

Chapter

7

AGING & EMPLOYMENT

*Social Security: A Comprehensive Overview
of Where We Stand Today*

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Abstract

- Debates among policy makers, foundations and advocacy groups regarding the solvency of the Social Security plan in the United States have been ongoing since the 1980's. The upcoming 2004 Presidential Elections have refreshed the public's interest in this controversial topic.
- Early Social Security history shows a trend toward self-reliance and a response to specific problems, rather than the implementation of a national social policy system.
- The Great Depression enlightened policy makers about the need for a national old-age benefits system. President Franklin D. Roosevelt signed the Social Security Act on August 14, 1935, providing benefits and unemployment insurance for retirees of industry and commerce.
- In 1939, The Federal Insurance Contribution Act (FICA) sets payroll taxes at 2%. The tax rate has increased steadily over the subsequent decades; reaching a level of 15.3% (12.4 % OASDI and 2.9% Medicare) today, divided equally between the worker and employer, up to a maximum income level of \$87,000. Benefits calculations vary by individual.
- In 2001, President George W. Bush formed a temporary Commission to strengthen Social Security. In its findings, the Commission presented three different models for reform, but underlying each of these models was the establishment of a voluntary personal account system.
- The 2004 Social Security and Medicare Board of Trustees annual report on the actuarial soundness of the program revealed that the growing annual cash deficits

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in Social Security will lead to exhaustion in trust fund reserves in 2042, and that the growth rate projections are not sustainable under current financing arrangements.

- Federal Reserve Chairman Alan Greenspan's report to the Committee on the Budget called for immediate structural changes to the Social Security system. Future budget deficit projections confirm that adjustments should come in the form of a revision to the price index used by the program and/or an increase in the minimum age at which retirement benefits can be claimed.
- Many foundations and advocacy groups have been formed to analyze the health of the Social Security system and other programs that benefit older Americans. Among the most active are: AARP, the Brookings Institute, the CATO Institute, the Maxwell School, the NCPA, and the Century Foundation.
- Semi- and fully-privatized Social Security systems are found throughout the world. A survey of those found in Chile, Sweden, and Great Britain provide excellent sources of insight into how to achieve success in creating such a program, while also maintaining benefits for future participants. In the United States, three Texas counties adopted a successful privatized plan in 1981, which also serves as an informative model.
- Our recommendations take into account the views of the foundations and advocacy groups surveyed within, as well as the experiences of Chile, Sweden, Great Britain and Texas. We recommend a flexible system where the individual has the choice of including both a private account and a traditional plan account in their Social Security benefits portfolio, or keeping all funds in the traditional plan.

Introduction

United States government officials and policy makers have been aware of the probability of future Social Security insolvency since the 1980s. The impending eligibility of the first Baby Boomer cohort to collect Social Security benefits has escalated the debate among scholars, policy makers, advocacy groups, social policy foundations, and politicians over the long-term solvency of the program. Numerous reform proposals from all groups have been presented but none implemented. Although it is evident that change is necessary, our leaders are reluctant to move on the issue, especially in the wake of the 2004 elections, fearing the potential for political suicide. It is our intent in this paper to cover the basics of the issue and to present our recommendations for possible solutions. We include the research of a number of major players in this debate as well as some solutions that other countries have implemented.

Social Security Background

Early History

Since the settling of the original thirteen colonies, Americans have respected the individual's ability to be self-reliant in all aspects of life. This belief was further mirrored in the 'rugged individualism' of the frontier and the boom of the 1920's. Individuals could surely provide their own savings for retirement, and unemployment was not an issue worth fretting over. Even so, some argued the need for the protection of the American worker, both during his working life span and age of retirement. Many attempts at legislation for old age pensions and unemployment insurance were made and blocked prior to the final enactment of the Social Security Act of 1935.

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The attempt to legislate old age protection dates back to before the advent of a teacher's pension plan in New Jersey, in 1896. This plan was the oldest retirement plan for government workers. The need for such a system was not seen until industrialization and urbanization took hold on the United States, which made its citizens increasingly more dependent on a continuous flow of income. In fact, prior to 1870, more than 50% of U.S. adult workers were farmers, owning at least some land which could be used to generate income long after the typical working life-span (www.ssa.gov/history). During this period (and up until the 1920's or so), villages had their own poor relief systems and workhouses. In 1908, some states adopted workers' compensation programs, and all but four states followed suit by 1929. In the mid- 1920's, some states fostered old-age assistance programs. New York State and New York City developed a retirement service for their employees, and the Civil Service Retirement System was set-up for Federal employees and members of the Armed Forces. By and large, the pre-1930's showed a history of response to specific problems rather than a national agenda for social programs (www.ssa.gov/history).

The 1930's

The Stock Market crash of 1929 triggered the 'Great Depression' in the United States, leaving many destitute, and causing great strain on local and national resources. The increasing spread of industry had left many older workers jobless even before the Depression, and there was great difficulty replacing displaced jobs (Douglas, 1936). With unemployment at a record high, personal savings were drained as income no longer entered many households. In 1932, the Federal Government started the Emergency Relief and Public Works programs, providing loans and grants for direct relief and work relief.

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Other programs furthering social welfare were rumored to be in the works, and private industries feared they would be asked to bear much of the burden. Individual businesses were concerned that interstate commerce competition would put them at risk if states and corporations were asked to carry too much of the burden. Increasing capitalism brought doubts about the survival of a social security system (Douglas, 1936).

The Townsend Plan was proposed before Congress in 1934. It called for a \$200 per month benefit payment to those retirees over 60. Regulations required that the entire sum must be spent in its entirety, during the month in which it was received. This mandatory spending was intended to spur the economy. A proposal to fund this benefit through a national tax on transactions was ultimately abandoned; however, it did serve as a precursor to the 1935 plan.

President Franklin D. Roosevelt's Committee on Economic Security proposed the Social Security economic legislation to Congress, which passed into law on August 14, 1935. The Social Security Act covered two main areas: 1) Old Age Benefits for retired workers of industry and commerce, and 2) Federal-State Unemployment Insurance. It also provided income to the elderly who were ineligible for Social Security and aid for the blind. Additionally, grants for maternal and child welfare were installed. Funds for these payments were secured by taxes levied against salaries, up to a maximum salary of \$250 per month. The tax was progressive; lower incomes paid a lower tax but received a higher percentage of benefits. Those over age 65 who had contributed for over 200 weeks received benefits upon retirement of 10% of their average wages, plus 1% for every year contributed over 5 years. Payments were to be made through state offices, with contributions being deposited into a Federal account.

Timeline of Social Security History from 1939 to 2000

1939: Benefits for dependents of retired workers and surviving dependents of deceased workers are added. The Federal Insurance Contribution Act (FICA) sets payroll taxes at 2%.

1950's: Benefits are broadened to cover many jobs previously excluded. Disability insurance for seriously disabled workers over age 50 and benefits for adult disabled children of retired/deceased workers are put into place. Benefits for children are broadened. Payroll taxes rise twice to reach 4%. Women are granted early retirement at age 62.

1960's: The age requirement for disability benefits is removed. Food stamps and WIC are created. Medicare and Medicaid are created to meet the medical needs of those 65 and older, regardless of income level. Widows and Widowers over age 50 now receive benefits. Early retirement for men is set at age 62. Payroll taxes are 6%.

1970's: Automatic cost of living increases (COLAs) are linked to CPI. Delayed retirement credits are established for extra incentive benefits if one retires after the age of 65. Federal Supplemental Security Income replaces the cash assistance for aged blind and disabled beneficiaries. The benefit computation method is changed so that it indexes to economic changes over the time span during which credits are earned. COLAs are found to overstate inflation by 25% for those born between 1910 and 1916, but are later corrected. Payroll taxes increase twice to 9.9%. Social Security is deemed actuarially sound.

1980's: Social Security is declared actuarially unsound, and the National Commission on

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Security Reform is created. State and local governments can no longer opt out of the system as

coverage for Federal civil and non-profit employees becomes mandatory. The age of eligibility

is set to gradually increase from age 65 to 67, starting with those who are 62 in the year 2000.

Income tax will now be charged on some high-income beneficiaries. Social Security is declared

sound again. The Social Security Trust is moved off the balance sheets to be tracked separately

from the rest of the budget. Payroll taxes increase to 11.4%.

1990's: Taxable benefits increase to 85% for upper incomes. Social Security Trustees report the probability of a deficit by 2012 and exhausted funds by 2029. An advisory panel suggests investing all or part of the trust funds in the private sector. The unfunded liability increases by \$752 billion to \$19 trillion. Payroll taxes reach 12.4%. To keep the trust sound, taxes would have to either increase to 18%, or benefits would need to be cut by 30% (www.ssa.gov and www.socialsecurityreform.org).

Social Security Today

Today, Social Security accounts for over 22% of the Federal expense budget. It is set up as an entitlement program so that all who are legally eligible receive benefits automatically. The demand for funds sets the spending levels. These levels can only be changed through legislation. 95% of U.S. Workers (135 million) are covered by the

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system. Excluded from coverage are: Federal civilian employees before 1984, railroad workers covered by the Railroad Retirement System, some state and local government employees, household farm workers not meeting the minimum required income, self-employed individuals with low income levels, children working in a family business, and certain religious exemptions. Payroll taxes are a total of 15.3% (12.4 % OASDI and 2.9% Medicare), divided equally between the worker and employer, up to a maximum income level of \$87,000.

There is no easy formula for determining an individual's Social Security benefits as they are "based on earnings averaged over most of a worker's lifetime (www.socialsecurity.gov)."

In order to determine benefits, the Social Security Administration (SSA) indexes the earnings "to account for changes in average wages (www.socialsecurity.gov)" and then calculates the average monthly income over the 35 years during which the individual earned the most. A series of formulas are then applied to this total to arrive at the basic benefit amount for full retirement age. Another formula is applied for those who wish to start receiving their benefits before they reach full retirement. The age for full retirement for those born prior to 1938 is 65, but that age gradually increases for those born after 1938 until it reaches 67 for those people born after 1959 (www.socialsecurity.gov). The average monthly Social Security benefit payment for those retiring in 2004 at the age of 65 is \$1,190 (www.ssa.gov).

Along with individual benefits, married individuals are eligible for spouse's benefits. This amount is currently equal to 50% of the spouse's full retirement benefits. If the individual has worked long enough over the course of his (or her) lifetime to be eligible to receive his own benefits, the SSA will always pay that entitled amount first.

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If, however, the individual would receive a higher benefit through his spouse's benefits than he would through his individual benefits, he receives a combination of benefits (both individual and spouse's) that equals the higher amount.

The SSA also pays survivor's benefits. These benefits can be paid to:

- A widow/widower at full retirement age (full benefits) or as early as age 60 (reduced benefits). A disabled widow/widower may receive benefits as early as age 50.
- A widow/widower at any age if he or she takes care of the deceased's child under age 16 or a disabled child who receives Social Security benefits.
- Unmarried children under 18, or up to age 19 if they are attending elementary or secondary school full time. A child can receive benefits at any age if he or she was disabled before age 22 and remains disabled. Under certain circumstances, benefits can also be paid to stepchildren, grandchildren, or adopted children.
- Dependent parents at 62 or older (www.socialsecurity.gov).

