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CREATING A BETTER SOCIAL SECURITY SYSTEM FOR AMERICA

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INTRODUCTION

America's Social Security system is in serious trouble. Payroll tax rates have been increased 17 times in the past 40 years, yet promised benefits exceed projected revenues by trillions of dollars. Moreover, Social Security has become an increasingly bad deal for American workers who must pay record high taxes to a system that provides only meager levels of income for their retirement years. Even worse, there is no way to fix the current system to remedy these problems. Additional payroll taxes or benefit reductions would address the massive long-term deficit, but only by making the system an even poorer investment for working Americans; and raising benefits or cutting taxes, both of which could improve the rate of return for workers, would catapult Social Security into bankruptcy even sooner.

The only answer to these seemingly intractable problems is to privatize the Social Security system. Countries around the world, including Chile, Australia, Mexico, Singapore, and Great Britain, have allowed workers to opt out of unsound government schemes in favor of private savings plans. The results have been spectacular, with higher levels of retirement income and more security for senior citizens. Less well known is the success of private retirement savings in the United States. More than 1 million state and local government employees in the United States have been exempted from Social Security and are now enjoying higher levels of retirement income through private pension plans.

Privatization would not require any reductions in benefits for those who already are retired or nearing retirement. It would enable America's future elderly to retire with dignity, in addition to bringing enormous benefits to the economy overall. Replacing the payroll tax with a system of private savings accounts would boost the anemic level of savings in the United States. It also would boost the creation of jobs by sharply reducing the tax penalty imposed on employment. The resulting increase in economic growth would add thousands of dollars to the average family's income.

Despite these benefits, lawmakers may delay implementing necessary changes simply because of the political risk they associate with trying to reform Social Security. Doing nothing, however, only guarantees that the United States will face a crisis of alarming proportions when the baby-boom generation finally retires.

THE SORRY STATE OF AMERICA'S SOCIAL SECURITY SYSTEM

Despite mounting national and international evidence to support privatization as a remedy for Social Security's looming crisis, policymakers are proceeding with great caution. Many of them consider Social Security a "third-rail" issue, and the dishonest "mediscare" campaign of the last election cycle likely has made the subject even more difficult to address. But the political and human costs of doing nothing far exceed the risk of reform:

1. **Social Security is going broke.**

   - In 1950, 16 workers supported each Social Security recipient. Now there are barely three workers per recipient, and by 2030 the ratio will fall to two per beneficiary.[1]
   - When Social Security was created in the 1930s, the average life expectancy was less than 65 years. Now the average person lives until about 75.[2]
   - Under current law, promised benefits under Social Security will exceed projected payroll tax revenues by about $160 trillion between 1997 and 2075.[3]
   - The "present value" of this unfunded liability, measured by the amount of money that would be needed today to balance the system, falls between $9 trillion and $12 trillion.[4]
   - Social Security will begin running a deficit in 2012—sooner if the economy's performance weakens.[5]
   - Some argue that the Social Security Trust Fund can delay the problem until 2029, but the Trust Fund is a hoax: It contains nothing but government IOUs.[6]

2. **Social Security taxes are too high.**

   - Using higher taxes to close the Social Security deficit would mean raising payroll taxes by at least 50 percent.[7]

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1 Social Security Administration, *The 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, communication from the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, House Doc. 104–228 (Washington, D.C.: U.S. Government Printing Office, 1996).

2 Social Security Administration, *Life Tables for the United States Social Security Area*, Actuarial Study No. 107, August 1992.

3 Office of the Actuary, Social Security Administration, unpublished data, 1996.

4 Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," *American Economic Review*, Vol. 86, No. 2 (May 1996).

5 SSA, *1996 Annual Report*.

6 Dan Goodgame, "Many Happy Returns," *Time*, January 20, 1997.

7 Feldstein, "The Missing Piece."

- A payroll tax hike of that magnitude would destroy about 3 million jobs.[8]
- In the past 50 years, the Social Security payroll tax rate has climbed from 2 percent to 12.4 percent.[9]
- As recently as 1971, the tax applied only to the first $7,800 of income. Now workers must pay the full 12.4 percent on all income up to $65,400.[10]
- The combination of higher rates and greater amounts of income subject to tax has caused the maximum Social Security payroll tax to climb from $60 in 1949 to more than $8,000 today.[11]

3. **Social Security is a bad deal for workers.**

- Even though future benefits greatly exceed projected revenues, the system is not a good investment for workers. Almost all Americans under 55 will receive far less from Social Security than they could earn by investing their payroll tax dollars in private mutual funds or pension accounts.[12]
- Social Security is an especially bad deal for certain demographic groups. Two-earner couples are hit particularly hard. Black males, because of their low life expectancy, also are big losers.[13]
- The rate-of-return figures assume that future retirees will receive the benefits currently promised. Projected Social Security revenues, however, are only sufficient to cover about 70 percent of promised benefits. Higher taxes or benefit reductions to close that gap will make the rate-of-return figures even worse.[14]
- Social Security's one-size-fits-all approach, forcing participants to pay taxes in exchange for monthly retirement checks, prevents workers from exercising better options. Workers with lower life expectancies, for instance, would be far better off with private savings plans that they could pass on to their children and grandchildren.[15]

4. **Privatization is the way to guarantee a safe and secure retirement.**

- There is only one way to solve the long-term Social Security deficit without making the system worse for American workers: privatization.[16]

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8 Stephen J. Entin, "Private Savings vs. Social Security: Many Happier Returns," Institute for Research on the Economics of Taxation *Congressional Advisory* No. 55, September 4, 1996.

9 SSA, *1996 Annual Report.*

10 Social Security Administration information at *http://www.ssa.gov/OACT/COLA/CBB.html.*

11 Author's calculations.

12 Arthur P. Hall, "Forcing a Bad Investment on Retiring Americans," Tax Foundation *Special Report* No. 55, November 1995.

13 Arthur P. Hall, "Social Security: A Bleak Outlook for Baby Boomers," Tax Foundation *Special Report* No. 56, January 1996.

14 William G. Shipman, "Retiring with Dignity: Social Security vs. Private Markets," Cato Institute *SSP* No. 2, August 14, 1995.

15 Michael Tanner, testimony before Subcommittee on Social Security and Family Policy, Committee on Finance, U.S. Senate, August 2, 1995.

16 Peter J. Ferrara, "Power to the People: A Private Option for Social Security," Americans for Tax Reform *Policy Brief*, 1996.

- A privately based retirement system would be simple to administer. Payroll taxes could be replaced by mandatory retirement savings accounts that would be invested in stocks, bonds, and other financial assets.
- Annual stock market returns over the last 70 years have averaged 7 percent compared with the negative returns now promised by Social Security.[17]
- Private savings bring higher returns than Social Security, so privatization would allow people entering the workforce at least to triple their retirement income.[18]
- Older workers also could benefit from privatization, with the increase in their retirement income dependent on how many years they have left to participate in the workforce.[19]

5. Thousands of Americans already have private retirement systems.

- Government employees from the Texas counties of Galveston, Brazoria, and Matagorda chose to opt out of Social Security in the early 1980s.[20]
- The amount these employees pay into the system is similar to the Social Security tax, but the return is much greater. Retirement income for low-income workers in the private plan will be three times greater—and for middle-income workers, five times greater—than it would be if they were forced to pay Social Security taxes.[21]
- Moreover, the disability and life insurance benefits available under the private Texas plan are more generous than those available under Social Security.[22]
- In addition, 1 million state and local government workers from California, Ohio, Nevada, Colorado, and Maine are exempt from Social Security and use defined benefit pension plans instead.

6. Privatization could jump-start the economy.

- Privatization could increase annual economic output by 5 percent ($350 billion) by boosting savings and job creation.[23]
- The total gain to the economy over time, in present value, would be at least $10 trillion.[24]
- Annual income for the average family of four would climb by more than $5,000.[25]

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17 Bruce Bartlett, "Social Security Privatization," National Center for Policy Analysis *Brief Analysis* No. 209, August 20, 1996.

18 Shipman, "Retiring with Dignity."

19 Arthur P. Hall, "A Primer on Social Security Reform," Tax Foundation *Special Report* No. 66, November 1996.

20 E. J. Myers, "Social Security Privatization Is Here," *The Wall Street Journal*, January 16, 1997.

21 Merrill Matthews, Jr., "Some Americans Already Have Privatized Social Security," National Center for Policy Analysis *Brief Analysis* No. 215, November 4, 1996.

22 Stephen Glass, "Mrs. Colehill Thanks God for Private Social Security," *Policy Review*, No. 83 (May/June 1997).

23 Feldstein, "The Missing Piece."

24 *Ibid.*

25 Author's calculations.

Glossary of Social Security Terms

Rate of return: The percentage increase, usually on an annual basis, in the value of an asset, plus any net income the asset produces. Money invested in the stock market, for example, has increased in value an average of more than 10 percent annually since 1926. Rate-of-return calculations frequently are expressed in real terms (adjusted for inflation). For example, the real rate of return for stock investments over the past 70 years has averaged 7 percent. Returns on investments vary with risk.[†] Rates of return are important in the Social Security reform debate because workers would receive much higher returns if they had the freedom to take the money now consumed by Social Security payroll taxes and put it into private savings.

Present value: A technique used to calculate the worth today of a given amount of future income or liabilities. Part of the calculation is an adjustment in the figures to reflect inflation. Also part of the calculation is what professionals call the "time value" of money. Simply stated, money has value because it can be used for consumption or invested to yield an inflation-adjusted return. Thus, even if adjusted for inflation, money is more valuable today than it will be in the future. Present value is important in the Social Security reform debate because these calculations expose why the system is deeply in debt (even though currently running a surplus) and why workers are getting a bad deal.

Unfunded liability: A description applied when projected future income will not be sufficient to pay future obligations. Another way of stating the concept is to say the system is not actuarially balanced. This calculation is important in the Social Security reform debate because promised benefits exceed estimated tax revenues by $160 trillion (even though, when adjusted to present value, this falls to a "mere" $9 trillion to $12 trillion).

Annuity: An agreement by one entity (usually a financial services company) to provide someone with a certain level of income, either for a fixed number of years or for the rest of the recipient's life. In discussing Social Security reform, annuities are important because it is widely assumed that upon retirement, individual workers would use some or all of their private savings to purchase annuities. The actual income provided by the annuity (plus inflation adjustments) would depend on the amount of savings in the worker's account and on the worker's remaining life expectancy.

Pay-as-you-go: A reference to systems, such as Social Security, in which retirement benefits are financed by current workers.

Full-funded, advance-funded: A reference to retirement systems in which the worker builds up private savings that then are used to finance retirement income.

† Equities (shares or ownership of an income-producing asset) produce higher returns on average; the returns, which can comprise both dividends and capital gains, will vary with economic conditions. Private bonds, which are commitments to pay a fixed stream of income in exchange for a loan, generally pay lower returns, but also have less risk (that is, there is less fluctuation in either the market value of the bond or the stream of income it generates). Finally, certain investments, like government bonds or bank accounts, have relatively little risk and pay commensurably low returns.

- At least 1 million new jobs would be created.[26]

7. Privatization is sweeping the globe.

- Fully or partially privatized systems exist or are being implemented in Great Britain, Chile, Australia, Singapore, Mexico, Peru, Italy, Colombia, Sweden, Uruguay, Malaysia, El Salvador, Argentina, and Bolivia.[27]
- Chile's system is based on what is probably the purest form of privatization and, not surprisingly, is the most successful. More than 90 percent of workers choose the private savings alternative.[28]
- Australia recently privatized its Social Security system, replacing government payments with income from mandatory private savings accounts.[29]
- Singapore has had a fully private retirement system in place for more than 40 years. Because of the savings required under this system, Singapore has the highest savings rate in the world, and its people enjoy a safe and secure retirement.[30]
- Britain already has a partially privatized system (like workers in Chile, workers in Britain prefer the marketplace: 75 percent choose the private savings option), and the government has proposed full-scale privatization, to begin around 2000.[31]
- The World Bank, not normally considered a hotbed of free-market thought, has endorsed Social Security privatization.[32]

Why Social Security Is in Trouble

If Social Security were a private pension system, it would be forced to declare bankruptcy. The gap between what Social Security has promised to pay and what it expects to collect is staggering—and this huge unfunded liability is just part of the problem. Equally grave is the inadequate income Social Security provides upon retirement when compared with the record amount of taxes workers are forced to pay into the system.

In addition, this troubled system threatens the economy as a whole. Left on autopilot, entitlement programs like Social Security could push the overall budget deficit to record levels. Even reasonably optimistic estimates conclude that federal borrowing will grow at least sixfold, consuming 15 percent of economic output.[33] According to the Bipartisan

26 Author's calculations.

27 Peter J. Ferrara, John Goodman, and Merrill Matthews, Jr., "Private Alternatives to Social Security in Other Countries," National Center for Policy Analysis *Policy Report* No. 200, October 1995.

28 Robert J. Myers, "Chile's Social Security Reform, After Ten Years," *Benefits Quarterly*, Third Quarter 1992.

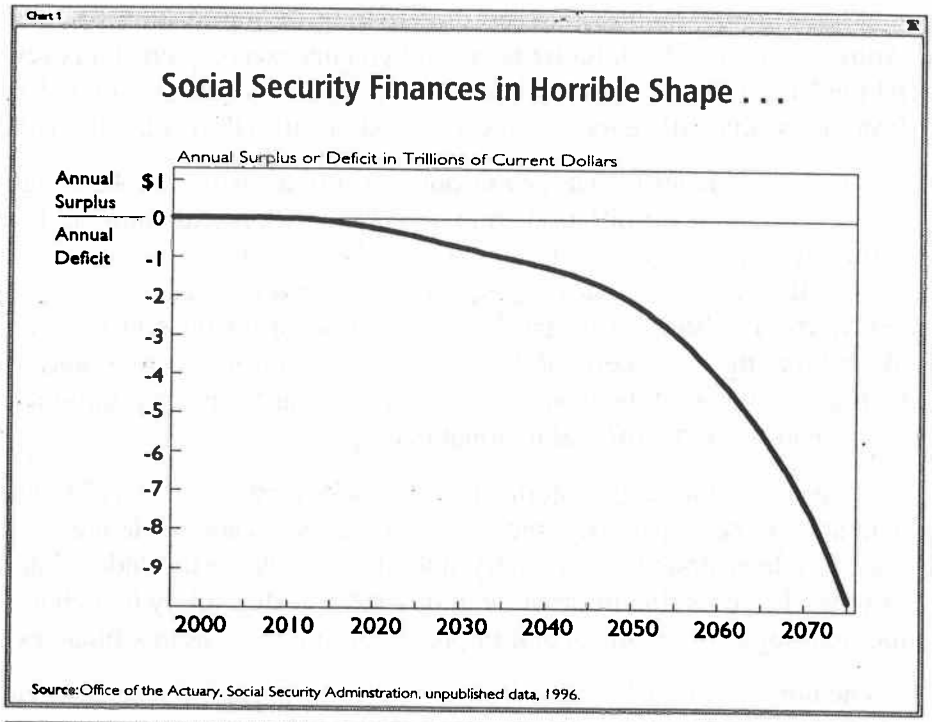
29 Sylvester J. Schieber and John B. Shoven, "Social Security Reform: Around the World in 80 Ways," *American Economic Review*, Vol. 86, No. 2 (May 1996).

