Privatization of Social Security in the United States: Magic Bullet or Sleight of Hand?

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The social security system in the United States is racing towards its own death. In 35 years the number of Americans over age 65 is expected to double, while the number of new workers will likely decline. As a result, the Social Security Trust Fund, which relies on current taxes to pay benefits, is predicted to deplete its resources by 2029. The program long considered untouchable by politicians is now in desperate need of meaningful reform. This paper reviews the importance of social security and examines its likely future. It briefly examines options put forth to reinvigorate the system, focuses on the potential of social security privatization, and concludes with a solution which is both politically feasible and fiscally responsible.

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The Funding Dilemma

Demographers tracking the United States population have chronicled what many would consider to be extraordinarily good news. In the past 60 years, the average life expectancy for people reaching the age of 65 has leapt from 12.6 to 17.5 additional years of life. By 2030, those who reach 65 years of age can, on average, expect to enjoy an additional 19 years (Kerrey 1994, 14). This trend, together with the aging of the "baby boomers," will double the number of Americans over age 65 in the next 35 years (U.S. Bureau of the Census 1995, Table 17). Demographers have also observed a decline in the birthrate over this period and anticipate further declines (U.S. Bureau of the Census 1995, Table 4; U.S. Bureau of the Census 1975, Table B1-4). Most would consider this to be good news as well.

Taken together, however, these trends are extremely bad news for those responsible for maintaining the health of the Social Security Trust Fund. The social security system in the United States is an unfunded, or pay-as-you-go, system. Tax revenues collected from current workers are used to pay the benefits of current retirees. Under this framework, the number of workers per retiree, or support ratio, determines the burden on those workers.

The support ratio has fallen dramatically over time and is expected to continue its downward trend. In 1950, there were 16 workers for each recipient of social security. Today there are only 3.2 workers per retiree. The Board of Trustees of the Social Security Trust Fund predicts that by 2030 only 2 people will be contributing to the Fund for each dependent retiree (Board of Trustees 1995, 122).[1] Anticipating the declining support ratio, Congress has sharply increased social security tax burdens in the past 20 years. Table 1, which presents total tax liabilities in constant 1995 dollars, provides evidence of the magnitude of the rise in taxes necessary to keep up with the dwindling support ratio.

The relatively high present-day taxes yield revenues which exceed annual obligations of the Trust Fund, thus providing a surplus for the federal government. This strategy was planned with the goal of raising revenue necessary to provide for the "baby boom" generation, those born following World War II and into the mid-1960s (1946–1964). Most baby boomers will retire between the early 2010s and the early 2030s, significantly boosting the government's fiscal responsibilities. The trust fund surplus is expected to peak in 2013 at about $1.3 trillion (in constant

Table 1. Old Age and Survivors Insurance, Tax Rates and Taxable Income in Constant Dollars.

Year	Tax Rate	Maximum Taxable Income (1995 constant dollars)	Maximum Tax (1995 constant dollars)
1937	2%	$31,917	$638
1951	3%	$21,212	$636
1971	8.10%	$29,505	$2,390
1991	11.20%	$60,065	$6,727
1995	10.52%	$61,200	$6,438

Source: 1993 Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance

1984 dollars) (Subcommittee on Social Security 1994, 53), but will then begin a steady decline as more baby boomers retire and the support ratio continues to fall. As the government continues to pay out more than it collects in taxes, it will deplete this large surplus. Intermediate estimates by the Social Security Trust Fund's Trustees predict that by 2029 the Fund will be insolvent and the government will have to provide general funding or raise taxes to support continued benefit payments (Subcommittee on Social Security 1994, 47).

These predictions have led many workers to question whether they will ever see the money which is currently being taken from their paychecks. Critics of the system have labeled social security a "Ponzi scheme"—paying off early investors with the money of later investors, who typically get little or no return from their investment (Genetski 1993). More telling than such name calling are the results of a recent survey of 500 Americans ages 18 to 34:

- Eighty-seven percent of young people do not think the social security system will have the money available to provide them benefits when they retire.
- Nearly two-thirds of young people surveyed do not believe Social Security will even exist by the time they retire.
- Almost twice as many young people believe in unidentified flying objects (UFOs) as believe in the long-term existence of the social security system (Subcommittee on Social Security 1994, 124).

At best, the long-term vitality of the social security system is uncertain. This paper reviews the importance of social security and examines its likely future. Given constraints imposed by the goals of social security and political considerations, the paper briefly examines options which have been put forth to reinvigorate the system. The paper focuses on the promise and problems of one option, social security privatization, and concludes with a solution which is both politically feasible and fiscally responsible.

Why Do We Have Social Security?

