Cato Institute Social Security Choice Paper No. 8: A Plan for Privatizing Social Security

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Executive Summary

As Social Security—the debate grows it becomes more important to move beyond generalizations and provide detailed proposals for how such privatization can be accomplished. Without endorsing any specific proposal, the Cato Project on Social Security Privatization will present a number of possible privatization scenarios.

In this study, Peter Ferrara offers a proposal based on the following key elements:

- Current workers could be free to choose either the private option or Social Security. For those who choose the private plan, workers and employers will each pay 5 percent of wages, instead of the current Social Security payroll tax of 6.2 percent for each, into private investment accounts, resulting in an eventual payroll tax cut of 20 percent. Besides supporting retirement benefits, the accounts would finance private life and disability insurance, thus replacing Social Security survivors and disability benefits.

- Workers who opt out of the current Social Security system would receive recognition bonds from the federal government that would pay them a proportion of future Social Security benefits equal to the proportion of lifetime taxes they had already paid.

- Benefits promised to current retirees would be paid in full, with no reduction of any kind.

The biggest objection to privatizing Social Security has been the transition to a privatized system. But the projections of the fiscal impact of the plan offered in this study show that the transition can be financed without new taxes and without cutting benefits for today's recipients.

Indeed, the yearly transition deficit would be offset after about 14 years. After that, the privatization reform actually starts producing a surplus for the federal government. About 20 years after the reform is begun, that surplus would be large enough in 1996 dollars to eliminate completely a federal deficit as large as today's.

These projections place the transition in a whole new perspective. They show that the transition is financially feasible and manageable, and that modest short-term sacrifices would lead to long-term surpluses that would ultimately reduce the federal budget deficit.

Introduction

Politics is the art of the possible, the saying goes. In regard to Social Security, what was once impossible is now probably inevitable.

What was unthinkable in mainstream politics just a few years ago—the privatization of Social Security—is now highly popular at the grass roots. Every day brings more establishment and institutional support for the idea as well. Moreover, this mushrooming support is coming from across the political spectrum.

Those who have not followed the issue in recent years should consider the following:

Public opinion is shifting. While Social Security was once the "third rail" of American politics, Americans are increasingly willing to consider reform of the system, including privatization. A 1994 Gallup Poll found that 54 percent of Americans thought that participation in the Social Security system should be made voluntary, which is actually a more radical change than privatization. Another Gallup Poll, this one in January 1995, found that by 47 to 32 percent, Americans thought that Social Security was not a good program for today's younger workers. The same poll found that by 53 to 23 percent, those interviewed believed that most people could make more...
money by investing their retirement funds in the private sector than they could with Social Security.Â®[2]

Likewise, a poll by GrassRoots Research in November of 1995 found that 38 percent of todayÂ’s Social Security if offered the option, even if they received nothing in return for the taxes they have already paid. Among workers ages 30 to 39, 48 percent would choose to leave the current system.[3] Last year, Public Opinion Strategies conducted a nationwide poll for the Cato Institute which found the public favoring the idea by 68 to 11 percent.[4]

Social Security privatization is gaining momentum worldwide. Since Chile successfully privatized its Social Security system in 1981, other countries across Latin America have begun to consider and implement similar reforms. Argentina, Colombia, El Salvador, Peru, Mexico, and Uruguay have already started privatizing their systems. With far less fanfare, Great Britain began Social Security privatization almost 20 years ago, and about three-fourths of its workers have now opted out of half the system there.[5]

Indeed, in 1994, the World Bank issued a report advocating Chilean-style privatization for all countries, to address the worldwide crisis in Social Security systems and stimulate economic growth.[6]

In this country, economic and political leaders are beginning to advocate privatization. In a May 1996 address to the American Economics Association, Professor Martin Feldstein of Harvard estimated that the present value of the future benefits to the United States of privatizing Social Security would be an astounding $10Â±$20 trillion.[7] Privatization of Social Security has also been endorsed by Nobel Prize-winning economists Gary Becker, James Buchanan, and Milton Friedman, as well as the current president of the American Economics Association, Arnold Harberger.

On Capitol Hill, Social Security is no longer the Â“third railÂ” of politics. Reps. Jim Kolbe (R-Ariz.) and Charles Stenholm (D-Tex.) launched a bipartisan House Caucus group to promote discussion of Social Security reform, including privatization. Approximately 50 members from both parties have joined. Among those developing specific legislation are Reps. Nick Smith (R-Mich.), Mark Sanford (R-S.C.), Bill Thomas (R-Cal.), and John Porter (R-III.). In the Senate in 1996, Sens. Robert Kerrey (D-Nebr.) and Alan Simpson (R-Wyo.) (since retired) introduced legislation calling for partial privatization of the system. With Sen. Simpson retired, Sen. Judd Gregg (R-N.H.) is expected to join Sen. Kerrey in sponsoring legislation this year.

And, despite being more than a year late in coming and clouded by internal disagreements, the usually staid Social Security Advisory Council issued a groundbreaking report in which all members recommended using private capital markets to shore up Social Security.

The 13-member panel, appointed by Health and Human Services secretary Donna Shalala, split three ways over the specifics of restructuring Social Security.[8]

- Former Social Security commissioner Robert Ball and five other members, mostly representatives of organized labor, support a plan that would rely on a series of small measures in the short term, primarily small tax increases and shifting funds from other programs. To close the long-term deficit, this group suggests that the government be allowed to invest up to 40 percent of the Social Security Trust Fund in the stock market.

- A second group of five council members, led by Sylvester Scheiber of the account-ing firm Wyatt-Watson Worldwide and Carolyn Weaver of the American Enterprise Institute, would allow individuals to divert 5 percentage points of their payroll tax to individually owned accounts that would be privately invested, similar to 401(k) plans or Individual Retirement Accounts. The remaining payroll tax would be used to provide a flat floor benefit to all Social Security recipients.

- The final group of two members, including Council chairman Ned Gramlich of the University of Michigan, would gradually reduce Social Security benefits, while imposing a new mandatory savings program of 1.6 percent of payroll on top of the current payroll tax. Individuals would be able to invest this new savings in a limited number of government-developed plans.