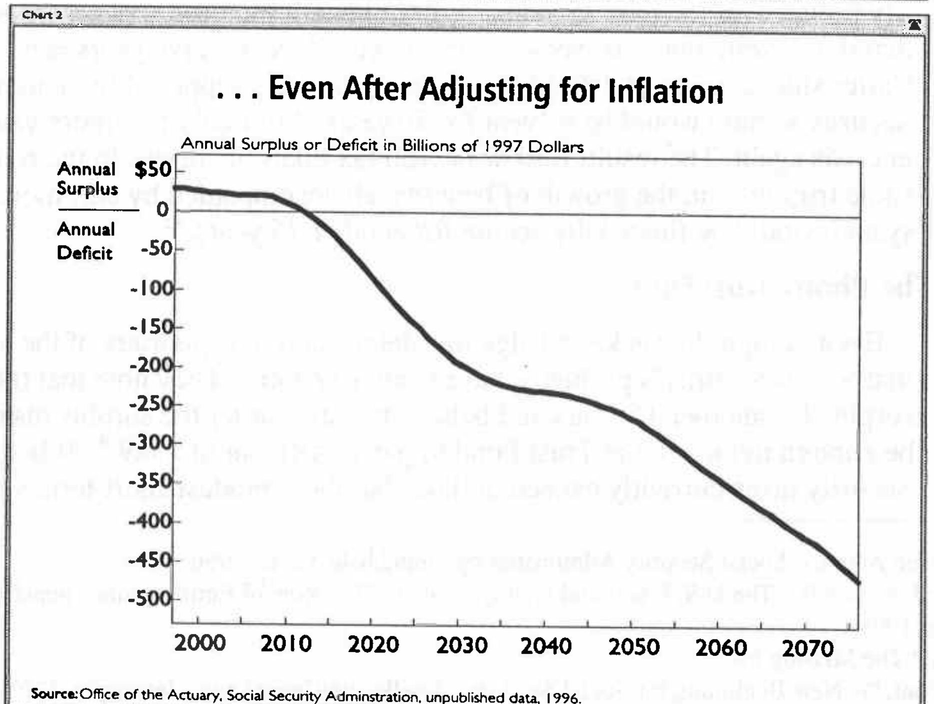
30 Mukul G. Asher, "Compulsory Savings in Singapore: An Alternative to the Welfare State," National Center for Policy Analysis *Policy Report* No. 198, September 1995.

31 "Tomorrow's Pensioners," *The Economist*, March 8, 1997.

32 World Bank, "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth," *Policy Research Report* (New York, NY: Oxford University Press, 1994).

33 William Modahl, "Social Security Imbalances Could Wreck the U.S. Economy," *The American Enterprise*, January/February 1997.





Commission on Entitlement and Tax Reform, entitlement spending alone by 2030 will exceed total tax revenue collections, meaning government would have to borrow just to fund all defense spending, all non-entitlement domestic spending, and net interest.[34]

Opposing parties in Washington battle regularly over how best to deal with the $4 trillion national debt. It turns out, however, that they may be focusing on the molehill

34 Bipartisan Commission on Entitlement and Tax Reform, *Interim Report to the President*, Washington, D.C., August 1994.

and ignoring the mountain. According to long-term projections by the Social Security Administration (SSA), future benefit payments exceed payroll tax revenues by an astonishing $160 trillion over the next 80 years.[35] Annual deficits alone begin to exceed $1 trillion in less than 40 years, and the yearly shortfall will reach $9.8 trillion by 2075.

The "good" news is that the outlook is not quite as bad as these figures suggest. Once they are adjusted for inflation and interest rates ("present value"), the figure for these future deficits, although still huge, is smaller. According to Boston University's Laurence Kotlikoff, the present value of the unfunded liability totals $10 trillion.[36] Harvard Professor Martin Feldstein's estimate is slightly less optimistic: $11 trillion.[37] Some have concluded that the unfunded liability is "only" $9 trillion,[38] while others put it at $12 trillion.[39] The point, however, is the same: Social Security's unfunded liability is still more than twice the official national debt.

There is no guarantee that this massive unfunded liability will not become even worse. The Social Security Trust Fund's Board of Trustees acknowledges that the long-range balance has deteriorated significantly since 1983, with the unfunded liability increasing in 12 of those 13 years (the improvement in 1988 was due solely to a change in accounting methodology, not to any actual improvement in the system's finances).[40]

The unreliability of the government's estimates can be seen by reviewing Social Security policy over the past 25 years. A 1972 benefit increase was accompanied by promises that the system would be solvent for another 75 years. Five years later, President Jimmy Carter signed a record payroll tax increase that was supposed to guarantee the Social Security system would be solvent for 50 years. After only five more years, the system was in crisis again. The result: further payroll tax hikes, increases in the retirement age, and some trimming in the growth of benefits, all accompanied by still more promises that the system would be financially secure for another 75 years.[41]

The Phony Trust Fund

Even though they acknowledge this deterioration, supporters of the status quo claim that Social Security's problems have been overstated. They note that the system will run a surplus for another 15 years and believe that even after the surplus disappears, there will be enough money in the Trust Fund to pay benefits until 2029.[42] It is true that Social Security taxes currently exceed outlays, but these modest short-term surpluses are

35 Office of the Actuary, Social Security Administration, unpublished data, 1996.

36 Laurence J. Kotlikoff, "The U.S. Fiscal and Savings Crises—The Role of Entitlements," unpublished manuscript, December 1994.

37 Feldstein, "The Missing Piece."

38 Pete du Pont, "A New Beginning for Social Security," IntellectualCapital.com, January 9, 1997; available on the Internet at *http://www.intellectualcapital.com/iced.htm*.

39 Karl Borden, "Dismantling the Pyramid: The Why and How of Social Security Privatization," from Cato Institute *SSP* No. 1, August 14, 1995.

40 SSA, *1996 Annual Report*. See also *The 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, communication from the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, D.C.: U.S. Government Printing Office, 1988).

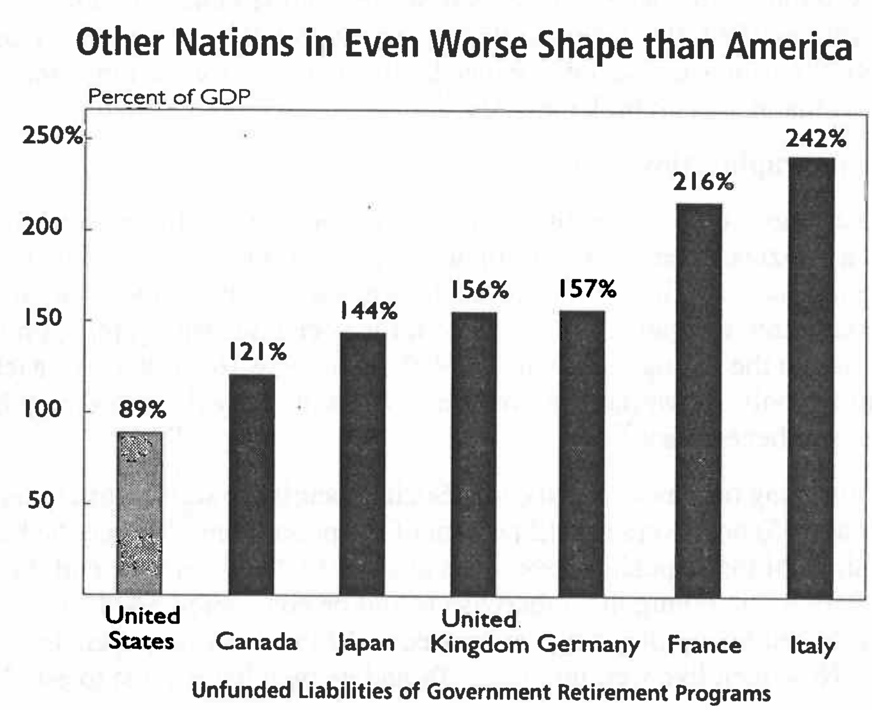
41 Carolyn Weaver, "Social Security Myths in the Making," *On the Issues*, American Enterprise Institute, January 27, 1995.

42 Henry Aaron, "The Myths of the Social Security Crisis: Behind the Privatization Push," *The Washington Post*, July 21, 1996.

THE GRASS IS GREENER ON THIS SIDE OF THE FENCE

America's Social Security system may be actuarially bankrupt, but government retirement systems in several other countries around the world are in far worse shape.† As Chart 3 illustrates, the World Bank calculated several years ago that the unfunded liabilities of the U.S. system are considerably lower than those of other major industrialized democracies.†† The situation is even worse in former Soviet-bloc countries: As they try to boost growth and escape the legacy of socialism, their economies are stifled by the payroll taxes—often exceeding 30 percent—needed to support government-run retirement programs.†††

Chart 3



Source: The World Bank, "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth," 1994.

† Martin Wolf, "Mind the pensions gap," *Financial Times*, January 28, 1997.

†† World Bank, "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth," *Policy Research Report* (New York, NY: Oxford University Press, 1994).

††† *Ibid.*

dwarfed by the deficits that will begin when the baby-boom generation decides to start retiring in about a dozen years. The SSA's own figures show that the system will begin to experience deficits in 2012 (2009 if the federal government's "share" of federal employee payroll taxes is not counted). At that point, deficits begin to grow exponentially and will top the $1 trillion mark by 2036.

The argument that Social Security can rely on the Trust Fund is even more ill-founded. Simply stated, the Trust Fund is a hoax.[43] It contains nothing more than IOUs—money the government owes itself. The annual surpluses that many thought were being used to build up a reserve for baby boomers have been spent on other government programs, leaving the Trust Fund holding a bag of government bonds.

People cannot write IOUs to themselves and have that piece of paper represent real assets; neither can the government. As the Congressional Budget Office (CBO) has noted, "The government's ability to finance a given schedule of Social Security benefits is not inherently related to the solvency of the Social Security Trust Funds...because the assets of the Social Security Trust Funds do not represent any real stock of resources set aside to pay for benefits in the future."[44] Thus, when Social Security begins to run a deficit, either in or by 2012, the only way these bonds can be redeemed is by cutting benefits, raising taxes, or issuing more debt. Yet these are precisely the circumstances the Trust Fund was created to avoid.

Even those who believe the Social Security Trust Fund is real have reason to worry. As recently as 1984, there supposedly were enough IOUs to cover the Trust Fund until after 2060.[45] It is now estimated (the date has been moved forward in eight of the past ten years alone) that it will go broke in 2029.[46]

A Demographic Time Bomb

Years ago, liberal economist Paul Samuelson noted with approval that Social Security was a Ponzi scheme.[47] In addition to the fact that they are illegal in all 50 states,[48] Ponzi schemes have another serious problem: They work only if more and more people are suckered into the game.[49] The problem for Social Security is that population trends are heading in the wrong direction. In 1950, there were 16 workers for each retiree. Today, there are only 3.2 workers per retiree.[50] By 2030, only 2 workers will be available to support each beneficiary.[51]

This aging of America will cause Social Security to self-destruct. Senior citizens (those over age 65) now comprise 12 percent of the population.[52] When the baby boomers retire, the share of the population over 65 will jump to 20 percent. One of the reasons for this problem is something that otherwise would be considered good news: rising life expectancy. When Social Security was created in 1935, the average person did not live to be 65.[53] Now men live well into their 70s and women live almost to 80.[54]

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43 Goodgame, "Many Happy Returns."

44 Congressional Budget Office, *The Economic Effects of Uncompensated Changes in the Funding of Social Security*, 1991.

45 David Koitz and Gary Sidor, "The Long-Range Social Security Projections," *CRS Report for Congress*, Congressional Research Service, January 7, 1997.

46 Michael Tanner, "Public Opinion and Social Security Privatization," Cato Institute *SSP* No. 5, August 6, 1996.

47 Michael Tanner, "Sixty Years of Tinkering," *The World & I*, November 1995.

48 Michael Tanner, "The Other Trust Fund Report," Cato Institute, available on the Internet at *http://www.cato.org/dailys/12-05-96.html*.

49 Thomas Sowell, "A legal con game," *Forbes*, March 27, 1995.

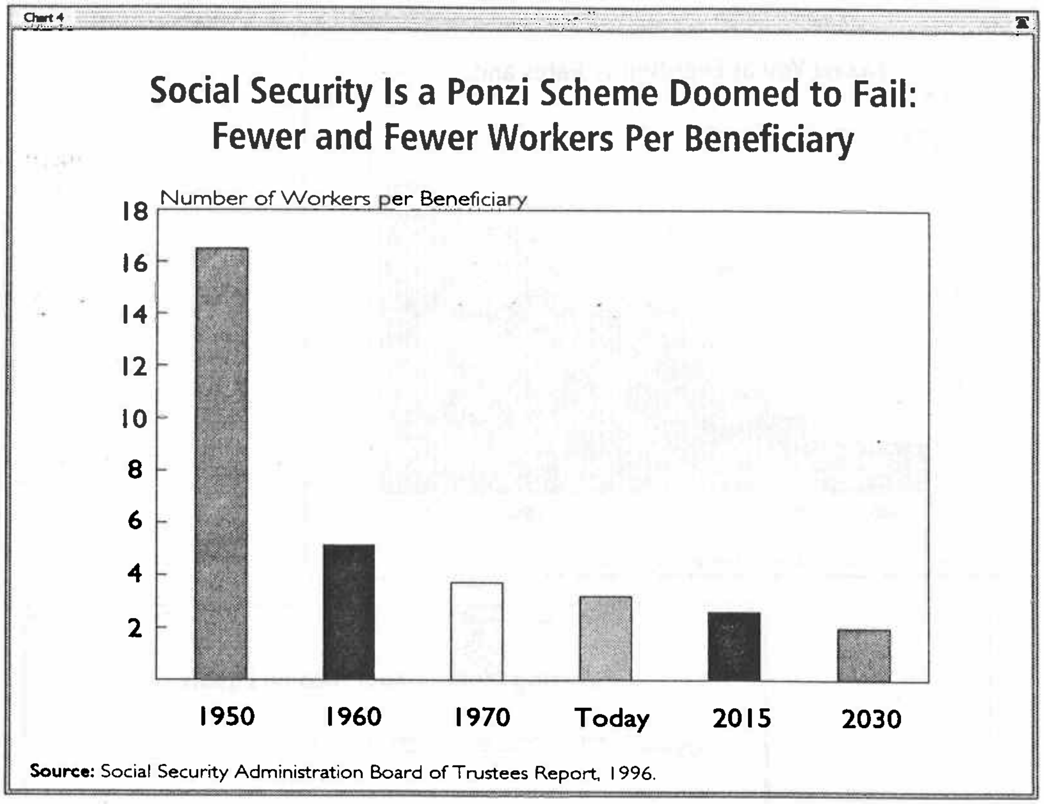
50 SSA, *1996 Annual Report*.

51 Tim Penny, "Social Security Reform: The Progressive Case," *Policy Report*, Cato Institute, Vol. XVIII, No. 5 (September/October 1996).

52 Stephen J. Entin, "Social Security Retirement and Disability Programs Need Help Now," Institute for Research on the Economics of Taxation *Congressional Advisory* No. 54, May 14, 1996.

