

# **Privatizing Social Security**

**by**

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## Executive Summary

The U.S. Social Security system is broke. It does not have the assets to pay promised benefits. Unless the system is fundamentally changed, solvency will require either massive tax increases for future workers or draconian cuts in benefits for future retirees.

Social Security is also treating the vast majority of people who are working and paying taxes very badly. For example:

- Eighteen-year-olds entering the labor market today and earning only an average income can expect to accumulate more than \$700,000 in tax payments by the time they reach age 65.
- Yet they can expect to withdraw from the system just over \$140,000 in benefits (discounted to age 65) — a fraction of what they will have paid in.
- And receipt of even these benefits will be uncertain — since it will likely require that future workers face 50 percent higher payroll tax rates than now exist.

Some defend the current system on the grounds that it is progressive, providing a safety net for those who might otherwise be unable to maintain a decent standard of living in retirement. Although it has done much good, the system takes a bigger share of the lifetime income of the poor than it does of the rich.

- Virtually all groups born since World War II can expect to pay more in taxes than they will receive in benefits, but this burden is not distributed equitably.
- Those who fare the worst are the middle class, who face a burden (as a percent of lifetime income) that is several times higher than those who earn the highest incomes.
- The burden for the top tenth of the income distribution is not only lower than for those in the middle, it is only one-half that of the burden faced by the bottom tenth.
- Because of their shorter life expectancies, blacks do worse than whites.
- And those without a college education do worse than those with college degrees.

Even if Social Security keeps all of its promises, the vast majority of working taxpayers will get a return on their contributions far below what they could have earned by investing those same tax dollars in the private capital market. For example:

- Baby boomers will get a real rate of return of less than 2 percent.
- Generation Xers will get less than 1 percent.
- Today's newborns will get a rate of return close to a zero.

Fortunately, there is a better way. The plan proposed here would replace that portion of the payroll tax used to pay for Social Security retirement benefits with a consumption tax. Instead of paying Social Security taxes, workers would deposit those dollars in private accounts earning the rate of return paid by the international capital market. Near the time of retirement, they would convert their investments into annuities providing a retirement income larger and more secure than that promised by Social Security.

This plan has been endorsed by 65 of the nation's leading academic economists, including three Nobel Prize winners. Not only would it solve the problem of Social Security, it also would create other economic benefits for society, increasing the nation's output per person by an estimated 15 percent.

## Introduction

The U.S. Social Security System is broke. Indeed, it's in much worse fiscal shape than the public thinks or government representatives acknowledge. Paying all of Social Security's promised benefits on an ongoing basis appears to require an immediate and permanent 6 percentage point increase in the current 12.4 percentage point payroll tax used to finance the system. That means the system needs to take 6 cents more out of every dollar earned by the average American worker not only in this generation, but in every generation that follows.

This staggering truth about Social Security's long-term finances cannot be read in the *Trustees Report*.<sup>1</sup> On the contrary, the trustees say the system needs only 2 cents more per dollar earned to stay afloat. Given that workers have only 100 pennies out of each dollar they earn to give away to government and that they are already paying roughly 30 cents on the dollar in net taxes (taxes paid net of transfer payments received), taking even 2 more cents is serious. Indeed, even this substantial understatement of the system's fiscal position has been large enough to get President Clinton's attention. His response has been to initiate a national "conversation" about "saving" Social Security.

Most Democrats and Republicans have taken saving Social Security to mean simply coming up with a set of piecemeal fixes that will leave the system basically intact. But a growing number in both parties believe that the only way to "save" Social Security is to privatize it. Full privatization entails letting workers contribute their Social Security payroll taxes to private accounts and using another fiscal instrument, during a transition period, to pay existing retirees their full Social Security benefits and existing workers their accrued Social Security benefits. Under full privatization, the system is shut down at the margin, and no new benefits accrue. Partial privatization lets workers contribute some, but not all, of their Social Security payroll taxes to private accounts and accrue Social Security benefits by making additional contributions.

Unfortunately, with the help of the trustees, both sides are conveniently ignoring two-thirds of the system's true fiscal problem. Consequently, neither the patches proposed by the would-be saviors nor the proposals of the would-be privatizers come close to guaranteeing current retirees and workers all the Social Security benefits due them based on their past contributions to the system.

In saying that he wants to save rather than reform Social Security, the president has suggested preserving the existing system. Since the alternative to being its savior is being its destroyer and since no would-be privatizer wants to wear that label, members of Congress are discussing only partial privatization schemes that resemble mandatory, small-scale IRAs.

*"A growing number believe the only way to 'save' Social Security is to privatize it."*

For the self-appointed saviors of Social Security, these schemes are easy targets. First, they entail high transaction costs per dollar invested. Second, they lack progressive elements that would help the poor to save. Third, they permit people to invest in the financial markets in a risky, undiversified manner. Fourth, they permit different workers to earn very disparate rates of return. Fifth, they provide no direct protection of dependent spouses. Sixth, they provide no clear mechanism for converting account balances into inflation-protected pensions in retirement.

In addition to all these defects, the “saviors” of Social Security rightly point out that the proponents of these schemes are making heroic assumptions about the stock market’s performance over time, which is another way of saying they are not adjusting properly for the market’s risk. In this respect, the saviors of Social Security, who seek to invest the Social Security Trust Fund in the stock market, are open to the same criticism.

Is full privatization a rational alternative? Can it be accomplished in a way that deals with all the legitimate objections to partial privatization? And can it guarantee that the old Social Security system pays all the benefits it owes? The answer to each of these questions is yes.

The Personal Security System is a plan for fully privatizing the retirement portion of Social Security. I developed it with Jeffrey Sachs, an economics professor at Harvard University, and 65 of the nation’s leading academic economists, including three Nobel Prize winners, have endorsed it. The plan protects dependents, assists the poor, limits transaction costs, prevents people from playing or timing the market, provides everyone a fully diversified portfolio, ensures everyone the same rate of return on their contributions, transforms account balances at retirement into inflation-protected pensions and has a fiscal mechanism for paying off 100 percent of the accrued liabilities of the old system. What’s more, the plan is simple. Furthermore, its method of paying off all the liabilities of the old system is transparent, hinging neither on heroic assumptions nor on hard-to-discern details.

*“Privatization can be accomplished in a way that guarantees the old Social Security system pays all the benefits it owes.”*

## **Our Kids Are in Trouble**

Before discussing why Social Security’s problem is three times worse than the trustees acknowledge, and why the Personal Security System is the solution, it is important to view the nation’s fiscal and economic problems in a broader, long-term context.

**Transfers from young to old.** The U.S. government has spent the last half-century taking ever larger sums of money from poor, middle-class and rich young people and giving them to poor, middle-class and rich old people. These transfers far exceed anything the young would have done for the elderly on a voluntary basis. The principal mechanisms the government has used are Social Security and Medicare. Other programs (e.g., Medicaid) and other

fiscal mechanisms (e.g., accumulating large amounts of official debt and creating tax breaks for the elderly) also have been used.

In taking from the young to give to the old, politicians have made the old — who have both the time and inclination to vote — very happy. They have placated the young with the implicit message, “Don’t worry, you’ll get yours from the next set of young when you retire.” In so doing, politicians started the biggest pyramid scheme in history. But, as with any pyramid scheme, those who are in at the beginning win big and those at the end are left holding empty promises.

**Burdens for future generations.** America’s great pyramid is now crumbling. For babies born this year, projected Social Security benefits are so small relative to contributions that 81 cents of every dollar they contribute to the system represents a pure tax that will not be matched by offsetting benefits. Since Social Security’s payroll tax rate is 12.4 percent, the system greets newborns with the following birthday message: “More than 10 cents of every dollar you’ll ever earn is ours.”

Of course Social Security is just one of the many fiscal programs facing our newborns. Adding up all programs, through an analytic method called generational accounting, the birthday greeting from Uncle Sam and Aunt Sally (a pseudonym for state and local government) is: “Unless things change a lot and very soon, you’ll owe us half of every dollar you ever earn!”

**Generational accounting.** This extremely troubling picture is being provided courtesy of none other than our own federal government, specifically the Federal Reserve Bank of Cleveland (Cleveland Fed) and the Congressional Budget Office (CBO).<sup>2</sup> Their recent *generational accounting* for the United States, which is based on arguably overly optimistic demographic and fiscal projections, shows lifetime net tax rates (taxes paid net of transfer payments received divided by lifetime labor earnings) of almost 50 percent for everyone born this year and afterward.<sup>3</sup> This net tax rate is not only enormous in absolute terms, it is also huge compared to the 30 percent rate most adults now alive will pay under current law. [See the discussion below.]

