Saving Retirement in Michigan:
Responsible Alternatives to Social Security

How the Legislature Can Advance Reforms that Are Fair to Michigan's Working and Retired Generations

by Kent Davis

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Executive Summary

On August 14, 1935, President Franklin Roosevelt signed the Social Security Act into law, declaring it to be "a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness."

Today, politicians and citizens alike are discovering that the government-funded retirement system begun by Roosevelt is not only financially unsound, but is increasingly incapable of meeting the human needs of America's growing elderly population.

Many Americans believe that their Social Security taxes go into an account from which they will draw when they retire. In reality, Social Security is a "pay-as-you-go" system whereby taxes on current workers are directly transferred to current retirees in the form of benefits. This system worked when there were 16 taxpaying workers to support each individual retiree. Today, however, the ratio of workers to retirees has fallen to 3-to-1 and is expected to drop to 2-to-1 by 2030.

In addition, the Social Security Trust Fund will begin paying out more money than it takes in as early as 2015, when the wave of retiring Baby Boomers is expected to double the number of retirees drawing Social Security checks.

These facts mean that the current Social Security system can be maintained only if benefits to the growing ranks of elderly retirees are slashed dramatically or payroll taxes are raised to confiscatory and immoral levels on younger workers. Fortunately, there is a third alternative to dealing with the looming Social Security crisis: opting out of the system in favor of privatizing retirement planning.

The idea of privatization—allowing individuals to privately invest their own retirement savings—is not new. Countries including Chile, Great Britain, and Australia now allow workers to invest all or part of their payroll taxes privately, and the results have been impressive. Chilean retirees, for example, now enjoy three times the benefits that they would have received under the old government system.

Here in America, three Texas counties chose to leave the Social Security system in 1981 when Congress allowed state and local governments to opt out. The alternative private investment plan designed by the counties for their employees has also yielded greater returns and increased benefits for its participants.

More than 65 million Americans now choose to supplement their retirement nest eggs with private investment instruments such as Individual Retirement Accounts (IRAs) and employer-sponsored 401(k) and 403(b) plans that also outperform Social Security.

The current Social Security system can be maintained only if benefits to the growing ranks of elderly retirees are slashed dramatically or payroll taxes are raised to confiscatory and immoral levels on younger workers.

Michigan should demand that Congress take the correct course and privatize the Social Security system or allow states to opt out and design their own pension plans.

Social Security privatization would benefit all workers, especially the bottom 20 percent of wage earners who cannot afford to invest part of their paychecks and must rely mostly on Social Security for their retirement. Workers who were allowed to invest even 2 percent of their paychecks (as opposed to the 5.26 percent of their payroll taxes that go toward retirement) could earn instead 9 to 35 percent more than what they would receive from Social Security, depending on their income level.

A number of plans to privatize all or part of the Social Security system have been proposed, but one kind of "privatization" which involves having the federal government manage retirement fund investments should be avoided. Direct government investment in the stock market versus individual private investment would lead to unprecedented politicization of the American economy. "Politically incorrect" companies and their customers and stockholders would suffer as important market decisions were made by politicians and bureaucrats, not by workers and retirees, the people with the largest stake in the investment.

Critics of Social Security privatization suggest that private investment of retirement funds is too risky. They warn that market downturns could wipe out the nest eggs of workers who are ready to retire. But this fear is unsubstantiated. Although it is true that markets experience short-term fluctuations, retirement savings are invested over a lifetime. An analysis of the performance of stocks shows that since 1800, there has never been a 20-year period in American history when stocks produced a net loss in real terms.

In May 1997, the Oregon Legislature passed a resolution urging Congress to grant waivers to let states opt out of the federal Social Security system and design their own retirement plans for both private-sector and government employees. Since then, Colorado has adopted a similar measure and six other states—Arizona, Indiana, Missouri, New Hampshire, South Carolina, and Washington—are also considering opt-out proposals. The Michigan Legislature should adopt a resolution that asks Congress to either

- Partially privatize the existing Social Security program by allowing workers to shift all or part of their current 5.26 Social Security retirement payroll taxes into privately owned and managed accounts up to the allowable limit of $10,000 per year; or

- Grant the state of Michigan a waiver to opt out of the federal Social Security system and design a sounder and more beneficial retirement plan for its citizens.

Many countries have already increased millions of citizens' retirement security by turning to private investment to restore fiscal soundness and improved benefits to their pension programs. With a strong economy and government surpluses forecast for the next decade, the United States is in a solid position to move to a privatized pension program that stimulates economic growth, promotes private savings, and restores individual freedom.

Michigan should join with Oregon and Colorado to demand that Congress take the correct course and privatize the Social Security system or allow states to opt out and design their own pension plans.