53 SSA, *Life Tables*.

54 Mark Weinberger, "Social Security: Facing the Facts," Cato Institute *SSP* No. 3, April 10, 1996.



More important for purposes of Social Security, however, is the life expectancy of those who do reach age 65. In 1935, the average 65-year-old was expected to live about 12.6 more years. Today, people who reach age 65 are expected to live more than 17 additional years. And by 2040, they will be expected to live at least another 19 more years.[55]

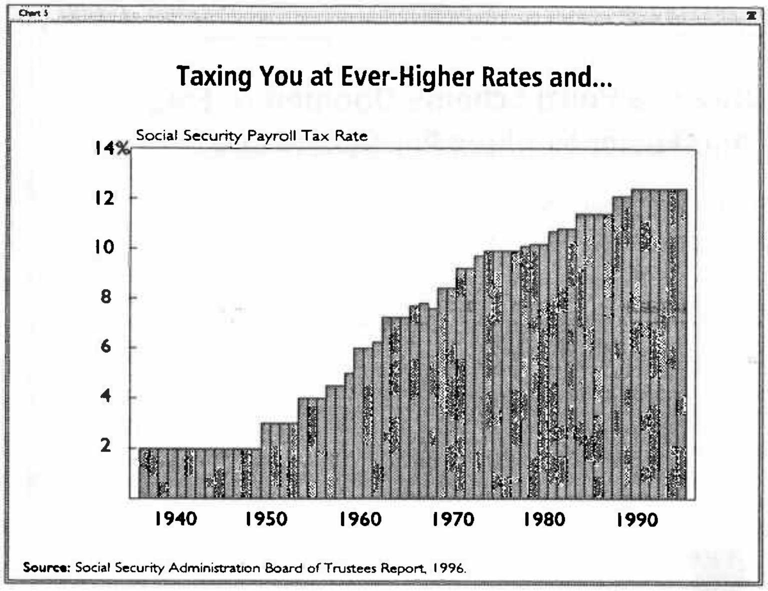
Longer life spans, however, are just one piece of the puzzle. Another is the trend toward early retirement. As recently as 1960, 77 percent of people in their early 60s remained in the workforce. Today, that number has dropped to 55 percent.[56] Needless to say, instead of continuing to pay into the system, early retirees become a burden on those who still work.

Adding to the demographic squeeze of increasing life expectancy and early retirement is the falling U.S. fertility rate. Women in the 1940s, 1950s, and 1960s averaged at least two and one-half children each, and sometimes more than three. Fertility rates are considerably lower today; women barely average two children each, and that rate is expected to fall even more after the turn of the century.[57]

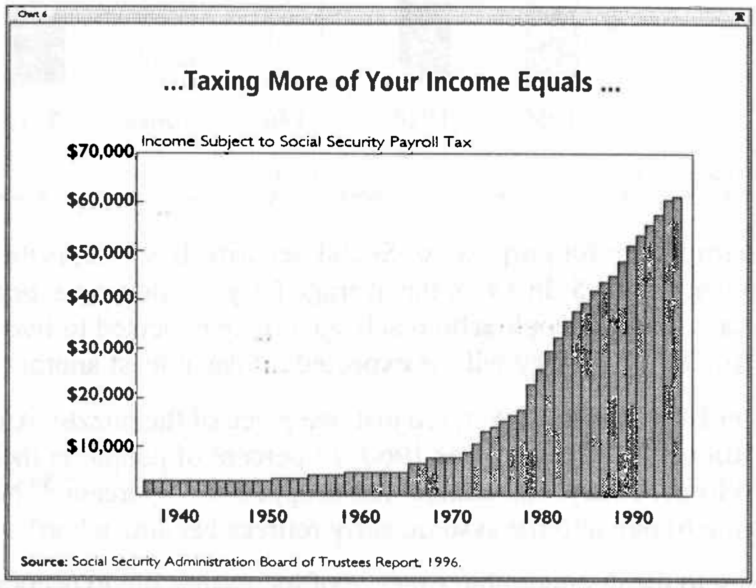
The Record High Tax Burden

Payroll taxes have been one of the fastest-growing burdens on families over the past three decades. As Charts 5, 6, and 7 illustrate, the rate has climbed steadily. The payroll tax, however, is only part of the burden. As recently as 1971, Social Security taxes were applied only to the first $7,800 of income; today, they are applied to the first $65,400 in wages. By taxing more of a worker's income and at a higher rate, the payroll tax has become a bigger burden than the income tax for about 75 percent of U.S. workers.[58]

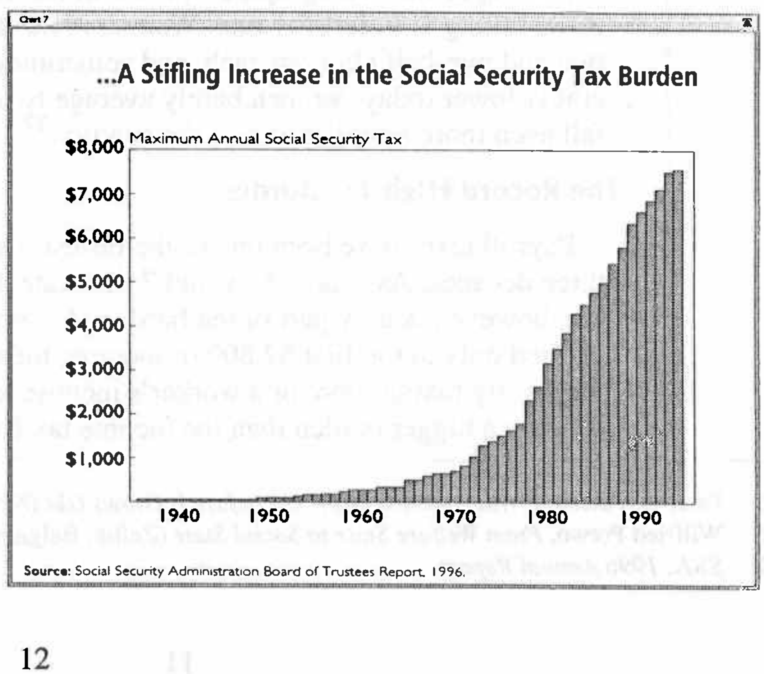
55 Peter G. Peterson, *Will America Grow Up Before It Grows Old* (New York, N.Y.: Random House, 1996).
56 Wilfried Prewo, *From Welfare State to Social State* (Zellik, Belgium: Centre for the New Europe, October 1996).
57 SSA, *1996 Annual Report*.



Source: Social Security Administration Board of Trustees Report, 1996.

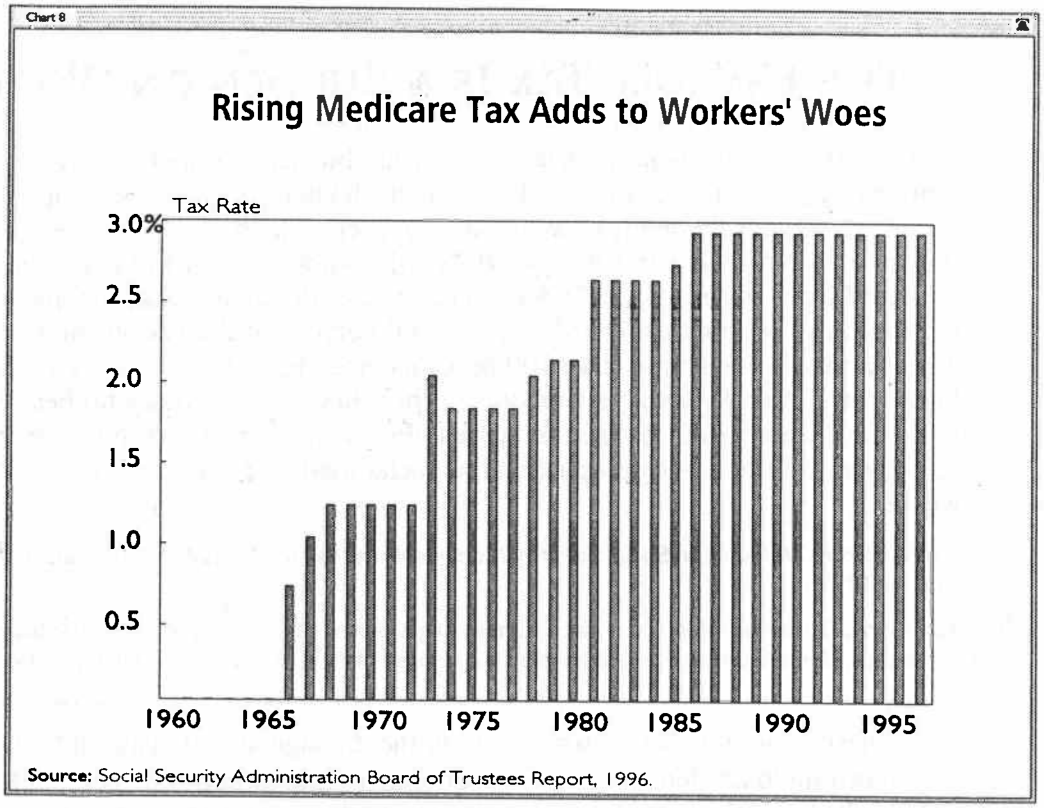


Source: Social Security Administration Board of Trustees Report, 1996.



Source: Social Security Administration Board of Trustees Report, 1996.

58 Shipman, "Retiring with Dignity."



Because of this crippling burden, the consequences of trying to finance Social Security's deficit with higher taxes would be catastrophic. Just bringing the system into balance would require an increase of about 6 percentage points in payroll tax rates.[59] Moreover, this estimate is based on a set of economic assumptions that may not be warranted. Based on SSA's less optimistic assumptions, payroll tax rates would have to rise to 28 percent (40 percent or more including Medicare) for promised benefits to be paid.[60] Although such tax increases might be sufficient to pay promised future benefits, the economy would suffer severe consequences. Total job losses could reach as high as 3.5 million even under the more favorable assumptions,[61] and fewer jobs would mean lower Social Security payroll tax collections, causing the actual tax burden to climb even higher.

The numbers are even more depressing when Medicare is added to the equation. As Chart 8 illustrates, the Medicare payroll tax has jumped from 0.7 percent to 2.9 percent in just 30 years (and, unlike Social Security, with no limit on the amount of income subject to the tax).[62] Because of the system's poor design, even this quadrupling of the tax rate leaves Medicare teetering on the edge of bankruptcy.[63] The tax increase needed to keep Medicare solvent eventually could add 14 points to the tax rate, double or triple the total number of jobs lost,[64] and cause overall economic output to drop by nearly 10 percent.[65]

59 Feldstein, "The Missing Piece."
60 Borden, "Dismantling the Pyramid."
61 Entin, "Private Savings vs. Social Security."
62 SSA, *1996 Annual Report.*
63 Stuart M. Butler, testimony before Subcommittee on Medicaid and Health Care for Low-Income Families, Committee on Finance, U.S. Senate, March 6, 1997.
64 Entin, "Private Savings vs. Social Security."

THE PAYROLL TAX IS A BURDEN ON WORKERS

Some argue that the real Social Security tax burden is only 6.2 percent because the employer pays 50 percent of the 12.4 percent levied. Just because the employer sends money to the government, however, does not change the fact that the worker pays the bill, as one SSA researcher has noted: "workers actually pay the tax, even though it is collected from the employer."[†] A perfect analogy is the personal income tax. Because of withholding, businesses technically pay 100 percent of the tax on their employees' wages and salaries (more than 100 percent once income tax refunds are considered). But most, if not all, taxpayers recognize that they are the ones who bear the burden. Even the Clinton Administration agrees, testifying that the "true incidence of both the employer and the employee portions of social insurance taxes ultimately falls on the worker."[††]

† Dean R. Leimer, "A Guide to Social Security Money's Worth Issues," *Social Security Bulletin*, Vol. 58, No. 2 (Summer 1995).

†† J. Mark Iwry, Statement of Benefits Tax Counsel, Department of the Treasury, before Subcommittee on Tax and Finance, Committee on Small Business, U.S. House of Representatives, June 28, 1995.

These economic losses would add to the damage already caused by high payroll taxes. According to academic research, economic output already is 1 percent lower on an annual basis because the payroll tax discourages both the quantity and quality of employment.[66] One percent may not sound like much, but it amounts to about $70 billion, or an average loss of more than $1,000 in output for a family of four.

A Bad Investment

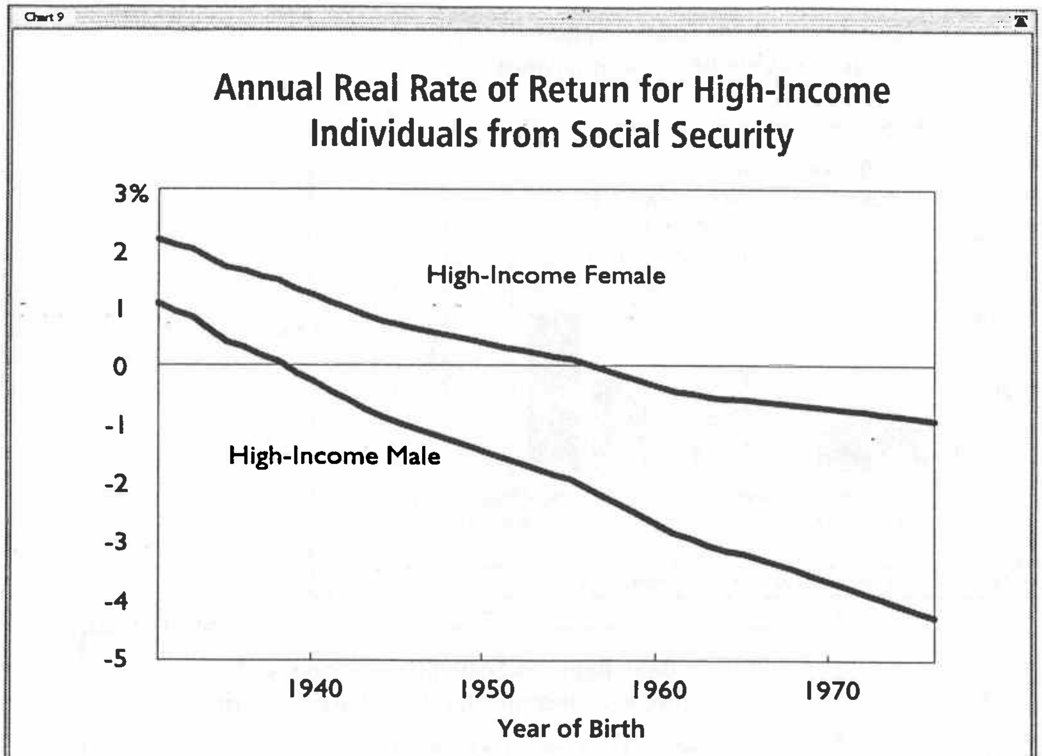
Paying record high taxes into Social Security might not be so bad if workers eventually could get their money back, but there is little doubt that Social Security is a poor investment for American workers.[67] Charts 9 and 10 illustrate that many age groups, including some of those who already are retired, would have been much better off if they had been able to participate in private savings plans. Even workers making low wages would have been better off with private savings.

The Heritage Foundation figures are replicated by other experts. William G. Shipman of State Street Global Advisors in Boston, for example, compares the amount of retirement income provided by Social Security with the amount private markets would provide. These figures show that stocks would provide the highest level of retirement income, but that even a very cautious investment in bonds would give people of all age groups and all income levels more retirement income than Social Security can provide (Charts 11, 12, and 13).