Figures I and II present generational accounts in dollars and cents. As Figure I shows:<sup>4</sup>

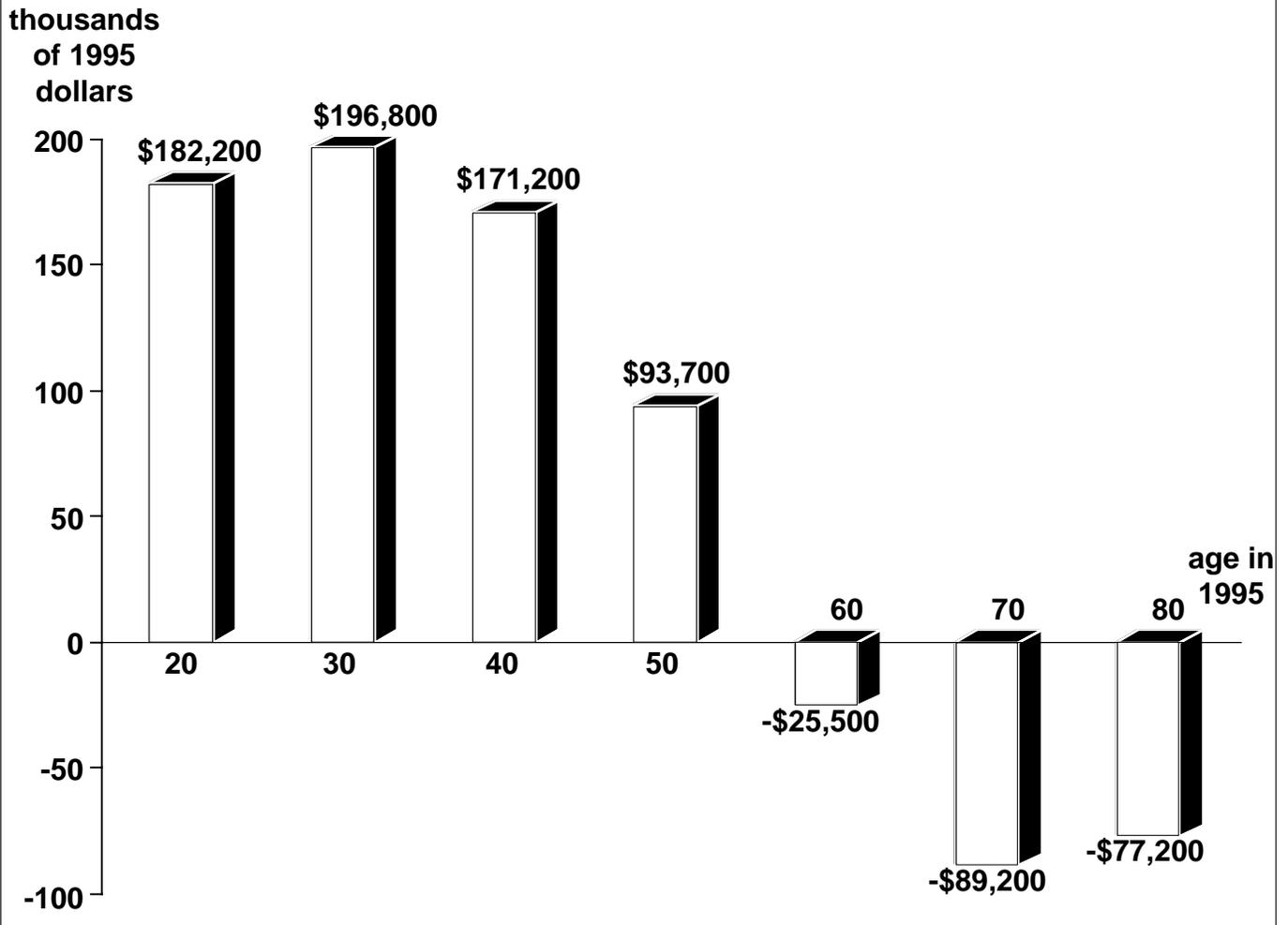
- The average 20-year-old male can expect to pay \$182,000 in taxes over the remainder of his life in excess of any benefits he will receive from government.
- The average 20-year-old female can expect to pay \$115,000 over and above any benefits over the remainder of her life.

By contrast, 70-year-old retirees are receiving between \$89,200 (males) and \$101,000 (females) in net benefits!

*“For babies born this year, 81 cents of every dollar they contribute to Social Security will never be matched by offsetting benefits.”*

FIGURE I

## Net Lifetime Taxes (Taxes Minus Benefits) Due to All Government Programs for U.S. Males (present values in 1995 dollars)



*“The average 20-year-old male can expect to pay \$182,000 in taxes in excess of benefits received from all government entitlement programs.”*

**Causes of the generational imbalance.** The depth of our generational imbalance reflects two factors. First, the population is rapidly aging. By 2030, when the enormous baby boom generation will have retired, the average age in the country as a whole will be the same as that of present-day Florida. Second, the level of benefits we are giving to today’s retirees and promising to future retirees is rising much faster than are the real wages of the workers expected to pay for this largesse.

### Our Economy Is Being Jeopardized

The decades-long policy of “pass-the-generational-buck” that threatens our children’s livelihoods also has adversely affected our economy.

**Subsidizing elderly consumption.** In taking from the young and giving to the old, the government has been taking from savers and giving to

spenders. In the process, it has engineered an enormous increase in the absolute and relative consumption of the elderly. Today's typical 70 year-old consumes roughly 40 percent more than today's typical 30 year-old. Back in 1960 these figures were reversed.

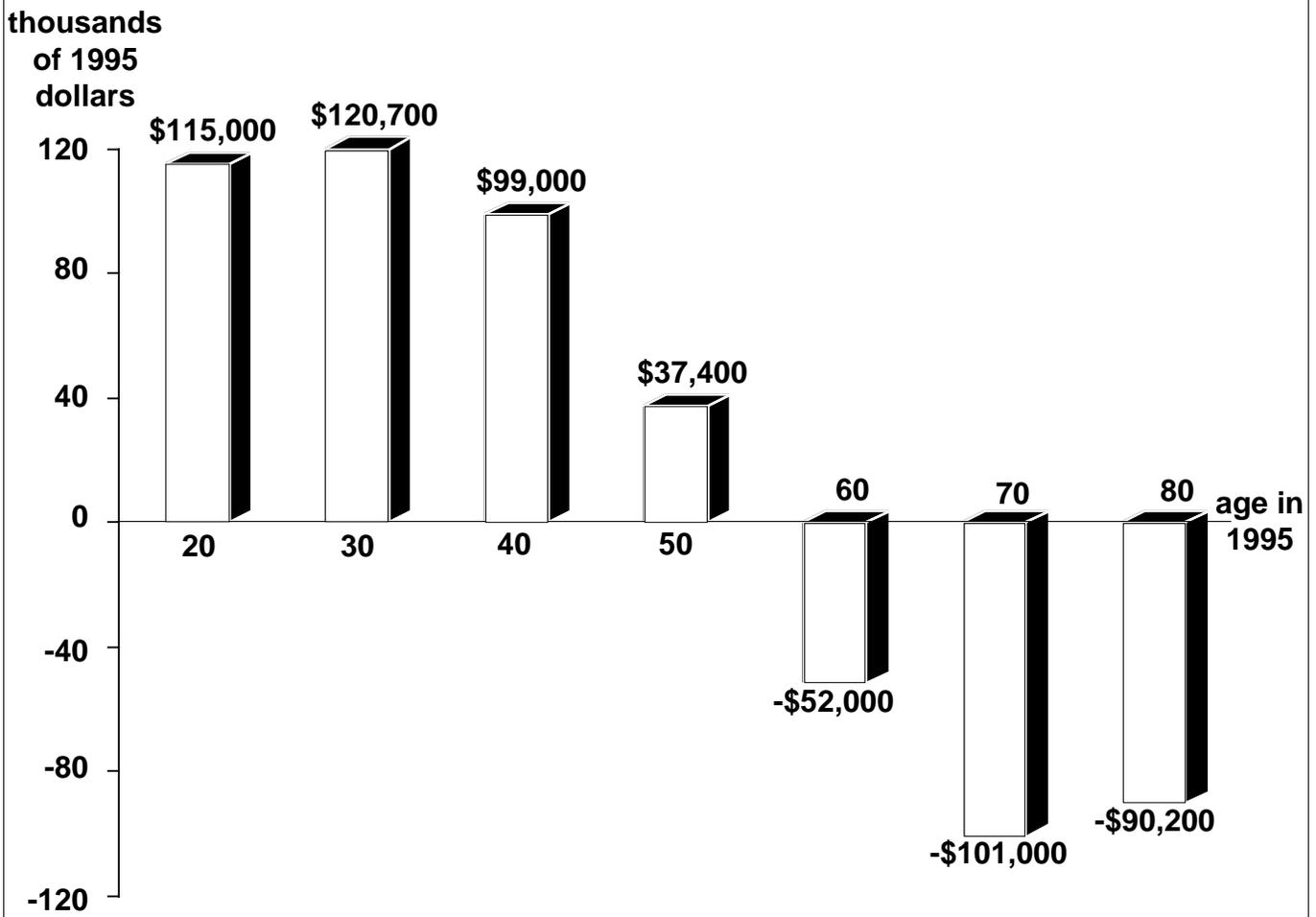
The elderly are big spenders compared to the young for a simple reason: they have fewer years left over which to spread their assets. This encourages them to spend a bigger fraction of any dollar they have on immediate consumption. Indeed, research I coauthored indicated that the fraction of each additional dollar spent on consumption by older Americans is roughly twice that of younger ones.<sup>5</sup>

