Privatizing Social Security the Right Way

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The U.S. Social Security System desperately needs reform. The system faces a long-term fiscal crisis roughly twice as bad as what the government is publicly admitting. Continuing to pay Social Security benefits according to present rules would require taxing workers another six cents out of every dollar they earn, starting now and continuing forever. For those born in the postwar period, Social Security already represents, on balance, a bad deal. Raising taxes or cutting benefits by the amount needed to keep the program solvent will turn a bad deal into an awful one.

Many of the same politicians and bureaucrats who inadequately reformed the system in 1977 and again in 1983, and thereby delivered us into our current mess, now claim to have the answer: Raise Social Security's retirement age, make Social Security benefits subject to a means test, increase the income taxation of Social Security benefits, change the benefit formula, bring uncovered state workers into the system, raise taxes a bit now and more later, invest the trust fund in the stock market, and partially privatize the system by compelling workers to contribute 1 to 2 percent of their wages to private accounts.

This combination of piecemeal policies is, unfortunately, the likely outcome of our national "conversation" about Social Security. Its adoption will, almost surely, deliver less than half of what is needed on the fiscal side and turn Social Security's privatization into a costly fiasco.

The real way to reform Social Security is to privatize fully its retirement program and require everyone who can to contribute to paying off the liabilities of that

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The Independent Review, v.V, n.1, Summer 2000, ISSN 1086-1653, Copyright © 2000, pp. 55–63

program. Anything short of full privatization, with full payment of the transition costs, will leave us to have another "conversation" fifteen years from now, but facing even worse options than those we currently face.

In this article I present the main outlines of a plan for fully privatizing the retirement portion of Social Security. The plan was developed by me and Professor Jeffrey Sachs of Harvard University. It has been endorsed by sixty-five leading academic economists, including three Nobel laureates. The plan is simple enough to describe on a single page. It protects existing retirees, women, and the poor, has very low administrative costs, requires full portfolio diversification of account balances, forces contributors to invest for the long term, transforms accumulated account balances into inflation-protected pensions at retirement, and fully pays off the liabilities of the old system in a generationally equitable manner.

Social Security's Long-Term Fiscal Crisis

According to the intermediate projection of the Social Security Trustees, paying promised benefits over the next seventy-five years requires an immediate and permanent 2.0-percentage-point increase in the program's current 12.4 percent tax rate. Fixing Social Security for seventy-five years is not, however, fixing it for good. Each year that passes brings into the current seventy-five-year planning horizon a year that wasn't there before. For example, we are currently seventeen years beyond the seventy-five-year planning horizon that the Greenspan Commission considered back in 1983. Recall that the Greenspan Commission was charged with solving Social Security's financial problems once and for all. The mistakes underlying that commission's failure should not be repeated. Not only was the planning horizon too short, but the commission used economic and demographic assumptions that were far too optimistic.

Unfortunately, when the Social Security actuaries look beyond seventy-five years, they see enormous deficits. These deficits are so large that paying Social Security benefits on a continuing, rather than simply a seventy-five-year, basis requires an immediate and permanent 4.7-percentage-point tax hike. This unpublished estimate comes from Steven Goss, the highly respected deputy chief actuary of the Social Security Administration. Goss is also responsible for developing the 2.0-percentage-point tax hike estimate for the seventy-five-year case.

The 4.7-percentage-point tax hike needed for true long-term solvency is, of course, more than twice the 2.0-percentage-point increase announced by the Trustees in their *Trustees Report*. The Trustees' failure to allow Goss and his colleagues to publish the tax hike needed for true long-term solvency represents a dereliction of duty that merits congressional attention.

