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A False Sense of Security: The Social Security Debate

Chris Shipman-Sercu
Claremont McKenna College

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Professor Marc Massoud

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Dean Gregory Hess

by

Chris Sercu

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I. OBJECTIVE

My motivation to write this thesis is based on the controversy surrounding the Social Security system that has recently infiltrated the media. Through my research, I have discovered the debate concerning Social Security is not a recent development but has existed since the 1930's. Many sources are warning citizens to no longer count on Social Security as they most likely will not receive benefits until a extremely old age if they receive benefits at all. Current retirees are fearful of either a decrease in benefits or not receiving the money they contributed to the system through the years of employment at all. Proposals and options for overhauling the system have moved to center stage in politicians' agendas and numbers of solutions have surfaced.

As information presented by the media may carry a bias, I aim to discover exactly how the system works and whether the accusations that the system is headed for ruins are grounded in rational empirical evidence. After completing this research, it seems highly likely that the system is going to face trouble in the future. The precarious situation surrounding social security led me to examine possible solutions to the existing system and how feasible a new, private structure is for the United States.

Unfortunately, this debate is creating a huge divide between party lines in Congress. Some argue for more government control while others advocate privatization. The goal for this thesis is to perform a cost/benefit analysis of the two ideologies and determine which is more practical and realistic for both the government and the people.

I. INTRODUCTION

The United States Social Security program is universal – it affects every American as they consider their retirement plans. The objective of the Social Security system is to offer assurance to current retirees, future retirees, and the disabled through social risk management with programs such as Old-Age, Survivors, Disability insurance (OASDI), Medicare and Medicaid, unemployment benefits, and supplemental income. Though Americans should be confident that they will obtain Social Security benefits when they retire, this thesis examines the economic threats citizens will face if a solution to the Social Security problem does not occur.

The possible solutions to the Social Security dilemma are to alter the existing guidelines as done in the past, establish a fully privatized system, or incorporate privately managed accounts in the existing system. The increased number of beneficiaries as the baby boomer generation begins to retire has intensified the debate over social security. In addition, as healthcare improves, beneficiaries tend to live longer and require more years of support from social security.

Though originally a small-scale program, OASDI, a provision of Social Security, has become the paramount social insurance program in the world and sustains millions of beneficiaries. Benefits have evolved from a hedge against poverty to a program that ensures quality of life. Many question whether the government can continue to provide a retirement service while maintaining the bureaucracy and running a country. The question to the American population is: would they rather have some say in their retirement or let the government continue to control their future?

This thesis examines the history of the Social Security Act as a framework for measuring whether the alternate systems will uphold the original vision behind social insurance. Though social security was fairly stable until the 1970s, eventually issues were identified, which generated the modern debate surrounding social security. The remainder of the thesis will analyze the quantitative shortcomings that plague the current system, as well as its positive aspects that may be jeopardized in a semi-privatized or fully privatized system. The advantages and disadvantages of a fully privatized system are examined through the existing system in Chile and the cost benefit analysis of a semi-privatized system is examined through George Bush's semi-private proposal and the Thrift Savings Plan.

II. THE ROOSEVELT REVOLUTION: BEGINNINGS OF SOCIAL SECURITY

The establishment of the American welfare system was not merely an impulsive response to the Great Depression; it came to fruition after almost three decades of deliberation. At the start of the 20th century, European governments began to adopt preliminary forms of social welfare in which the government assumed a few responsibilities previously completed by the family (Nash 3). Progressive reformers and leading social economists in America began to publicize governmental social insurance based on Germany's innovative welfare framework, composed by Chancellor Otto von Bismarck in 1883, which entitled workers to health insurance, accident insurance, and old age pensions. These initiatives proved to be a unifying force between Germany's government and its people, providing a fair compromise for the social movement and the government amidst rapid industrialization (Nash 182). President Theodore Roosevelt was the first prominent figure in America to promote social insurance, implementing a program that aided single-head families and abandoned children.

The campaign for a public welfare system lost momentum during the First World War but was not forgotten as an increasing number of academics produced literature on welfare economics during the 1920's. Progressive reformers advocated government adoption of a social welfare system because of the quality of life discrepancy among Americans seeking retirement as well as the rapid industrialization of U.S. economy. Estimates from the early twentieth century indicate half of the elderly population lived comfortably upon retirement, but a mere fifteen percent of the elderly population could provide for their basic needs. The remaining thirty-five percent of the elderly population lived in poverty, highlighting the need for a government program to ensure the well-being of the elderly who had paid their dues in the American workforce. Industrial corporations employed a majority of the labor force, tilting the balance of power in their favor and eliminating the bargaining power of the working class. Specialization in modern industry nearly dispensed the need for the experience of older workers. Consequently, the unemployment rate for workers over the age of sixty-five was double that of the average laborer (Skidmore 24).

Labor unions began to populate the nation, posing a threat to the economic stability of large corporations. Motivated mainly by self-interest and the impending risk of unions, a small number of employers began offering company pensions to secure relationships with their employees. Pensions had never been used in an employment setting as they had failed to take hold at the state level. In 1910, the Massachusetts Commission on Old Age Pensions criticized the pensions, claiming they were “inadvisable” and “impractical” (Asen, 24). The Commission argued that these pensions would threaten self-reliance and could potentially expand the class of dependents. In the 1920’s, however, the attitude toward old-age pensions changed as the quality of life for the elderly began to diminish.

The Great Depression completely transformed the complexion of the social welfare debate as the entire American financial system was in jeopardy. The socioeconomic disaster caused a massed reconsideration regarding the proper role of the federal government in respect to the economy and social well-being. From 1929 to 1933, unemployment rose from approximately three percent to almost twenty-five percent. The numbers were much worse for the elderly. Unemployed workers over the age of sixty-five suffered from an unemployment rate fifty percent higher than the rest of the working class (Nash 6). In addition, the elderly endured periods of unemployment that were twice as long as the younger population, causing progressive leaders to claim that opportunities for older workers had "almost completely vanished" and that "the nature and extent of old age dependency in the United States clearly indicate that it is not due to individual maladjustment but rather to social and economic forces altogether beyond the control of the individual" (Asen, 25). Ultimately, the socioeconomic well-being of the American elderly needed to be considered at the federal level.

President Franklin D. Roosevelt acted swiftly during his first one hundred days in office and proposed new legislation in an attempt to expedite the process of America's economic recovery, which led to the New Deal in 1933. The first wave of the plan, now deemed the First New Deal, proved to be extremely successful but only provided immediate, temporary relief primarily for U.S. banks, industry, and agriculture to stimulate the economy. Nonetheless, the First New Deal would have a relatively minute impact compared to the Second New Deal.

During the presidency of FDR, social movements gained momentum and advocated political change. A California physician by the name of Francis Townsend was the backbone of the social movement for old age pensions. Townsend's campaign began with a humble article in a local newspaper in Long Beach, California. The article proposed a monthly pension of $200 for those over the age of sixty-two who agreed to withdraw from the work force. Townsend would require the beneficiaries to use their entire pension each month, which he predicted would revive the economy. The pensions would be paid using a two percent national tax (Skidmore 23). Dr. Townsend's proposal received such positive feedback that Congress agreed to hear his ideas. The excitement ignited by Townsend's testimonies meant that politicians had to consider supporting his economic stimulus plan in their campaigns for the 1936 election. Huey P. Long, a Senator from Louisiana and potential presidential candidate, advocated a similar plan that included old-age pensions, health care, education, unemployment insurance, and public relief (Kennedy 363). In June of 1934, President Roosevelt revealed a future comprehensive social welfare program of his own saying, "we may well undertake the great task of furthering the security of the citizen and his family through social insurance," to combat his opponents for the presidential elections.

The social welfare program, named the Second New Deal was constructed by the Committee on Economic Security, a group established by President Roosevelt, and signed into law in 1935. Secretary of Labor Frances Perkins, a proponent of social welfare, acted as the head of the committee which included another social insurance visionary, Harry Hopkins. Roosevelt knew Perkins shared the same enthusiasm for social welfare and was quoted telling Perkins, "You care about this thing, you believe in it.

Therefore I know you will put your back to it more than anyone else, and you will drive it through. You will see that something comes out, and we must not delay" (Asen 27). The council saw a promising policy future in social insurance, and introduced Old-Age Insurance (OAI). The committee delineated that benefits would be received based on contributions from previous wages earned. Workers would be encouraged to maintain employment and wages to earn the right to a higher rate of benefits when they grew old. The committee also saw public pensions and social insurance a universal benefit as "you are able to retire persons after they have outgrown their period of usefulness and replace them by more efficient workers. Therefore in the long run they pay for themselves" (Kennedy 363). Kennedy's statement suggests social welfare could have solved the existing problems despite the evolution of the American economy.

Many new social welfare programs were instituted in the New Deal, including the prize of their discussions, the Social Security Act. On August 14, 1935, President Roosevelt signed the Social Security Act into law. President Roosevelt insisted that system "should be self-sustaining in the sense that funds for the payment of insurance benefits should not come from the proceeds of general taxation" (Kennedy 364). On June 8th, 1934, President Roosevelt also explained to Congress "[a]s our Constitution tells us, our Federal Government was established among other things 'to promote the general welfare,' it is our plain duty to provide for that security upon which welfare depends." The Social Security Act echoes President Roosevelt's proclamation. The prologue of the Social Security Act declares the purpose of the act, to:

> Provide for the General welfare by establishing a system of Federal old-age benefits, and by enabling the several States to make more adequate provision for aged persons, blind persons, dependent and crippled children, maternal and child welfare, public health, and the administration of the unemployment compensation laws; to establish a Social Security Board; to raise revenue and for other purposes (Nash 8).

The OAI was initially intended as a smaller clause under a larger general welfare act; the effect OAI would ultimately produce was not anticipated by anyone. The act included eleven titles surrounding ten programs, nine of which were existing programs such as aid for the blind and aid for dependent children. OAI was the only strictly federal insurance program. Titles II and VIII of the Act pertained to OAI; Title II outlined the basic operation of the program while Title VIII delineated the financing for the program. The act stipulated that the levying of payroll taxes would begin on January 1, 1937 and the distribution of benefits would commence on January 1, 1942 to a minority of the labor force (Nash 34).

