

ARTICLE

SOCIAL SECURITY REFORM: DOES PRIVATIZATION STILL MAKE SENSE?

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The issue of Social Security reform is of critical if not unrivalled importance—and not just because the program is headed for insolvency as the baby boomers enter retirement. Lawmakers continue to introduce Social Security reform legislation, some proposing far-reaching structural changes including personal accounts. An important motivation is that America’s demography and economy have evolved to such an extent that the program no longer provides social insurance benefits as effectively as it once did, but instead, economic losses from its tax and benefit rules are continuing to accumulate. The longer that reforms are delayed, the larger will be the net economic harm that Americans must endure.

On balance, Social Security appears to be a regressive tax-transfer system and provides minimal wage insurance. Many of its features, especially the extreme complexity of its tax and benefit rules, weaken and mask the link between payroll taxes and benefits to induce large economic losses from dislocations to participants’ labor market choices. The program over-provides longevity insurance, with benefits commencing well in advance of the time when work abilities are depreciated and participants approach the end of their expected lifetimes. By providing benefits to retirees in excess of their past contributions, Social Security transfers resources from younger and future generations toward older ones in the form of annuities. These features stimulate consumption during retirement to reduce national saving, capital formation, and prospective economic growth.

Social Security’s approaching insolvency implies that someone must bear an adjustment cost. The larger the adjustment cost imposed on today’s older generations, the smaller the burden on younger and future generations, improving their ability to save for their own retirements. Transcending this zero-sum policy trade-off, however, requires a transition to a system with personal accounts. Personal accounts will not improve the program’s solvency directly, but would help generate new resources by strengthening the link between “contributions” and benefits, thereby reducing dislocations of individual labor-supply choices. At a minimum, personal accounts could be an effective mechanism for sequestering from government spending additional resources intended to reduce Social Security’s unfunded obligations.

Following the theme of Harvard Law School’s symposium on Government Privatization and Outsourcing held in the winter of 2012, this paper discusses the financial mechanics involved in privatizing Social Security, its potential contribution toward improving Americans’ retirement security, and the problems that may emerge from such a structural change to the program.

* Senior Fellow, Cato Institute; Member, Social Security Advisory Board. This paper was prepared for Harvard Law School’s *Journal on Legislation*. It is an augmented version of the author’s remarks and discussion during Harvard Law School’s Symposium on Government Privatization and Outsourcing that was held on February 16, 2012. The author gratefully acknowledges provision of unpublished data on Social Security’s operations and projections by Alice Wade of the Social Security Administration and very helpful comments by Katie Bailey, Erin Partin, Sita Slavov, Peter Van Doren and Jeffrey Wrase.

I. INTRODUCTION

A seventy-seven-million-strong wave of aging baby boomers is currently transitioning from work and into retirement and becoming eligible to collect Social Security benefits.¹ Despite expecting to be healthier and to live longer during retirement than earlier generations, many boomers appear not to have saved sufficiently and are financially ill prepared for retirement.² Their reliance on Social Security is likely to increase. The baby boomers will likely strive to maintain and perhaps even increase their Social Security benefits. But the workforce is projected to increase at a considerably slower pace and high unemployment and low labor force participation rates are worsening prospects of rapid payroll growth—the base from which Social Security benefits are drawn.³ Increasing payroll taxes under such conditions could prove counterproductive because most of the ensuing Social Security surplus is unlikely to be saved and invested by the government and increasing marginal tax rates would exacerbate costly distortions to worker's labor-market choices.⁴

Social Security's trustees project that if current laws are maintained, the program will be unable to pay its liabilities in full after the year 2035.⁵ More than two decades seems to be sufficient time for enacting reforms after a careful evaluation of the policy options. Consider, however, that the last major Social Security reform (in 1983) was not undertaken until the program's

¹ U.S. Census Bureau, *National Characteristics Datasets: Monthly Postcensal Resident Population* (Dec. 1, 2011), <http://www.census.gov/popest/data/national/asrh/2011/2011-nat-res.html>. Figure calculated by the author as the resident population aged forty-seven to sixty-five as of December 2011.

² The median net worth of families headed by someone between the ages of fifty-five and sixty-four in 2010 was only \$179,400. The median financial asset holding of this group in 2010 was \$55,800. Jesse Bricker et al., *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, FED. RES. BULL., June 2012, at 1, 17 tbl.4, 30 tbl.6. For a discussion of retirement savings shortfalls among Americans, see generally ALICIA MUNNELL ET AL., CTR. FOR RET. RESEARCH, *IS THERE REALLY A RETIREMENT SAVINGS CRISIS? AN NRRI ANALYSIS* (2007), available at <http://crr.bc.edu/briefs/is-there-really-a-retirement-savings-crisis-an-nrri-analysis>.

³ The number of Social Security beneficiaries is projected to grow at an annual rate of 2.3%, while the size of the labor force in occupations covered by Social Security is projected to grow at just 0.7% per year. BD. OF TRS., FED. OLD-AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, 2012 ANNUAL REPORT, H.R. DOC. NO. 112-102, at 53 tbl.IV.B2 (2012) (figures calculated by the author). The commentary on the long-term effects of continued high unemployment on worker skills, labor-force attachments, and labor productivity is extensive. See, e.g., Ben Bernanke, Chairman, Bd. of Governors of the Fed. Res. Sys., Address at the National Association for Business Economics Annual Conference (Mar. 26, 2012), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20120326a.htm>.

⁴ For a description of how the annual surpluses of the Social Security Trust Fund have been utilized, see H.R. DOC. NO. 112-102, at 26, 154.

⁵ *Id.* at 56–58. The trust fund exhaustion date cited in the text refers to the Old Age and Survivors Insurance (“OASI”) program, which is the main focus of the discussion in this article. The OASI trust fund exhaustion date is projected by the trustees of the program.

insolvency approached to within a few months.⁶ The program's trust fund exhaustion date has regressed rapidly in recent years and may continue to do so as program officials adjust projection methods and assumptions.⁷ This is especially so because, arguably, the program's trustees appear to be underestimating its financial shortfalls.⁸

Social Security's fiscal (tax and benefit) treatment varies widely across demographic groups and those in different economic situations—in both intended and unintended ways—and opinions about how the program should be reformed also vary widely across the political spectrum. For example, Social Security provides a much more generous rate of conversion of past earnings into benefits for low-income individuals compared to high earners.⁹ Married single-earner households receive larger benefits per dollar of past earnings than single earners or married dual-earner couples whose labor earnings are roughly similar.¹⁰ One unintended consequence of its age eligibility conditions is that minorities, who tend to experience higher average mortality rates compared to other groups, collect benefits for fewer years, which reduces their lifetime returns from the system—an issue that is independent of the system's intended progressivity in annual benefits across low and high earners.¹¹ Unfortunately, the public debate on Social Security suffers from misperceptions about the program's effectiveness in providing intended social insurance benefits weighed against the economic losses it induces by dislocating participants' economic choices. The program's strong labor-supply disincentive effects mean that it induces workers to exit the labor force earlier, bringing benefit payouts forward and depriving the economy of labor services and associated payroll, income, and other taxes.

⁶ The 1983 National Commission on Social Security Reform (known as the Greenspan Commission) reported that revenues and trust fund assets would be insufficient to make benefit payments by July 1983. NATIONAL COMMISSION ON SOCIAL SECURITY REFORM, REPORT J14 (1983).

⁷ The 2011 Annual Report of the Social Security Trustees projected that the OASI trust fund would be exhausted by 2038. BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. AND FED. DISABILITY INS. TRUST FUNDS, 2011 ANNUAL REPORT, H.R. DOC. NO. 112-23, at 58 tbl.IV.B3 (2011). That exhaustion date was 2043 in the 2005 Annual Report of the Social Security Trustees. BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. AND DISABILITY INS. TRUST FUNDS, 2005 ANNUAL REPORT, H.R. DOC. NO. 109-18, at 52 tbl.IV.B3 (2005).

⁸ For an independent evaluation of Social Security's finances, see generally JAGADEESH GOKHALE, SOCIAL SECURITY: A FRESH LOOK AT POLICY ALTERNATIVES (2010) [hereinafter GOKHALE, A FRESH LOOK]. See also Jagadeesh Gokhale, *Trustees' Projections Mask Social Security Shortfall*, POLITICO (Apr. 30, 2012), <http://www.politico.com/news/stories/0412/75747.html>.

⁹ See BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. AND FED. DISABILITY INS. TRUST FUNDS, 2010 ANNUAL REPORT, H.R. DOC. NO. 111-137, at 201-02 tbl.VI.F10 (2010).

¹⁰ *Social Security: The Long-Term Budget Implications: Hearing Before the H. Comm. on the Budget*, 107th Cong. 47 (2002) (statement of C. Eugene Steurle, Senior Fellow, Urban Inst.).

¹¹ For example, the life expectancies of black men and women are lower than those of their white counterparts. Elizabeth Arias, Ctrs. for Disease Control & Prevention, *United States Life Tables, 2007*, 59 NAT'L VITAL STAT. REP. no. 9, at 4 (2011).

One type of reform that is especially controversial concerns “privatizing” the system—either by diverting existing payroll taxes into personal retirement accounts or requiring additional contributions into such accounts. Many lawmakers and experts have proposed Social Security reforms that would create personal retirement accounts with the objective of shifting the responsibility of retirement saving away from the federal government.¹² This is not only because of poor stewardship of the program by the government to date but, more importantly, because of the potential economic benefits of such a structural change. This paper first describes the current operations and financial condition of Social Security’s Old-Age and Survivors Insurance (“OASI”) program (excluding the Disability Insurance program, which is considered separately). It then explores the financial mechanics involved in privatizing the OASI program, the potential beneficial effects of doing so, and the problems that may be encountered along the way of implementing this policy option.¹³

II. SOCIAL SECURITY’S EVOLUTION, KEY FEATURES, AND CURRENT FINANCIAL CONDITION

Social Security was introduced in 1935 as a program of economic protection for the elderly.¹⁴ It originally provided benefits only to workers aged 65 and older as partial income replacement against loss of income-earning ability because of old age.¹⁵ The program has evolved over time, mainly by extending such protection to broader population groups. Survivor, dependent, and child benefits against the loss of income from old age (or loss of the primary Social Security benefit recipient) were added in 1939. Benefits to disabled workers were introduced in 1956. The early retirement age was introduced for women in 1956 and for men in 1961, largely in response to demands to provide relief to older workers unable to find employment. Benefit levels were increased in an ad hoc manner until the 1970s and thereafter indexed against inflation. Payroll taxes for funding benefits were initially set at two percent on the first \$3,000 of wage earnings (one percent of wages, each, on employers and employees). The payroll tax rate and the earnings

¹² See *infra* text accompanying note 72.

¹³ The OASI and the Social Security Disability Insurance (“SSDI”) programs have independent trust funds. Though the SSDI trust fund is projected to be insolvent much sooner than the OASI trust fund, the SSDI trust fund also has a unique and independent set of problems that are not amenable to be solved via privatization or prefunding. See generally JONATHAN SCHWABISH, CONG. BUDGET OFFICE, POLICY OPTIONS FOR THE SOCIAL SECURITY DISABILITY INSURANCE PROGRAM (2012), available at <http://www.cbo.gov/publication/43421>. Consequently, the discussion in this paper on privatizing Social Security is limited to the OASI program. Note, however, that SSDI beneficiaries are shifted over to the OASI trust fund upon attaining full retirement age. The OASI trust fund projections used in the text assume that this practice will continue in the future.

¹⁴ See *Historical Background and Development of Social Security*, SOC. SEC. ADMIN., <http://www.ssa.gov/history/briefhistory3.html> (last updated May 16, 2012).

¹⁵ See *id.*

cap were both increased gradually to accommodate successive benefit expansions. Today, OASI payroll taxes are levied at the rate of 10.6%—5.3% each on employers and employees in covered occupations—to pay for retirement, dependent, survivor, and other benefits.¹⁶ The occupations included under the Social Security program were broadened so that more than 95% of the workforce is covered under the program today. Under today's laws, Social Security retirement benefits replace about 40% of pre-retirement earnings, on average, for those who retire at their full retirement age (currently age sixty-six).¹⁷

Figure 1 shows OASI's financial history since 1970 and its latest financial projections as reported by the program's trustees through the year 2086. It shows that the program's revenues—payroll taxes plus income taxes on the Social Security benefits of high-income retirees—exceeded the program's benefit payments and administrative costs until 2009.¹⁸ Surplus payroll taxes are required by law to be invested in special-issue Treasury securities.¹⁹ As a result, those funds are used up immediately for financing current federal non-Social Security operations. Indeed, studies suggest that Social Security surpluses may be counterproductive with respect to the goal of increasing national saving. Although past Social Security surpluses have been spent for providing public goods and services to today's citizens—cumulatively worth \$2.5 trillion—Treasury IOUs held in the OASI trust fund imply a corresponding liability of the Treasury to the OASI trust fund.²⁰

¹⁶ The temporary two percentage-point partial reduction in the payroll tax for 2011 and 2012 is ignored here because the estimated revenue loss to the OASI trust fund is to be replaced with federal general revenues.

¹⁷ In contrast, financial planners usually suggest a retirement income replacement rate of between seventy and eighty percent in order to maintain one's pre-retirement living standard after retirement. See Christine Benz, *Digging into the 80% Rule for Income Replacement in Retirement*, MORNINGSTAR (Sept. 10, 2012), <http://news.morningstar.com/articlenet/article.aspx?id=567108>. See also *Exploring the Economics of Retirement: Hearing Before the S. Spec. Comm. on Aging*, 109th Cong. 13 (2005) (statement of Hon. Alan Greenspan, Chairman, Fed. Res. Bd.). Benefits per person for workers' dependents and survivors are generally no larger than retirement benefits. Nonretirement benefits account for about one-fourth of the OASI program's total annual Social Security benefits expenditures of the OASI program. See SOC. SEC. ADMIN., ANNUAL STATISTICAL SUPPLEMENT, at fig.6.A3 (forthcoming 2012), available at <http://www.ssa.gov/policy/docs/statcomps/supplement/2012/6a.html#table6.a3>. The calculation adds together the product of the total number and average monthly benefit for (a) retired workers, (b) spouses of retired workers, (c) children of retired workers, (d) children of deceased workers, (e) widowed mothers and fathers, and (f) nondisabled widow(er)s. Taking the ratio of (a) to the sum of (a) through (f) yields 76.2%, confirming the claim. Note that the benefits of disabled workers would be paid out of the SSDI trust fund, and not the OASI trust fund.

