FIXING SOCIAL SECURITY — WHAT WOULD BISMARCK DO?

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Social Security needs to be fundamentally reformed without undermining its legitimate mission — forcing people to save and insure and providing forms of social insurance that the private market would either not provide or provide poorly. Although the system has done great good, it is incomprehensible, inefficient, inequitable, and, most important, insolvent. This paper lays out a simple, modern version of Social Security that Bismarck would surely support. My proposed Personal Security System is fully funded, transparent, efficient, fair, and progressive. It features personal accounts that are collectively invested by the government (not Wall Street) at zero cost to workers.

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Imagine bringing the father of Social Security, Otto von Bismarck, back to life. Imagine doing so, here, in the United States. And imagine asking Bismarck to take a careful look at our current Social Security system and give us suggestions for reform.

Bismarck would surely be thrilled to learn about Social Security’s long track record of assisting impoverished elderly and disabled Americans, of its protection of widows and orphans, and its providing most retirees with their primary form of old-age income — income that is guaranteed at the same inflation-adjusted level no matter how long one lives.

But after patting himself on the back, Bismarck would raise a question or two. First, he would ask about the program’s finances. Then he would ask about its structure and incentives. Finally, he would ask about the fairness of the current system.

The answers would give Bismarck pause, indeed, sufficient pause to drop dead once again and leave us with these parting words: “What a mess. Toss it out, and start from scratch.”
I. SOCIAL SECURITY IS BROKE

According to its Trustees, Social Security is short a lot of money — the program’s infinite horizon fiscal gap is $16 trillion to be exact (Board of Trustees, 2010, Table IV.B6, p. 65). The $16 trillion is not a future shortfall. It is a present shortfall, that is, a present value. And it is big by our standard economic ruler, namely GDP, which is roughly $15 trillion. Every U.S. worker and piece of capital would need to toil more than 365 days, turning over to Social Security the value of every final good and service produced, to give the system enough money to cover its unfunded liability.

The infinite horizon is, of course, a long time. A natural question is whether it makes sense to look out so far into the future in considering the system’s finances. Isn’t 75 years a long-enough time over which to worry? For example, the 75-year fiscal gap is only half of the infinite horizon fiscal gap and thus seems much more manageable. Unfortunately, the infinite horizon fiscal gap is the only appropriate measure of the status of the Social Security problem, because fiscal gaps, whether calculated for a single government program or for all government operations taken together, aren’t well defined over finite horizons. The reason is due to a pervasive labeling problem in fiscal accounting. As discussed most recently in Green and Kotlikoff (2009), any fiscal program’s receipts and payments can be described using an infinite number of internally consistent labeling conventions, with each convention producing a different time-path of cash flows — “taxes less non-interest outlays” — and a different fiscal gap over any finite horizon. In contrast, the infinite horizon fiscal gap is invariant to labeling conventions, as every set of internally consistent labels will produce the same infinite horizon fiscal gap.

Chile’s pension reform in the early 1980s illustrates this labeling problem. Prior to the reform, the Chilean government took money from workers using the label “tax payments” and then distributed the money to retirees using the label “pension benefit payments.” Under the reform, the government directed the workers to send the same money to pension funds, which the government then borrowed, and, therefore, labeled as “borrowing,” in order to make the same “pension benefit payments.” Voilà, because the same receipts were re-labeled “borrowing” rather than “taxes,” the Chilean government began reporting a larger “deficit” (i.e., a smaller “surplus”). Whether the Chilean reform constituted more than just a change of language is a question for another article, but the labeling problem reminds us that form is not substance and that “privatized social security” may be no different, with respect to economic fundamentals, than “socialized social security.”

The labeling problem delivers another important and, in some ways, more troubling message. It tells us that policy cannot be broken down into “short term” and “long term.” We cannot, as economists, join the Trustees in claiming that Social Security is solvent for 37 more years, but “runs out of money and has to borrow” thereafter. Such a claim is based on a particular and, it bears saying, politically convenient labeling of Social Security’s cash flows. Unfortunately, there is a continuum of labeling conventions that
can arbitrarily be selected to “show” that Social Security’s Trust Fund is already depleted or will be depleted either tomorrow, the day after tomorrow, next month, next year, or in 500 years. For example, starting with this year, we could label Social Security’s Old Age, Survivor’s and Disability Insurance (OASDI) Federal Insurance Contributions Act (FICA) contributions as “borrowing” and label what each year’s contributors ultimately receive from Social Security in benefits as “repayment of principal plus interest on the borrowing, less a net old-age tax.” With no “tax” receipts being recorded in the short run, Social Security’s trust fund would be depleted in four years.