Unfortunately, a 4.7-percentage-point increase is not the limit of the tax hike we're likely to face. If the 4.7-percentage-point increase is not imposed immediately

and if one assumes that all benefits will be fully paid, the payroll-tax rate will have to be raised by more than 4.7 percentage points when the tax hike is finally implemented. Moreover, the required 4.7-percentage-point tax hike is calculated on the basis of what appear to be overly optimistic "intermediate" assumptions concerning increased life expectancy and real-wage growth. Leading demographers, such as Professor Ron Lee of the University of California at Berkeley, believe that life expectancy will grow by about eight years over the next seventy-five years—roughly twice the increase being projected by the Trustees in their intermediate forecast. Indeed, the technical panel of the board of Social Security advisers recently recommended such a change in the life expectancy assumption.

The historical use of a truncated planning horizon and overly optimistic "intermediate" demographic and economic assumptions is responsible for about two-thirds of the current long-term imbalance in the program. The remaining third appears to reflect technical mistakes that the actuaries uncovered in their own forecasting methodology. In this regard it is worth pointing out that the actuaries are using what they themselves consider a crude method for projecting long-term benefits and taxes. Their method is crude because it is based on aggregate relationships rather than a micro-simulation model that tracks the benefits received and taxes paid for individuals. Although the actuaries are currently actively involved in evaluating existing micro-simulation models and developing one of their own, it will be several years until more reliable, micro-based projections become available.

Based on the current projection methodology, the incorporation of more realistic life-expectancy and real-wage-growth assumptions raises the tax hike needed for long-run solvency from 4.7 percentage points to more than 6 percentage points. Because the Social Security payroll-tax rate is now 12.4 percent, such an increase would leave American workers paying close to a fifth of their wages to the system. Medicare also faces a severe long-run funding problem. In combination, the two programs could eventually result in payroll-tax rates of 25 percent or more. Payroll-tax rates of that magnitude, in conjunction with the rest of the U.S. tax structure and the need to pay interest on our large stock of official debt, would have a highly detrimental impact on the U.S. economy.

The alternative to imposing dramatically higher Social Security taxes is either to cut Social Security benefits drastically or to privatize the existing system. In contemplating these alternatives, it is important to understand just how badly the system, based on the current levels of taxes and benefits, is treating Americans born since 1945.

Social Security's Treatment of Postwar Americans

In a recent study, five colleagues and I used a highly detailed micro-simulation model to examine how Social Security is treating postwar Americans (see Steven Caldwell and others, "Social Security's Treatment of Postwar Americans," in *Tax*

Policy and the Economy, vol. 13, edited by James M. Poterba [Cambridge, Mass.: MIT Press, 1999]). In addition to considering the treatment of different postwar cohorts, the study compares the treatment of different types of individuals within each of those cohorts.

The study uses two tools: CORSIM, a dynamic micro-simulation model, and SOCSIM, a detailed Social Security benefit calculator. CORSIM generates a representative sample of lifetime earnings and demographic trajectories for Americans born or to be born between 1945 and 2000. SOCSIM determines the Old Age and Survivor Insurance (OASI) benefits received and taxes paid by the CORSIM sample. These benefits and taxes are then used to (*a*) compute the lifetime net benefits (benefits less taxes) paid to different cohorts and subgroups within cohorts of the baby boomers and their children, (*b*) calculate the rate of return different cohorts and groups within cohorts are implicitly earning on their contributions to the current system, and (*c*) consider the extent to which the OASI system pools risk across cohort members by reducing the variance of lifetime income.

CORSIM starts with a representative sample of Americans alive in 1960. It then "grows" this sample demographically and economically. Specifically, it ages, marries, divorces, fertilizes, educates, employs, unemploys, reemploys, retires, and kills original sample members and their descendants over the period from 1960 through 2090.

SOCSIM uses completed lifetime demographic and economic experiences to determine OASI retirement, spousal, widow(er), parent, child, and divorcee benefits as well as OASI taxes. It does so taking into account Social Security's earnings test, family benefit maxima, actuarial reductions and increases, benefit recomputation, eligibility rules, the ceiling on taxable earnings, and legislated changes in normal retirement ages.