All that building political momentum, along with the high cost of ignoring Social SecurityÂ’s question of exactly how Social Security should be privatized. This study will address that question. After briefly reviewing the basic rationale for privatization of the program, the study will address basic issues in designing a particular Social Security reform plan and offer a specific and detailed plan that can be turned into legislation. Perhaps most important, the study will discuss how the transition to the new system can be financed, including year-by-year projections of the fiscal impact of the transition.

Up until now, the biggest objection to privatizing Social Security has been the fiscal impact of the transition to a privatized system. During that transition, benefits to todayÂ’s investments. This will leave a transitional shortfall in the financing for outstanding benefit obligations. But the projections of the fiscal impact of the reform plan offered in this study show that
The transition can be financed without new taxes and without cutting benefits for today’s recipients. Indeed, the transition can be financed while also providing for a 20 percent payroll tax cut after 10 years.

- Apart from the tax cut, the net transition deficit would be eliminated in only 14 years.

- Before that point, the transition deficits can be financed in part by issuing new government bonds, or selling existing Social Security trust fund bonds, totaling no more than $500 billion (in 1996 dollars). However, privatization would produce sufficient net surpluses by the 22nd year after it begins to completely pay off and retire all the bonds previously sold to finance the transition.

- The remaining net transition deficits in the early years can be offset by reductions in government spending totaling approximately $60 billion per year, or approximately 4 percent of total federal spending.

- Perhaps most remarkably, once the bonds issued to finance the transition are paid off, privatization would actually start producing large surpluses that would reduce the federal budget deficit.

Consequently, rather than producing concern over the short-term budgetary impact of the transition, Social Security privatization should be seen as the only means of eliminating the currently projected, enormous, long-term federal deficits, and indeed ultimately producing large additional surpluses that can be used to cut taxes or to reduce the national debt.

This proposal is not intended to represent the only possible route to privatization. However, it illustrates the way a privatized system could be designed and how the transition could be managed. In that sense it proves that Social Security privatization is practical.

**Why Privatize Social Security?**

The reasons Social Security should be privatized have been discussed in great detail in numerous books and publications. Briefly, those reasons include the following:

**Insolvency**

The current Social Security system is inevitably headed for bankruptcy. According to the 1996 annual report of the Social Security system time in the last 10 years that the insolvency date has been brought forward.

But even this does not provide the full story of Social Security currently bring in more revenue than the system pays out in benefits. The surplus theoretically accumulates in the Social Security Trust Fund. However, as shown in Figure 1, in 2012 the situation will reverse. Social Security will begin paying out more in benefits than it collects in revenues. To continue meeting its obligations, it will have to begin drawing on the surplus in the Trust Fund. The trouble is, the Trust Fund is really little more than a polite fiction. For years the federal government has used the Trust Fund to disguise the actual size of the federal budget deficit, borrowing money from the Trust Fund to pay current operating expenses and replacing the money with government bonds essentially an IOU.

Beginning in 2012, Social Security will have to start turning in those bonds to the federal government to obtain the cash needed to pay benefits. But the federal government has no cash or other assets with which to pay off the bonds. It can obtain the cash only by borrowing and running a bigger deficit, increasing taxes, or cutting other government spending.

Based on the more pessimistic projections of the Social Security system the current 15.3 percent payroll tax (including both Social Security and Medicare) to those entering the workforce today could require doubling or tripling that tax to as much as 30 to 40 percent. That level of taxation is neither economically nor politically feasible. Consequently, there is no prospect that today’s young workers will receive their currently promised benefits.

In a privatized system, this financial crisis will be avoided, as all future benefits will be fully funded by private savings and investment. Indeed, once the transition costs of a privatization reform are offset, the reform starts producing surpluses in the federal budget that grow quite large over time, ultimately eliminating the total federal deficit and allowing for large reductions in taxes or the national debt. This situation is discussed in detail below.

**Bad Deal for Young Workers**

Even if Social Security did somehow manage to pay all its promised benefits, the taxes for today’s the benefits would be a bad deal in return for those taxes. These benefits would represent a low, below market rate of return, or effective
interest rate, on the taxes workers and their employers had to pay into the system throughout their careers. Studies show that investing these tax funds instead in private savings and insurance would likely yield three or more times the benefits Social Security promises to today’s young workers.\[13\]

Investing through the private system and earning modest returns, the average two-earner couple would retire with a trust fund of over $1 million in today’s dollars, which they could split in half, leaving enough for their children or other heirs, while Social Security accumulates no savings that seniors can leave to their children.\[14\]

**Savings and Economic Growth**

Social Security operates on a pay-as-you-go basis, with the funds coming in immediately paid out to current beneficiaries. This system displaces private fully funded alternatives, where each worker’s result is a large net loss of national savings, reducing economic growth.\[15\]

Shifting to a private system, with hundreds of billions of dollars invested in individual retirement accounts each year, could produce a large net increase in national savings, assuming that the government did not finance the entire transition through debt. This would increase national investment, productivity, wages, jobs, and economic growth.

**Equity**

The poor would be among the biggest gainers from a private system. That is because they tend to live fewer years in retirement and consequently collect less in benefits. In a private, invested system, by contrast, individual workers would each retain control over the funds paid in, and could pay themselves higher benefits over their fewer retirement years, or leave more to their children or other heirs.\[16\]

In addition, the higher returns and benefits in a private invested system would be most important to the poor. Even without counting the lower life expectancy of the poor, a private invested system would pay minimum-wage earners more than three times the benefits promised by Social Security.\[17\] The saved funds in the private system that could be left to the children of the poor would also greatly help families break out of the cycle of poverty.\[18\]

**Freedom of Choice and Control**

Privatization of Social Security would give American workers direct personal control over the thousands and thousands of dollars they and their employers now must pay into Social Security each year. The desire for such control is fueling much of the public support for privatization. Moreover, through the private market people would be free to tailor their retirement and insurance benefits to their own personal needs and circumstances. They would have broader freedom to choose their own retirement age, for example, or the level of life and disability insurance protection appropriate for them.

**Basic Issues of Reform**

Developing a specific Social Security privatization proposal raises basic design issues that need to be explored.

**Benefits for Current Retirees**

Any privatization proposal should begin by assuring current retirees that they will not be affected by the reforms. The proposal should irrevocably commit and emphasize that currently promised benefits for current retirees would not be reduced or changed. The government has led these people to rely on its promises, and at this late stage in their lives, and after all the money they have paid into the system, it is too late for them to make alternative arrangements.