¹⁸ BD. OF TRS., FED. OLD-AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, 2012 ANNUAL REPORT, H.R. DOC. NO. 112-102, at 36 tbl.IV.A1 (2012). The fact that 2009 was the last year with a payroll tax surplus for the OASI program can be deduced by observing that the program's net interest income is larger than the increase in the OASI trust fund's assets after 2009.

¹⁹ Social Security Act, 42 U.S.C. § 401(d) (2006). See also DAWN NUSCHLER, CONG. RESEARCH SERV., RS20607, SOCIAL SECURITY: TRUST FUND INVESTMENT PRACTICES 1 (2010).

²⁰ H.R. DOC. NO. 112-102, at 64 tbl.IV.B5.

Thus, despite projected revenue shortfalls, the OASI trust fund can continue paying Social Security benefits at current-law levels by drawing down those IOUs—that is, without explicit authorization by Congress.

As Figure 1 shows, Social Security's trustees project that the trust fund's IOUs will be exhausted by 2035. After that year, without changes to Social Security's tax and benefit rules and without conferring to the trust fund the ability to borrow funds, only about 75% of current-law benefits would be payable after 2035. This makes the trajectory of current law "payable benefits" (dashed line in Figure 1) the appropriate baseline for comparing the effects of alternative Social Security reforms. The "scheduled benefits" trajectory (small-dotted line in Figure 1) is relevant from an "adequacy" perspective—if current-law benefits are deemed to deliver the appropriate level of Social Security benefits. In order to avoid the inability to pay benefits as mandated by law, Congress must change Social Security's tax and benefit rules before 2035.

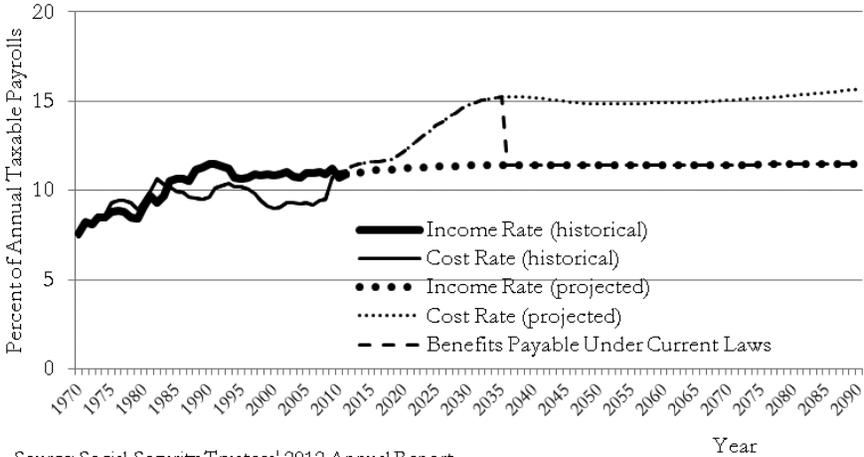
A useful summary measure of the program's financial condition is the "open group unfunded obligation." It is calculated as the present value of projected total benefits under current program rules minus the present value of projected revenues and minus the value of the OASI trust fund—with present values calculated over a specific number of future years—usually seventy-five. This unfunded obligation measures excess benefits projected under OASI's current laws relative to the resources available to the program under those laws—both assets in hand (the trust fund) and projected revenues. The present value of OASI's current-law benefit obligations over the next seventy-five years, discounted to account for the time interval before they come due (\$48.8 trillion), minus the present value of future OASI revenues discounted similarly (\$38.9 trillion) equals \$9.9 trillion.²¹ Subtracting the OASI trust fund of \$2.5 trillion, which captures the net result of all *past* OASI taxes and benefits—yields \$7.4 trillion.²² This amount reflects the program's net unfunded obligations on account of past, current, and future generations through the next seventy-five years (2012–2086). Taking its ratio to the present value of taxable payrolls yields 2.17 percentage points. This is the percentage point increase required through 2086 in OASI's current payroll tax rate of 10.6%. The higher payroll tax rate of 12.77% would have to

²¹ The choice of discount rate is not a trivial issue. The future revenues and benefits of the Social Security program should be discounted to reflect the government's expected average long-term opportunity cost of obtaining funds (the rate that the United States Treasury expects to pay, on average, to borrow long-term). For illustrative purposes, however, the discount rate used here is the same as that of the Social Security Trustees' intermediate interest rate assumption: 5.7% (nominal). H.R. Doc. No. 112-102, at 103. Using a higher discount rate would be expected to change the quantitative results but not necessarily the qualitative nature of the paper's conclusion.

²² The figures cited in this paragraph are reported in H.R. Doc. No. 112-102, at 64 tbl.IV.B5. This dollar estimate can be interpreted as the amount of additional funds that the government must have, invested at interest, to cover future shortfalls for the next seventy-five years and obviate the need to change Social Security's taxes and benefits during that period.

be implemented immediately and maintained through 2086 to cover OASI's unfunded benefit obligations of \$7.4 trillion over that period.²³

FIGURE 1
SOCIAL SECURITY'S (OASI) FINANCIAL HISTORY AND PROJECTIONS



Source: Social Security Trustees' 2012 Annual Report.

Unfortunately, a seventy-five year projection horizon seriously understates Social Security's financial shortfall. Under the program's pay-as-you-go financing structure, current payroll taxes—that are fully used to pay current OASI benefits—also create valid public expectations of additional future benefits beyond the seventy-five year budget window. A finite budget window, even one that is seventy-five years long, excludes sizeable benefit obligations beyond the budget window created by payroll taxes within the window. It implies that focusing on *solvency*—whether the government can pay benefits through a finite period—is inadequate. Hence, official reports of Social Security's financial condition include measures of *sustainability* to assess whether the program can cover its current-law benefit obligations throughout the future.²⁴

²³ The higher payroll tax rate is likely to reduce labor supply and the payroll tax base, making the required payroll tax rate increase larger than 2.17 percentage points. The Social Security Administration does not undertake the dynamic scoring of such second order effects.

²⁴ See, e.g., H.R. Doc. No. 112-102, at 46. An often-used but inadequate measure of Social Security's financial sustainability (called "sustainable solvency") measures whether (1) revenues would cover benefits over the next seventy-five years and (2) whether the trust fund's size is projected to be increasing toward the end of the seventy-five year budget window. Social Security is declared to be sustainable only if both conditions are met. *Id.* Unfortunately, under this ad hoc measure, some reforms may appear to be sustainable, but are actually not, while others may appear to be unsustainable but actually are sustainable. See Jagadeesh Gokhale & Kent Smetters, *Measuring Social Security's Financial Outlook Within an Aging Society*, 135 DAEDELUS 91, 97 (2006).

If one includes in the estimate of OASI's unfunded obligations the post-seventy-fifth year projected obligations net of post-seventy-fifth year projected revenues, there is a sizable increase in the estimate of these unfunded obligations. OASI's "infinite horizon" unfunded obligation—on account of past, current, and all future participants—amounts to \$15.9 trillion.²⁵ Calculating the ratio of this estimate to the present value of future payrolls shows an imbalance ratio of 3.1 percentage points—the payroll tax rate increase that would be required to cover the unfunded obligation under current laws.²⁶ Thus, either OASI's current tax rate of 10.6% would have to be increased immediately and permanently to 13.7% to cover OASI's total unfunded obligations, or OASI benefits would have to be reduced to fit within available revenues, or some combination of the two, to achieve program sustainability.²⁷

A looming insolvency—inability to pay liabilities when due—compels debtors to either seek additional funding or a debt restructuring to increase short term liquidity and stave off bankruptcy. Such restructuring implies a renegotiation of debt terms with creditors. In the case of OASI, creditors are all current participants but funding sources include current and future participants. Any restructuring of OASI's tax and benefit rules will also affect future participants' economic possibilities and choices.

III. SHOULD WE SIMPLY INCREASE PAYROLL TAXES?

The short answer is: "No."²⁸ An increase in OASI's payroll tax rate by 3.1 percentage points of taxable payrolls—equal to the imbalance ratio cited

²⁵ The Social Security Administration does not provide an estimate for the infinite horizon OASI open group unfunded obligation. The estimate cited in the text was constructed by the author by extrapolating OASI benefits and revenues beyond the last projection year (2086) reported in the 2012 OASI trustees' annual report. *See* H.R. Doc. No. 112-102, at 64–67. The construction of this estimate uses unpublished data provided to the author by the Social Security Administration. The estimation method subtracts the value of the OASI trust fund at the beginning of 2012 of \$2.5 trillion from the present value difference in OASI benefits and payroll taxes. The author estimates the present value of OASI taxable payrolls to be \$505.7 trillion. The imbalance ratio of 3.1 percentage points mentioned in the text equals the ratio of the infinite horizon unfunded obligation of \$15.9 trillion to the present value of payrolls of \$505.7 trillion.

²⁶ Similar to all projections, the infinite horizon estimate and its ratio to the present value of projected taxable payrolls are not forecasts about the future. These are intended only as metrics—or characterizations—of current OASI tax and benefit rules under the assumption that those rules would be continued indefinitely. Indeed, the existence of such a large financial shortfall under OASI's current tax and benefit rules implies that those rules cannot be continued and, hence, that the estimated shortfalls will not be actually realized. The utility of these metrics, then, is to inform policymakers about how large future cumulative adjustment to OASI's tax and benefit rules must be to eliminate the shortfalls measured under current rules. For a fuller discussion, see generally JAGADEESH GOKHALE & KEN SMETTERS, *FISCAL AND GENERATIONAL IMBALANCES: NEW BUDGET MEASURES FOR NEW BUDGET PRIORITIES* (2003).

²⁷ The author's calculations show that the immediate and permanent benefit cut on all current and future beneficiaries would have to be twenty-one percent.

²⁸ The following description will exclusively focus on increasing the current 10.6% OASI tax rate.

in the previous section—would increase program revenues and generate annual surpluses in the medium term—through 2028 (see Figure 2 below). However, it would increase labor market distortions—tax-induced reductions in the amount of labor that workers choose to supply—causing even larger economic losses. Those include losses to workers in terms of reduced net-of-tax compensation and to consumers in terms of fewer and costlier gross-of-tax prices of the goods and services produced by workers. It is a well-established economic theorem that those losses are larger than the additional revenues that the higher payroll tax rate would generate. Moreover, it is unclear if any of the resulting surplus would be effectively saved and invested for paying future OASI obligations—as discussed in greater detail below.

A. Labor Market Distortions from the Payroll Tax

The OASI payroll tax rate already provides a significant labor market disincentive. The average marginal income tax rate in the US is estimated to be 26% (the sum of average marginal federal income tax rate of 21.7% and of the average marginal state sales tax rate of 4.3%).²⁹ Adding the current marginal OASI tax rate of 10.6% and adjusting for the fact that the employer portion of the OASI payroll tax is excluded from employee gross income increases the average marginal tax rate to 34.76%.³⁰ Increasing the payroll tax rate by an additional 3.1% to eliminate the program's unfunded obligation, again adjusting for the exclusion of the employer portion of the new tax from employee gross income, increases the total average marginal tax rate to 37.15%.³¹

Economic efficiency losses—that is, the losses of economic opportunities and resources—associated with a given increase in the tax rate on labor

²⁹ See Robert J. Barro & Charles J. Redlick, *Macroeconomic Effects from Government Purchases and Taxes* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 15369, 2009), available at <http://www.nber.org/papers/w15369>. Their calculations account for the zero marginal rate for Social Security (not Medicare) taxes for high-income individuals when calculating average marginal tax rates. They do not allow for offsetting future Social Security (and Medicare) benefits at the margin that those contributions trigger.

³⁰ H.R. Doc. No. 112-102, at 138–39. Current OASI payroll tax rate is reported in Table V.C6 of the 2012 Annual Report of the Social Security Trustees. *Id.* at 7. The adjustment for the exclusion of employer OASI payroll taxes from employee gross wages is implemented by adding together the total OASI payroll tax rate of 0.106 and the average marginal income tax rate of 0.26 and dividing that sum by the gross employer OASI payroll tax rate of 1.053—the rationale being that the gross wage would be commensurately larger were the entire payroll tax levied on the employee. This calculation yields the average marginal (income plus payroll) tax rate of $(0.26+0.106)/1.053=0.3476$, or 34.76%.

³¹ The calculation of the 3.1% estimate of additional payroll taxes required to eliminate OASI's unfunded obligation is described in the penultimate paragraph of section II above. The calculation of the total average marginal tax rate facing workers, including the additional 3.1 percentage point tax rate, is implemented as $(0.26+0.106+0.031)/1.0685=0.3715$. Here, the new employer portion of the payroll tax is $[0.053+(0.031/2)]=0.0685$.

services are larger the higher is the initial tax rate on those services.³² In the labor market, the cost (pecuniary, physical, and psychic) of supplying labor services—work hours, work intensity, cost of training and education, a longer career, and so on—is compensated for by wages and other fringe benefits. Whereas these costs increase with every additional unit of labor services provided by workers, employers' willingness to compensate for those services per unit declines with total labor services hired. With no taxes, labor services would be provided and hired until employers' willingness to compensate for the last unit hired equals the cost to workers of its provision. Imposing a tax on wages introduces a wedge between cost and compensation: With a tax on labor earnings, labor services whose provision costs more than the compensation rate minus the tax rate would be withheld from the labor market. It follows that the larger the tax wedge, the larger the withdrawal of marginal labor services from the market. The value of the economic opportunity and activity foregone because of (income and payroll) taxes on wages also depends on responsiveness of workers' labor service provision to increases in the tax rate which, in turn, depends on how rapidly the human and material costs of providing labor services increase with the amount provided.

