

# Social Security Privatization and the Fiscal Gap

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*Social Security privatization is a package whose main components are offering portfolio choice, prospectively eliminating transfers within the system, and changing the program's official language to one of "individual accounts" rather than a collective "trust fund." The language change is aimed at jawboning Congress into regarding Social Security's financing as more off-limits when it makes other tax and spending decisions. All three changes are debatable, and while the language change might modestly help in addressing the \$44 trillion fiscal gap that, within the next twenty years, is likely to cause serious disruption to our economy and political system, more direct action to narrow the fiscal gap might be preferable.*

## I. INTRODUCTION

This Article makes two main points. *First*, the question of whether we should "privatize" Social Security is poorly posed. Privatization proposals actually are packages of multiple proposed changes to Social Security, relating to (1) portfolio choice by participants with respect to their benefits, (2) transfers within Social Security between participants, and (3) how the system is officially described. A better-posed set of questions would therefore address separately each of the items in the privatization package. No one should feel compelled to give a single up-or-down verdict on all three of them.

*Second*, one important motivation for privatization might be to facilitate, as a political matter, introducing and retaining greater pre-funding of the system's long-term obligations. This, in turn, might be lauded as (1) making Social Security, or current government policy generally, more sustainable, (2) adjusting our fiscal policy to be more favorable towards future generations, and (3) generating an increase in national saving. However, whether privatization would accomplish any of these aims depends on how it is done, and on Congress's unpredictable response over the long term to changing how Social Security is officially described. Moreover, even if any such effects are realized, they are likely to be swamped by the opposite effects of the tax cuts that Congress passed in 2001 and again in 2003.

## II. CURRENT SOCIAL SECURITY

As I discussed in my book, *Making Sense of Social Security Reform*, Social Security is best conceptualized as a three-part program.<sup>1</sup> *First*, it seeks to induce

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<sup>1</sup> DANIEL SHAVIRO, MAKING SENSE OF SOCIAL SECURITY REFORM 27-29 (2000).

lifetime consumption smoothing or forced saving by participants.<sup>2</sup> *Second*, it denies participants portfolio choice with respect to their forced saving within the system.<sup>3</sup> *Third*, it transfers wealth in various ways between participants.<sup>4</sup> Social Security has other relevant features as well, such as those concerning how it is administered and how the government officially describes it, but those features are secondary.

### A. *Forced Saving or Consumption Smoothing*

Social Security imposes taxes on workers and then offers them benefits once they have reached the applicable retirement age.<sup>5</sup> The effect on a given worker, if she does not reverse it through other decisions, is to require her to save a portion of her lifetime income, net of taxes and transfers, for retirement. Workers may respond by saving less outside Social Security than they otherwise would have. They generally do not, however, actually negate the forced saving, such as by borrowing in advance against the benefits' expected value.<sup>6</sup> Social Security, therefore, effectively sets a floor on one's retirement saving given one's lifetime income net of taxes and transfers.<sup>7</sup>

In *Making Sense of Social Security Reform*, I called this system feature "forced saving."<sup>8</sup> As I noted, however, this term risked inviting the mistaken conclusion that Social Security actually increases, or at least does not reduce, national saving.<sup>9</sup> After all, if everyone is being forced to save, then seemingly the country as a whole is being forced to save. This is not the case, however, and there is strong (though controversial) empirical evidence that Social Security has actually reduced national saving over time.<sup>10</sup>

The joker in the deck that permits this result is Social Security's requiring people to save a portion of their lifetime income, *net of taxes and transfers*. As a result, one's forced saving may consist simply of the transfer from future workers that one is saving in the sense of not yet consuming its present value. No one

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<sup>2</sup> *Id.* at 29–31.

<sup>3</sup> *Id.* at 67–69.

<sup>4</sup> *Id.* at 69–73.

<sup>5</sup> *See id.* at 13.

<sup>6</sup> *Id.* at 66–67.

<sup>7</sup> Medicare adds to this floor. For a full discussion of Medicare reform issues, similar to my analysis of Social Security reform in SHAVIRO, *supra* note 1, see generally DANIEL SHAVIRO, WHO SHOULD PAY FOR MEDICARE? (forthcoming Mar. 2004).