Initially, legislation excluded federal, state, and local government employees, non-profit and perhaps most-importantly excluded agricultural, domestic, and casual laborers. A reserve account was formed where reserve funds could be invested only in interest-bearing obligations of the United States or other obligations guaranteed by the US. The tax for OAI did not serve as a tax deduction for the employees. The Act specified a three percent return. The contributions to the system would go into the Social Security Trust Fund where future payments would be made, accruing interest from US bonds. The government could use the reserve as a way to borrow funds to use at their discretion for the country, basically setting up an IOU system.

The Amendment to the Social Security Act in 1939 changed many details regarding the original act before any benefits were actually paid. Each of the programs in the Act was to be funded by the Federal Insurance Contributory Act (FICA), also commonly known as the United States payroll tax, through a taxation of one percent of both the employers and employees up to a limit of $3,000, until 1950 (Nash 12). The Amendment called for an expedited pay schedule with benefits becoming available in 1940 instead of 1942. Though the original act held that benefits would be paid out of the large reserve, the amendment manipulated the system so that benefits would be paid through a “pay-as-you-go” system and surpluses would accumulate in the reserve. OAI has evolved to include benefits to dependents of deceased workers, disabled workers, and their dependents; and appropriately, is now called the Old-Age, Survivors, and Disability Insurance (OASDI).

III. THE SOCIAL SECURITY SAGA

Congress transformed the Social Security system into a "pay-as-you-go" (PAYG) system in 1939, a move that sparked the modern social security debate. In the aftermath of WWII, social insurance expanded from a program to protect wage-workers to a program that, in theory, should protect all citizens. The post WWII social security system also included a redefinition of what qualified "security". Security no longer meant merely living above the poverty line; security had come to mean maintaining standards of living.

Up until the mid 1970's, Social Security was essentially a non-issue. After 1972, real median income stalled and eventually fell after a long period of success. In 1980, the US experienced the largest single decline in real family income – a shocking 5.5%. Severe recessions in the US from 1974-75 and 1980-82 diminished the optimism surrounding social security. High unemployment rates and higher inflation increased the need for social expenditures but at the same time depleted the available resources under the pay-as-you-go system (Nash 17). Policymakers saw Social Security as a huge success and the central component of the federal retirement policy, so they wanted to compensate retirees further by ensuring benefits against inflation which would theoretically mean retirees would be able to keep pace with any increase in the cost of living.

Congress designated Social Security as an earned right, expanding coverage to nearly every American, which created a three to one worker to beneficiary ratio. The early decades of the social security were deceptively successful because the system was covering a limited number of Americans. Benefits increased as the country experienced high inflation; benefits increased by 15% in 1969, 10% in 1971, and 20% in 1972. In the 1972 Social Security debates, it was generally accepted that a cost of living adjustment should be added to ensure the quality of life for retirees since one in four seniors lived in poverty – twice the poverty rate of the general population. Congress noted that inflation took an exceptionally painful toll on seniors, whose fixed income did not allow them to adjust for the rising prices of goods and services (Nash 20).

The 1980's proved to be even more tumultuous for the social security system. In the 1982 trustee's report, the SSA announced the OASDI trust fund would not be able to pay all benefits on time through July 1983. After a few years of using the reserve funds, the assets began to dry up. In December 1981, President Reagan announced the formation of a National Commission on Social Security Reform. The commission consisted of fifteen members appointed by the White House and was chaired by Alan Greenspan. Greenspan identified a financing problem with the social security fund in both the short and long run. Congress then passed a series of legislation that would hopefully sustain the social security system. Congress increased the payroll tax rate, raised the retirement age from sixty-five to sixty-seven, and raised taxes on the self-employed. For citizens born after 1960, the standard retirement age has remained 67 (Asen 57).

Eventually, criticism of the economic side effects and fears of long-term infeasibility of the social security program began to drown out the near unanimous praise as the greatest social triumph in the twentieth century. Contributors began to protest the increases in the payroll tax, while the beneficiaries began to wonder if they would have sufficient income upon retirement. Not seen since the inception of the program, debate returned concerning higher taxes and possible bankruptcy.

Complete privatization proposals did not emerge until the mid-1990's. Congressional hearings focused on the logic of the rights asserted by the original supporters of Social Security, arguing that these benefits were an earned right – a right secured by a worker's contributions. Advocates of the existing system held that Social Security is an insurance program, whereas proponents of privatization counter that social security should be an investment program. President Bush initiated a semi-privatization plan that heightened the debate surrounding the ethics and economic feasibility of privatization (Stephenson 29).

ELEMENTS TO CONSIDER IN THE SOCIAL SECURITY DEBATE

There are three main issues in the Social Security debate: how the benefits should be set, how much social assistance should be granted, and the impending depletion of the reserve. In considering any proposal for reforming the social security system, these issues must be analyzed. Unfortunately, there is no clear-cut solution.

The manner in which benefits are set primarily involves who assumes the risk. For a defined-contribution plan, where retirement benefits are based on the contributions and returns of a participant's account, the risk defaults to the account holder because overall market fluctuations and investment risks are the primary concerns. Under a combined-benefit plan, like the current social security system where participants are paid based on a formula including how much they have earned and how long they have worked, risk is spread out across the whole system as the single account is substituted with a large government trust fund.

In examining reforms to the social security system, inflation is another key concern as it greatly affects the purchasing power of retirees. The cost of living adjustment (COLA) in the existing program adjusts benefits according to the consumer price index. For a defined-contribution plan, extra precautions need to be put in place as inflation poses a big problem. According to the Congressional Budget Office (CBO), long-term projected inflation of 2.5% can cut the purchasing power of an unindexed pension plan by 43% over twenty-three years (Aaron 31).

The amount of social assistance that should be provided is another subject for debate. Historically, low-earners and couples have been given more assistance than individuals and high-earners. Payments to surviving spouses and children of deceased workers provide benefits equivalent to those of a life insurance plan. The fundamental principle of Social Security is to provide social insurance and welfare upon retirement so it seems logical that the amount of social assistance provided should be enough to promote the general welfare. Despite the impending financial troubles of the system, Social Security keeps twice as many people out of poverty than every other government welfare program combined (Aaron 42). A controversy arises over the initial intentions of the founding contributors to social security when examining a fully privatized system; complete privatization would eliminate a majority of the social insurance to the ones who, as defined by the founding principles behind social security, need it the most.

The last major contested issue is the amount of reserve accumulation in the Trust Fund. The original founders of Social Security preferred a PAYG system because it provided an easier structure to build large reserves through the flexibility of setting benefits to a level where reserve accumulation is possible. Reserves in the Social Security Trust Fund are invested in government-backed bonds. Despite this advantage of the PAYG system, many consider it a Ponzi or pyramid scheme where early depositors are paid by later depositors, leaving the later depositors in a precarious situation as future funds begin to dry up (Aaron 44).

Currently, all reserves are invested in Treasury bonds but they do not accumulate interest in a fund like a normal account. The Federal government borrows the proceeds from payroll taxes and uses them in other government programs. In order to reimburse the borrowed funds, the Treasury uses tax money that it collects through the Internal Revenue Service to repay the original amount borrowed plus the accrued interest. So the payroll taxes do not actually sit in an account and accrue interest, they are forwarded straight to the Treasury in the form of public debt that the government uses to fund other programs. The government promises to pay back the principal plus the interest as if the contributions were in an account accruing interest. Recently, as the government has run a deficit repaying these Social Security obligations, they have issued more debt through Treasuries in order to fulfill their promise ("Analytical Perspectives" 417).

The main question regarding the reserve is whether to continue to build it for the future in a PAYG system or through a separate individual defined-contribution system. Building a reserve would increase national savings as well as increase benefits in the future, as there would be more funds to draw upon. However, building the reserve does have some risky implications. As these benefits become larger and more secure, individuals may save less and borrow more. If individuals saved less, national savings would remain stagnant, as there would be more public savings at the expense of private saving. If the trust fund grows too large, it would be likely that the government could do other, more beneficial things with the reserve such as increasing educational funding.

TROUBLES WITH THE CURRENT SYSTEM

For all the problems plaguing social security, there are three basic solutions: cut benefits, raise taxes, or borrow from the Federal Government. Each of these solutions has serious downsides that must be taken into consideration. Cutting revenues by beginning to fund defined-contribution accounts would slash benefits and renege on the pledges given to near-retirees. If taxes increase, workers have to support the retirees as well as simultaneously contribute more to their own retirement. If the government borrows against Social Security, in the end, that burden would shift to the taxpayers. It is largely accepted that some alteration needs to be made in order for the system to survive. Many different factors contribute to the inevitable demise of the current system: improvements in healthcare resulting in a longer-living population, the increase in untaxed wages, and increased cost of living.

The declining ratio of workers to retirees has been at the forefront of the debate for years. In a pay-as-you-go system, this poses an enormous problem. As the number of contributors to number of recipients ratio decreases, the reserve for the future generations will shrink. The general life expectancy of Americans at age sixty-five has risen by about five years since 1940 (Hitzlik 223). As retirees live longer, they draw benefits from social security longer, increasing the strain on the system. In 1950, there were sixteen workers for every social security recipient, now there are approximately two and a half workers for each beneficiary. As the "Baby Boomers" continue to retire, the ratio is expected to fall to a two to one ratio (Stephenson 7). With these low ratios, the Trust Fund will ultimately disappear and eventually halt the payout of benefit pensions altogether.

Payroll tax is regressive because higher earners pay a smaller percentage into the system than the lower earners. After the 1983 Social Security reforms, only 10% of earnings were not covered by the wage base, that share has risen to over 15% today and will continue to rise (Hitzlik 226). The wage base, which now sits at $106,800, is the limit that can be drawn from payroll taxes. Any wages earned above the $106,800 cap evade the payroll tax and therefore will not contribute to Social Security. Recent tax cuts and limits on taxation of equity compensation have furthered the regressive nature of the payroll taxes.