Over 60 years ago, President Franklin D. Roosevelt unveiled his plan for a system which would "take care of human needs and at the same time provide the United States an economic structure of vastly greater soundness" (Social Security Administration 1996). Initially set up to supplement retirement funds, the program quickly came to be seen as an effective social program to raise the living standards of older Americans. The poverty rate among the elderly has declined from 35 percent in 1959 to 13 percent in 1994. Without these benefits, the Social Security Administration estimates that the rate of poverty among the elderly would likely approach 50 percent (Kunerth 1995).[2]

Social security is only designed to serve as a floor of income protection. In what has been called a "three-legged approach," private pensions and personal savings and assets are meant to serve as the primary means of income upon retirement, with social security benefits providing supplemental assistance (Subcommittee on Social Security 1994, 100). As President Eisenhower explained, "The system is not intended as a substitute for private savings, pension plans, and insurance protection. It is, rather, intended as the foundation upon which these other forms of protection can be soundly built" (Social Security Administration 1996). The federal government provides this essential foundation at a minimal cost. The system transfers billions of dollars ($323 billion in 1994) at an administrative cost of less than 1 percent of the benefit expenditures (Papian 1995).

The social welfare aspect of the program cannot be overlooked; social security plays a crucial role in maintaining a good standard of living for older Americans. This is especially the case for poorer individuals, who may not have had opportunities to contribute to pension plans or amass large savings. Today, social security benefits provide 90 percent of the total income for over a quarter of the elderly and for 14 percent of those

receiving social security payments, it is the sole source of income (Seffers 1995). However, the poor are not the only ones who benefit from social security. Among nonpoor elderly families, nearly one-third of income is derived from social security. These benefits have been largely responsible for the rise in income among the elderly in recent years, as the per capita median income has risen from $3,408 in 1975 to $11,032 in 1992, yielding a 24 percent increase in real purchasing power for this age group (Subcommittee on Social Security 1994, 60). This rise in income is even more dramatic when viewed in conjunction with downward trends in contributions to private retirement funds: "employer contributions dropped 51 percent between 1980 and 1991 while total private pension contributions dropped 22 percent between 1985 and 1991 (in constant dollars)" (Hershey 1995, D2).

The progressive nature of the social security system serves twin goals: adequacy and equity (Subcommittee on Social Security 1994, 70). The adequacy goal seeks to ensure that those with the lowest income will have sufficient resources upon retirement. The equity goal seeks to help those who earned more in their lifetimes sustain the quality of life they have come to enjoy. Although the current social security tax structure, with a uniform tax which only applies to the first $61,200 in earnings, is clearly regressive,[3] the redistribution of these funds favors those who earned less during their working years. For example, a retired worker who consistently earned one-half of the earnings of the average worker receives roughly 65 percent of the average benefit. In contrast, someone who consistently earned 50 percent more than the average worker receives about 30 percent more than the average benefit (Subcommittee on Social Security 1994, 30).

The State of Social Security Today

The U.S. Social Security program, by many accounts the country's most effective social program, appears to be speeding towards insolvency. Legislators have long realized that drastic reforms would be needed to maintain the baseline social security benefits. However, unlike recipients of most social programs, social security recipients are heterogeneous, vocal and politically powerful.[4] This distinction has earned social security the reputation of being "the third-rail of American politics" (you touch it and you're dead).[5] Indeed, most presidential candidates in the current election cycle, have refused to discuss how they would breathe new life

into the social security system. As *Time* magazine concluded in a recent cover story:

> The problem is the sort that representative governments are not good at solving: a potential disaster that can be clearly foreseen but is not imminent, and that can be escaped only by accepting some present pain as the price of avoiding much worse future pain. So long as the crisis is not about to burst next month, Democrats will see political profit in portraying any proposal to change social security as a Republican conspiracy to starve the poor and elderly. Republicans will think the only defense is to swear eternal fealty to the system as it is. Whether both parties can overcome the impulse to demagoguery and agree on some reasonable reforms poses nothing less than a severe test of democratic government (Church 1995).

Despite the existence of such political obstacles, Congress has successfully instituted reforms in the past to maintain the health of the system. In 1977 Congress approved a payroll tax increase to be phased-in over the following 12 years and a new indexation structure which more accurately reflected the impact of inflation. In 1983 Congress acted to reduce the rate of growth in social security benefits, increase the tax rate once again and reduce benefits to those who retire before age 65. This legislation also increased the age at which people become eligible for full benefits, which had not been altered since the Social Security Act was passed in 1935. In addition, the 1983 legislation made one-quarter of income received from the Trust Fund subject to taxation. This was boosted to 85 percent in 1993 (Gokhale 1995).

Further changes along these lines present opportunities to prolong the solvency of the Trust Fund. Legislation passed in 1983 established an increase in age of full eligibility, beginning to increase gradually from age 65 in 2003 and reaching age 68 by 2017 (Passell 1996). Given the large increase in life expectancy since the original social security legislation was passed, a more rapid extension of the retirement age may be justified.