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I. The Problem: Social Security Is Going Broke

Introduction

On August 14, 1935, President Franklin Roosevelt signed the Social Security Act into law, declaring it to be "a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness."

Today, 63 years later, there is a growing realization among politicians and citizens alike that the government-funded retirement system begun by Roosevelt is not only financially and actuarially unsound, but is increasingly incapable of meeting the human needs of America's growing elderly population.

Social Security operates as a pay-as-you-go system, meaning that taxes collected from current workers are used to support current retirees. Because the ratio between workers and retirees is rapidly shrinking, payroll taxes will either have to be hiked dramatically or retirement benefits cut significantly in order to keep the system afloat in the future.

Of course, neither of these options is popular with Americans. But polls show that there is broad public recognition of the fact that the future of Social Security, as it exists now, is bleak. In 1975, 88 percent of Americans were "fairly sure they could count on Social Security for retirement." Today, that figure is under 46 percent and still dropping.

As public awareness of the problem increases, what was previously untouchable as a political issue has now moved to center stage with the president and both political parties wanting to "save" Social Security.

How did Social Security come to be in such a mess? The current problems are caused not only by the original design of the program but are also the result of major changes in society over the decades since it was enacted:

- Lower birth rates have resulted in a dramatically smaller ratio of people to pay benefits for the ever rising number of retirees;

- Longer life expectancies have boosted the costs of providing retirement assets as benefits are now paid for significantly longer periods of time;

- Increasing numbers of people are retiring before becoming eligible for Social Security benefits at age 65 due to the accumulation of private retirement assets through Individual Retirement Accounts and employer-sponsored 401(k) and 403(b) savings plans; and

President Franklin Roosevelt declared the Social Security Act to be "a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness."

Ostensibly, a trust fund collects Social Security payroll taxes from employees and employers. In reality, however, the fund is used to pay benefits to current retirees. The money is not saved or invested for the retirement benefits of each contributor.

- Shorter average life expectancies for lower-income workers mean they get less from Social Security than others who will live longer.

A quick review of history shows how we arrived at the current state of affairs.

Social Security: A Brief History

When Social Security was created in 1935, the average life expectancy was under the retirement age of 65. This fact ensured that comparatively few people would receive Social Security benefits and so the payroll taxes to support them were low (two percent on an annual income of $3,000, or $60 per year).

Ida Fuller was the first person to receive Social Security benefits. She retired in 1940 after paying only $44 into the system, and by the time of her death in 1975 at age 100, she had received $21,000 in benefits.[1] Her case shows the inherent unfairness of the pay-as-you-go nature of Social Security: A savings of $44 cannot possibly pay $21,000 in benefits over 35 years, so her benefits were actually paid by taxes collected from younger workers.

Ostensibly, a trust fund collects Social Security payroll taxes from employees and employers. In reality, however, the fund is used to pay benefits to current retirees. The money is not saved or invested for the retirement benefits of each contributor. The trust fund is simply an accounting fiction, not the equivalent of a private account owned by an individual which can be invested for the future. A big first step in building support for change is broad public understanding of the pay-as-you-go design of Social Security versus accounts owned by each person.

Since the 1940s, significant shifts in birth rates and life expectancies have occurred. At the outset of Social Security, there were 16 workers paying into the system for every retiree drawing benefits. Today, the ratio is three workers for every retiree and by 2030 the ratio will fall to two workers per Social Security beneficiary, according to government estimates.[2] At the same time, retirees are living longer than ever (average life expectancy now exceeds 75): This fact is a key reason why greater retirement resources are needed for current and future retirees.

Over the past 60 years, Congress has raised Social Security payroll taxes repeatedly in an effort to keep the benefits flowing. The current tax rate of 6.2 percent for both the employer and employee is applied to wages up to $68,400 and marks an amazing 950 percent increase from the initial $60 per year paid to Social Security by employers and employees.[3]

[1] William Wilson, "Should You Count on Social Security?" Mackinac Center for Public Policy, *Viewpoint* 95-05, February 1995.

[2] Social Security Administration, *The 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D. C.: U. S. Government Printing Office, 1996), quoted in Daniel Mitchell, "A Brief Guide to Social Security Reform," Heritage Foundation, August 1997.

[3] William Shipman, "Facts and Fantasies about Transition Costs," The Cato Project on Social Security Privatization Paper No. 13, Cato Institute, October 1998.

Of that 6.2 percent, 0.94 percent goes toward survivor benefits in the case of death and disability benefits for people unable to work. The remaining 5.26 percent is applied primarily toward retirement benefits for current retirees. An additional uncapped 1.45-percent payroll tax is also levied for Medicare, but this report's focus is on Social Security retirement benefits only.