II. SOCIAL SECURITY’S INFINITE HORIZON FISCAL GAP

Social Security’s combined employer-employee FICA contribution is 12.4 percent of labor earnings up to the covered earnings ceiling, which is currently $106,800. Since the system’s $16 trillion infinite horizon fiscal gap is 3.3 percent of the $483 trillion present value of its taxable wage base, the system is 27 percent (0.27 = 0.033/0.124) underfunded; that is, we could immediately and permanently raise the FICA contribution rate by 27 percent and make Social Security solvent.

Extracting 3.3 percent of the labor income, up to the covered earnings ceiling, of all current and future generations represents a well-defined (label-free) change in the present values of the remaining lifetime net tax payments — the generational accounts — of these generations. Hence, wrapping this generational policy in alternative fiscal words will not change the damage done to current and future generations’ lifetime consumption and leisure opportunities.

Effecting these generational account changes, which impact current and future workers but not current retirees, is thus one way that Social Security’s solvency could be restored. Another way is to cut Social Security benefits immediately and permanently by 20 percent. Doing so would ask the current elderly to make a significant contribution to saving Social Security and, thereby, limit the economic losses visited on their current and future progeny.

There are, of course, other generational policy options for dealing with the Social Security problem. One could, for example, exempt the elderly from benefit cuts and simply cut the benefits of today’s and tomorrow’s workers. A specific proposal would be to increase the full retirement age to 70 for workers now age 50 and younger. Such as policy is isomorphic to cutting the benefits of such workers by 20 percent. But initiating a 20 percent benefit cut starting 20 years from now is very different, in present value terms, from permanently cutting all current and future recipients’ benefits starting immediately. Stated differently, increasing the full retirement age in the future does far too little too late to deal with the system’s insolvency.

III. THINGS THAT CAN’T GO ON WILL END TOO LATE

Herbert Stein, President Nixon’s Chairman of the Council of Economic Advisors and a distinguished economist, was fond of saying that, “Things that can’t go on will end,”
(Stein, 1997). His statement is true, but suggests that it doesn’t matter when we solve our fiscal problems. Nothing could be further from the truth. As shown in Kotlikoff (2003), generational policy is a zero-sum game, and exempting current generations from paying the government’s bills simply shifts the burden to future generations.

Consequently, there is something very real, very nasty, and very dangerous in doing too little too late. The Greenspan Commission’s reforms are a case in point. The Commission was established in 1983 to save Social Security. It didn’t. The Commission reasoned that looking out 75 years was long enough. It wasn’t. In looking out only 75 years, it ignored the program’s funding problems in 2058 and thereafter — problems that were clearly visible back in 1983.

Today the Social Security System is in worse fiscal shape than it was in 1983 when Alan Greenspan and his co-commissioners “fixed” it. Back then, the 75-year fiscal gap (the Trustees didn’t start calculating an infinite horizon fiscal gap until 2003), was 1.8 percent of taxable payroll (Social Security Administration, 1983). Today, with 28 out-years included in the current 75-year projection window — years that the Greenspan Commission ignored — the 75-year fiscal gap is 2.1 percent of taxable payroll.

Furthermore, as indicted above, the Commission looked at an arbitrary measure of the 75-year fiscal gap. Indeed, it considered just one of an infinite number of such measures the Commission could have constructed by using alternative, internally consistent, labels. And had the Commission used a set of labels that led to a much larger 75-year fiscal gap as of 1983, it would, presumably, have taken much stronger steps at the time — steps that would have left us in better shape today.

In doing too little, too late, and in being guided by an inherently meaningless measure of the system’s long-term fiscal condition, the Greenspan Commission reforms avoided imposing a burden on early generations, and thereby redistributed toward them and away from later generations. These later generations will face all the benefit cuts and tax hikes implemented by the Greenspan Commission, plus many others that will surely be enacted to deal with the current crisis.

