare benefits, the potential application of Medicaid helps to ensure that they will be able to afford the costs to them of receiving healthcare through Medicare.

sent law in which they arguably, and to a degree mistakenly, regard the program as imposing a pure tax on work at the margin would presumably cease to be as prevalent as it is today.

Moving in this direction does not require that Social Security be actually less redistributive, on balance, than it is today. For example, a “progressive privatization” plan in which taxes or contributions were to a degree effectively transferred, at the government’s behest, from high-earners’ to low-earners’ accounts, might be more transparent even if it were comparably redistributive overall. Even under the traditional structure, however, it surely would be possible to increase both the appearance and the reality of a marginal link between paying additional taxes and earning additional benefits.

Consider, for example, the fact that, under the present system, only one’s thirty-five highest-earning years (as adjusted in certain respects) affect retirement benefits.<sup>119</sup> If workers generally understood how the benefit formula works, this might offer a tradeoff between reducing work discouragement in years that one expected to be in the top thirty-five and increasing it in other years.

Arguably, however, this message gets lost because the overall benefit computation is so complicated and poorly understood. Thus, it is conceivable that one could reduce Social Security’s discouragement of labor supply by changing the rules to be more transparent and understandable than under current law—without making them, on average, either higher or lower, or more or less progressive on a lifetime basis, than they are today. An example might involve counting all covered earnings in the benefit formula, with an eye to making it clear that one is always accruing benefits at the same rate as tax liabilities, with other adjustments to keep benefit levels on average the same.

### C. Distributional Issues Raised by Social Security’s Overall Tax-Benefit Relationship

The opacity of Social Security’s tax-benefit relationship is by no means an accident. It serves at least two purposes that can reasonably be defended on political economy grounds. The first is its aim of allowing the initial age cohorts that it covered to do very well from the program. This was at least arguably defensible not only in Samuelson

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119. MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 30–31.

terms, but as a response to old-age poverty during the Great Depression, and perhaps on the view that transfers to older generations are progressive because lifetime income has been increasing over time.<sup>120</sup>

The second purpose at least arguably served by the opacity of the tax-benefit link rests on the view that “programs for poor people make poor programs” (as Social Security architects Wilbur Cohen and Robert M. Ball famously argued),<sup>121</sup> in that voters will refuse to fund them at adequate levels. Under this view, embedding Social Security’s redistributive effects within a broader universalist framework is politically efficacious, as it permits adequate funding of impoverished seniors to survive politically.

Obviously, these claims are both empirically and normatively controversial. For example, some would argue that Social Security’s political popularity causes aid to poor children and the working-age poor to suffer relative to non-means-conditioned aid to seniors. Others, such as those in the Paul Ryan camp, may agree with the Robert Ball view empirically, but consider it a good thing if clearer labeling leads to reduced transfers to the elderly poor.

However, even if one accepts the political economy argument for opacity of the tax-benefit link on both empirical and normative grounds, it comes at a price to informed decisionmaking in instances where the payoff is not so clear. Thus, consider the fact that both Social Security and Medicare transfer substantial resources from single individuals and two-earner married couples to one-earner married couples. They have this effect because members of the latter group earn spousal benefits without having to pay additional payroll taxes. As I noted in *Who Should Pay for Medicare?*:

[While] having greater needs than a household of one, a household of two adults also has greater resources, in the form of an extra pair of hands that it can use in meeting those needs. While this is perhaps most obvious if both spouses work in the labor market for a wage, it remains true if one of them stays home. Suppose that two households have the same economic opportunities, but that in one the wife stays home while in the other she works. If each household has chosen the course that its members consider best, one has no basis for concluding that the second household is better-off. This would imply that the people in the

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120. For an overview of various factors that might affect an analysis of intergenerational redistribution through Social Security or broader budget policy, see Daniel Shaviro, *The Long-Term Fiscal Gap: Is the Main Problem Generational Inequity?*, 77 GEO. WASH. L. REV. 1298, 1320–22 (2009).

121. See BERKOWITZ, *supra* note 53, at 4.

first household made the wrong decision from the standpoint of their own self-interest, which might be the case but would require further inquiry. [Thus, while] we should want retirement health insurance to cover non-working spouses . . . [that does not mean] the coverage should be funded by a transfer from other households. One could instead require one-earner households to pay more for the extra coverage they get—just as two-earner households do through the income and payroll taxes on both spouses' earnings.<sup>122</sup>

In both Social Security and Medicare, however, the lack of a direct link between taxes and benefits impedes thinking about the system's transfer content between households in this way. The result is a substantial disparity in the relative treatment of different types of households, not obviously justified on distributional grounds, and accentuating rather than offsetting similar biases elsewhere in the fiscal system, such as in the federal income tax.<sup>123</sup> This adverse byproduct of obscuring the tax-benefit link in Social Security and Medicare should not be denied or minimized, even if one considers it a cost worth bearing on balance.