A simple approach to quantifying economic losses from payroll taxes utilizes estimates of responsiveness of taxable payrolls instead of labor supply.³³ In addition, the calculation requires the average marginal income and payroll tax rates—those mentioned at the beginning of this section—and the total amount of taxable earnings. Using information on taxable payrolls from the Social Security Administration and applying a conservative estimate of the responsiveness of taxable earnings to tax rate increase, this method yields an estimated annual 2012 economic loss of \$316.9 billion.³⁴ Of this

³² This refers to the well-known economic principle that the economic loss from a tax rate grows in proportion to the square of the tax rate. See Arnold Harberger, *Taxation, Resource Allocation and Welfare*, in *THE ROLE OF DIRECT AND INDIRECT TAXES IN THE FEDERAL REVENUE SYSTEM* 25 (John F. Due ed., 1964). For a more general explanation, see generally JONATHAN GRUBER, *PUBLIC FINANCE AND PUBLIC POLICY* 577–610 (2d ed. 2009).

³³ See Martin Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax*, 81 *REV. ECON. & STAT.* 674, 674–80 (1999). Focusing on taxable payrolls rather than directly on labor supply helps to incorporate many other forms of labor market dislocations—those associated with making alternative career choices, changing the intensity of work, increasing charitable contributions, hiring tax professionals, choosing to receive compensation as non-taxed health and other fringe benefits, and so on, which augment economic losses arising from the tax-induced reduction in labor supply alone.

³⁴ H.R. DOC. NO. 112-102, at 37. Total 2012 payroll taxes of \$602.8 billion include federal general revenue transfers of \$95.8 billion in lieu of the temporary employee payroll tax cut of 2.0 percentage points. The formula for calculating the economic loss from imposing a tax is: $L = 0.5 \times \tau^2 \times [1 / (1 - \tau)] \times \epsilon \times TI$ where τ represents the average marginal tax rate, ϵ represents the elasticity (responsiveness) of taxable payrolls with respect to increases in the average marginal tax rate, and TI represents taxable payrolls. The estimate of the economic loss reported in the text (\$316.9 billion) corresponds to the total economic loss from the average marginal tax rate of 0.3476 corresponding to existing income taxes, state sales taxes, and payroll taxes. In constructing this estimate the value of ϵ was taken to be 0.6—intermediate between early estimates in the economics literature that ranged between 0.84 and 1.36 and more recent estimates

amount, the economic loss associated with just the existing (employer plus employee) payroll tax rate is estimated to be \$160.5 billion—26.6% of total payroll taxes of \$602.8 billion collected in 2012.³⁵ If the payroll tax rate is increased by an additional 3.1%, the annual economic loss from income and payroll taxes would increase to \$375.9 billion—an increase of \$59.0 billion each year that would make the losses from payroll taxes alone equal to \$219.6 billion—about 28.2% as large as the higher payroll taxes that would result.³⁶

Two caveats apply to these estimates. First, they are based on average marginal tax rates facing *all* households. However, taking into account marginal tax rates from federal programs directed to low income individuals and families—such as earned income credit, nutrition and housing support, Medicaid benefits, and so on—average marginal tax rates excluding OASI are much *higher* for low wage earners.³⁷ It implies much larger labor supply distortions from OASI taxes for low earners, potentially fully offsetting Social Security’s wage insurance provision for such households.³⁸ Second, mitigating these concerns is the fact that these estimates fully apply only if workers perceive zero linkage between their marginal OASI taxes and future OASI benefits. If workers do perceive such a linkage, OASI’s addition to marginal tax rates would be smaller as would the associated labor market distortions. Given the complexity of OASI tax and benefit rules, however, most individuals are unlikely to know or be able to assess their benefit-tax linkage.³⁹

ranging between 0.12 and 0.4. See Feldstein, *supra* note 33, at 679; Emmanuel Saez et al., *The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review* (Nat’l Bureau of Econ. Research, Working Paper No. 15012, 2009).

³⁵ This estimate is calculated by including only federal income and state sales taxes in forming the average marginal tax rate and subtracting the result from the estimated \$316.9 billion in economic loss. See *supra* note 34 and accompanying text.

³⁶ The 3.1% increase in payroll taxes would be needed to cover OASI’s total unfunded obligations—as mentioned in the penultimate paragraph of section II. As a result, with an increase in the employee plus employer payroll tax rate from its current value of 10.6% to 13.7%, payroll tax revenues would increase from \$602.8 billion to \$779.1 billion. The new ratio of economic losses from payroll taxes to total payroll taxes would be \$219.6 billion divided by \$779.1 billion, or 28.2%.

³⁷ Jagadeesh Gokhale et al., *Does It Pay to Work?* 63 tbl.4 (Nat’l Bureau of Econ. Research, Working Paper No. 9096, 2002).

³⁸ See GOKHALE, A FRESH LOOK, *supra* note 8, at 142.

³⁹ See Laurence J. Kotlikoff, *Thirty-Four Social Security Secrets You Need To Know Now*, PBS NEWSHOUR (July 30, 2012), <http://www.pbs.org/newshour/businessdesk/2012/07/social-security-secrets-you-ne.html>. See generally Jeffrey B. Liebman & Erzo F.P. Luttmer, *Would People Behave Differently If They Better Understood Social Security? Evidence From a Field Experiment* (Nat’l Bureau of Econ. Research, Working Paper No. 17287, 2011). The Social Security Administration now provides internet-based personalized earnings and benefit information to inform participants about the future Social Security benefits that workers might expect to receive under various life circumstances. However, benefit estimates in those statements are associated with past earnings and not with annual taxes. Indeed, the Social Security Administration says, “Remember, it’s your earnings, not the amount of taxes you paid or the number of credits you’ve earned, that determine your benefit amount.” SOC. SEC. ADMIN., SSA-7005-OL, YOUR SOCIAL SECURITY STATEMENT (2012), available at www.ssa.gov/my

The foregoing discussion naturally leads one to wonder whether the value of the program's social insurance provision—narrowly considered to be “old-age insurance” to mitigate the risk of old-age poverty from lost earning ability for workers and their dependents and survivors—is larger than its annual economic efficiency cost. The value of OASI's old-age insurance provision obviously cannot be equated with its total annual benefit payments because the alternative, in its absence, would be for workers to self-insure by saving for retirement, potentially generating a similar amount of retirement resources.

The program's insurance value resides in its guarantee of a basic level of support even when personal savings or other retirement income sources become devalued. As the experience during the Great Depression of the 1930s and, more recently, during the Great Recession of the 2000s showed, personal retirement savings may be severely dented by sharp declines in asset values, leaving retirees with few options for an economic recovery. However, although OASI's implicit goal is to reduce retirees' exposure to asset market risks, the program's large unfunded obligations imply that benefit payments remain exposed to political risks—the possibility that benefits will be significantly reduced. Indeed, unlike private sector defined benefit plans, Social Security benefits are not insured. And unlike most state and local defined benefit pensions, they are also not constitutionally protected, and are subject to amendment by Congress as and when necessary.⁴⁰

Some on the political left oppose quick OASI reforms because it can fully pay scheduled benefits for more than two decades and pay three-quarters of scheduled benefits after the OASI trust fund is exhausted in 2035. This policy stance implies a preference against gradual, smaller, and more even distribution of adjustment costs—and one favoring a large, sudden, and potentially uneven adjustment imposed on future generations. Such a preference translates into one favoring continued accumulation of political risks for future retirees, the fundamental source of which is economic and demographic developments.⁴¹ Those risks mean that the debate about whether personal Social Security accounts should be included is not one involving a choice between a “safer” versus a “riskier” system, but one of selecting out of a range of risky institutional alternatives. Given that the current system itself exposes participants to risks of economic loss—future benefit reductions and payroll or other tax increases—that appear to be just as significant as the market risks it helps participants to avoid, its overall insurance provision seems very unlikely to exceed the sizable annual economic losses that it generates.

statement/SSA-7005-OL.pdf. Thus, workers may continue to view their payroll taxes as taxes rather than as saving for financing their future retirement spending.

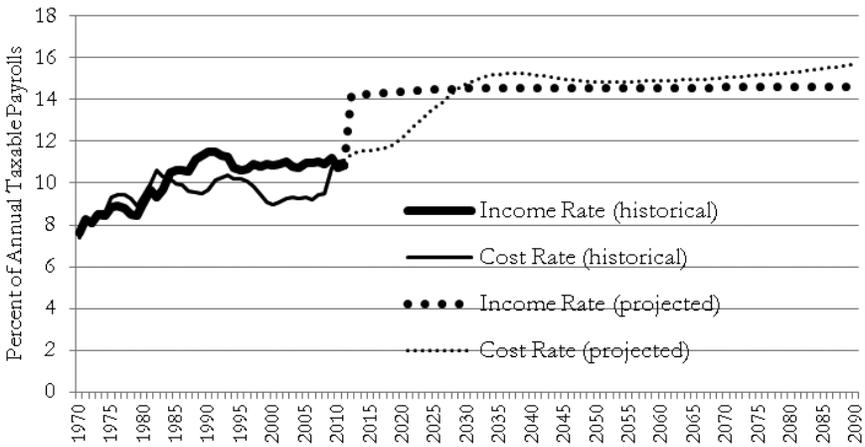
⁴⁰ See *Flemming v. Nestor*, 363 U.S. 603, 610–12 (1960).

⁴¹ See John B. Shoven & Sita N. Slavov, *Political Risk Versus Market Risk in Social Security* (Nat'l Bureau of Econ. Research, Working Paper No. 12135, 2006).

B. Payroll Tax Surpluses and Saving for the Future

Under current laws, increasing payroll taxes by 3.1% immediately and permanently will directly increase the Treasury securities held in the OASI trust fund.⁴² Figure 2 shows the cash flow implications of such a policy change with an increase in the payroll tax rate by 3.1 percentage points.⁴³ Early-year surpluses would eventually turn negative, but future annual deficits would be small so that the system's finances would be balanced in present value terms.

FIGURE 2
SOCIAL SECURITY'S (OASI) FINANCIAL HISTORY AND PROJECTIONS



Source: Social Security Trustees' 2012 Annual Report.

Year

Because the OASI trust fund's revenue surpluses must, by law, be invested in special-issue Treasury securities, the new surpluses would be made available to the federal government to spend immediately on non-Social Security programs—as happened in the past. Theoretically, it is impossible to know whether past OASI surpluses, the last of which occurred in 2009, were saved or dissipated unproductively by the federal government. That's because we will never observe the pattern of government expenditures that would have unfolded without those surpluses. Carefully implemented empirical studies that attempt to answer this question, however, conclude that the availability of OASI surpluses, far from increasing national saving, appear to

⁴² 42 U.S.C. § 401(d) (2006). The securities held in the OASI trust fund are “special issue” Treasury securities intended only to be held in that trust fund. That is, they are not marketable securities. See NUSCHLER, *supra* note 19, at 1.

⁴³ Figure 2 shows calculations of the author using unpublished annual OASI financial projections obtained from the Social Security Administration.

have done the opposite by inducing even larger federal expenditures.⁴⁴ These studies imply that the current Social Security trust fund arrangements are likely counterproductive relative to the goal of saving and investing those resources for meeting future Social Security obligations.⁴⁵

One may be justifiably skeptical that *any* institutional arrangement involving the government as “custodian” of Social Security surpluses would be effective in increasing national saving and investment.⁴⁶ Given that the balance of evidence suggests that the current institutional set-up (the Social Security trust fund) may be counterproductive, an approach that does not involve direct government control of any new Social Security funding under a reformed OASI program is worth considering. International evidence on public pension conversions from defined benefit to defined contribution systems also shows that many other developed countries have adopted the “privatization” path in response to demographic pressures compelling shifts from pay-as-you-go financing to funded Social Security systems.⁴⁷

IV. SOCIAL SECURITY’S EFFECT ON AMERICANS’ ECONOMIC CHOICES

Section III described the costs associated with labor supply distortions that the OASI payroll tax induces and described the difficulty of effectively saving resources for the future via the federal government. This section describes other sources of economic losses including ways in which Social Security’s social insurance provision has been diluted during recent decades.

A. Longevity or “Old Age” Insurance

Social Security’s provision of longevity insurance is traditionally considered to be very significant since the majority of its benefits are paid after

⁴⁴ See Kent Smetters, *Is The Social Security Trust Fund A Store Of Value?*, 94 AM. ECON. REV., 176, 180–181 (2004). Indeed, the empirical tests in this study are biased toward finding that past Social Security surpluses reduced federal debt. See Sita Nataraj & John B. Shoven, *Has The Unified Budget Undermined the Federal Government Trust Funds?* (Nat’l Bureau of Econ. Research, Working Paper No. 10953, 2004); BARRY BOSWORTH & GARY BURTLESS, BROOKINGS INST., PENSION REFORM AND SAVING (2004), available at <http://www.brookings.edu/~media/research/files/papers/2004/1/05useconomics%20bosworth/200401bosworthburtless>.

⁴⁵ Given these well-known concerns about saving funds for the future through the federal government, some Social Security experts propose increasing payroll taxes “as needed” to balance the program’s cash flows each year. For an example of such a proposal, see Robert Ball, *A Golden Opportunity for the New Congress*, WASH. POST, Oct. 29, 2007, at A15. The problem is that such a policy would exacerbate labor-market distortions even more by increasing marginal tax rates.

⁴⁶ One such mechanism was Vice President Al Gore’s idea of a Social Security “lock box” to ensure that the federal government would not be allowed to spend those funds on other government programs. Although legislation introduced by Representative Wally Herger (R-Cal.) was passed by the U.S. House of Representatives, it was filibustered by the Democrats in the Senate. See H.R. Res. 1259, 106th Cong. (1999).