<sup>8</sup> *See SHAVIRO, supra* note 1, at 29.

<sup>9</sup> *See id.* at 30.

<sup>10</sup> *See id.* at 67.

needs to be setting aside any current resources in order for this forced saving to occur.

To illustrate, suppose the government awards me a \$10 million zero-coupon bond, to be paid in 2030 but subject to restrictions that effectively prevent me from borrowing in advance against its accruing value. Suppose further that the government finances the bond through a uniform head tax, to be levied in 2030 on all persons who were born in 2005. This is “forced saving” by me, but if anything it will probably induce me to consume more today, given how it helps pay for my retirement. The people who will end up financing it cannot yet save, and even their parents may be unlikely to respond very much or indeed at all. Hence, the “forced saving” by me implies reduced, rather than increased, societal saving.

Why might we favor a forced consumption-smoothing (or forced saving) program? The key reason is paternalism with a dollop of externalities. It seems indisputable that people generally ought, in their own self-interest, to save at least some minimum portion of their lifetime income for retirement. They do not always do so, however, and there are psychological theories, grounded in myopia and self-control problems, that plausibly explain low retirement saving as a failure in optimization rather than as a reflection of a stable preference for sooner consumption.<sup>11</sup> Thus, forced consumption smoothing plausibly may improve people’s welfare on balance, even where it denies them the choice they would otherwise have made.

The externalities version of this explanation rests on noting that people who enter retirement with inadequate savings are likely to get financial support from others who feel compelled to alleviate their distress. Hence, by requiring them to save for their own retirement, we can prevent them from imposing these costs on us. This rationale does not apply, however, if Social Security ends up increasing the transfers that we make to them.

### *B. Denial of Portfolio Choice Within Social Security*

Social Security offers a fixed, real life annuity, the value of which depends on one’s thirty-five best years of earnings up to the Social Security tax ceiling.<sup>12</sup> Benefits are indexed to wage growth up to the point when one begins to draw benefits and, afterwards, to inflation.<sup>13</sup> The system does not, however, permit one to exercise portfolio choice with respect to benefit accrual.<sup>14</sup> Thus, for example,

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<sup>11</sup> See, e.g., David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443, 443 (1997) (theorizing that financial commitment opportunities are a valuable means of overcoming problems of self-control).

<sup>12</sup> See SHAVIRO, *supra* note 1, at 13.

<sup>13</sup> See *id.* at 13–14.

<sup>14</sup> See *id.* at 67–68.

you cannot elect to have the value of your retirement benefits depend on the performance of the stock market or of particular stock or bond funds.

The rationale for denying portfolio choice with respect to Social Security benefits is the same as that for forced consumption smoothing. People arguably ought to have a relatively safe investment of this kind in their portfolios to avoid the downside of entering retirement with too little saved. Left to their own devices, however, they might make poor choices, either out of irrationality, ignorance or in the expectation that others will rescue them in the event of a bad outcome. The system, therefore, limits choice on paternalist grounds or to address externalities.

### *C. Transfers Within Social Security*

Social Security's biggest transfer is from younger to older generations. It also is somewhat progressive because, while high-earners get the most under the benefit formula and also tend to live the longest, this does not fully make up for their paying higher payroll taxes.<sup>15</sup> In addition, Social Security favors one-earner married couples relative to single individuals and two-earner couples because one-earner couples qualify for spousal benefits without having to pay for the extra coverage.<sup>16</sup>

Transfers through Social Security are relatively non-transparent. People are not told how their expected benefits at retirement compare to their tax payments, and the system was structured to make benefits look—often misleadingly—like a mere return of taxes paid. One rationale for this misleading structure is that it provides political cover for poverty relief by stapling it to a popular middle-class entitlement program. However, any such political cover comes at a high cost since it tends to shield from scrutiny the transfers to groups, such as current seniors and one-earner couples, that are not necessarily among the neediest.