Cost-of-living adjustments, which have also been modified in the past, have also come under scrutiny in recent months. A number of prominent economists, including Federal Reserve Board Chairman Alan Greenspan, have suggested that the current method of calculating inflation and the corresponding cost-of-living adjustment overstates true inflation by as

much as 1.5 percentage points (Driscoll 1995). Reducing the cost-of-living adjustment would offer a second mechanism to provide partial relief.

While such measures may offer effective short-term solutions, more fundamental changes must be made to the social security system if it is to continue to serve as a floor on retirement income into the next century. Additional tax increases may be politically difficult to implement and big cuts in benefits may not be feasible in the present political climate. Several legislators have offered more unconventional solutions that they believe have the potential to reform the system in a way which both taxpayers and retirees would endorse.

Legislation submitted by Senators Kerrey and Danforth, Senator Simpson and Representative Porter all rely on a mix of conventional reform proposals, as well as a unifying element which has not been seriously considered in the past.[6] All three proposals suggest that taxpayers should have greater control over a portion of their social security contributions. While none of the proposals eliminate the taxpayers' obligation to provide contributions to the Social Security Trust Fund, they all reduce the obligation slightly and replace it with a private savings requirement. These reforms, as well as others put forth by academics and private sector experts, have sought to "privatize" the social security system to varying degrees.

Privatization as a Solution

Proposals to rebuild the social security system take a number of forms, ranging from a slight shift in government responsibility to the elimination of government involvement in the social security system. Most of these proposals for privatization fall into two broad categories: those that aim to improve the investment performance of the Social Security Trust Fund and those that give individuals more control over the money they contribute to the Fund. Proponents of privatization plans claim that allowing alternative investments will result in higher rates of return, which will stimulate economic growth and postpone the expected insolvency date.[7] In addition, they argue that privatization would remove the growing surplus from the government's control, thus promoting greater fiscal responsibility.

This latter advantage, that gained from removing the surplus from government control, deserves elaboration. In anticipation of the jump in the number of social security recipients brought about by the retirement

of the baby boomers, Congress increased the tax burden to build up a stock of reserves in the Social Security Trust Fund. By law, these funds must be invested in a special class of U.S. Treasury securities. However, under the unified budget system used by the government, all cash receipts are used to meet current expenditures, with excess contributions used to reduce the size of the federal budget deficit. If the Social Security Trust Fund surpluses were not used in this manner, this year's budget deficit would be more than $250 billion, rather than the official figure of slightly less than $200 billion (Marlowe 1995).

Many have argued that this system makes it easier for the government to act in a fiscally irresponsible manner, since the true gap between receipts and expenditures is partially hidden from public view. To the extent that lawmakers perceive these funds to be available for additional current spending (at an artificially low cost), the provision of future benefit payments, which are dependent on the surpluses currently being accumulated, may be problematic. While this does not present a flaw in the social security system, the effect of this budgeting practice should be considered in any reform efforts.

A second aspect of the present system which allows fiscal irresponsibility is the way in which assets in the Social Security Trust Fund are used to finance government debt. Debt is a way of lowering taxes on current generations in exchange for a promise to tax future generations more heavily. Social security similarly "borrows" from the current young in exchange for a promise to repay them when they are old. The key difference is essentially a legal one. It is easier for the government to default partially on social security payments than to default partially on debt payments. While social security payments can be lowered in a variety of ways, debt service can only be lowered in real terms through inflation. From this perspective, the social security system can be seen as a low-cost borrowing mechanism for the government (Rogoff 1996).

Improving the Investment Performance of the Social Security Trust Fund

One method to privatize social security would be to allow the government to invest the surplus in private securities which can be expected to yield higher returns than the special Treasury issues in which the surpluses are currently invested. In addition to the potential of increasing the yield of assets in the Social Security Trust Fund, separating the Trust Fund money

from the budget would force the Treasury to borrow more from the public, permitting a more accurate assessment of the budget deficit.

These supposed benefits are outweighed by the negative aspects of allowing such private investment. The primary argument for investing the trust fund in private securities, the opportunity to gain higher returns, is flawed in several ways. While it is true that returns on Treasury securities have historically been poorer than those of stocks and bonds, the variance of the return has been significantly smaller for Treasury securities. In fact, between 1926 and 1992, common stocks have had negative returns in 20 years and corporate bonds have yielded negative returns in 17 years. In comparison, the return on Treasury Bills exceeded the rate of inflation in every year but one (Rubenstein 1995). Investors must be willing to face a higher level of risk in order to achieve higher returns. While a diversified portfolio would likely achieve a better risk to return ratio, most people tend to be risk-averse with their retirement savings (Subcommittee on Social Security 1994, 27). By keeping the surplus in Treasury securities, the government provides sound insurance against market uncertainties and ensures that even if the other two legs of retirement funding collapse, the floor of social security will still be available.