As it was, the Greenspan Commission’s most significant benefit cut — the increase by two years (to 67 years) in the normal retirement age — and the Commission’s most significant tax increase — federal income taxation of some Social Security benefits — were both phased in very gradually, thereby ensuring that later, rather than earlier, generations would bear virtually all of the burden of these changes to the program. The increase in the normal retirement age and the taxation of benefits mean that today’s 30-year olds will receive roughly 35 percent less in net benefits when they retire. If their full retirement age is further raised to 70, which seems quite likely, they will end up with less than half of the net benefits they would otherwise have received.

IV. IS SOCIAL SECURITY’S FISCAL GAP WELL DEFINED?

Truth be told, what we classify as Social Security versus what we call the rest of the government’s fiscal enterprise is, itself, entirely arbitrary. A dollar is a dollar, and decid-
ing that this dollar comes from Social Security or that dollar belongs to Social Security is, from the perspective of economics, measurement without meaning.

This point is easiest to see by considering how to classify federal income tax revenues derived from taxing Social Security benefits. Such taxes are labeled part of Social Security revenues, but they could just as well be labeled general revenues. Nothing in economic theory tells us that one classification is more appropriate than the other. Likewise, nothing in economic theory tells us to say that FICA contributions are Social Security taxes as opposed to general revenues.

What happens to Social Security’s fiscal gap if one adopts a quite different taxonomy and classifies all “Social Security revenues” as “general revenues”? The system’s fiscal gap explodes to over $75 trillion and becomes one of the largest components of the federal government’s overall fiscal gap of $202 trillion (Kotlikoff, 2010b).

The government’s overall fiscal gap is, by the way, invariant to fiscal labels. The reason is that it is measured over an infinite horizon and incorporates all fiscal programs, regardless of their labeling. What is arbitrary, however, is the decomposition of the government’s overall fiscal gap among different government programs.

Many prominent economists, such as Paul Krugman, Peter Diamond, and Peter Orszag, argue that Social Security should not be touched or not be touched very much because it will be solvent for almost the next four decades (Krugman, 2010; Diamond and Orszag, 2005). They treat the trust fund as owned by Social Security, the OASDI FICA tax, and the income taxes levied on Social Security benefits as owned by Social Security, and the OASDI benefits as owed by Social Security. In so doing they are making value judgments predicated on accounting that, like the Emperor in Hans Christian Anderson’s fairy tale, has no clothes.

The unfortunate economic truth is that the United States government is insolvent. Covering its $202 trillion fiscal gap via tax increases would require an immediate and permanent 77 percent increase in all annual federal revenues. And how much of this painful adjustment should come from higher “Social Security taxes” or from lower “Social Security benefits” is a matter of opinion and private preference, not economic science. The fact that Krugman, Diamond, Orszag and others say that only certain reforms and not others are needed to address Social Security’s problem does not mean that doing just those reforms suffices to address the real problem, namely, the nation’s overall fiscal gap. That is, one can legitimately argue that much more needs to be done by or to “Social Security” in order to get the overall fiscal gap down to zero.

V. 2,728 RULES AND COUNTING

The Social Security’s Handbook lists 2,728 rules for the program. This is a lot of rules for the public to learn in order to understand its most important source of retirement

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1 These calculations are based on the Congressional Budget Office’s (2010) projections of expenditures and receipts. This projection is made for 75 years, but I extended it to an infinite horizon by assuming the primary deficit would grow at 2 percent in real terms. I used a 3 percent real discount rate to form the present value fiscal gap, which is very close to the value used by the Social Security Actuaries.
saving (Social Security Administration, 2011). But this is just where the complexity begins, as the Handbook is simply Social Security’s bible. Its Talmud (interpretation of the bible) is its Program Operating Manual System (POMS). This is a vast trove containing thousands of rules about the rules, which are critical because the rules themselves are, to a large extent, indecipherable. Unfortunately, many of the rules about the rules are equally hard to follow. In fact, fully understanding Social Security’s provisions requires first mastering what amounts to a foreign language because the POMS is chock full of acronyms and because one needs to parse the language of the Handbook and POMS very carefully. The resulting complexity implies that Social Security is far from the ideal of a transparent system that facilitates retirement saving decisions.

VI. ASSESSING ONE’S MARGINAL TAX RATE

Economics has a well-developed theory about how households react to economic incentives they understand and how to measure the costs of distorting those incentives. But it doesn’t tell us how households should react to incentives they can’t possibly understand.