Survivor's benefits can also be paid to surviving divorced spouses providing the marriage lasted longer than 10 years (this does not affect the benefit rates for other survivors). A widow or widower will not receive benefits if "[she remarries] before the age of 60 (50 if disabled) unless the latter marriage ends, whether by death, divorce, or annulment. However, remarriage after age 60 (50 if disabled) will not prevent payments on a former spouse's record (www.socialsecurity.gov).” A survivor's benefit amount is based on a percentage of the deceased spouse's earnings. The following are typical payment percentage amounts for survivors:

- Widow or widower full retirement age or older: 100 %.
- Widow or widower age 60 to 64-about 71: 94 %.
- Widow or widower at any age with a child under age 16: 75 %.
- Children : 75 % (www.socialsecurity.gov).

One other point of note: if someone is receiving widow's benefits and is eligible for her own benefits, she will be paid, upon retirement, the higher of the two benefits, but not both.

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The Social Security Trust currently takes in more funds than it doles out. These surpluses are skimmed by the government to fund other Federal programs such as defense, domestic discretionary and other entitlements. By 2014, the projected start of the deficit, the government will have borrowed \$3 trillion without plans for repayment. This will be especially problematic since the retirement of Baby Boomers will be at its peak and individuals in this cohort will be straining the system. It is speculated that for the government to pay back its debt, it will need to raise each family's taxes by \$43,000 (more than the average family income) or increase the national debt yet again. Interestingly, more people age 18 to 34 believe in UFOs than believe they will ever collect Social Security benefits. (www.socialsecurityreform.org).

Social Security Trustees Report, 2004

There are six members of the Social Security and Medicare Board of Trustees: the Secretary of the Treasury, the Secretary of Labor, the Secretary of Health and Human Services, the Commissioner of Social Security and two members appointed by the President and confirmed by the Senate to represent the public. The Public Trustees are currently John L. Palmer, University Professor at Syracuse University's Maxwell School of Citizenship and Public Affairs, and Thomas R. Saving, Director of the Private Enterprise Research Center and Professor of Economics at Texas A & M University. Each year the Trustees of the Social Security and Medicare trust funds report on the current status and projected condition of the funds over the next 75 years. Following are highlights of the 2004 trustee report, released to the public on March 23, 2004 (Social Security and Medicare Board of Trustees, 2004):

- The growing annual cash deficits in Social Security will lead to

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- exhaustion in trust fund reserves in 2042
- The currently projected long run growth rates of Social Security and Medicare are not sustainable under current financing arrangements
- The annual cost of Social Security benefits represents 4.3 percent of GDP today and is projected to rise to 6.6 percent of GDP in 2078
- Social Security can be brought into actuarial balance over the next 75 years in various ways, including an immediate increase in payroll taxes of 15 percent or an immediate reduction in benefits of 13 percent (or some combination of the two).

The trustees conclude that Social Security faces difficult, though not insurmountable, challenges. They stress the fact that the sooner action is taken to remedy the problems, the less disruptive the solutions can be. Funding the program will likely require frequent future legislative adjustments, as it has in the past.

Major Players

In this section we cover the research and proposals of some of the major Social Security stakeholder organizations in the nation. While this is by no means a complete representation of all the advocacy and social policy groups in the United States, it is a comprehensive representation of the literature and reform recommendations available to the public.

The Federal Reserve

The Federal Reserve System is the central bank of the U.S. It was founded in 1913 to provide policy which stabilizes the monetary and financial system. The Federal Reserve's duties fall into four general categories (www.federalreserve.gov):

- Conduct monetary supply by influencing money and credit conditions in pursuit

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- of full employment and stable prices.
- Supervise and regulate the nation's banking institutions to ensure the soundness of the financial system.
- Maintain the stability of the financial system and contain systemic risk which may arise in financial markets.
- Provide certain financial services to the U.S. government, to the public, to financial institutions, and to foreign institutions, including playing a major role in operating the nation's payment systems.

The Federal Reserve's policies are integral to the growth and overall stability of the U.S. economy. Alan Greenspan, the current Chairman, regularly reports to Congress on the state of the economy, focusing on such key areas as the federal budget, interest rates, unemployment, inflation, productivity, and other economic indicators. These reports have far-reaching influence, from the actions of Congressional legislators to stock prices at the major exchanges.

Alan Greenspan, Federal Reserve Chairman

The large budget deficit and the depletion of federal programs' funds have created a tense environment for the Federal Reserve. On February 25, 2004, Alan Greenspan spoke before the U.S. House of Representatives Committee about the Budget. With the 2004 elections rapidly approaching, Greenspan took the opportunity to address his concerns about the federal budget and future Social Security solvency.

Greenspan began by suggesting the 2004 economy is off to a strong start, but he tempered his optimism by saying "this favorable short-term outlook for the U.S. economy is playing out against a backdrop of growing concern about the prospects for the federal budget (Greenspan, 2004)." He warned that if current policies remain in place, the budget, which had a \$375 billion deficit in FY2003, will continue to stay in deficit.

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The bleak budget forecast will impact federal programs such as Social Security and Medicare. Greenspan reported that with the first cohort of Baby Boomers soon reaching the early retirement age of 62, a system already stretched thin will be further burdened. Today, federal outlays under Social Security and Medicare amount to less than 7% of GDP. The Federal Reserve projects that these outlays would increase to 12 % of GDP by 2030 under current policy (Greenspan, 2004).

Greenspan recommends two significant structural adjustments to the current system. First, he suggests that Congress replace the current measure of the “cost of living” that is used as a spending index for many federal programs. Specifically, he proposes a change to the chained consumer price index (CPI) from the official price index. The chained CPI is based on the same underlying prices as the official CPI, but it combines those prices so as to remove some of the inadvertent bias in the official price index, and thus better measures changes in the cost of living (Greenspan, 2004). Greenspan argued that if the chained consumer price index had been used for indexing over the past decade, the overall level of federal debt would have been reduced by about \$200 billion (Greenspan, 2004). Second, Greenspan suggests increasing the minimum age at which Social Security benefits can be claimed. The ratio of the number of years that the typical worker will spend in retirement to the number of that person’s working years will rise in the long term. Greenspan asserts that increasing the minimum age will stabilize this ratio by insulating the system’s finances from further increases in life expectancy (Greenspan, 2004).

The Federal Reserve Chairman’s report drew heated reaction from democrats and republicans alike. Both parties disagreed with what they interpreted as Greenspan’s

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suggestion that retiree benefits and payments be cut back in the long term. Greenspan denied that he was specifically endorsing a reduction of retiree benefits, claiming instead that he was merely suggesting better “technical means” of setting benefits (www.money.cnn.com, 2004).

Edward M. Gramlich

Edward M. Gramlich is a member of the Federal Reserve Board of Governors in Washington, D.C. From 1994 to 1996 he served as Chair of the Quadrennial Advisory Council on Social Security, a body established to examine the actuarial finances of Social Security and to suggest policy changes. From 1986 to 1987, Gramlich was both Deputy Director and Acting Director of the Congressional Budget Office (www.federalreserve.gov). Gramlich is considered an expert on such topics as macro economics, budgetary policy, income redistribution and social security. Like Alan Greenspan, Edward Gramlich is concerned with the new set of financial burdens placed upon federal programs by the aging Baby Boomers. He feels the most important tenet of Social Security reform should be to raise national saving, in effect prefunding future benefit payments, while preserving the program’s system of social protections.

Gramlich offers several approaches to reform. The first, which he refers to as the standard twentieth century solution,” is to raise payroll taxes. The increased taxes would be invested in government securities, yielding future interest returns to help pay for the rising costs of benefits. He estimates that an immediate 1.9 % increase in the combined payroll tax rate is necessary to finance the present benefit schedule for the next seventy-five years (Gramlich, 2001). However, he acknowledges that raising payroll taxes is not an entirely appealing option. From an economic standpoint, marginal tax rate increases

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tend to decrease incentives for people to work and be productive. Moreover, this solution is only temporary as taxes cannot be increased indefinitely. He feels countries with aging populations must ultimately get off the “tax-and-spend treadmill” and find better alternatives (Gramlich, 2001).

A second approach strongly advocated by Gramlich is mandatory individual accounts held in addition to traditional Social Security. These accounts would be owned by workers, but centrally managed by professionals. Individuals would be free to invest these funds in a limited set of stock and bond index funds, much like employer-controlled defined contribution private pension accounts. Central management of the funds would reduce the risk of contributions being invested unwisely. These accounts would not be thought of as new taxes since individuals would own them. The funds would represent new saving, and their returns would exceed present contributions to the pay-as-you-go system. The funds would be converted to real annuities upon retirement. This also protects against inflation and the chance that retirees would overspend in their early retirement years (Gramlich, 1998).

Gramlich argues that long-term cuts to Social Security benefits are necessary to bring the trust fund into actuarial balance. One such cut could come in the form of an increase in the minimum age at which benefits can be received. A second option is to trim the benefits of high-income individuals while leaving the benefits of low-income and disabled individuals fully intact (Gramlich, 2001).

The central tenet of Gramlich’s reform approach is that the system must provide new national saving, rather than re-appropriating present savings. The suggested reforms with the most political appeal, he argues, may be the programs with the least effect on

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national savings. He cites his individual account plan as politically-unpopular, even though it provides considerable new savings.

David Altig and Jagadeesh Gokhale

David Altig is vice president and economist and Jagadeesh Gokhale is a senior economic adviser with the Federal Reserve Bank of Cleveland. Together, they have crafted a specific privatized Social Security Reform proposal. Following are the main tenets of their plan:

- Workers under age 32 would be allowed to divert up to 46 % of their payroll taxes to individually owned, privately invested accounts, similar to individual retirement accounts or 401(k) pension plans. The remainder of the payroll tax would be used to continue to provide benefits for the currently retired and those who will retire soon.
- Assuming private investment returns below historic averages, individuals in the privatized system would receive retirement benefits equal to or greater than those currently promised by Social Security. However, individuals would receive no recognition of or benefits based on past payroll taxes paid.
- During the early years of the transition, the government would issue new debt to supplement revenues from the continuing portion of the payroll tax. Once benefits to current and soon-to-be retirees had been paid, the continuing portion of the payroll tax would be used to service and retire the debt.
- No new taxes are required to finance the transition.

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Altig and Gokhale define privatization as mandated contributions to approved private saving plans, such as the standard 401(k) plans. One key to the feasibility of their reform plan is the fact that the rate of return in the privatized system will exceed that under the current pay-as-you-go system. The low cutoff age (32) provides younger workers more time to accumulate plan contributions at higher private rates of return. However, that must be traded off against the fact that the liabilities to those remaining under the current system (which increase as the cutoff age is lowered) must be partly financed out of the contributions of those who are shifted to the new plan (whose numbers decrease as the cutoff age is lowered). Calculations using the current distributions of Social Security benefits by age and sex suggest that 32 is the appropriate cutoff age (Altig & Gokhale, 1997).

The economists acknowledge that defined contribution schemes shift market risk to contributors, which is problematic. However, they counter by arguing that the majority of feasible Social Security reform plans have defined contribution elements, and are thereby subject to this same risk. Additionally, given the current financial state of Social Security, the future uncertainty of benefits is as bad as, if not worse than, defined contribution market risk (Altig & Gokhale, 1997).

Altig and Gokhale also acknowledge critics' arguments that such a privatized plan would incur significantly greater administrative costs than the current system. Ultimately, the administrative costs will depend on the exact nature of the plan, including whether benefits are paid out in lump sums or as annuities, and how much choice investors have in choosing among available options. The authors argue that

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representative 401(k) plans have administrative costs that range from .84 to 1.88 % of total assets. Even at the higher end of this range, Altig and Gokhale feel their plan is viable (Altig & Gokhale, 1997).