Even if concerns about risk could be set aside and private investments of Social Security Trust Funds did achieve a greater rate of return, such investment might not be welcomed by the financial community.[8] In recent testimony, Robert Reischauer, then Director of the Congressional Budget Office, noted that, absent growth in the economy, "better investment performance of the Trust Fund would reduce income earned by other investors, in precise proportion to the amount that it increased returns to the Fund" (Subcommittee on Social Security 1994, 25). Further, the government may not be able to evaluate market risks and opportunities as well as private investors, so it might choose investments which have less appealing risk-return ratios (Subcommittee on Social Security 1994, 25).

Even if a small portion of the Social Security Trust Fund is invested in the private market, the magnitude of the Trust Fund surplus could result in large scale government ownership of the private sector. For example, if just three-eighths of the social security tax were invested in mutual funds today, this market would more than double in size (Wyatt 1996). Such widespread public ownership of the private sector runs counter to the interests of many who support social security privatization and poses potential market difficulties.[9]

An additional danger of permitting the government to invest its large surpluses in vehicles other than Treasury securities is the likelihood of politicization of investments. Any attempts by legislators or the administration to direct government investments to their states, districts, or political supporters would result in the inefficient allocation of these funds. This problem can potentially be avoided by allowing private fund managers to invest the assets.

Last, concern over fiscal responsibility could be addressed by simple changes in budgeting. For example, a "firewall" could be placed between social security surpluses and the general budget for fiscal decisions. While social security surpluses could still be used to support the deficit, this modification in bookkeeping would force the true budget deficit to be revealed to the public.

Private investment of the Social Security Trust Fund does not seem to offer a viable alternative to the current system. The likelihood of a higher yield is far from assured, and a host of other factors all lead to the conclusion that such funds are best held by the Treasury. In contrast, the second option, giving taxpayers more direct control over their social security contributions, is not conducive to such a straightforward analysis.

Giving Individuals More Control Over Their Social Security Funds

There are a number of ways in which individuals can be given more control over their social security contributions. At one extreme, the government could eliminate the social security tax and urge workers to save enough to provide for their own retirement. A more moderate approach would preserve the government's role as the provider of a safety net, but would allow workers greater discretion as to how their taxes are invested. In 1981, Chile adopted this type of retirement system. Chile's experience is reviewed below, followed by a discussion which focuses on issues which must be considered if the United States were to adopt a similar system.

The Chilean Experience

In the late 1970's, Chile's pay-as-you-go social security system, similar to the present-day system in the United States, faced mounting difficulties. The support ratio had fallen from eight workers for every retiree in 1960

to two workers for every retiree by 1980. The falling support ratio coupled with inefficiencies in the system hastened the need for reform. In 1980 the government was forced to provide a subsidy of 29 percent of total social security revenues to maintain promised benefit levels. Absent changes in revenue and expenditure patterns, the required subsidy was expected to jump tenfold by 2000 (Santamaria 1992, 40).

In 1981 the Chilean government took the unprecedented step of allowing employees to divert their social security taxes to a limited number of private investment funds. Those who chose to participate in the new system were given "recognition bonds" which provided an amount roughly equal to their total previous contributions.[10] Those who chose not to participate in the program—primarily older workers—were able to continue payments to the old system, but at a higher tax rate. In addition, employers were no longer asked to pay social security taxes, but were instead required to grant a one-time 18 percent wage increase to their employees.[11]

Employees who chose to participate in the new system were still obligated to contribute to their retirement. However, they were now able to invest their mandatory contributions with newly formed private institutions called Administradoras de Fondos de Pensiones (AFPs). Participants' recognition bonds were transferred directly to these privately managed pension funds. This tangible income transfer provided workers with some immediate satisfaction and confidence in the new system. The government did not leave the retirement security business altogether. In addition to maintaining the pared-back social security system for those who chose not to join the privatized system, the government provided a safety net which offered a minimum pension to retirees who had not amassed pensions which would provide income equivalent to 85 percent of the minimum wage (Santamaria 1992, 41).

By most measures, Chile's privatization has been a resounding success. The national savings rate increased significantly in the decade following the implementation of the privatized social security system (Gluski 1994, 62). Approximately 90–95 percent of the formal Chilean workforce had switched to the new system by 1992 (Borden 1995). These workers have seen their retirement pensions grow to 50 percent of the country's GDP, and expect the value of the assets to surpass the Chilean GDP by 2005 (Klein 1994, 50). Seventeen AFPs compete for retirement funds on the basis of investment return and service. These investment funds have recently grown at a real average rate of nearly 13 percent, while the real annual interest rate paid on short-term deposits has been slightly above

5 percent (Chile Country Profile 1995, 35). The government maintains a strong presence in the retirement industry by mandating financial and investment requirements for the AFPs and by closely monitoring their behavior.