**Relief from Payroll Taxes**

One of the basic principles of Social Security privatization is that those who opt for the private system should expect that they would no longer pay taxes into Social Security, so they can use the funds to pay into the private system instead.\[19\] Whether and how this should be accomplished is the subject of considerable debate among those who favor privatization.

One view follows the Chilean reforms. Chilean workers who opted out of the government-run Social Security system were no longer required to pay anything into the old system. They were allowed to keep all their money and invest in the private system instead. In fact, the required payments into the private system were substantially less than the taxes required for the old system, a change that effectively provided a large tax cut for those who opted for the new system. The reduction was justified because with the substantial investment returns of the private system, much more in benefits could still be paid even with the lower payments during working years.

The other view essentially follows the British model of reform. In that country, workers choosing the private individual account option are relieved from paying only part of the payroll taxes to invest in the private system. They are still required to pay a substantial part of the taxes for the old system to help finance the continuing benefits of that system. Based on this approach, some suggest that we should relieve...
workers of just enough of the taxes to get them to choose the private option, with the rest continuing to be paid into Social Security. This is advocated as a way to finance the transition to the new system.

The Chilean approach is vastly preferable. That approach allows workers to receive the full benefits of the private system. As a result, it will maximize the proportion of workers who choose that system. Requiring those who opt for the private system to continue to pay substantial amounts into the old system is essentially a bias against the private option, or effectively a tax on it, which undermines the appeal of that option.

Moreover, the Chilean approach ensures that workers will benefit greatly from that option. That, in turn, ensures that the reform will be a stable, lasting success. It would be dishonest to promote privatization by telling workers that they will receive far higher retirement benefits through private investments, but then to create a privatization plan that allows them to receive only a fraction of those benefit gains because they are actually allowed to invest only a tiny portion of their Social Security taxes.

Finally, there are better ways to finance the transition, as discussed below. We should not finance the transition costs through means that directly undermine the appeal of the private option itself.

However, as a compromise between the two views discussed, it would not create a serious problem to require those who opt out to continue paying a small amount into the old system for a temporary period, as described in the next section. This would provide some funding for the transition, without undermining the appeal of the private option in any significant way.

**Required Payments for the Private System**

As the discussion of the Chilean model indicates, a privatized retirement system would not require payments as large as the current Social Security system. That is because the investment returns of the private system provide so much more in benefits over the long run. As discussed, studies indicate that for today’s Social Security for the same amount of payments. Therefore, the private system can require substantially less in payments than Social Security while still paying far more in benefits.

This would effectively provide a substantial tax cut for those who choose the private option. A reasonable approach might be to require the worker and employer each to pay 5 percent of salary, for a total of 10 percent, into the private system, instead of the Social Security payroll tax of 6.2 percent each on worker and employer, for a total of 12.4 percent. (Another 2.9 percent payroll tax finances Medicare.) Workers would then pay 20 percent less into the private system and still probably get more than twice as much in benefits.

However, to help provide funds for the transition to the new system, the effective tax cut from choosing the private option could be delayed for a few years, with the funds going into Social Security to help finance its outstanding benefit obligations. For example, workers and employers each could pay 5 percent into the private options as suggested above, and could continue to pay 1.2 percent each into the old system for 5 to 10 years, thus keeping the total at the current 6.2 percent each in those years. As indicated, this represents a compromise between the views described in the earlier section. Such a compromise involves a well-defined limit on how much will be paid into the old system—the amount of the eventual effective tax cut from choosing the private option. Committing the funds to an eventual effective tax cut also limits the continued payments to some temporary period.

**Refund of Past Taxes Paid Into the System**

For those who have already been in the work force for many years when the private option is adopted, a question arises as to what will happen to the taxes they and their employers have already paid into Social Security if they opt out. Will they get some sort of refund for these past taxes?

Social Security is now such a bad deal for younger workers that up until about the age of 40 or 45 they will probably still be better off in the private sector even without the refund of any past taxes, as long as they no longer have to pay into Social Security in the future and can use all those funds for their private investment accounts instead. The private individual account option in Great Britain in fact provides no refund for past taxes paid. The big advantage of this approach is that it substantially reduces the transition costs. For example, if all workers under 40 opt out of Social Security without any refund for past tax payments, once those workers reach retirement and the older workers are paid off, there will be no further transition costs. (Of course, those who object to the “unfairness” of losing their entitlement to past Social Security contributions could always choose to remain in the current Social Security system.)

On the other hand, this approach has no effect in reducing transition costs until those workers opting out do reach retirement. For example, if it is primarily workers under 40 who opt out, then this will have little effect in reducing Social Security obligations until 25 to 30 years later, when those workers 40 and older at the time the new system is adopted reach retirement. Reducing transition costs so far in the future would provide little help in addressing the transition cost concern. The big transition costs are really in the first 10 to 15 years. The projections in Table 1 in fact show that 25±30 years after the reform the transition deficits have long been offset, and the new system is producing surpluses.

Moreover, this approach again creates an effective bias against the private option. Past Social Security taxes are counted if you stay in Social Security, but not if you choose the private option. One result of this bias is that the benefits from the privatization option will vary
greatly based on age. The youngest workers will benefit the most, and those benefits will decline sharply by age until reaching zero for those at 40 to 45 and above. Many may see this sharp variance by age as unfair. This will also mean that no workers above this age will opt out, effectively eliminating any privatization option for them. In addition, even apart from any age difference, many may view the government's paying nothing for past Social Security taxes as simply unfair in any event.

The opposite approach would be to pay all workers who opt out a full refund for their past taxes. Ideally, this would involve calculating the proportion of lifetime taxes the worker and his employer already paid. The refund would then equal this same proportion of expected lifetime benefits, in present value terms. The worker could be given this refund in government bonds for his private retirement account. The bonds would accrue interest over the years, reaching at retirement the present value of the proportion of retirement benefits the worker should receive based on the past taxes paid. The bonds could then be partially cashed in each year to help finance the worker's benefits. The government would not have to make any actual expenditures for the past tax refunds until that point, cashing out some of the bonds each year in retirement. That is basically how the Chilean reform worked.