The President's Commission to Strengthen Social Security

On May 2, 2001, President George W. Bush formed a temporary Commission to Strengthen Social Security. He charged the Commission with the task of studying and reporting “specific recommendations to preserve Social Security for seniors while building wealth for younger Americans (President’s Commission to Strengthen Social Security Charter, www.csss.gov).” The group was comprised of eight Republicans and eight Democrats, with Senator Daniel Patrick Moynihan and Richard Parsons, AOL/Time Warner COO, serving as co-chairs.

The following guidelines were established by President Bush:

- Modernization must not change Social Security benefits for retirees or near-retirees.
- The entire Social Security surplus must be dedicated only to Social Security
- Social Security payroll taxes must not be increased
- The government must not invest Social Security funds in the stock market
- Modernization must preserve Social Security’s disability and survivors insurance programs
- Modernization must include individually controlled, voluntary personal retirement accounts, which will augment Social Security (www.csss.gov)

The Commission filed its final report, entitled “Strengthening Social Security and Creating Personal Wealth for All Americans,” on December 21, 2001 and disbanded shortly thereafter.

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The report presents three different models for reform; underlying each of these models is the establishment of a voluntary personal account system. The Commission argues that personal accounts:

- Improve retirement security by facilitating wealth creation and granting individuals the right to control their own assets
- Give individuals the ability to pursue higher expected rates of return than they currently receive through their Social Security contributions
- Will help increase national saving and improve incentives for labor force participation
- Will aid in the advanced funding of Social Security
- Can be designed with low administrative costs
- Can contribute toward the fiscal sustainability of Social Security (President's Commission to Strengthen Social Security, p.12, 2001)

Model 1 establishes a voluntary personal account system without making any other changes to current Social Security. This system allows workers to invest 2% of their wages in a personal account. Their benefits are then reduced by an amount equal to their personal account investments with a compounded interest rate of 3.5% above inflation. Because no other changes are made, however, a financing gap would exist, and additional revenues would be needed in order to sustain Social Security (President's Commission to Strengthen Social Security, 2001).

Model 2 also establishes a personal account system. Workers are allowed to contribute 4% of their payroll (up to \$1000 annually) to a personal account. Their Social Security benefits are reduced by that same amount with interest compounded at 2% above inflation. Traditional Social Security benefits would be price indexed. The Commission expects that a medium earner who contributes under this plan would have benefits that are 88% higher than a current medium earner receives. In addition, a minimum benefits payable system would be established for 30-year workers earning

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minimum wage to bring them up to 120% of the poverty line. The Commission believes that at the end of the 75-year valuation period, the personal account system would hold \$1.3 trillion (Present Value) and have a positive cash flow without needing to increase taxes or other payments. It admits that temporary cash transfers would be needed to fund this model and keep it solvent for the first several years (President's Commission to Strengthen Social Security, 2001).

Under Model 3, an additional contribution is mandated in order for the worker to be able to divert part of his payroll tax into an individual account. The size of the account is "...2.5 % up to \$1000 annually (indexed annually for wage growth) – for any worker who contributes an additional 1 % of wages subject to Social Security payroll taxes (President's Commission to Strengthen Social Security, 2001)." This would be partially subsidized by a refundable tax credit. Traditional Social Security benefits would be reduced by the amount of contributions with compounded interest at 2% above inflation. A minimum benefits payable system, indexed to wage growth, would be established for 30-year workers earning minimum wage to bring them up to 100% of the poverty line (for those working 40 years, it would be at 111% of the poverty line). Traditional benefits would be adjusted to increased life expectancy, thus decreasing benefits for early retirement, increasing benefits for late retirement, and flattening the benefit formula. New sources of revenue would be added to the system in the amount of .6% of payroll over the 75 years. Additional temporary cash transfers would also be needed. The Commission expects that a medium earner who contributes under this plan would have benefits that are 88% higher than a current medium earner receives. The Commission believes that at the end of the 75-year valuation period, the personal account

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system would hold \$1.6 trillion (PV) and have a positive cash flow (President's Commission to Strengthen Social Security, 2001).

In a testimony before the Senate Finance Committee, Dr. Olivia S. Mitchell, Commission member, focused mostly on an explanation of Model 2 because "it is the one that passes the most rigorous tests of fiscal sustainability (Mitchell, Oct. 3, 2002)." Mitchell promotes the creation of a personal account system as the best way to make Social Security solvent and sustainable without raising taxes or reducing benefits.

AARP

AARP (formerly the American Association of Retired Persons) was founded in 1958 by Dr. Ethel Percy. It is a nonprofit advocacy association that strives to improve life for those ages 50 and over; its core values are independence, dignity, and purpose. An annual membership, costing \$12.50 per year, is required. Spouses and partners are free. Your membership card entitles you to a monthly newsletter, advocacy services, tax preparation help, consumer protection, and discounts on many items, including insurance, travel, and consumer goods. AARP membership has reached 35 million today. Nearly one third of all members are under the age of 60, 46% are age 60-74, and 21% are 75 and older (www.aarp.org/leadership). Office locations may be found in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

Current CEO and executive director, Bill Novelli, is proud of his organization and its size (PR Week, 2003). "I make no apologies for the size of the organization or its resources," he says. "We are formidable...When your voice is heard like ours is, you have to be very careful - not just on strategy, but to make sure you're speaking responsibly." Novelli takes his PR role seriously, holding firm by maintaining 75 PR

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employees in Washington, D.C., and one in each of the 50 state offices. They also preview the State of the Union, upcoming sessions of Congress, and are briefed by the Supreme Court before a new session begins. They do not endorse specific candidates, but do post the opinions of candidates on their web site. AARP often creates partnerships in its communities in order to help carry out its objectives.

Unhappy members have been giving AARP slack for endorsing the new Medicare law. Its presence at the Social Security forums would have further worsened its bad PR, as it would have helped the Bush administration's argument that reform is necessary. AARP supports the concept of personal investment accounts, but only if no money is diverted from the funds that pay traditional benefits (Newsday, 2003). The AARP has flip-flopped in its stand as to the privatization/partial privatization of the social security system, over the past six months. It had agreed to sponsor, along with the Bush administration, a series of Social Security town hall meeting forums. The first was to be held in Minneapolis on January 15, 2004. On December 15, 2003, AARP notified participants that it was dropping out "because the forums would be too politically charged in the aftermath of the Medicare flap (Newsday, 2003)." The reason given was that such issues are especially touchy near an impending election, and partisan connections would be dangerous.

In 2004, AARP changed its views toward personal investment accounts, strongly opposing replacing any part of Social Security with individual accounts. It believes individual accounts are to be created only as private accounts by the individual as part of their retirement savings plan. AARP holds that Social Security is the most important source of income for retired Americans. For this reason, it devotes many resources to

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this arena. Its opinion is that the problem is not as big as some have claimed. Its forecasts show 100% of promised benefits being paid through 2042, without any kind of change being implemented (www.AARP.org). Even though the state of Social Security may not be as grave as previously speculated, AARP continues to look forward in time to the long term solvency of Social Security after 2042. Its outline of solvency options is as follows:

- Benefit reductions (requires change in benefit formula)
- Revenue enhancers (tax increases/subsidies)
- Increase return on trust fund investments (through the hiring of money managers).

One popular method of achieving higher returns is through individual accounts and add-ons or carve-outs. Add-ons maintain the current benefits structure and add on to individual accounts. This has no impact on solvency, so alternatives for fixing the short fall would still need to be found. Carve-outs create individual accounts, using taxes that fund Social Security. AARP feels this would worsen solvency and decrease benefits, unless taxes are increased. It believe such accounts would hurt low-wage earners, women, minorities, disability insurance beneficiaries, surviving spouses' and children, and today's young workers. Such plans, in its opinion, would not be good long-term solutions for future generations, in their opinion.

On February 5, 2004, AARP released its first-ever annual "AARP Quality of Life Index" for people age 50 and older. Results show that life for Baby Boomers and their parents has improved, but that vulnerabilities remain (www.aarp.org/research/press). The report shows that the percentage of Americans 62 and older who receive a portion of their retirement income from non-Social Security sources has declined, rather than increased,

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as the stock market boom of the 1990's would have expected. Social Security, thus, remains a necessary source of income for most Americans, and it must be protected.

Brookings Institution

In 1916, a group of reformers founded the Institute for Government Research (IGR), the first private organization dedicated to analyzing national public policy issues. Robert Somers Brookings, a financial supporter of IGR, established in 1922 and 1924, respectively, the Institute of Economics and a graduate school in his name. Both organizations were supporters of the IGR. In 1927, the three were merged to form the Brookings Institution.

Today, the Brookings Institution “is an independent, nonpartisan organization devoted to research, analysis, education, and publication focused on public policy issues in the areas of economics, foreign policy, and governance (www.brookings.edu). The Institution’s scholars analyze and offer solutions for these emerging issues. Institution activities are carried out through its three research programs (Economic Studies, Foreign Policy Studies, and Governance Studies), its Center for Public Policy Education, and its Brookings Institution Press.

Diamond and Orszag

The Institution’s front-ranking scholar on Social Security is Peter R. Orszag. Mr. Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies. Much of his work

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is done in collaboration with MIT Institute Professor and Professor of Economics, Peter A. Diamond.

“An Assessment of the Proposals of the President’s Commission to Strengthen Social Security”

In their working paper “An Assessment of the Proposals of the President’s Commission to Strengthen Social Security,” Diamond and Orszag present an extensive description and analysis of the Social Security reform solutions presented by the Commission. Of the three models proposed by the Commission, Diamond and Orszag only analyze Model 2 and Model 3. They do not consider Model 1 because, as they assert, “it would not restore long-term balance to Social Security (Diamond and Orszag, 2002).…” They find that Models 2 and 3 would achieve actuarial balance through the substantial reduction of benefits *provided* these models do not incorporate individual account proposals.

The authors show that for Model 2, without individual accounts, actuarial balance would be restored from -1.86% of the national payroll to +.01% of the payroll (Diamond and Orszag, June, 2002). This would involve reducing initial benefits levels by shifting from a wage-indexed system to a price-indexed system. A portion of the saving that this would create would be used to raise benefits for long-career low earners and widows/widowers.

Diamond and Orszag show that for Model 3 without individual accounts, the actuarial balance would be restored from -1.86% of the national payroll to +.08% of the

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payroll (Diamond and Orszag, June, 2002). This would be accomplished by dedicating new revenues to Social Security, reducing monthly benefits in line with improvements in mortality, and reducing benefits for early retirees and high earners. As in Model 2, a portion of the savings would be used to provide higher benefits for long-career low earners and widows/widowers.

Diamond and Orszag then provide an analysis of the addition of individual accounts to the models. The Commission proposes individual accounts in all three of its models. Workers would be given the option of having a portion of their payroll taxes diverted into individual accounts. For a worker who chooses to participate, these assets would accumulate and be made available upon retirement. However, because this diverted revenue would reduce the financing available to the Social Security system, a liability account would also be established that “accumulates the amounts diverted plus interest and so determines the debt owed back to Social Security...Upon retirement, the debt would be repaid by reducing traditional Social Security benefits (Diamond and Orszag, June, 2002).”

