

# Should Social Security and Medicare Be More Market-Based?

Daniel Shaviro  
NYU Law School

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# Sustainability vs. structure

The long-term fiscal sustainability issues faced by Medicare (& to a lesser extent Social Security) are well-known.

But this is not the prime source of disagreement about the programs' futures, at least as between the center-left & the right.

E.g., the Obama Administration and Ryan budget plans project similar rates of long-term Medicare spending growth.

And recall the Bush Administration's 2005 Social Security plan, featuring private accounts that concededly did nothing to improve long-term financing.

Financing issues have helped to rationalize proposing major structural changes, but are orthogonal to the design questions.

# The key issue in design debates

Should Social Security and Medicare be structured more like private insurance? (Though all agree they should remain mandatory.)

E.g., tighter relationship between contributions & benefits, more consumer choice, greater role of private firms in furnishing benefits.

Republicans have backed off the language but not the substance, of “privatization” and “vouchers,” & might still accept “more market-based.”

Is this a standard “government vs. markets issue”? Yes and no.

The sides line up as one would expect, but all agree: (a) more market-based isn't always better (e.g., tax farming), (b) major government role & political choice issues will remain, (c) markets can't entirely handle the core problems that support retaining the programs.

Once all that's conceded, is one merely “haggling over the price”?

# Social Security & Medicare as “social insurance”

While they provide insurance, the label partly reflects mere form (dedicated financing, but pay-in  $\neq$  expected benefits, money is fungible). Cf. income tax/ transfers as social insurance (ability risk, under-diversified human capital).

We call them “entitlements.” But unlike private insurance, they are designed to limit people’s ability to make their own choices.

E.g., how much or little to save for retirement, how to invest retirement savings, how to structure the eventual payout, whether to hold health insurance.

On both paternalist & externality grounds, they in effect make people eat their spinach.

This makes it less than obvious when/if they should be made more market-based.

# The what & why of Social Security & Medicare

In addressing this issue, I draw on *Making Sense of Social Security Reform* (2000) & *Who Should Pay for Medicare* (2004).

In particular, discussion of the Samuelson (1958) model, plus my conceptual decomposition of the 2 programs.

Samuelson: Social Security as an inter-generational compact using what we today would call an implicit financial instrument.

My earlier work: Social Security as a 3-part program (forced saving, limited portfolio choice, transfers).

Both are easily extended to Medicare, though its proper design also turns on issues particular to the healthcare market.

# Samuelson model

Suppose all age cohorts live for 2 periods (work & retirement), each overlapping with another age cohort.

Saving resources between periods is assumed to be impossible, can't have financial markets across periods.

Generation 1 retires just at the moment when children supporting their retired parents has gone "out of fashion."

If each generation is self-interested & retirement saving is impossible, Generation 1's prospects may initially look dark indeed.

But not to worry – they have a proposition to offer Generation 2.

Enact permanent fixed rate payroll tax, pay out proceeds to retirees.

Gen 2 should agree if Gen 3 would agree in turn, which it should if Gen 4 would, ad infinitum until the final working generation loses.

# What we learn from the Samuelson model

(1) Fiscal sustainability – free benefits to the early participants need not be Ponzi-like – the key is feasible vs. exploding growth rate.

(2) Social Security as offering an implicit financial instrument – within the model, payoff depends on cohort size, wage growth. Aaron (1966): this can offer a better payoff than other available instruments.

(3) Political economy – With population growth & wage growth, never face the political problem of needing to adjust taxes or benefits.

Medicare: Some of the retirement saving pays for health insurance, raising the added issue of healthcare-to-wages stability.

Alas, rising life expectancy + baby bust + wage stagnation + exploding healthcare costs have created problems in all 3 dimensions.

# Social Security as a 3-part program

Tautologically,  $B = T = rT + X$ . Social Security is a forced saving program, restricts portfolio choice, & transfers net lifetime resources. (Medicare adds required health insurance rather than cash.)

Each feature is both conceptually and administratively separate.

Forced saving: programs take away money when you work, give it back later, must wait even for net transfers, fixed real life annuity is forced saving during retirement.

Restricted portfolio choice: can't, e.g., adjust risk or otherwise adjust the terms of the implicit investment.

Transfers: high-earners -> low-earners, younger -> older age cohorts, singles & two-earner couples -> one-earner couples.

Unlike short-lived -> long-lived (or, in Medicare, cheaper -> costlier), these transfers either lack obvious insurance rationales or not need to be done through retirement programs.



# “Traditional” Social Security reform

Bowles-Simpson offers a typical example:

Increase/index retirement age, change benefit formula & inflation adjustment, slowly increase the cap on covered earnings.