The Chilean approach again seems superior. Workers under this approach again receive the full benefits of the private system. Moreover, all workers have an equal incentive to opt out of the old system for their remaining working years regardless of age. Workers at 60, 50, 40, and 30 would each receive the full net advantage of the private system over the public system for their remaining working years. Consequently, the great majority of workers of all ages would likely opt out, resulting in immediate maximum privatization, as in Chile.

It should be noted that instead of a refund for past taxes, the same effect can be achieved simply by paying workers a proportion of benefits based on past taxes paid. The bonds paid into their personal accounts could then be dispensed with altogether. However, having actual bonds in their own accounts would probably appeal more to workers and would be a firm legal obligation. Finally, there is no need to put any maximum age limit on those who could opt out, which will only make some who might want to opt out feel excluded.

**Government Regulation and Guarantee of Investments**

Another key question is government regulation of the private retirement investments. Some would favor strictly limiting the investment options to those deemed safe, so that workers won't return to the private investments and consequently sharply reduce the retirement benefits they could pay.

Ideally, the restrictions on the private retirement investments should be minimal, to maximize the reasonable returns and retirement income workers could expect to receive. The current regulations that apply to individual retirement accounts (IRAs) are a good model, prohibiting only the most high risk investment alternatives. Workers must have broad freedom to invest in corporate stocks in the United States and abroad, as well as corporate bonds and government securities. This would provide very high returns and benefits compared to Social Security, while maintaining reasonable risk that does not seriously threaten long-term retirement security.

A related question is whether government should guarantee the private retirement investments. Such government guarantees are in fact counterproductive and unnecessary. By ensuring against losses, such a guarantee would encourage investors and investment firms to take greater risks to get greater returns, knowing that the government will make up any losses. This would induce more losses than would occur otherwise, with taxpayers bearing the cost.

Moreover, investors are always free to choose government-guaranteed investments that already exist in the market, if that is what they want. These include U.S. government bonds, treasury bills, and certificates of deposit, among others. This choice provides a government guarantee without the drawbacks cited above.

However, workers would have all the investment security they need simply investing in broad-based mutual funds that own shares in a wide range of companies. This strategy avoids significant risk from the losses of any one company, and yields investment returns that track the performance of the economy as a whole. No one, not even the government, is immune from general economic performance. With a calamitous and persistent economic downturn, for example, the government would not be able to get the tax funds to pay all Social Security benefits either.

Moreover, the security of such retirement investments is greatly enhanced by the fact that such investments are so long term. A retirement investment program lasts from the time of entry into the work force all the way through retirement up until death, a period of 50 to 70 years for most. Consequently, poor economic performance in one year would be offset by better economic performance the next. For mutual fund type investments that are basically tracking the general economy, even extended bad economic times would be averaged out by better times. For example, with half the average stock return in the United States over the past 70 years, a period that includes the Great Depression (which no government program can guarantee against), today promised to them by Social Security.[20]

Finally, all needed assurance could be provided in any event by a simple government safety net for the private system. That safety net would involve a guaranteed minimum benefit level, payable out of general revenues. If the benefits payable by the private investments fell below that minimum level for some reason, the government would make up the difference. Such a minimum benefit is included in the Chilean system.

The minimum benefit would guarantee that no one...
of the private system described above, government expenditures for the minimum benefit are likely to be quite small. Indeed, the reform overall would probably reduce current government income assistance spending by far more than is spent on the minimum benefit, because workers would retire with far higher benefits through the private system and would need less government assistance than today. The public can consequently be assured that no one would be left destitute, while workers would enjoy the freedom and prosperity offered by the private system.

Chile also adopted a good system for avoiding fraud and abuse of unsophisticated investors. Workers there were required to choose an investment company to manage and invest their pension funds. Only companies that had applied for and received government approval could handle such investments. There are about 20 such companies in Chile, and workers can switch among them on short notice.

In the United States there would be hundreds and perhaps thousands of such approved companies. Over time, provisions could be adopted to allow more individual self-direction of the investments under appropriate circumstances.

**Taxation of the Private Option**

Funds contributed to the private retirement accounts should be taxed, either upfront or at retirement. That is, if the contributions to the private accounts are tax deductible, then the retirement income they pay should be included in taxable income. If the contributions to the private accounts are not deductible, then the retirement income they pay should not be taxed. Most important, the returns to the private account investments should be tax exempt, as IRA returns are today. This is critical for allowing the retirement savings to grow.

Today, the employer’s share of the Social Security payroll tax is deductible. But the worker’s share of the payroll tax poses both political and economic problems.

The employer would, therefore, allow the employer’s contributions to be tax deductible but not the worker’s share of the payroll tax to be tax deductible. This is means, however, that half the retirement income paid by the accounts should be subject to tax and half not.

Under this approach, while the returns paid directly to the accounts would not be taxed, substantial taxes would still be paid on the investments at the business level. Business enterprises would use the capital investments to generate on average the typical before-tax rate of return to capital. They would then pay their full taxes on that return and other tax assessments before paying the tax-exempt interest, dividends, and other returns to the investment accounts. This would still leave the investors with sufficient returns to receive the high benefits discussed earlier. At the same time, substantial new tax revenues would be generated for the government to help finance the transition costs of the reform and, ultimately, eventually to reduce long-term federal budget deficits.

Another question is whether workers should be allowed to voluntarily contribute more than the required amounts to their private accounts. In Chile, workers are required to contribute 10 percent of wages, but can voluntarily contribute another 10 percent, for a maximum of 20 percent. This encourages savings and allows workers to better control their retirement finances. They can contribute more, for example, if they want to retire earlier. Consequently, this would be a desirable component of reform.

**A Social Security Option**

Another issue is whether workers should remain free to stay in Social Security if they prefer that over the private option. This would be valuable in the early stages of reform because it would assure skeptics that they will not be forced into the private system if they don’t want it, and it would allow advocates to focus on the irresistibly appealing principle of allowing each worker the freedom to make his or her own choice. Over time, as the superiority of the private system is demonstrated, the public Social Security option will make little difference as few if any workers will choose it.

A continued Social Security option raises the question of what future Social Security benefits will be promised to those who might choose that option. On the one hand, workers should not be offered the current benefits that are well in excess of what Social Security will be able to pay in the future. If workers are going to have the option to stay in Social Security, they should be offered only the future benefits that the system can finance in a steady state. The World Bank in its study advocating privatization in fact recommended bringing future Social Security benefits in line with revenues as the first step of reform.[23] These future Social Security spending reductions also would help to finance the transition to the private system, as discussed further below.