Today, the Social Security trust fund is theoretically in surplus and will continue to be until about 2015—"theoretically" because all excess money above what is needed to pay benefits to current retirees is immediately borrowed for other government spending.

The real crisis will begin after 2015, when Social Security benefit payments will exceed the amount of money workers pay into the system and large numbers of baby boomers begin to retire. Changes must be made now to keep the current system from going bankrupt and leaving today's workers and tomorrow's retirees both out in the cold.

Changes must be made now to keep the Social Security system from going bankrupt and leaving today's workers and tomorrow's retirees both out in the cold.

The problem of Social Security's looming bankruptcy is serious. A number of proposals for "saving" Social Security have been made, many of which argue that taxes must be raised sharply on younger workers or else benefits cut to retirees. But fortunately there is a positive alternative to higher taxes and decreased benefits: opting out.

II. The Solution: Opting Out of Social Security

The idea of allowing individuals to opt out of a mandatory state-funded pension system in favor of privately investing their own retirement funds is not new. In 1980, Chile became one of the first countries to allow its citizens to opt out of its failing government system. In 1981, before Congress made participation in Social Security wholly mandatory, three counties in Texas opted out to design their own retirement plan. And a record number of Americans, especially younger ones, are quietly opting out themselves by building their nest eggs with employer-provided 401(k) and 403(b) pension plans.

The success of these private alternatives to Social Security led Oregon in 1997 to become the first state to pass a resolution calling on Congress to grant individual states waivers to opt out of Social Security and explore alternative pension plans. Colorado passed a similar measure in May 1998, and six other states, including Arizona, Indiana, Missouri, New Hampshire, South Carolina, and Washington, are also considering opt-out measures.

How successful have these private alternative plans been? What follows is a brief analysis of how these plans have performed or are likely to perform as well as recommendations for how Michigan can take positive steps to protect its workers and retirees from the coming Social Security crisis.

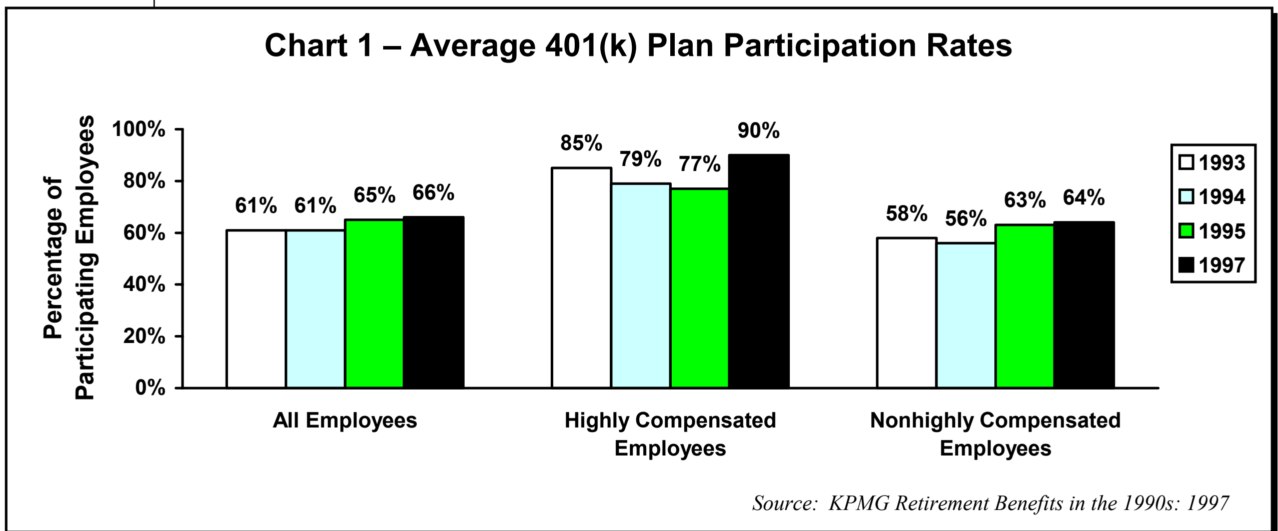
More than 65 million Americans now choose to save for retirement through investing in Individual Retirement Accounts and employer-sponsored pension plans.

Opting Out for Individuals: A Solution Already in Progress

More than 65 million Americans now choose to supplement their retirement nest eggs through investing in Individual Retirement Accounts (IRAs) and employer-sponsored 401(k) and 403(b) pension plans.[4]

Under current law, workers can invest up to $10,000 per year in their 401(k) or 403(b) accounts with a variety of investment choices such as mutual funds. Workers are thereby able to supplement their retirement assets and take responsibility for their own futures rather than depending upon Social Security to meet their retirement needs.