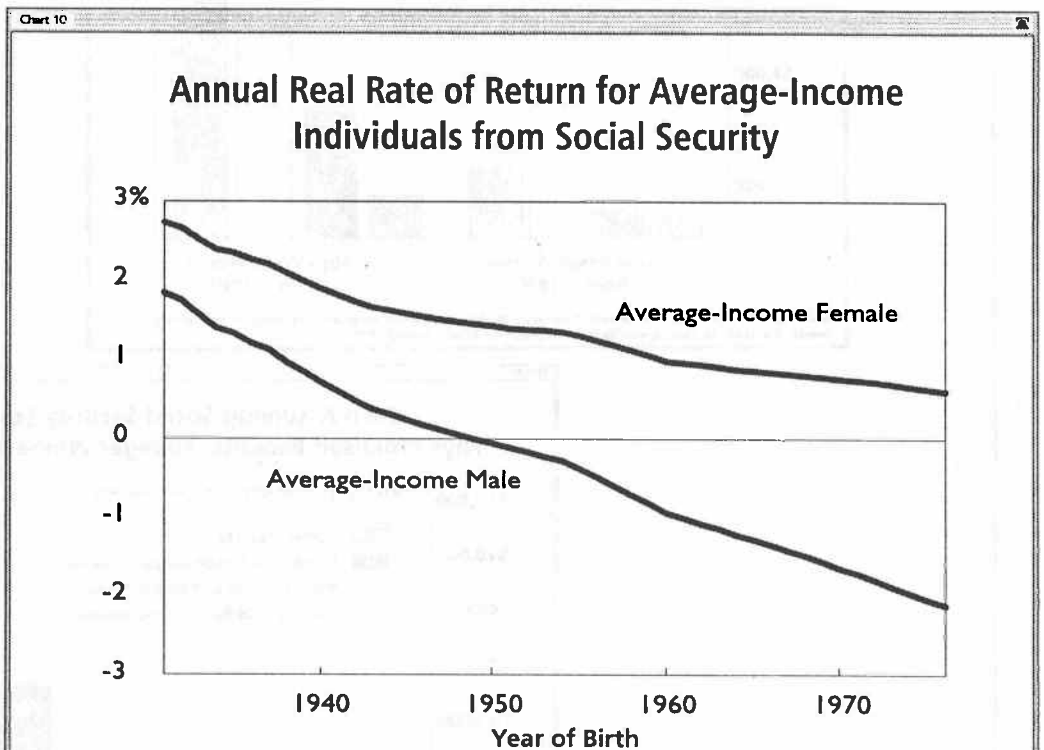
65 Gary Robbins and Aldona Robbins, "Salvaging Social Security: The Incredible Shrinking Trust Fund and What We Can Do About It," Institute for Policy Innovation *Policy Report* No. 130, April 1995.

66 Feldstein, "The Missing Piece."

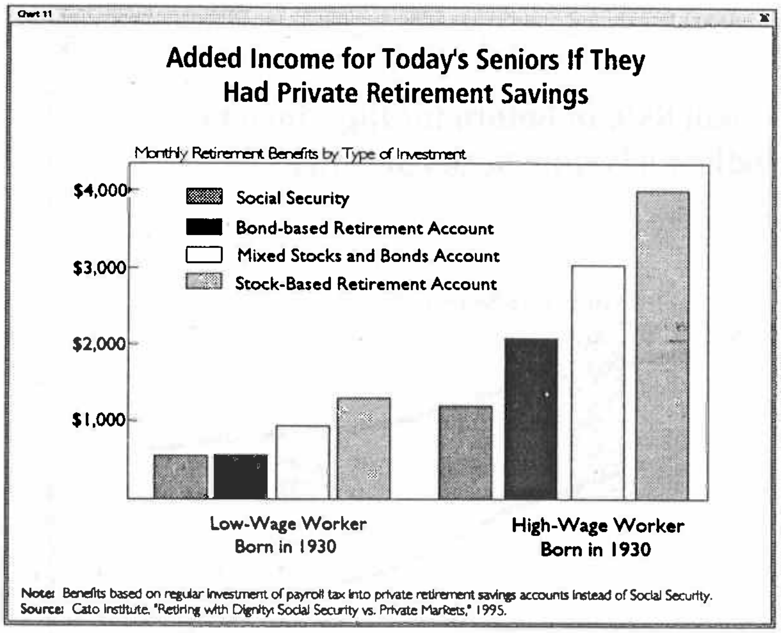
67 Workers who retired before the mid-1980s generally are receiving a good rate of return when the amount of tax paid is compared with the benefits received. For more details, see Geoffrey Kollmann, "How Long Does It Take for New Retirees to Recover the Value of Their Social Security Taxes," *CRS Report for Congress* No. 90–67 EPW, updated January 30, 1990.

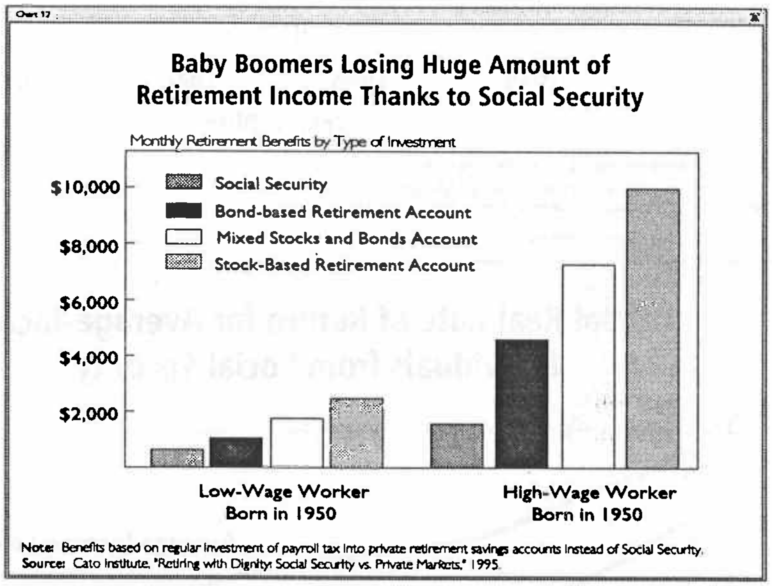


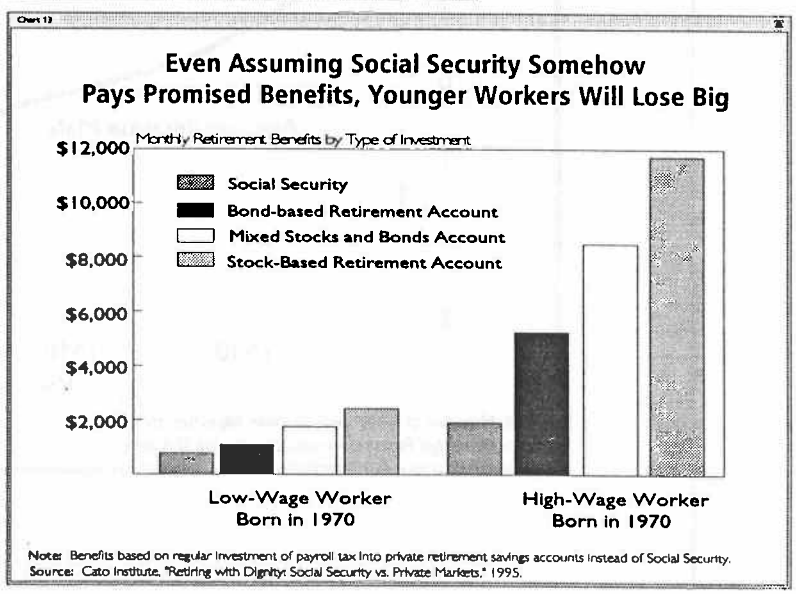
Note: Male rate of return reflects lower life expectancy.
Source: Heritage Foundation calculations using SSA data.



Note: Male rate of return reflects lower life expectancy.
Source: Heritage Foundation calculations using SSA data.


Added Income for Today's Seniors If They Had Private Retirement Savings
Monthly Retirement Benefits by Type of Investment
$4,000
$3,000
$2,000
$1,000
Social Security
Bond-based Retirement Account
Mixed Stocks and Bonds Account
Stock-Based Retirement Account
Low-Wage Worker Born in 1930
High-Wage Worker Born in 1930
Note: Benefits based on regular investment of payroll tax into private retirement savings accounts instead of Social Security.
Source: Cato Institute, "Retiring with Dignity: Social Security vs. Private Markets," 1995.


Baby Boomers Losing Huge Amount of Retirement Income Thanks to Social Security
Monthly Retirement Benefits by Type of Investment
$10,000
$8,000
$6,000
$4,000
$2,000
Social Security
Bond-based Retirement Account
Mixed Stocks and Bonds Account
Stock-Based Retirement Account
Low-Wage Worker Born in 1950
High-Wage Worker Born in 1950
Note: Benefits based on regular investment of payroll tax into private retirement savings accounts instead of Social Security.
Source: Cato Institute, "Retiring with Dignity: Social Security vs. Private Markets," 1995.


Even Assuming Social Security Somehow Pays Promised Benefits, Younger Workers Will Lose Big
Monthly Retirement Benefits by Type of Investment
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
Social Security
Bond-based Retirement Account
Mixed Stocks and Bonds Account
Stock-Based Retirement Account
Low-Wage Worker Born in 1970
High-Wage Worker Born in 1970
Note: Benefits based on regular investment of payroll tax into private retirement savings accounts instead of Social Security.
Source: Cato Institute, "Retiring with Dignity: Social Security vs. Private Markets," 1995.

Social Security's poor performance record has been confirmed in study after study. Arthur P. Hall of the Tax Foundation, for example, has concluded that dual-income couples in their 30s and 40s are among the biggest losers in today's system with real rates of return ranging only between -1 and -1.5 percent. This analysis assumes workers will get what they are promised even if Social Security runs a deficit. If payroll taxes are increased to keep the system solvent, the rates of return for younger baby boomers drop below -1.5 percent.[68] The Tax Foundation's analysis also shows that the post–baby boom generation will get little from Social Security. If payroll taxes are raised so that benefits can be paid, the rates of return for today's average-wage working couples in their 20s will be less than -1.8 percent.[69] The news is even worse for children: Real rates of return for today's teenagers will fall below -2 percent, and those born today will see a return on their Social Security investment of somewhere between -2.5 and -3 percent.[70]

A slightly more optimistic outlook is provided by Dean R. Leimer of the SSA's Division of Research. Even after including the increase in payroll taxes needed to pay future benefits, he concludes that the average rate of return for those born in 1950 will be 2.2 percent, which will fall to 1.8 percent for those born in 1975 and 1.5 percent for those born in 2000.[71] As Chart 14 illustrates, the only "winners" were those born before 1926.

Chart 14

Source: "A Guide to Social Security Money's Worth Issues," *Social Security Bulletin*, Vol. 58, No. 2 (Summer 1995).

Low-income workers are supposed to be one of the few groups that benefit from the current system. More specifically, it is argued that couples with low incomes and one working spouse are big winners. A detailed study of this group, however, found that more

68 Hall, "Social Security: A Bleak Outlook."
69 Hall, "Forcing a Bad Investment."
70 *Ibid.*
71 Leimer, "Guide to Social Security Money's Worth Issues."

than 50 percent received a negative rate of return from the program.[72] Another study concluded that minimum-wage workers who retired in 1994 would have been better off if they had invested in private savings accounts. Investing in stocks, for example, would have brought in $100,000 more than Social Security.[73]

Another way to examine the numbers is to compare how much taxpayers receive with how much they have invested. Unfortunately, the results are no better. A dual-income couple retiring in 2010 will have paid $73,000 more than they will receive in benefits. A similar couple retiring in 2030 will have lost $173,000 when taxes paid are compared with benefits received.[74] It should be borne in mind, moreover, that this result may well be overly optimistic because it assumes that Social Security will have the money to pay benefits currently promised.

No Way Out

Defenders of the status quo are beginning to attack privatization as a solution. Their primary argument is that Social Security is much stronger than people think and that its unfunded liability can be eliminated by a "modest combination" of payroll tax increases and benefit reductions.[75] Some opponents of privatization even warn of a Wall Street plot.[76] In general, these defenders of the existing system would "fix" it by taking some or all of the following actions:[77]

- **Raise** payroll taxes;
- **Increase** the retirement age;
- **Force** all state and local government workers into the system;
- **Tax** Social Security benefits more harshly;
- **Scale back** the cost of living adjustment (COLA);
- **Means-test** benefits;
- **Require** government-controlled investment of the Trust Fund; and
- **Use** price-indexing rather than wage-indexing to reduce the initial benefit amount.

On paper, these reforms could be shown to reduce some of Social Security's unfunded liability, but this would come only at a high price: Each one also would make the program's grossly inadequate rates of return even worse. The current government-run system forces workers to pay record amounts into Social Security but promises only meager levels of retirement income in exchange. Any policy change that raised taxes or reduced benefits would simply make this unbalanced equation even worse for taxpayers.

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72 Daniel Garrett, "The Effects of Differential Mortality Rates on the Progressivity of Social Security," *Economic Inquiry*, No. 33 (July 1995), pp. 457–475.

73 David R. Henderson, "It's Not Just the Kids Who Lose," *Fortune*, September 30, 1996.

74 "Social Security's End," *Investor's Business Daily*, March 4, 1996.

75 Richard C. Leone, "What Crisis?" *The New York Times*, January 15, 1997.

76 Robert Dreyfuss, "The End of Social Security as We Know It?" *Mother Jones*, November/December 1996.

77 Thomas W. Jones, "A Strategy to Maintain Social Security Benefits: The Social Security Debate," *Challenge*, Vol. 39, No. 5 (November 21, 1996).

When confronted with this evidence, some defenders of Social Security respond that the entitlement program was never designed to be a pension system[78] and, although it is unfortunate if workers who are forced to participate happen to lose money, it is part of the system. Others admit that Social Security cannot be fixed without making the rate of return worse, but then nitpick about the transitional problems that might occur in moving to a private system.[79]

Not only is privatization necessary, but the sooner it occurs, the easier it will be to solve these problems.[80] This can be explained by examining the growing scope of the changes that would be needed just to keep the current system solvent. Carolyn Weaver, a member of the Social Security Advisory Council, estimates that if lawmakers were to act immediately, benefits would have to be reduced by 15 percent to close the long-range funding gap. If they wait until the Trust Fund runs out of "money," the benefit reduction could exceed 25 percent.[81]

The Privatization Solution

There is no way to fix the current Social Security system, but there is a way to guarantee workers a safe and secure retirement. The answer lies in privatization, which has the added virtue of being relatively simple to implement. Younger workers would be allowed to pay the major portion of their current payroll tax burden into private retirement accounts, the money from which would be invested in stocks, bonds, and other income-producing assets (a portion of the tax could be retained to help finance benefits for current retirees and those nearing retirement). Upon retirement, these accounts would be exchanged for annuities that would pay workers a stream of income well in excess of the amount Social Security now promises to provide.

Sharing the Wealth

There is some truth to the old saying that it takes money to make money. Those with financial resources can save and invest their money and take advantage of compounded returns to increase their wealth. One of the strongest arguments for Social Security privatization is that it will allow low-income and middle-income workers to improve their financial stability in the same way. Instead of sending 12.4 percent of their income to the government, where it is spent immediately, low- and middle-income workers could elect to set aside some or all of that income in private retirement accounts.