Diamond and Orszag contest that the administrative account charges as well as the initial funding costs were not correctly assessed by the Commission. They are also concerned about the large transfers of general revenue that would be needed to fund the individual accounts: “...all three Commission reform models involve significant transfers of general revenues to Social Security for sustained periods without Commission recommendations of any other changes in the Federal budget to finance the transfers (Diamond and Orszag, June, 2002).” In addition, there could be a substantial cash flow

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problem as the payroll tax diversion would precede any benefit reductions by many years. These scholars show that for Model 2, with 100% participation rates in individual accounts and no revenue transfers, the actuarial balance would only climb from -1.86% of national payroll to -1.07%. For Model 3 under the same circumstances, the balance would only climb from -1.86% to -.36% (Diamond and Orszag, p.57, June, 2002).

The two scholars react fairly positively to the aspects of Models 2 and 3 that don't include the individual accounts. They are strongly against the incorporation of individual accounts both because of funding problems and also because of the possibility that the government will not enforce a prohibition on pre-retirement access to the funds by individual workers.

“Reforming Social Security: A Balanced Plan”

More recently, Orszag and Diamond have released a Brookings Institution Policy Brief (December, 2003) that presents their own solution to Social Security reform. The scholars claim that Social Security is one of America's most successful government programs in that it has “helped millions of Americans avoid poverty in old age, upon becoming disabled, or after the death of a family wage earner (Orszag and Diamond, December, 2003).” They stress that the program should not be destroyed altogether but rather should be reformed:

“Our plan restores balance to Social Security without drawing on general revenues, preserves the program's basic structure, and strengthens its social insurance functions. Its combination of revenue and benefit changes reflects the type of balanced approach that was successfully adopted in the 1983

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reforms of Social Security (Orszag and Diamond, p.1, December, 2003).”

Their reform plan has three components:

- **Life Expectancy:** The increase in life expectancy at age 65 by four years for men and five years for women since 1940 has increased the number of payments to workers and decreased the amount of money in the Trust Fund. Orszag and Diamond recommend adjusting Social Security for increased life expectancy with half of the adjustment occurring through benefits reductions and the other half through payroll tax increases.
- **Earnings Inequality:** This inequality is the result of a combination of the fact that earnings have risen most rapidly among workers with the highest earnings and that the Social Security payroll tax has a maximum taxable level that has not risen as quickly. Compounding this problem is the fact that the life expectancy has grown faster for those who earn more money and have higher educations, and so these people gain more from Social Security than do lower earners with less education. Orszag and Diamond recommend that the maximum taxable earnings base rises until the share of total earnings that is above the base has declined from 15% to 13%. They also recommend lowering the benefits for the highest paid workers from 15 cents in benefits for each dollar of lifetime earnings to 10 cents.
- **Legacy Debt:** One of the largest drains on Social Security is the legacy debt. This debt results from earlier beneficiaries who received larger benefits than could have been financed from their own contributions plus the returns on those contributions. Provided benefits are protected for anyone 55 or older in 2004, this debt totals \$11.5 trillion. In order to finance this debt, Orszag and Diamond recommend the following: mandatory Social Security coverage for newly hired state and local government workers (about 4 million currently do not contribute); a legacy tax to be imposed on earnings above the maximum taxable earnings base (so that high earners contribute in proportion to their full earnings); and a universal legacy charge on future workers and beneficiaries in the form of benefit reductions (for those becoming eligible in or after 2023) and modest payroll tax increases (from 2023 on) (Orszag and Diamond, December, 2003).

Orszag and Diamond suggest that the government could, as an alternative to some of the reductions and increases discussed, dedicate revenue from another source to Social Security. They also propose increasing benefits for those with low lifetime earning and

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for those who are widowed. For the former, benefits will increase until they are brought above the poverty line. For the latter, benefits will be at 75% of what the couple had received when they were both alive (Orszag and Diamond, December, 2003).

These changes would be sufficient to restore actuarial balance and to extend and slowly increase the trust fund throughout the next 75 years. The plan would not affect those currently receiving benefits or those who are 55 or older in 2004. The reductions would decrease the amount currently scheduled to be received by workers, but for older workers, this reduction would equal as little as less than 1%, and for younger workers, benefits would still remain higher (due to expected higher career earnings) than those of older workers. The employee payroll tax would rise from 6.2% in 2005 to 7.1% in 2055. The combined payroll tax would rise from 12.4% in 2005 to 12.45% in 2015 to 13.2% in 2035 to 14.2% in 2055. The scholars strongly recommend against individual accounts.

Other Writings and Presentations

In addition to the above papers, Orszag and Diamond have written and published a book entitled *Saving Social Security (Brookings Institution, 2003)*, which discusses even further the above program reforms and reviews the approach to Social Security that the United States has pursued over since the program's inception.

Mr. Orszag also gave a testimony before the Joint Economic Committee on March 10, 2004, entitled "Strengthening Retirement Security," that, among other items,

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addressed the need to preserve the Social Security system. He argues that Social Security's success is attributable to the following:

“It provides participants with a well-defined, assured basic income that is protected against inflation, the risk of outliving one's assets, and financial market fluctuations. It is progressive, providing larger annual benefits (relative to previous wages) for lower earners than for higher earners. And it provides families with insurance against the disability or death of a wage earner, in addition to retirement benefits (Orszag, March 10, 2004).”

Orszag also presents arguments against the creation of individual accounts. First, he asserts that diverting revenue into individual accounts worsens Social Security's financial status. The creation of liability accounts to offset this reduction causes cash flow problems, as the flow into individual accounts will precede the offsetting reductions by several years. Second, he argues the likelihood that individual accounts would require benefits to keep pace with inflation, last for the entire life of the beneficiary, and protect surviving spouses, as the Social Security program ensures, is slim. Third, he fears there might be pressure to allow withdrawals from the individual accounts prior to withdrawal. Finally, Social Security is not currently subject to market risk, but individual accounts certainly would be. He contends that if the Administration were to enact the proposals that he and Diamond have suggested and retract the tax cuts enacted by President Bush, the deficit could be cut in half relative to the baseline deficit (Orszag, March 10, 2004).

Gary Burtless

“Increasing the Eligibility Age for Social Security Pensions”

Gary Burtless, Senior Fellow of Economic Studies at the Brookings Institution published a study on Social Security for the Senate Special Committee on Aging on July 15, 1998. His paper, “Increasing the Eligibility Age for Social Security Pensions,” suggests that the best way to solve Social Security’s financing problem is to trim benefits by increasing the early eligibility age and the normal retirement age for workers: “This reform is justified by the substantial increase in life spans that has occurred since Social Security was established in the 1930s. An increase in life spans, when the normal retirement age remains unchanged, is equivalent to a sizable increase in lifetime Social Security benefits (Burtless, 1998).” By increasing both the early eligibility age and the normal retirement age, older workers would be pressured into staying in the labor force.

Improvements in life expectancy have increased the funding requirements of Social Security. In 1940, the average remaining life expectancy at age 65 was 12.71 years; in 2000, it was 17.49 years; the projection for 2030 is 18.68 years (Burtless, 1998). Monthly pension premiums have not been reduced to offset growth in the average number of pension payments made to retirees. Instead, it’s the contribution rate that has typically been increased. Burtless recommends two options for increasing the retirement age: accelerating the already scheduled increase from 65 to 67 or increasing the normal retirement age automatically in line with increases in life expectancy. He also recommends that the early eligibility age increase in conjunction with the retirement age increase. Such changes would require workers to stay in the labor force longer, cutting

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down on the financial outlays of Social Security. The author stresses that special provisions would have to be made for those with impaired health so that they might obtain disability benefits at a younger age than the early eligibility age (Burtless, 1998).

Cato Institute

The Cato Institute is a non-profit, public policy research foundation that was founded in 1977 by Edward H. Crane. Its mission is to “broaden the parameters of public policy debate to allow consideration of the traditional American principles of limited government, individual liberty, free markets and peace (www.cato.org/about/about.html).” As Cato wishes to remain independent of the government, it accepts no government funding but rather receives its funding from foundations, corporations, and individuals. The Institute’s researchers publish a vast amount of literature that covers the spectrum of public policy. The Institute also holds policy forums, book forums, and policy conferences. Cato considers itself to be a “market liberal” organization:

The Jeffersonian philosophy that animates Cato’s work has increasingly come to be called “libertarianism” or “market liberalism.” It combines an appreciation for entrepreneurship, the market process, and lower taxes with strict respect for civil liberties and skepticism about the benefits of both the welfare state and foreign military adventurism (www.cato.org/about/about.html).

Andrew Biggs

Andrew G. Biggs is the assistant director of the Cato Institute’s Project on Social Security Choice. A Social Security analyst, Mr. Biggs served as a staff member on the President’s Commission to Strengthen Social Security.

“Perspectives on the President’s Commission to Strengthen Social Security”

In his article for the Cato Project on Social Security Privatization, Mr. Biggs speaks strongly in favor of the work that the President’s Commission to Strengthen Social Security has done. He believes that this group has presented a better set of alternatives than any other organization to date.

Before launching into his opinion of the three proposals, Biggs spends some time explaining the difference between promised benefits (what the Social Security benefit formula promises a worker with a given wage history) and payable benefits (what the under funded system will actually pay under current law). The PAYG system is the actual rate required to pay the benefits promised, while current law is the 12.4% rate that is presently in effect (Biggs, 2002). He argues that it is important to keep these distinctions in mind when considering any proposals regarding the Social Security system.

Biggs describes the first plan as one which makes no changes to the current system, other than allowing individuals to have private retirement accounts. While it gives workers the reward of personal asset accumulation, it does nothing to address the longer-term solvency issues of the program. The author notes that, from a financing perspective, if this system were funded only through payroll taxes, the deficit would be increased by 0.32% of the payroll (Biggs, 2002). If handled properly, however, the size of the “general revenue infusions” needed to pay full benefits would be reduced by 8% while paying higher benefits.

The second plan, Biggs’s favorite, is structured to maintain a real inflation-adjusted foundation on which other savings could build through switching from wage-

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based indexing to price-indexing (which would help bring solvency to the system). This “ensures that benefits for all workers at least keep pace with inflation and, for lower wage workers, rise at a faster rate (Biggs, 2002).” Biggs argues in favor of personal accounts because they overcome the current program’s financial limitations and allow the total retirement benefits to be higher than they are under the current system. It also provides workers with more autonomy and a greater guarantee of benefits. While the transition cost will, admittedly, be high, Biggs counters that they will be much larger if we are forced to maintain the current system (Biggs, 2002).

Despite the fact that the third plan succeeds in matching or exceeding the benefits currently promised by Social Security at a lower cost, Biggs foresees that low-wage workers will not be able to take advantage of the additional contributions and will, therefore, not gain as much from this system as higher-income workers will. If this program were adopted and funded by a combination of payroll taxes and general revenue transfers, it would be effective in bringing Social Security cash surpluses and long-term sustainability (at half the cost of maintaining the current program)(Biggs, 2002).

Biggs highlights several key points about each of the Commission’s plans:

- They would all pay higher benefits than under the current law
- They would all require less general revenue than the current program requires
- They would all leave Social Security with substantially greater asset over the long term

In answering the question regarding where the government would find the money to fund the transition, Biggs states that it would obtain the money from the same source it would use to keep the current system afloat (and less money would be needed!) (Biggs, 2002).