Such political considerations aside, there generally are not strong reasons for using Social Security as an instrument of lifetime redistribution, other than that from shorter-lived individuals to longer-lived individuals. (The latter get more out of a lifetime annuity, thus redistributing from the worse-off to the better-off (if we would rather live longer), but appropriately so given the greater lifetime needs of a longer-lived individual.) In the case of a high-earner and low-earner with the same lifespan, one might well ask why we would use retirement annuities, which mainly serve forced saving purposes, for redistribution as well. One answer might be that we have better lifetime (as opposed to merely annual) information about

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<sup>15</sup> See *id.* at 69–71.

<sup>16</sup> See *id.* at 72–73.

their earnings at retirement than previously.<sup>17</sup> Insofar as this is the motive for progressive redistribution through Social Security, however, it might be desirable if the low-earner could borrow in advance against the extra redistributive portion of her Social Security benefits, since only administrative or measurement reasons underlie making her wait for it. A second possible reason for reserving some progressive redistribution for Social Security would be that work incentives are no longer distorted once one has definitively retired. Here, however, we must also consider the high labor supply elasticity of the younger elderly as they contemplate retirement and the effect on a current worker's labor supply and saving decisions if she anticipates extra progressive redistribution (based on her wealth at the time or her lifetime earnings) once she has retired.

Social Security's inter-generational redistribution is not only larger, but also politically more fundamental to it than is its progressivity. A principal reason for its enactment in 1935 was to give money to contemporary retirees, some of whom the Great Depression had left in poverty.<sup>18</sup> Subsequent expansions reflected the political power of the elderly, along with the widely held view that seniors ought to share in the bounty as society grew richer. More generally, insofar as one favors inter-generational redistribution, retirement programs are a convenient place to do a lot of redistribution. Insofar as one fears the political power of the elderly to demand excessive transfers, retirement programs are the most important place in which to cut back.

#### D. Other Features of Social Security

Social Security has low administrative costs given the amount of money that flows through the system. But, this reflects the low level of customer service that its fixed structure makes feasible. The offering of portfolio choice inevitably would raise the costs of running it and probably would require outsourcing various administrative functions from the Social Security Administration to private firms.

Current net revenues from operating the system are officially credited to the Social Security Trust Fund, which is a legally mandated set of bookkeeping entries maintained by the Treasury Department to help keep track of the system's fiscal performance over time.<sup>19</sup> A given year's Social Security surplus (since annual deficits within the system remain more than a decade in the future) is included in, and thus reduces, the official "unified" budget deficit but not the official "on-budget" deficit. Many commentators believe that one or the other of

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<sup>17</sup> See generally JEFFREY B. LIEBMAN, SHOULD TAXES BE BASED ON LIFETIME INCOME? VICKREY TAXATION REVISITED, at <http://www.ksg.harvard.edu/jeffreyliebman/LiebmanLLTAX.v1.pdf> (July, 2002).

<sup>18</sup> See SHAVIRO, *supra* note 1, at 20.

<sup>19</sup> See *id.* at 76.

these two measures, whether or not it has any direct economic significance, influences congressional behavior.<sup>20</sup> An annual budget surplus of the relevant kind ostensibly invites Congress to cut taxes or increase spending, although it has the power to do either or both of these whether there is a budget surplus or not.

Despite Social Security's current operating surplus, it is mainly a pay-as-you-go, rather than a pre-funded, system. The amounts needed to meet future liabilities are not set aside in advance. Were Social Security a privately operated system, this would likely lead down the road to default on its obligations. Given the government's power to raise taxes, however, the lack of pre-funding has no such automatic significance here. Instead, the extent to which Social Security obligations are ultimately honored depends on future discretionary political decisions in light of the overall sustainability of the fiscal path that the government sets for itself. The main significance of pre-funding, therefore, lies elsewhere, as I discuss in Part IV below.

### III. PRIVATIZATION

The core of the privatization idea is that Social Security participants would have their own individual accounts funded (at least once the system was fully phased in) by their own wage contributions. A participant would then have some discretion regarding how her account was invested. For example, she might be able to choose between a number of diversified stock and bond funds, perhaps with a required ratio (or range of permissible ratios) between stock and bond holdings. The value of the fixed real life annuity (and any other permitted benefits, such as inheritability if she died young) would depend on the amount in her account at retirement.