Marco Santamaria studied the Chilean case and found that the privatization reduced inefficiencies, enhanced equitability, and provided larger benefits relative to the previous system. In addition, the private social security system increased net wages while lowering labor costs and decreasing long-term government expenditures. He further concluded that the effects on overall saving were uncertain; the increase in private saving has been offset by dissaving by the government due to a gap between receipts and obligations (1992, 41–47).

Before attempting to duplicate Chile's success elsewhere, it is important to examine the mechanics of the transition period and flaws in the present day system. Chile's government, under the dictatorship of Augusto Pinochet, operated under a budget surplus in the years prior to privatization. These surplus funds, in addition to revenue earned from the large scale privatization of state-owned industries, provided the necessary capital to fund the expensive transition.

It is unlikely that the high rates of return enjoyed by the present-day system will be sustained. Indeed, critics of the Chilean model expect a 3 percent real rate of return in the medium- to long-term while supporters contend that a 5.5 percent long-term rate of return can be achieved (Subcommittee on Social Security 1994, 117). Further, administrative costs have been notoriously high. These costs have fallen in recent years, but remain at nearly 25 percent of total contributions (Subcommittee on Social Security 1994, 117). In addition, the government relies largely on general revenues to continue its support of the old social security system as well as the safety net (Roberts 1995, 25).

Nonetheless, a number of countries hope to emulate Chile's success. Other South American countries—including Argentina, Brazil, Bolivia, Columbia and Peru— are considering similar plans, and Australia, Mexico and the United Kingdom have expressed interest in partial privatization of their social security systems (Feldstein 1995, 2; Social Security: U.S. Should Copy Mexico's Tentative Reform 1995; and Gokhale 1995). As discussed above, this same idea has recently attracted a great deal of interest in the United States. The balance of the paper will examine the prospects for such a system in the United States and conclude with a plan for reform.

Problems and Potential of Giving Individuals More Control Over Their Social Security Funds in the United States

Transition Challenges

Perhaps the most challenging aspect of switching from the current system to a privatized one is how to shoulder the burden of the transition costs. The existing social security system is in financial distress and is expected to become insolvent by 2029. Any plan which decreases the quantity of contributions being paid to the Social Security Trust Fund would exacerbate the already dismal situation.

The transition could be modeled after Chile's. Special government bonds could be issued to each worker which would be equal to previous contributions plus accrued interest. Chile overcame transitional difficulties by relying on government surpluses and the privatization of government-owned industries. However, these funds alone were not sufficient. The government continues to rely on general funds to supplement contributions in order to provide benefits for those who did not choose to enter into the privatized system and provide a safety net for those whose investments are not successful. The United States, which is unlikely to run a budget surplus at any point in the near future and has few resources which could be readily privatized, would probably face severe financial difficulties in funding the transition.

The magnitude of the potential shortfall would cause even the most zealous advocates of privatization to wince. Last year, the Social Security Trust Fund paid out nearly $350 billion in benefits. The real value of benefits will rise as baby boomers begin to retire and people continue to enjoy longer lives. If the social security system were completely privatized, the Social Security Administration estimates that the federal government would have to provide a staggering $8 trillion in new revenues to fund the transition between the present day system and one which relies on personal retirement accounts (Hage 1995).

Martin Feldstein recently offered an economic justification for incurring the transition costs. His research has shown that the deadweight loss associated with distortions of labor supply and the form of compensation due to the payroll tax amount to roughly one percent of the U.S. GDP. He contends that privatization reduces deadweight loss in perpetuity and provides opportunities for individuals to earn a higher rate of return on their retirement savings. Given these mutually reinforcing effects, a

program could be designed that spreads the cost of transition over several generations and makes each successive generation slightly better off (Feldstein 1996, 27).

However, in his analysis Feldstein appears to neglect the portion of the deadweight loss that would be maintained if the transition is financed through taxes. Even if the plan worked in theory, the practical implementation could be extremely difficult. As Feldstein himself acknowledges, "although debt financed privatization of social security implies very large gains in the present value of consumption, a majority of the adult population (i.e., employees and retirees) alive at the time of the privatization might be made worse off. If so, their opposition could make privatization politically impossible" (Feldstein 1995, 23).