⁴⁷ See Kent Smetters & Walter E. Theseira, *A Matter of Trust: Understanding Worldwide Pension Conversions* 6 (Nat’l Bureau of Econ. Research, Working Paper No. 17015, 2011).

retirement and protection against outliving resources is valuable for retirees. Social Security was enacted as a social response to growing economic uncertainties that workers faced in an increasingly interdependent market economy—particularly the risk that lifelong savings could be wiped out by financial market turmoil, thus causing destitution among older workers with declining work abilities.⁴⁸ At a time of growing industrialization and the widespread geographic dispersion and dissolution of the extended families that eroded traditional sources of support for older workers, Social Security was introduced to provide “protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.”⁴⁹ When it was enacted in 1935, however, Social Security’s benefit eligibility was set at age sixty-five—about three and a half years short of the average age of survival conditional on reaching age twenty.⁵⁰ Thus, Social Security was provided as insurance against the accident of living longer than one’s expected lifespan with no wage earning ability because of old age.

Today, however, the likelihood of survival through one’s mid-sixties and in good health is much higher, which means that the program’s old-age insurance function is now considerably diluted.⁵¹ Indeed, Social Security’s relatively stable benefit eligibility age relative to gains in life-expectancy and the decline in the modal age of collecting benefits from sixty-five to sixty-two during the past several decades suggests that the program has been gradually transformed from providing old-age insurance to replacing retirement saving. These developments mean that the social response of providing

⁴⁸ See *Historical Background and Development of Social Security*, SOC. SEC. ADMIN., <http://www.ssa.gov/history/briefhistory3.html> (last updated May 16, 2012).

⁴⁹ Presidential Statement Upon Signing the Social Security Act, 4 PUB. PAPERS & ADDRESSES OF FRANKLIN D. ROOSEVELT 324 (Aug. 14, 1935).

⁵⁰ See Elizabeth Arias, Ctrs. for Disease Control & Prevention, *United States Life Tables, 2007*, 59 NAT’L VITAL STAT. REP. no. 9, at 48 (2011), available at [www.cdc.gov/nchs/data/nvsr/nvsr59_09.pdf](http://www.cdc.gov/nchs/data/nvsr/nvsr59/nvsr59_09.pdf). This table shows that for all races and both genders, average life expectancy at age 20 was approximately age 68.5 during the late-1930s.

⁵¹ See *id.* This table shows that for all races and both genders, average life expectancy at age twenty was through age seventy-nine in 2007—the latest year for which statistics are available. Although adult life expectancy at age twenty has now increased to age seventy-six for men and eighty-one for women, Social Security’s full retirement age is scheduled to increase from sixty-five to just sixty-seven. *Id.* Life expectancy at age sixty-five has also increased since the 1940s. *Id.* More importantly, the share of those aged twenty surviving through age sixty-five has increased considerably from 65% in the 1940s to 85% today, making the collection of Social Security benefits a surer bet. Elizabeth Arias, Ctrs. for Disease Control & Prevention, *United States Life Tables, 2008*, 61 NAT’L VITAL STAT. REP. no. 3, at 48 tbl.20 (2012). Even these survival probabilities are calculated based on current mortality experience and not on projected future survival rates. See *id.* at 1. Moreover, the evidence shows significant improvements in Americans’ health status during recent decades at Social Security’s early retirement age of sixty-two—health-equivalent ages relative to age sixty-two in 1960 appear to be higher by between five to ten years depending on the particular metrics used. David M. Cutler et al., *An Expanded Model of Health and Retirement* 18 (Nat’l Bureau of Econ. Research, Working Paper No. NB07-15, 2007) (“Considering all the evidence, it is clear that health near traditional retirement ages has improved markedly over time. Our best guess is that people aged 62 in the 1960s or 1970s are in equivalent health to people aged 70 or more today.”).

insurance against “loss of earnings” from old age has morphed into one that incentivizes workers to lose their earnings soon upon attaining the age of first benefit eligibility (age sixty-two).⁵² Note that, upon retirement, Social Security benefits are provided as monthly annuities that last through the end of retirees’ life spans and not as one-time lump sum awards at retirement to support retirement expenses during the entire remaining lifespan. The annuity form of benefit provision is intended to insure against outliving retirement resources. However, the program’s much smaller scheduled increase in its full retirement age relative to human life span extensions during the last several decades implies that such annuities (and, therefore, the associated longevity insurance) are now provided for a significant portion of retiree lifetimes during which survival is a much surer bet. By implication, the increase in longevity well beyond Social Security’s statutory retirement ages implies over-provision of longevity insurance through non-optional annuitization of Social Security benefits.

B. *Saving and Intergenerational Inequality*

Without Social Security, a longer expected lifetime and a longer retirement life span would motivate greater saving during working years.⁵³ But expectations of Social Security benefits means that workers who target a particular retirement living standard can save commensurately less out of their earnings.⁵⁴ Indeed, this negative savings effect is cemented by non-optional annuitization of Social Security wealth. The longevity insurance

⁵² Social Security’s negative impact on the labor force participation of older workers is well documented. See generally Peter Diamond & Jonathan Gruber, *Social Security and Retirement in the United States*, in *SOCIAL SECURITY AND RETIREMENT AROUND THE WORLD* 437 (Jonathan Gruber & David A. Wise eds., 1999). Diamond and Gruber point out almost sixty percent of men aged sixty-five to sixty-nine were participating in the labor force in 1950, but that by 1990, that figure had fallen to just twenty-six percent. *Id.* Whereas only seventeen percent of workers collected Social Security benefits at age sixty-two during the early 1960s, more than half of new retiree cohorts today begin collecting benefits at age sixty-two while only one-quarter collect benefits at ages sixty-five or older. Cutler et al., *supra* note 51, at 4. The early retirement effect of Social Security likely stems from its benefit formula, which limits the number of prior years’ earnings that can contribute toward benefit determination. Marginal payroll tax rates (payroll taxes net of present valued marginal benefits from additional earnings) spike when new earnings no longer replace earlier ones in the benefit formula.

⁵³ This is an inference based on the assumption that most individuals would attempt to spread consumption over working and retirement. Given expected lifetime resources (earnings plus any inheritances) a longer anticipated retirement would induce less consumption when working to allocate more resources for retirement support.

⁵⁴ U.S. national saving has followed a downward trend since the 1960s and early 1970s. Much of this decline can be explained by the increase in Social Security and Medicare benefits to retirees—in amounts considerably exceeding their prior payroll tax contributions for these programs. See Jagadeesh Gokhale et al. *Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis*, *BROOKINGS PAPERS ON ECON. ACTIVITY*, no. 1, 1996, at 315, 381–82. The author’s unpublished calculations show that the declining trend in national saving has not reversed since that study was published.

provided by Social Security increases the rate of consumption out of that wealth, again to reduce national saving.⁵⁵

It is also noteworthy that the expectation of Social Security benefits during retirement does not necessarily imply that workers clearly perceive a link between their payroll taxes and their future Social Security benefits. While working, payroll taxes may appear as pure taxes rather than saving for retirement and distort workers' labor-supply choices. Approaching retirement, benefits may then be perceived as pure subsidies triggering offsetting effects on personal saving and influencing choices about when to stop working.

Corresponding to Social Security wealth perceived by participants based on the program's current rules is a payment obligation of the federal government. One can split OASI's total unfunded payment obligations under current rules into (1) unfunded obligations to current and past participants (that is, including transactions with past generations that are embedded in the program's trust fund) and (2) unfunded obligations to future participants. OASI's unfunded obligations arising from transactions in the past and future expected transactions with current participants under today's OASI rules equal the present value of current participants' projected Social Security benefits minus the present value of their projected OASI (employer plus employee) payroll taxes, and minus the OASI trust fund of \$2.5 trillion (which includes both, the net account of past participants and past transactions of current participants). This component of OASI's total unfunded obligations is estimated to be \$16.0 trillion.⁵⁶ Because OASI's total unfunded obligations to past, current, and future participants equals \$15.9 trillion (as reported earlier), one can infer that its projected unfunded obligation to future participants is negative—\$100 billion in present value.⁵⁷ To the extent that the federal government's \$16.0 trillion *excess* OASI obligations appears as net retirement wealth to current participants, especially older workers and retirees, it could cumulatively displace personal saving of a similar magnitude as those participants anticipate the receipt of excess OASI benefits in the future.

Moreover, because Social Security's benefit formula replaces a higher portion of pre-retirement earnings for low earners compared to high earners, the reduction in saving incentives is stronger for low compared to high earn-

⁵⁵ See Alan J. Auerbach et al., *The Annuitization of Americans' Resources: A Cohort Analysis* 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 5089, 1995), available at <http://www.nber.org/papers/w5089>.

⁵⁶ This is the author's estimate of OASI's future unfunded obligations to current generations (also known as the "closed group" unfunded obligation). It is calculated by extending beyond 2086 the 2012 Social Security trustees' projections through that year of OASI non-interest revenues and expenditures. Note that the OASI trust fund value of \$2.5 trillion—which constitutes a claim on future taxpayer incomes—is considerably smaller than gross OASI obligations to current generations of \$18.6 trillion.

⁵⁷ See *supra* note 25 and accompanying text. It implies that future generations are projected to pay \$100 billion, on net, under OASI's current tax and benefit rules.

ers. Low saving by low-earning individuals because Social Security replaces a larger share of their pre-retirement earnings translates into lower wealth levels at retirement, skewing the distribution of retirement assets in favor of upper income individuals. And a skewed distribution of personal retirement assets implies, on average, larger bequests for the children of upper income and wealthier parents. In this manner, Social Security also increases the persistence of income and wealth inequality across successive generations.⁵⁸

C. Fairness in Fiscal Treatment of Population Groups

Beyond its effects on retirement choices, the program's structural inequities are also a source of work disincentives. For example, single heads of household and married two-earner couples where both spouses pay similar amounts of payroll taxes, receive fewer benefits per dollar of payroll taxes than do nonworking spouses in a single-earner married families. Social Security's misalignment of benefits with earnings and payroll taxes is a source of labor-force disincentives for secondary workers in dual-headed families—inducing them to remain out of the work force, seek part time instead of full time employment or retire earlier.⁵⁹ In addition, OASI's benefit formula that includes only the thirty-five highest career earnings implies earnings beyond the thirty-fifth year—when many participants are approaching their sixties—lead to smaller incremental benefits, increasing OASI's net marginal payroll tax rate from the program.⁶⁰ Such work disincentives introduced by Social Security's tax and benefit rules deal a double blow to the nation's economy and to Social Security's finances: earlier retirements bring benefit payouts forward, and labor force withdrawals deprive the economy of labor services and reduce payroll taxes.

D. Lifetime Wage Insurance

Social Security is also designed to provide wage insurance that private markets do not provide. As a way of reducing lifetime income inequality, Social Security benefits are provided at more generous rates relative to past earnings and payroll taxes to workers with lower career-average earnings.⁶¹

⁵⁸ See Jagadeesh Gokhale et al., *Simulating the Transmission of Wealth Inequality via Bequests*, 79 J. PUB. ECON. 93, 111–13 (2001).

⁵⁹ The labor supply response to the spousal benefit is found to be quite strong. Jeffrey B. Liebman et al., *Labor Supply Responses to the Social Security Tax-Benefit Link 6–7* (Nat'l Bureau of Econ. Research, Working Paper No. 06-12, 2006). Indeed, Social Security's retirement-related incentives are found to have significant effects on labor force withdrawal behavior of older males as well. See Courtney C. Coile & Jonathan Gruber, *Future Social Security Entitlements and the Retirement Decision*, 89 REV. ECON. & STAT. 234, 234–35 (2007).

⁶⁰ See Gopi Shah Goda et al. *Removing the Disincentives in Social Security for Long Careers 4* (Nat'l Bureau of Econ. Research, Working Paper No. 13110, 2007), available at <http://www.nber.org/papers/w13110>.

⁶¹ BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. AND FED. DISABILITY INS. TRUST FUNDS, 2011 ANNUAL REPORT, H.R. DOC. NO. 112-23, at 201–02 tbl.VI.F10 (2011).

There are several reasons to doubt whether the program's lifetime income redistribution is effectively progressive.⁶²

Although Social Security is designed to provide low-income individuals with higher returns on their payroll taxes, their shorter expected life spans almost fully offsets the benefit formula's progressivity.⁶³ Because of OASI's rigid age-eligibility limits, minority and low-income groups are unable to compensate for shorter life spans by collecting benefits even before the age of first-eligibility (age sixty-two). Furthermore, the system's lifetime benefits progressivity may become even more diluted on a lifetime basis as the ongoing increase in the scheduled full retirement age progresses but minority groups' mortality improvements do not keep pace, further undermining its wage-insurance objective. Furthermore, progressive income taxes and other non-Social Security programs such as Unemployment Insurance, Supplemental Nutrition Assistance, Housing, Medicaid and other general welfare programs already provide considerable insurance against low lifetime earnings, making Social Security's contribution to such insurance marginal, at best, on a lifetime basis.⁶⁴ Finally, wage insurance through Social Security and other programs may induce more young workers to choose nontraditional and often low-earning career paths, thereby increasing the underlying dispersion of lifetime income and not reducing lifetime income inequality by much, on net.

E. Implications for Privatization

Social Security (OASI) is significantly less effective in delivering its intended social insurance benefits under today's considerably altered demographic and economic environment compared to when it was enacted in the 1930s. The program alters participants' economic choices to work and save by much more today than it did in the past, continues to redistribute considerable amounts of resources from younger to older generations, does not

⁶² The degree of lifetime income redistribution through Social Security is reduced because the ceiling on taxable payrolls makes the tax side of Social Security regressive and because higher earners live and collect benefits for longer, on average. Under expanded metrics of lifetime income, the program is even found to be regressive overall. See Jeffrey R. Brown et al., *Is Social Security Part of the Social Safety Net?* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 15070, 2009), available at <http://www.nber.org/papers/w15070>. See generally DON FULLERTON & BRENT MAST, *INCOME REDISTRIBUTION FROM SOCIAL SECURITY* (2005); GOKHALE, A FRESH LOOK, *supra* note 8; Julia Lynn Coronado et al., *The Progressivity of Social Security* (Nat'l Bureau of Econ. Research, Working Paper No. 7520, 2000), available at <http://www.nber.org/papers/w7520>. But see NOAH MEYERSON & JOHN SABELHAUS, CONG. BUDGET OFFICE, *IS SOCIAL SECURITY PROGRESSIVE?* 5–7 (2006), available at <http://www.cbo.gov/publication/18266>.