The consumption propensities of older Americans are also larger than those of Americans not yet born, since their propensity to consume in the present is obviously zero. When the government makes a transfer to the

*“The average 20-year-old female can expect to pay \$115,000 over and above benefits received.”*

FIGURE II

**Net Lifetime Taxes (Taxes Minus Benefits) Due to All Government Programs for U.S. Females**  
(present values in 1995 dollars)



current elderly and forces those not yet born to pay for it by paying interest on explicit debt or paying payroll taxes to pay-as-you-go-financed social insurance schemes, it engineers an unambiguous immediate increase in aggregate consumption, since the consumption of the current elderly goes up and that of future generations remains at zero.

**Reducing national saving and investment.** The increase over the last few decades in the absolute and relative consumption by the elderly has raised national consumption and lowered national saving. Since national saving finances domestic investment, domestic investment has fallen as well. To be precise, national saving and domestic investment rates today are roughly half of their levels in the 1950s and 1960s. The domestic investment rate indicates the speed at which we add to the stock of computers, machines, factories, and other tools that make workers more productive. Domestic investment is also a critically important mechanism for introducing new technology. Together the capital stock and the state of our technology determine workers' productivity. Workers' productivity, in turn, is the main determinant of their real wages.

Hence, in financing a consumption binge by the elderly, the government has reduced not only saving and investment, but also labor productivity and the growth of real wages. Although labor productivity and real wage growth have improved in the last couple of years, since the early 1970s they have been growing at roughly one-third the rate observed in the 1950s and 1960s.

**Prospects for the future.** Unfortunately, the long-run prospects for our economy are bleak. If we don't get Social Security, Medicare and the rest of our fiscal house in order very soon, we'll end up with payroll tax rates of 35 percent or more and even higher federal income tax rates than those we now face. When tax rates get too high, people will stop working and saving, and output will stop growing. The government will find it cannot collect the taxes it needs to pay its bills and will resort to printing money. This will cause inflation and all of its attendant problems, including high interest rates and a weak currency. The resulting stagflation could linger for decades until some devastating economic event, like hyperinflation, wipes out the government's explicit or implicit liabilities.

This augury will seem overly pessimistic only to those unfamiliar with the degree to which retrograde government policies have undermined economies in Latin America, the former Soviet Union, Africa and other regions of the world.

*"The increase in consumption by the elderly has raised national consumption and lowered national saving."*

## How Did Things Get So Bad?

The answer, in part, is that we are keeping a set of books that systematically ignore the future and encourage us to think we are doing better when we are actually doing worse. I'm referring to deficit accounting, which records as government debt only those obligations we decide to officially recognize. Obligations that are no less real — like paying baby boomers their promised Social Security benefits — are completely omitted. Unfortunately, our unofficial obligations exceed our official ones by a factor of roughly three. Moreover, these unofficial obligations have been growing rapidly even as growth of the official ones has slowed.

**Failures of deficit accounting.** Take the first term of the Clinton administration, during which the official deficit shrank relative to the size of the economy. At the same time this was happening, the administration and Congress permitted real Medicare benefits per beneficiary to grow by one-quarter. In so doing, it raised not just the immediate real benefit levels of the elderly, but also the benefits of the baby boom generation that is soon to retire. Why? Because the government never has reined in the growth of Medicare benefits, let alone cut them in absolute terms. So in giving current beneficiaries a real Medicare increase of 25 percent, the government effectively made this increase permanent. The fiscal consequences are horrendous. The government allowed a multi-trillion-dollar unfunded liability to grow by 25 percent in just four years! Had the government been forced to record the growth of this liability, it would have reported huge and rapidly growing deficits relative to GDP.

In addition to being based on an economically arbitrary definition of debt, deficit accounting focuses only on the short term. For example, the recent budget agreement sought to achieve “budget balance” by 2002. How did the Republican leadership in Congress, which apparently chose that date, decide that we needed to think only about the next few years? It was not, I'd suggest, the result of their thinking about the fate of their children and grandchildren.

**Potential benefits of generational accounting.** Fortunately, there is a good alternative to deficit accounting that considers all government liabilities on an even footing and looks at the future without blinders. This alternative, generational accounting, is being used by 27 countries from Chile to Norway and Japan to Israel. Among the governments and multilateral economic institutions using generational accounting techniques are the Bank of England, the Bank of Japan, the Finance Ministry of Norway, the Treasury of New Zealand, the International Monetary Fund, the World Bank and the European Union. In the United States, Congress remains largely oblivious to the existence of generational accounting, and the Clinton administration finds it embarrassing. Indeed, the administration's top “economist” — Gene Sperling — overruled the Office of Management and Budget and removed it from the federal budget.

*“Under deficit accounting, government records as debt only those obligations it decides to officially recognize — about a third of the real total.”*

## The Ethical Challenge

I am accusing the federal government of expropriating the earnings of today's young as well as future generations through the expansion of the Social Security, Medicare, Medicaid and other programs. In doing so, I risk being accused of ignoring all the good these programs have done. Let me plead innocent on that score. I appreciate the critically important functions these programs perform. Chief among them are making people a) save for their retirement; b) insure against early death, disability and large medical expenses; and c) join a pool that prevents insurance companies from covering those with small expected losses and leaving exposed those with high expected losses.

*"We need not steal from future generations to meet the legitimate goals of Social Security, Medicare and Medicaid."*

To say that we need to make people save, insure and pool risks does not imply that we should ask our children and grandchildren to save for us or to pay for our insurance. We need not steal from future generations to meet the legitimate goals of Social Security, Medicare and Medicaid.