A related avenue of research explores the likelihood "that some individuals, because of their age, financial circumstances, and preferences, would be willing to forego their current claims on social security benefits without explicit compensation and to increase their total saving in exchange for not having to contribute to the pay-as-you-go program in the future" (Feldstein 1996, 28). Feldstein's preliminary research in this area suggests that it might be possible to shift workers from the current unfunded system "to a privatized funded system without raising taxes or reducing national saving" (Feldstein 1996, 28). While this sounds suspiciously like a "free lunch," future research may provide more concrete details concerning how to tackle this difficult issue.

Greater Riskiness

Today, the Social Security Trust Fund is invested entirely in Treasury securities which are backed by the "full faith and credit of the federal government." The risk-free nature of government securities protects the safety net which social security provides. Any deviation from the current system would introduce several types of risk.

One type of risk, that inherent in investments which yield higher returns, has been discussed above. While stocks and bonds have historically performed better than Treasury securities, high variability in returns could pose significant threats to the security of retirement investments. Further, the high historical returns of stocks and bonds have been observed over an extended time period, one substantially longer than the time frames of most investors. Indeed, a market crash or severe downturn in the economy could leave an entire generation without the means of retiring at a reasonable standard of living. Efforts could be made

to minimize this risk. For example, investments of retirement savings could be restricted to broad index funds. However, as Reischauer notes, "such rules would also reduce the possibility of high returns and would give individuals little latitude in managing their retirement assets, thus undermining one of the goals of [a privatized system]" (Subcommittee on Social Security 1994, 29).

Several additional risks are associated with the ability of investors to convert their retirement savings into an annuity. As investors prepare for retirement, they will want to convert their investments into a stream of payments. Poor market performance at the time of this conversion could significantly reduce funds available for investment (Subcommittee on Social Security 1994, 29). Even if the markets are strong when investors convert their funds, it may be difficult for them to purchase an annuity which is priced at an actuarially fair level because of adverse selection problems faced by those offering annuities. If some workers decide not to purchase an annuity and instead rely on accumulated savings, uncertainty concerning the number of years which the savings must last may cause the retirees to live on an overly tight budget or deplete their savings too quickly. Last, the administrative burden of maintaining a large number of small accounts could be severe (Subcommittee on Social Security 1994, 29). The burden of these risks and uncertainties is currently borne by the social security system, which provides a subsistence income regardless of the state of the market and the length of the recipient's life, at an extremely low administrative cost (Subcommittee on Social Security 1994, 29).

Even if people were given the opportunity to privately invest their social security contributions, it is unclear whether these investments would yield markedly higher returns. The vehicles available for retirement investment today (401(k) plans and self-directed retirement funds for federal workers, teachers and professors) tend to be heavily invested in low-risk securities which generate fixed incomes (Subcommittee on Social Security 1994, 27). Only one-third to one-half of these retirement funds is invested in equities or stock mutual funds, which tend to yield higher returns but also face greater risks. If this preference for less risky but lower-yielding investments applies equally to individuals' decisions concerning retirement investments, resources available for future retirees are unlikely to increase (Subcommittee on Social Security 1994, 27).[12]

Decreased Progressivity

The progressive nature of today's social security system assures that equity and adequacy considerations will be satisfied. The system is equitable in that it provides those who contributed more over their working lives with greater benefits in absolute terms, but relatively less in proportional terms. At the same time, it ensures adequacy since the distribution of benefits is progressive rather than proportionate. However, as larger percentages of contributions are invested in private retirement accounts, the system becomes less progressive. In the extreme case, in which all contributions are invested in private retirement accounts, the progressive nature of the system would be eliminated. Further, low-wage workers, who may be more risk-averse in their investments, will likely achieve lower than average yields (Subcommittee on Social Security 1994, 30). This form of privatization would therefore deviate strongly from the progressive goals of social security. Solutions are available to maintain the progressivity of retirement benefits as long as the system is not entirely privatized, but these would entail large scale government involvement and would likely be quite complicated.

Adverse Selection During the Transition

If those people currently funding the pay-as-you-go system are given the option of switching to a privatized system, as they were in Chile, adverse selection problems are likely to be severe. Those who are most likely to opt out of the current system would be young, high wage earners who contribute the maximum tax to the trust fund. This group pays high taxes but receives proportionately less benefits when they retire under the current progressive system. "Those most likely to remain would include a disproportionate number of low-wage, low-tax workers, who rarely have jobs that come with good pensions" and who would have difficulties saving money for retirement (Church 1995). This could place a severe strain on an already overburdened system. Further, any additional taxes would place an onerous burden on poorer individuals, most of whom already pay more social security tax than federal income tax (Church 1995). The classic solution to the adverse selection problem is mandatory participation. However, unless the government requires enrollment in the new program, this problem will be difficult to avoid during the transition period.