The following paragraphs summarize the findings of our study.

Social Security represents a bad deal for postwar Americans. Moreover, the deal has gotten worse over time. Under current law, baby boomers are projected to lose, in taxes net of benefits of the OASI program, roughly 5 cents of every dollar they earn. Generation X'ers and today's children will lose in net taxes more than 7 cents of every dollar they earn. These losses assume no adjustment to Social Security's taxes or benefits. But, as indicated earlier, major adjustments are inevitable unless the system is privatized. If OASI taxes are raised immediately by the amount needed to pay for OASI benefits on a continuing basis, baby boomers will forfeit 6 cents of every dollar they earn in net OASI taxes. Those born after the baby boom will forfeit 10 cents of every dollar they earn.

Measured as a proportion of their lifetime labor incomes, the losses from Social Security by members of the middle class are the biggest, but measured in absolute dollars, the losses of the rich are greater. On average, postwar middle-class workers pay 8 cents per dollar earned to OASI in net taxes compared with 5 cents for the lowest-paid workers and 3 cents for the highest-paid workers. But in abso-

lute terms, today's highest earners pay roughly $1 million measured as of age sixty-five, compared to $400,000 for today's middle-class workers, and $50,000 for today's lowest earners.

As an average, out of every dollar that postwar Americans contribute to the OASI system, 74 cents represents a pure tax. The pure-tax component of each dollar contributed is 55 cents for the oldest baby boomers and 81 cents for today's newborns. The degree of pure OASI taxation is less than 50 cents on the dollar for very low lifetime earners and greater than 80 cents on the dollar for very high lifetime earners.

Men pay about 1 percent more of their lifetime earnings to OASI in net taxes than do women. The higher male net-tax rates obtain even controlling for lifetime earnings. They reflect shorter male life expectancy and less frequent receipt of OASI dependent and survivor benefits. Nonwhites, because of their shorter life expectancies, face slightly higher (about a third of a percentage point) lifetime OASI net-tax rates than do whites. This difference is particularly notable at lower levels of lifetime earnings. College-educated workers face somewhat lower (about two-thirds of a percentage point) lifetime OASI net tax rates than non-college-educated workers, but this difference disappears when one controls for lifetime earnings.

One rationale for the OASI program is that it pools earnings, life-span, and longevity risks through the progressivity of its benefit schedule as well as through its provision of dependent and survivor benefits. The data support this view. Across all postwar cohorts, the OASI program reduces the variance of lifetime income by 11 percent. Within each cohort, OASI reduces lifetime income variance by between 6 and 10 percent.

The internal rate of return earned by postwar cohorts on their Social Security contributions is very low. It is also falling. Those born right after World War II will earn, on average, a 2.4 percent real rate of return. Those born in the early 1970s will average about a 1 percent real rate of return, and those born at the end of the 1990s will average essentially a zero rate of return. These internal rates of return would be lower still if one factored in either the massive tax increases or the benefit cuts needed to restore Social Security to long-run solvency.

Privatizing Social Security via the Personal Security System

Privatization is far from a painless panacea for the ills of the Social Security system, but it does represent an opportunity to resolve, once and for all, most of the system's financial woes and to rationalize a program that is highly inequitable both intra- and intergenerationally, replete with inefficiencies and economic distortions, and extraordinarily uninformative about the benefits it is providing in exchange for its mandatory contributions.

Once one decides that privatization is worth doing, the next question to consider is whether one wants to privatize the system fully or partially. As suggested, partial privatization would leave the unprivatized portion of the system vulnerable to periodic financial half-measures that would condemn the system to ongoing financial difficulties. Equally important, partial privatization would leave us with two basic retirement systems, which would entail substantial extra administrative costs. Finally, partial privatization would eventually result in a large number of extremely small retirement accounts, namely, those of society's lowest earners. The fixed transactions costs of transmitting and recording contributions to these accounts, sending annual reports to their owners, and disbursing payments could wipe out much of the return the accounts could be expected to earn. In short, if privatizing a dollar of the retirement portion of Social Security makes sense, privatizing all of it makes much more sense. The remainder of this section outlines our proposal for privatizing the Social Security system by means of the Personal Security System.