Some United States workers have managed to avoid contributing to the system. Illegal immigrants pose a huge problem to Social Security. The estimated nine million illegal immigrants give next to nothing in terms of taxes while using a significant share of public services, such as health care (Hitzlik 227). Employers of illegal immigrants pay them under the table stripping potential contributions into the system. The last major groups exempt from membership in Social Security, other than illegal immigrants, are State and local officials. They can choose to be involved in their own pension systems provided by either the state or local governments, or be covered by Social Security. About a third of state and local workers in the state of California are not covered by Social Security primarily because of the California State Teachers Retirement system (Baily 212). Many other states have local and state employees that are not covered and many employees that are covered are subject to “offsets” which reduce Social Security benefits if they are part of another pension program (Baily 211). Additional funding from state and local employees not already covered under Social Security would not solve the large deficit the Social Security is projected to incur, but they would help by adding sustainable and predictable revenues into the system.

Each year the trustees of the OASDI program supply projections for the system seventy-five years in the future to gauge the health of the system. In 1993, the Social Security Administration projected that contributions would exceed the costs up until 2013 and sustain a positive balance until 2050. The Congressional Budget Office (CBO) predicts that in 2010, total expenditures would be greater than total contributions and that the Trust Fund would have a positive balance only until 2041. *Figure 1* shows the CBO's projected tax revenues and outlays paid out in the future. As outlays outpace tax revenues in the future, the SSA will have to either draw from Social Security reserves to pay out the remaining benefits or increase taxes. As *Figure 1* shows, for as long as is projected, outlays top revenues, which illustrates that the reserve fund can continue to provide benefits until fund exhaustion. This shows how underestimation and recent economic struggles have further jeopardized the system. *Figure 3* displays the CBO's simulation of possible exhaustion date for the reserve fund. A 50% likelihood of exhaustion is simulated to occur in 2038 and 80% is simulated for 2046 only thirty-six years from now. *Figure 3* illustrates the future projections of Social Security expenses as a percentage of GDP. Currently, Social Security expenses as a percentage of GDP sit at 4.1%. This is projected to quickly escalate to over 6% as soon as 2030 as more and more baby boomers continue to retire. Over a twenty year span, Social Security as a percentage of GDP will unprecedentedly increase by almost 50% further presenting how the system will grow larger and be relied upon by more and more retirees. The year 2009 was the first year since 1975 that benefits were not increased from the previous year (Stephenson 27).

Another method that can be used to gauge the health of the Social Security system is to consider the mean replacement ratio, which is defined as the amount of benefits received in the first year of retirement as a percentage of earnings in the last year of employment. The increase in benefits over time is illustrated in *Figure 6* by historical and future replacement rates. The mean replacement ratio from the beginning of the Social

Security Act until 1950 was approximately 30%. Today the replacement ratio is roughly 45% and projected to increase slightly in the future. The replacement has risen because historically, benefits were not indexed to inflation, so benefits would not rise from year to year. This figure acknowledges the present state of benefits in the Social Security system by showing how Social Security has gone from a supplemental welfare or needs program to a supplement for a quality of life.

The Cost of Living Adjustment is widely considered as another trouble surrounding the current system. Since increases in benefits through COLA are raised each year by the Consumer Price Index, they are subject to the accuracy of the CPI. The CPI is calculated by the Bureau of Labor Statistics using changes through time in the prices of consumer goods and services. In the past, the Bureau of Labor Statistics has been scrutinized for misrepresenting the rate of inflation in the United States, making a large impact on COLA payments that are paid. The index was calculated using a basket of goods that consumers would purchase or use in their everyday lives. The Bureau of Labor Statistics has recently changed how they calculate CPI, by removing biases that used to overstate the index, and switching to an index that more closely reflects the increase in the cost of living (Aaron 104). In 1998, the Congressional Budget Office (CBO) provided data showing that if they lowered their projected CPI in the Cost of Living Adjustment by .1%, after five years, benefits would decrease by $2.4 billion and revenues would increase by $2.1 billion (Aaron 105). Currently, monthly social security payments include payment from each individual’s base payment provided by the benefit formula, plus the Cost of Living Adjustment increase proportional to their base.

IV. PRIVATIZATION

The privatization of Social Security has become a major political issue. Concerns have manifested regarding the sustainability of the program as retirees are living longer and as baby boomers continue to feed into the system. This year is projected to be the first year since the 1980's where the system pays out more than it will collect. As the current system acquires debt for the first time, it is important to consider other alternatives such as privatization.

In order for privatization to succeed, two main goals must be obtained: a defined-contribution pension system must be arranged where each person owns their own personal retirement account, and eventually the current Social Security retirement benefits would have to be eliminated through a new system. The pay-as-you-go system would cease to exist and workers would have control of where their money is invested. The system would be closely related to the existing Individual Retirement Account (IRA), but the government would oversee the system. Private financial institutions selected by the individual or the government would control retirement accounts under a completely private plan. All of the funds in the account would be available to sustain pensions for the account holder as they move into retirement. The total funds in the account would rely on the amount that was contributed plus the account's investment returns minus administrative costs.

Many factors need to be taken into consideration if a private social insurance system was put into place: the size of the proposed plan as well as the distribution of the funds, the cost of transition, and the different investment rules that would be put into place. The move from the current system to a completely privatized system would imply a significant financial outlay. Investment rules pertaining to each individual's accounts would be a highly contested topic. Many have urged open investment in any approved financial asset such as corporate stocks and bonds. Each investment would have to be government certified in order to limit the risk of each account. Restrictions would be put into place to establish guidelines regarding individual control over their accounts but the restrictions would also reduce the likelihood that the returns of some participants would fall way short of the market.

Defined contribution pensions plans providing workers with individual accounts are beginning to dominate pension plan growth worldwide. Contributions are put into the accounts, usually by workers though sometimes by employers. Return on investment from the fund is credited to the account. The participating worker usually has some choice over the investment of the account and therefore bears the resulting financial risk. At retirement, the participant can convert the account balance to an annuity or take benefits through phased withdrawals.

A major drawback to privatization is the substantial reduction in Social Security benefits to the less fortunate. Disability and Survivor's insurance programs would still be in place, but would not have the same effect as under the current system. Proposals to maintain the disability and survivor's insurance entail either requiring individuals to purchase private life and disability insurance policies or to fund the programs through actual taxation.

Definite contribution plans, or individually managed retirement accounts, did not become an important source of retirement income until the 1980s. Most countries have chosen defined contribution plans as the traditional social security plan for workers. Many countries in Latin America and Europe have adopted mandatory individual accounts after facing existing plans with financial problems.

CHILE: A MODERN EXAMPLE OF COMPLETE PRIVATIZATION

In the 1980's, Chile faced a similar problem to the one the US is currently experiencing. Chile's public pay-as-you-go system was well on its way to bankruptcy. Like the US, Chile faced the threat of deterioration in its worker to beneficiary ratio, also called the "support" ratio. Ultimately, Chile enacted the most radical social security reform – getting rid of its public defined-benefit system and replacing it with an individually funded and privately administered mandatory defined-contribution system (Stephenson 127).

Chile's former pay-as-you-go system had many problems that eventually spurred the drastic change. High administrative costs, inequitable benefits, and persistent fraud led to the public system's demise. Chile's social insurance system expanded into thirty different subsystems where benefits were based on occupation. Unequal qualification criteria and benefits created high administrative costs and unfair pay. White-collared workers received pensions almost equal to the average of their last five years of salaries whereas manual laborers would receive pensions at about 70% of their final pay (Stephenson 128). Manual laborers needed to work until the age of 65 to qualify for these benefits compared to Chile's white-collared professionals who typically qualified for their benefits after only thirty-five years of employment. Bankers and parliamentarians qualified for these pensions after only twenty-four years and fifteen years of employment respectively (Stephenson 129). All of these issues essentially caused the system to go bankrupt and the government decided radical reform was the only solution.

Chile's newly privatized system eliminated payroll taxes for both employees and employers, instead requiring individuals to fund their own pensions. Each employee is required to continue contributing until retirement with payments of 10% of their pre-tax salary, and their contributions are tax deductible (Baily 284). These contributions are withheld from employees and deposited directly into their private accounts. Employees covered by the old system were given the choice of participating in either system but new workers, after 1981, were required to join the new system. Approximately 85-90% of workers covered under the old system made the switch to the privatized system (Turner 44). Individuals that could not completely fund their own accounts would be compensated from taxes collected from higher earners. Each employee is required to continue contributing until retirement age of sixty-five for men and sixty for women, or until the allocated pension reaches 70% of that employee's average indexed wage from their last ten years of employment (Stephenson 128-129). The indexed wage is based on changes Chile's consumer price index.

Contributions are sent to highly regulated private pension funds called Administradoras de Fondos de Pensiones (AFPs) who invest the contributed funds (Turner 115). The system was originally compromised of twenty AFPs that citizens could choose, but after some mergers, the system currently has six AFPs. The AFPs can offer funds that range from A-E and are classified based on the amount of risk in their investments from high to low. "A funds" can invest in a maximum of 80% equities, where D funds can invest a mere 20% in equities and E funds must contain only bonds (Baily 284). AFPs can choose to offer any or all of these funds. The system provides certain guidelines regarding to which funds certain citizens can allocate their contributions. For example, men that are fifty-six and older and women fifty-one and older are prohibited from investing in Fund A, the riskiest of the funds. Participants are not obligated to choose a specific fund if for some reason they choose not to or lack the knowledge required to make a reasonable decision. In this case, employees are assigned to funds based on their age, with younger employee's being defaulted to a higher-risk fund and older employee's to lower-risk funds.

As aforementioned, benefits may become distributable after a man turns sixty-five or women turns sixty unless they have contributed enough to where their annuitized benefit is at least 50% of their average indexed earnings from the previous ten years.