While none of the plans is ideal, all are superior to the alternatives, and provide ways in

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which workers can obtain individual control of their money, while also strengthening the assets and wealth of many Americans. The second plan in particular would “allow workers to regain control over their retirement savings while giving the federal government the budgetary flexibility that comes from a pension program that can live within its means (Biggs, 2002).

Michael Tanner

Michael Tanner joined the Cato Institute in 1993 after serving as Director of Research for the Georgia Public Policy Foundation. At Cato he directs research on new, market-based approaches to health, welfare, and other social policy issues. Most recently, he directed Cato’s Project on Social Security Choice, which propounds private savings programs. Mr. Tanner has many publications and has also appeared on multiple television and radio news programs.

“The 6.2 % Solution: A Plan for Reforming Social Security”

Michael Tanner authored “*The 6.2 % Solution: A Plan for Reforming Social Security*” as a result of the Project on Social Security Choice. The paper provides a specific reform proposal that gives individual workers control of their retirement funds while restoring long-term solvency to the Social Security program and reducing costs as well as reliance on the government.

Tanner points out that the Social Security Trust Fund, which is supposed to have enough assets to pay benefits through 2018, consists purely of government bonds that will eventually have to be repaid by the taxpayer through higher taxes, public borrowing, or the reduction of benefits. With liabilities of almost \$26 trillion (Tanner, 2004), tax

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increases or benefit reductions would have to be quite large in order to maintain solvency within Social Security. Tanner hypothesizes that by 2078, the government will have to acquire revenues equal to \$4,193 per worker in order to maintain benefits paid to workers. This translates into either a payroll tax hike from 12.4% to 18.9% or an equivalent increase in income or other taxes (Tanner, 2004).

Social Security provides less than a 2% return for most workers. Tanner states, “Social Security taxes are already so high, relative to benefits, that Social Security has quite simply become a bad deal for younger workers (Tanner, 2004).” The solution: allow individuals to invest their payroll taxes privately so that they can be provided with higher returns and a more secure retirement. Tanner projects that shifting to a private account system would increase national savings, productivity, wages, jobs and economic growth. He also expects that such a system would help break the cycle of poverty for many low-income households by providing parents with more inheritance money for their heirs.

The Cato Institute proposes the following for Social Security Reform:

- Beginning January 1, 2005, workers born after January 1, 1950, would have the choice of remaining in the traditional Social Security system or of diverting half of their payroll tax (6.2%) to individually owned, private accounts.
- For those who remain in the traditional program, benefits as of 2012 would be indexed to price inflation rather than wage growth.
- For those who choose the private account system, the remaining 6.2% of their payroll taxes would be used to pay transition costs and to fund disability and survivors' benefits.
- Participants in the new system would also receive bonds in recognition of their past contributions to the Social Security system that would be fully tradable on secondary markets, but the proceeds would have to be deposited into their individual accounts.
- These participants would also have the option of depositing an additional 10% of their earnings into their accounts.

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The individual accounts would be set up under a three-tiered system. Under the first tier, the worker's employer would send payroll taxes to the U.S. Treasury, informing them how much of the payment is from employees who have chosen the personal retirement account option. The Treasury would transfer that portion to a private-sector custodian bank. In the following year, when the contribution is reconciled against the individual's name through the W-2 form, the fund's share representing her contributions and interest credit would be transferred to the individual's default account as specified under the second tier (Tanner, 2004).

Under the second tier, workers have an initial choice of three investment options. The default portfolio has 60% stocks and 40% bonds. The other two have the same asset classes but with different weights. The younger workers would have the option of higher weights in stocks, and older worker would have the option of higher weights in bonds (Tanner, 2004).

Under the third tier, once a worker has accumulated a certain level of funds, that worker can participate in a much larger range of investment options, similar to those available under 401(k) plans. The assets can be allocated at will among these providers, ensuring competition (Tanner, 2004).

Upon retirement, workers can choose an annuity, a programmed withdrawal option, or the combination of an annuity and a lump-sum payment. If the retiree dies before receiving all of his payment, the assets become part of his estate and are fully inheritable. The latter of the three involves an annuity providing payments equal to 120% of the poverty with the remainder being the lump-sum payment (Tanner, 2004).

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Also under this proposal, the federal government would provide a safety net to ensure that no worker's retirement income would fall below 120% of the poverty line. Workers who don't receive enough income to purchase an annuity that provides them payments at that level would receive necessary funds to make this purchase. This safety net would be funded through general revenues (Tanner, 2004).

This paper provides three suggestions for funding this transition to the new system:

- The portion of taxes on SS benefits currently used to fund Medicare should be redirected back to Social Security.
- The Cato Institute "has identified more than \$87 billion annually in corporate welfare, roughly defined as "any government spending program that provides payments or unique benefits and advantages for specific companies or industries." It recommends eliminating such subsidies and using the funds for Social Security reform.
- Contributions to individual accounts can be taxed to help finance the transition (Tanner, 2004).

While there are many doubts about allowing individuals to invest their Social Security retirement funds in private accounts, Tanner argues that there is relatively little risk involved:

Given the long-term investment horizon envisioned for workers choosing individual accounts under this proposal, market investment is remarkably safe...we know that, even under the best of conditions, Social Security will provide below-market returns... even with recent stock market declines, a worker investing all of his payroll taxes in stocks would receive benefits 2.8 times greater than he would receive had he "invested" the same amount of money in Social Security (Tanner, p.11).

"No Second Best: The Unappetizing Alternatives to Social Security Privatization"

In *"No Second Best: The Unappetizing Alternatives to Social Security Privatization,"* Tanner presents several of the same arguments that are presented in the *"6.2% Solution"* paper. He does make some additional points to reinforce the benefits of

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privatization. Among other justifications, Tanner argues that the current Social Security system is rife with inequities towards women, minorities, and low-income workers; implementing a privatization program will establish property rights, make benefits fairer to women, and allow low-income workers to accumulate wealth (Tanner, 2002).

He also argues that proponents of increasing payroll taxes to maintain Social Security's solvency are not considering either the amount by which payroll taxes will have to be increased or the tremendous burden this will have on taxpayers (as an example, the payroll taxes of 1988 and 1990 resulted in an estimated permanent loss of 510,000 jobs)(Tanner, 2002). Removing the cap on Social Security payments would be similar to a tax increase in that it would cost the economy nearly \$136 billion in job growth and 1.1 million jobs while only increasing Social Security's lifespan by 7 additional years (Tanner, 2002). Tanner is also not in favor of allowing the government to invest Social Security funds in the stock market because it would give the government the ability to politicize its investment decisions and to put government workers on corporate boards.

Privatization is especially important because it gives workers the right to their own retirement benefits---under the current system, workers do not own rights to the money they put into the system. At this time, retirement security is entirely dependent on our politicians (Tanner, 2002).

The National Center of Policy Analysis (NCPA)

The National Center for Policy Analysis (NCPA) is a nonprofit, nonpartisan public policy research organization, established in 1983. The NCPA's goal is to develop

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and promote private alternatives to government regulation and control, solving problems by relying on the strength of the competitive, entrepreneurial private sector (www.charitynavigator.com). NCPA's principal areas of research include health and welfare, economic issues, political issues, environment and natural resources, and education. The organization is funded by foundations (75%), corporate donations (14%) and private donations (11%) (www.nira.go.jp).

The NCPA takes pride in the fact that many of its studies are used by members of Congress to shape policy. In 1990, an NCPA study on how Social Security rules penalize senior citizens and discourage them from working was released on Capitol Hill by more than 50 members of the House of Representatives (www.pfaw.org).

Former fellows of the NCPA are currently represented in the Bush administration. Most notably, Senior Fellow Thomas R. Saving was appointed to the Board of Trustees of the Social Security and Medicare Trust Funds and to President Bush's Social Security Commission.

Semi-Privatized Reform

The NCPA advocates semi-privatization as the most important Social Security reform measure. Fears that Personal Retirement Accounts (PRAs), which put funds into IRA-like accounts, are subject to unacceptably high market risk have prevented such systems from gaining political acceptance. To eliminate the downside of market risk, The NCPA's plan echoes "the Galveston Model (See section on Galveston, Texas)." The plan would be managed by a professional financial management company, which loans the employee funds to a top-rated financial institution for a guaranteed interest rate. Those rates have varied from around 5 % up to 15.5 %, but average in the 7.5-8 % range

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(Matthews, 2002). This model effectively eliminates the employees' market risk; the financial institution which guarantees the minimum return bears the risk. Additionally, professional money managers make all of the investment decisions, refuting the argument that most people are not qualified to manage privatized accounts. Employees of Galveston, Texas have used this plan effectively for over 20 years.

Opponents of PRAs argue that privatized plans have exceptionally high administrative costs compared to Social Security. The NCPA counters that PRAs, based on a banking model, would have low administrative fees. In most cases, they argue, banks internalize administrative costs rather than pass them on to the consumer. Banks make their money on the spread between what they pay on a deposit and what they can make investing that money. In most cases administrative costs are covered by a portion of the spread, and this limits fees passed along to the PRA.

The NCPA outlines a 12-step plan for social security reform (Matthews, 1998).

Included below are some highlights of the plan:

- **Give workers a choice between the public system and a private plan.** Funds contributed towards a private plan would be invested in stocks, bonds and real assets that would fund the workers' retirement and other benefits covered by Social Security. In the case of death, private account balances would become part of the deceased's estate.
- **Give workers credit for Social Security taxes already paid.** Workers who choose the private option should receive full or partial credit for the money they have already contributed to the Social Security system. One way to do that would be to give them "recognition bonds" backed by the full faith and credit of the government. These nonnegotiable bonds could be cashed in at retirement to supplement their income from the private accounts. Alternatively, workers choosing the private option could receive Social Security benefits in amounts based on their previous contributions in addition to their private accounts.
- **Offer a choice of private plans.** The key to consumer satisfaction in creating such private and individual retirement accounts is competition. The law should permit a number of federally approved private-sector plans to compete to manage workers' private pension accounts.

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- **Include life and disability benefits in private plans.**
Those who choose the private option should be required to purchase life and disability insurance as part of their plan. Participating insurers would have to accept all applicants.
- **Require retirees to purchase minimum-income annuities.**
To ensure that retirees do not deplete their retirement funds too quickly, individuals should be required to purchase an annuity at retirement that would pay a fixed monthly amount- say, 60 % of their pre-retirement income - for the rest of their lives. Funds above the amount needed to purchase the annuity would not be restricted. After they purchased the annuity or set aside funds for its purchase, they would not have to make further contributions.
- **Guarantee that private account holders don't lose.**
Government should guarantee that no one will be worse off for having opted out of the public system. At least during the transition period, the federal government should be prepared to "top up" the personal retirement account of any retiree so that the retiree could purchase a minimum-income annuity comparable to what would have been paid by Social Security.
- **Let people choose their own retirement age.**
As long as individuals have sufficient funds in the account to purchase a lifetime annuity, they should be allowed to retire whenever they choose.

The NCPA recognizes that Social Security reform is necessary and should be addressed immediately. Current spending trends are unsustainable, and without reform, taxes will likely rise by an amount at least equal to the projected rise in entitlement spending (www.ncpa.org). The NCPA favors a semi-privatized plan that allows for a portion of an employee's payroll taxes to be deposited into a Personal Retirement Account. Private financial management firms would loan the employees' funds to top-rated banks in exchange for guaranteed returns, averaging 7.5-8%. This allows market risk to be assumed by the banks, rather than by the employees.