These private retirement accounts would be completely different from Social Security. First, they would be private property; unlike promised Social Security benefits, income from private savings would not depend on the twists and turns of politics. Second, because their money would be invested in stocks, bonds, and other financial assets, workers would benefit from the real rates of return on capital, which have averaged more than 7 percent over the past 70 years (even including the Great Depression).[82] Perhaps even more

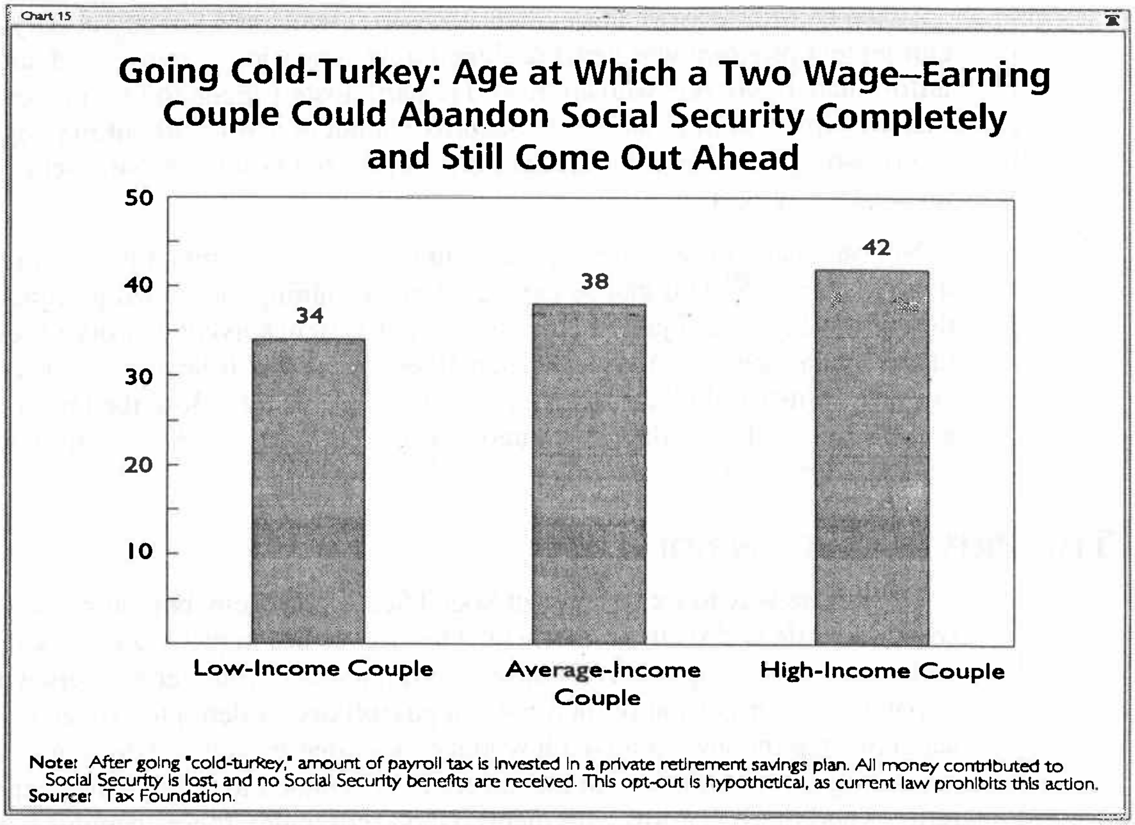
78 Joe White, "Is Social Security Bankrupt?" *Slate*, January 27, 1997; available on the Internet at *http://www.slate.com/DandD/Current/DandD.asp?file=SocialSecurity&idate=3*.

79 Michael Kinsley, "Social Security: From Ponzi Scheme to Shell Game," *Slate*, December 13, 1996; available on the Internet at *http://www.slate.com/Features/SocSec/SocSec.asp*.

80 David Altig and Jagadeesh Golchak, "Social Security Privatization: A Simple Proposal," unpublished manuscript, January 1997.

81 Weaver, "Social Security Myths in the Making."

82 Bartlett, "Social Security Privatization"; "Spending for a Rainy Day," *Investor's Business Daily*, April 11, 1996.



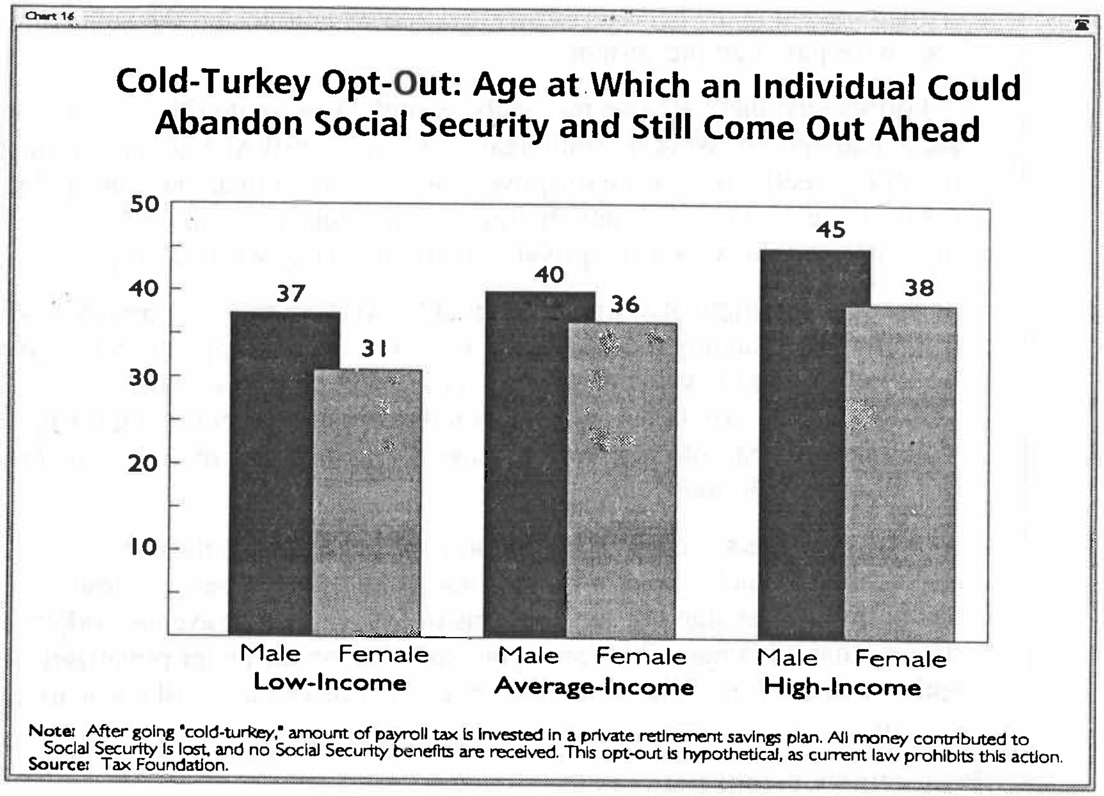
compelling, in any single 30-year period within those 70 years, the average rate of return did not fall below 6 percent.[83] This obviously is far more favorable than the mediocre—or even negative—rates of return provided by Social Security.

A Better Deal

Laurence Kotlikoff estimates that if payroll taxes were invested privately, workers' retirement income could be three times the amount promised by Social Security.[84] The Institute for Research on the Economics of Taxation (IRET) has found that private investment would allow a worker to retire with five times as much as Social Security can provide (and more than seven times as much as it can afford).[85] Put another way, the retirement income a worker can generate by privately saving only 2 percent of current income is greater than the amount the same worker can receive in exchange for taxes now sent to Social Security.

Similarly, Martin Feldstein has concluded that contributing 2.5 percent of income to a private savings account would provide the same benefits as one receives in exchange for the full 12.4 percent payroll tax sent to Social Security.[86] According to a National Chamber Foundation study, the couple with average income who started working in the mid-1980s would retire with more than $1 million if they had been free to save privately what they now pay to Social Security—even if financial markets performed only half as well as

83 David R. Henderson, "Personal Savings Accounts Would Be Good for Everyday Americans," *The American Enterprise*, January/February 1997.
84 Kotlikoff, "The U.S. Fiscal and Savings Crises."
85 Entin, "Private Savings vs. Social Security."
86 Feldstein, "The Missing Piece."



the historical average.[87] Economists at Texas A&M University have concluded that privatization would enable workers to generate retirement income that is between 1.5 and 5.5 times greater than the Social Security benefits now promised.[88]

Benefits for Older Workers

Almost all analysts agree that younger workers would be better off with a private system, but some are concerned that older workers, because they are trapped in Social Security, would not be able to profit from privatization. This view is mistaken. Private savings accounts could be set up for workers at any stage of their careers, with benefits dependent on the number of years remaining until retirement. The only real issue is how to account for all the payroll taxes workers have been sending to the government all these years.

Depending on their circumstances, some workers would be so much better off under a private system that they could quit Social Security today and still come out ahead. As Charts 15 and 16 illustrate, exactly when workers could leave Social Security profitably without receiving anything in exchange for their taxes depends on three factors: sex, marital status, and income.

Even though many workers would do better by walking away from Social Security and writing off the taxes they have paid into it (and even though they might be happy with such an opportunity), such an approach might appear to be unfair. If workers have been forced to pay into the system for years, they should receive something in return. Moreover, many would be too old for a "cold turkey" approach. There should be a way to allow

87 Peter Ferrara, "The Social Security Mess: A Way Out," *Reader's Digest*, December 1995.

88 Thomas R. Savings, "How to Put Security Back in the Social Security System," *Perspectives on Policy*, Private Enterprise Research Center, Texas A&M University, October 1995.

workers to enjoy the benefits of privatization without losing the value of the payroll taxes they have paid into the system.

Fortunately, there are two reasonably simple ways to do this. The first would be to create a dual system. Workers could leave Social Security and, upon retirement, receive a monthly benefit check from the government based on their earnings and the amount of taxes they paid into the system before privatization. The bulk of their retirement income, of course, would come from private savings accounts set up after privatization.

The second option also would allow older workers to set up private savings accounts. Instead of maintaining a dual system, however, the government would give workers a rebate reflecting the value of what already had been paid into the system. This rebate, probably in the form of a bond that would mature upon retirement (as is done in Chile), would become part of the private savings account. A vast majority of workers would benefit under this approach.

Finally, workers should have the option of remaining in the current Social Security system. Although such a decision would not make financial sense, allowing them to choose this option would alleviate the concerns of extremely risk-averse workers while demonstrating that it is impossible for anyone to be worse off under privatization. When this option was used in Chile, more than 90 percent of workers still chose to join the private system.

Protecting Current Retirees

All privatization proposals explicitly guarantee that benefits for those who are retired or near retirement will not be touched. The most obvious reason for this is political. Social Security reform looks like an uphill battle as it is, and it is almost certain that antagonizing existing beneficiaries would make reform impossible.

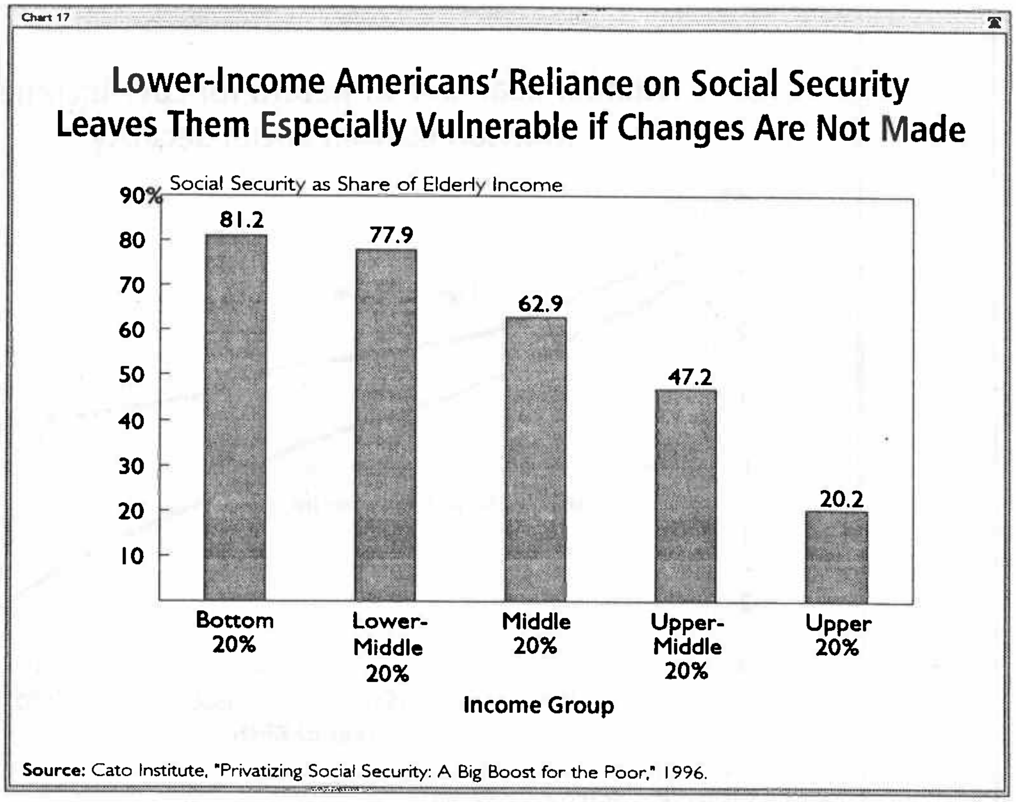
There is also a moral argument that favors preserving the status quo for senior citizens. Simply stated, the government made a contract with them to provide a certain level of benefits in exchange for taxes paid, and it would be wrong to break that contract. Some critics note that older retirees are getting much more from Social Security than they paid in, but that argument would have been worth making when the system was first created. To renege on the deal now would disrupt the lives of millions of recipients who have assumed that the government would honor its word.

Especially Good for the Poor

Although privatization generally is a win-win proposition, some groups will receive disproportionately better benefits. Among the biggest winners would be the poor.[89] More than any other group, lower-income Americans rely on Social Security for their retirement income. For the poorest 20 percent of the elderly, it represents more than 80 percent of their income.[90] A private system that allows the poor to build a nest egg of savings for retirement also will give them greater and more secure income when they retire. The benefits for the poor are even clearer when one considers that, according to the SSA's own figures, future tax collections will be sufficient to pay only 70 percent of future benefits.[91]

89 This analysis also explains why black Americans, who generally have lower incomes and lower life expectancies, would benefit greatly from a privatized Social Security system.