The future spending reductions raised by the Bipartisan Commission on Entitlement and Tax Reform and proposed in legislation by Sens. Bob Kerrey (D-Nebr.) and Alan Simpson (R-Wyo.) would bring future benefits in to balance with steady-state revenues.[24] They involve primarily delaying the retirement age to 70 and reducing the growth in benefits by indexing them to prices rather than wages during working years. The changes would have no effect on anyone already in retirement.

On the other hand, however, raising the specter of the benefit reductions may needlessly frighten current elderly voters who may perceive
the changes as a threat to their current benefits. Because the private option is so much superior to Social Security even with currently promised benefits, and because virtually all workers will choose the private system anyway, it may be wiser to avoid the political fallout of trying to enact future benefit reductions for the old Social Security system, as that system will be rendered moot by workers choosing the private option.

A Proposal for Reform

The concrete proposal for privatization of Social Security that follows is based on the previous discussion. The discussion shows that the proposal covers numerous policy variables that are a matter of judgment and can be adjusted without losing the main objective. But the proposal outlined here is carefully designed to produce a highly appealing and successful private option—maximizing the freedom and prosperity of working people.

1. **Move Social Security Completely Off Budget.** The first step in any reform plan is to move Social Security completely off budget, including the program completely off budget. The transition consequently will not interfere with the effort to balance the rest of the budget.

   Indeed, moving Social Security off budget will in fact start to address the transition costs. Current surpluses would no longer be lent to the rest of the government and spent. Instead, the surpluses would have to be saved in some way, starting the process of fully funding the system, while the government starts to adjust to living without the surpluses.

   This last point leads to one potential political problem. If Congress is no longer able to use the Social Security Trust Fund to disguise the actual size of the federal deficit, it will significantly complicate proposals for balancing the budget by 2002. Balanced budget proposals by both President Clinton and Congress rely on using the Trust Fund surplus. Without those funds, the deficit will increase significantly in the short run, requiring further spending cuts.

2. **The Private Option.** The next reform step would be to allow workers the freedom to choose to provide for their retirement, survivors, and disability benefits through a private investment account, like an IRA or 401(k) plan, rather than through Social Security. For those who choose this option, the worker and employer would each pay 5 percentage points of the current 6.2 percent Social Security tax on each into the private account up to the maximum taxable limit calculated, as is the case today. Workers and their employers would have the freedom to contribute more if they choose, up to some overall limit, perhaps 20 percent of wages, as in Chile.

   The remaining 1.2 percent of the current tax on each employer and employee would continue to be paid for 10 years after the worker opted out, with the funds used to finance the reform portion of the tax, which would allow a reduction of the payroll tax. As discussed earlier, workers do not need to be required to pay as much into the private system as Social Security, because the benefits payable through the private system with these funds are so much higher than Social Security.

3. **Life and Disability Insurance.** Part of the funds in the investment account would have to be used to purchase private life and disability insurance covering at least the same survivors (preretirement) and disability benefits as Social Security. Workers would consequently be covered for these contingencies through the private system as through Social Security.

4. **Investment Regulations.** The same rules, regulations, and restrictions would apply to the private retirement accounts as apply to IRAs today, except that no withdrawals would be allowed before retirement. Workers would also be required to choose from among approved private investment companies to manage their account investments, with the freedom to change companies on short notice. Companies would apply to the federal government to obtain such approval, upon demonstrating their financial soundness, stability, and reliability. As discussed above, this would make the system simple for unsophisticated investors and avoid fraud and abuse. Over time, workers could be allowed more self-direction of the account investments if they prefer, in appropriate circumstances. A good place to start would be to allow such self-direction for any extra contributions made to the accounts.

5. **Taxation of the Retirement Accounts.** Employee contributions to the private accounts would not be tax deductible, just as employee Social Security taxes are not deductible. Employer contributions would be deductible as a business expense like wages, just as employer Social Security taxes are deductible today. Investment returns to the accounts over the years would be tax exempt until withdrawal, just like IRAs. In retirement, half the benefits would be included in taxable income and half not, unless the worker made voluntary, nondeductible, supplemental contributions. Then a formula would have to determine what proportion is taxable and what not.

6. **Retirement Benefits.** Benefits at retirement would equal what the accumulated funds would support. The worker could use the funds to purchase an annuity paying promised benefits for the rest of the worker's life. Regulations would limit such withdrawals so the retiree could not use up all the funds early and then be left without retirement support.

   Workers in the private system could retire at any age after 59 and a half. They could even retire earlier if their accumulated retirement funds were sufficient to satisfy a specified standard of benefits. This is one reason why workers may want to make additional voluntary contributions during their working years.

7. **Recognition Bonds.** For workers who chose the private option, the government would pay into their accounts recognition bonds...
compensating them for past taxes paid into the Social Security system. The bonds would be credited with interest over the years. The amount of the bonds would be set so that with interest they would pay a proportion of future benefits equal to the proportion of lifetime Social Security taxes paid. At retirement, workers can turn in the bonds to the government over time for cash to finance their benefits, along with the benefits payable from the private savings and investment accounts accumulated after the worker shifted to the private system. This system would give all workers a proportionally equal incentive to opt out for their remaining working years.

8. Minimum Benefits. The government would guarantee all workers a minimum benefit as in Chile. This minimum benefit would be financed out of general revenues, supplementing private benefits to the extent necessary to reach the minimum benefit level. As described above, this would assure that no one would fall below the minimum necessary for a dignified retirement, with little significant cost to the government.

9. Right to Stay in Social Security. Workers would have the complete freedom to choose to stay in the public Social Security system if they prefer.

10. Social Security Benefits. There would be no benefit reductions for anyone currently receiving Social Security. Current law already provides that starting in the year 2000 the retirement age will be delayed two months per year until the age reaches 66 in 2005. The reform proposed here would continue to delay the retirement age two months per year after that until it reaches 70. Early retirement would still be available at age 62, with a full actuarial reduction in benefits. In addition, the indexing of future Social Security benefits during working years would be changed from wage-indexing to price-indexing. As discussed, the benefit changes are justified to bring the system expenditures in line with steady-state, long-run revenues.