The Century Foundation

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The Century Foundation (originally the Twentieth Century Fund) is a research foundation that conducts research and provides analyses of relevant economic, political, and social issues and institutions. Its mission is “to persuade those who care about issues such as economic inequality, population aging, homeland security, discontent with government and politics, and national security that significant improvements are possible even when the conventional wisdom says they are not.” The organization achieves its objectives by: convening groups of experts to form a consensus behind new policy ideas; commissioning works from individual experts; publishing information about issues and reform policies; and holding public forums and public events to disperse information (www.tcf.org/AboutUS/AboutUs.html, 4/02/04).

“10 Myths About Social Security”

On June 1, 1998, The Century Foundation published its Issue Brief #3, entitled “10 Myths About Social Security.” The paper focuses on rebutting some of the reasons that politicians and policy makers cite when touting their reform programs. The following is a list of some of these “myths” as well as the arguments against these myths (The Century Foundation, 1998):

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1) **Social Security will have to stop payments to retirees in 2032.**

Estimates show that while the Social Security Trust Funds will potentially be depleted by this time, payroll taxes will be sufficient to finance about 75% of the benefits owed. This means a shortfall rather than a total bankruptcy.

2) **We would all do better if Social Security were replaced by a system**

of individual private accounts. Moving from a PAYG system to a private, pre-funded system would require a large amount of extra funding that would need to be financed through additional taxes, lower benefits, or an increase in the national debt.

3) **The Social Security Administration is a big government bureau-**

cracy that wastes a lot of taxpayers' money. Administrative costs amount to 1% of benefits.

4) **The ratio of non-workers to workers will reach unprecedented**

heights during the next few decades, imposing unsustainable burdens not just on Social Security but on the entire economy.

There were almost five people between the ages 20 and 64 for each person over 65 in 1995; by 2030, estimates predict ratio to fall to nearly three people between 20 and 64 to each person over 65. However, the total ratio of dependents to workers is estimated to be 79:100 in 2030, compared to 71:100 in 1995. This is still much lower than the

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ratio in 1965 of 95:100.

- 5) **Compared with the private investment market, Social Security provides a meager payoff to workers relative to their lifetime contributions.** Social Security provides benefits that other private investments won't, including insurance protections, low maintenance fees, and guaranteed retirement benefits for life. It is also relatively risk free in that it is tied to past earnings histories and marital status rather than market fluctuations.

- 6) **The elderly generally enjoy comfortable living standards and would have little difficulty getting by if Social Security benefits were less generous.** In 1996, Social Security provided average benefits of \$745/month, without which, half of the elderly would have fallen below the poverty line. In 1994, 66% of America's elderly relied on Social Security for at least half of their total income.

“A New Minimum Social Security Benefit”

In January, 2000, the Century Foundation published its Idea Brief No. 1, “A New Minimum Social Security Benefit,” which presented its own solution to Social Security reform. The organization proposes to lift the elderly poor out of poverty by increasing payments to households that are heavily dependent on Social Security and that have income below the poverty line (The Century Foundation, 2000). In order to achieve this

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result, the Century Foundation favors the reintroduction of a broad-based, non-discriminatory, minimum Social Security payment that would be available to “households that receive 75% or more of their income from Social Security and have total income below the poverty line (The Century Foundation, 2000).” Such a benefit would guarantee that every household that is heavily dependent on Social Security would receive poverty-line income.

Unfortunately, at the time of this proposal, the Century Foundation had been unable to collect much information regarding the cost of implementing such a program. It was unable to collect data on the number of eligible households and the gap between their current benefits and the poverty line:

Because most households receive some Social Security, and because the poorest 40% of households receive 80% of their incomes from Social Security, we expect that most poor elderly households will be covered by the New Minimum Benefit. So the cost of greatly reducing poverty among retired American workers would be on the order of \$6 billion per year, less than 2% of existing Social Security benefits.

In its brief, The Century Foundation does not present any methods of financing such a project.

“Social Security Reform: A Century Foundation Guide to the Issues.”

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In 2002, as part of its “The Basics” series, the Century Foundation published a new solution to the Social Security financing problem. The guide discusses how Social Security is financed and the Social Security Trustees’ projections about the Trust Funds, and it provides a recommendation.

Social Security is financed mostly by about 96% of the workers, who contribute by paying a flat tax of 6.2% of their wage income up to a certain amount, with their employers contributing an equal amount. Additional revenue is raised through the taxation of benefits of high-income beneficiaries. The administrative costs are less than 1% of benefits paid.

The Social Security Trustees’ projections about the Trust Funds are based on assumptions about the demographic and economic trends over the next 75 years (note: these are from the 2002 reports---some statistics have changed since then). They produce three sets of projections: an optimistic, a pessimistic, and an intermediate. The intermediate projections in 2002 were of a shortfall of 1.86% of the taxable payroll. Beginning in 2016, the annual benefits paid to retirees would exceed the payroll tax revenues. From 2016 to 2024, the interest generated from the Trust Funds would be needed to meet the current Social Security obligations. From 2025-2037, the Trust Fund principal and accruing tax revenues would be needed to meet expenses. And by 2038, these funds would be spent. However, the system would not be bankrupt because payroll taxes will be sufficient to pay 73% of the obligations to Social Security recipients at that time. This would decline to 66.66% in 2075 (Century Foundation, 2002).

The solution: since Social Security is projected to slip out-of-balance by an amount equal to 1.86% of the total taxable payroll, an immediate increase of 1.86% over

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the current 12.4% combined rate would generate adequate funds to pay full benefits through 2075.

The Maxwell School of Citizenship and Public Affairs

The Maxwell School of Citizenship and Public Affairs was founded at Syracuse University. The school:

- is renowned for a graduate professional education in public administration and international relations;
- grants master's and doctoral degrees in the social sciences (e.g., political science, history, economics); and
- teaches the social sciences to undergraduate students of Syracuse University (www.maxwell.syr.edu/deans)

Timothy M. Smeeding

Timothy Smeeding is the Director of Maxwell's Center for Policy Research. The Center for Policy Research is an applied policy research program that conducts research in such areas as aging, social welfare, income security policy, and domestic, urban and regional issues (www-cpr.maxwell.syr.edu).

Mr. Smeeding has written and contributed to multiple books, articles, and policy briefs in the area of social welfare. The bulk of his writings on Social Security reform have to do with the impact of Social Security on women.

“Income Maintenance in Old Age: Current Status and Future Prospects for Rich Countries.”

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This article was published in the journal *Genus* in 2003. It was originally prepared for the U.N. Conference “Status of the Older Population: Prelude to the 21st Century” in Sion, Switzerland in 1999. The study compares the approaches that different rich nations take in reducing poverty rates among the elderly (especially among women) and presents issues needing to be addressed in the future. The countries examined are the United States, Canada, Australia, the U.K., Spain, France, Luxembourg, Belgium, Denmark, Germany and The Netherlands.

Smeeding shows that the United States has one of the highest overall poverty rates of the above countries. In all nations except the Netherlands, “the highest poverty rates are among single elderly women living alone...older women are the large majority of all elderly people in most rich countries and also then the majority of all very elderly poor (Smeeding, 2002, p.14).”

Most nations try to fight poverty by combining social retirement and social assistance programs. The former are typically pay-as-you-go, defined benefit programs that are designed to provide income replacement to retirees. The latter are targeted supplement social retirement payments for low-income retirees. Of all countries examined, Australia is the only one which relies entirely on a social assistance program to support its elderly. Smeeding’s research shows that social retirement systems have the largest affect on old age poverty in every nation (except Australia).

Because the impact of social retirement systems on lowering the elderly poverty rate is significant, Smeeding argues that taxes will either need to be raised to support such systems, or benefits will need to be curtailed (Smeeding, 2002). All of the nations presented are working on changing their systems to support the growing elderly

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population. The author suggests that more, better-targeted spending and adequate minimum benefits are the best way to curtail decreases in social security systems.

“Social Security Reform: Improving Benefit Adequacy and Economic Security for Women”

This paper was published by Smeeding in 1999 as part of a Policy Brief Series for the Maxwell School. It is based on a larger report, “Social Security Reform and Older Women: Improving the System,” which was co-authored by Carroll L. Estes and Lou Glasse and sponsored by the Retirement Research Foundation. The brief was “designed to raise awareness of the current and future economic circumstances of older women, and the ways in which Social Security reform can help alleviate their unmet needs (Smeeding, 1999).” In the document, Smeeding presents some proposals to help reduce the long-run Social Security deficit as well as the future poverty status of older women.

Because women are the major beneficiaries of the current Social Security program, they will be affected the most by changes made to the system. Some of the statistics supporting this fact are:

- More than two in three persons aged 75 and over are women; and almost three in four persons aged 85 and older are women;
- Three of every four poor elderly people are women;
- Without Social Security and barring any behavioral change, more than half of all older women would be poor today (Smeeding, 1999).

Women are “at risk” for many reasons. First, they typically have fewer years of earnings (due to child-rearing and care-giving) and therefore have many more years with no countable earnings to contribute to Social Security. This equates to lower Social Security benefits. Second, divorce and single parenthood rates are escalating. The effect

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of single parenthood on a woman's ability to save for retirement, thus supplementing benefits received, is negative. In order to be eligible for retirements based on a past marriage, that marriage needs to have lasted longer than ten years. When coupled with traditionally lower earnings, women are placed in a lower benefit bracket. Third, women are typically widowed at a much earlier age than men; the average older female survivor spends over 15 years as a widow (Smeeding, 1999). Though labor force participation among women is climbing, these increases in pensions and long-earnings careers will still be offset by rising rates of divorce, non-married status, and poor earnings.

Smeeding's reform proposals are "aimed at strengthening rather than weakening survivors' benefits (Smeeding, 1999)." He suggests several options that fall under the categories of better survivors' benefits, more equitable benefits for divorcees, and a better income safety net, all of which work together in alleviating poverty in old age. They are:

- Better return on earnings and better survivor's benefits for older women (ex: a lower initial benefit for couples of 133% of the higher earner's initial individual benefit upon retirement in combination with a higher benefit for the surviving spouse of 75% of both spouses' combined initial benefits);
- Lower the number of required years to be married prior to divorce in order to be eligible to collect benefits based on the earnings history of the former spouse OR institute earnings sharing for all years of marriage (for divorcees only) thus making the lifetime Social Security contributions proportionate to covered earnings over the number of years married;
- Enhance the Supplementary Security Income program by: 1) easing asset limits, allowing beneficiaries to protect a larger amount per month of their Social Security benefits, and lowering the qualifying age, or 2) incorporate a new targeted minimum benefit guarantee that would be income tested and set at the poverty line within the Social Security system and separate from the SSI (Smeeding, 2001, pp. 12-18).

Smeeding admits that the budgetary costs of his program are difficult to calculate, but the preliminary estimates with changes in all three categories "would total less than one-half of one % of the long run payroll gap between revenues and outlays, about \$20

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billion per year in 1998 dollars (Smeeding, 2001).” The reform policies are designed to help improve the economic well-being of elderly women.