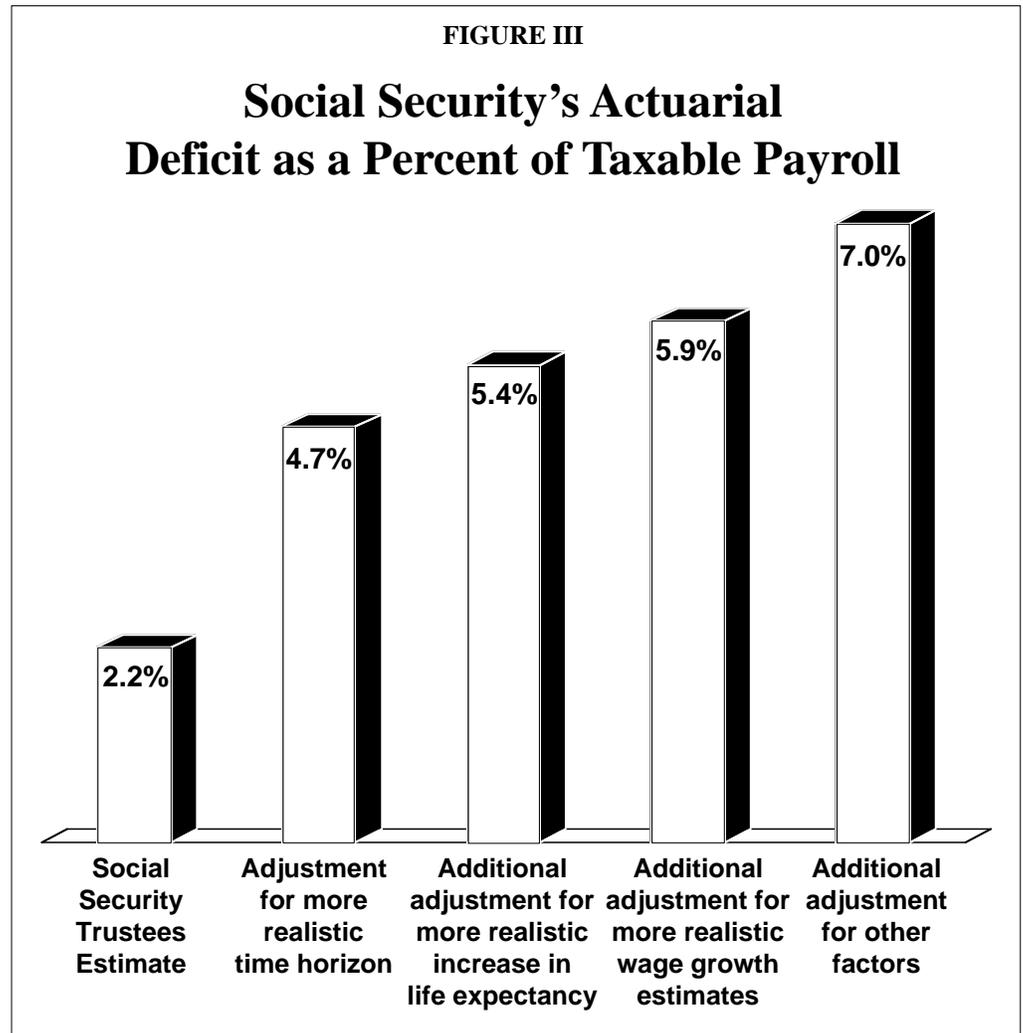
As the father of two small children, I'm appalled at our country's fiscal child abuse and the lengths to which our so-called leaders are going to disguise this behavior. One way they do so is to portray the question of reforming entitlement programs as a left wing-right wing fight between Democrats and Republicans. Each side claims it cannot move the other, and they end up compromising on a "solution" that does too little and starts too late.

In truth, the issue breaks down not along party or ideological lines but along generational lines. The great ethical question of our day is: are we adults going to protect our children or prey upon them?

This question prompts others. Are we going to do long-term fiscal planning or pretend that 2002 is the end of time? Are we going to acknowledge all of Social Security's fiscal problems or just a third of them? Are we going to continue making overly optimistic forecasts of future Social Security, Medicare and Medicaid expenditures and then claim things turned out worse than we could have predicted? Or are we going to stop talking about "saving Social Security" and start asking a) what are the legitimate goals of the program and b) how can we achieve those goals without embezzling from our children? Are we going to discuss publicly the size of the net tax rates we are willing to impose on our children? Finally, are we going to do what it takes to achieve generational balance?

Having considered the grave state of U.S. generational policy and the great ethical question it presents, let us examine Social Security's role in our nation's generational imbalance and how we can restore the balance through privatization while retaining the legitimate objectives of the system.

“The Trustees Report discloses only about a third of the system’s long-range financial imbalance.”



## Social Security’s Long-Term Fiscal Imbalance

As noted above, Social Security’s *Trustees Report* discloses only about a third of the system’s long-run financial imbalance. [See Figure III]. There are two main reasons: the trustees use too short a planning horizon, and they use overly optimistic economic and demographic assumptions.

**Effects of using a more realistic time horizon.** In forming their estimates, the trustees instruct the Social Security actuaries to look only 75 years into the future. Although 75 years may seem a reasonable projection horizon, Social Security is slated to run major deficits in all years beyond this horizon. The use of the 75-year projection period explains, in part, why Social Security’s finances are again deeply troubled after having been “fixed” by Alan Greenspan, Robert Dole and the rest of the Greenspan Commission in 1983. Each year that passes brings another major deficit year within the 75-year projection window, and 15 years have now passed since the Commission met.

The highly respected actuaries of the Social Security Administration have examined the system’s long-run finances without truncating their analysis. Yet the trustees have failed to include so much as a footnote containing

their actuaries' findings in their lengthy annual reports. This dereliction of duty, which merits Congress' attention, would be less troublesome if the nontruncated results were close to the truncated results. They are not. Based on the truncated planning horizon, the actuaries tell us we need to raise the Social Security payroll tax rate by 2.2 percentage points starting now and continuing for the next 75 years.<sup>6</sup> In so doing we'll be able to pay all benefits that come due over those years.

*“To guarantee benefits on an ongoing basis, not just for the next 75 years, would require increasing the Social Security payroll tax by 4.7 percentage points — a 38 percent increase.”*

But how high must the immediate and permanent tax hike be to guarantee the payment of promised benefits not just for 75 years, but on an ongoing basis? The answer, according to Steve Goss, Deputy Chief Actuary of the Social Security Administration, is 4.7 percentage points — more than twice the tax hike being disclosed by the trustees! Since the current Social Security employer/employee payroll tax rate is 12.4 percent, raising the rate to 17.1 percent would represent a 38 percent tax hike.

As painful as a 38 percent tax hike would be, even it would likely fall short of what is really needed to sustain Social Security without cutting benefits. The demographic and economic assumptions used by the actuaries appear to be overly optimistic on at least two important counts. First, they assume a slower growth in life span than the U.S. has experienced in recent decades. Second, they assume higher future real wage growth than recent experience would suggest is realistic.

**Effects of more realistic projections of life expectancy.** Life expectancy for Americans born this year is 76 years. The intermediate projection assumes that, over the next 45 years, life expectancy will rise by only three years, to 79 years — which is Japan's current life expectancy. So the Social Security Administration would have us believe that it will take America another 45 years just to reach the current Japanese life span! In assessing this prognosis, we should bear in mind that the last time U.S. life expectancy grew by three years, it took only 20 years — from 1977 to the present.

Leading demographers, including Professor Ronald Lee of the University of California at Berkeley, project much more rapid growth in life expectancy. Indeed, the mid-range of Lee's projection indicates a 10-year rather than a five-year life-span extension between now and 2070. This is twice the increase forecast over this period by Social Security. Assuming Lee is right, the immediate and permanent tax hike needed rises from 4.7 to 5.4 percentage points.

**Effects of more realistic wage growth assumptions.** Since 1975 real wages have grown at only .4 percent per year, although the growth rate in this decade has been almost twice as high. The Social Security actuaries assume a .9 percent per year growth rate in real wages over the next 75 years. In conjunction with an extra five years of life, lowering the real wage growth assumption to .4 percent would raise the needed tax hike to 5.9 percentage points — a 48 percent increase relative to its current value!

This increase in the payroll tax would push the Social Security tax rate to 18.3 percent. But that's only if it is enacted immediately. If the government waits, say, another 10 years, it will have to raise the tax rate by another .8 percentage points to 19.1 percent to generate the same amount of tax revenue in terms of present value. If it waits 20 years, a tax rate of more than 20 percent will be needed.

**Effects of other factors.** Additional factors including fertility and net migration could impact Social Security more than the trustees are projecting. For example, the actuaries' high-cost projection assumes that all critical factors will be worse than those assumed in the intermediate projection discussed above. Under the high-cost assumptions (which are very close to Lee's with respect to life-span extension and assume .4 percent future real wage growth), we will need a 7 percentage point tax rate hike right now and forever to pay for Social Security's benefits on an ongoing basis. This would put the tax rate at 19.4 percent.

## Social Security's Treatment of Postwar Americans<sup>7</sup>

In a recent study, five colleagues and I used a detailed micro simulation model to examine how Social Security is treating postwar Americans.<sup>8</sup> In addition to considering the treatment of different postwar cohorts, the study compares the treatment of different types of individuals within each cohort.

**Modeling methods.** The study uses two tools: a dynamic micro simulation model and a detailed Social Security benefit calculator. The simulation model generates a representative sample of lifetime earnings and demographic trajectories for Americans born or to be born between 1945 and 2000. The benefit calculator determines the Old-Age and Survivors Insurance (OASI) benefits received and taxes paid. These benefits and taxes are then used to a) compute the lifetime net benefits (benefits less taxes paid) for 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 Social Security contributions and c) measure the extent to which the system pools risk across cohort members by reducing the variance of lifetime incomes.