⁶³ See GOKHALE, A FRESH LOOK, *supra* note 8, at 162–65.

⁶⁴ Calculations by the author show that the U.S. fiscal system provides sizable welfare benefits to those with low income or resources, benefits that are withdrawn if welfare recipients begin to earn a modest income. See JAGADEESH GOKHALE ET AL., NAT'L CTR. FOR POLICY ANALYSIS, *DOES IT PAY TO WORK?* 2–3 (2003) [hereinafter GOKHALE, *DOES IT PAY TO WORK?*], available at <http://www.nepa.org/pub/st258?pg=8>.

provide significant lifetime-earnings insurance, and over-provides longevity insurance.

Reforming Social Security to achieve prefunding—that is, to shift to a system where retirement and other benefits or insurance purchases are funded out of own past savings rather than through pay-as-you-go transfers from younger participants—within its existing structure will be difficult given conflicting objectives. For instance, many reform plans recommend increasing the system's full and early retirement ages and indexing them to future longevity improvements.⁶⁵ However, doing so in a one-size-fits-all manner will further erode the system's wage insurance role as low-income participants with shorter expected post-retirement life spans would receive fewer lifetime benefits.

Similarly, increasing the ceiling on taxable payrolls—another popular reform element—will increase marginal taxes significantly for high-income workers during late-career stages, inducing earlier retirements by the most experienced and productive of workers.⁶⁶ Indeed, the increase in marginal tax rates can be very high if most of the increase in earnings occurs for the very highest earners and very little of the earnings increase accrues to those just above the existing taxable earnings maximum. In such cases, increasing the taxable maximum leads to higher taxes even when earnings have not increased by much (or at all)—implying very high marginal tax rate increase for this earnings group. Finally, increasing the system's progressivity yet more to preserve wage insurance will increase already steep work-disincentives at low-income levels that the rest of the fiscal system imposes—because greater progressivity implies steeper tax increases as low earners attempt to increase their earnings by working harder and acquiring more education and training—only to tighten the fiscal system's low-income trap.⁶⁷

Privatizing marginal Social Security contributions would help strengthen the link between work-effort and returns and would constitute a way to reduce such shortcomings. Privatization could also allow liberalization of rigid age-eligibility rules—permitting workers greater flexibility to retire early if they have accumulated sufficient resources in their personal

⁶⁵ See, e.g., Memorandum from Office of the Chief Actuary, Soc. Sec. Admin. to Sen. Kay Bailey Hutchison (R-Tex.) (Sept. 12, 2012), available at <http://www.ssa.gov/OACT/solvency/index.html>; Memorandum from Office of the Chief Actuary, Soc. Sec. Admin. to Rep. Jason Chaffetz (R-Utah) (Nov. 9, 2011), available at <http://www.ssa.gov/OACT/solvency/index.html>.

⁶⁶ See Mark J. Warshawsky, *The Fairness of Recent Social Security Tax Proposals*, 130 TAX NOTES 929, 929 (2011). Using a stylistic example, Warshawsky shows that under the combination of economic changes we are witnessing today—greater earnings inequality and the need to fund larger benefit expenditures because of an increase in the number of beneficiaries—an increase in Social Security taxable earnings ceiling could impose very high marginal tax increases on those just above the existing earnings ceiling—to the tune of 172%—for those whose earnings did not increase.

⁶⁷ See GOKHALE, DOES IT PAY TO WORK?, *supra* note 64, at 2–3 (assessing the progressivity of the U.S. fiscal system at the individual level).

retirement accounts. Finally, privatization would provide a way of ensuring that resources intended for meeting future benefit obligations are saved and invested rather than being spent on non-Social Security government programs.⁶⁸

V. SOCIAL SECURITY PRIVATIZATION

A. Rationale

The retirement of the boomers, population aging, and the continued low post-baby-boom fertility rates that are driving the program toward insolvency requires a solution.⁶⁹ Social Security privatization, which has many proponents, will not directly contribute toward eliminating the program's insolvency. Treating insolvency requires prefunding, and privatization is neither necessary nor sufficient for achieving that goal. Much of the Social Security debate has confused those two terms because many of those who support privatization appear to have the prefunding goal in mind.⁷⁰ However, as described in this paper, privatization could have ancillary benefits—of reducing economic distortions and providing a way to sequester resources meant for future retirement needs from expenditures on other government programs. Unequivocal rejection of “privatization” implies that the shift to prefunding (that is, reducing the system's unfunded obligations) must be accomplished through a combination of benefit reductions and payroll tax increases. As neither of these two options is politically popular, continued stalemate until insolvency becomes imminent cannot be ruled out.

The program's approaching insolvency is not the only reason for reforming Social Security to include personal accounts. The program no longer delivers social insurance benefits as effectively as during its early decades but continues to impose considerable economic losses on participants—losses that have only grown larger as the program's size and coverage increased over the decades. The key policy issue concerns how to restore program solvency without large payroll tax increases and benefit reductions, and to maintain adequate retirement support, enhance the program's social insurance advantages, and minimize economic losses.

⁶⁸ See discussion *supra* Part III.B.

⁶⁹ The Social Security trustees assume that future average fertility rates will remain at 2.0. See BD. OF TRS., FED. OLD-AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, 2012 ANNUAL REPORT, H.R. DOC. NO. 112-102, at 78 (2012). This is the average number of children born to a woman during her lifetime if she were to experience the birth rates by age observed in (or assumed for) the selected year, and if she were to survive the entire childbearing period. See *id.* at 170 tbl.V1.D1 n.b. Fertility rates were well above 2.5 during the boom years of 1946–64, peaking at 3.68 in 1957. See *id.* at 84 tbl.V.A1.

⁷⁰ Prefunding involves reducing the system's unfunded obligations to current generations by setting aside sufficient assets. Privatizing the system by diverting payroll taxes into personal accounts does not necessarily accomplish prefunding if the government continues to pay full benefits by incurring debt that it services by raising other taxes.

The answer must include more than simply “zero-sum” tinkering with Social Security’s taxes and benefits. It lies in promoting more rapid economic growth by ensuring greater saving and investment in the economy. Without a policy approach that promotes greater risk-taking and entrepreneurship and ensures effective saving and investment—in particular, by altering Social Security’s structure—future growth prospects for the economy as a whole and prospects that Social Security will avoid insolvency are unlikely to improve.

B. *Initiatives and Strategy*

Examples of prominent past proposals to include personal Social Security accounts are the “Bipartisan Retirement Security Act” (and subsequent variants) by congressmen Jim Kolbe (R-Ariz.), Charles Stenholm (D-Tex.), and Allen Boyd (D-Fla.); “A Non Partisan Approach to Reforming Social Security” by Jeffrey Liebman, Maya MacGuineas, and Andrew Samwick; and, “Model 2” of President George W. Bush’s Commission to Strengthen Social Security.⁷¹ Unfortunately, the Bush administration’s public education campaign on Social Security personal accounts included several self-defeating elements. The administration’s ultimate proposal, based on “Model 2” of President Bush’s 2001 Social Security Commission’s report, sought to incentivize public support for privatizing Social Security in a way that would weaken rather than strengthen the program’s overall financial condition. The result of that effort has been to attach a pejorative connotation to the term “Social Security privatization”—as a policy that would reduce or eliminate important social protections without commensurately increasing retirement benefits and security, on balance.

Despite the unsuccessful attempt by President George W. Bush to add Social Security personal accounts, reforms to include them continue to be proposed by lawmakers and other experts. Examples of more recent proposals include those by Representative Jason Chaffetz (R-Utah) which introduces add-on personal accounts; former Representative Thaddeus McCotter’s (R-Mich.) proposal to introduce federal general fund financed personal accounts to replace current law OASI benefits and confer borrowing authority on OASI trust fund; Representative Paul Ryan’s (R-Wis.) proposal as part of his “Roadmap for America” tax and entitlement reform legislation, and so on. One quasi-privatization proposal by Representative

⁷¹ See Bipartisan Retirement Security Act of 2005, H.R. 440, 109th Cong. (2005). See also JEFFREY LIEBMAN, MAYA MACGUINEAS & ANDREW SAMWICK, NONPARTISAN SOCIAL SECURITY REFORM PLAN (2005), available at http://www.dartmouth.edu/~samwick/lms_nonpartisan_plan_description.pdf; COMM’N TO STRENGTHEN SOC. SEC., STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 119 (2001), available at http://govinfo.library.unt.edu/csss/reports/Final_report.pdf.

Jeffrey A. Landry (R-La.) would allow voluntary reductions of payroll taxes in exchange for future benefit cuts by increasing the full retirement age.⁷²

Only one of the two principal approaches to Social Security privatization constitutes “true” privatization. The other, supported by liberal-leaning analysts, is to directly invest the OASI trust fund into private securities.⁷³ This form of privatization raises concerns about whether it could effectively increase government saving. In addition, government investment in equities of private firms would raise the specter of government involvement in micro-managing firms’ operational and strategic decisions to make them “socially desirable,” inevitably opening the potential for politicizing those decisions according to the preferences of elected officials or government bureaucrats—which could undermine the objective of maximizing the firms’ economic value. This form of Social Security privatization also does not eliminate the economic efficiency losses from the current system’s tax and benefit rules, and it would not improve the system’s provision of social insurance benefits—because no structural reforms would be made to those rules.

The other form is to introduce “add-on” and “carve-out” personal accounts. Under the add-on strategy, new resources are devoted to Social Security, either by increasing payroll taxes (increasing the payroll tax rate or increasing the taxable maximum) or earmarking new revenue sources to Social Security—to supplement payable benefits that existing payroll taxes would fund. Under the carve-out approach, existing payroll taxes would be diverted into personal accounts created for each worker. This approach requires additional changes to Social Security’s scheduled benefits to make up the existing shortfall of program resources and cover the additional shortfall created by the payroll tax diversion. The most recent sustained effort toward adopting personal Social Security accounts was undertaken by President George W. Bush.⁷⁴ The mechanics of add-on and carve-out approaches to Social Security privatization are described in greater detail below.

⁷² Jason Chaffetz, *Social Security Reform Act of 2011*, CHAFFETZ.HOUSE.GOV, <http://chaffetz.house.gov/sites/chaffetz.house.gov/files/Legislative%20Text.pdf> (last visited Oct. 20, 2012) (Representative Chaffetz’s bill did not receive a bill number.); H.R. 2889, 112th Cong. (2011) (proposed by Representative McCotter), available at <http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.2889.IH.>; H.R. 4529, 111th Cong. (2010) (proposed by Representative Ryan), available at <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4529ih/pdf/BILLS-111hr4529ih.pdf>; H.R. 3551, 112th Cong. (2011) (proposed by Representative Landry), available at <http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.3551.IH.>

⁷³ Memorandum from Stephen C. Goss, Chief Actuary, Soc. Sec. Admin., to Robert M. Ball (Apr. 14, 2005) (providing analysis of Ball’s proposal to improve Social Security finances), available at http://www.ssa.gov/OACT/solvency/RBall_20050414.html. This approach does not constitute true Social Security privatization because past payroll tax surpluses, although invested in private securities, would continue to be controlled by the government through the OASI trust fund.

⁷⁴ See generally COMM’N TO STRENGTHEN SOC. SEC., *supra* note 71.

VI. THE FINANCIAL MECHANISM OF PREFUNDING—ACKNOWLEDGING
SOCIAL SECURITY'S DEBT

OASI's total unfunded obligation to past, current, and future generations is estimated at \$15.9 trillion.⁷⁵ The shortfall on account of just past and current generations equals \$16.0 trillion.⁷⁶ It implies OASI's current tax and benefit rules are closely balanced for future generations, who are collectively projected to make a net payment of just \$100 billion in present value as of today.

OASI's large prospective financial shortfall means that lawmakers must "renegotiate" OASI's tax and benefit rules with its "creditors" in the not too distant future. One alternative is to restate the nature of OASI's current benefit obligations and change the nature of future benefit commitments to different age cohorts among living generations. Most likely, such a renegotiation will include protections for "senior" (in both senses) creditors and impose higher adjustment costs on "junior" ones. The sooner that lawmakers reform the program to restore solvency, the better-off "junior" participants would be because they would be better able to revise their future expectations and economic choices regarding working, earning, saving, and choosing when to retire and collect Social Security benefits.

Because today's older generations—older workers and retirees—have planned on continuing to receive Social Security benefits, and would face more difficulty in adjusting their economic choices and retirement plans in response to any OASI tax increase and benefit cuts, it is likely that the government will commit itself to meeting those benefit obligations. As a result, all of the adjustments will likely be imposed on younger and future generations.⁷⁷ If the entire OASI trust fund (currently valued at \$2.5 trillion) is devoted toward funding the benefit obligations to today's older generations, the remaining unfunded obligation to those generations must be financed out of some combination of higher payroll taxes and smaller OASI benefits for younger and future generations.⁷⁸ Figure 3 shows OASI's net unfunded obli-

⁷⁵ See *supra* note 25 and accompanying text.

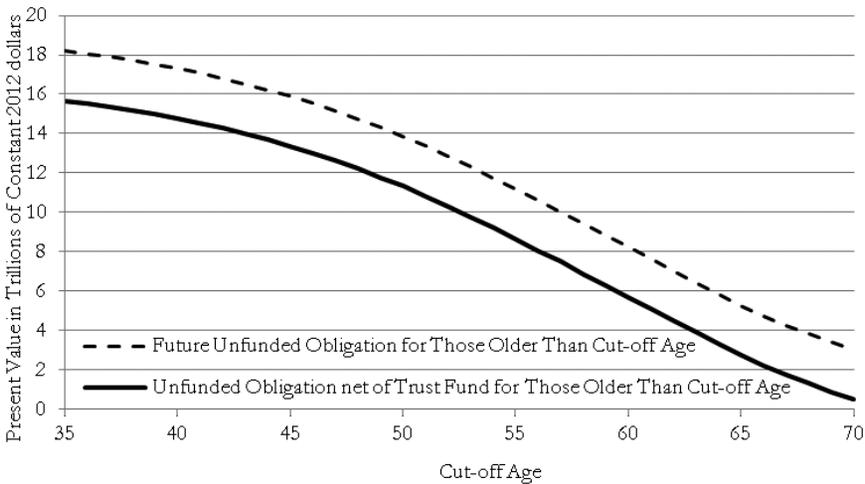
⁷⁶ See *supra* note 56 and accompanying text.