KPMG Peat Marwick, a major accounting firm, surveyed companies and individuals to determine that the rate of employee participation in 401(k) retirement plans is high and increasing (see Chart 1, below). The 1998 data show that 59 percent of nonhighly compensated employees and 81 percent of highly compensated employees participated (in 1998, the government considered workers making over $80,000 to be "highly compensated"). Employees contribute on average five to seven percent of their paychecks to their retirement plans, a figure roughly equivalent to what Social Security taxes take from their pay.

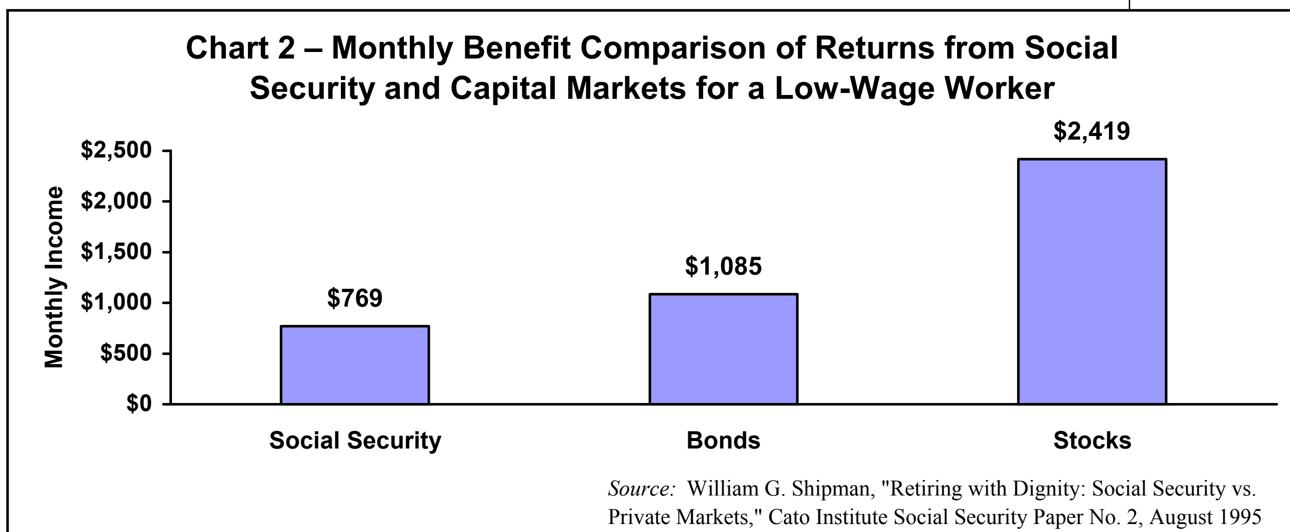


In many cases, employers match employee contributions to their plans at rates of 25 to 50 percent, which enhances the amount of savings employees can invest for retirement purposes. Another benefit for employees using these plans is that their contributions are pre-tax dollars, meaning the money is invested before taxes are taken out. Having this extra money to invest can add up. For example, an employee in the 15 percent tax bracket will have $150 more per year to invest for every $1000 he contributes. An employee in the 28 percent bracket would have $280 more per year, and so on. The taxes are deducted upon withdrawal of the money. Funds from IRAs and 401(k) and 403(b) plans cannot be withdrawn except for emergencies of personal hardship and are therefore working throughout an employee's life to earn returns on the investment.

[4] Employee Benefits Institute, *Current Population Survey*, April 1993.

The Wall Street Journal recently reported that market forces have created low-cost retirement plans for even very small employers: 33 million people who work for companies of less than 50 employees are now becoming eligible to participate in building their own secure retirement through private plans.[5] This will further boost the number of Americans investing in private retirement plans and likely create irresistible pressure for fundamental Social Security reform.

How do these 401(k) and 403(b) plans perform? Based on historical returns of at least seven percent in the stock market and four to five percent in bond markets, employees investing in these plans will far exceed anything Social Security will ever provide. The Cato Institute has documented the much higher returns generated by private investment over Social Security (see Chart 2, below). Cato has also established an interactive Internet feature at **www.socialsecurity.org** that allows users to supply their birth date and income estimates to calculate how much they can gain in future benefits through private investment.