Social Security Privatization Around the World

Beginning with President Clinton, the possibility of nationally investing in the stock and bond markets came to light. Some states, like Texas, had already begun privatizing their Social Security accounts. President Bush and others are also pushing this option. Younger workers are facing an increasingly low rate of return on their Social Security taxes, leaving some form of privatization a viable option. Allowing such will, according to USA Today (2/24/2004):

- Help restore Social Security to long-term solvency without having to resort to massive tax increases
- Provide workers with higher benefits than Social Security would otherwise be able to provide.
- Create a system that treats women, minorities, and young people more fairly.
- Allow low-income workers to accumulate real, inheritable wealth for the first time in their lives.
- Give workers ownership and control over their retirement funds.

A survey of the implementation and effectiveness of privatized Social Security systems around the world follows.

TEXAS

The 1970's brought a sense that all was not well with the Social Security system. Texas, a state long known for its independence, found a loophole and broke out of the typical Social Security plan in 1981, having given the required two year's notice in 1979. This loophole permitted municipal governments to opt out of the system. Galveston County took this liberty, and Brazoria and Matagorda counties also followed suit.

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Congress closed this loophole in 1983, after voters in Galveston County chose to leave the system by a vote of 78% to 22%. As of 1996, these plans were earning 6.5% on their vested funds (County employees are vested immediately), compounded daily (www.ncpa.org). Interest rates may fluctuate from year to year, but the plan is guaranteed to pay a minimum interest rate. The total contributions to accounts was 13.78%, with 9.737% going straight to the employee's individual account, and the remaining going toward disability and life insurance premiums for the employee in the case of accident or death. Medicare payroll taxes are still paid by the workers. First Financial Benefits, Inc., who was administering the plan in 1996, says the benefits of such a plan are far greater than those of the Social Security plan. Those under the alternate plan have the freedom to choose between a lump sum when they retire, and an annuity. Social Security offers only an annuity.

Union representatives opposed to the privatization of Social Security, claimed it was too risky. The Texas county plans, however, are rather conservative and choose not to invest in large stock index funds. Union officials tried to convey the tableau of senior citizens standing in soup kitchen lines, due to Social Security privatization, in their 1994 testimony before the House Ways and Means Committee. The widow of a Galveston sanitation worker painted an opposite tableau, in her testimony. She "...thanked God that some wise men privatized Social Security here. If it wasn't for them, if I had regular Social Security, I'd be broke when he died - eating cat food or something (Glass, 1997)." Mrs. Cole received a benefit check for \$126,000, within days of his death. She was able to pay for her husband's funeral, and return to school to get a better paying job to

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support her and her son, with this sum. Regular Social Security benefits would have provided her with a mere \$255 (Glass, 1997).

Meredith Kansan told a similar story to *Policy Review*. She had originally fought privatization, to the point of tears, and thought it would be the end of her security. After working for twelve years under the new system, she retired. The check she received was twice as large from her private benefit plan as it would have been under the Social Security system, even though she had worked under it twice as long. Ms. Kansan, an avid knitter, later moved to Arizona and opened a yarn shop. This was her dream, and it would not have been possible had privatization not increased her benefit (Glass, 1997). Of privatization, she said in January 1997, "...Privatization was no nightmare - it was a pure miracle."

Although Mrs. Cole's and Ms. Kansan's experiences were more beneficial under the privatized system, others believe the Texas system still to be flawed, at least as far as disability insurance is concerned. The group 2030 Action estimates that there are 2.5 million Social Security beneficiaries statewide, with more than 827,000 individuals collecting disability and survivors benefits; 282,000 are under age 39, with 76,000 in the age group 18-19 and 206,000 ages 17 and under. The group estimates that a national plan would divert funds away from disability and survivors, and into the stock market. But if the national plan were modeled after the plans of the 3 Texas counties, this would not happen. The Texas plan currently pays 60% of a worker's salary while on disability leave, until he either returns to work or retires. Texas plan administrator, Kebodeaux says about his program, "...you will always get equal or better benefits than under Social Security. That's just not up for debate (Glass, 1997)." Union officials take the stand that

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more money now isn't always better. The union members took a different stance, not understanding that of the leadership, and voted 78% to 22% in favor of privatization. "It's clearly better for us. This is precisely what they should be advocating we get. They should like us getting more money. It seems basic (Glass, 1997)."

SWEDEN

Sweden, the land of safe cars and cradle-to-the-grave welfare services, privatized its Social Security system in 1998, after realizing the expensive benefits system had damaged its economy (www.ncpa.com). Swedish workers are obligated to set aside 18.5% of their income for retirement. Two and a half percentage points go into personal retirement accounts that are managed by a professional fund manager of the worker's choice. Today the worker has a choice of around 600 funds in which to invest her accounts (New York Times, 2004). As a comparison, the old system would have eventually required her to set aside 36% of her salary; privatization has reduced this amount by almost half (www.ncpa.com). Upon retirement, the worker receives an annuity.

The city of Stockholm hosted the 27th General Assembly session of the International Social Security Association in September, 2001. During this assembly, it was discovered that the history of Sweden's and America's Social Security systems is quite similar. Sweden's movement from an agrarian to an industrialized nation in the late 19th century led to a system of relief funds from trade unions. These funds later developed into a social insurance system. From 1945 to 1970, Sweden's economy blossomed, and social insurance systems broadened. Today, these systems cost a great deal, making up about

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36% of the Gross Domestic Product Social insurance benefits for old age pensions making up 20% of the GDP (ISSA, 2001).

Along with the high cost of social programs, the number of old-age pensioners in relation to those still working is constantly increasing. There are 30 old age pensioners for every 100 working persons (ISSA). The old age pension system was meant for steady economic growth, but low growth rates combined with an increasing number of pensioners receiving higher and higher pensions threatened the system. Most political parties represented in Parliament agreed to the need for a new system as well as to the type of system required.

As early as 1991, Parliament set up committees to address its social insurance problems. They decided that individual accounts were the best option in 1994. In 1995, the government began putting 2.5% of payroll aside for employees to invest once the new system was set up (New York Times, 2004).

By the year 2000, Sweden had introduced a new national pension system to help alleviate the costs incurred in funding the old system. The three parts of this new system are income pension, premium pension, and guaranteed pension (for low or no income participants). Those born between 1938 and 1953 are to be gradually transitioned from the old system to the new system. Those born in 1937 and before still take part in the old system, and those born in 1954 or later take part in the new system. The old system is a pay-as-you-go system, where retirement income depends on the best 15 years of income from age 16 to 64. The new system entitles the worker to a pension (annuity) upon retirement. All earnings from employment, from age 16 on, go into this pension, half coming from the employee, and half from the employer. Pensions may be collected as

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early as age 61, but the fully guaranteed pension does not take place until age 65. Provisions for regularly recalculating the future costs of pensions are in place.

At the time of the new system's introduction, most workers chose funds, understandably, that invested heavily in Swedish companies, thus achieving a low diversification level. Still other workers did not choose funds at all and were placed into the default fund that the government set up. This fund is comprised of 80-90% stocks. The government advised people to choose rather than be placed in the aggressive default fund. The default funds were comprised of the following:

Government Default Fund	Funds Chosen by Investors
Sweden 17%	Sweden 48%
North and South America 35%	North and South America 23%
Europe 20%	Europe 18%
Asia 10%	Asia 7%
Bonds 10%	Bonds 4%
Hedge Funds 4%	
Private equity 4%	

(New York Times, 2004)

The start of Sweden's private plans coincided with a down turn in the stock market. As it turned out though, the default fund lost less money than those chosen by the average worker; 30% vs. 40%, respectively. The default fund was safer in the market of the past three years, but it is evident that a safer alternative may have been better. Luckily, there

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is still a strong safety net for the Swedish worker. The Swedish government places 16% of payroll into an earnings-linked pension system.

Chile

The Chilean government's social security system has been studied and evaluated both by our politicians and by U.S. social policy scholars because Chile is one of the few countries using a fully privatized pension system. Prior to 1981, Chile had a pension system that was fully-funded, with most of the contributions being made by the employers. Chile's old system was riddled with problems, including: a benefits scheme that was calculated on the basis of the individual's earnings in only the last few years of work (the period of time when most workers earn the most); a significant percentage of workers who did not participate in the program, and; an economy that suffered from rapid inflation which devalued the accumulated pensions.

In 1981, military dictator, Augusto Pinochet, and his assistant, José Piñera, implemented a privatized pension plan. This plan is financed entirely by employee contributions. At least 10% of a worker's salary goes toward old-age pensions, and 3-3.5% goes to survivor and disability pensions. The personal accounts are managed by a small number of private companies. The system also contains a minimum benefit provision approximately equal to 85% of the minimum wage which is financed through general tax revenues.

Under Chile's system, each worker automatically has 10% of his wages deposited each month by her employer into her pension savings account. The contribution percentage applies only to the first \$22,000 of annual income. The worker can contribute an additional 10% each month. The contributions are tax deductible, and no social

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security taxes are paid to the state by the employer or the employee. The pension companies, which exist solely to manage these funds, are strictly regulated, and are expected to guarantee a diversified and low-risk portfolio (Piñera, 1996). A separate government agency provides oversight of the companies. Each company operates a mutual fund that invests in stocks and bonds, and workers are free to switch between companies, thus ensuring competition. All investment decisions are made by these companies.

Life insurance and disability insurance are also provided by the pension companies. Workers who contribute for at least 20 years but, upon reaching retirement, do not draw a government-defined minimum pension, receive subsidies from the government.

Upon retiring, workers may choose between two methods of receiving their payments: they may either purchase a monthly annuity from any private company which guarantees an inflation-indexed payment for life, or they may leave their money in their account and make programmed withdrawals. In either case, workers may withdraw a lump-sum in excess of the amount of the annuity or programmed withdrawal (Piñera, 1996).

Until fairly recently, there were several proponents of this system, including Piñera himself, who, in 1995, was the President of the International Center for Pension Reform and Co-Chairman of the Cato Project on Social Security Privatization. In *“Empowering Workers: The Privatization of Social Security in Chile,”* Piñera writes:

“Pensions in the new private system already are 50 to 100 % higher—depending on whether they are old-age, disability, or survivor pensions—than they were in the pay-as-you-go system...By improving the functioning of both the capital and labor markets, pension privatization has been one of

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the key reforms that has pushed the growth rate of the economy upwards from the historical 3 % a year to 6.5 % on average during the last 12 years. It is also a fact that the Chilean savings rate has increase to 27 % of GNP and the unemployment rate has decreased to 5.0 % since the reform was undertaken (Piñera, 1996).”

In its brief “*Chile’s Experience with Social Security Privatization: A Model for the United States or a Danger Sign?*” the Century Foundation states that for the first fifteen years, the returns on the privatized accounts seemed fantastic. High interest rates and the selling off of state enterprises contributed to an annual real return of 16.6%. “Almost half of the investments were in government bonds that were indexed to inflation, which was high during that period (The Century Foundation, 1998).”

However, with the downturn in the market that followed several years of financial growth, it started to become apparent that Chile’s system was not immune to risk. Between September, 1994, and August, 2000, the real rate of return declined to an average of 4.9% (Edwards and Edwards, 2002), and the program’s expenses ranged from 15-20% of annual contributions. The Century Foundation reports that in 1995, fees and commissions amounted to 2.4% of average wages (1998). According to “*Social Security Reform: A Century Foundation Guide to the Issues*,” several problems exist within Chile’s system.

First, the change to the privatized system resulted in huge (10-20% of an individual’s contribution) administration and transition costs. Along with these costs, the government mandated a 17% wage increase for all workers to help with the initial financing of the system.