Privatization apparently derives its name from the administrative outsourcing to private firms that the offering of portfolio choice might, as a practical matter, necessitate.<sup>21</sup> This outsourcing, however, is a relatively trivial feature of the proposed package of changes. Those of greater significance are (1) offering portfolio choice, (2) possibly eliminating certain transfers within Social Security, and (3) changing certain conventions that the government uses in its official descriptions of the program.

#### *A. Portfolio Choice in a Privatized System*

Anyone who believes that people often have the best information regarding their preferences and the best incentive to pursue their own interests ought to consider the possibility that Social Security could be improved by offering enrollees some portfolio choice. While paternalist and externality concerns clearly

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<sup>20</sup> See *id.* at 150.

<sup>21</sup> See *id.* at 127.

limit the range of choice that is likely to be desirable, they do not necessarily require operating a one-size-fits-all system in which no “bet” on the performance of the stock or bond markets is permitted with respect to one’s accruing benefits.

The big problem with this sort of structure, even if one generally likes consumer choice, is that it would raise the system’s administrative costs. These costs would be especially significant, relative to the value of offering portfolio choice in Social Security, for the small-sized accounts that most workers would have. Commentators disagree both about the magnitude of these costs and about whether any significant collateral benefits, such as encouraging more people to become informed investors and/or to feel more like economic stakeholders, would be realized.<sup>22</sup>

During the stock market boom (and Internet bubble) of the late 1990s, two additional (but bogus) considerations seemed to support allowing workers to invest in the stock market through Social Security. The first was that stocks appeared to be an incredibly good investment, supposedly guaranteed to continue rising indefinitely by 10% or more per year. We now know better. Second, many were too quick to conclude that people who do not own stock must have underdiversified portfolios. The problem with this view was that it overlooked the implicit financial stake that all prospective Social Security beneficiaries have in the stock market—or, more precisely, in the same set of economic variables as those that control the long-term performance of the stock market—through the fiscal system and their own direct stakes in the United States macro-economy.<sup>23</sup> Real diversification for most Americans, therefore, would involve “shorting” the United States economy to go long in the world economy, as the economist Robert Shiller has suggested,<sup>24</sup> rather than directly owning stock in United States companies.

The alarming performance of the stock market in the early 2000s has probably killed most of the political appeal of portfolio choice within Social Security. As I noted during the boom, however, the resolution of this design issue really ought not to depend on such short-term considerations.<sup>25</sup> If portfolio choice within Social Security is a bad idea, then it is due to the paternalist grounds for limiting choice plus the administrative costs of managing small accounts.

### B. *Eliminating Transfers Within Social Security*

Privatization would eliminate all transfers within Social Security if the value of one’s benefits depended purely on the accrued value of an account that had

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<sup>22</sup> See *id.* at 137–42.

<sup>23</sup> See SHAVIRO, *supra* note 1, at 115.

<sup>24</sup> See generally ROBERT J. SHILLER, *MACRO MARKETS: CREATING INSTITUTIONS FOR MANAGING SOCIETY’S LARGEST ECONOMIC RISKS* 6–9 (1993).

<sup>25</sup> See SHAVIRO, *supra* note 1, at 116.

been funded solely through one's own wage contributions.<sup>26</sup> Prominent versions of privatization would indeed have this character once they were fully phased in, although it is not an inevitable consequence of using individual accounts. In principle, one could easily modify privatization to include such redistributive features as government transfers to low-earners' accounts and/or taxes on high-earners' accounts. These taxes and transfers could depend on participants' annual or career earnings or on the amounts in their accounts at retirement (reflecting investment performance).<sup>27</sup>

A truly non-redistributive privatized system would eliminate the dominant transfer within Social Security to date, which is that from younger to older generations. However, no prominent privatization proposal to date has targeted the benefits of current seniors or even older current workers. The approach, rather (for reasons of understandable political prudence) has been to guarantee existing benefits while switching gradually to the new ones, at least initially just when the initial benefits are the greater.