Source: William G. Shipman, "Retiring with Dignity: Social Security vs. Private Markets," Cato Institute Social Security Paper No. 2, August 1995

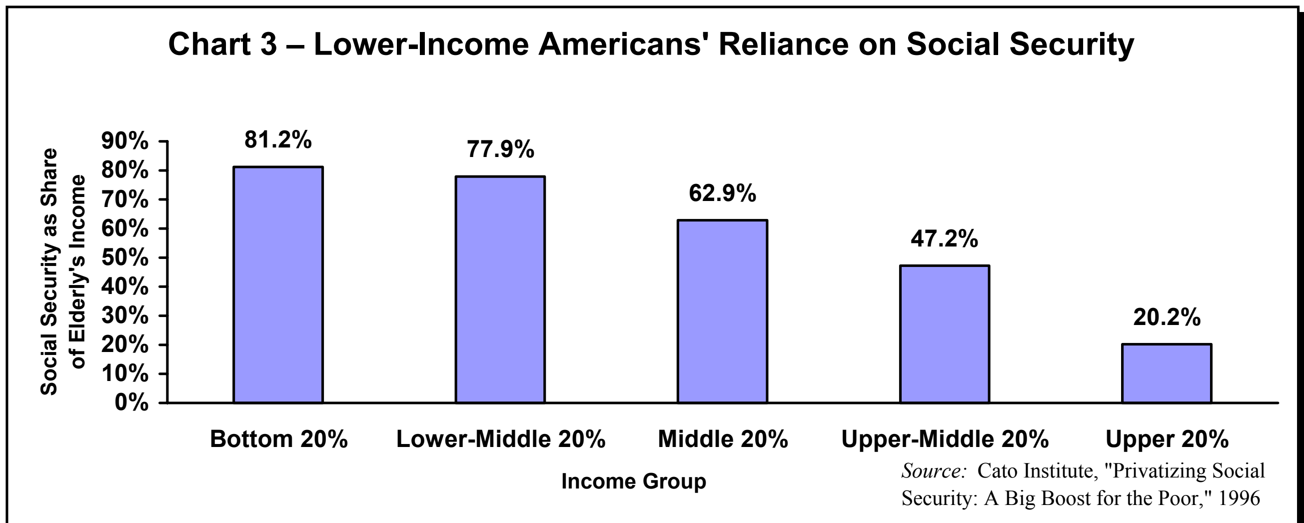
Meanwhile, however, lower-income workers remain at risk, with employees in the bottom 20 percent income group depending most heavily on Social Security benefits (see Chart 3, next page). The top 20 percent of earners are much better prepared and less dependent on Social Security. Within the next 20 years great gains can be achieved for lower-income workers by partially privatizing Social Security.

Within the next 20 years great gains can be achieved for lower-income workers by partially privatizing Social Security.

PARTIAL PRIVATIZATION: MOYNIHAN-KERREY AND OTHER PROPOSALS

Private investment is the key to solving the impending Social Security crisis. While today's payroll taxes are used to provide benefits to current retirees, the pre-tax funds invested in 401(k) and 403(b) accounts remain the property of each worker and will be there upon retirement. And as mentioned above, private investment offers greater returns.

5 Ellen E. Schultz, "Poodle-Parlor Retirement Plans," *Wall Street Journal*, November 13, 1998, p. C1.



But lower-income workers often cannot afford to invest any of their paychecks in retirement plans. They must, however, pay payroll taxes, and that is why Senators Daniel Patrick Moynihan of New York and Bob Kerrey of Nebraska have proposed partially privatizing Social Security by allowing individuals to use part of their payroll taxes to invest for retirement. Under the Moynihan-Kerrey plan, workers could shift two percent of their paychecks into privately managed accounts and expect to increase their retirement income from 9 to 35 percent more than what they would receive from Social Security if no changes were made, depending on their working income (See Table 1, below).

Table 1 – Net Percentage Change in Annual Retirement Income under the Moynihan-Kerrey Social Security Plan

(For Workers Retiring at Age 65 in 2025 after Combining Income from Private Accounts with Social Security Benefit Reductions)

	Worker Earnings		
Estimates	**Low Wage**	**Avg. Wage**	**Max. Wage**
Without Income from Private Account	-11.0%	-11.0%	-6.0%
Including Income from 100% Bond Portfolio	1.5%	5.9%	19.5%
Including Income from 50% Bonds/ 50% Equity Portfolio	4.9%	10.4%	26.3%
Including Income from 100% Equity Portfolio	9.4%	16.4%	35.3%

Notes: Low-wage worker is assumed to earn 45% of average wage ($11,661 in 1996), average-wage worker is assumed to earn 100% of average wage ($25,914 in 1996), and maximum-wage earner is assumed to earn $62,700 in 1996. The real value of the maximum wage is scheduled to increase under the Moynihan-Kerrey plan. However, worker is assumed to invest only 2% of current law maximum taxable amount in retirement and to take the remainder as salary increase. It should be noted that although the Social Security benefit decrease for maximum wage worker under the Moynihan-Kerrey plan is smaller relative to average- and low-wage workers, this reflects a greater increase in payroll taxes for maximum-income worker as the maximum taxable threshold is substantially increased in the future above current law levels.