90 Michael Tanner, "Privatizing Social Security: A Big Boost for the Poor," Cato Institute *SSP* No. 4, July 26, 1996.



Defenders of the current system argue that Social Security is still a reasonably good deal for lower-income workers because calculations of monthly retirement checks are skewed to help the poor replace a greater share of pre-retirement income. The fact that rates of return for middle- and upper-income workers are worse than the rate of return for lower-income workers (Chart 18), however, does not mean that the poor would not be better off in a system based on private savings, especially when one considers that life expectancies vary with income. The poor generally do not live as long as those with higher incomes, and therefore also do not live long enough to collect as much in Social Security benefits. Moreover, because benefits depend on only 35 years of wages, those who work for longer periods get absolutely nothing in exchange for the additional payroll taxes they have paid. Needless to say, the biggest victims are the poor, who work longer than those with higher incomes, largely because they spend fewer years in school.[92]

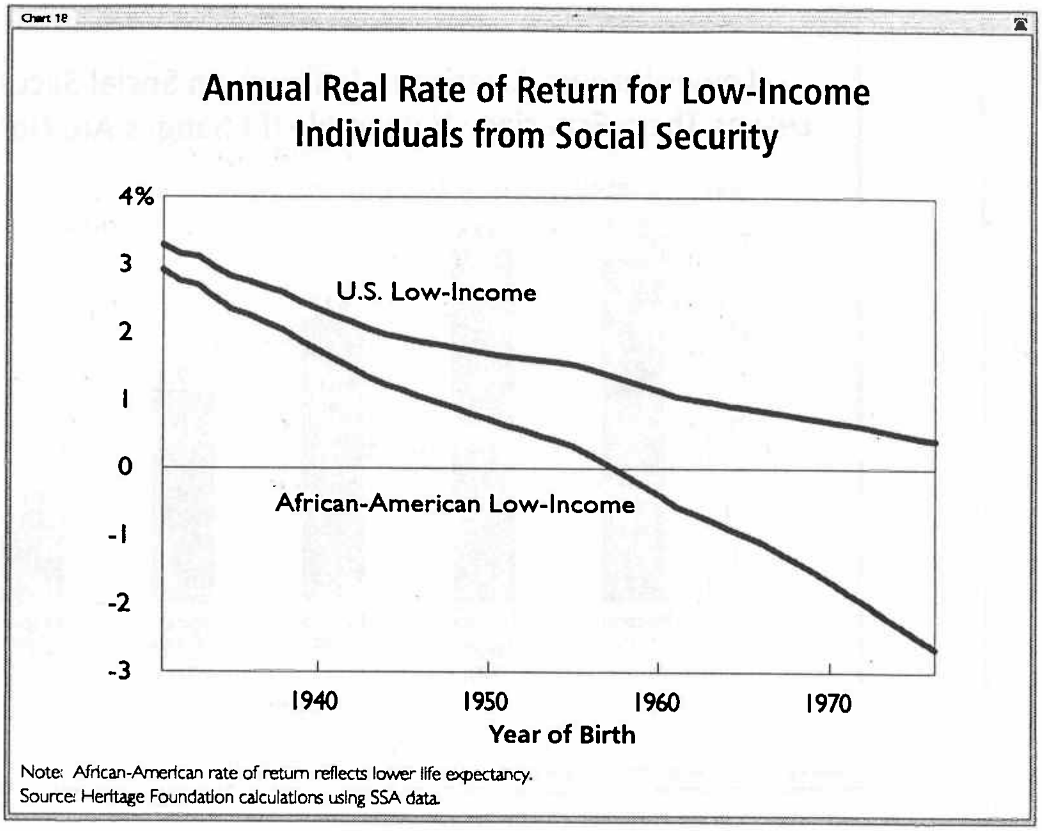
The poor also stand to reap additional benefits from privatization. Specifically, they are the most likely to benefit from the increased economic growth and job creation that would follow a shift from a tax-based entitlement program to a savings-based private savings plan.

A Big Boost for Savings

One of the big benefits of privatization is the positive impact it would have on the rate of savings in the United States. A global study conducted by the World Bank found that

91 Stephen J. Entin, *Social Security: Problems and Opportunity,* Institute for Research on the Economics of Taxation, June 19, 1995.

92 C. Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform* (Washington, D.C.: Urban Institute, 1994).



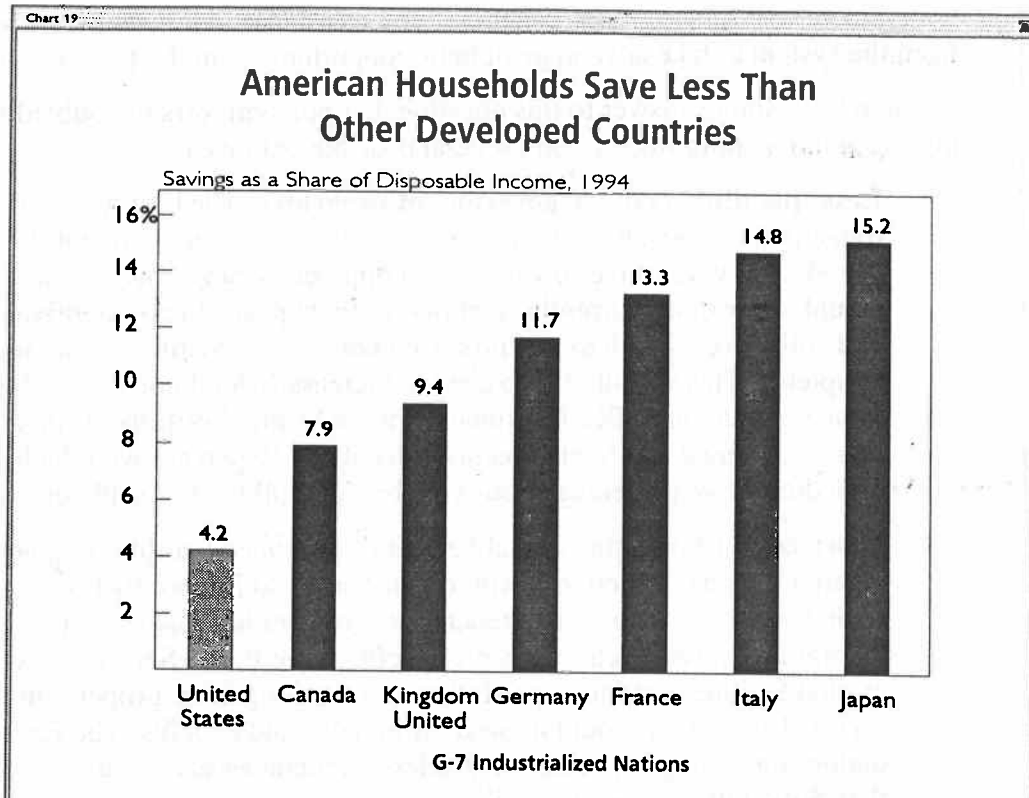
government systems undermine savings,[93] and this conclusion is confirmed by the U.S. experience. Analysis of household behavior in the United States indicates that every dollar of perceived Social Security benefit reduces private savings by 60 cents.[94] Even a study co-written by a researcher at the SSA confirms that "a dollar of Social Security wealth substitutes for about three-fifths of a dollar of fungible assets."[95] Privatization would reverse this corrosive effect, replacing a system that drastically reduces savings with an approach based on real savings.

As Chart 19 shows, the rate of personal savings in the United States is among the lowest in the world. Not only does the U.S. government punish the frugal by double taxing (and sometimes triple taxing and quadruple taxing) savings and investment income, but politicians have eliminated most of the reasons to save. The subliminal messages being sent out are (1) that saving for retirement and health care expenses is unnecessary because the government will tax someone else to give you money when you get old in addition to providing you with Medicare and Medicaid benefits; (2) setting aside money for education is not necessary because the government is picking up more and more of the tab; and (3) buying a house will not be difficult because the government has numerous ways to subsidize the purchase.

93 World Bank, "Averting the Old Age Crisis."

94 Feldstein, "The Missing Piece."

95 Dean R. Leimer and David H. Richardson, "Social Security, Uncertainty Adjustments, and the Consumption Decision," *Economica*, No. 59 (August 1992).



Source: Organization of Economic Cooperation and Development.

Privatization of Social Security might not address all of the government's anti-savings policies, but creating private retirement accounts based on real savings would be a step in the right direction. Countries that have privatized their Social Security–type systems have seen their savings rates skyrocket. In Chile, for example, the savings rate increased by at least 150 percent during the 1980s.[96] Total savings in the newly privatized Australian system, meanwhile, jumped from AUS$155 billion to AUS$224 billion (an Australian dollar is worth about 75 cents) in three short years.[97] Singapore, which never made the mistake of creating a government system in the first place, has the highest savings rate in the world.[98] There is every reason to think the same thing could happen here; one recent study, for example, estimates that privatization would boost the U.S. savings rate by 2.6 percent of gross domestic product (GDP) by 2010.[99]

Paying for the Transition

There is growing agreement that a system of private retirement accounts would be better for workers and the economy than Social Security. Because of the current system's $10 trillion unfunded liability, however, many people wonder whether privatization is feasible. More specifically, because lawmakers almost surely will have to fulfill the promises made to those currently receiving benefits and those nearing retirement, they wonder how the

96 Mario Marcel and Alberto Arenas, "Social Security Reform in Chile," Inter-American Development Bank *Occasional Paper* No. 5, 1992.

97 Australian Insurance and Superannuation Commission bulletin, September 1995.

98 Ferrara, Goodman, and Matthews, "Private Alternatives to Social Security."

99 Neil Howe and Richard Jackson, *Natural Thrift Plan Project,* National Taxpayers Union Foundation and Center for Public Policy and Contemporary Issues, November 15, 1996.

government will finance those benefits if younger and middle-aged workers withdraw from the system to take advantage of better opportunities in the private sector.

There is no single answer to this question, but policymakers undoubtedly will consider mixing and matching from among several possible options:

- **Less spending on other government programs.** The best way to finance the transition to a private system is to reduce the size of government. Eliminating or reducing wasteful, duplicative, and non-performing government programs would allow those currently working to divert payroll taxes to private accounts and still leave enough to pay promised benefits to existing Social Security recipients. There would be no need to increase federal borrowing. Steve Entin, Resident Scholar at IRET, estimates that reducing government spending (other than net interest and Social Security) by about 10 percent would allow workers to dedicate five percentage points of their payroll tax to mandatory savings.[100]

- **Asset sales.** Eliminating Social Security's unfunded liability is a one-time cost, albeit a big one. It therefore would make sense to finance that one-time cost with one-time revenues. The federal government has many assets—including federal lands, the electromagnetic spectrum, the Postal Service, electrical generation facilities, and loan portfolios—that belong more properly in the private sector. These assets could be sold off to help fund benefits. The Reason Foundation, for example, projects that sales of federal assets could generate more than $300 billion in revenues.[101]

- **Exit tax.** Because private retirement accounts would provide much more income than Social Security, younger and middle-aged workers would come out ahead even if they had to pay a modest payroll tax to leave Social Security. Of the current 12.4 percent payroll tax, for example, 10 percent might go into a private account to fund retirement and other benefits, with the other 2.4 percent left in the system to finance current and future benefits. Such a proposal would leave take-home pay unchanged while still allowing for a safer and more secure retirement.

- **Growth.** If the estimates by economic experts are even remotely accurate, privatization of Social Security would boost growth substantially by increasing savings and reducing the tax penalty on job creation. This would mean more jobs, higher income, and increased profits—and both more taxable income and less demand for government services. In other words, the deficit would fall and the reduction would be linked to how much faster the economy expands. The CBO projects that by 2002, an increase in annual growth of just 0.5 percent would reduce the deficit by $50 billion and that by 2007, the deficit would be reduced by $150 billion.[102]

- **Bonds.** Some of the costs of privatization can be spread over time by borrowing. Opponents claim this would add to the national debt and hurt the economy, but the system's unfunded liability already is a debt owed by the federal

100 Telephone conversation with Steve Entin, March 25, 1997.

101 *Privatization 1996: A Comprehensive Report on Privatization of Government Assets, Enterprises, and Public Services* (Los Angeles, CA: Reason Foundation, 1996).

102 Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1998–2007*, January 1997.

The Tax Code's Bias Against Savings

As the country moves toward privatization, one issue that will require attention is the treatment of savings in the tax law. A neutral, fair tax system should not impose a higher burden on income that is saved and invested than on income that is consumed, yet that is exactly what happens under the current law.

The most obvious bias is the double tax on savings. A taxpayer who spends his after-tax income incurs little or no federal tax liability. The taxpayer who saves and invests the money is not nearly so lucky. Even though the income was taxed when first earned, any interest or other earnings generated by that income are subject to an additional layer of tax. To make matters worse, because of capital gains taxes, double taxation of dividend income, and death (estate) taxes, some income is taxed three or four times.

Even if Social Security is not privatized, this bias against savings and investment should be eliminated.† This can be accomplished in one of two ways. The first would be the traditional IRA approach, which allows the taxpayer to defer taxation on income that is saved, with the tax later applied to both the original income and any returns when the money is withdrawn. The second approach, known as "municipal bond treatment," would tax income that is saved, but all subsequent withdrawals, including any interest or other earnings, would be spared the second layer of tax.

The double taxation of savings would be eliminated in tax reforms like the flat tax that treat all taxpayers and all income equally. These broad-based reforms would repeal other provisions of the tax code—including the capital gains tax, the death tax, and the double tax on dividends—that tax income twice.††

† Daniel J. Mitchell, "Taxes, Deficits, and Economic Growth," Heritage Foundation *Lecture* No. 565, June 17, 1996.

†† Daniel J. Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax," Heritage Foundation *Backgrounder* No. 1035, May 25, 1995.

government. Thus, officially acknowledging this debt would entail no adverse macroeconomic consequences (just as acknowledging the savings and loan bailout debt had no impact on capital markets).[103] It still would be best to finance the transition with lower spending and asset sales, but issuing bonds would be acceptable if the savings from other options proved insufficient. Borrowing has been part of Social Security privatizations in other countries. Chile, for example, used debt to finance about 40 percent of its privatization.[104]

Existing Private Systems

Critics of privatization argue that replacing Social Security with a system of private retirement accounts is a gamble. However, tens of millions of Americans already participate in various private retirement savings arrangements, including pensions, individual retirement accounts (IRAs) and 401(k) and 403(b) employee savings plans. The number

103 Congressional Budget Office, *The Economic and Budget Outlook: An Update*, August 1991.
104 José Piñera, "Empowering Workers: The Privatization of Social Security in Chile," *Cato's Letters*, Cato Institute, No. 10 (1996).

undoubtedly would be even higher were it not for government restrictions and the harsh tax bias against savings (see box, "The Tax Code's Bias Against Savings").

Private Plans Already Offered by Local Governments

Opponents will argue there is a difference between wholesale privatization and private plans that simply augment Social Security. Perhaps the most compelling evidence for totally private savings comes from the experience of three Texas counties: Galveston, Brazoria, and Matagorda. In the early 1980s, all three governments exercised their option to withdraw from Social Security and rely instead on a private retirement savings plan. (Perhaps fearing that other municipal governments might take the same step, Congress revoked this option in 1983.)[105] Galveston County's workers voted to privatize their retirement pension by an astounding margin of 78 percent to 22 percent.[106]

The results have been spectacular. For about the same amount of money that it would cost to participate in Social Security, employees of these three counties now receive greater benefits than they could derive from Social Security:

- A low-wage worker earning $20,000 a year, for example, could turn his retirement account into an annuity paying $2,740 per month—more than three times the Social Security monthly benefit of about $775.[107]
- A worker with a middle-income salary of $50,000 annually will be able to obtain an annuity paying more than $6,800 per month—five times the $1,302 monthly benefit he would receive from Social Security.[108]
- In addition to higher retirement income, these private retirement plans give workers life insurance policies that range between $50,000 and $150,000.[109] Social Security offers a surviving spouse a one-time death benefit of only $255.
- The disability insurance accompanying the private plan pays 60 percent of a worker's salary until age 65, or until he returns to work.[110]

The fire department in Houston, Texas, has been operating a private retirement system since 1937. The system has more than $1 billion in real assets (unlike the IOUs in the Social Security Trust Fund), and retired firefighters enjoy more than three times the income they would receive from Social Security.[111]

More than 1 million state and local government workers across the country also are exempt from Social Security taxes and participate instead in private pension plans. Analysis of these plans—which cover state workers in Maine, Nevada, Ohio, and Colorado; teachers in California and Ohio; and city employees in Los Angeles—confirms that senior citizens can enjoy a more prosperous retirement if their savings can be invested in private-sector assets. In particular:

105 Matthews, "Some Americans Already Have Privatized Social Security."
106 E. J. Myers, "Social Security Privatization Is Here,"
107 Pete du Pont, "How to Retire on $2,740 a Month," *IntellectualCapital.com,* December 12, 1996; available on the Internet at *http://www.intellectualcapital.com/library/issues/ic121296/iced.html.*
108 Matthews, "Some Americans Already Have Privatized Social Security."
109 Glass, "Mrs. Colehill Thanks God for Private Social Security."
110 Matthews, "Some Americans Already Have Privatized Social Security."
111 E. J. Myers, "Social Security Privatization Is Here."