Financing the Transition

Probably the key issue raised by this proposal for reform is how to finance the transition to the new system. More precisely, with workers paying into the private system rather than Social Security, how will the federal government finance the benefit obligations of the old system until those obligations mostly end and future retirees are relying on the new system instead?

Some have characterized this transition as current workers paying for two retirements—the retirement of current retirees through the old Social Security system and their own retirement through the new private system. But this characterization is misleading. The reform involves a shift from the current pay-as-you-go system, where funds are immediately paid out in current benefits rather than saved for the future, to a fully funded system, where today’s payments are saved to finance completely the future benefits of today’s cost of that transition is simply the cost of the increased saving in the fully funded system. Moreover, the cost of that saving is the same as the cost of any savings increase forgiven current consumption equal to the amount of the savings increase. That cost is worthwhile because of the investment returns earned by the savings increase, adding to income and economic growth.

Here is an example to demonstrate the analysis just given. Assume a Social Security system in the year of reform with $100 billion in revenues and $100 billion in benefit expenditures. Suppose the workers invested the $100 billion in revenues in a private system instead.

Now suppose that to obtain the funds to finance outstanding benefit obligations, the government cut spending on other programs by $100 billion. The result is $100 billion in increased savings, through the private system. Moreover, the $100 billion in reduced government spending involves forgiven present consumption, by society as a whole and not just current workers, of $100 billion as well. The cost of the transition is simply the cost of the increased savings, which is the same as the cost of any other savings increase forgiven present consumption equal to the amount of the savings increase. Moreover, to the extent that the reform generated efficiency gains and stimulated greater economic growth, that would offset the forgiven present consumption, reducing the cost of the savings increase.

Once the nature of the transition cost is properly understood, that still leaves the question of the best way to finance that cost. The numerous ways that this transition cost can be financed are discussed below. As with the system design discussed above, this example should not be considered the only possible method of financing the transition. The actual combination of financing mechanism will be the result of many political and economic factors. The important lesson to draw from this example is that the transition can be successfully financed.

1. Replaced Social Security Benefits. As workers opt for the private system, they will receive fewer benefits from the old Social Security system in the future as a result, with those benefits more than replaced by the new private system. But it will start off relatively slowly. In the first few years, new retirees who opted out for their last few years will receive a little less in benefits from the old public system as a result. But there will be another bigger effect at that time as well. Starting in the very first year, the disability and preretirement survivors benefits for everyone who opts out and becomes eligible that year would be paid through the private disability and life insurance rather than Social Security. This adds up to significant amounts right away.

2. Reduced Social Security Benefit Growth. Reducing the growth in Social Security benefits as discussed earlier would also help to reduce transition costs. In particular, this means that the amounts that would have to be paid in recognition bonds for those who opt out would be substantially less than otherwise, as the Social Security benefits they must compensate for would be substantially less.

3. Revenue Feedback. Another major offset to the transition costs would be the generation of substantial new tax revenue for the government as a result of the new savings and investment in the private system. This new savings will generate the full before-tax rate of
return to capital. As discussed earlier, businesses will pay substantial taxes on these returns before they pay the interest, dividends, or other returns to the tax-exempt private retirement accounts.

Feldstein estimates that the full, real, before-tax rate of return to capital is 9.3 percent annually. Of that, he estimates that 3.9 percent would be captured by the government in taxes paid at the business level before remaining returns are paid to the retirement investment accounts. This is consistent with market investment data. With the private retirement account savings growing to huge amounts relatively rapidly, this would result in the generation of significant amounts of new tax revenue to offset the transition costs.

It should be noted that the private system can and should be structured so that this proportion of the full before-tax real return to capital is taxed away to help finance the transition. These full before-tax returns are so high that the private benefits would still be overwhelmingly higher than those paid by Social Security, just as discussed. Moreover, the full before-tax returns do not go completely untaxed in any other savings vehicle. Consequently, this seems to be the least painful way to help finance the transition. It simply follows a basic principle of successful privatization strategies: using some of the benefits of the reform to offset any costs.

4. Continuing Payroll Taxes. As discussed, under the proposed private system, workers and employers will each pay 5 percent of wages into the retirement accounts, instead of the current 6.2 percent payroll tax on each. But they will continue to pay an additional 1.2 percent each in payroll taxes for a temporary 10-year period to help finance the transition. This will generate significant revenue during that time to offset the transition costs.

5. Social Security Surpluses. For the next 15 years or so, Social Security is projected under intermediate assumptions to produce a surplus of taxes over expenditures of about $35 billion per year. (The surplus does not include interest on the Trust Fund bonds, which is not net revenue to the government because it is paid by the government itself.) This creates a cushion that will partially offset the shortfall of revenue to pay Social Security benefits because of the private option. The net shortfall of revenues to pay the benefits each year will be reduced by the amount of the Social Security surpluses for the year, which can be used to pay these benefits.

Of course, these Social Security surpluses will then not be available to the government to borrow to pay for other spending, which has been the practice in the past. But ending the abuse of the Social Security Trust Funds is not a new cost to the government imposed by the privatization plan. Using the surpluses to pay for continuing Social Security benefits during the transition is simply a matter of using the funds to pay such benefits now rather than later, after lending them to the government for current spending and then claiming them back with interest after Social Security goes into deficit. This does not involve a net new cost to the government. It only involves the elimination of cover for higher government spending on other programs, which is not properly a cost of a Social Security privatization plan (although it will involve a cost to the government). Pending legislation to eliminate the use of Social Security surpluses for other government spending should be adopted, along with commensurate reductions in such spending.

6. Waiver of Past Tax Payments. As discussed above, recognition bonds for past tax payments could be waived for all workers under 30 or some other cutoff age. This would reduce transition costs only when workers under the cutoff age at the time of the reform start to retire (35±40 years from now for workers under 30 today). As the projections in Table 1 show, however, by that time the transition deficits would already have long been offset by the other sources discussed, and the reform would be producing large net surpluses for the federal government. Consequently, that element was not included in the reform plan discussed here.