Workers who have supplied enough money to fulfill these requirements may stop contributing and start withdrawing at any time, even while still working. Participants also have the luxury of choosing their distributions through a price-indexed annuity, a phased withdrawal, or a combination of both. A phased withdrawal mirrors most pensions funds where distributions are calculated based on life expectancy and amount in the fund and the balance remaining after death would become part of their estate and available to their descendants. The benefits are recalculated every year after evaluating fund performance and the health of the participant. However, a price-indexed annuity is an uncommon feature in pensions. Price-indexed annuities are most frequently used in social security defined benefit systems such as in the current U.S. system where benefits increase as inflation increases. The price-indexed annuities are unique for individual accounts as they require price-indexed assets in which to invest. Chile has a liquid market for price-indexed bonds, which enables this method of payment distribution. The price-indexed annuities are not provided by the AFPs but by private insurance companies (Turner 115).

The Chilean government still plays a large part in their social security system even though it is under private sector management. Workers who have contributed for at least twenty years into the system are offered a guaranteed minimum benefit. Anyone contributing for fewer years is provided an anti-poverty benefit. If at any point, an AFP is unable to provide a minimum return, they are terminated and the government guarantees a minimum rate of return.

The immediate fiscal effects of the program had a positive impact on the Chilean economy. In the program's infancy, social security deficits were equal to seven percent of the nation's GDP and transition costs were funded by general government revenues (Stephenson 130). The transition was fairly easy for Chile as they carried a surplus in their general taxation during the early 1980's. They used this surplus to fund the PAYG system for the current and future retirees under the old system while new workers contributed only to their own retirement. But, as time has gone on and as the number of old beneficiaries dwindled, the deficits have nearly disappeared. The labor costs associated with the new system were driven down substantially as the payroll taxes have decreased, which had a positive effect on hiring and overall business expenditure. For Chile, the completely privatized system proved to solidify financial markets as more capital flowed into them and also increased the government's awareness of market risks and regulatory needs (Stephenson 130).

The performance of Chile's private system after it was established has largely been successful. Since 1981, Chile has slashed the country-wide poverty statistic by an astounding 50%. The unemployment rates have dropped dramatically as well in Chile. In 1982, Chile's unemployment rate was estimated to be 26.4% of the eligible working population. In 2009, after the effects of the privatized system had set in, Chile's estimated unemployment rate was under 8% (Baily 302). These impressive declines can be attributed to the fact that employers no longer paid into their employees' retirement after the elimination of employer payroll taxes. This made it less costly for companies to hire and keep employees. Replacement rates for retirees have steadily risen as well. As Chile has observed high market returns the last couple decades, those who have paid into the system have done well as replacement rates have risen to an average of sixty to sixty-five percent (Baily 304). However, one of the problems facing Chile's system is that those who have not been able to pay into their own individual accounts have struggled to fund their retirement. The government responded by promising a minimum benefit through general taxation if deposited funds are insufficient.

Many countries have followed the Chilean system as it has been generally accepted as an economic triumph. Currently, more than thirty countries have created mandatory individual accounts as either a part of or their aggregate social security system. Countries that have directly followed Chile's example by discontinuing old public social security systems with mandatory individual accounts include Bolivia, El Salvador, Hong Kong, Hungary, Russia, and Mexico. Countries that have adopted mixed systems with both traditional, public social security plans and individual accounts include Uruguay, Poland, Sweden, Switzerland, Australia and Japan ("NCPA" 4).

The fully privatized system shifts the impending bankruptcy burden from the government-controlled system to each individual and their account. Without privatization, the younger population would eventually find themselves amidst a bankrupt system and would no longer receive benefit payments though they have been contributing to the system. A completely private system would polarize the political agendas of the young and old generations. Under a defined-benefit plan, near-retirees would vote for protection of retirement benefits at all costs while younger workers would vote to minimize social security taxes as long as possible so they would not have to pay as much into the system. Politicians may try and please one group or the other without consideration for actual responsible fiscal management. Under a defined-contribution system, as retirement income is increasingly linked to performance of domestic corporations and the nation as a whole, there would be a stronger incentive to vote for politicians who endorse economic policies that will be beneficial for growth and the financial markets. Under a completely privatized system, the politicians' interests would be aligned with their constituents' interests, pushing politicians to promote policies that would benefit the entire economy, not just one group or the other (Baily 344).

One of the main advantages of privatization is the potential for increased retirement incomes through larger returns. Currently, Social Security benefits increase at the rate of inflation or, more accurately, wage inflation at about 2-3% a year. Common equities, on the other hand, over the past forty years have had an average annual return of 8.2% and 11.4% over the last twenty years (Aaron 74). Many argue that personal accounts that hold real financial assets reduce the risk participants face under a pay-as-you-go system where this is no collateral attached. Without collateral, if the system dries up or goes bankrupt, there will be nothing for beneficiaries to gain since their contributions would have disappeared (Aaron 75). This presents a huge risk to the young contributors because retirement and collecting benefits is a long way off. Personal accounts provide the opportunity for each individual to hold onto their assets and watch them grow and quantitatively track exactly how much they will receive when they retire. In a defined-contribution plan, individuals could see contributions not as taxes but as deferred savings (Baily 284).

A misconception regarding social security is that the system guarantees the benefits that retirees will receive in the future. Unfortunately, these “guarantees” merely guarantee a payment in the future, not benefits that can provide for a sound retirement. This holds individuals accountable for contributing to their own retirement plan without reliance on the government who can only guarantee future payment but not actually hold it.

TROUBLES WITH TOTAL PRIVATIZATION

Even though total privatization would solve the long-term funding issue, a completely privatized system would compromise the founding vision of social security. Social insurance would only be provided to those who have funded their accounts with enough capital to make it through retirement. Survivors and the disabled most likely would not be able to draw any substantial funds from their retirement and they would likely have to rely on other government programs. They may have been dependent on a spouse staying alive or staying healthy to collect enough in their retirement accounts to retire comfortably.

Everyone is aware that a problem with Social Security exists but many argue that nothing drastic needs to be done. A continuing government system is viable if either benefits are cut or taxes are increased. The largest issue with total privatization has to do with its cost, namely, transitional costs followed by management costs. Privatization enthusiasts admit this is a transitional problem associated with a privatized system. But it is not a transitional problem. It is a long-term problem. As Brookings economist Henry Aaron explained, if you could pour in enough money to pay for the transition to privatization, you would have enough money to keep the current system afloat (Aaron 91). The crisis associated with the current system would be solved; privatization would not be needed.

The largest concern associated with switching to a fully privatized system is the transition costs necessary to phase out the PAYG system. As young workers stop contributing to the PAYG system and fund their own individual accounts, it would leave retirees and soon to be beneficiaries without any benefits as money is no longer being deposited into the Social Security Trust Fund. As in the case with Chile, these shortcomings would need to be funded with general government taxes, which would increase existing deficits. Most proposals include using Reserve funds as a way to pay for a portion of the transition, but doing so would not fail to cover all of the costs. U.S. economists estimate the transition costs for the United States to equal approximately $2 trillion after depletion of the existing Reserve Fund which equals approximately $2.5 trillion (Aaron 74). The additional $2 trillion in costs, or 14% of 2009 GDP, would further add to an already enormous national deficit. It is estimated that the conversion would take several decades and these costs would be spread out over time. This would mean that workers would have to fund their own individual accounts for retirement as well as support existing retirees and those who were not part of the new system. This outcome is inevitable as Social Security has an "unfunded liability," or the excess of benefit obligations to retirees and current workers over accumulated reserves (Aaron 74). This "unfunded liability" must be paid for whether Social Security is privatized or if the current system remains (Aaron 74).

The current Social Security system has many strengths that privatization could potentially jeopardize. Preservation of extra assistance for low earners is essential as they rely most heavily on their Social Security benefits at a replacement rate of about 60% of their final pay as shown in *Figure 7*. This assistance ensures that low earners receive benefits sufficient to sustain financial independence upon retirement. Recent replacement rates provide benefits to a lifetime, minimum-wage worker a pension just below the poverty threshold for a single person which sits at just under $11,000; a minimum-wage married retiree received a benefit that was just above the threshold for a couple at $13,991 ("US Census Bureau" 2). Benefits for low earners would fall by over 25% if pensions were proportional to earnings or payroll tax payments (Steuerle 207). The Social Security system favors low earners as well as survivors, spouses, and divorcees. A completely privatized system would overlook these potential beneficiaries, an omission central to the original vision of social welfare programs.

The current system also provides inflation protection. At the end of each year, benefits are raised enough to compensate for price increases that have taken place during the previous year through the Cost of Living Adjustment. No major private pension plan has ever offered comparable protection because long-run inflation is unpredictable. Social Security remains the only retirement income authority that is protected from unanticipated inflation (Baily 117). The current system also protects contributors from wage risk. Benefits depend on a worker's average lifetime earnings, not on when the worker receives the earnings. Defined-contribution pensions depend on workers' earning patterns, which determine when contributions are made to personal accounts. Workers with similar average lifetime earnings who have made similar contributions can end up with vastly different pensions (Aaron 95).

Fluctuations in asset values and interest rates do not affect the benefits of individual workers under Social Security because they are based on the earnings of each worker and how it figures with the benefit formula. The defined-benefit formula is subject to an increase in political risk as the trust fund faces future financing deficits. The return earned from the trust fund affected the amount of benefits issued but at a very small amount. In the long-run, the financial balance depends most on payroll tax revenues and benefit payments (Aaron 95). In individual accounts, investing in capital markets may expose participants to risk-related fluctuations in the value of their pension assets. Social Security payments do not subject individuals to financial market uncertainty.

In light of the recent financial crisis, it is necessary to analyze how a totally private system would fair in a similar crisis. There are many more risks that go along with individual private accounts and those risks are all realized in times of financial uncertainty. Regular fluctuations in interest rates, asset values, and individual wages cause variability in total funds at the time of retirement for participants. The only way to combat these variations is to adjust contribution rates during or immediately following a period of economic instability. An example of this variability is based on historical returns from the S&P 500 index, an average retiree in 1969 would have benefited from a 104% replacement rate. Unfortunately, a retiree of 1975, just six years later, would have realized a replacement ratio of a mere 39% (Aaron 33). This is just one extreme example of how market fluctuations can affect benefits.