Some versions of privatization might even increase the transfer from future generations to current workers. Suppose that, during the transition to privatization, all contributions to people's individual accounts came from the government. This might be done, for example, on the view that existing payroll taxes are needed to pay off current law benefits, and that increasing mandated wage contributions (in effect, by increasing the payroll tax) would be undesirable or politically unfeasible. Suppose further that the government contributions led to increased benefits for current workers and were financed through debt that was repaid by future generations. Under this scenario, privatization would end up increasing transfers from future generations to current workers, even if it eliminated further inter-generational transfers once it was fully phased in.

Evidently then, the main transfer through Social Security that privatization would target is that from high-earners to low-earners. Its adoption would reduce the overall progressivity of the fiscal system unless offset by other changes, such as to the income tax or welfare rules. To some privatization proponents, one suspects that this is actually more of the point than they are publicly prepared to admit. Whether it is a problem, however, even if one favors at least the current level of progressivity, depends on whether one should expect offsetting changes elsewhere, either immediately or down the road. Any such offsetting changes are highly unlikely to accompany any privatization package that emerges from the Bush Administration. However, it is less clear whether (and, if so, how)

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<sup>26</sup> More precisely, this would eliminate all transfers within Social Security if one computed benefits in terms of expected value at retirement and ignored the problem of dying before retirement. A fixed real life annuity ends up transferring resources *ex post* from the short-lived to the long-lived, even if it is actuarially fair *ex ante*.

<sup>27</sup> See SHAVIRO, *supra* note 1, at 153–55.



eliminating Social Security's progressivity would affect the long-term political equilibrium regarding wealth redistribution.

As I noted in *Making Sense of Social Security Reform*, progressive privatization, or that which included transfers from high-earners' to low-earners' accounts, might have an important political economy advantage over the current system. It would tend to make Social Security transfers more transparent, and perhaps more coherent, than they presently are.<sup>28</sup> For example, the current system's bias in favor of one-earner married couples might be more visible in an individual account system, potentially encouraging a sensible requirement that the non-working spouse's benefits be paid for through greater tax contributions by one-earner couples.<sup>29</sup> Those who dislike transparency, on the ground that obfuscation permits greater progressivity, may be mistaken as to its political effects. Social Security's political sanctity, founded on the false notion that it offers only fully earned benefits, aids it in competing for scarce government resources with programs whose constituencies may be considerably less well-heeled than the seniors who get the bulk of its benefits.

### C. *Changing the Official Description of Social Security*

Privatization's use of individual accounts would also be a change in how the system is officially described. Wage contributions that were used to fund benefits, instead of being described as taxes that swelled the Social Security Trust Fund and reduced the unified budget deficit, would be described as belonging to individuals through their Social Security accounts. Less would actually have changed than the language suggests. Even with a collective trust fund, people have strong expectations of receiving the benefits that the current law promises. Even with individual accounts, people's ability to access the funds would depend on what Congress subsequently decided to permit.

While the language change might make people's benefit expectations more secure, this would not be the main reason for it. The main aim, rather, is to change Congress's thinking in the hope of making pre-funding, and greater fiscal restraint across the board, more politically feasible. Commentators have long recognized that pre-funding is more problematic in a government-provided plan than in a private retirement plan, because the government's strength (its power to change the laws at any time) is, in a sense, its weakness. Credible and sustainable pre-commitment is harder for it than for private firms that can put accumulating funds beyond their legal reach, such as through escrow and trust arrangements. A burgeoning Social Security surplus, therefore—even though it is officially excluded from the on-budget deficit measure—might be viewed by Congress as

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<sup>28</sup> See *id.* at 150–54.

<sup>29</sup> See *id.* at 153.

just so much available boodle for it to shower on favored constituents and programs.

Even with a collective trust fund, one can try to address this problem in various ways. President Clinton used the phrase “saving Social Security” to denote avoiding tax cuts and spending increases that would reduce the unified budget surplus to less than the Social Security surplus.<sup>30</sup> The supposed budgetary “lockbox” that was in vogue during the 2000 Presidential campaign and then remained so until September 11, 2001 connoted the same idea, with a portion of Medicare added to the mix. These constraints evaporated on that day, however, for no reason that (beyond the short term) made any sense whatsoever. The costs of fighting terrorism indicated that the long-term fiscal picture might be worse than we had previously thought, not better, thus calling for greater fiscal discipline, not less.