The Personal Security System (PSS) fully privatizes the retirement portion of Social Security.[1] Briefly stated, its major provisions are as follows:

- Social Security's Old Age Insurance (OAI) payroll tax is eliminated and replaced with equivalent compulsory contributions to PSS accounts.
- Workers' PSS contributions are shared fifty-fifty with their spouses.
- The government matches PSS contributions on a progressive basis.
- PSS balances are invested in a single market-weighted global index fund of stocks, bonds, and real estate.
- Current retirees and current workers receive their full accrued Social Security retirement benefits.
- Between ages sixty and seventy, PSS balances are annuitized on a cohort-specific and inflation-protected basis.
- A federal business cash-flow tax finances Social Security retirement benefits during the transition as well as the ongoing progressive government matching of PSS contributions.

1. This version of the Personal Security System plan differs in two details from the original version that was endorsed by Sachs and the other academic economists. Rather than calling for just a diversified portfolio, it insists that all account balances be invested in a single security: the market-weighted global index fund of stocks, bonds, and real estate. It also calls for financing the transition with a business cash-flow tax rather than a retail sales tax, although a retail sales tax would be just as good.

2. These programs also need to be reformed if their costs are to be held to the levels of their tax receipts. Whether privatizing them is the best method to achieve this objective is, however, a subject for another paper.

Features of the Personal Security System

The PSS plan would leave unchanged the contributions paid to and benefits received from the disability and survivor insurance portions of Social Security.[2] Only the contributions currently being made to the OAI portion of Social Security (about 70 percent of total OASDI contributions) would be eliminated and replaced with mandatory contributions of equal size to PSS accounts.

To protect nonworking spouses as well as spouses who are secondary earners, total PSS contributions made by married couples would be split fifty-fifty between the husband and wife before being deposited in their own PSS accounts. Although this provision is gender neutral, it is much more important for women than for men because women remain the major caregivers for young children and have, as a result, less time to spend in formal work.

The federal government would match PSS contributions of low-income contributors on a progressive basis. It would also make PSS contributions through age sixty-five on behalf of disabled workers.

PSS contributions would be subject to the same tax treatment as current 401(k) accounts. Contributions would be deductible and withdrawals taxable.

All PSS balances would be invested in a single, market-weighted global index fund of stocks, bonds, and real estate. Participants would purchase this security from (set up their accounts with) their preferred financial institution. Although participants could choose the financial institution in which they wanted to hold their global index fund, they could not sell that holding to purchase other securities. Forcing everyone to hold this and only this asset would ensure maximum portfolio diversification and guarantee all participants the same rate of return on their PSS contributions. It would also prevent people from playing the market; they would be forced to invest for the long term.

Between ages sixty and seventy, participants in each birth cohort would have their PSS balances converted into inflation-protected pensions that continued until they died. This conversion would be organized by the government through competitive bidding by the insurance industry. The insurance company winning the bid to annuitize a cohort's PSS account balances would provide each PSS participant an inflation-protected pension in proportion to his or her account balance, where the factor of proportionality would be the same for all participants; that is, all participants would become annuitized on identical terms, so there would be no "cherry-picking" by the insurance industry. The insurance company winning the bid for a particular birth cohort would sell off a portion of the cohort's PSS global index fund holdings each day as the cohort aged from sixty to seventy. This process would average out the risk of annuitizing PSS account balances when financial markets are temporally depressed. Because insurance companies would be forced to bid for the right to annuitize a cohort's PSS account balances, the industry would end up providing this service at the lowest possible price.

If contributors died prior to age seventy, any non-annuitized portion of their PSS account balance would be bequeathable to their heirs.