A chief concern regarding individual accounts is the private institutions that actually hold the accounts. In an ordinary bank account, the Federal Deposit Insurance Corporation (FDIC) insures the balance in the account only up to a certain amount. When dealing with large retirement accounts, this would leave the large balances susceptible to depletion if the institution is allowed to draw from them like an ordinary bank (Diamond 127). To combat these issues, provisions must be set in place to eliminate the use of these funds such as creating a trust that cannot be drawn upon.

V. The Road to Reform: Modern Semi-Private Proposals

All reform plans fall under three categories: proposals to completely replace the current system, proposals to partially replace the current system with private accounts, or proposals to modernize the current system. Supporting and modernizing the current system would incur costs of either higher taxes or reduced benefits. Proposals that would completely replace the current system would fail to provide satisfactory insurance to those who social security initially sought to relieve: disabled, survivors', and low-income earners. The last possibility for reform is to partially replace the current system with private accounts.

More and more semi-private proposals have crept into the social security debate as semi-privatization is perhaps the most feasible solution. The main concern regarding a switch to a semi-private system continues to be transition costs. Complete privatization would require huge transitional costs but semi-privatization could potentially at least appease the transitional cost dilemma. Many have advocated using the existing trust fund as a way to subsidize these transitional costs. Then, the question is: are the benefits worth the major transition costs? Could semi-privatization really solve America's social insurance problems?

The objective of semi-private proposals is to maintain the current social insurance especially for lower-earners, to continue to provide benefits for survivors and disabled, and to cultivate a solvent trust fund. These goals are the same as the current ones and should not come as a huge shock. Most of these proposals provide the same amount of assistance regardless of whether each individual is a low-earner or high-earner; the social security benefits would provide for the basic welfare of its participants and not for their quality of life.

Semi-private proposals provide incentive to high-earners because they deposit a percentage of their earnings or of their payroll tax into their own individual account. The more an individual earns, the more they can deposit into their account. This provides motivation for lower-earners to work harder and earn more so they can deposit more of their wages into this account without jeopardizing the minimum level of benefits they are already subject to. As mentioned before, the biggest concern surrounding a semi-private system is the transition cost and management thereafter. These proposals shed some light on these costs and aim to clarify these concerns.

Freedom of choice is one of the main benefits of a semi-private system. Future retirees can stipulate the exact amount of risk they want to assume in their retirement investment portfolio based on their individual preferences of risk and return. They can do this while still relying on the fact they would receive a government-guaranteed base benefit when they retire.

Strengthening Social Security for the 21st Century: President Bush's Proposal

President George W. Bush created the Commission to Strengthen Social Security (CSSS) in 2001 in order to devise a partial privatization solution to relieve the strain on the current system. The proposal from the CSSS included stipulations where a percentage of the existing payroll tax could be voluntarily deposited into an individual account for retirement and the rest would continue to be paid out in the existing pay-as-you-go system or into the Trust Fund. The proposal gathered plenty of opposition as many viewed it as a plan that would benefit higher-wage earners at the expense of the low-wage earners.

Features of the proposal are similar to Chile's current system. Small contributions and record keeping are put under government control, while actions to lower administrative costs and actual investments are handled by private-sector asset managers. Participants would be able to choose from a few reputable funds that would have few limits to what they could invest in. At retirement, deviating from the Chilean system, Bush's proposal would require retirees to purchase an annuity with the balance in their individual account (Baily 341).

The proposal submitted by the CSSS aimed to solve the problem of the future exhaustion of the reserve fund while retaining benefits for low-earners, survivors, and the disabled. The plan specified a voluntary deposit of 2-4% of a participant's payroll tax be deposited into an individual account up to a maximum annual amount of $1000. The program projected a lengthy transitional cost period of about fifteen years after its inception in 2002, and then a return to surpluses by 2050 without complete exhaustion of the reserve fund (“CSSS” 84).

There are many concerns with the CSSS’s proposal. The main concern continues to be the cost of transition. Future retirees would be better off than under the current system but this would come at the sacrifice of higher taxes to aid in transition (Stephenson 163). No additional national savings would be created as the increase in taxes would offset short-term savings. In the long-run, however, after the transition has been financed, additional savings would ensue and the proposal would solve the current funding issues. This causes a short-term period of struggle and economic difficulty but creates a sustainable system in the long-run.

Another element of debate in the proposal is the inclusion of progressive indexing. The government-controlled section of the semi-privatized system would hedge against elderly poverty by offering a minimum benefit as opposed to a common retirement program (Baily 343).

Administrative costs and fees are another contested issue. The proposal projects fees earned by the private-sector funds would be .3% of total assets, but later revisions of the proposal estimated these fees would likely fall between .6% and .9% of fund assets (Baily 341). After the revisions, these administrative costs would be much higher than the present systems which are .25% of total assets (“TSP” 1). This begs the question, if this proposal could not provide lower administrative fees, would returns have to overcome these increased fees to provide benefit on top of the current program?

Despite criticisms of the program, the proposal presented some crucial findings with regards to Social Security. A semi-private system could potentially solve the long-term funding issue of the Social Security Trust Fund, but would require a high initial cost. Though the plan would benefit everyone in America in the long run, it could possibly deplete the reserves of the Trust Fund in the short-run. Using a portion of existing payroll taxes would decrease the amount available to distribute to beneficiaries. However, this proposal did not shed enough light on the potential transition costs and management costs in the future other than that they would potentially be paid for through the existing trust fund.

THRIFT SAVINGS PLAN: A MODEL FOR SEMI-PRIVATE REFORM

If semi-private plans cannot provide lower administrative fees after taking returns into consideration, than they would not seem like a viable option for future reform. However, one widely successful government program provides insight on a projectable cost structure that is lower than the current Social Security system. The Thrift Savings Plan (TSP) is a retirement benefit program offered to Federal employees. It was established in the Federal Employees' Retirement System Act of 1986 and is similar to 401(K) plans offered by BlackRock Institutional Trust Company, a private trust company

(“TSP” 1). The funds are not assets of BlackRock, they are held in trust and cannot be used by Blackrock to meet financial obligations. TSP is a defined-contribution plan that is independently audited and provides annual financial statements. The TSP Trust Fund currently holds $250 billion worth of assets. Contributions from federal employees can be invested in a variety of securities. BlackRock supports the day-to-day maintenance and administration of all of TSP accounts (“TSP” 1).

TSP offers many features in their investment program. Participants may choose any or all of the 10 funds available to diversify their investment portfolio. Each fund offers different investment goals and strategies depending on individual needs. There are five individual funds with varying amounts of risk, from complete investment in government securities to international and small cap indices. The other five funds are “lifecycle” funds that change the allocation mix of assets as participants’ age (“TSP” 1).

Despite the private control of the TSP funds, they are relatively inexpensive to manage. The expenses include management fees for each fund, cost of operating and maintaining TSP’s record keeping system, cost of providing participant services, and the printing and mailing of notices, statements, and publications. Total costs in 2009 were $69 million or just .028% of the fund assets annually and the average total cost of the program since inception has been .1% of the fund assets (“TSP” 1). The cost of Social Security in 2009 was over $6 billion, with an expense ratio that was .25% of annual trust fund assets (“SSA” 2). Comparing the costs to international examples, the TSP’s costs are much lower than other countries. Fees for normal accounts are essentially equal to other large countries around the world such as Sweden and Australia as seen in *Figure 9*. To reconsider Chile, initial administrative fees were over 10% of contributed assets each year due to inflation and an inefficient system. As of last year, however, these fees have shrunk to 1.2% of total assets each year.

Since its implementation in 1987, the TSP has observed great returns from the original three funds. On an annual average, these funds have produced returns ranging from 6.2%-9.3%. A main concern of individual accounts continues to be how they respond to economic downturns and financial crises. Considering the performance of the Thrift Savings Plan over the last few years can provide insight on how the plan would affect a retirement program. Looking at *Table 1*, we can see how the different TSP funds have performed historically. Riskier funds investing in small cap and international equity indices, predictably, performed the worst over the last three years. The three funds have lost, on an annual percentage, in between 4%-6% since the beginning of 2007 independent of new contributions. These returns are rather alarming and would greatly harm current or near-retirees, which is why the TSP would cap the percentage of assets that could be invested in riskier funds based on the age of the investor.

The less risky funds, which contain mainly bonds, have performed extremely well in light of the crisis. The two funds composed of strictly bonds have returned 3.9% and 6.2% annually over the last three years compared to the 6.2% and 7.1% at inception. For essentially riskless investments, these funds have produced quite outstanding returns, even considering inflation. These returns are much higher than returns of the current Social Security system, which are based on inflation.

The TSP program offers a view of how a government-controlled, private, defined-benefit program would work in the United States. Though Bush's semi-private proposal required high management and administrative costs, the TSP would slash the management costs to less than one-tenth percent of the asset reserve. And though both semi-private and private systems would require large transition costs, the semi-private system would have lower transition costs associated with it.