Source: Adapted from the Heritage Foundation Center for Data Analysis. Calculations based on projections of *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* reductions are calculated on the basis of Congressional Research Service Memorandum to Representative Charles Rangel, “Benefit Analysis of Three Recent Social Security Reform Proposals,” June 16, 1998. Worker is assumed to earn 10% return on equity investment (6.5% after inflation), 8.15% return on mixed bond/equity investment (4.6% after inflation), and 6.3% (2.8% after inflation) on Treasury Bonds.

If even two percent private investment could produce such gains for lower-wage workers, then allowing them to invest the 5.26 percent Social Security payroll tax deducted from their paychecks for retirement could produce even greater benefits. In fact, an official Social Security Advisory Council appointed by Department of Health and Human Services Secretary Donna Shalala has recommended completely converting half of the nation's retirement accounts into individually owned, privately managed accounts.[6]

The details of these various partial privatization proposals vary, but all have common threads including the private investment of a portion of the money deducted for current Social Security taxes and individual ownership of the funds. A word of warning, however, is required with regard to one category of Social Security "privatization" proposals which involves having the federal government manage the investment of retirement funds. Direct government investment in the stock market versus individually owned investment would lead to an unprecedented politicization of the American economy. Various political interests and pressures would likely negatively affect investment choices and possibly even reduce investment returns. "Politically incorrect" companies and their customers and stockholders would suffer, and all companies would likely open new wings in their lobbying departments to vie for government investment. In short, important market decisions about resource allocation and wealth development would be made by a small group of politicians and bureaucrats with an agenda, not by workers and retirees, the people with the largest stake in the investment. People's retirement earnings should not be political footballs and American companies should not be dependent on government for the capital essential for their existence.

Direct government investment in the stock market versus individually owned investment would lead to an unprecedented politicization of the American economy.

MANAGING THE TRANSITION TO PRIVATE INVESTMENT

The major political challenge to effective Social Security reform involves managing the transition costs from a 100-percent government-funded system to some form of privatized investment. Critics argue that the reduced payroll taxes coming from workers who elect to start managing their funds privately would cause a shortfall to the Social Security trust fund that pays benefits to current retirees and those workers who do not opt out of the system. How could this shortfall be made up?

Studies conducted by the Cato Institute and other researchers have shown how transition costs to a privatized pension system can be managed.[7] Partial privatization would allow workers to either shift a portion of the money they normally pay in Social Security taxes into a privately managed and owned account or remain in the Social Security program. In the first year of partial privatization, an estimated 50 percent of workers would elect to opt out of Social Security in favor of privatized accounts. The following year the number would increase to 75 percent and finally reach 90 percent in the third year. In less than 15 years, Social Security would begin enjoying surpluses and within 40 years, $770 billion surpluses would be created per year (see Table 2 on page 11).

[6] Carolyn Weaver, "Creating a New Kind Of Social Security," *American Enterprise*, January/February 1997, pp. 45-49.

[7] Shipman, n 3 *supra*.

A variety of proposals have been made that outline how to finance the transition costs which arise when people start withdrawing a portion of their payroll taxes from Social Security and investing it in private accounts. Most of these proposals require the employer portion of the payroll taxes to continue to be paid into Social Security until the transition costs are fully paid in 20 to 30 years. As Table 2 shows, additional funds would come from expected government surpluses and sale of government bonds and assets. The exact proportion of each source of transition financing will depend on economic conditions such as growth rates, interest rates, and feasibility of asset sales.

The speed with which the United States could expect to move into a totally privatized retirement program is ultimately dependent on both economic and political factors. The advantages of partial privatization include first building public acceptance and confidence through demonstrated results and care for current beneficiaries. The experience of other countries that have already instituted privatized pensions has been that over 90 percent of the workers convert to the private program within just three to five years.

Government's ability to raid the Social Security trust fund would be lost once the country made the switch to privatized accounts, resulting in improved fiscal discipline and a sounder economic footing for retirees. The increased saving and investment would also fuel a new boom in economic growth.

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Table 2 – Financing the Transition

(All figures in billions of 1996 dollars)