Understanding one’s work incentives requires knowing what receipts one will get back, either now or in the future, at the margin, in exchange for one’s current payments to the government. To do this accurately with respect to payments made to our existing Social Security System, one needs to understand, depending on one’s circumstances, a multitude of complex concepts, including wage indexation, the calculations of elapsed years, base years, and computation years, the calculation of average indexed monthly earnings, the calculation of the Primary Insurance Amount, early retirement reduction factors, family benefit maximums, the delayed retirement credit, the earnings test, the windfall elimination provision, the government offset provision, the recomputation of benefits, spousal benefit eligibility, spousal benefit age-related reduction factors, spousal benefit computation, divorcée benefits, mothers and fathers benefits, survivor benefits, survivor benefit reductions for age, child benefits, and parent benefits — and the list goes on.

Even if one understood all the details of all these provisions, understanding their impact on one’s work incentives is daunting. Consider the complexity associated with deciding when two spouses should take their retirement and spousal benefits. Since this decision impacts what one gets back from Social Security at the margin, it is a key part of assessing the marginal effective tax rate (which could be negative) faced by a household.

There are eight years during which each spouse can apply for each of the two benefits. This produces 4,096 alternative combinations of ages that the couple needs to consider in deciding when to take each of these two benefits. The problem is further complicated by restrictions imposed by the system on a household’s ability to independently choose these ages. Specifically, Social Security forces an individual to take the spousal benefit

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early when taking the retirement benefit early, *but only if one’s partner is also taking his/her retirement benefit early.*

This is the so-called “deeming provision,” under which an individual is deemed to be taking spousal benefits early when taking retirement benefits early, but this deeming is deemed to be “undeemed” (I kid you not) if one’s partner is not taking his/her retirement benefit early. Also, if a partner is taking his/her retirement benefits early, an individual is deemed to be taking the retirement benefit early if taking the spousal benefit early. Furthermore, once one reaches full retirement age without taking spousal or retirement benefits, one can defer collecting the retirement benefit and collect an unreduced spousal benefit, provided a partner is either collecting retirement benefits or has filed to collect them but then elected to suspend their collection.

Thus, the benefits one spouse receives from the system depend on what the other spouse is doing, and vice versa. Moreover, both spouses can’t simultaneously collect spousal benefits based on their partner’s earnings record. But one can collect spousal benefits for a period of time and thereafter have the other spouse begin collecting spousal benefits.³

This discussion clearly illustrates the basic point: Social Security’s benefit provisions are so intricate as to preclude typical workers from knowing their effective marginal net tax on additional labor supply.

**VII. MAKING OPTIMAL LABOR SUPPLY DECISIONS IMPOSSIBLE**

The problem that Social Security presents to individuals who are trying to make optimal labor supply decisions is even worse than just described. In fact, Social Security’s provisions make it literally impossible to make optimal labor supply decisions even with full mastery of its rules. The reason is that Social Security considers all earnings from age 16 onward in calculating potential benefits. But it includes only the highest 35 years of earnings in deciding the actual level of benefits to pay.

For example, consider an individual of age 60 who will definitely retire at 61, who started working, at least part time, at age 18 and thus has an earnings history that spans 42 years. In deciding how much labor to supply, the individual must determine whether working this year will generate enough earnings to replace one of the highest 35 years of earnings currently in his/her earnings history. Hence, making this decision requires knowing his/her earnings history on a year-by-year basis. That is, all 42 years of past earnings become state variables in the optimization problem for deciding how much to work this year.

It is one thing to decide at age 60 how much to earn, given one’s earnings history and also knowing that the current year will be final year worked. It is quite a different matter if one is, say, 20 years old, has not yet worked, and is deciding how much to work this year given that one is expecting to work for the next 50 years. To solve this

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³ Financial planning software can help people make these computations, but doing so requires both time and money.
lifetime utility maximization problem, either in the presence or absence of uncertainty, a dynamic programming solution is required. In solving this programming problem, one must start in the last possible year of life, say, age 100, and work backward to age 70. During those last 30 years, the only state variable that is related to Social Security and will enter one’s analysis is the Primary Insurance Amount. But once one reaches age 69, there are 48 new state variables to consider, namely the amount earned in the prior 48 years. And when one reaches age 68, there will be 47 state variables to consider, namely the amounts earned in the prior 47 years, etc.