The simulation model 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, re-employs, retires and kills original sample members and their descendants over the period 1960 through 2090. The benefit calculator uses completed lifetime demographic and economic experiences to determine retirement, spousal, widow(er), mother, father, children and divorcee benefits as well as taxes.<sup>9</sup>

*"Social Security is a bad deal for postwar Americans and has gotten worse over time."*

**Overall findings.** The study’s findings show that Social Security is a bad deal for postwar Americans. Moreover, the deal has gotten worse over time. On the average, out of every dollar postwar Americans are contributing to Social Security, 74 cents represent a pure tax without any offsetting benefits.<sup>10</sup> 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 taxation is less than 50 cents on the dollar for very low-wage earners and greater than 80 cents on the dollar for very high-wage earners. These losses assume no adjustment to Social Security’s taxes or benefits. But, as indicated above, major adjustments are inevitable unless the system is privatized.<sup>11</sup>

**Comparing income groups.** In absolute terms, the burden of Social Security appears to be distributed progressively. Today’s highest earners pay roughly \$1 million in taxes over and above any benefits they can expect to receive, measured as of age 65. The comparable figures are \$400,000 for middle-class workers and \$50,000 for the lowest earners. [Taxes and benefits for today’s 18-year-olds are shown in Figure IV.] However, measured as a proportion of their lifetime labor incomes, the middle class are the biggest

*“Today’s 18-year-olds in every economic class will pay more in taxes than they receive in benefits.”*

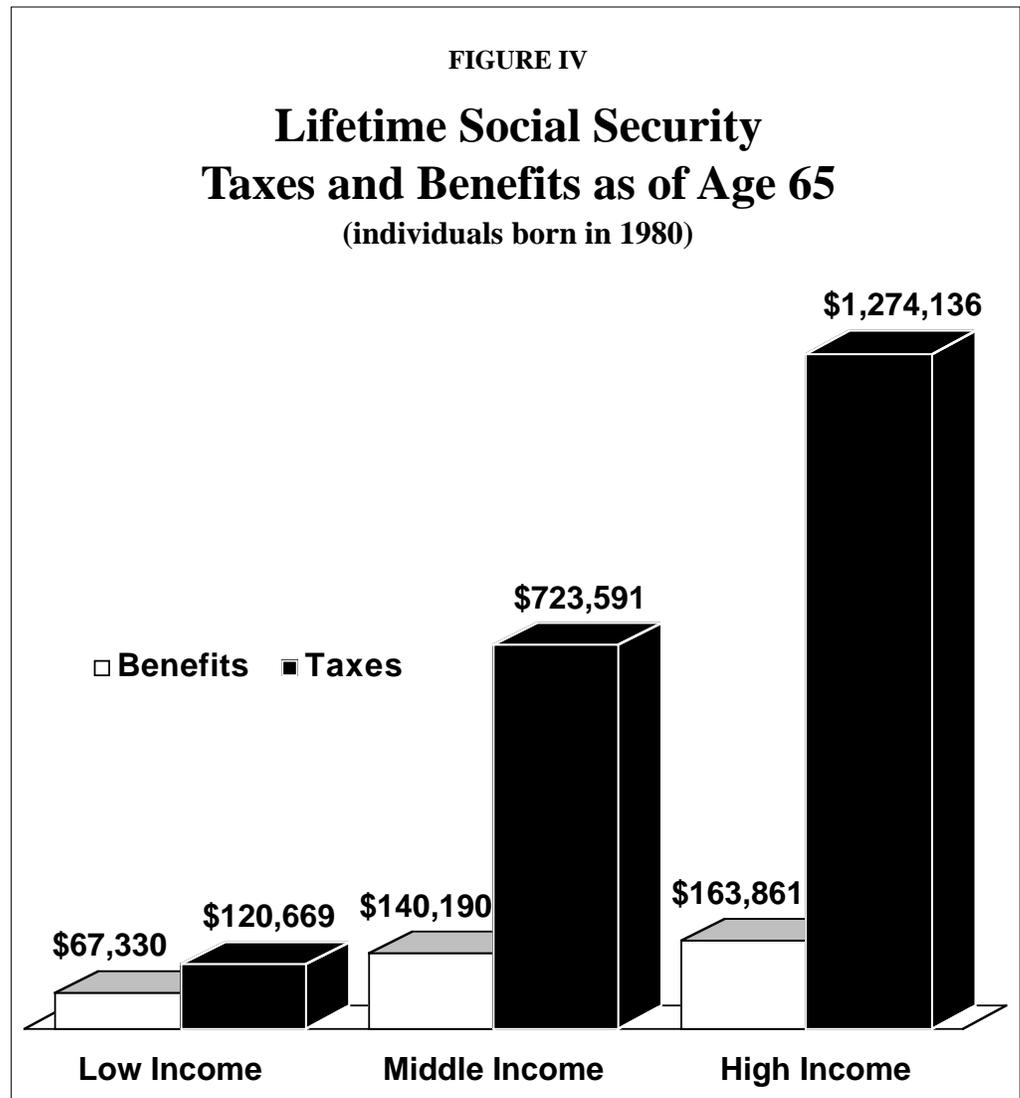
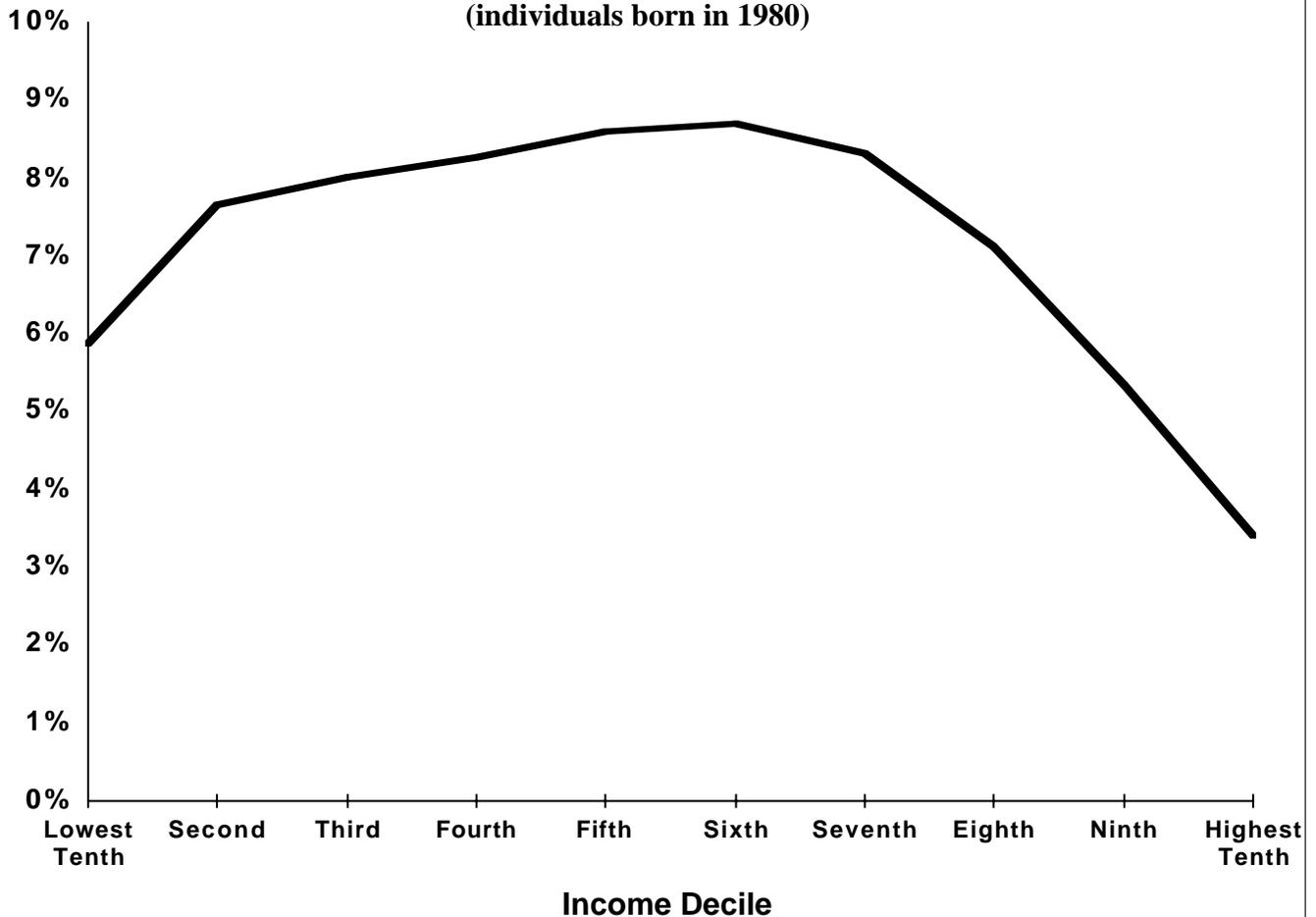


FIGURE V

**Net Burden of Social Security\***  
**As a Percent of Lifetime Income**  
 (individuals born in 1980)



\* Present value of taxes minus benefits.