Enter privatization, supposedly to the rescue. Under its descriptive conventions, money that went into and out of the system would no longer be described as going to or coming from the government. Assuming an annual Social Security surplus, the annual budget deficit would now look greater (or more specifically, the on-budget surplus would look more like the true one). Moreover, Social Security pre-funding that accumulated over time would ostensibly look more off-limits to future Administrations and Congresses.

How much should we credit this little story? On the one hand, we have recently seen just how frail the “lockbox” metaphor proved to be under the current set of descriptions. On the other hand, we are also learning anew just how completely an Administration and Congress can scorn the goal of long-term fiscal sustainability. Might they be more reckless still if Social Security were not looming as a long-term problem—wholly without regard to whether it was reported as governmental or non-governmental?

For a number of different reasons, it is hard to have much confidence in the power of nomenclature changes to constrain future fiscal decisions by the government. Mere language conventions can always be ignored. The underlying realities that the conventions do not change may have some influence (even if slight) no matter what. And the language choices do not alter the fundamental set of opportunities that Congress and the President face at any time. It used to be argued, for example, that a budget surplus is dangerous because, if the money is there, then Congress will spend it.<sup>31</sup> But the report of a surplus has no effect on what can actually be spent. Congress has the power to enact whatever tax and spending changes it likes, with the level of public debt adjusting for any gap between the two.<sup>32</sup> The effect of the surplus, therefore (itself merely the product

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<sup>30</sup> *See id.* at 93.

<sup>31</sup> *See id.* at 150.

<sup>32</sup> At some point, if Congress took this to the limit, it would find that the government could no longer borrow, or even print, money that would be treated as valuable in global credit

of a set of fiscal language conventions), is purely hortatory. It has no bearing on what money is actually “there” to be spent.

Perhaps the greatest potential advantage of the language change would be its facilitating the enactment of a tax increase. Extra withholding from people’s paychecks that was described as funding their individual accounts might be easier to sell politically than if it were described as going to the collective Social Security Trust Fund. Unfortunately, however, any moves towards privatization in the next few years are unlikely to take this form. Better (from a crass political standpoint) to make the supposed contributions pain-free by having them come from the government, which can simply borrow the money and describe the budget deficit as greater. The net effect of the accounts, if they raised expectations as to future promised benefits, might actually be to worsen rather than improve our long-term fiscal posture.

Even if the tax increase version of privatization were possible, however, any benefit would be outweighed by the countervailing effect of the enormous tax cuts that Congress enacted in 2001 and again in 2003. Accordingly, those who favor privatization as a device for achieving a more responsible long-term fiscal policy, and yet who did not oppose the tax cuts, gave new meaning to the expression “penny-wise and pound-foolish.” I show this next by discussing the overall United States fiscal gap.

#### IV. PRIVATIZATION AND THE OVERALL UNITED STATES FISCAL GAP

Social Security is merely a part of the broader United States fiscal system. The historical reason for calling it a separate entity with its own dedicated financing was simply to create a political pre-commitment device. As President Franklin Roosevelt said when the program was first enacted, “[w]ith those [dedicated payroll] taxes in there, no damn politician can ever scrap my social security program.”<sup>33</sup> Despite Social Security’s ostensibly separate structure, however, it undoubtedly is subject to the broader vicissitudes of the United States fiscal system as a whole. For example, any shortfall in Social Security would undoubtedly be made good through the use of general revenues if they otherwise exceeded planned spending. Likewise, over-funding of Social Security might induce budgetary spillover of some kind (as reflected in concerns about the “lockbox”). The overall fiscal picture is therefore what really matters; as the late economist Robert Eisner used to say, it all goes “into the same stomach.”<sup>34</sup>

Suppose for the moment, however, that Social Security were a stand-alone system, completely insulated from other taxes and spending. Why would we care

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markets. But, we are far from that point, and the effect of a given budget surplus on its proximity is too trivial to be worth considering.

<sup>33</sup> See SHAVIRO, *supra* note 1, at 90.