There is no computer available today or likely to be built any time in the foreseeable future that can handle a dynamic program with 48 state variables. The maximum number of state variables that economists have been able to consider thus far is 11 (Krueger and Kubler, 2004). The problem is that for each state variable one must consider the range of possible values on a discrete grid. With just 100 possible grid values (which entails an extremely crude grid), one must calculate 100 raised to the power of 48 (the number of choices of labor supply and consumption at age 69) — that is, the problem is combinatorial with the number of combinations dependent on the number of state variables. Thus, it is no wonder this problem is called “The Curse of Dimensionality.”

In fact, the number of state variables will be even larger than 48 at age 69 because one’s regular and retirement account assets will also be state variables. Moreover, if married, one must consider, for the reasons indicated above, spousal earnings and Social Security decisions in choosing an optimal plan. If one’s spouse is the same age, all of his/her past earnings become state variables in the optimization problem as well.

The inescapable conclusion is that the Social Security benefit computation formula is so complex as to preclude individuals from being able to determine an optimal earning plan now and in the future. The same holds true with respect to other human capital decisions, such as whether to return to school for a higher degree, as the same plethora of state variables arises in these decisions.

For labor economists, this is a depressing reality. It effectively makes it impossible to (1) calculate optimal labor supply, given a person’s preferences and earnings ability, and (2) compare optimal labor supply with actual labor supply. But no labor economist I know has given up her trade due to the problems inherent in measuring effective tax rates under the Social Security program. Instead, labor economists simply assume a different, much simpler Social Security benefit formula or ignore the feedback of labor earnings to benefits in their analyses. This raises questions about the accuracy of their research. And, because we have no way to know what behavior should be, we have no way of assessing this accuracy.

VIII. EGREGIOUS INTERGENERATIONAL REDISTRIBUTION

Not only is Social Security broken, its thousands of rules indecipherable, and its complexity sufficiently great to preclude optimal labor supply, saving, and consumption choices, but the system is egregiously unfair.
Indeed, the system is a major part of a massive six-decades-long Ponzi scheme that has taken ever-larger amounts of resources from young and future generations and given them to older generations. This has produced an enormous fiscal gap whose closure could entail visiting today’s and tomorrow’s children with lifetime net tax rates (the ratio of lifetime taxes net of transfers, measured as a present value, to the present value of lifetime earnings) that are twice those that today’s baby boom generation will face (Kotlikoff, 2010b).

The process of taking from the young, who are savers (with low propensities to consume because they need to spend each dollar of resources over many years), and giving to the old, who are big spenders (with high propensities to consume because they have few years over which to spend each dollar of resources) has dramatically reduced the U.S. national saving and net domestic investment rates (Gokhale, Sabelhaus, and Kotlikoff, 1996). In 1965 both of these rates were roughly 15 percent. In 2009 the net national saving rate was –1.7 percent and the net domestic investment rate was 2.5 percent. By investing so little for so long, the United States has chosen to endow workers with less plant and equipment than otherwise would have been the case, and consequently made them less productive. One sees this effect in data on average real hourly wages and average real weekly earnings reported by the Bureau of Labor Statistics. Average hourly real wages for 2010 were little higher than they were 40 years ago in 1970, and average real weekly earnings are somewhat lower.

By comparison, total real compensation per hour, including fringe benefits, such as employer-paid medical insurance premiums, has risen by just over 50 percent or by about 1 percent per year for the past 40 years, indicating that all of the increase in real compensation has gone to fringe benefits, primarily health insurance. Nevertheless, labor productivity has risen by over 100 percent, at an annual growth rate of 2 percent, suggesting either a growing disconnect between what people produce and what they earn, or perhaps that our measure of labor productivity is inaccurate, picking up, for example, output produced by off-shore labor, but not counting that input in forming the ratio of output to hours worked.

IX. CAPRICIOUS INTRAGENERATIONAL REDISTRIBUTION

Because Social Security was initiated at a time when female labor force participation was far less prevalent than today, the system was established with generous spousal and survivor benefits to protect non-working wives. But these benefits were made available to the spouses of high-earning partners as well as to the spouses of low-earning partners. Consequently, we have a system in which the non-working husbands or wives of high-earning spouses can spend their entire lives on the golf course, contribute nothing to Social Security and receive thousands of dollars per year throughout their old age based on their spouse’s earnings record — at no additional cost to their working

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spouses, who will be asked to pay not a penny more for this largesse. Thanks to these spousal and survivor benefits, non-working spouses can receive far more than single males or females who worked full time throughout their entire potential earning years and paid, together with their employer, 12.4 percent of their total lifetime earnings as Social Security taxes year in and year out to the system.