⁷⁷ See PAUL RYAN, U.S. H.R. COMM. ON THE BUDGET, A ROADMAP FOR AMERICA'S FUTURE 53, 55 (2010) (this proposal was prepared by the Committee's Republican staff, but was not approved by the full Committee), available at <http://roadmap.republicans.budget.house.gov/issues/issue/?IssueID=8521>. Exemption of those above age fifty-five is also a feature of the George W. Bush Social Security reform plan. See COMM'N TO STRENGTHEN SOC. SEC., *supra* note 71, at 75. For a counter argument to this rationale, see Robert J. Samuelson, *Ryan's Budget Asks Nothing of the Elderly—Unfortunately*, WASH. POST, Aug. 15, 2012, at A13, available at http://www.washingtonpost.com/opinions/robert-samuelson-ryans-budget-asks-nothing-of-the-elderly—unfortunately/2012/08/15/ed2c6c2c-e6fb-11e1-8f62-58260e3940a0_story.html.

⁷⁸ The rationale for subtracting the OASI trust fund's value from Social Security's unfunded obligation to older generations is that it represents a commitment of future resources to OASI—in the same manner as future payroll taxes of those generations represent a commitment to funding OASI and are subtracted when calculating the overall unfunded obligation measure.

gation to those above various cut-off ages both before and after subtracting the OASI trust fund's value. At a very low cut-off age, the net-of-trust-fund line in Figure 3 (the unbroken line) approximates OASI's imbalance on account of past and current generations (\$16.0 trillion) because almost all of them are included among the protected group. The unfunded obligation to those above the cut-off age also declines very slowly as the cut-off age is increased from a low value because, considering their prospective payroll taxes, younger workers' share of that unfunded obligation is small in present value. The unfunded obligation is quite small when the cut-off age is set at a high value because older retirees have shorter remaining life spans during which to collect benefits.

FIGURE 3
OASI UNFUNDED OBLIGATIONS TO THOSE OLDER THAN CUT-OFF AGE



Whatever the cut-off age that is considered reasonable (age fifty-five is used in the forthcoming discussion just as an example), imposing an additional fiscal burden on younger and future generations collectively in order to hold older generations harmless is unavoidable—a *fait accompli* bequeathed by the OASI policies adopted by earlier generations. This is true regardless of how this additional financial burden is distributed among younger and future generations and irrespective of whether personal retirement accounts are introduced under a future Social Security reform. Indeed, because this debt to seniors must be paid under any and all circumstances, it should not be included in the so called “transition cost” of introducing personal Social Security accounts.

Clearly, the politically unpalatable prospect of making this levy on younger and future generations explicit has caused lawmakers to postpone its adoption. But the longer the postponement, the more older workers (those

just below the cut-off age, wherever it is set) will escape adjustment costs by joining the older, protected age cohort. Moreover the size of the adjustment that must be imposed on younger and future generations would grow larger as unfunded obligations to the older cohort (currently \$8.7 trillion in present value if fifty-five is used as the cut-off age) accrues interest costs, making the debt even more difficult to resolve.⁷⁹ This adverse political-economy dynamic is another reason to be concerned that despite the currently estimated time gap of twenty-four years until OASI becomes insolvent, policy changes may not be undertaken in a timely manner.

On the other hand, explicitly devoting a portion of existing payroll taxes of younger and future generations (aged fifty-four and younger today) for amortizing unfunded obligation to older generations will remove the latter's fear that future program changes would reduce their benefits. Therefore, a necessary first step in introducing personal Social Security accounts is the explicit segregation and funding of OASI's unfunded obligations to older generations.

Explicitly earmarking a portion of age fifty-four, younger, and future generations' existing OASI payroll taxes to finance age fifty-five and older generations' unfunded OASI obligations of \$8.7 trillion implies relabeling that portion as a *pure tax*.⁸⁰ As a ratio of the payroll base of those aged fifty-four, younger, and future generations (not including income taxes on future Social Security benefits), this amount equals 1.75 percentage points.⁸¹ That leaves 8.85 percentage points of younger and future generation's OASI payroll taxes for funding their own future benefits. Figure 4 (line in dashes) shows in percentage point terms how this "pure tax" component of the pay-

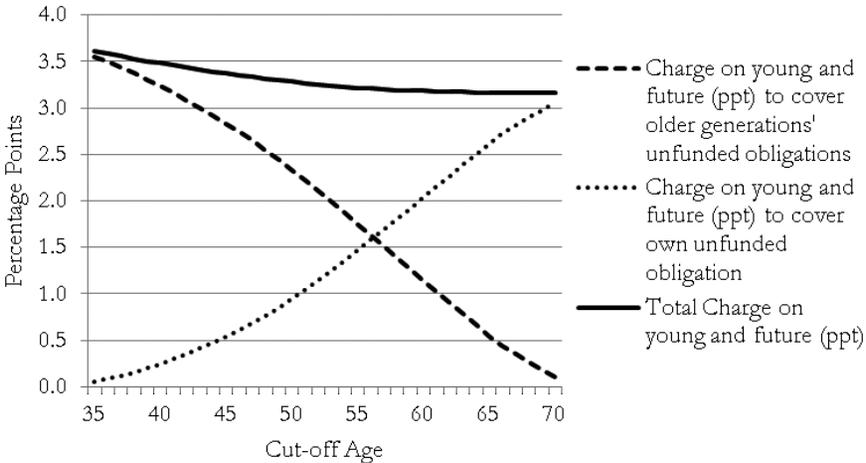
⁷⁹ It is worth noting that OASI's gross-of-trust-fund unfunded obligation of \$11.2 trillion to those age fifty-five and older (far in excess of the OASI trust fund's value of \$2.5 trillion) is not recorded on the government's books in the same manner as the government's outstanding contractual debt (value of outstanding government bonds). Indeed, OASI debt to older generations may be considered to be much more secure than the government's contractual debt because it is protected against inflation.

⁸⁰ Payroll tax withholdings from workers' paychecks are labeled as Federal Insurance Contributions Act (FICA) withholdings—a label that would no longer apply to the earmarked portion for all current and future generations.

⁸¹ The \$8.66 trillion present value unfunded obligations to the fifty-five and older age cohort taken as a ratio of the present value of younger and future generations' current-law payroll taxes of \$52.41 trillion in present value equals 0.165. Multiplying this ratio by the current payroll tax rate of 10.6% yields 1.75 percentage points. Note that although future born generations' projected OASI taxes and benefits are balanced under current laws (their current-law unfunded obligations are only \$100 billion), excluding them from sharing in the cost of holding today's older generations harmless would require much more than a 1.75 percentage point pure tax burden on today's younger generations. Figure 4 shows how this tax burden would change with the cut-off age (line in dashes). As the cut-off age is increased from a low level, the size of the protected age cohorts' unfunded obligation declines slowly and the sizes of the payroll base and payroll taxes of younger and future generations grows larger. Hence the percentage point levy on younger and future generations also declines slowly. At higher cut-off ages, the decline in the percentage point levy is more rapid corresponding to the faster decline in older cohorts' unfunded obligation and a slower increase in the payroll base of younger and future generations, fewer of whom remain in the work force after their fifties.

roll tax rate of younger and future generations would vary with the cut-off age above which participants are held harmless from OASI adjustment costs.

FIGURE 4
OASI UNFUNDED OBLIGATIONS TO OLDER GENERATIONS



However, as discussed earlier, today's 10.6% OASI tax rate is insufficient to fully fund current-law OASI benefits of age fifty-four, younger, and future participants. Their share of OASI's total fiscal imbalance—\$7.2 trillion (\$15.9 trillion minus \$8.7 trillion)—must also be resolved. Calculations show that covering this amount would require an additional 1.47 percentage points of payroll taxes from younger and future generations, and makes the payroll tax rate on those generations required to fully fund their own current law OASI benefits 12.07%. Figure 4 (line in dots) shows how this additional cost varies with the cut-off age defining the protected older age cohort. At a low cut-off age, shifting a marginal age-cohort from the protected to the non-protected group increases the latter group's unfunded obligations by very little because the future benefit obligations to the marginal age group are almost fully offset by its prospective payroll taxes.

Figure 4 also shows that the total burden (unbroken line) on younger and future generations—to cover OASI's unfunded obligations on account of themselves and the protected older age cohort—declines uniformly with the cut-off age, approaching close to 3.1 percentage points as the cut-off age is increased. This is the ratio of infinite horizon unfunded obligation to the present value of future payrolls described earlier.⁸² This just demonstrates

⁸² See *supra* notes 25–26 and accompanying text. Note that if the Social Security trust fund were not netted out of the unfunded obligations of the older age cohort, the pure tax to be levied on younger and future generations to pay off those obligations would be larger by about 0.51 percentage points (a payroll tax rate increase by 2.26 percentage points instead of 1.75 percentage points). However, that would make the trust fund available for paying of unfunded

that the higher the cut-off age, the smaller the group of protected older generations and the smaller the total cost (as a share of taxable payrolls) that must be imposed on those younger than the cut-off age.

If the cut-off age were set to fifty-five, the gap between the payroll tax rate available to fund their current-law benefits (8.85%) and that required to fully fund those benefits (12.07%) is 3.22 percentage points.⁸³ It is larger than the 3.1% infinite horizon imbalance ratio because the entire OASI shortfall is now imposed on the subset of age fifty-four, younger, and future generations.⁸⁴

Thus, if younger and future generations were required to contribute 3.22% of payrolls into personal accounts—that is, in addition to the 10.6% current payroll tax rate (1.75+8.85)—and if those “add-on” personal accounts reaped investment returns at the same (relatively conservative) rate as the government’s nominal discount rate (5.7% per year as is consistent with the Social Security trustees’ most recent economic assumptions), they would supplement younger and future generations’ traditional payable benefits to provide (in present value) total benefits equal to current-law scheduled levels. Of course, OASI’s benefit laws would have to be changed in tandem to now deliver current-law payable rather than scheduled benefits to younger and future generations.

VII. FINANCIAL MECHANICS OF PRIVATIZATION—THE MEDIUM-TERM SURPLUS OF YOUNGER AND FUTURE GENERATIONS

Subtracting the future taxes and benefits paid to age fifty-five and older generations and subtracting the “pure tax” levied on younger generations to finance unfunded obligations to age fifty-five and older generations from annual OASI revenues and expenditures trajectories (those shown in Figure 1) yields the trajectories shown in Figure 5. This Figure shows the annual revenue trajectory (short dashes) for younger and future generations available for meeting their own future benefit obligations. It also shows the trajectory of younger and future generations’ current law annual OASI scheduled

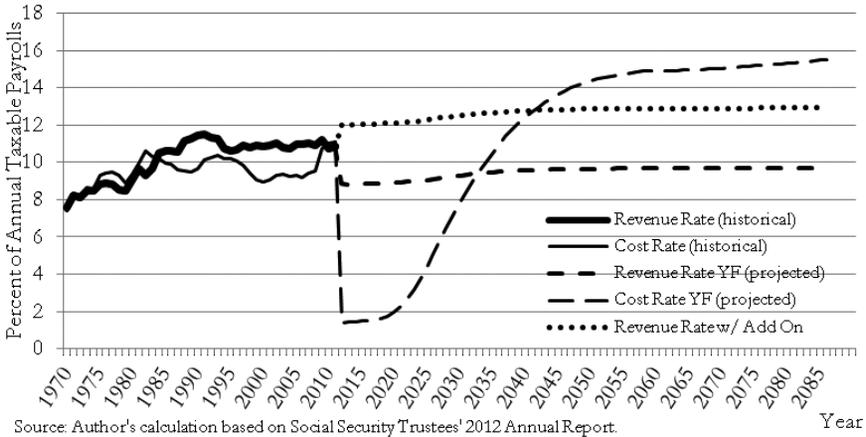
obligations to the younger and future age cohorts, making the required levy on account of their own unfunded obligations smaller—also by 0.51 percentage points. The fact that, having decided to fully honor Social Security obligations to older generations, the total charge required on younger and future generations remains unchanged under these alternative allocations of the OASI trust fund indicates that the trust fund is economically irrelevant.

⁸³ Alternatively, funding the total gap would require a 25.2% cut in OASI benefits of younger and future generations.

⁸⁴ Note that the protection of older generations’ OASI benefits and add-on personal account contributions to cover unfunded OASI obligations to younger generations need not be sourced from payrolls. Alternative taxes such as consumption or income taxes could also be used. Under those alternatives, the incidence of adjustment costs would not necessarily be limited to younger and future generations. Alternative financing sources would also exert different effects on labor supply, consumption, saving and capital formation in the long term. See generally Laurence J. Kotlikoff, *Simulating the Privatization of Social Security*, in *PRIVATIZING SOCIAL SECURITY* (Martin Feldstein ed., 1998).

benefits (long dashes)—a part of which would be obtained from personal accounts' principals and returns.

FIGURE 5
SOCIAL SECURITY'S (OASI) HISTORY AND PROJECTIONS UNDER
SEQUESTRATION OF YOUNG AND FUTURE GENERATIONS PAYROLL TAXES



Source: Author's calculation based on Social Security Trustees' 2012 Annual Report.