- The private plans provide 3.3 to 7.5 times more retirement income than Social Security when the fortunes of workers with equal earning histories are compared.[112]
- Workers in these plans earn a much higher rate of return on their retirement contributions than the vast majority of the population that is being forced to participate in Social Security.[113]
- Because Social Security favors some demographic groups and penalizes others, the link between benefits and contributions is stronger in these plans.[114]
- Unlike the Social Security system, these plans are not saddled with huge unfunded liabilities.[115]

The Mounting International Evidence for Privatization

These experiences demonstrate that privatization is neither risky nor untested. Not only does it work in the United States, but countries around the globe have been replacing government-run schemes with retirement systems based on private savings.[116] Some have embraced full privatization, while others have privatized only a portion of their systems; in each case, however, private retirement accounts invested in private-sector assets have been great financial deals for individual workers and a boost to the national economy.[117]

Chile

In 1924, Chile became the first country in the Western Hemisphere to create a government-run pension system.[118] Over time, however, this system developed many of the symptoms afflicting Social Security programs throughout the world.[119] Costs exploded, unfunded liabilities expanded, and high taxes stunted job creation. By 1981, the Chilean government had decided that the only way to solve the problem was to phase out its Social

112 William E. Even and David A. MacPherson, *Freed from FICA: How Seven States and Localities Exempt a Million Employees from Social Security and Provide Higher Pension Benefits to Retirees* (New York, N.Y.: Third Millennium, March 1997).

113 *Ibid.*

114 This is particularly noteworthy because the pensions being reviewed are defined benefit plans rather than defined contribution plans (as in the Texas counties). In a defined benefit plan, a worker's initial retirement benefit is determined by formulas that depend on income levels and number of years worked, with administrators responsible for setting contribution levels that will allow these benefits to be funded. In defined contribution plans, retirement benefits, instead of being predetermined, depend on the amount of money that is saved and the rate of return earned by those funds.

115 There are, to be sure, actuarially unbalanced defined benefit pension plans, but it is not clear whether their soundness is the result of (or in spite of) the fact that the workers are not also forced to participate in Social Security. Because defined benefit plans have a checkered history, advocates of Social Security privatization recommend using defined contribution plans.

116 The government retirement programs in many of these countries had experienced greater financial problems than the U.S. Social Security system—a fact that demonstrates there is a way out for U.S. policymakers. See Paul Craig Roberts, "It's Time to Privatize Social Security," *Business Week*, February 27, 1995.

117 For a discussion of private pension coverage in major industrialized countries, see E. P. Davis, "The Structure, Regulation, and Performance of Pension Funds in Nine Industrial Countries," World Bank *Policy Research Working Paper* No. 1229, December 1993.

118 Barbara E. Kritzer, "Privatizing Social Security: The Chilean Experience," *Social Security Bulletin*, Vol. 59, No. 3 (Fall 1996).

119 Peter Russell, "How Chile Farms Out Nest Eggs: Can Its Private Pension Plan Offer Lessons to the U.S.?" *The New York Times*, March 21, 1997.

Security system and replace it with mandatory private savings.[120]

Under Chile's private system, new workers are required to deposit 10 percent of their income in pension funds of their choice;[121] currently, there are more than 20 options. More than 90 percent of Chile's older workers, who were given the choice of staying with the government-run Social Security scheme, chose the private options.[122] The overwhelming support for private savings options should come as no surprise; those who participate over their working years will be able to retire with an average of 70 percent of pre-retirement income—more than three times the amount promised under the old system.[123] After just 14 years of operation, benefits already are 40 to 50 percent higher than under the government's plan.[124]

This private system has been good for the Chilean economy as well. Over the past ten years, economic growth has averaged nearly 7 percent annually, placing Chile among the world's fastest-growing economies.[125] Unemployment is down around 5 percent, and the government is in the enviable position of having to decide how to dispose of a budget surplus.[126] Little wonder, then, that Chile has the highest credit rating of any country in Latin America.[127]

The private retirement plan also has turned Chile's workers into capitalists, with savings equal to four times their annual income (quadruple the average in the United States).[128] Indeed, the pension fund is the biggest asset owned by the average Chilean.[129] Finally, for that small handful of workers with meager earnings or checkered employment histories, the Chilean government provides a guaranteed safety net. The minimum pension for an average-wage worker is 40 percent of pre-retirement income.[130]

Australia

In 1992, the Australian government created a system of mandatory private pensions for all workers. Under this system, which will be phased in completely by 2002, workers will contribute 12 percent of their income to private retirement accounts (9 percent will be "paid" by employers). The Australian government estimates that these accounts, known as Superannuation Guarantees, will provide workers with pensions equal to between 79 and 106 percent of pre-retirement income.[131]

The equity in the average account already totals about US$30,000. Workers have

120 Geoffrey Kollmann, "Social Security: The Chilean Example," *CRS Report for Congress* No. 95–839 EPW, October 21, 1996.

121 Workers also contribute 3 percent for disability and survivors' benefits.

122 Piñera, "Empowering Workers."

123 Sara E. Rix, "Chile's Experience with the Privatization of Social Security," AARP Public Policy Institute *Issue Brief* No. 23, August 1995.

124 Piñera, "Empowering Workers."

125 *Ibid.*

126 *Ibid.*

127 Comments by Jose Pinera at conference on "The Other Side of the Pyramid: A New Social Security System for the Next Century," Cato Institute, Washington, D.C., February 14, 1997.

128 Suneel Ratan, "How Chile Got It Right," *Time*, March 20, 1995; "Social Security's Shaky Outlook," *Investor's Business Daily*, October 10, 1995.

129 Piñera, "Empowering Workers,"

130 R. J. Myers, "Chile's Social Security Reform."

131 Australian Department of Social Services, *Superannuation Guarantee*, November 9, 1995.

considerable freedom to invest their own savings or, if they prefer, to choose from more than 1,000 professionally managed pension funds.[132] In addition, the Australian government, like the government of Chile, will continue to provide a safety-net pension for those whose earnings are too low to fund an adequate private pension.

Great Britain

The United Kingdom has a two-tiered retirement system.[133] All workers must participate in a traditional government Social Security program that provides a minimum income upon retirement. The second tier, however, allows workers to choose a private system as long as it is guaranteed that benefits will match what would have been provided if they had chosen to remain completely in the government system. Because the private pension funds will provide more retirement income for lower costs, more than 70 percent of British workers have exercised this option.[134] To help finance these private savings (and because they agree to forego the second tier of government pension payments), workers who choose the private option receive a tax reduction of 4.8 percentage points.[135] Moreover, because of the reduction in future benefit payments, as well as an exit tax levied on those who choose the private option, the fiscal benefits to the government have been enormous: There no longer is any significant unfunded liability for future taxpayers.[136]

The British private savings alternative has been so popular that, in March 1997, the Conservative government proposed to privatize the remaining government-run part of the system. In addition to yielding major long-term budget savings, this proposal would boost savings and give British workers more retirement income.[137] As with other privatization efforts, the actual mechanics are easy and straightforward. Taxpayers in Britain would receive a tax cut amounting to about nine pounds a week, which they would be required to invest in a private pension.[138]

Singapore

Singapore, which has never had a government-run pension scheme, in 1955 created a private system that is widely viewed as the most extensive program of forced private savings in the world.[139] Workers are required to set aside 40 percent of their income each year (on income of up to approximately $50,000) in personal accounts.[140] As a result, Singapore now has the world's highest savings rate. It is especially noteworthy that even though the population is aging rapidly (those over age 60 will total 30 percent of the population in less than 40 years), private savings under this plan will allow Singapore to avoid the fiscal crisis faced by most other economies with aging populations.[141]

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132 Australian Insurance and Superannuation Commission bulletin, *op. cit.*

133 For a thorough discussion of the British retirement system, see forthcoming Heritage Foundation paper by Robert E. Moffit on Social Security in Great Britain.

134 "Social Insecurity," *Investor's Business Daily*, November 16, 1995.

135 John Goodman, "Social Security Reform: Other Countries Are Leading the Way," National Center for Policy Analysis *Brief Analysis* No. 212, August 30, 1996.

136 Carolyn L. Weaver, "Creating a New Kind of Social Security," *The American Enterprise*, January/February 1997.

137 Jill Sherman, "Major says reforms offer new security in old age," *The Times of London*, Internet version, March 6, 1997.

138 "Tomorrow's Pensioners," *op. cit.*

139 Goodman, "Social Security Reform: Other Countries Are Leading the Way."

140 Pete du Pont, "Chile, Singapore, and Seniors," *The Washington Times*, March 17, 1996.

141 Prewo, *From Welfare State to Social State.*

This private savings account is used not only to fund retirement, but also for health care, home purchases, insurance, and higher education.[142] The retirement portion of the plan operates in a manner similar to Chile's. Upon retirement, the worker purchases an annuity that will pay a guaranteed income for the rest of his or her life. The savings plan also seems to be good for housing: 85 percent of the population—the highest rate in the world—lives in owner-occupied housing.[143]

A shortcoming of the Singapore system, however, is that the government has a role in directing the investments. As a result of this needless intervention, funds do not earn nearly as high a rate of return as they otherwise could.[144] This is why a large majority of residents take advantage of a provision that allows them to withdraw their funds at age 55 and place them in more lucrative privately directed investments.[145]

Other Countries[146]

Considering the stunning success of Chile's private system, it should come as no surprise that other countries throughout Latin America also are adopting this approach. Peru, Argentina, Uruguay, Colombia, Bolivia, Mexico, and El Salvador either have privatized or are engaged in privatizing their retirement systems.[147] Although not all of these plans are identical in their details, they share a common feature: using the superior performance of private investment to give senior citizens a more safe and secure retirement.

Numerous other countries are moving in the same direction.[148] Workers in Sweden, for example, set aside 2 percent of their income in private retirement accounts.[149] This may be small in comparison to the government portion, but it is noteworthy in a nation known for its cradle-to-grave welfare state. Both Denmark[150] and Italy[151] also recently added private elements to their retirement systems. Privatization is only partial at this stage, but if the Australian experience is any indication, the evidence soon will become so convincing that these countries probably will scrap their expensive government-run systems. Other European countries with modest amounts of mandatory private savings include Switzerland and Finland.[152]

Other countries with mandatory private savings include Ghana, Kenya, Nigeria, Tanzania, Uganda, India, Indonesia, Nepal, and Sri Lanka,[153] although the results in these countries have not been very satisfactory, largely because their governments manage the investments. Moreover, politicians in most countries misuse this authority and direct the

142 "Social Insecurity," *op. cit.*

143 Goodman, "Social Security Reform: Other Countries Are Leading the Way."

144 World Bank, "Averting the Old Age Crisis."

145 Mukul G. Asher, "Compulsory Savings in Singapore."

146 Office of Research and Statistics, Social Security Administration, "Social Security Programs Throughout the World, 1995," *Research Report* No. 64, July 1995.

147 G. Ricardo Campbell, "Argentina Approves a Privatization Option for Social Security," *Social Security Bulletin*, Vol. 56, No. 4 (Winter 1993), and "Colombia Moves Closer to the Privatization of Social Security," *Social Security Bulletin*, Vol. 56, No. 2 (Summer 1993).

148 Geoffrey Kollmann, "Social Security: Worldwide Trends," *CRS Report for Congress* No. 96–32 EPW, November 14, 1996.

149 Schieber and Shoven, "Social Security Reform: Around the World."

150 World Bank, "Averting the Old Age Crisis."

151 G. Ricardo Campbell, "Italy Creates Private Pension Funds," *Social Security Bulletin*, Vol. 56, No. 2 (Summer 1993).

152 Ferrara, Goodman, and Matthews, "Private Alternatives to Social Security."

153 World Bank, "Averting the Old Age Crisis."

money in ways that enhance their political standing rather than maximize income for workers. (Singapore and Malaysia are rare exceptions, and even they underperform the privately managed funds.)

The Economic Benefits of Privatization

The existing Social Security system's negative impact on the U.S. economy is twofold. First, by its very nature, it significantly reduces incentives to save because many people mistakenly believe the government will take care of them after they retire.[154] Second, this negative impact on savings is compounded by the way the payroll tax discourages employment. In effect, Social Security imposes a 12.4 percent penalty on jobs, thereby simultaneously penalizing businesses which create jobs and discouraging the unemployed from taking jobs.[155]

Perhaps the best way to understand the economic harm imposed by the current system is to review how the economy would benefit under privatization. Martin Feldstein estimates that privatization would provide a $10 trillion to $20 trillion boost to the economy over time. Put another way, the economy would become 3 percent larger every year into the future.[156] As time passed, this additional growth would mean thousands of dollars in additional income for American families. One study concludes that wages would increase from 13 percent to 26 percent under a privatized option.[157]

Laurence Kotlikoff's estimates of the economic benefits of a private retirement system are similarly encouraging. According to his research, the future boost to the economy could be as much as 4.5 percent.[158] A comprehensive study by two other economists found that potential benefits could equal 3 percent to 5 percent of GDP.[159] Even though translating this higher growth into new jobs would be somewhat speculative, the increase in employment would be significant, judging by previous research on what has happened when tax rates have increased. The 1988 and 1990 payroll tax rate increases, for example, cost the economy 500,000 jobs.[160]

154 Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in United States Savings: A Cohort Analysis," unpublished manuscript, November 1994; Lawrence H. Summers and Chris Carroll, "Why Is United States National Savings So Low?" *Brookings Papers on Economic Activity*, Vol. 2 (1987), pp. 607–635; Feldstein, "The Missing Piece"; World Bank, "Averting the Old Age Crisis"; Kotlikoff, "The U.S. Fiscal and Savings Crises."

155 Job losses caused by government Social Security schemes are a worldwide phenomenon. See World Bank, "Averting the Old Age Crisis."

156 Feldstein, "The Missing Piece."

157 Howe and Jackson, *National Thrift Plan Project*.

158 Laurence Kotlikoff, "Privatization of Social Security: How It Works and Why It Matters," Institute for Economic Development *Discussion Paper Series* No. 66, October 1995.

159 Patricio Arrau and Klaus Schmidt-Hebbel, "Macroeconomic and Intergenerational Welfare Effects of a Transition from Pay-As-You-Go to Fully-Funded Pension Systems," paper presented to Econometric Society conference, August 1993.

160 Aldona Robbins and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Institute for Research on the Economics of Taxation *Economic Report* No. 39, February 1988.

Q: Should lawmakers start by privatizing the surplus?

A: Because of the interest in privatization and concern that Social Security Trust Fund money is being exchanged for IOUs and spent on other government programs, there is considerable interest in rebating surplus Social Security revenues to workers and requiring that this money be placed in IRAs. This is a good idea, but the effect would be very limited. Because Social Security's financial status has declined very rapidly since the last big bailout in 1983, annual surpluses between now and 2012 will average only about $30 billion.[161] This amounts to about $250 per worker per year before the system would begin to run a deficit.[162]

Q: Should government be in charge of investment?