	Revenues Invested in the Private System Instead of Social Security[1]	Total Accumulated Funds Invested in the Private Retirement Accounts[2]	Replaced Revenue Feedback from Private Investments[3]	Saving in Social Security Benefits for Those Who Opt Out[4]	Expenditure Savings Due to Reduced Benefit Growth[5]	Extra Revenue Generated by Additional Economic Growth[6]	Revenue Lost Due to Waiver of Continuing Taxes by Those Who Opt Out[7]	Net Shortfall of Revenues to Pay Benefits After Prior Columns[8]	Reductions in Other Government Spending[9]	Sale of Government Bonds[10]	Interest on Transition Bonds Sold to the Public
1997	154	156	7	9	—	—	—	–110	57	53	2
1998	157	312	14	17	—	—	—	– 97	55	42	4
1999	159	466	22	26	1	—	—	– 83	59	24	5
2000	241	704	32	36	1	—	—	–146	66	80	9
2001	245	944	45	47	2	—	—	–127	66	61	11
2002	248	1182	59	59	2	—	—	–103	58	45	14
2003	302	1475	74	72	3	—	—	–130	56	74	17
2004	306	1767	90	87	5	—	—	–104	63	41	19
2005	311	2073	109	88	6	—	—	– 88	63	25	19
2006	318	2386	129	92	7	—	—	– 72	62	10	19
2007	324	2717	149	95	9	—	43	– 98	65	33	20
2008	329	3063	171	99	12	—	44	– 77	64	13	20
2009	334	3427	196	102	15	—	44	– 53	53		19
2010	338	3809	221	106	20	—	68	– 49	49		18
2011	344	4179	245	112	23	—	69	– 30	30		18
2012	349	4566	272	118	28	—	70	– 8	8		17
2013	354	4969	299	125	34	—	85	+ 5			12
2014	359	5390	327	131	41	—	86	+ 33			
2015	363	5828	456	138	48	—	87	+ 64			
2016	368	6236	382	148	57	—	88	+ 90			
2017	373	6659	411	158	67	—	90	+119			
2018	377	7095	440	167	77	—	90	+151			
2019	381	7546	469	177	88	—	91	+185			
2020	385	8010	500	188	98	—	92	+222			
2021	389	8424	527	201	107	—	94	+251			
2022	394	8849	554	215	115	—	95	+283			
2023	399	9281	582	229	124	—	96	+317			
2024	403	9722	610	243	134	—	97	+354			
2025	406	10170	639	258	143	—	97	+392			
2026	412	10545	663	275	153	—	99	+426			
2027	417	10923	686	292	164	—	111	+450			
2028	422	11303	710	310	174	—	112	+486			
2029	426	11684	733	329	186	—	113	+525			
2030	430	12067	757	346	199	—	115	+566			
2031	436	12351	773	368	207	—	116	+599			
2032	442	12632	789	389	218	—	118	+633			
2033	447	12906	804	410	229	—	119	+669			
2034	452	13172	818	433	239	—	121	+705			
2035	457	13427	831	454	250	—	122	+740			
2036	464	13564	836	479	261	—	124	+770			

[1] Assumes that 50% of workers opt out in each of the first three years, 75% opt out in each of the next three years, and 90% opt out after that.
[2] This column presents the accumulation of the invested funds plus returns on the investments, assuming a 4% annual real rate of return. The benefits paid from the private system are subtracted from these accumulated funds each year.
[3] This column presents the new revenues produced from taxation of the full, before tax real returns earned by the net increase in the private investments, after subtracting the amount of government bonds sold each year.
[4] This column presents the savings arising from replaced Social Security retirement, survivors and disability benefits of those who opt for the private alternatives.
[5] This column presents the savings arising from delaying the retirement age and changing future benefit calculations from wage-indexing to price-indexing.
[6] Assumes conservatively that no extra revenues are generated by additional economic growth generated by the reform.
[7] Assumes that after 10 years, employees and employers pay only 5% of wages each into the private system and no longer pay an additional 1.2% each into Social Security to help finance transition benefits, as they did for the first 10 years.
[8] Includes effect of Social Security surpluses and the continuing 1.2% of taxable wages paid by employees and employers each for the first 10 years after the worker opts out of Social Security.
[9] Assumes that projected total federal spending is reduced by the amounts shown to help finance the transition. This does not include approximately $35 billion per year in additional cuts between 1997 and 2011 that will be necessary if the Social Security Trust Fund is not used to finance general operating expenditures.
[10] Assumes the government sells bonds each year to raise money to pay continuing Social Security benefits. These can be either new government bonds or the already existing bonds in the Social Security trust funds.

Source: Peter J. Ferrara, "A Plan for Privatizing Social Security," Cato Institute, April 1997.

Opting Out by State: Oregon Proposes Its Own Plan

In May 1997, the Oregon Legislature approved a resolution urging Congress to grant waivers to let states opt out of the federal Social Security system and design their own retirement plans for all workers, government and private. The resolution was based on a study produced by the Cascade Policy Institute, an Oregon-based free-market research organization.[8] Author Randall Pozdena also proposed an alternative retirement system for Oregon, if Congress granted a waiver. Key features of his plan include

- Funding the transition to a private system by requiring employers to continue paying their 5.26 percent share of Social Security taxes for another 20 years;
- Requiring workers to contribute their 5.26 percent share of Social Security payroll taxes into qualified investment plans of their choosing;
- Shifting workers born after a certain date (perhaps 1955) from the federal Social Security system to the new state-based plan; and
- Continuing retirement benefits to current Oregon retirees equal to their benefits plus inflation adjustments.

