

**Privatizing Social Security the Right Way**

**Testimony to the Committee on Ways and Means**

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**Chairman Bunning and other distinguished members of the Committee on Ways and Means, Subcommittee on Social Security,**

I'm honored by this opportunity to discuss with you fundamental reform of the U.S. Social Security reform.

***Social Security's Options – Real Reform or Real Financial Distress***

The U.S. Social Security System is in desperate need of reform. The system faces a long-term fiscal crisis that is roughly twice as bad as our government is publicly admitting. Continuing to pay Social Security benefits on an ongoing basis requires taxing workers another nickel out of every dollar they earn – starting now. For those born in the postwar period, Social Security already represents, on balance, a bad deal. Raising taxes or cutting benefits by the amount needed to keep the program solvent will turn a bad deal into an awful one.

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

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

The real way to reform Social Security is to privatize fully its retirement program and require everyone who can to contribute to paying off the liabilities of that program. Anything short of full privatization, with full payment of the transition costs, will leave us having another “conversation” 15 years from now, but facing even worse options than those we currently face.

This article presents a plan for fully privatizing the retirement portion of Social Security. The plan was developed by myself and Professor Jeffrey Sachs of Harvard University. It has been endorsed by 65 leading academic economists, including three Nobel Laureates. The plan is simple enough to describe on a single page. It protects existing retirees, women, and the poor, has very low administrative costs, requires full portfolio diversification of account balances, forces contributors to invest for the long-term, transforms accumulated account balances into inflation-protected pensions at retirement, and fully pays off the liabilities of the old system in a manner that is generationally equitable.

Before describing the plan, I discuss Social Security’s long-term finances as well as its treatment of postwar Americans. Knowledge of both these issues is critical for judging whether or not Social Security should be privatized.

***Social Security's Long-term Fiscal Crisis***

According to the intermediate projection of the Social Security Trustees, paying promised benefits over the next 75 years requires an immediate and permanent 2.2 percentage point increase in the program's current 12.4 percentage point tax rate. Fixing Social Security for 75 years is not, however, fixing it for good. Each year that passes brings into the current 75-year planning horizon a year that wasn't there before. For example, we are currently 15 years beyond the 75-year planning horizon that the Greenspan Commission considered back in 1983.

Recall that the Greenspan Commission was charged with the job of solving Social Security's financial problems once and for all. The mistakes underlying their failure should not be repeated. These mistakes go beyond using too short a planning horizon. They also include using economic and demographic assumptions that were far too optimistic.

Unfortunately, when the Social Security actuaries look beyond 75 years they see enormous deficits. These deficits are so large that paying Social Security benefits on an ongoing, rather than simply a 75-year, basis requires an immediate and permanent 4.7 percentage-point tax hike! This unpublished estimate comes from Steven Goss – the highly respected Deputy Chief Actuary of the Social Security Administration. Goss is also responsible for developing the 2.2 percentage point 75-year tax hike estimate.

The 4.7 percentage-point tax hike needed for true long-term solvency is, of course, more than twice the 2.2 percentage-point being announced by the Trustees in their Trustees Report. The Trustees' failure to allow Goss and his colleagues to publish the tax hike needed for true long-term solvency represents an incredible dereliction of duty and one that merits Congressional attention.

Unfortunately, a 4.7 percentage-point tax hike is not the limit of the tax hike we're likely to face. For starters, if the 4.7 percentage-point tax hike is not imposed immediately and if one assumes that all benefits will be fully paid, the payroll tax rate will have to be raised by more than 4.7 percentage points when the tax hike is finally implemented. Moreover the required 4.7 percentage-point tax hike is calculated based on what appear to be overly optimistic "intermediate" assumptions concerning lifespan extension and real wage growth. Top demographers, like Professor Ron Lee of the University of California at Berkeley, believe lifespan will grow by about 10 years over the next 75 years -- roughly twice the increase being projected by the Trustees in their intermediate forecast. In the case of real wage growth, the intermediate forecast assumes that real wages will grow in the future at .9 percent per year -- over twice the rate they've grown since 1975.