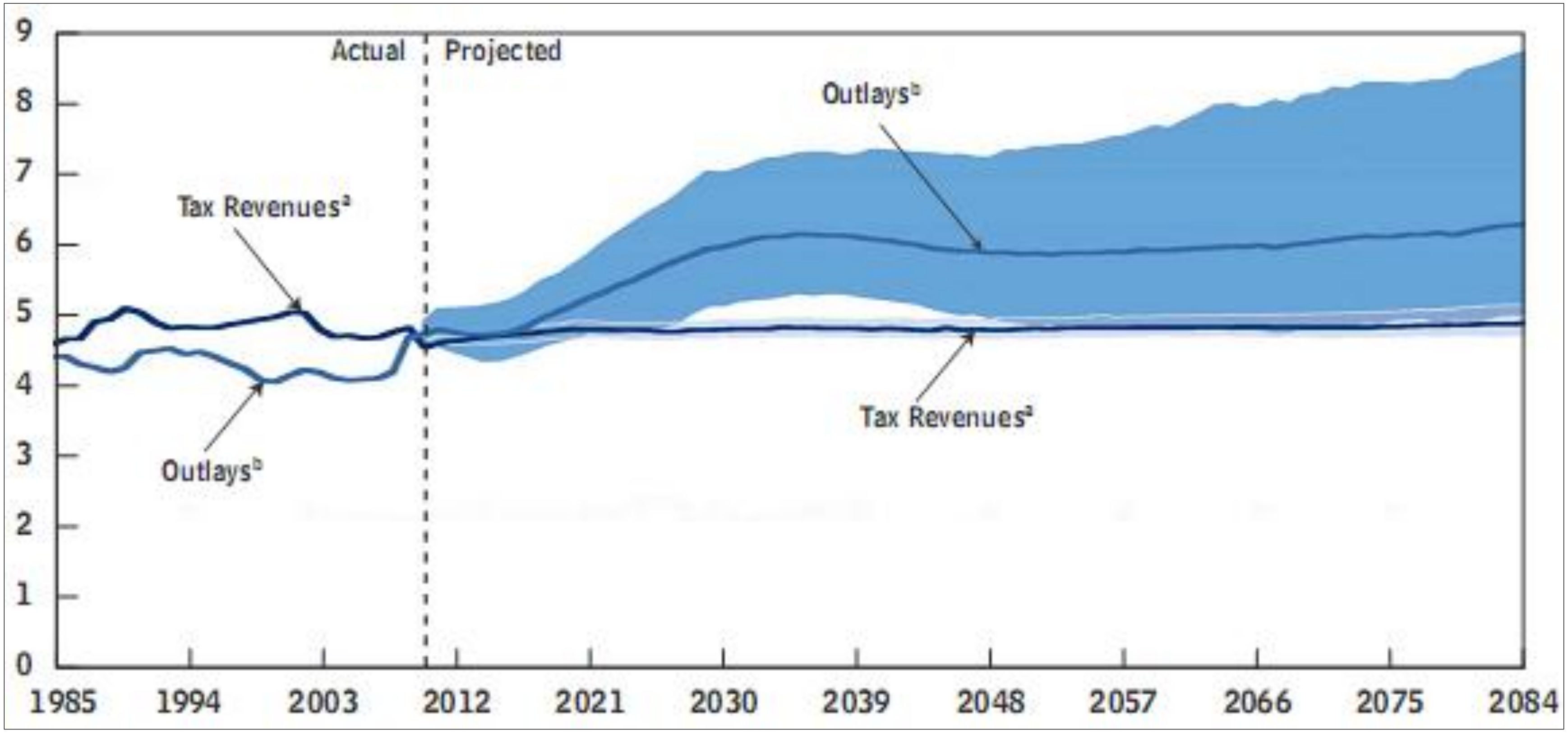
VI. Conclusion

Whatever the solution is for the United States, it will not be an easy one to digest. Undoubtedly, either the entire population or a single generation of the population will be adversely affected by Social Security reform. The goal should then be to harm the fewest number of people while instituting a logical system that is sustainable in the long-run. A partially privatized system is best suited to accomplish these goals as it creates a system where those who earn more will be fairly compensated in retirement while providing equal, welfare benefits in the form of social insurance to all others including lower-earners, survivors, and the disabled. Need for reform is imminent, as waiting too long could lead to disaster due to diminishing funds.

Some reform to the Social Security system is necessary if beneficiaries wish to continue to receive benefits without further taxation or slashing pension payments. The problem with continuing to adapt the program is that it is a temporary fix; solely considering the short-run for a long-run program dooms the system to failure. Increasing the benefit age will anger near-retirees. If current retirees are compensated, younger contributors will continue to complain. Neither generation would appreciate raising taxes. There is no clear-cut solution. Arthur Altmeyer, the system's first commissioner, called Social Security "a goal, never a finished thing because human aspirations are infinitely expandable just as human nature is infinitely perfectible" (Hiltzik 222). It is likely that we will never find or obtain a perfect system but we can strive for perfection starting to partially privatize our current system.

VII. TABLES AND GRAPHS

FIGURE 1 – SOCIAL SECURITY TAX REVENUES AND OUTLAYS (% OF GDP)

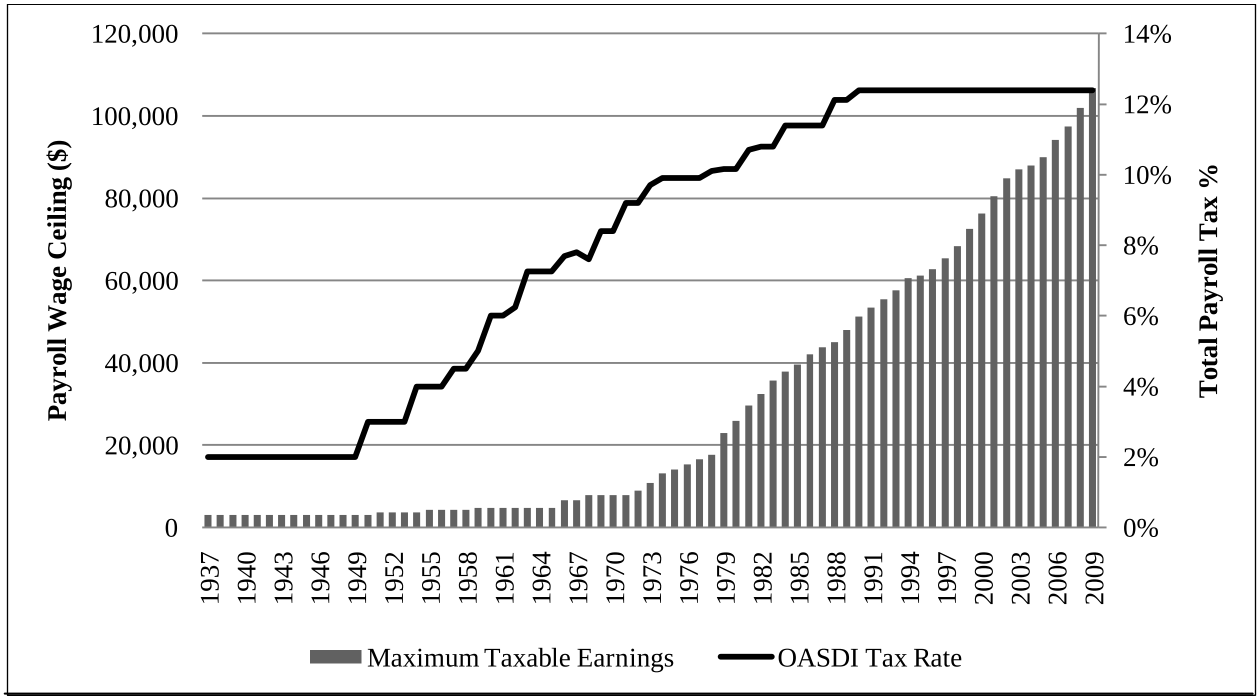


Source: Congressional Budget Office (2010)

Notes: The lines indicate CBO's projections of expected outcomes. The shaded areas indicate the 80 percent range of uncertainty

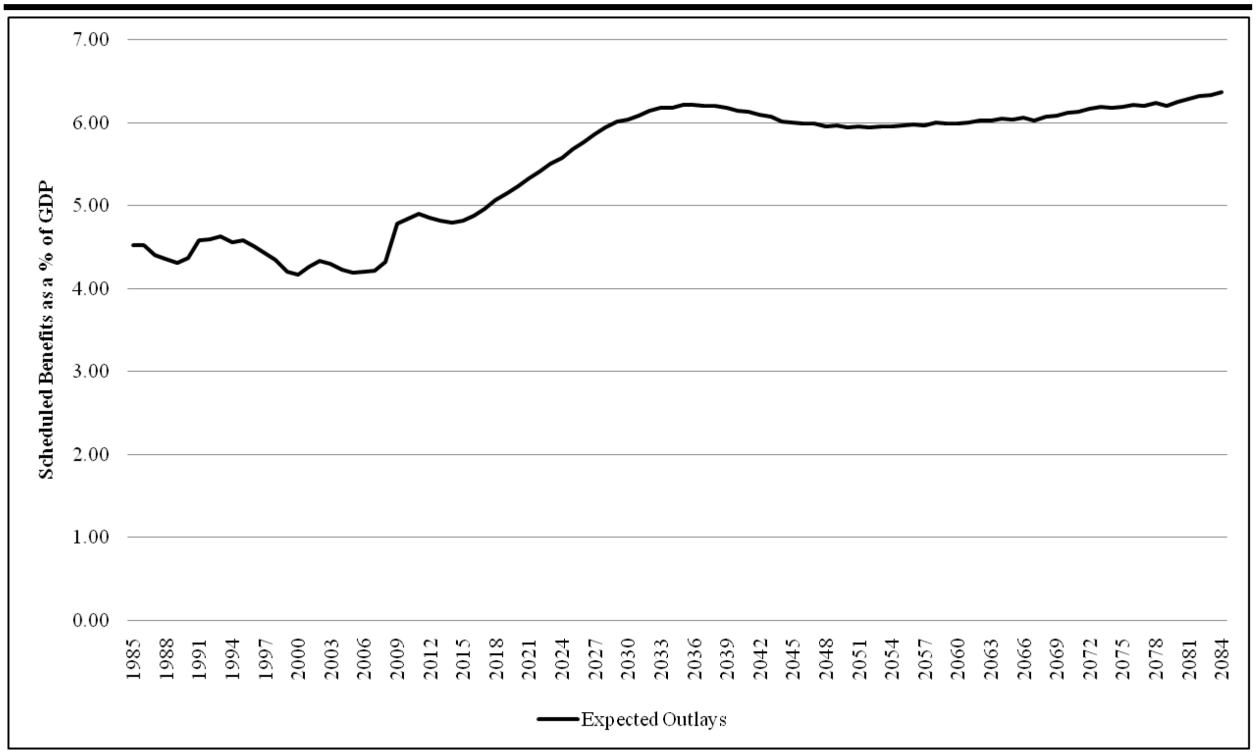
a. Includes payroll taxes and income taxes on benefits
b. Includes scheduled benefits and administrative costs