<sup>34</sup> ROBERT EISNER, *THE MISUNDERSTOOD ECONOMY* 133 (1994).

about the adequacy of its pre-funding, given that the United States government's ability to raise taxes and print money shields it from most of the default risk of an unfunded private retirement system? The main reasons are as follows:

(1) A long-term shortfall would indicate that Social Security was not currently on a sustainable course. At some point, then, its taxes would have to be increased and/or its benefits cut. The failure to place the system on a sustainable course, or to explain how the shortfall would ultimately be made up, would create needless planning uncertainty for people who wanted to know what to expect from it down the road. Those who failed to understand that the present course is unsustainable might make systematic errors, such as planning for future benefits that were unlikely to materialize in full. In Washington's charged political environment, there would also be a significant chance that ignoring the problem until it reached crisis proportions would lead to panicky, ill-considered responses at the last minute.<sup>35</sup>

(2) The failure to provide adequate funding would favor current generations at the expense of future generations, by leaving a large unfunded liability for the latter to meet.<sup>36</sup>

(3) The failure to set aside funds would tend to reduce national saving, for the reasons described in my earlier example concerning the \$10 million zero-coupon bond.<sup>37</sup> Making large transfers from future to current generations has an income effect on the latter, encouraging them to spend more on consumption.<sup>38</sup> The members of future generations cannot respond by consuming less when they have not yet been born. A tax increase devoted to funding future benefits reduces the funds available for people to spend today, and, if it is really being set aside, then government spending for current consumption does not increase either.

Broadening our perspective to reflect that Social Security is part of the larger United States fiscal system does not change these concerns. It merely widens the set of taxes and spending programs that we must look at when determining the extent to which our current long-term policy path is under-funded. To this end, economists have recently developed a measure called the fiscal gap (or fiscal imbalance), measuring the size of the long-run tax increase and/or spending cut that would be needed to put our long-term fiscal policy on a sustainable course.

One recent estimate puts the current fiscal gap at \$44 trillion, or about four times our annual gross domestic product (GDP).<sup>39</sup> Another recent estimate,

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<sup>35</sup> See Daniel N. Shaviro, *The Growing U.S. Fiscal Gap*, 3 *WORLD ECON. J.* 1, 5-6 (2002).

<sup>36</sup> See SHAVIRO, *supra* note 7, at 100.

<sup>37</sup> See *supra* Part II.A.

<sup>38</sup> See SHAVIRO, *supra* note 1, at 86.

<sup>39</sup> JAGADEESH GOKHALE & KENT SMETTERS, *FISCAL AND GENERATIONAL IMBALANCE: NEW BUDGET MEASURES FOR NEW BUDGET PRIORITIES 2* (2003).

predicting the 2003 enactments, puts it at 11.07% of GDP,<sup>40</sup> or \$74 trillion if we assume that real GDP will grow at 1.5% annually (its average in the United States since the end of World War II) and that the real interest rate is 3% (as in the United States government's official long-term Medicare forecasts).<sup>41</sup> One key reason for the difference between these two forecasts is that the higher one is based on assuming that the 2001 Tax Act will be retained indefinitely rather than expiring after 2010 (as current law provides),<sup>42</sup> and that reform of the alternative minimum tax to prevent it from applying to ever-more taxpayers will be politically necessary. These are eminently plausible adjustments to the law on the books in projecting our current policy course.

These estimates are admittedly (and, given their long-term nature, necessarily) both speculative and subject to considerable change. As unbiased forecasts, however, they could just as easily go up as down. They also are, to a significant degree, growth-proof. Over the long run, Social Security benefits are roughly pegged to the growth of the economy via the wage indexing in the benefit formula. Moreover, Medicare is pegged to the size of the healthcare sector, which for years has been growing faster than GDP.<sup>43</sup> Congress's appetite for discretionary spending may also tend to grow with the economy, which determines tax revenues and the level of available resources. And the two main causes of the fiscal gap, increasing life expectancy and ever-improving (but costlier) healthcare technology, appear to be stable trends.<sup>44</sup>

What does it mean to have a fiscal gap of \$44 trillion or \$74 trillion? It is similar to owing that amount as public debt (which in April 2003 stood at only \$6.5 trillion), except that the commitment is not quite as fixed and thus can be lowered without an explicit act of default. In the case of Social Security and Medicare, however, which are responsible for most of the fiscal gap, our commitments under present law are viewed by many as scarcely less inviolate than the government's commitment to honor its explicit debts.