Current recipients of Social Security retirement benefits would continue to receive their full inflation-indexed benefits. Upon reaching retirement, workers would receive the full amount of Social Security retirement benefits that they had accrued as of the time of the reform. Those benefits would be calculated by filling in zeros in the OAI earnings records of all Social Security participants for years after the transition begins. Because new workers joining the workforce would have only zeros entered in their OAI earnings histories, new workers would receive no OAI benefits in retirement. This arrangement would ensure that, over a transition period, aggregate Social Security retirement benefits would declined to zero.

During the transition, Social Security retirement benefits would be financed by a federal business cash-flow tax. This tax would also finance the government's ongoing PSS contribution match. Over time, the PSS business cash-flow tax rate would decline as the amount of Social Security retirement benefits declined. Provisional calculations suggest that the tax would begin around 8 percent and would decline to a permanent level of roughly 2 percent within forty years.

Advantages of the Reform

The Personal Security System would improve the linkage between taxes and benefits, enhance protection for survivors, and equalize treatment of one- and two-earner couples. It would offset the ongoing transfer of resources from the young to the old, provide better protection to nonworking spouses in case of divorce, and make the system's progressivity apparent. At the same time it would resolve Social Security's long-term funding problem and ensure Americans an adequate level of retirement income.

With regard to its macroeconomic effects, simulation studies suggest that this reform would, over time, increase the economy's output by roughly 15 percent and the capital stock by roughly 40 percent.

The PSS would not harm the poor. A business cash-flow tax represents an indirect way of taxing consumption. The current poor elderly living on Social Security benefits would be fully insulated from the tax because their benefits are guaranteed in real terms through the system's indexation of benefits to the consumer price level. Middle-class and rich elderly as well as middle-aged and younger members of society would jointly bear the burden of the tax. For young and middle-aged workers, the reform would mean an overall decline in the tax burden, because they would no longer pay the OAI tax. For the economy as a whole, the tax change would be revenue-neutral; the business cash-flow tax would simply replace the OAI payroll tax.

Simulation analyses show that poor members of current middle-aged generations, poor members of current young generations, and poor members of future generations have the most to gain from privatizing social security.

Asking the middle-class and rich elderly to pay their share of Social Security's unfunded liability is intergenerationally equitable, particularly in light of the massive transfers that have been made to the elderly through Social Security, Medicare, and other programs in the postwar period.

Conclusion

The Social Security system does lots of useful things. It forces us to save and to insure, and it protects us from running out of money in old age. But the system was financed from the start on a chain-letter basis, and the end of the chain is in sight. We now have two options. We can try to con our children and grandchildren into buying our inherently worthless chain letters by continuing to disguise the true nature of Social Security's long-term fiscal problems. Or we can decide to act like adults and reform once and for all a system that imperils the financial well-being of our offspring.

By fully privatizing Social Security's retirement program along the lines presented here, we can change the bath water without discarding the baby. The PSS proposal achieves all the legitimate goals of Social Security. It forces us to save, it protects dependent spouses, it assists the poor, and it provides annuity insurance. It also gives American workers immediate access to the world capital market in a manner that precludes their trying to time or otherwise play the market. Finally, it asks all who can pay, including the middle-class and rich elderly, to recognize our collective obligation to pay the liabilities of the current system so that we can ensure real social security for our children.

Acknowledgments: This article is adapted from testimony to the U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Social Security, June 3, 1998.

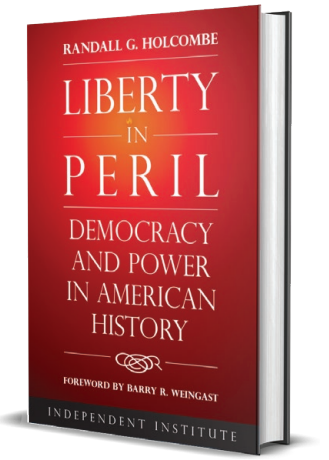
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