Moral Hazard and the Government's Safety Net

Assuming that the government maintains its commitment to provide a safety net for the elderly which prevents them from falling into poverty, a privatized system could present moral hazard problems. If individuals know that the government will always rescue them with a safety net program, they have a diminished incentive to save and a greater incentive to invest in risky assets. The degree to which investors pursue this strategy depends largely on the generosity of the government in its benefits. Since it is unlikely that the government would be able to provide anything more than the most basic benefits, this probably would not pose a major problem.

Inefficiencies in Private Administration

The present social security system is efficient, with a total administrative expense as a percent of all social security benefits of 0.9 percent. This is due in large part to mandatory participation in the program and the use of relatively simple investment instruments. In contrast, 25 percent of contributions in the Chilean system are used to cover administrative expenses. Private pension funds in the United States, which put 10 percent of every pension fund dollar toward administrative expenses, are more efficient than the Chilean system but are still inferior to the existing social security system (Subcommittee on Social Security 1994, 116). The feasibility of any large scale private retirement program would depend in part on lowering these high administrative costs.

Where Does This Leave Us?

Chile's success with privatization of their social security system offers an excellent case to examine, but does not provide a plan which could be duplicated successfully in the United States. By allowing private investment of funds designated for retirement, incomes would be shifted in unpredictable ways. Some people would be made better off and others worse off. Barring an increase in savings rates, these shifting funds would simply cancel each other out, yielding no net improvement in social welfare (Subcommittee on Social Security 1994, 27). Further, short-term trends in markets could distort retirement decisions and leave some individuals with far fewer resources than they anticipated.

Chile was able to bear the enormous transition costs associated with a shift from the pay-as-you-go system to a privatized retirement system

largely because of its consistent budget surpluses and income earned from privatization of major industries. Transition would be considerably more difficult for the United States. Future research may reveal opportunities to implement a transition in a way such that the long run benefits of switching outweigh the costs, but no concrete mechanism is available at this point.

Problems with adverse selection and moral hazard could plague a system similar to Chile's unless participation is mandatory and the safety net provided by the government is minimal. Further, inefficiencies in the administration of private savings relative to the existing system make privatization less attractive. While giving workers greater control over their retirement income may be effective in developing countries with economies similar to that of Chile, full privatization of the social security system in the United States would likely be problematic.

The Potential of a Partial Privatization Plan

Before examining details of how the U.S. social security system can be improved, one should examine what underlying changes in the American economy are needed to provide long-term prosperity for workers and retirees. The key lies in bolstering the low savings rate in the United States. As Reischauer explained, "If we don't increase total national saving, which means private saving as well as reduced government dissaving, we will not have a larger pie in the future out of which to provide benefits for the retired population and wages and income for the working population" (Subcommittee on Social Security 1994, 32). Increasing the savings rate is not an unreasonable goal. The savings rate in the United States, which surpassed 8 percent of disposable personal income in the 1970s, has hovered below 5 percent since the late 1980s. This rate is substantially lower than that of most developed countries. For example, in 1993, savings as a share of disposable personal income was over 14 percent in France, Italy and Japan and over 10 percent in Canada, Germany and the United Kingdom (1994 Handbook of Economic Statistics 1994, Table 25).

The following Savings and Social Security Reinvigoration Plan (SRP) would address the need to enhance savings rates and revive social security. The success of the SRP would depend on the implementation of a comprehensive package. Basic changes to the current social security system would include the following:

- A more rapid increase in the retirement age than currently planned, with a higher (age 70) target age. Life expectancy has increased greatly since the social security system was put in place in 1935, yet the retirement age has only been altered slightly.
- A 2 percent Personal Retirement Contribution (PRC) would be added to the existing tax burden, split 75/25 between the employee and the employer. The PRC would be levied on the entire income earned by workers.[13]
- Workers would be able to invest the savings amassed by the PRC in a range of investment vehicles that the government will loosely supervise. Funds, similar to those in Chile, would be encouraged to compete for the taxpayers' PRCs.
- The level of benefits given to recipients of social security would be slowly lowered based on the number of years taxpayers are employed and the amount of funds in their PRC accounts. These reductions would be small, but would give additional inducement to save for retirement.
- Money in the Social Security Trust Fund, while still held in government securities, would be partitioned from the federal budget for all budgetary decisions. These funds could still be used to support the budget, but politicians would be forced to meet budgetary requirements without the potentially misleading benefit of the social security surplus.