Current GDP is about \$11 trillion.<sup>45</sup> Thus, in order to eliminate the fiscal gap, we would have to set aside (through tax increases or spending cuts) a set of cash flows with the same present value as paying *today* an amount that (depending on which estimate one uses) is more than four times, or more than seven times as

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<sup>40</sup> Alan J. Auerbach, William G. Gale & Peter R. Orszag, *The Budget Outlook and Options for Fiscal Policy*, 95 TAX NOTES 1639, 1644 (2002).

<sup>41</sup> Shaviro, *supra* note 35, at 2.

<sup>42</sup> Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, 115 Stat. 38 (2001).

<sup>43</sup> See SHAVIRO, *supra* note 7, at 6.

<sup>44</sup> Shaviro, *supra* note 35, at 4.

<sup>45</sup> See U.S. DEP'T OF COM., BUREAU OF ECON. ANALYSIS, NEWS RELEASE: GROSS DOMESTIC PRODUCT AND CORPORATE PROFITS, at <http://www.bea.doc.gov/bea/newsrel/gdpnewsrelease.htm> (Jan. 30, 2004).

great as our society's entire economic production over a year. This obviously far exceeds what is either politically or practically feasible.

It should be clear, therefore, that our current fiscal policy is under-funded and unsustainable. It will have to change whether we want to change it or not; and, when it does, many people will be disappointed. Might Social Security privatization help in addressing the problem if it aids the enactment of a tax increase and discourages Congress from treating the added revenues as so much more boodle for it to distribute? Perhaps it could. But is Social Security privatization, with all the collateral issues that it raises concerning portfolio choice, retirement security, and distributional policy, a well-chosen political tool for beginning to address the fiscal gap? That appears considerably more doubtful. Consider, for example, that the 2001 Tax Act—lauded by many supporters of privatization—has been estimated, if made permanent, to increase the fiscal gap by \$13 trillion.<sup>46</sup> Privatization would have to increase net revenues by 1.9% of GDP (or nearly \$200 billion per year at the start, pegged to the economy) merely to offset this effect of the 2001 Act, without even beginning to reach the preexisting Social Security and Medicare shortfalls.

## V. CONCLUSION

Social Security privatization is a package, rather than a unitary proposal. Its main components are (1) offering portfolio choice with respect to Social Security benefits, (2) eliminating transfers within the system from high-earners to low-earners, and (3) changing official descriptions of the program to use the language of individual accounts rather than of a collective trust fund. The last of these changes is aimed at permitting the system to be pre-funded without as great a likelihood that Congress would simply dissipate the extra funds.

The merits of the first two of these changes are debatable. Consumer choice, including portfolio choice by investors, is often a good thing. But one of Social Security's key purposes is to limit people's choices, concerning both when they consume and how they invest, as a paternalist measure to ensure their retirement security. While this purpose does not rule out offering Social Security participants some portfolio choice, the cost-effectiveness of offering such choice is in dispute.

Eliminating progressive redistribution through Social Security has no obvious appeal, unless one thinks that the fiscal system as a whole is currently too progressive. Simply shifting the redistribution to other fiscal instruments, such as the income tax and various transfer programs, might be unobjectionable, but, under the current Bush Administration, there is little prospect of this happening. Privatization appears unlikely to address Social Security's enormous, and in some views excessive, transfers from younger to older generations.

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<sup>46</sup> Shaviro, *supra* note 35, at 3.

Privatization's re-casting of the Social Security system in terms of individual accounts, rather than a collective trust fund, is more language than substance. It might modestly aid efforts to increase the system's pre-funding, which, if not offset by other tax cuts or spending increases, would be a step toward addressing the overall United States fiscal gap. However, directly addressing the fiscal gap would be a lot more constructive than relying on privatization, which raises so many extraneous issues (and hackles) while offering so little aid other than the purely semantic.