7. Sell New Government Bonds. Another source of funding for the transition would be to give the Social Security Administration authority to sell new government bonds to the public to raise the money. That is in fact how Nobel prizewinners in economics Milton Friedman and James Buchanan have advocated financing the transition. They have correctly argued that the bonds would not involve new government debt, but only explicit recognition of the implicit debt the government already owes through Social Security. Financing a large proportion of benefit obligations each year through such bonds would be feasible because of the huge amounts of savings that would be generated through the private retirement accounts. The World Bank supported initially financing the transition through this means as well in its 1994 report on the subject. Chile also financed about half its transition costs in this way. The bonds effectively allow the transition to be financed over several generations instead of imposing all the cost on the first generation.

Because Social Security would be off budget under the reform plan, these bonds would be off budget as well. That is sound because the bonds are again not a new debt but in fact explicit recognition of a debt already incurred. So they are really not a part of each year's budget on a current basis. The government has accounted for similar situations in the past off budget as well. Moreover, the transition is a temporary event, not a recurring program.

To the extent the transition is financed by issuing new bonds, the savings generated by the reform would be reduced. That is because the savings increase resulting from contributions to the private retirement accounts each year would be offset by the government's private savings through the bonds. For this reason, it would be wise to limit such bond financing as much as possible.

8. Sell Social Security Trust Fund Bonds. Selling the bonds currently in the Social Security trust fund would have the same economic impact as issuing new bonds. However, it may be easier for people to see that selling the trust fund bonds does not involve the creation of new debt, simply the recognition of an already existing debt that will inevitably come due. It may also be easier for people to understand that the government is only selling bonds that are going to be liquidated later and, therefore, having no impact on national
savings that will not occur under the existing system (although the short-term negative effect on savings from the sale of bonds is fully counted in the projections in Table 1). Selling the trust fund bonds may also be easier under Congress’s budget rules.\textsuperscript{[30]}

9. *Enhanced Economic Growth.* The net increased savings as a result of the shift to the private system also would produce enhanced economic growth. The increased saving will increase investment, productivity, wages, and jobs that will translate into more productive output and income, and then still more savings, which will produce still more economic growth in all these ways.

Economic growth also would be enhanced by removing the burden of the payroll tax. Under the proposed reform plan, the required payments into the private system would be about 20 percent less than the Social Security payroll tax, providing an effective 20 percent payroll tax cut. Moreover, contributions to the private retirement accounts are owned directly by the worker and, therefore, will be seen as part of the worker’s payroll tax does. Feldstein and other economists predict this will lead to greater work, employment, wages, jobs, productive output, and overall economic growth.

This higher economic growth would help to finance the transition by increasing government revenues and reducing government expenditures for those formerly in need of assistance.

The reform would also likely produce efficiency gains. For example, private insurers would be more effective in weeding out illegitimate disability claims, which are causing runaway costs in the disability program. Also, the private retirement benefits would not be subject to the earnings test, which reduces benefits to the extent workers continue to work and earn wages after retirement, exceeding certain low limits. This will again increase work and employment. All such efficiency gains will produce more economic growth and income, offsetting the transition costs.

However, to be conservative, no estimate of the extra revenue and reduced spending likely to result from increased economic growth is included in the projection below of the transition costs of the proposed reform plan. Sophisticated econometric studies would later provide some reasonable estimates of these effects.

10. *Cut Other Government Spending.* Any remaining transition costs should be financed by cutting other government spending, much of which is wasteful and even counterproductive. Reducing it will not amount to a significant cost. To the extent that the money can at least be more efficiently spent in the private sector, cutting this spending will produce an efficiency gain that again will help to offset the transition costs.

To illustrate how these sources can feasibly finance the transition, the rough amounts that may be derived from each are presented in Table 1. These figures are meant to provide a general idea of the likely magnitude of each source over time, and not a precise estimate. They are calculated from the Social Security Administration’s own projections of the future income of Social Security, using the government’s own assumptions.

To make these calculations, it was assumed that the reform plan was implemented this year (1997), and that 50 percent of all workers would choose the private system over Social Security in each of the first 3 years. Then 75 percent of all workers were assumed to choose the private option in each of the next three years. Finally, 90 percent of all workers were assumed to choose the private option every year thereafter. All figures in the table are presented in 1996 dollars.

Column 1 shows the amounts that would be invested in the private system each year instead of being paid into Social Security. As indicated, workers and employers each pay 5 percent of wages up to the Social Security maximum taxable income into the private system. The transition would have to come up with alternative means of offsetting the shifted payments to continue to pay Social Security benefits.

Column 2 shows the total amount of invested funds that would be accumulated in the private system each year. The private retirement investments were assumed to earn an average real rate of return of 4 percent, which is justified by market experience.\textsuperscript{[31]} The benefits paid from the private system were subtracted from the accumulations each year. The projections show that the private trust funds would grow quickly to almost $1 trillion after just 5 years (2001) and to over $2 trillion after 9 years. Forty years after the reform (2036), the private trust fund would grow to $13.5 trillion in assets in 1996 dollars. (Individuals would not receive all of these funds as retirement income. A portion would be used to provide disability and survivors benefits.)

Column 3 shows the additional tax revenues that would be generated from the private investments. With the huge accumulation in private trust fund assets, these tax revenues grow to large amounts rapidly as well.

As previously discussed, workers who chose the private option would receive fewer and ultimately no benefits from the old public system, receiving likely better benefits from the new private system instead. Column 4 estimates the savings from this effect that would help to reduce the transition costs. The great majority of the savings shown in the early years results from sharp reductions in disability benefits and preretirement survivors benefits paid by the old system. As previously indicated, workers who opt into the private system would have all such benefits thereafter paid through private life and disability insurance rather than the public system, thus producing the immediate savings. Over the years, savings from forgone retirement benefits would grow to large amounts, as more and more workers retired who had paid into the private system instead of Social Security for more and more years. Indeed, eventually this effect alone would completely...
eliminate transition costs.

Column 5 shows the savings that would result from delaying the retirement age under Social Security and changing the program’s calculation formula from wage-indexing to price-indexing, as discussed earlier. This eventually grows to large amounts as well, as the amount that must be paid in recognition bonds for those who choose the private option is substantially reduced.

Column 6 shows that no extra revenue or expenditure savings resulting from increased economic growth due to the reform was assumed to help finance the transition. Column 7 shows the revenue that would be lost when workers and employers who have opted out stop paying the payroll tax entirely after 10 years.