The system not only redistributes from the young to the old and from workers to non-workers, it also redistributes from singles to married couples, and from those with shorter life expectancies to those with greater longevity. To understand the transfers from singles to married couples, consider a married couple in which each spouse earns $50,000, in today’s dollars, per year. As indicated above, this couple is eligible to receive a free spousal benefit for several years by having one spouse apply for spousal benefits starting at full retirement age and having the other spouse file and suspend collection of his/her retirement benefit. Depending on the earnings level of the spouse filing and suspending retirement benefit collection, the free spousal benefit could represent nearly $60,000 — money not available in any part to a single worker.\(^5\) Redistribution based on life expectancy simply reflects the fact that Social Security benefits are paid out in the form of life annuities. Two people with identical contribution histories — one who can expect to live to 90 and the other who can expect to live to 80 — can expect to receive dramatically different internal rates of return on their FICA contributions.

These forms of redistribution, as well as the fact that the system’s progressive benefit formula ensures larger net benefits, on average, to low-wage workers, are well known to Social Security researchers. What is less well known and appreciated is the extent to which two households in identical circumstances can fare very differently simply by making a mistake with respect to when they opt to collect particular types of benefits.

Recall the 4,096 plus combinations of ages at which husbands and wives can opt to take their retirement and spousal benefits. Many, if not most couples will have no information as to when to apply for which type of benefit to maximize their benefits, and will not understand how one spouse’s decisions can materially influence the benefits received by the other spouse. Indeed, those who are counseled to take their benefits early to ensure they receive them (advice formerly given by the Social Security Administration) will effectively forego an excellent option to buy, from Social Security, an inflation-protected annuity at a very low price. That is, an individual who waits to collect retirement benefits until age 70 will receive a net real benefit that is roughly 74 percent higher over his/her remaining lifetime, at the cost of foregoing benefits between ages 62 and 70. But unless one has a relatively short maximum (not expected) age of life, waiting to collect substantially raises the recipient’s sustainable living standard starting immediately — by roughly 5 to 10 percent (Kotlikoff and Burns, 2008). Thus, those who understand the advantages of filing and suspending benefits — which they may have learned by sheer accident — will receive a much larger net benefit under

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\(^5\) This amount is based on the author’s calculations, assuming the partner’s primary insurance amount is $30,000 per year.
Social Security than those who are unaware, or unable to take advantage, of this strategy.6

X. FIXING SOCIAL SECURITY FOR GOOD

Social Security’s problems — insolvency, complexity, opacity, inefficiency, and inequity — are clear. What is also clear is that it will be very hard to fix the system in a piecemeal fashion, even if that appears more politically feasible. This is what the politicians will want to do, but it is the last thing we need. On the financial side, a piecemeal solution will repeat the mistake of the Greenspan Commission by doing far too little and leaving future generations an even bigger problem than we now face. And we will never be able to make the system understandable, efficient, or fair by modifying its 2,728 rules.

Designing a new system requires clear objectives. In this section, I define a set of objectives and then provide a reform proposal that meets them and is simple and transparent. First, the new system must force people to save at a minimally adequate level and purchase minimally adequate amounts of life and disability insurance. Second, the new system has to be solvent. Third, the new system has to require each cohort to cover its own costs except in exceptional situations calling for intergenerational risk sharing. Fourth, the new system has to be progressive, so that poor members of a generation are treated better than rich members. Fifth, the new system must be transparent, permitting participants to see easily what they are getting for their contributions. Sixth, the new system must derive its return from the capital market, not from expropriating successive generations. Seventh, the new system must be run at low cost and not enrich Wall Street at the expense of the public. And eighth, the new system must recognize that society, in general, cannot “beat the market.” Everyone cannot earn returns that are above the market average — and establishing a system in which all compete to do so is socially wasteful.

XI. THE PERSONAL SECURITY SYSTEM

My proposed fix for Social Security is called the Personal Security System (PSS), a plan I developed in the early 1990s in collaboration with Jeffrey Sachs. After designing the reform, we obtained over 150 endorsements from very prominent economists, including several Nobel Laureates. Unfortunately, we were not able to interest politicians in the unpublished proposal.