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

Based on the current projection methodology, the incorporation of more realistic mortality and real wage growth assumptions raises the tax hike needed for long-run solvency from 4.7 percentage points to over 6 percentage points. Since the Social Security payroll tax rate is now 12.4 percent, such a tax rise would leave Americans workers paying close to a fifth of their wages to the System. Medicare faces an even more severe long-run funding problem. In combination, the two programs could eventuate in payroll tax rates of 30 percent or more. Payroll tax rates of this magnitude in conjunction with the rest of the U.S. tax structure and the need to pay interest on our large stock of official debt would have a highly detrimental impact on the U.S. economy.

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

### ***Social Security's Treatment of Postwar Americans***

In a recent study, I, together with five colleagues, used a highly detailed micro simulation model to examine how Social Security is treating postwar Americans.<sup>1</sup> In addition to considering the treatment of different postwar cohorts, the study compares the treatment of different types of individuals within each of these cohorts.

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

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

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

### ***The Study's Findings***

This study's findings, culled from its executive summary, are indicated below:

Social Security represents a bad deal for postwar Americans. Moreover, the deal has gotten worse over time. Baby boomers are projected to lose roughly 5 cents of every dollar they earn to the OASI program in taxes net of benefits. Generation X'ers and today's children will lose over 7 cents of every dollar they earn in net taxes.

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. If OASI taxes are raised immediately by the amount needed to pay for OASI benefits on an ongoing basis, baby boomers will forfeit 6 cents of every dollar they earn in net OASI taxes. Those born after the baby boom will forfeit 10 cents of every dollar they earn.

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<sup>1</sup> See Caldwell, Steven, 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.

Measured as a proportion of their lifetime labor incomes, the middle class are the biggest losers from Social Security, but measured in absolute dollars, the rich lose the most. On average, postwar middle-class workers pay 8 cents per dollar earned to OASI in net taxes compared with 5 cents for the lowest paid workers and 3 cents for the highest paid workers. But in absolute terms, today's highest earners pay roughly \$1 million measured as of age 65, compared to \$400,000 for today's middle-class workers, and \$50,000 for today's lowest earners.

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

Men pay about 1 percent more of their lifetime earnings to OASI in net taxes than do women. The higher male net tax rates obtain even controlling for lifetime earnings. They reflect shorter male life expectancy and less frequent receipt of OASI dependant and survivor benefits.

Non whites, because of their shorter life expectancies, face slightly higher (about a third of a percentage point) lifetime OASI net tax rates than do whites. This is particularly true at lower levels of lifetime earnings.

College-educated workers face somewhat lower (about two thirds of a percentage point) lifetime OASI net tax rates than non college-educated workers, but this difference disappear once one controls for lifetime earnings.

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

The internal rate of return earned by postwar cohorts on their social security contributions is very low. It'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. These internal rates of return would be lower still if one factored in either the massive tax increases or benefit cuts needed to restore Social Security to long-run solvency.

### ***Privatizing Social Security***

As described above, the U.S. Social Security System is badly broke and is treating the vast majority of its current contributors very badly. Privatization is far from a painless panacea, but it does represent an opportunity to resolve, once and for all, most of the System's financial woes and to rationalize a program that is intragenerationally as well as intergenerationally highly inequitable, replete with inefficiencies and economic distortions, and extraordinarily

uninformative about the benefits it is providing in exchange for its mandatory contributions.

Once one decides that privatization is worth doing, the next question to consider is whether one wants to fully or partially privatize the system. As suggested, partial privatization will leave the non privatized portion of the system vulnerable to periodic financial half-measures that 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 eventuate in a large number of extremely small retirement accounts -- namely those of society's lowest earners. The fixed transactions costs of transmitting and recording contributions to these accounts, sending annual reports to the owners of these accounts, and disbursing payments could wipe out much of the return these accounts could be expected to earn. In short, if privatizing a dollar of the retirement portion of Social Security makes sense, privatizing all of it makes much more sense.

### ***The Personal Security System<sup>2</sup>***

The Personal Security System (PSS) fully privatizes the retirement portion of Social Security. The plan has the following seven provisions:

***Social Security's Old Age Insurance (OAI) payroll tax is eliminated and replaced with equivalent compulsory contributions to PSS accounts.***

***Workers' PSS contributions are shared 50-50 with their spouses.***

***The government matches PSS contributions on a progressive basis.***

***PSS balances are invested in a single market-weighted, global index fund of stocks, bonds, and real estate.***

***Current retirees and current workers receive their full accrued Social Security retirement benefits.***

***Between ages 60 and 70, PSS balances are annuitized on a cohort-specific and inflation-protected basis.***

***A federal business cash-flow tax finances Social Security retirement benefits during the transition as well as the ongoing progressive government matching of PSS contributions.***

### ***Scope of the Proposal***

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<sup>2</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.*

The PSS plan leaves unchanged the contributions paid to and benefits received from the disability and survivor insurance portions of Social Security.<sup>3</sup> Only those contributions currently being made to the OAI portion of Social Security (about 70 percent of total OASDI contributions) are eliminated and replaced with mandatory contributions of equal size to PSS accounts.