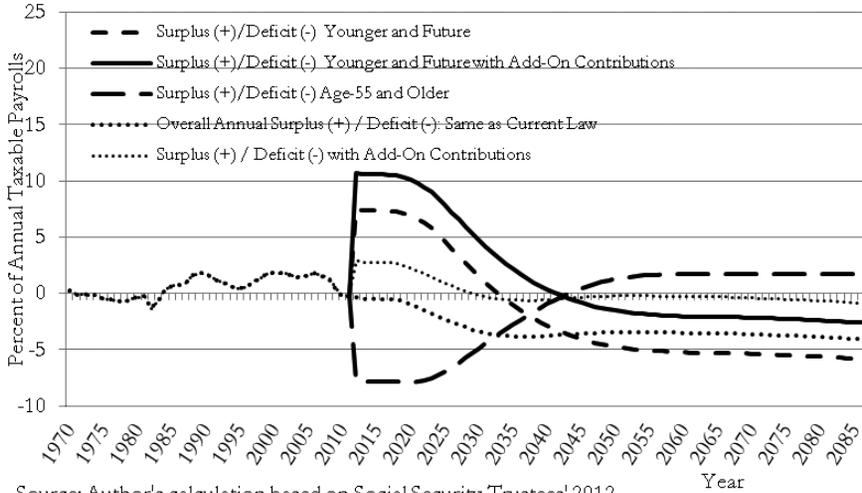
The restructuring, funding, and segregation of older generations' OASI debt shows that remaining annual revenues from younger and future generations are considerably larger than those generations' annual benefits in the medium-term—until 2032 (the intersection of the line in long dashes with that in short dashes in Figure 5). With no other changes, this portion of the surplus would continue to accrue with the OASI trust fund. Younger and future generations' add-on contributions of 3.22 percentage points of their taxable payrolls would be deposited into personal accounts. The total surplus from both funding sources together over benefit expenditures for younger and future generations is projected to accrue through 2041 (the intersection of the dotted line with the long-dashed line in Figure 5).

Treating the unfunded OASI obligations to older age cohorts as a corpus of explicit debt to be serviced by dedicating a part of younger and future generations' existing payroll taxes, of course, does not imply the direct availability of additional investible funds in cash flow terms. As Figure 6 shows, corresponding to each dollar of cash-flow surplus on account of younger and future generations until 2032 (short dashes) is a dollar of cash-flow deficit on account of older generations (long dashes). Adding the cash flows shown in these two trajectories yields the trajectory of the current-law annual funding shortfall (large dotted line).⁸⁵ The funding and sequestration of OASI obligations to older generations accomplished under such a "restructuring"

⁸⁵ Note that when the post-restructuring surplus of age fifty-four, younger, and future generations (short-dashed line) becomes zero in the year 2032, the corresponding total deficit

is simply an accounting change and does not directly bring forth new resources if no other changes occur.

FIGURE 6
OASI CASH FLOW PROJECTIONS



Source: Author's calculation based on Social Security Trustees' 2012

The restructuring of debt to today's seniors may generate induced beneficial effects, however, if it is communicated correctly to younger and future generations. As described earlier, most workers do not perceive a close link between their OASI payroll taxes and future OASI benefits. This leads to the belief that OASI taxes are pure taxes; adding to total marginal tax rate perceptions and reducing work incentives.

The most effective way to communicate to younger and future generations that a major portion of their payroll taxes are devoted to paying their own Social Security benefits would be through an explicit redirection of those taxes—those remaining after 1.75% of payroll taxes are earmarked as *pure taxes* for covering OASI's unfunded obligations to older generations—into personal retirement accounts. The change in perception induced by the funding and segregation of older generations' OASI obligations and partially or fully shifting the remainder of younger and future generations' payroll taxes into personal retirement accounts would induce sizable gains in economic efficiency. Such a re-direction of payroll taxes would trigger the replacement of a commensurate amount of traditional benefits by additional benefits from personal accounts. Simulation studies have long suggested that the gains from improved labor-market choices by workers from privatizing the OASI program could be as high as 9% of annual GDP. Indeed, these

(long-dashed line) becomes equal to the cash-flow deficit under current OASI tax and benefits rules (large dotted line).

potential long-term gains in economic efficiency estimates are *larger* than the current share of payroll taxes in GDP.⁸⁶

Figure 6 shows that, allowing “carve-out” contributions into personal accounts (in addition to the add-on contributions described earlier) would redirect the medium-term surplus of younger and future generations (shown in Figure 5) into personal accounts, but an identical amount of debt would accrue on the books of the federal government. This conversion of implicit debt on account of older generations would reflect OASI’s debt more fully and accurately and acknowledge it explicitly on the government’s books. Correspondingly, the accrual of assets in personal accounts would reveal more accurately the amount of retirement saving that OASI would accrue on behalf of current workers under the restructuring, funding, and sequestration of debt to older generations as described above.

Opponents of personal accounts usually deny the existence of any debt on account of Social Security because of its positive trust fund. They also deny any debt on account of older generations, supported mainly by the assertion that their benefits are an “earned right” by virtue of past payroll tax payments.⁸⁷ The issue, however, is that such a right could involve an implicit or “legacy” debt because past payroll taxes were not sufficient to cover the benefits scheduled under the program’s current laws.⁸⁸ Even those who acknowledge the existence of such implicit debt express doubts that its sudden conversion into explicit debt on the government’s books under a carve-out personal accounts reform would be tolerated by financial markets.⁸⁹ These views are simply misguided for two reasons.

⁸⁶ ALAN J. AUERBACH & LAURENCE J. KOTLIKOFF, *DYNAMIC FISCAL POLICY* 151 (1987). More recently, Smetters and Nishiyama have estimated efficiency gains to be as large as \$21,900 per future family in their benchmark simulation. Kent Smetters & Shinichi Nishiyama, *Does Social Security Privatization Produce Efficiency Gains?* (Nat’l Bureau of Econ. Research, Working Paper No. 11622, 2005). These authors estimate that the gains from Social Security privatization would be offset by more the more valuable the wage and longevity insurance that the program provides. *See id.* at 3–4. Note that markets cannot provide such insurance. However, the thesis here is that the program’s provision of wage insurance itself is marginal at best and that, under today’s demographic and economic environment, the system over-provides longevity insurance. For an example of the work-reducing effect of higher marginal taxes, see Edward C. Prescott, *Why do Americans Work So Much More Than Europeans?*, 28 *FED. RES. BANK OF MINNEAPOLIS Q. REV.* 2 (2004). *See also* Martin Feldstein, *Would Privatizing Social Security Raise Economic Welfare*, in *PRIVATIZING SOCIAL SECURITY* (Martin Feldstein ed., 1998).

⁸⁷ *See* Michael Kinsley, *Entitlement Myths*, *TIME* (Jan. 29, 2009), <http://www.time.com/time/magazine/article/0,9171,1874858,00.html>; *see also* Stephen D. Foster Jr., *Social Security and Medicare ARE Entitlements, The Right-Wing Just Distorts the Meaning of the Word*, *ADDICTING INFO* (Oct. 3, 2011), <http://www.addictinginfo.org/2011/10/03/social-security-and-medicare-are-entitlements-the-right-wing-just-distorts-the-meaning-of-the-word>.

⁸⁸ The term “legacy debt” is used in PETER A. DIAMOND & PETER R. ORSZAG, *SAVING SOCIAL SECURITY: A BALANCED APPROACH* (2004).

⁸⁹ Indeed, even those who support carve-out Social Security private accounts, such as former Federal Reserve Chairman Alan Greenspan, suggest caution because financial markets could react adversely. Greenspan has said: “If you’re going to move to private accounts, which I approve of, I think you have to do it in a cautious, gradual way.” William Neikirk, *Green-*

First, if one believes that older generations' benefits (given any cut-off age) are sacrosanct, this debt has already been incurred but remains unreported. Thus, the argument against adopting personal accounts on these grounds reduces to a plea to keep that debt hidden from public view, promoting its denial. Second, even if the debt is revealed under a carve-out privatization reform, financial markets as a whole would experience no change in net financial inflows and in the total amount of investible resources. Financial market inflows from personal account investments would match—dollar for dollar—the increased Treasury securities issued by the government to finance retiree benefits. Indeed, add-on personal account contributions worth 3.22 percentage points of taxable payrolls would represent a *net increase* in investible resources (thin dotted line in Figure 6), that is, if such new contributions are not offset through reduced personal saving.⁹⁰

How large federal deficits and offsetting personal account accumulations would become depends only on how large the carve-out portion of personal accounts is selected to be. At one extreme, the entire 8.85 percentage points of young and future generations' OASI taxes could be diverted into personal accounts—in which case, federal deficits would increase sharply but then decline gradually as the cohort of protected generations grows older and passes away. Thereafter, the 1.75 percentage point pure payroll tax on younger and future generations would service the accumulated debt in perpetuity. At the other extreme, no carve-out personal account contributions would mean no additional deficits on the federal government's books. In either case, the consolidated cash flows into financial markets (excluding add-on contributions accruing into them) would generate the same surplus/deficit as under current law (thick dotted line in Figure 6).

But the key argument in favor of carve-out contributions into personal accounts is that they would generate *new* resources through improved labor market incentives of younger and future generations. Restructuring the debt to seniors and privatizing the medium term surplus on account of younger and future generations would lead to worker perceptions of lower marginal tax rates than is the case under today's system. It should be emphasized, however, that for the carve-out portion of contributions into personal accounts, the only source of economic gains is beneficial labor-market effects.⁹¹

span Endorses Private Accounts; But Fed Chief Warns of Heavy Borrowing, CHI. TRIB., Feb. 17, 2005, at C22.

⁹⁰ A reduction in personal saving in response to mandatory add-on contributions into personal accounts is unlikely because overall personal saving is already close to zero, many individuals have very low net assets that they could liquidate to maintain current consumption levels, and a high proportion of U.S. households have limited borrowing ability. See JAGADEESH GOKHALE & LAURENCE J. KOTLIKOFF, HOW MUCH AND IN WHAT MANNER SHOULD AMERICANS SAVE? REPORT TO THE U.S. DEPARTMENT OF LABOR 3 (2004), available at <http://www.dol.gov/ebsa/pdf/GokhaleKotlikoff052004.pdf>.

⁹¹ Arguments favoring carve-out personal accounts that disregard such labor-market efficiency gains and depend only on presumed higher rates of return compared to returns on payroll taxes under the current OASI system are misguided. The higher expected returns on

An additional and important adjustment required for establishing carve-out personal retirement accounts would be to ensure that younger and future generations receive proper compensation for OASI (payable) benefits accrued through their past payroll taxes. One way to do so is to simply print “recognition bonds” and deposit them in participants’ personal accounts. Older individuals among those aged fifty-four and younger would receive larger amounts of recognition bonds redeemable for benefits after retirement—commensurate with their larger accrued OASI benefits compared to those of younger participants.⁹² An alternative is to offset carve-out personal account accumulations by reducing traditional OASI benefits (which would be replaced by benefits from personal accounts). In this case, those close to retirement would receive smaller traditional benefit offsets because their personal account accumulations through retirement would be smaller.⁹³

VIII. COULD “ADD-ONS” CREATE SPACE FOR “CARVE-OUTS?”

The carve-out individual Social Security accounts described earlier involve a one-for-one increase in federal debt. This section describes how the introduction of add-on accounts would enable a gradual increase in carve-out-financed individual accounts but would *not* generate a corresponding amount of federal debt.

The approaching OASI insolvency must be directly addressed by increasing funding. However, as argued earlier, any add-on payroll “contributions” should be deposited into personal retirement accounts, instead of simply increasing payroll taxes under the current system. Account investments may be subject to prudent portfolio management guidelines but should be owned by the workers themselves to fully sequester the savings from government ownership and control that may result in their expenditure for non-Social Security purposes. In addition, borrowing by workers against those savings should be disallowed. Under these rules, new early-year surpluses (see Figures 2 and 5) would be effectively saved and invested in the economy. When workers retire, benefits from personal account investments would augment OASI’s payable benefits to provide retirees with a similar

personal account investments in private capital markets represent compensation for extra investment risks. But in the context of Social Security, mitigating that risk would require extra resources for any benefit guarantees provided by the government, potentially wiping out those extra returns. The “higher rate of return” argument was key among the popular justifications for personal accounts that undermined the Bush administration’s efforts to privatize Social Security.

⁹² No additional change would be required as the add-on contributions ensure that the system’s unfunded obligations are fully funded.

⁹³ See John Geanakoplos & Stephen P. Zeldes, *Market Valuation of Accrued Social Security Benefits* 16–17 (Nat’l Bureau of Econ. Research, Working Paper No. 15170, 2009). Under both alternatives, the reinstatement of accrued benefits to younger generations could include “haircuts” to recognize the risky nature of the government’s commitment to pay future OASI benefits. The larger the haircuts, the smaller the size of add-on contributions needed to balance OASI’s revenues and outlays in present value.

level of OASI benefits as those scheduled under today's laws. Of course, this means that traditional OASI's scheduled benefits would have to be reduced to make them equal to current-law payable benefits.

Indeed, such add-on contributions would gradually create space for carve-out contributions that, unlike the carve-out contributions discussed earlier, do not involve a commensurate increase in federal debt. This would be feasible if traditional current-law (that is, without add-on) payable benefits are held constant even under the system with add-on contributions. Add-on contributions into personal accounts would gradually increase U.S. domestic investment and capital per worker. Thereby, those investments would accelerate output growth and expand the payroll tax base beyond levels attainable in the absence of add-on personal account contributions. This increase in the payroll tax base would be fully attributable to the add-on contributions and not to the current-law OASI payroll tax rate of 10.6%.

Because the projected total payroll taxes trajectory would be lower without add-on contributions compared to that with add-on contributions, it would be possible to generate the without-add-on OASI payroll taxes trajectory with a payroll tax rate that is less than 10.6% under the add-on policy. Under the add-on policy, this lower payroll tax rate implies space for carve-out personal account contributions.⁹⁴ This includes incremental revenues from any future growth in the payroll tax base stimulated by a net increase in saving and investment from add-on Social Security contributions. This space for carve-out personal account contributions would gradually increase over time as effective saving and investment in the economy accumulates and the gap between with and without add-on payroll tax bases widens.

Thus, although under an existing pay-as-you-go financed system, no investment principal is available to fund an exclusively carve-out Social Security privatization, carve-out contributions that do not increase federal deficits and debt become feasible, in principle, if one starts with add-on contributions into personal accounts that effectively increase national saving and investment and the payroll tax base.⁹⁵

The problem, then, is to devise a mechanism and policy compact to adhere to the non-observable (counterfactual) path of payable traditional Social Security benefits that would prevail *without* add-on contributions, but in a world where add-on contributions are actually implemented. Estimates based on conservative assumptions suggest that under a policy of 3.22 per-

⁹⁴ Social Security status-quo supporters maintain that revenues from the current law's 10.6% payroll tax rate, whatever they turn out to be, are to be entirely dedicated to paying traditional Social Security benefits. The argument made in the text, however, depends upon conceptually separating the revenue increment from add-on investments and using it to fund carve-out contributions to personal accounts. It involves freezing payable traditional Social Security benefits at their (counterfactual) trajectory under a no-add-on-contributions policy.