Column 8 shows the net shortfall in revenues to pay continuing Social Security benefit obligations, after all the previous changes to revenues and expenditures. This shortfall is reduced over the next 10 to 15 years by the Social Security surpluses that are projected for that time, and by the continued partial payment of payroll taxes by workers and employers who have opted out. (Note that this does not include any shortfall caused by taking Social Security off budget.)

Column 9 shows the amount of other government spending cut to finance the transition. These amounts are equal to less than 4 percent of the total federal budget now projected for each of the first 12 years after the reform.

Finally, the last column shows the interest that must be paid on the government bonds sold to the public. This is reduced in 2013 and completely offset thereafter by the net surpluses produced by privatization and shown in column 8. The government could avoid any interest outlay during the early years of the transition by issuing zero coupon bonds that will accumulate the interest until maturity. The government could then pay the interest out of the interest expense it would save by avoiding future Social Security deficits and Social Security trust fund draw-down, when it would otherwise be incurring huge interest expenses.

Quite remarkably, Table 1 shows that apart from the 20 percent cut in payroll taxes, the annual transition deficits are actually eliminated within 14 years. In that year, $68 billion is lost due to the tax cut, while the total transition cost is only $49 billion. From that year forward, cuts in other government spending are required only to finance the tax cut.

Before the 14th year, the annual transition deficits can be entirely offset by the spending cuts shown, less than 4 percent of projected federal spending, and by the sale of government bonds.

Moreover, 17 years after privatization begins, even the cost of the payroll tax cut has been offset, and privatization starts to produce surpluses. Within a few years, these surpluses grow to large amounts. Indeed, within 5 more years, 22 years after privatization begins, the surpluses will be large enough to completely pay off all the bonds previously sold to help finance the early years of the transition.

After that, the surpluses can be used to reduce the federal deficit. Indeed, by that time the annual surpluses will be larger than the entire 1996 federal deficit (in 1996 dollars). Thirty years after privatization, the surplus is equal to $426 billion (in 1996 dollars), or approximately 3.5 percent of GDP. Forty years after privatization, the annual surplus exceeds 5.5 percent of GDP.

These projections radically change the whole outlook for the transition of Social Security to the private sector. Instead of raising concern over the short-term budget impact of the transition in producing deficits, Social Security privatization should be seen as a way of eliminating long-term federal deficits, which are now projected to explode over the next few decades. Indeed, the huge surpluses that would result over the long run from Social Security privatization would be large enough not only to eliminate those deficits, but to allow major reductions in federal taxes or the national debt as well.


dConclusion

Privatization of Social Security is an idea whose time has come. Mushrooming support for the idea across American society reflects international trends. Although there are many issues to be resolved in designing a privatized Social Security system, it is clearly possible to design a workable and fair program.

Moreover, the transition to the new system is feasible. Indeed, projections of that transition uncovered a new benefit not previously understood. The transition deficits can be eliminated on net in about a dozen years, and after that point the privatization reform starts producing surpluses that grow to large amounts after just 20 years. The surpluses are in fact sufficient to cover the revenue lost from a 20 percent payroll tax cut, to balance the federal budget, and eventually to finance further reductions in taxes or the national debt.

Many of the specifics of such a proposal are matters of economic and political judgment that may lead others to propose variations on the details. This study shows at least the various issues that a concrete proposal must address. What is important is to show the public how a concrete proposal can work and be feasibly implemented.

Table 1

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1. Assumes that 50% of workers opt out in each of the first three years, 75% opt out in each of the next three years, and 90% opt out after that.
2. This column presents the accumulation of the invested funds plus returns on the investments, assuming a 4% annual real rate of return. The benefits paid from the private system are subtracted from these accumulated funds each year.
3. This column presents the new revenues produced from taxation of the full, before tax real returns earned by the net increase in the private investments, after subtracting the amount of government bonds sold each year.
4. This column presents the savings arising from replaced Social Security retirement, survivors and disability benefits of those who opt for the private alternatives.
5. This column presents the savings arising from delaying the retirement age and changing future benefit calculations from wage-indexing to price-indexing.
6. Assumes conservatively that no extra revenues are generated by additional economic growth generated by the reform.
7. Assumes that after 10 years, employees and employers only pay 5% of wages each into the private system and no longer pay an additional 1.2% each into Social Security to help finance transition benefits, as they did for the first 10 years.
8. Includes effect of Social Security surpluses and the continuing 1.2% of taxable wages paid by employees and employers each for the first 10 years after the worker opts out of Social Security.
9. Assumes that projected total Federal spending is reduced by the amounts shown to help finance the transition.
10. Assumes the government sells bonds each year to raise money to pay continuing Social Security benefits. These can be either new government bonds or the already existing bonds in the Social Security trust funds.

Notes

1. The poll of 1,000 adults was conducted by the Gallup Organization on behalf of the Employee Benefit Research Institute in January 1994. Individuals were asked, "Do you think participation in Social Security should be made voluntary?" Fifty-four percent responded "yes"; 44 percent responded "no."

2. The poll of 1,007 adults was conducted by the Gallup Organization on behalf of the Employee Benefit Research Institute in January 1995.

3. The poll of 1,000 registered voters was conducted November 1-8, 1995, by GrassRoots Research of Charlotte, N.C. The margin of error was +/-3 percent.


10. Ibid., p. 5.


August 14, 1995.


17. Shipman, p. 4.

18. For a more thorough discussion of these issues, see Ferrara, *Social Security: The Inherent Contradiction*, chapter 6.

19. In an ideal world, Social Security would be voluntary. However, political reality makes such an approach impossible today.


21. Legislation to make the payroll tax deductible has been introduced by Rep. George Nethercutt (R-Wash.).

22. Exempting the account investments from tax will not result in a revenue loss because such a saving does not exist under the current system and, therefore, is not generating any taxes now.


24. Details of the commission—


26. It is also consistent with our assumption below that the accounts would directly receive a 4.0 percent real rate of return out of the full before-tax 9.3 percent return.


29. The author is grateful to George H. O'Neill Jr. for this suggestion.

30. Indeed, if a balanced budget amendment is adopted that does not take Social Security off budget, the sale of new bonds to finance the transition may not be allowed without the amendment—bonds would not be restricted.