*“The overall distribution of the Social Security burden is somewhat regressive.”*

losers from Social Security and the overall distribution is somewhat regressive. On the average, postwar middle-class workers pay 8 cents per dollar earned to Social Security in net taxes compared with 5 cents for the lowest-paid workers and only 3 cents for the highest-paid workers. [The distribution for 18-year-olds is shown in Figure V].

**Men vs. women.** Men pay about 1 percent more of their lifetime earnings in net taxes than do women. The higher male net tax rates obtain even for men and women earning the same lifetime incomes. This reflects shorter male life expectancy and less frequent receipt of dependent and survivor benefits.

**Whites vs. nonwhites.** Nonwhites, because of their shorter life expectancies, face slightly higher (about a third of a percentage point) lifetime net tax rates than do whites. This is particularly true at lower levels of lifetime earnings. [See Figure VI for 18-year-olds.]

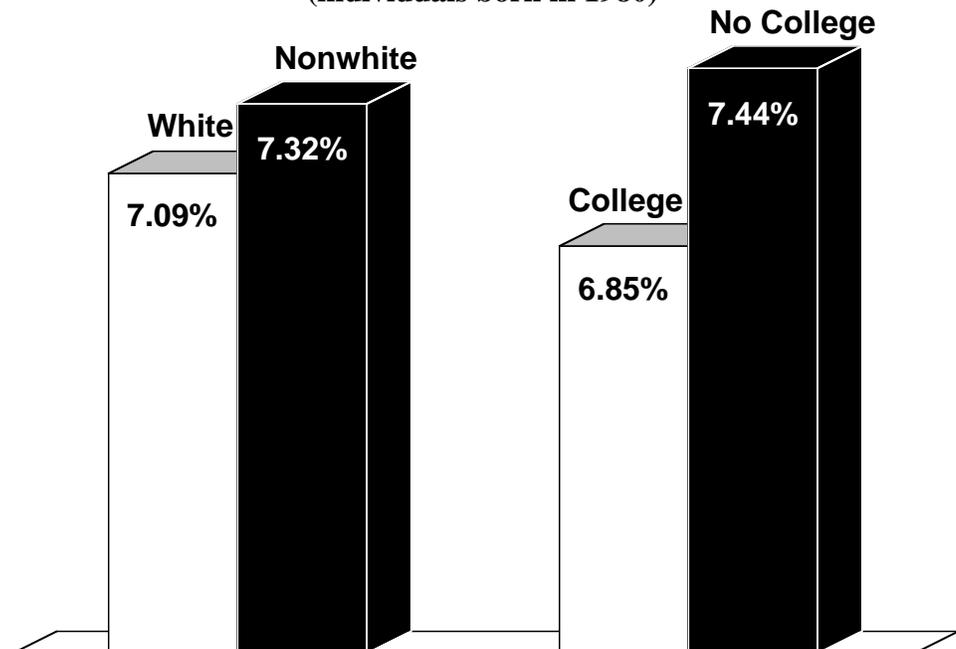
**College vs. no college.** College-educated workers face somewhat lower (about two-thirds of a percentage point) lifetime net tax rates than non college-educated workers. [See Figure VI for 18-year-olds.] This difference disappears once one controls for lifetime earnings.

**Insurance against risks.** One rationale for Social Security is that it pools risks — the risk of low wages, the risk of dying early and the risk of a lengthy retirement — 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 age groups, Social Security reduces the variance of lifetime income by 11 percent. Within each age group, Social Security reduces lifetime income variance between 6 and 10 percent.

**Rates of return.** The internal rate of return earned by those born after World War II on their Social Security contributions is very low. It’s 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 this decade will average essentially a zero rate of return. [See Figure VII.] These internal rates

FIGURE VI

**Net Social Security Burden\*  
As a Percent of Lifetime Income**  
(individuals born in 1980)

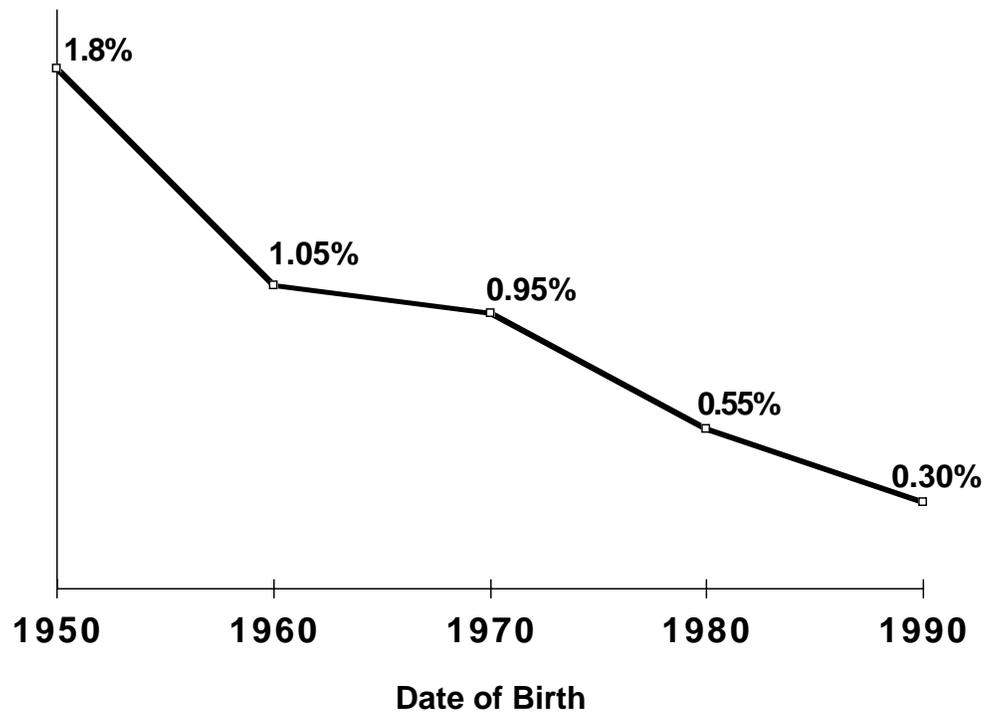


*“Nonwhites get a worse deal than whites; those who don’t attend college do worse than those who do.”*

\* Present value of taxes minus benefits.

FIGURE VII

## Real Rates of Return under Social Security by Age Group



*“The real rate of return from Social Security is very low — and falling.”*

of return would be even lower if one factored in the massive tax increases or the benefit cuts needed to restore Social Security to long-run solvency.

## Privatizing Social Security

To recapitulate, the U.S. Social Security system is broke and is treating the vast majority of current contributors very badly. Privatization is far from a painless panacea, but it does represent an opportunity to resolve most of the system’s financial woes and to rationalize a program that is highly inequitable, replete with inefficiencies and economic distortions and extraordinarily uninformative about the benefits it provides in exchange for the contributions it demands.

**Full vs. partial privatization.** Once we decide that privatizing is worth doing, we must decide whether to fully or partially privatize the system. As noted above, partial privatization will leave the nonprivatized portion vulnerable to periodic financial half-measures which condemn the system to ongoing financial difficulties. Equally important, partial privatization will leave us with two basic retirement systems with all the extra administrative costs that entails. Finally, partial privatization will lead to a large number of

*“The Personal Security System fully privatizes the retirement portion of Social Security, leaving unchanged the disability and survivor portions.”*

extremely small retirement accounts — those of society’s lowest earners. The fixed transaction costs of transmitting and recording contributions to these accounts, sending annual reports to the accounts’ owners and disbursing payments could wipe out much of the returns. For these reasons, if privatizing a dollar of the retirement portion of Social Security makes sense, privatizing all of it makes more sense.

**A proposal.**<sup>12</sup> The Personal Social Security (PSS) plan fully privatizes the retirement portion of Social Security. [See the sidebar.] The PSS plan leaves unchanged the contributions and benefits under the disability and survivor insurance portions of Social Security.<sup>13</sup> Only those contributions currently being made to the retirement portion of Social Security (about 70 percent of the total) are eliminated and replaced with mandatory contributions of equal size to private PSS accounts. What follows is a summary of the plan’s seven provisions.