#### D. The Issue of PSA Inheritability

The issue of PSA inheritability also has distributional elements. In existing Social Security, when people die before retirement age, while there are survivors' benefits for spouses and minor children, there is no literal inheritance based on the decedent's taxes paid to date or annuity expectations. The Ryan plan, by contrast, would make PSAs inheritable when the participant dies before purchase of the retirement annuity.<sup>124</sup>

Suppose PSAs were forfeited to the government when the worker died before reaching retirement age and thus the purchase of a life annuity. Indeed, to increase the parallelism to current Social Security, in which the payroll taxes paid by people who die during their working years help fund the program as a whole, suppose the amounts in forfeited PSAs were used in some pro rata fashion to help purchase larger retirement annuities for everyone else (thus reducing the amounts that needed to be set aside up front). The result would be

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122. WHO SHOULD PAY FOR MEDICARE?, *supra* note 7, at 70.

123. See MAKING SENSE OF SOCIAL SECURITY REFORM, *supra* note 7, at 72–73.

124. Ryan, *supra* note 4, at 54.

redistribution from people who die before retirement (and their heirs) to those who live longer.

The 2010 Roadmap describing the Ryan plan for Social Security lauds inheritability as an important property rights feature that helps to narrow the gap between Social Security and private retirement accounts.<sup>125</sup> However, as a policy matter, once one considers the particular reasons for having the government impose forced saving on retirees, the provision of this feature is quite puzzling. It bears no obvious relationship to the problems of consumer failure, market failure, and altruistic or fiscal externalities that help motivate forced saving programs.

Redistribution from the shorter-lived to the longer-lived is inherent to the life annuity insurance model, reflecting that one has reason to insure against the “risk” of living too long and thus needing more lifetime resources. In private annuity markets, people can, if they like, pay for a minimum-return feature in cases where they die either before the start of the payout period or too early within it. Obviously, the value of this feature requires reducing the regular annuity payouts relative to the premiums paid for the coverage.

Suppose that people who purchase life annuities (or who would do so if choosing rationally in a market setting where adverse selection was not a problem) were to decline any such minimum-return feature. Unless we posit that failing to leave a bequest is irrational, there is no obvious reason to posit consumer failure here. Nor is there any reason to think that the market could not adequately price this feature (which if anything reduces adverse selection problems based on inside information about one’s own actual life expectancy). It also is unclear why failing to select a minimum-return feature would trigger altruistic or fiscal externalities, other than in the case where one has left dependents who are counting on one for support. This, however, calls at most for survivorship features like those that traditional Social Security already has, as distinct from general and full inheritability.

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125. *See id.*

## VII. Conclusion

Contemporary political debate about Social Security and Medicare often conflates questions about the programs' long-term fiscal sustainability with those about their proper design. In fact, subject to political economy issues that the design may affect—but not in any obvious or straightforward manner—the two sets of questions are quite separate. One can make either program more market-based without improving its long-term budgetary projections, and, if such changes are independently desirable, their adoption should not depend on the long-term fiscal picture.

Making government programs more market-based—formerly known, and other than for Social Security and Medicare still commonly known, as “privatization”—is easy to endorse in cases where there is no persuasive rationale for a government role. Thus, in the aftermath of the recent U.S. government rescue of General Motors and Chrysler, it was probably a good idea to ensure that the companies would remain in private hands and not become state-managed enterprises. After all, it is hard to see what distinctive advantages the government would realize by substituting political control for that by profit-seeking private actors.

In the case of Social Security and Medicare, however, the basic rationales for the programs—which few openly contest, and which I find genuinely persuasive—rest on concerns about consumer and market failure. Making the programs more market-based is thus not obviously correct, even if one strongly favors the market provision of consumer goods in most circumstances. What is more, politics will retain ongoing importance even if the programs become more market-based. For example, in the Ryan Medicare plan, Congress will inevitably play a role in deciding whether the rate of healthcare expenditure growth is allowed to slow as projected. And in a private accounts-based Social Security system, it is inevitable that Congress will consider intervening if a stock market collapse causes account balances to drop sharply just when a given age cohort is on the verge of retirement.

Overall, I believe that the cases for making Social Security and Medicare more market-based are largely unpersuasive. In the case of Social Security, while there are potential efficiency advantages to making the marginal link between one's taxes paid and one's benefits received both stronger and more transparent, the case for offering great-

er portfolio choice through the program appears to me to be extremely weak. In particular, it ignores the distinctive role that Social Security plays in people's overall retirement portfolios, as the irreducible bottom tier of one's retirement saving.

As for Medicare, it is not clear how well markets can operate with respect to healthcare provision, given problems with adverse selection and consumer choice, along with the widespread availability of subsidized or free healthcare (reflecting widespread agreement that people should not be denied vitally important treatment). In addition, even granting that Medicare's growth rate relative to GDP cannot exceed the limits of sustainability, I am skeptical that we should favor attempting to impose a GDP-based, consumer-side "hard cap" that could result in coverage that is ever-worsening relative to contemporaneous medical treatment norms, even if ever-improving (for technological reasons) in absolute terms.