FIGURE 2 – PAYROLL TAX AND WAGE CEILING OVER TIME



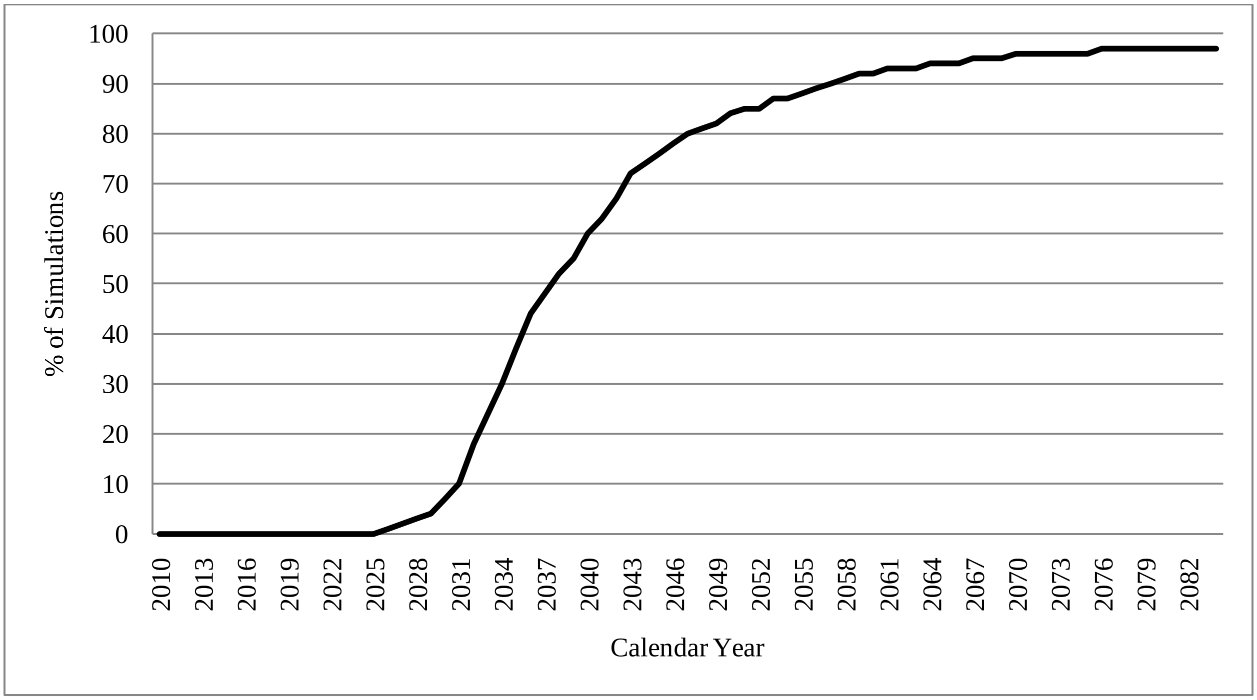
Source: Urban Institute and Brookings Institution

FIGURE 3 – SCHEDULED BENEFITS AS A % OF GDP



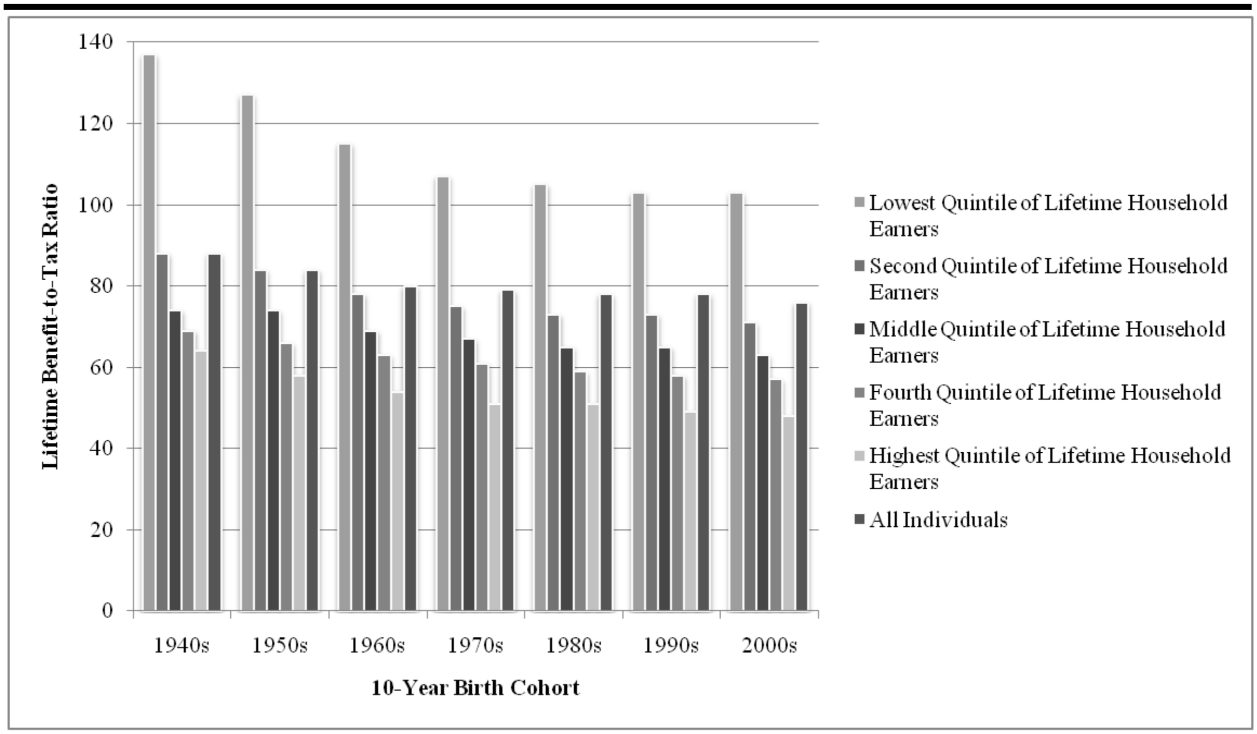
Source: Congressional Budget Office (2010)

FIGURE 4 – PERCENTAGE OF SIMULATIONS SHOWING TRUST FUND EXHAUSTION BY YEAR



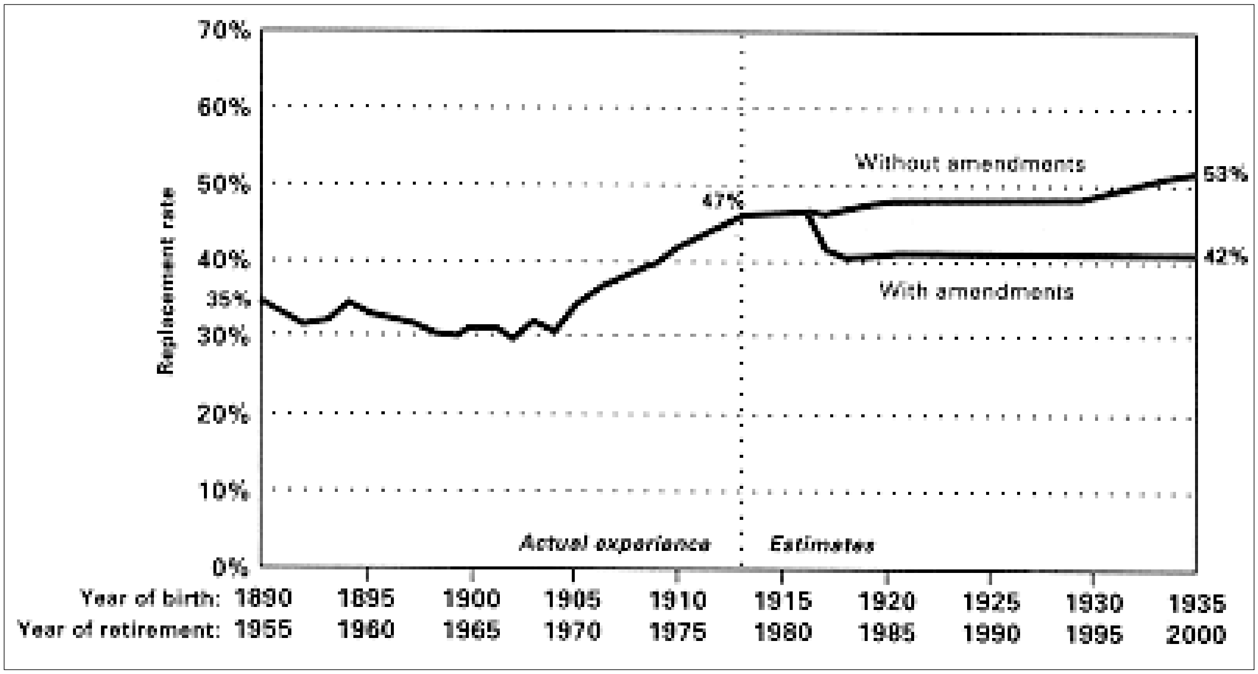
Source: Congressional Budget Office (2010)

FIGURE 5 – LIFETIME BENEFIT-TO-TAX RATIO OF FUTURE RETIREE COHORTS



Source: Congressional Budget Office (2010)