**Protecting spouses.** To protect nonworking spouses as well as spouses who are secondary earners, total PSS contributions made by married couples are split 50-50 between the husband and wife before being deposited in individual PSS accounts. Although this provision is gender neutral, it is much more important for women than for men since women remain the major caregivers for young children and spend less time in the labor market.

**Protecting low-income earners.** The federal government would match PSS contributions of low-income contributors on a progressive basis,

## **The Personal Security System**

- 1. Social Security’s Old-Age Insurance (OAI) payroll tax is eliminated and replaced with equivalent compulsory contributions to PSS accounts.**
- 2. Workers’ PSS contributions are shared 50-50 with their spouses.**
- 3. The government matches PSS contributions on a progressive basis.**
- 4. PSS balances are invested in a single market-weighted, global index fund of stocks, bonds and real estate.**
- 5. Current retirees and current workers receive their full accrued Social Security retirement benefits.**
- 6. Between ages 60 and 70, PSS balances are annuitized on a cohort-specific and inflation-protected basis.**
- 7. 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.**

allowing them to accumulate proportionately more savings than they otherwise would. It would also make PSS contributions through age 65 on behalf of disabled workers.

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

**Investment of PSS account balances.** 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 their financial institution, they could not sell their global index securities and purchase others. 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 force people to invest for the long term and prevent them from playing the market.

It is useful to contrast this approach to the one Chile adopted in privatizing its social security system. Chile requires participants to invest their mandatory savings with pension companies. The pension companies charge very high fees for “managing” contributors’ money.<sup>14</sup> But the system is so highly regulated that all of the pension companies choose identical portfolios. Hence, as in the PSS proposal, the Chilean system is delivering a single portfolio, but at very high transaction cost and with a huge regulatory bureaucracy. The Chilean pension companies also invest almost solely in Chile, depriving Chilean workers of the opportunity to invest in stocks and bonds of major and minor companies around the world as well as U.S. Treasuries and other bonds issued by national governments. If the Chilean economy suffers a major downturn, the value of its assets and the retirement incomes of its elderly will decline precipitously. Putting all your eggs in one basket (in this case, your own country) makes no sense for Americans or for Chileans.

**Annuity of PSS account balances.** Between ages 60 and 70, participants in each birth cohort would have their PSS balances converted into inflation-protected pensions that continued until they died. This conversion would take place under government-established rules. After a competitive bidding process the insurance company winning the bid for a cohort would provide each PSS participant an inflation-protected pension based on his or her account balance. All participants would be annuitized on identical terms, regardless of their health status (life expectancy). 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 between 60 and 70. This would average out the risk of annuitizing PSS account balances when financial markets are temporarily depressed.

*“All PSS balances would be invested in a single, market-weighted global index fund.”*

In being forced to bid for the right to annuitize a cohort's PSS account balances, the insurance industry would end up providing this service at the lowest possible price. The annuities would be paid out from the date of conversion so people would start receiving pension income even as they continued to work. The choice of a retirement date would be completely up to the individual — his or her pension income would be unaffected. Insurance companies could easily hedge the risk of protecting the annuities against inflation by investing the annuity premiums in inflation-indexed U.S. Treasury bonds.

**Survivor provisions of PSS accounts.** If contributors died prior to age 70, any nonannuitized portion of their PSS account balances would go to their heirs. Survivors would also receive precisely the same Social Security survivor benefits they receive under the current system. Hence, the proposal increases survivor protection.

**Protecting current retirees and the past contributions of current workers.** Current recipients of Social Security retirement benefits would continue to receive their full inflation-indexed benefits. When they reached retirement, future retirees would receive the full amount of Social Security retirement benefits they had accrued as of the time of reform. These benefits are calculated by filling in zeros in the earnings records of all Social Security participants for years after the transition begins. Since new entrants to the workforce would have only zeros entered in their earnings histories, they would receive no Social Security benefits in retirement. This ensures that after a transition period aggregate Social Security retirement benefits would be completely phased out.

**Financing the transition.** During the transition, Social Security retirement benefits would be financed by a federal business cash-flow tax that would operate like a value-added tax. The business cash-flow 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 40 years.

No one likes paying taxes, so it's important to note that financing the transition in this manner is revenue neutral – it does not represent an overall tax increase. Recall that the payroll tax being used to pay for Social Security retirement benefits is, under the PSS plan, being eliminated. It's true that workers are compelled to contribute these amounts to the PSS accounts, but this represents private saving. Workers who are already saving at more than adequate levels would be free to cut back on their non-PSS saving. Workers who are saving less than the compulsory PSS contribution likely are saving too little and would benefit the most from being forced to save.

Other proposals being debated call for letting workers contribute their Social Security taxes to private accounts and finance the transition with mod-

*“Benefits of current Social Security recipients and past contributions of current workers would be protected.”*

est increases in other taxes. These proposals tend to a) recognize only a third of the long-run fiscal problem, b) be highly complicated, c) invoke heroic assumptions and d) finance the transition in large part by wiping out workers' claims to the future Social Security benefits they already have accrued. Such proposals sound too good to be true — because they are.

## Advantages of the Reform

The proposed reform has a number of advantages. In particular, the Personal Security System would:

- Improve the link between contributions and benefits.
- Provide better protection for survivors.
- Equalize the treatment of one- and two-earner couples.
- Phase out the ongoing transfer of resources from the young to the old.
- Provide better divorce protection for nonworking spouses.
- Make the system more progressive.
- Resolve Social Security's long-term funding problem.
- Ensure Americans an adequate level of retirement income.

Let's take a closer look at a few of these.

**Impact on the economy.** Knowing precisely how and when any major fiscal reform will affect the economy is impossible. But economists try to get some insight on this issue by developing and simulating large-scale dynamic computer models. My joint research with Kent Smetters and Jan Walliser, two top economists at the Congressional Budget Office, which uses such a model, indicates that privatizing Social Security can produce a significant short-run increase in national saving and a significant long-run increase in the economy's capital stock and its output of goods and services. Over time, this reform will increase the economy's output by roughly 15 percent and the capital stock by roughly 40 percent.<sup>15</sup>

*“Over time, this reform will increase the economy's output by roughly 15 percent and the capital stock by roughly 40 percent.”*

However, the transition to such an improved economy will take time. Moreover, how we finance the transition will determine the duration of the transition as well as the economy's final resting place. Financing privatization through a consumption tax, as is advocated here, would deliver the fastest and most efficient transition. In addition to eliminating a distortionary payroll tax, a consumption tax entails an implicit one-time wealth tax on retirees when they consume. The consumption tax also redistributes from older spenders to younger savers, promoting national saving. In contrast to consumption tax finance, income tax finance entails highly distortionary short-run tax rates that dramatically slow down the transition.

**Effects of alternative methods of funding the transition.** Another of our findings is that using deficit finance to limit the imposition of higher marginal income tax rates as one is paying off Social Security’s accrued liabilities makes the economy’s short run look better and its long run look worse. Sufficient reliance on deficit finance will leave the economy in a worse position in the long run than the one at which it started. For example, suppose the government lets workers contribute their Social Security taxes to private accounts and then borrows to make up the revenue shortfall needed to pay existing retirees their Social Security benefits. In this case, the workers will have been handed an explicit government IOU — government bonds that are issued to fund the increased debt — instead of an implicit IOU — promises of future Social Security benefits — in exchange for their contributions. Under this policy, future generations won’t have to pay high Social Security taxes on which they receive a negligible rate of return. Instead, they’ll have to pay high income and other taxes to pay the interest and principal on the explicit debt issued by the government.

**Intergenerational equity.** Asking the middle-class and rich elderly to pay their share of Social Security’s unfunded liability is intergenerationally equitable given the massive transfers made to the elderly through Social Security, Medicare and other post-World War II programs.

**Impact on the poor.** We’ve also learned that Social Security’s privatization is remarkably progressive with respect to its lifetime impact on the rich and poor. Even without a progressive government matching contribution, the lifetime poor enjoy a larger improvement in their well-being than do the lifetime rich. Why? Because a larger fraction of their labor earnings would otherwise be subject to payroll taxation.

A business cash-flow tax represents an indirect way of taxing consumption. The current poor elderly living on Social Security benefits will 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. So if the consumption tax causes prices to rise, their Social Security benefits will rise proportionately. The middle-class and rich elderly as well as middle-aged and younger members of society will jointly bear the burden of the tax. For young and middle-aged workers, the overall tax burden will decline since they will no longer pay the Social Security payroll tax. For the economy as a whole, the tax change is revenue neutral, with the business cash-flow tax simply replacing the Social Security payroll tax. Simulation analyses show that poor members of current middle-aged generations, of current young generations and of future generations have the most to gain from privatizing Social Security.