Second, the system appears to be underfunded. The Chilean government originally estimated that a 10% payroll contribution would provide workers with benefits

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of 50-70% of their final salaries. The rates of return that the government had forecasted have turned out to be overly optimistic (Century Foundation, 2002).

Third, the possibility exists that retirees will outlive their pensions. Because this system is not guaranteed for the life of the worker, the defined contribution plan may run out before the individual dies.

In an article in the journal Revolution, Fred J. Solowey discusses the failure of Chile's privatized system. Solowey quotes several statistics from the United Nations Program for Development 2000 report on Chile:

- at least half of the six million workers in Chile will get no benefits for retirement other than a possible \$35 per month in welfare
- another 25 %, low-earners who contribute regularly to their individual accounts, will have to rely on the minimum pension guaranteed by the government (\$130 per month for anyone contributing to their individual accounts for 20 years)
- the minimum pension is 75% of the poverty level minimum wage
- fees for the privatized system totaled \$4.5 billion from 1982-1998 and ate up a large portion of each individual's savings (Solowey, 2001)

According to Solowey, a report issued by Chilean investment firm CB Capitales states that the real rate of return of the individual accounts has averaged only 5.1% since 1982. For a young worker starting out in 1994, the losses through 1998 total 6.6% per year. Since the program's inception and throughout the economic downturn, the private pension companies have earned an average profit of 20% each year.

It is expected that this system will have substantial effects on women as they typically earn less than men, live longer than men, and are less likely to accumulate 20 years of pension contributions due to child and dependent care. The UN study found that the welfare caseload has jumped 400% since the privatized system was enacted (Solowey, 2001).

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Chile's system is also riddled with underreporting and evasion problems (low-wage workers believe they can receive higher payments from a guaranteed minimum pension than they can with retirement funds). Additionally:

A United Nations Development Program estimated that 40% of AFP contributors will require additional assistance. The less one earns and the longer one lives, the more likely it is that an AFP account will not suffice...The only safety net for the poor is a minimal pension that provides barely enough to pay for a loaf of bread and a cup of coffee each day. And even that austere program is limited to 300,000 Chileans, excluding thousands of the most destitute (The Century Foundation, 1998).

It is estimated that in 1998, the Chilean Government spent about 6% of the GDP on pensions.

Solowey includes a news clip at the end of his article which states that the Congressional Research Service warned that President Bush's partial privatization plan would only worsen Social Security's financial problems. Also included in the clip is some information from the group Campaign for America's Future:

Even if the stock market performs fairly well, the Bush plan could mean almost 20 % less in benefits...The group gives as an example a young worker who earned \$31,685 last year and would retire in 2037. Under the current system, the person would get \$15,877 per year from Social Security. Under the Bush plan, they'd get \$8,296 from Social Security and \$5,300 (using optimistic figures) for a total of \$12,882, or 19% less (Solowey, 2001).

England

In 1978, the British Government under Margaret Thatcher implemented a semi-privatized state pension system to address the funding problems associated with an aging population. The two-tiered system consists of a bottom tier (a minimum income paid to all retirees) and a second earnings-based tier that is comparable to a private pension.

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In 1986, the British government began to permit employers to contract their employees out of the second tier by providing them with a private pension at least as generous as the government pension they would have received. Workers are permitted to redirect about one-fourth of their payroll taxes to employers' plans, or they can set up individual retirement accounts-- using the money at retirement to buy an annuity that pays a set yearly benefit until death. Workers investing in private plans are guaranteed benefits at least as generous as the state-run system -- even if the market goes sour.

Individuals who “contract out” give up the right to draw a second-tier pension from the state. In return, they receive a tax reduction of 4.8 percentage points. The tax reduction is calculated so that employees will, on average, gain financially from contracting out.

Those who choose not to contract out remain in the State Earnings-Related Pension Scheme (SERPS). Originally enacted in 1975, SERPS was designed to significantly supplement the minimal and inadequate basic pension (Schulz, 2000).

By shifting the burden of retirement savings to individuals, the British government's pension costs by 2030 are projected to be 6.2 % of gross domestic product (GDP). This compares with a projected 12 % of GDP in the U.S., 14.2 % in Germany and 17.2 % in France (Stevenson, 1998). Private pension funds now have more than \$1 trillion in assets -- an amount almost as large as the entire British economy and larger than the pension funds of all other European countries combined (Moffit, 1999).

In 2003, British pension funds gained an estimated 15.8 % return as rising stock markets helped them to their best return since 1999. However, last year's gain followed

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a three year bear market during which most pension plans fell into deficit (www.investmentsmagazine.com, 2004).

Britain's semi-privatized plan has now been in place for over two decades. Many analysts observing the new system argue that it reduces the overall benefits received by retirees. Critics cite mis-selling of plans by financial institutions, a prohibitively complex system, high administrative costs and market risk as inherent flaws to the system.

Perhaps the biggest shock to the British personal pension system came with the 1993 revelation that financial institutions were using deceptive and unethical procedures to encourage workers to opt out of occupational plans (private pensions) and into personal pensions (Schulz, 2000). Independent studies reported that inadequate analyses of clients' circumstances and biased information led many workers to switch into personal plans. These plans produced poorer pensions than would have resulted from their original investments. David Blake of the University of London reports that "as many as 90 % of the people who had transferred [from employer-sponsored plans] might have been given inappropriate advice (Schulz, 2000)." The accounting firm KPMG reported that in 60 % of cases examined, the client's attitude toward risk was not recorded in the case files (Schulz, 2000). Client risk is one of the most important considerations in a client's pension plan.

In reaction to the scandal, the British Securities and Investments Board mandated that financial firms review cases where mis-selling was likely and compensate misled pension holders. Millions of suspected cases needed to be reviewed; it is estimated that the cost of review combined with compensation was over \$6.6 billion (Schulz, 2000). The scandal has led to more stringent standards for giving retirement planning advice, but

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mis-selling is still rampant among pension sales people, who are ultimately paid to sell their company's products.

Critics also contend that the pension system is too complex for the average citizen to understand and navigate. For the idea of "freedom of pension choice" to work, it is argued, ordinary people need accurate information and the unbiased help of professionals. The mis-selling scandal has already shattered the notion that unbiased financial advice is a standard component of the system.

People choosing a pension plan must pick from multiple pension schemes, each with numerous variations. They need to be able to calculate and compare among competing products and incongruous administrative cost schedules. Then, they must choose among the vast number of annuity options offered at retirement. The typical retiree has neither the expertise nor technical knowledge to make the optimal decisions.

In 1999, the Chancellor of the Exchequer, in an effort to clarify the administrative costs of the various pension plan options, instructed the government's Financial Services Authority to publish more comparative data on private pension costs and charges (Schulz, 2000).

High administrative costs are a serious problem. There is almost no regulation of personal pension costs; providers can charge whatever the market will bear. Given the complexity of administrative cost schemes among the providers, plan participants often unknowingly pay exorbitant fees. An initial transfer into a personal pension can carry costs as high as 25 % of the transfer value, in addition to annual commissions of up to 2.5 % of the annual premium. The British Institute of Actuaries estimates that this level of

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administrative costs equates to a 10-20 % reduction in the amount actually going into an individual's pension account (Schulz, 2000).

Surveys of companies indicate that significant variations in administrative costs exist. A 1996 Money Management survey of various plans projected the future values of investment returns based on administrative costs of the chosen plan. Using standardized rates of return, the plan with the lowest administrative costs reduced the projected retirement value by 8%. In contrast, the plan with the highest costs reduced the projected value by 29%. The industry average reduced retirement value by 23% (Schulz, 2000).

Lastly, market risk assumed by individuals is commonly considered a flaw of the system. Even though last year's average rate of return for pension plans was 15.8%, the previous three years saw significant losses due to unfavorable market performance (www.investmentsmagazine.com, 2004). Historical averages dictate that privatization leads to average returns greater than government-funded plans; however, the timing of an individual's retirement has much to do with her final interest return. Consider the extreme example of an individual with a personal pension primarily in equities, retiring at the time the stock market crashed worldwide on October 30, 1987. That person would have received an annuity that was 30 % less than if she had retired one week earlier (Schulz, 2000).

In conclusion, critics of the British pension plan system are wary that unscrupulous financial advisors, complex system choices, high administrative costs and market risk hinder the system's ability to provide retirement returns greater than the previous, non-privatized plan. Supporters of a semi-privatized Social Security plan in the U.S. can learn valuable lessons from the British model.

Recommendations

We have explored a variety of Social Security reform proposals by scholars and politicians within the United States. Additionally, we have looked at reforms that have been implemented in other countries and in three Texas counties. These previously implemented examples of reform have been particularly valuable in that they afford us an opportunity to assess the market performance of the benefits programs during both good and poor economic conditions. We draw our own recommendations for reform based on several of the examples previously discussed. They may be viewed below:

- **The adoption of a semi-privatized plan.** Generally speaking, we feel that a carefully crafted, semi-privatized plan offers the best means of reversing future Social Security bankruptcy projections while maintaining the core elements of the current plan. We recommend (in-line with Ed Gramlich's proposal) raising payroll taxes on Social Security by 2.6%, bringing the tax total to 15%. Of this payroll tax, workers can choose to put a set percentage into a private account and the remainder into the traditional plan, or contribute the full amount to the traditional program. We do not set an exact percentage here, but believe it should be in the range of 3-6%. Individual workers participating in the optional plan can choose from a number of equity and bond index funds which will be privately managed by a professional financial institution. A selection of financial institutions will ensure competitive rates and services. Qualified financial institutions should be regulated by the federal government. Upon retirement, the traditional Social Security benefits received by an

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individual will depend on the percentage contributed to traditional Social Security relative to the private accounts. Individuals within five years of retirement at the implementation of this system should not participate in private accounts as it is deemed too risky. They should, instead, remain 100% in the traditional plan.

- **Increase minimum retirement age.** The retirement age is in the process of increasing to 67. In line with Alan Greenspan's proposal, we recommend that the minimum retirement age be increased, as needed, to maintain a stable ratio of work years to retirement years. To minimize the strain on the system, the early retirement age, as Gary Burtless recommends, should also be raised accordingly.
- **Supplemental income clause.** With the additional revenues created by the increases in both payroll taxes and the early retirement age, retirees whose incomes fall below the poverty line should be guaranteed a supplemental income to bring them, at minimum, to the poverty line.

The recommendations outlined above offer reasonable reform options, which could realistically be implemented in the United States. Although there are countless adjustments that could be made to the current system, we choose to focus on reforms that will make the greatest impact: semi-privatization, an increase in the tax rate, an increase in the minimum age at which benefits can be claimed, and a supplemental income provision for individuals who fall below the poverty line.

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The U.S. must look to other nations to avoid the unforeseen reform problems that they have encountered. Considering England's financial industry scandal, where British workers were intentionally misguided in their personal pension planning, it is critical that qualified financial institutions managing workers' private account funds be regulated by a federal government agency. Similarly, we can learn from Sweden that workers must contribute their funds into carefully chosen, well-diversified portfolios to hedge against market downturns. We learn from Chile, where the welfare caseload has jumped 400% since the privatized system was enacted, that a supplemental income clause for those under the poverty line is a reasonable measure.

Finally, we reiterate the fact that Social Security reform must occur now. Despite overwhelming evidence supporting this fact, politicians and legislators have not yet taken steps to stimulate reform. With the 2004 elections approaching, it is likely the issue will continue to be postponed. The sooner real change happens, the less disruptive the reforms will be.

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