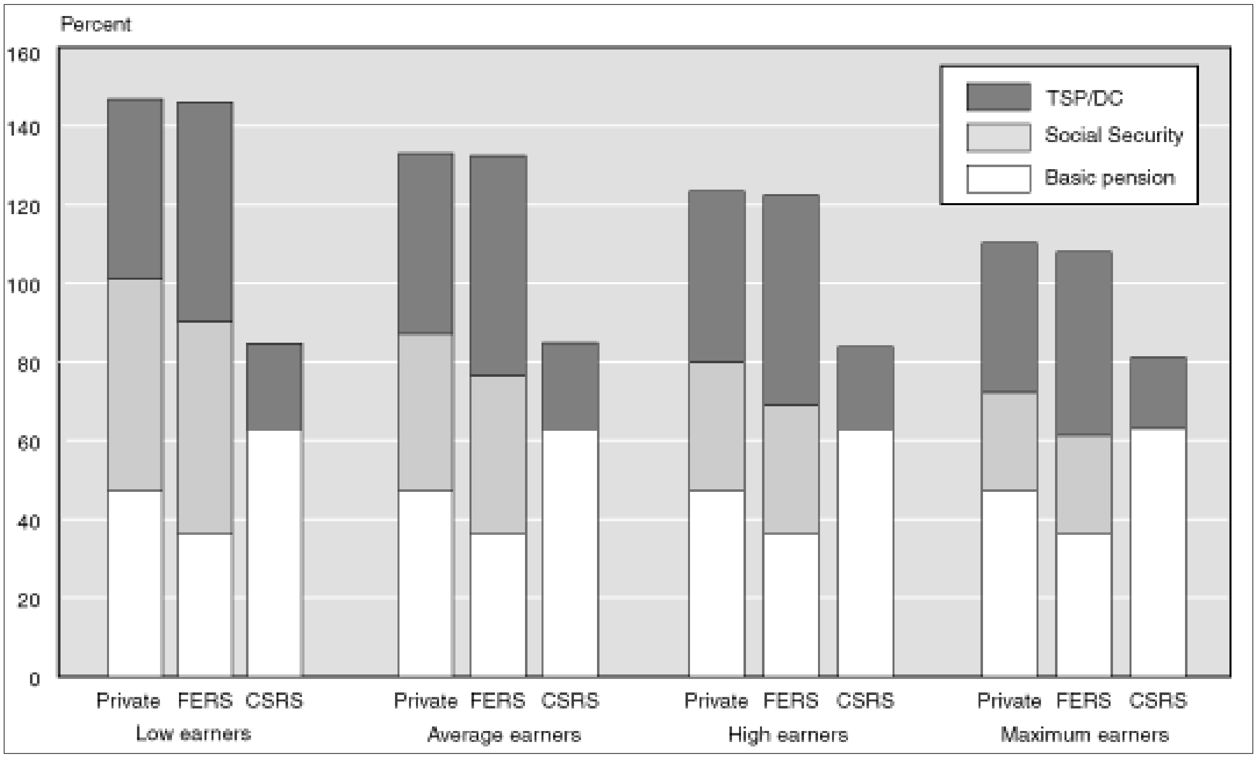
FIGURE 6 - ANTICIPATED VS. ACTUAL GROWTH IN REPLACEMENT RATES



Source: Social Security Administration

Notes:
Replacement rate is defined as benefits received in first year of retirement as a percentage of earnings in last year of employment.

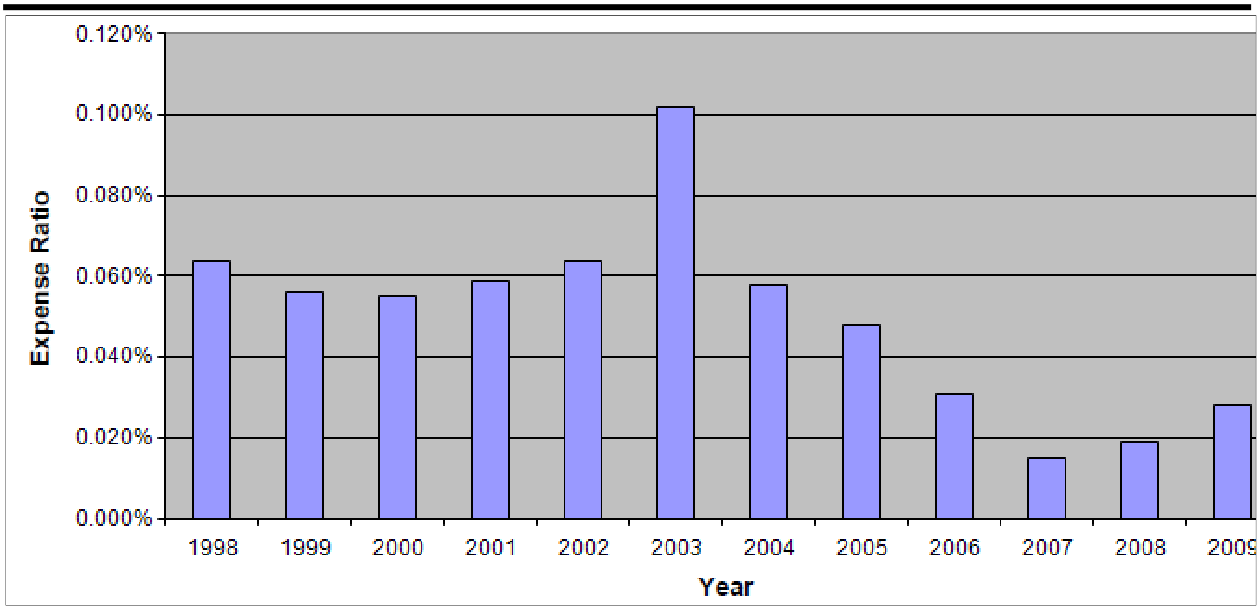
FIGURE 7 - ILLUSTRATIVE REPLACEMENT RATES UNDER VARIOUS BENEFIT SYSTEMS



Source: Social Security Administration (2010)

Notes: FERS = Federal Employee Retirement System; CSRS = Civil Service Retirement System; TSP = Thrift Savings Plan; DC = defined contribution.

FIGURE 8 – THRIFT SAVINGS PLAN FUND EXPENSE RATIO (TOTAL ASSETS)



Source: Federal Retirement Thrift Investment Board

TABLE 1 – THRIFT SAVINGS PLAN SUMMARY OF FUND RETURNS (ANNUAL AVERAGE RETURNS)

	L Income	L 2010	L 2020	L 2030	L 2040	G Fund	F Fund	C Fund	S Fund	I Fund
1-Year	8.6%	10.0%	19.1%	22.5%	25.2%	3.0%	6.0%	26.7%	34.9%	30.0%
3-Year	2.9%	1.6%	-0.6%	-1.7%	-2.7%	3.9%	6.2%	-5.6%	-4.3%	-5.9%
5-Year	3.6%	3.7%	3.0%	2.5%	2.2%	4.2%	5.1%	0.5%	2.3%	3.7%
10-Year	-	-	-	-	-	4.6%	6.4%	-0.9%	-	-
Since Inception	3.6%	3.7%	3.0%	2.5%	2.2%	6.2%	7.1%	9.3%	4.9%	4.0%
Inception Date	2005	2005	2005	2005	2005	1987	1988	1988	2001	2001

Source: https://www.tsp.gov/investmentfunds/returns/returnSummary.shtml

FIGURE 9 – ADMINISTRATIVE COSTS AND CHARGES FOR PARTIAL OR COMPLETELY PRIVATE SOCIAL SECURITY SYSTEMS

	Fee as Percent of Assets[a]	Fee in US$ per Account[b]	Reduction in Final Capital and Pension[a]	Centralized Collections
Latin America				
Argentina	4.2%	$72	23%	x
Bolivia	1.6%	12	11%	
Colombia	NA	NA	14%	
Chile	1.2%	60	16%	
Costa Rica	2.1%	20		x
Dom.Rep.	NA	NA	NA	x
El Salvador	9.5%	50	18%	
Mexico	2.5%	45	22%	x
Peru	3.8%	65	19%	
Uruguay	2.6%	39	14%	x
Eastern and Central Europe and Former Soviet Union				
Bulgaria	NA	NA	NA	x
Croatia	NA	NA	NA	x
Estonia	NA	NA	NA	x
Hungary	NA	NA	NA	
Kazakhstan[c]	3.7%	9	NA	x
Kosovo[d]	1%	2	20%	x
Latvia	NA	NA	NA	x
Macedonia	NA	NA	NA	x
Poland[c]	4.3%	19	NA	x
Other				
Sweden[e]	.7%		15%	
TSP[e]	.1%	27	2%	x
US, retail[e]	1.5%	360	30%	
US, institut'l[e]	.7%	NA	15%	
Australia, av[f]	1.0%	$150	26%	
Australia, retail[f]	2.0%	NA	40%	
Australia, corporate[f]	.7%	NA	15%	

Sources and notes:

a These fees include contribution-based and asset-based fees and cover investment and record-keeping services, marketing costs and profits. Fees for Latin America in column 1 are for 2002, from *Pension Reforms: Results and Challenges* (Santiago, Chile: FIAP, 2003). In most cases (notably Chile) they are lower in 2005. Numbers and simulations for column 3 are from (and details on methodology can be found in) Estelle James, Gary Ferrier, James Smalhout and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph Stiglitz, eds., *New Ideas About Old Age Security* (Washington DC: World Bank, 2001), revised version published in *Private Pensions Systems: Administrative Costs and Reforms* (Paris: OECD, 2001). Simulations in column 3 assume that current fee structure remains in the long run.

b Latin American numbers are derived from fees per contributor for 2002 in *Pension Reforms: Results and Challenges* (Santiago, Chile: FIAP, 2003). A distinction must be made between contributors and affiliates. An affiliate is a worker who has contributed at some point, therefore has an account. About half the total affiliates contribute at any point in time. Money and accounts are managed for all affiliates, including those who have temporarily dropped out of the labor market or the system and therefore don't contribute currently. These calculations assume that the number of accounts is twice the number of contributors, which is a typical case. Fee per contributing worker would then be double the number given.

c. Numbers are for 2002 from Agnieszka Chlon-Dominczak, "Evaluation of Reform Experiences in Eastern Europe," 2003.

d. Start-up costs in excess of 1 percent of assets per year in the new Kosovo system are subsidized by the United Nations. Kosovo was still in start-up phase taking in new contributors in 2004. These numbers are estimates.

e. U.S. numbers are from Estelle James, Gary Ferrier, James Smalhout and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," 2001. Numbers are averages across mutual funds, weighted by assets, for 1997. Swedish numbers are from 2004, based on personal communications with Annika Sunden.

f. Data are for 2001. Australian data are from Ross Clare, "Are Investment and Administration Fees in the Australian Superannuation Industry too High?" (Sydney: ASFA Research Center, 2001). Conversion to US $ by author, based on exchange rate in December 2001.

Source: National Center for Policy Analysis

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