The first step in implementing the SRP will involve a large-scale public education campaign. Since the basic details of social security are straightforward, discussion of demographic shifts and the earnest efforts by Congress to provide for the aging population can provide essential background information which will make the public more receptive to changes in the current law. If the facts are presented clearly and in a nonpartisan manner, it would become clear that the system will soon collapse, and that action must be taken.[14]

Democrats and Republicans alike must appreciate the gravity of this issue and drop their partisan rivalries to bring about meaningful reform. The prospects for such an outcome are not strong. Unlike the circumstances in 1983, when Congress was forced to act to avoid shortfalls in the immediate future, the Trust Fund today is flush with funds. Legislators seeking radical change can afford to wait a few years to get the changes they seek while those who prefer to patch the current system must

immediately agree to small changes to avoid big ones in the future (Passell 1996). The SRP, with its commitment to maintain a safety net for the elderly while simultaneously incorporating aspects of a partially privatized system, may offer broad enough appeal to make the reform successful.

Bipartisan support would not ensure passage of the SRP. The package, which includes both tax increases and benefit reductions, would face stiff political challenges. However, several aspects of the plan are aimed at making the plan politically feasible. The public education campaign would play the important role of convincing the American electorate that real change is needed in the social security system. While the concept of additional taxes surely would be met by resistance, the PRC would be more politically acceptable than most taxes because taxpayers would have direct control over their tax dollars. The benefit cuts, gradually increasing the retirement age and reducing benefits for those who have accumulated resources through their PRC investments, would also meet with resistance. Nonetheless, ample support for the cuts can be generated if they are portrayed as essential to preserve the integrity of the social security system and are distributed in a progressive manner.

The SRP would accomplish a number of goals. First, it would likely boost our country's low savings rate. While those who are better off and have the opportunity to contribute to private pensions may shift some saving to the PRC (thus crowding out private saving), the majority of Americans who do not have access to pensions would be given the opportunity to have a direct stake in their own well being upon retirement. This tighter link between contributions and benefits would also help restore confidence in the social security system.

Second, by increasing the retirement age and decreasing benefits over time, the SRP would help maintain the solvency of the Social Security Trust Fund. The social security system must continue to provide a floor of benefits for all Americans to avoid a resurgence of poverty among the elderly. In addition, the social welfare aspect of the system, resting in its progressive distribution of benefits, would be retained.

Third, the SRP would help renew America's faith in the social security system and in the government. By annexing the social security surplus from the budget, more honest budget decisions can be made. Further, the large scale public education program would give the American people a better understanding of the issues and greater confidence in the actions taken by the government.

In sum, the Savings and Social Security Reinvigoration Plan, by boosting national savings levels and sustaining crucial elements of the social security system, would contribute to America's continued economic growth and provide security to the retired people in our aging population.

Notes

[1]Worker productivity is a more accurate measure of the burden placed on wage earners. Productivity increases over this period have lessened the impact of the steep drop in the support ratio.

[2]This estimate may be biased upward since it does not take into account likely changes in behavior if the social security system did not exist.

[3]The system is regressive in that individuals with higher incomes pay a lower proportion of their incomes in taxes. Efforts have been made in recent years to make the system at least marginally more progressive. In 1991, the tax rate was lowered and the maximum amount of income taxed was raised.

[4]President Roosevelt made an effort to shield his program from political attack by spreading the benefits broadly. "He funded [the program] through a separate payroll tax to keep it closely identified in the minds of voters as a payback for their working years. That way, he once said, 'no damn politician can ever scrap my social security program'" (Church 1995).

[5]Barry Goldwater found this to be the case in 1964 when his off-hand remark, "make it voluntary," undermined his campaign (Gollin 1995).

[6]Representative Porter first introduced a form of his plan in 1990, but it did not receive much attention.

[7]The insolvency date would be extended if the government controlled investment of the assets or if privatization plans included reductions in benefits.

[8]Some parts of the financial community would welcome private investment of the Trust Fund. *The Wall Street Journal* recently suggested that such privatization "could be the biggest bonanza in the history of the mutual fund industry" (Schultz 1996).

[9]The concept of such widespread government ownership has been termed "economic socialism" by the Cato Institute. If the government owned a substantial part of the debt or equity of a corporation, the corporation may choose to make riskier investments, knowing that if it failed, the government would not shut it down. (Subcommittee on Social Security 1994, 136).

[10]The value of the recognition bonds was based on a complex formula which reflected past payments to the social security system as well as interest on these payments, which included adjustments for inflation.

[11]This mandatory wage increase approximately offset new tax burdens placed on employees.

[12]If the availability of personal retirement accounts boosts the national savings rate, retirees may be made better off.

[13]Edward Gramlich, the Chairman of the Clinton Administration's Advisory Council on Social Security, recently endorsed the concept of mandatory investment accounts which individuals would control. Funds for these accounts would be generated by a small increase in the current tax. He suggested that "individual accounts would give people an enhanced sense of ownership in social security, increasing confidence in the program" (Pear 1996, A10).

[14]This is exactly what Senators Kerrey and Danforth attempted to achieve with their Bipartisan Commission on Entitlement and Tax Reform. While their work demonstrates these points, it was not effectively presented to the public.

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