*“The poor have the most to gain from privatizing social security.”*

## Conclusion

The Social Security system does many important things. It forces us to save and to insure and protects us from running out of money in old age. But the system was financed from the start as a pyramid scheme and the pyramid is crumbling. We now have two options. We can try to con our children and grandchildren into adding more stones. Or we can act like adults and reform the system that imperils our offsprings' financial well-being. In considering these two options, we should bear in mind that Social Security's long-term financial imbalance is part of a bigger fiscal disaster that we have organized for our children.

By fully privatizing Social Security's retirement program along the lines outlined above, we can correct our errors responsibly. The PSS proposal achieves all the legitimate goals of Social Security, forcing us to save, protecting dependent spouses, assisting the poor and providing retirees with inflation-protected pensions. It also gives American workers 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 retire the liabilities of the current system and ensure real social security for our children.

*“Social Security’s long-term financial imbalance is part of a bigger fiscal disaster that we have organized for our children — but we can correct our errors responsibly.”*

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

## Notes

<sup>1</sup> *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Washington, D.C., April 1998.

<sup>2</sup> Jagadeesh Gokhale, Benjamin Page and John Sturrock, "U.S. Generational Accounts: An Update," *The Review of the Federal Reserve Bank of Cleveland*, Spring 1998.

<sup>3</sup> Of course, current law could change. But achieving generational balance – a situation in which our descendants face the same lifetime net tax rates as we face – would require changes in fiscal policy that go far beyond anything now being discussed in Washington. For example, the ways of creating generational balance include cutting all current and future government purchases by one fifth, raising federal income taxes immediately and permanently by one-quarter, or cutting all Social Security, Medicare and other transfer payments immediately and permanently by one-fifth.

<sup>4</sup> Jagadeesh Gokhale and Laurence J. Kotlikoff, "Medicare from the Perspective of Generational Accounting," paper presented at program on "Medicare Reform: Issues and Answers," April 3, 1998, Texas A&M University.

<sup>5</sup> See Jagadeesh Gokhale, Laurence J. Kotlikoff and John Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," *The Brookings Papers on Economic Activity*, 1996.

<sup>6</sup> This estimate and the ones that follow are based on the intermediate assumptions.

<sup>7</sup> The remainder of this paper draws heavily on my June 3, 1998 testimony to the House Ways and Means Subcommittee on Social Security entitled "Privatizing Social Security the Right Way."

<sup>8</sup> See Steven Caldwell, Melissa Favreault, Alla Gantman, Jagadeesh Gokhale, Thomas Johnson and Laurence J. Kotlikoff, "Social Security's Treatment of Postwar Americans," forthcoming in *Tax Policy and the Economy*, NBER volume, MIT Press, 1999. The study does not consider Social Security's disability insurance (DI) program.

<sup>9</sup> It does so taking into account Social Security's earnings test, family benefit maximums, actuarial reductions and increases, benefit recomputation, eligibility rules, the ceiling on taxable earnings and legislated changes in normal retirement ages.

<sup>10</sup> Baby boomers are projected to lose roughly 5 cents of every dollar they earn in net Social Security taxes (taxes minus benefits). Generation Xers and today's children will lose over 7 cents of every dollar they earn in net taxes.

<sup>11</sup> If taxes were raised immediately by the amount needed to pay for benefits on an ongoing basis, baby boomers would forfeit 6 cents of every dollar they earn in net taxes. Those born after the baby boom would forfeit 10 cents of every dollar they earn.

<sup>12</sup> 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.

<sup>13</sup> These programs also need to be reformed to hold their costs to the levels of their tax receipts. However, whether privatization of these programs is the best method to achieve this objective is a subject for another paper.

<sup>14</sup> In Chile, much of the management fee goes to marketing efforts to attract accounts. Chileans can move accounts from one pension company to another.

<sup>15</sup> Laurence J. Kotlikoff, Kent Smetters and Jan Walliser, "The Economic Impact of Privatizing Social Security," mimeo, Boston University, June 1997.

## About the Author

**Laurence J. Kotlikoff** is Professor of Economics at Boston University, Research Associate of the National Bureau of Economic Research, Fellow of the Econometric Society and a member of the Executive Committee of the American Economic Association. He received his B.A. in Economics from the University of Pennsylvania in 1973 and his Ph.D. in Economics from Harvard University in 1977. From 1977 through 1983 he served on the faculties of economics of the University of California at Los Angeles and Yale University. In 1981-82 Professor Kotlikoff was a Senior Economist with the President's Council of Economic Advisers. Professor Kotlikoff has served as a consultant to the International Monetary Fund, the World Bank, the Organization for Economic Cooperation and Development, the Swedish Ministry of Finance, the Norwegian Ministry of Finance, the Bank of Italy, the Bank of Japan, the Government of Bolivia, the Treasury of New Zealand, the Office of Management and Budget, the U.S. Department of Education, the U.S. Department of Labor, the Joint Committee on Taxation, the American Council of Life Insurance, Merrill Lynch, Fidelity Investments and other major U.S. corporations. He has provided expert testimony on numerous occasions to committees of Congress including the Senate Finance Committee, the House Ways and Means Committee and the Joint Economic Committee. Professor Kotlikoff is coauthor (with Alan Auerbach) of *Macroeconomics: An Integrated Approach*; author of *Generational Accounting, What Determines Savings?*; coauthor (with Alan Auerbach) of *Dynamic Fiscal Policy*; coauthor (with Daniel Smith) of *Pensions in the American Economy*; and coauthor (with David Wise) of *The Wage Carrot and the Pension Stick*. He also has published extensively in professional journals, newspapers and magazines on issues of deficits, generational accounting, the tax structure, social security, pensions, saving and insurance. Professor Kotlikoff is an Associate Editor of the *Japanese Economic Review* and a former Associate Editor of the *American Economic Review*.

## About the NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute funded exclusively by private contributions. The NCPA developed the concept of Medical Savings Accounts, which were part of the 1996 health care bill passed by Congress and have been adopted by a growing number of states. Many credit NCPA studies of the Medicare surtax as the main factor leading to the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, that a capital gains tax cut will increase federal revenue and that the federal government gets virtually all the money back from the current child care tax credit. Its forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The Republican Contract with America included the pro-growth tax changes recommended by the NCPA and the U.S. Chamber of Commerce as early as 1990. The NCPA produced a first-of-its-kind, pro-free enterprise health care task force report, written by 40 representatives of think tanks and research institutes, and a first-of-its-kind, pro-free enterprise environmental task force report, written by 76 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. According to NCPA reports:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in the environment.

### What Others Say about the NCPA

*“...influencing the national debate with studies, reports and seminars.”*

— **TIME**

*“...steadily thrusting such ideas as ‘privatization’ of social services into the intellectual marketplace.”*

— **CHRISTIAN SCIENCE MONITOR**

*“Increasingly influential.”*

— **EVANS AND NOVAK**

Privatizing Social Security will put billions of dollars into the pockets of Wall Street financial services corporations in the form of brokerage and management fees. Private Social Security accounts will be a boon to Wall Street, where banks and investment advisors could receive over \$100 in fees for each account. Social security should not be privatized because it privatization makes it easier for companies to scam older adults without appropriate government oversight. I believe the privatization of social security would be harmful because of the lack of government oversight. Companies would try to increase their own profits by exploiting older adults, especially those who are unable to navigate a more complicated, privatized industry. Privatizing Social Security will escalate federal deficits and debt significantly while increasing the likelihood that national savings will decline-all of which could reduce long-term economic growth and the size of the economic pie available to pay for the retirement of the baby boom generation. The 2004 Economic Report of the President's commission. Privatization Controversy. Privatizing Social Security has proved highly controversial. Americans are generally reluctant to support the privatization of Social Security. So many of us depend on Social Security in our old age and don't want to add more risk to the equation. Proponents of privatization via individual investment accounts argue that the reform would give Americans more control over the money that comes out of their paychecks in payroll taxes. Privatizing Social Security fills this void by studying the methods and problems involved in shifting from the current system to one based on mandatory saving in individual accounts. Get permission to reprint part of this book Purchase Book. Table of Contents. Front matter, table of contents, preface. Author(s): Martin Feldstein. Introduction to "Privatizing Social Security". Author(s): Martin Feldstein (p. 1-29).