Those to the right might rely more on benefit cuts; those to the left might rely more on payroll tax increases.

On greater means-testing, the left & right often switch sides, due to “Wilbur Cohen / Robert Ball problem” (program just for the poor = poor program?).

Suppose, a la Paul Ryan, one “raises taxes” by subjecting employer-provided health insurance to the payroll tax. Not actually a “tax increase;” incidence perhaps isn’t a surprise.

# Shifting to private accounts (PSAs)

Ryan 2010: workers can electively divert payroll taxes to PSAs, in exchange for forfeiting traditional benefits that are as yet unaccrued.

Actuarially fair election = selling or borrowing against those benefits to fund permissible PSA investments.

PSA can invest in T-bills or any of several funds (gov't securities, bond index fund, any of 3 types of stock index fund).

Annual admin fees might = 0.25% of assets.

PSA holders guaranteed inflation-adjusted breakeven over time – but no guarantee, e.g., against losing 80% of value just before retiring.

At retirement, must purchase fixed real life annuity w/ minimum value, balance can be used as one likes, all unused PSA balances are inheritable.

# Initial observations on the Social Security choice

(1) Actuarially fair shift to PSAs in stock index funds would have positive expected return, but net market value of zero.

(2) If greater portfolio choice is generally preferable, why stop here?

(3) Ryan plan eliminates progressivity within the new program, but could adjust outside &/or have “progressive privatization.”

(4) Stronger & clearer tax-benefit relationship could increase labor market efficiency for both real and optical reasons.

(5) Ryan plan worse fiscally than it looks?

(a) Benefit expectation -> stronger legal commitment,

(b) Implicit guarantee of PSA returns in excess of the explicit guarantee?

# “Traditional” Medicare reform

Key challenge of reducing the growth rate for Medicare spending to sustainable levels would be addressed within the existing structure.

ACA established Independent Payment Advisory Board (IPAB) to revise & continually review Medicare’s payment system.

Other ACA provisions or Obama Admin budget proposals include, e.g., Cadillac tax, premium surcharge for Medigap co-payment insurance, income-related premiums for basic coverage.

Traditional approaches tend to focus more on the provider side than the consumer side, and combine incentive changes with centralized administrative rationalization.

# Voucherizing Medicare

Ryan approach would limit the traditional Medicare mandate to those age 55+ at the time of enactment. Might also continue it as 1 option, but is this feasible?

Younger age cohorts would get vouchers to help pay for mandated coverage, offered by competing (& mainly private) providers. Regulators would determine mandated benefits, based on traditional Medicare.

Vouchers' annual growth rate would be capped (if future Congresses agreed) – say, at annual GDP growth + 0.5%.

Cost-saving hoped to come from competition & seniors' incentive to be cost-conscious at the margin, **in lieu of** the traditional program's reliance on exercising monopsony power.

# Initial observations on the Medicare choice

The trillion-dollar question: How well can & do private markets work with respect to healthcare? On the grounds for skepticism, see Kenneth Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 Am. Econ. Rev. 941 (1963).

Is the exercise of monopsony power undesirable? Yes in otherwise well-functioning consumer markets, but otherwise not necessarily.

Political sustainability problems could be critical either way – e.g., campaigning & lobbying against “benefit cuts” vs. pressure on Congress to forget about capping vouchers’ annual growth rate.

Medicare vouchers would grow faster than Social Security’s fixed real life annuity – but fast enough? Need to think about optimization across periods (via consumption smoothing if declining marginal utility in each period **and** all periods are the same).

# Why forced saving?

Let's examine each of the 3 features in my Social Security / Medicare decomposition with an eye to what we learn about reform choices. First, forced saving.

## Why set a floor on people's saving for & through retirement?

Milton Friedman: absent a good rationale to the contrary, transfers should be cash that people spend how & when they like. This avoids deadweight loss from giving value that is less than taxpayers' cost.

But 3 types of rationales for the limitations imposed by Social Security and Medicare: paternalism, market failure, fiscal & altruistic externalities.

# Paternalism and forced saving for / through retirement

For paternalism to be appealing, need persuasive theories both of optimization and of consumer failure.

Optimization: permanent income hypothesis (long-term planning) and lifetime consumption-smoothing (from period-specific declining marginal utility).

For Medicare, add the importance of assuring access to treatment that extends life &/or affects its quality, and the value of insurance for highly variable outcomes.

Consumer failure: myopia / hyperbolic discounting, potential under-appreciation of the value of insurance (e.g., has it been “wasted” ex ante if not used ex post?).



# The market failure and fiscal/ altruistic externality rationales

Could people purchase fixed real life annuities & retirement health insurance at attractive prices, absent mandatory government provision?