### ***Earnings Sharing***

To protect non-working 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 their own 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 have, as a result, less time to spend in formal work.

### ***Government Matching of PSS Contributions***

The federal government would match PSS contributions of low-income contributors on a progressive basis. It would also make PSS contributions through age 65 on behalf of disabled workers.

### ***Tax Treatment of PSS Accounts***

PSS contributions are subject to the same tax treatment as current 401k accounts. Contributions are deductible and withdrawals are taxable.

### ***Investment of PSS Account Balances***

All PSS balances are invested in a single, market-weighted global index fund of stocks, bonds, and real estate. Participants would purchase this security from (set up their accounts with) their preferred financial institution. Although participants could choose the financial institution in which they wanted to hold their global index fund, they couldn't sell it off to purchase other securities. Forcing everyone to hold this and only this asset would ensure maximum portfolio diversification and guarantee all participants the same rate of return on their PSS contributions.

It would also prevent people from playing the market; i.e., they would be forced to invest for the long term.

### ***Annuitization 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 be organized by the government through competitive bidding by the insurance industry.

The insurance company winning the bid to annuitize a cohort's PSS account balances would provide each PSS participant an inflation-protected pension in proportion to his or her account balance, where the factor of proportionality would be the same for all participants; i.e., all participants would become annuitized on identical terms so there would be no cherry picking by the insurance industry. The insurance company winning the bid for a particular birth cohort

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<sup>3</sup> These programs also need to be reformed to hold their costs to the levels of their tax receipts. Whether privatization of these programs is the best method to achieve this objective is, however, a subject for another paper.



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 temporally depressed. In being forced to bid for the right to annuitize a cohort's PSS account balances, the insurance industry will end up providing this service at the lowest possible price.

#### ***Survivor Provisions of PSS Accounts***

If contributors die prior to age 70, any non annuitized portion of their PSS accounts balances is bequeathable to their heirs.

#### ***Payment of Social Security Retirement Benefits to Current Retirees and Current Workers***

Current recipients of Social Security retirement benefits continue to receive their full inflation-indexed benefits. When they reach retirement, workers receive the full amount of Social Security retirement benefits that they had accrued as of the time of the reform. These benefits are calculated by filling in zeros in the OAI earnings records of all Social Security participants for years after the transition begins. Since new workers joining the workforce will have only zeros entered in their OAI earnings histories, new workers will receive no OAI benefits in retirement. This ensures that over a transition period aggregate Social Security retirement benefits will decline to zero.

#### ***Financing the Transition***

During the transition, Social Security retirement benefits will be financed by a federal business cash-flow 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 decline. 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.

#### ***Advantages of the Reform***

The Personal Security System would improve benefit-tax linkage, enhance survivor protection, equalize treatment of one- and two-earner couples, offset the ongoing transfer of resources from the young to the old, provide better divorce protection to non working spouses, make the system's progressivity apparent, resolve Social Security's long-term funding problem, and ensure Americans an adequate level of retirement income.

#### ***Macroeconomic Effects***

Simulation studies suggest that this reform will, over time, increase the economy's output by roughly 15 percent and the capital stock by roughly 40 percent.

#### ***Impact on the Poor***

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. 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 there is an overall decline in the tax burden since they no longer pay the OAI tax. For the

economy as a whole, the tax change is revenue neutral with the business cash-flow tax simply replacing the OAI payroll tax.

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

### ***Intergenerational Equity***

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

### ***Conclusion***

The Social Security System does lots of very useful 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 on a chain-letter basis and the end of the chain is in sight. We now have two options. We can try to con our children and grandchildren into buying our inherently worthless chain letters by continuing to disguise the true nature of Social Security's long-term fiscal problems. Or we can decide to act like adults and reform once and for all a System that imperils the financial wellbeing of our offspring.

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