A: Only if taxpayers want to lose money or enjoy rates of return that are about as poor as those now provided by Social Security. As Chart 20 illustrates, government-managed pension funds (even in systems based on private savings) do very poorly.[163] The reasons are easy to understand: Private pension fund managers have a legal responsibility to maximize the well-being of their clients. Even if this legal obligation did not exist, there would be tremendous competitive pressure to provide adequate returns in order to attract new customers and retain current ones. In government-managed systems, by contrast, political considerations often dominate. Some might argue that the United States would be immune to this kind of manipulation, but many politicians, including former Labor Secretary Robert Reich, have been quite candid about their desire to expropriate private pensions for political purposes.[164]

Government management of investment also could have serious consequences for taxpayers generally. Under a proposal advanced by a minority of the members of the Social Security Advisory Council, for example, the government would guarantee a minimum return on funds that politicians invested in the stock market.[165] This would be an open-ended invitation to abuse fiduciary responsibility and invest on the basis of politics: After all, the taxpayer guarantee would "protect" workers' pension earnings.

Q: Won't a private system lead to higher administrative costs?

A: Some critics argue that a private system would have much higher administrative costs than Social Security does.[166] They note that the SSA spends almost all of its money on benefits and less than 1 percent of its budget on bureaucracy.[167] This comparison presents three major problems. First, assuming the figures are accurate, workers would

161 Robbins and Robbins, "Salvaging Social Security."

162 *Ibid.*

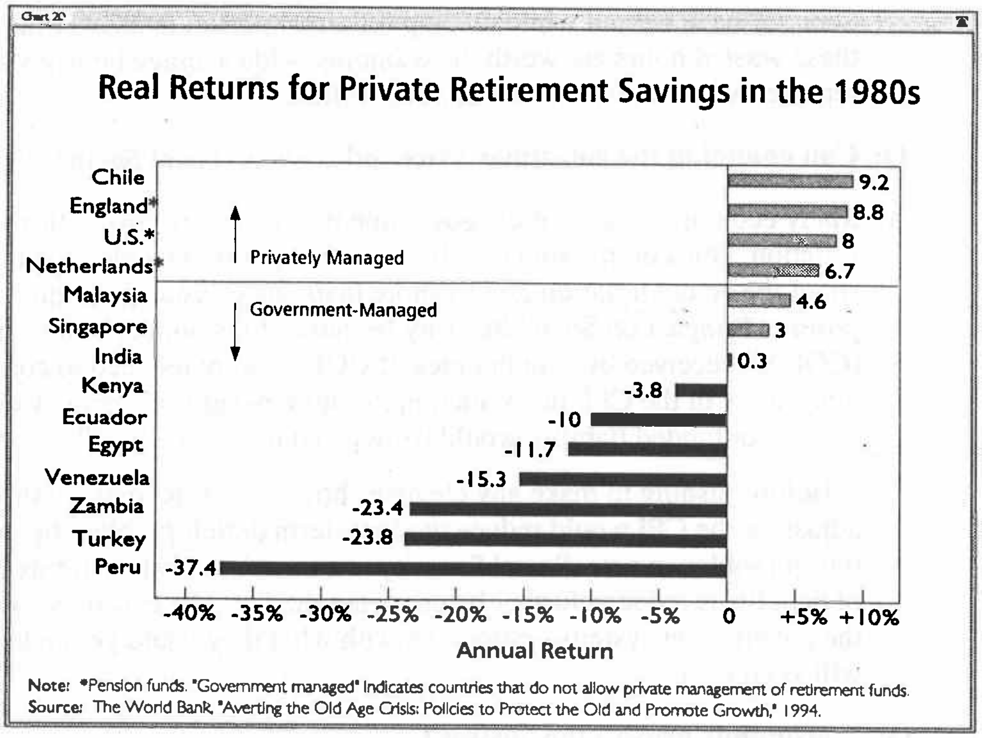
163 World Bank, "Averting the Old Age Crisis."

164 Kryzysztof M. Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," Cato Institute *SSP* No. 6, January 14, 1997.

165 "Social Security's Savings," *The Wall Street Journal*, January 6, 1997.

166 Robert J. Myers, "Privatization of Social Security: A Good Idea?" *Journal of the American Society of CLU & ChFC*, July 1996.

167 Peter Diamond, "Privatization of Social Security: Lessons from Chile," prepared for Seventh Annual Conference of the National Academy of Social Insurance, Washington, D.C., January 26, 1995.



Note: *Pension funds. "Government managed" indicates countries that do not allow private management of retirement funds.
Source: The World Bank, "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth," 1994.

still be better off with a private system because the rate of return is so much higher than Social Security's.[168] In effect, workers are willing to let their pension fund have a small slice as long as they get a good deal.

Second, during the early years, administrative costs chewed up more than 10 percent of Social Security's budget. Even as recently as 1969, overhead accounted for 2 percent of outlays.[169] Social Security has an advantage over private firms in that the government forces everyone to participate, thus allowing administrative costs to be spread widely. Private pension companies in a system of mandatory savings almost certainly would realize significant reductions in overhead costs—which is exactly what happened in Chile, Singapore, and Malaysia, where competition and experience led eventually to dramatic savings despite relatively high initial overhead costs.[170]

Finally, the overhead figures for Social Security do not include compliance costs that are imposed on the private sector. Private employers file 29 million employment tax returns with the federal government each year.[171] The most common—Form 941 for employer's quarterly payments—requires more than 14 hours of recordkeeping, preparation, copying, and assembling, according to estimates by the Internal Revenue Service.[172] With the cost of professional tax assistance averaging about $50 per hour,[173] the burden imposed on the private sector is significant. Another indication of the impact of these compliance costs is the 6.7 million hours that callers to Social

168 Private money managers have fees as low as four-tenths of 1 percent for assets they manage, and the average returns they generate for investors are well in excess of the income provided by Social Security.

169 Social Security Administration, *Annual Statistical Supplement* (Washington, D.C.: U.S. Government Printing Office, 1996).

170 World Bank, "Averting the Old Age Crisis."

171 Internal Revenue Service, Publication 55B, *Annual Data Book*, Table 7—Number of Returns Filed (1995).

172 Department of the Treasury, Internal Revenue Service, *Instructions for Form 941* (Revised January 1996).

173 Telephone conversation with Arthur Hall of the Tax Foundation, March 18, 1997.

Security have wasted while waiting for a real person to answer the phone. Assuming these wasted hours are worth the economy-wide average hourly wage of $15.09, this represents a compliance cost of $100 million.[174]

Q: Can changing the consumer price index solve Social Security's problems?

A: Many economists believe the government's consumer price index (CPI) overstates inflation. One commission concluded recently, for example, that the CPI may overshoot the actual inflation rate by more than one percentage point.[175] If true, this has a profound impact on Social Security because of the annual cost of living adjustments (COLAs) received by beneficiaries. If COLAs were reduced to correct for this alleged inaccuracy in the CPI, the reduction in future benefit payments would be so immense that the unfunded liability would be reduced dramatically.[176]

Before rushing to make any changes, however, policymakers should realize that adjusting the CPI would reduce the long-term deficit problem by making the rate-of-return problem worse. Social Security is a wretched deal for future retirees. If the level of benefits is reduced further by changing the CPI, the cost to workers of remaining in the government system—compared with what they could get under privatization—will skyrocket.

Q: Is economic growth the answer?

A: It would be difficult to imagine a single problem in society that could not be helped by faster economic growth. Social Security is no exception. According to the Trustees' report, increasing the average rate of economic growth by one percentage point each year would wipe out 50 percent of the system's deficit.[177] The question is how to achieve that growth. One way is to privatize the system, thereby rendering the whole issue of Social Security's deficit moot. Another would be to enact the flat tax.[178] It should be noted, however, that even though faster growth would reduce the unfunded liability, it would do little to make Social Security a good deal for workers.

Q: What happens if the stock market crashes?

A: There is always a risk that financial markets will perform poorly. An investor placing funds in the market in 1987 just before the market fell 500 points would have had a negative return if the funds were withdrawn at the end of the year. Private retirement accounts avoid this short-term risk because the money is invested for the long term. For those patient investors who placed their money in the market in 1987 (and investors would have to be patient in a privatized system), their original investment would have more than tripled by now.[179] Thus, although markets involve some risk, long-

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174 James L. Payne, "How Much Does Social Security Really Cost?" *The American Enterprise*, January/February 1997.

175 "Toward a More Accurate Measure of the Cost of Living," Final Report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index, December 4, 1996.

176 Max R. Lyons, "Fix the CPI and Keep Social Security From Going Broke," *fact & fallacy*, Employment Policy Foundation, Vol. III, No. 2 (February 1997).

177 Robbins and Robbins, "Salvaging Social Security."

178 Mitchell, "Jobs, Growth, Freedom, and Fairness: Why America Needs a Flat Tax."

179 *Total Return Analysis 9-30-87 to 12-31-96*, Bloomberg Financial Markets On-Line Service, Bloomberg L.P., March 24, 1997.

term investors almost certainly will realize the historical average rate of return of more than 10 percent (7 percent after adjusting for inflation).[180] This rate of return, incidentally, includes both the Great Depression of the 1930s and the 500-point decline of 1987. Simply maintaining the status quo, on the other hand, means betting that politicians will not cut Social Security benefits or take other steps that could reduce retirement living standards in the future.[181]

To the extent that policymakers feel that financial markets are too risky, they could structure a privatized system that offered guaranteed returns. In effect, the individual would contract with a financial services company that ensured a certain rate of return. Knowing that markets offer a historical real return of 7 percent, companies presumably would be willing to guarantee workers a return slightly below that. The company would profit when the market was particularly strong, but also would bear the downside risk when the market was weak. The individual worker would earn slightly lower returns over the long term, but also would have the comfort of knowing that returns were guaranteed. This is a key feature of the private retirement system used by the county workers in Texas.[182]

Q: Can workers be trusted to invest their own money wisely?

A: Government clearly has a bad track record when it comes to investing, but many in government believe that workers themselves would not do much better. If policymakers considered this a problem, they could impose restrictions on pension fund investments. The economic evidence, however, suggests that this concern is misplaced. A study by Watson Wyatt Worldwide, a benefits consulting firm, found that younger workers invested more heavily in stocks, apparently understanding that equity investments are the smartest strategy for those who take advantage of long-term average rates of return. Older workers are much more likely to shift to fixed-income assets such as bonds, demonstrating that they know they should minimize risk as retirement approaches.[183] Workers in countries that have privatized some or all of their retirement systems receive large amounts of information from pension fund managers detailing the benefits and risks of various investment strategies.

Q: What about means-testing Social Security?

A: Some policymakers have proposed reducing the massive Social Security deficit by reducing benefits for senior citizens with higher incomes.[184] But even though this would shrink the unfunded liability, it also would make Social Security an even worse deal for those senior citizens who are affected. Perhaps more important, means-testing has the same economic impact as an increase in tax rates. With means-testing, those who earn more than a certain amount of money would have their Social Security benefits reduced. Simply stated, productive economic behavior would result in less income.[185] The message this sends to workers and seniors is pernicious: "Don't work, don't save, don't be responsible and build up your own nest egg," because such

180 Shipman, "Retiring with Dignity."
181 Albert B. Crenshaw, "Is There a Stock Answer to Social Security Worries?" *The Washington Post*, June 2, 1996.
182 Glass, "Mrs. Colehill Thanks God for Private Social Security."
183 Anne Willette, "Wall Street, workers key to solvency," *USA Today*, December 30, 1996.
184 Peterson, *Will America Grow Up Before It Grows Old.*
185 World Bank, "Averting the Old Age Crisis."

behavior will result in a special penalty.[186]

Q: What would happen under privatization to other features of Social Security such as disability and survivors' benefits?

A: Private markets already provide identical products in the form of life insurance and disability insurance. Chile is a good example of how these additional features of Social Security can be moved to the private sector. Even an article published by the American Association of Retired Persons concedes that Chile's private retirement system has increased the level of disability and survivors' benefits.[187]

This question highlights another benefit of privatization: the ability to pass a nest egg on to one's children. Under the current system, workers who die early get very little out of Social Security. Surviving spouses and children will receive some benefits from the government, but a private system could provide equivalent benefits while also allowing the assets in the deceased worker's account to go directly to the family.[188]

Q: Why not just raise the retirement age?

A: Restricting benefits by raising the retirement age would improve Social Security's long-term balance; but by forcing people to work longer and leaving them with fewer years in which to collect benefits, a higher retirement age also would make the system an even worse deal for workers. A private system would give workers wide latitude in deciding whether to keep working or to retire, based on what is in each worker's best interests.

Q: What exactly did the Social Security Advisory Council propose?

A: There were three separate proposals advanced by the 13 members of the Council.[189] The conventional wisdom is that the Council endorsed a limited degree of privatization, especially because a common feature of the three plans was the diversion of some payroll taxes into private investments. There are significant differences in detail, however.[190] Only the plan (advanced by five of the Council's members) to allow taxpayers to invest five percentage points of their existing payroll taxes privately could fairly be called a real step toward privatization.[191]

Q: Should workers be forced to save?

A: Some have argued that shifting from today's Social Security system to one based on private savings does not go far enough. More specifically, they question whether the government should force people to save a certain amount of their income.[192] Social

186 David R. Henderson, "The Sneak Attack on Seniors," *Fortune*, March 4, 1996.

187 Rix, "Chile's Experience with the Privatization of Social Security."

188 Ferrara, "Power to the People: A Private Option."

189 For a complete explanation of the Council's actions, see Robert E. Moffit, "Reforming Social Security: Understanding the Council's Proposals," Heritage Foundation *F.Y.I.* No. 128, January 24, 1997.

190 J. D. Foster, "Rebuilding Social Security...," *The Washington Times*, January 21, 1997.

191 Sylvester J. Schieber, "Your Retirement, Your Social Security," *The Wall Street Journal*, January 8, 1997.

192 Dale Steinreich, "Social Security Reform: True and False," *The Free Market*, Ludwig Von Mises Institute, Vol. 14, No. 10 (October 1996).

Security reform certainly could be structured so that citizens were free to choose the level and timing of their participation. Because many in Washington do not believe individuals are smart enough to make the right choices, however, it is highly likely that any privatization would be accompanied by mandatory participation. This type of system also would avoid the "moral hazard" problem that would occur if some individuals, acting on the assumption that the government would take care of them in their retirement years, deliberately chose not to save.

CONCLUSION

Politicians understandably do not want to address Social Security's two major problems: (1) promised benefits that exceed projected revenues and (2) record-high taxes paid now in return for meager levels of retirement income paid in the future. Many policymakers realize the unfunded liability problem cannot be solved without ever-worsening rates of return for workers, but they also know that rates of return cannot be improved without adding to the system's debt.

The only option that would solve both problems is privatization. This option admittedly is accompanied by political risk, and the natural instinct among lawmakers will be to delay reform; but doing nothing guarantees the United States will face a crisis of incredible proportions once members of the baby-boom generation reach retirement age. Privatization would avoid this tragedy by dealing with the current system's huge unfunded liability while allowing workers to escape a government-run program that forces them to accept miserable returns on their payroll tax dollars. If lawmakers really want to improve living standards for tomorrow's workers and retirees, the choice is clear: It is time to privatize Social Security.