⁹⁵ See Alan L. Gustman & Thomas L. Steinmeier, *Offsetting the Principal in the New Social Security Accounts*, 107 TAX NOTES 109, 109–14 (2005). See also Jagadeesh Gokhale, *The Case for (Carve-Out) Personal Accounts*, IDEAS IN ACTION (July 5, 2005), http://www.ideasinactiontv.com/tcs_daily/2005/07/the-case-for-carve-out-personal-accounts.html.

centage point add-on contributions by younger and future generations, carve-out contributions could become as large as 1.64 percentage points of taxable payrolls after seventy-five years, and even larger beyond that time window. Moreover, participants' total Social Security benefits would closely approximate current-law scheduled levels because traditional payable benefits (projected under the no-add-on policy) would be supplemented by accumulated investments and returns in participants' personal Social Security accounts.⁹⁶

Despite the larger capital stock, increased labor productivity, and output growth that would be stimulated by the add-on-and-carve-out privatization described here, the policy would still impose an economic loss on younger and future generations. But this loss is already built into the current OASI system because of its prospective funding shortfall. A do-nothing policy will not avoid the loss it will only help current generations to grow its size before passing it on to future OASI participants. Moreover, the loss is not generated by personal accounts *per se*, it is only imposed by requiring additional contributions to close OASI's projected funding gap. This way of closing the funding gap, however, avoids ancillary economic inefficiencies through increases in marginal tax rates that would occur if payroll taxes were increased instead. It also prevents preemptive government consumption of new OASI surpluses under today's trust fund based "prefunding" mechanism. Indeed, gradually increasing carve-out contributions from the existing payroll tax rate as the payroll base expands would induce additional gains in growth and economic efficiency.

IX. DISABILITY INSURANCE

The discussion thus far has not considered the Social Security Disability Insurance ("SSDI") component of the program. SSDI, which is also financed out of dedicated payroll taxes, is facing insolvency much sooner. The program's trustees project that it will run out of funds by 2016.⁹⁷ The date of SSDI trust fund exhaustion has advanced in the aftermath of the recession of 2008–09 as high unemployment induced many more marginally disabled older workers to apply for SSDI benefits as a last source of support.⁹⁸

SSDI is not a program that can be "privatized" in the same manner as the OASI component of Social Security. That's because SSDI payroll taxes are akin to premiums for purchasing current insurance against the likelihood

⁹⁶ For an example of a Social Security reform that combines "add-on" and "carve-out" elements (but not with the same motivation as described in the text), see generally Memorandum from Stephen C. Goss, Chief Actuary & Alice H. Wade, Deputy Chief Actuary, Soc. Sec. Admin., to Jeffrey Liebman, Maya MacGuineas, & Andrew Samwick (Nov. 17, 2005), *available at* http://www.ssa.gov/OACT/solvency/Liebman_20051117.pdf.

⁹⁷ See Bd. of Trs., Fed. Old-Age and Survivors Ins. & Fed. Disability Ins. Trust Funds, 2012 Annual Report, H.R. Doc. No. 112-102, at 2 (2012).

⁹⁸ See Soc. Sec. Advisory Bd., Aspects of Disability Decisionmaking: Data and Materials 6 (2012).

of becoming disabled. No “saving for the future” element is involved and available to be diverted into a “personal account” in a manner similar to that feasible for OASI. Scope for privatizing SSDI exists, however, in the manner of extending support for disabled workers and extending their work tenure.

Some SSDI reform proposals propose superficial funding changes—increasing funding directly by increasing SSDI payroll taxes or shifting funds temporarily from the OASI program.⁹⁹ Other proposals, however, envision an expansion of private insurance to intervene more vigorously at the first onset of disabling conditions to prevent the disability from progressing rapidly and leaving those affected with no alternative but to enroll into SSDI.¹⁰⁰ Reforms to provide additional incentives for employers to retain disabled workers have also been proposed—including the stick of experience rating employers’ SSDI payroll tax liabilities (imposing higher taxes on employers with larger rates of work-related disability-causing incidents) and the carrot of subsidizing the provision of medical or other work-place accommodations to facilitate continued employment of disabled workers.¹⁰¹ Because health insurance coverage is more important to some SSDI beneficiaries than direct SSDI monetary benefits, some proposals would alter eligibility to Medicare to encourage potential enrollees to delay or avoid enrolling into SSDI. Looming SSDI insolvency and a tight federal budget environment may prompt future SSDI reforms along the lines of welfare program reforms from the mid 1990s—to provide time-limited benefits or benefits on a sliding scale according to the degree of disability.

Such “privatization” of SSDI appears to be worthwhile because remaining in the work force whenever possible promotes self-sufficiency, community involvement, and greater income, on average, for disabled individuals—increasing their overall well-being compared with permanent dependency on SSDI and other government disability programs.

X. CAVEATS TO SOCIAL SECURITY PRIVATIZATION POLICY

A cautionary note about private accounts is also appropriate: the need to reform OASI because of its looming insolvency does not imply that privatization would solve all problems and create no others. Program reforms that introduce personal Social Security accounts would make younger and future

⁹⁹ See KATHY RUFFING, CTR. FOR BUDGET & POLICY PRIORITIES, SOCIAL SECURITY DISABILITY INSURANCE IS VITAL TO WORKERS WITH SEVERE IMPAIRMENTS 16–18, 21, 23–24 (2012), available at <http://www.cbpp.org/files/8-9-12ss.pdf>.

¹⁰⁰ See DAVID H. AUTOR & MARK DUGGAN, CTR. FOR AM. PROGRESS & THE HAMILTON PROJECT, SUPPORTING WORK: A PROPOSAL FOR MODERNIZING THE U.S. DISABILITY INSURANCE SYSTEM 12, 17–18, 28 (2010), available at <http://www.brookings.edu/research/papers/2010/12/disability-insurance-autor>.

¹⁰¹ See generally RICHARD W. BURKHAUSER & MARY C. DALY, THE DECLINING WORK AND WELFARE OF PEOPLE WITH DISABILITIES (2011); see also AUTOR & DUGGAN, *supra* note 100, at 109.

workers more responsible for their own retirement security. It is likely to reduce the risk of losses from ad-hoc policy changes because of poor government stewardship of the program—that is, reduce the political risk that participants face under the current system—but it would also expose workers' retirement savings to greater market risks—the potential that stock market investments (as permitted by regulations on private accounts) would increase portfolio volatility and expose workers to the risk of a market downturn just as they approach retirement age. Another worry is the impact of a personal accounts Social Security system on the distribution of retirement wealth across participants experiencing widely divergent investment returns.¹⁰² Participants would have to evaluate those risks, learn about their own risk tolerance, decide about their desired level of retirement savings and choose the fraction of savings to annuitize to obtain adequate longevity insurance.

Another issue is the timing of annuitizing retirement savings. Market volatility may reduce the face values of their financial investments just as workers decide to annuitize a portion of retirement assets—exposing them to the risk of a reduced retirement living standard. This calls for a strategy of staggered purchases of deferred annuities throughout one's career, requiring careful long-term financial planning. Workers would have to learn about financial markets and financial management techniques and execute appropriate working, saving, investment, and retirement choices with adequate clarity and foresight.¹⁰³

Although some academic studies claim that high (risk unadjusted) returns would accrue in personal retirement accounts, whether this could happen in practice is not easy to analyze or predict. In practice, personal accounts will also be subject to the law of unintended consequences. Personal account contributions may end up with the government if “prudential management” regulations (issued by the government) compel account managers to allocate a large share of personal account portfolios to government bonds. The establishment and management of such accounts may be subject

¹⁰² See Martin S. Feldstein & Jeffrey B. Liebman, *The Distributional Effects of an Investment-Based Social Security System*, in *THE DISTRIBUTIONAL ASPECTS OF SOCIAL SECURITY AND SOCIAL SECURITY REFORM* 315–16 (2002). The authors demonstrate through a simulation calibrated to the historical U.S. distribution of investment returns that virtually all demographic groups would receive higher average benefits under a mixed Social Security system with an investment-based component than the benefits that they would receive under current Social Security rules. This would result in sizable reductions in rates of return on investment accounts compared to historical average returns. The authors report that this result is robust even assuming smaller rates of return on investment accounts compared to historical average returns.

¹⁰³ A strong empirical link is observed between net worth and financial literacy. The direction of causality that is usually inferred goes from literacy to wealth. See Maarten van Rooij, Annamaria Lusardi & Rob J. Alessie, *Financial Literacy, Retirement Planning, and Household Wealth* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 17339, 2011). The reverse direction of causality also appears worth investigating, however, especially as it relates to intergenerational transfers of human capital in financial literacy: are the children of parents enjoying greater retirement security or high net worth more likely to be financially literate?

to manipulation by private investment professionals—to circumvent regulations and assume riskier portfolios. High management fees may reduce investment returns substantially, making the provision of adequate (current law scheduled) retirement and other benefits less probable.¹⁰⁴ These caveats—gleaned from other countries' experience with privatizing public pension programs would have to be anticipated when designing such a reform in the United States.¹⁰⁵ For example, we can avoid the mistakes made by other countries who did not ensure low administrative costs (Chile),¹⁰⁶ failed to adequately reduce investment risks and debt (Argentina),¹⁰⁷ or failed to adequately regulate financial firms' incentives (the United Kingdom).¹⁰⁸ We can also learn positive aspects such as concomitantly adopting other tax reforms to support Social Security privatization, such as adopting incentives for older workers to remain in the labor force, and ensuring adequate support for current retirees. In general, the acquisition by the public of additional financial market knowledge and investment skills, readjustment of economic decisions and, perhaps, revision of economic preferences with a greater orientation toward long-term economic security are all desirable. While many remain skeptical about the prospects of such changes, it should be clear that they are unlikely to emerge unless entitlement programs are reformed to catalyze greater personal responsibility. With the steep learning curve involved, however, expectations of rapid progress in retirement wealth, adequacy, and security following Social Security privatization may be misplaced. Nevertheless, the most straightforward, quickest, and least costly path to avoiding growing dependency on Social Security, increasing economic distortions, and even greater financial illiteracy is to embark on a carefully crafted Social Security personal accounts reform.

One positive aspect of the Bush Social Security privatization effort was to demonstrate that despite the steep stock market decline during the early 2000s, sufficient enthusiasm and political momentum could be sustained among voters in favor of a personal accounts reform of Social Security.¹⁰⁹ The same is clearly not true in today's economic environment, which still shows significant after-effects of the financial and housing sector crises of the Great Recession of 2008–2009. Today's considerably greater economic

¹⁰⁴ See generally Olivia S. Mitchell, *Administrative Costs in Public and Private Retirement Systems*, in *PRIVATIZING SOCIAL SECURITY* 434 (Martin Feldstein ed., 1998).

¹⁰⁵ See generally ESTELLE JAMES, NAT'L CTR. FOR POLICY ANALYSIS, *REFORMING SOCIAL SECURITY: LESSONS FROM THIRTY COUNTRIES* (2005).

¹⁰⁶ *Id.* at 11.

¹⁰⁷ *Id.* at 30.

¹⁰⁸ *Id.* at 9.

¹⁰⁹ The Republican Party, for instance, adopted voluntary personal savings accounts "as the cornerstone of restructuring [Social Security]," which suggests that the issue was not perceived as a political liability. REPUBLICAN NAT'L COMM., *REPUBLICAN PARTY PLATFORM: A SAFER WORLD AND A MORE HOPEFUL AMERICA* (2004), available at www.presidency.ucsb.edu/papers_pdf/25850.pdf ("Choice is the key. Any new options for retirement security should be voluntary, so workers can choose to remain in the current system or opt for something different.").

and policy uncertainty has caused high risk-aversion among lenders and investors. Thus, support for privatizing Social Security appears very unlikely in the near term. Yet, Social Security's financial condition is also much worse today than it was a decade ago, and policy reforms that would improve labor-market incentives and spur national saving and investment, are needed even more urgently.¹¹⁰

XI. CONCLUSION

Social Security privatization received broad support as early as during 1994 when President Bill Clinton's bipartisan commission on entitlement reform provided three different approaches to Social Security reform, each of which included a privatization component.¹¹¹ Intermittent efforts at Social Security reforms continued throughout the 1990s and early 2000s, but met with no success. Following the failed effort of the George W. Bush administration to introduce personal Social Security accounts, Social Security privatization is generally viewed as undesirable. However, a broad assessment of Social Security's current operation and its effect on the economy suggests that privatization remains a viable option. A restructuring of Social Security's debt to older generations together with a well-designed and regulated personal Social Security accounts could improve retirement security, and reduce the current program's negative effects on resource utilization and economic efficiency. These advantages of personal accounts are particularly worth considering now because economic and demographic changes during the past several decades have diluted the program's social insurance provision and its growing unfunded obligations are increasing the political risk of sizable but unpredictable changes to its tax and benefit rules. The longer that Social Security reforms are delayed, the larger will be the net economic harm that future American generations will be compelled to endure.

¹¹⁰ The seventy-five-year actuarial deficit of the entire system (including SSDI) was estimated to be 1.87% in 2002. *See* BD. OF TRS., FED. OLD-AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, 2002 ANNUAL REPORT, H.R. DOC. NO. 107-196, at 3 (2002). That same deficit in 2012 was estimated to be 2.67%. BD. OF TRS., FED. OLD-AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, 2012 ANNUAL REPORT, H.R. DOC. NO. 112-102, at 4 (2012).

¹¹¹ *See generally* BIPARTISAN COMM'N ON ENTITLEMENT & TAX REFORM, FINAL REPORT TO THE PRESIDENT (1993), available at <http://www.ssa.gov/history/reports/KerreyDanforth/KerreyDanforth.htm>.