The reform begins by freezing the current system in place so that no additional benefits are accrued at the margin; that is, all participants in the current system receive, in retirement, their accrued benefits as of the time of implementation of the reform. Freezing the current system in place effectively implies filling zeros in workers’ earnings records under the current system from the date of the reform onward. This ensures a gradual transition

6 Divorcees and widows also have difficult and complex decisions regarding retirement and whether to take spousal or survivor benefits.
with respect to benefits provided under the old system. Current retirees receive the same Social Security benefits they are now receiving and workers near retirement receive Social Security benefits that are very close to what they would otherwise have received. Younger workers will, in contrast, receive much smaller benefits under the old system.

Freezing Social Security ensures a gradual transition to the new system in terms of benefits paid by the old system. But it also ensures that the current system no longer applies at the margin. At the same time Social Security is frozen, the PSS is introduced.

The PSS features an 8 percent compulsory contribution rate made to a personal PSS saving account. Spouses and legal partners have half their 8 percent contribution allocated to their spouse’s or partner’s PSS saving account, so that non-working or low-earning spouses and partners have the same size PSS account as their spouse/partner.

The government makes matching contributions on behalf of the poor. The PSS matching formula can be as progressive as deemed desirable. Hence, Social Security’s current degree of progressivity could readily be replicated by the PSS. The government also contributes on behalf of the unemployed and disabled, thereby ensuring that all Americans have a PSS account.

All PSS contributions are invested at zero cost by the federal government in a global market-weighted index of stocks, bonds (including government bonds), and real estate investment trusts. The government sets up one computer system to do this investing electronically.

Between ages 60 and 70, each individual’s account is gradually sold on a daily basis at no cost to the PSS participant and used to purchase shares of a cohort-specific longevity mutual insurance fund managed at no cost by the government. Thus, neither Wall Street nor private insurers play a role in this annuitization. This approach is very different from Chilean-type privatization plans, which rely on private insurance markets to provide longevity insurance to retirees — something that obviously raises the problem of adverse selection. The government guarantees that contributors’ account balances during the 10-year conversion-to-annuities period equal at least what they contributed, adjusted for inflation, that is, it guarantees a zero real return on workers’ contributions. This guarantee provides a minimum level of certainty about one’s future retirement income.

The PSS replaces an unfunded system with a fully funded one. But it also significantly reduces the overall fiscal gap. The reason is that the present value of accrued benefits is much lower than the present value of benefits projected under the current system. Clearly, these accrued benefits would have to be paid over time, which could be done by maintaining a much lower rate FICA tax until all the system’s accrued liabilities.

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7 This can be implemented mechanically by dividing each year’s contribution through age 59 (the last age of contributions) into 3,650 shares and designating one of these shares for conversion to annuities on a given day in the 10-year conversion period. By accumulating on each conversion day the shares of each year designated to be converted on that day, one can determine if the accumulated amount exceeds the sum of the shares. If the answer is no, the government would contribute the difference before the conversion on that day occurs.
have been retired. Another source of revenue would be the elimination of tax breaks for employer-sponsored retirement accounts as well as individual IRAs. In lieu of providing these tax breaks, the government could establish a separate, zero-cost global index fund to which all Americans could contribute on a non-subsidized basis. This fund would feature neither the zero-real return guarantee nor compulsory, cohort-specific, inflation-adjusted annuitization. It would simply be a way for all Americans to invest in the global market in a fully diversified manner at zero cost.

In addition to the 8 percent contribution to the saving component of the PSS, workers would be required to contribute another 2 percent of earnings to cohort-specific life-insurance pools and another 2 percent of earnings to cohort-specific disability insurance pools. As with Social Security’s old age insurance benefits, only survivor insurance, and disability insurance benefits under the old system that had accrued as of the time of the reform would be paid to survivors and the disabled.

XII. MEETING ITS GOALS

The Personal Security System meets all the legitimate goals for Social Security outlined above. It forces people to save and buy insurance. It is fully funded and thus solvent. It makes each cohort pay its own way except under the highly unusual circumstance in which a cohort earns a negative real return from investing in the global market place over many years, if not its entire work life. The system is progressive, transparent, market reliant, and operated at very low cost, with no payments going to Wall Street. And finally, the new system provides everyone with global diversification without pretending that, on average, the entire country can do better than the average.

I believe Bismarck would support this reform were he available for comment.

REFERENCES


See Kotlikoff (2010a) for a description of such insurance pools.