The big issue is adverse selection – arguably a problem for fixed real life annuities, definitely a problem for health insurance.

Fiscal externalities: note the incentives to under-save for retirement & to under-insure against sickness if one might receive some support & urgent treatment in any event.

Altruistic externalities: the ground for our providing support to the indigent elderly & offering emergency room treatment might be that we derive more utility from their “consuming” in this way than in other ways that they might rationally prefer ex ante.

# Forced saving & the “traditional Medicare vs. capped voucher” choice

Admittedly, the main question goes to the efficacy of the 2 systems' approach to how the healthcare market operates.

Centralized command & control is generally (and often rightly) doubted – but is healthcare different? (Market forces vs. monopsony.)

But there is also an issue re. the Ryan plan's “hard cap” approach of limiting vouchers' annual real growth rate even if costly advances might indicate growing faster. (Consider PV-equivalent plans where one starts lower but grows faster than the other.)

Does the case for lifetime consumption smoothing suggest that permitting a positive (even if capped) real annual growth rate is, if anything, too slow?

# The case for permitting fixed real annual growth in Medicare outlays

Pure consumption smoothing is not optimal if periods differ because healthcare technology is improving.

All else equal, rational consumers would want to allocate more value to periods when more can be done, even if at greater cost.

Hence, the capped voucher approach can create deadweight loss (lower utility to consumers at the same cost to taxpayers) relative to starting lower and permitting the amount to rise faster.

One way this could play out over time, if Congress stuck to the caps, is that seniors' healthcare treatment through the system would grow ever worse relative to the best treatment that was contemporaneously available – even if ever-better in absolute terms.

# Why limit portfolio choice?

Next, the rationales for limiting portfolio choice, and how they affect the case for offering PSAs in lieu of traditional Social Security.

Rationales overlap with those for forced saving (paternalism and fiscal / altruistic externalities), although the explanations are different.

We have strong normative theories explaining how people with typical utility functions should invest.

In particular, with declining marginal utility (e.g., because you address your most urgent needs first), you should (a) diversify and (b) have rising risk tolerance as your income or wealth increases.

But investors can be over-confident and/or misjudge this. Plus, may have fiscal & altruistic externalities, moral hazard.

# The arguments for increasing portfolio choice through PSAs

Three main arguments have been made:

1) Choice is good – But Social Security provides the bedrock, bottom tier of retirement saving. A fixed return, not bet on fluctuation financial markets, is just what a rational investor should want.

2) Social Security should emulate the shift in private sector plans from defined benefits (DB) to defined contributions (DC) – But the actual implications of this shift are opposite. Sound diversification counsels preserving a bottom-tier DB element.

3) Stocks offer above-normal returns, even taking account of risk – We don't hear this much any more. But even if true, people with enough assets to like the risk profile can do all the stock market investment they like outside Social Security.

So what is the point of the entire exercise??

# Transfers through Social Security and Medicare

Taxes vs. benefits: their marginal relationship affects efficiency, their overall relationship affects distribution.

In Social Security, but not Medicare, could strengthen the (actual & perceived) marginal relationship between taxes & benefits, thus reducing the extent to which the payroll tax indeed functions as a tax.

Even leaving aside the system's actual (overall) transfer content, there is much to be said economically for making the marginal tax-benefit link both stronger and more transparent.

This would, however, raise political economy concerns, given the Cohen-Ball argument about poverty aid.

I myself am somewhat skeptical about the Cohen-Ball line of argument (e.g., transfers may get misdirected, & we get anomalous ones), but it's hard to reach definitive conclusions.

# Further transfer issues

The normative issues raised by the programs' transfers to older age cohorts are complex, both normatively & empirically. Clearly the transfers have been quite large.

The transfers from singles and two-earner couples to one-earner couples are hard to justify. Non-earners increase a household's needs, but also its (market & non-market) productive resources.

PSA inheritability: raises further issues of both efficiency & distribution. On both grounds, this proposed feature lacks any discernible rationale.

The whole reason for mandating fixed real life annuities is that the longer-lived need greater lifetime resources than the shorter-lived.

What is the market failure that inheritability purports to address?

# A final word

Should Social Security and Medicare be more market-based?

I like markets, but the preconditions for their increasing people's welfare must be kept in mind.

The reason for having programs such as Social Security and Medicare is to respond to market failure (including consumer failure).

Even those who may privately doubt that there is any need for these programs do not express this doubt in public political debate.

And for good reason – as is indeed reflected in their program re-designs, which still significantly limit competition and choice.

While no blind worshipper of the existing programs, I see no good rationale either for increasing Social Security portfolio choice or for voucherizing and “hard-capping” Medicare.