Three Texas gulf coast counties selected a private investment firm to manage their employees' retirement plans with a guaranteed annual return of 6.5 percent.

The predicted results of the Oregon plan would be that over a 20-year period the existing system would be phased out and all new retirees would be receiving improved benefits as a result of superior investment returns. These predictions are based on the fact that no 20-year period since 1800 has witnessed overall negative investment returns, despite short-term cycles and disruptions.

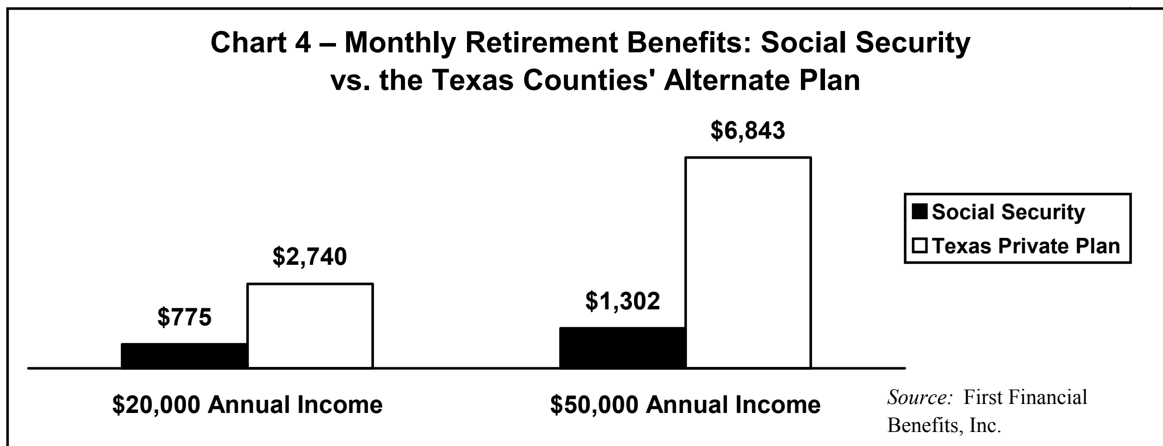
In May 1998, Colorado also adopted an opt-out resolution and Arizona, Indiana, Missouri, New Hampshire, South Carolina, and Washington are considering similar measures. See Appendix B on page 19 for the full text of Oregon's original resolution.

Opting Out in Texas: Three Counties Leave the Social Security System

A specific example of smaller local units of government choosing to opt out of Social Security to design their own pension plans occurred in 1981, when Congress still allowed government units to make that choice. The three Texas gulf coast counties of Brazoria, Galveston, and Matagorda selected a private investment firm to manage their employees' retirement plans with a guaranteed annual return of 6.5 percent.

By 1996 the results were in, and county employees' retirement benefits were triple what would have been paid by Social Security for a worker who earned $20,000 per year and over five times the Social Security benefits for a worker whose pay was $50,000 (see Chart 4, next page). Congress closed the local government opt-out window in 1983 with major Social Security reform legislation that raised taxes and effectively reduced benefits by raising the eligible retirement age after 2015.

[8] Randall J. Pozdena, "The New Oregon Option: Opting Out of Social Security," Cascade Policy Institute, July 1997.



Source: First Financial Benefits, Inc.

Opting Out by Country: Chile Leads the Way

The United States is not unique in instituting mandatory government-sponsored pension systems. Such programs were actually started in 1870s Germany by Chancellor Otto von Bismarck. He arbitrarily selected 65 as the retirement age, which is striking when one considers that life expectancies were under 50 at the time. Clearly, Bismarck and the original designers of the government retirement systems expected few benefits to be paid.

In the 20th century, government pension programs have become an important part of the "social safety net" in many developed countries. A number of countries, such as Chile in South America, started their programs before the United States created Social Security. But the inexorable dynamics of lower birth rates, longer life expectancies, and the political appeal of greater retirement benefits have put increasing burdens on government-funded pension programs in every country that has one.

In 1980, the pressures on Chile's government system became too great and a new system was introduced which allowed Chileans to opt out in favor of private investment. Large numbers of Chileans chose to leave the failing government system, and the results have been greatly increased benefits paid out to Chilean retirees.[9]

Other countries including Great Britain and Australia have revised their programs to include a small guaranteed government pension supplemented by a combination of employer-sponsored and personal pension plans under private management.[10] Participation rates in the partially privatized systems are in excess of 90 percent and assets are growing at greater market return rates.

Participation rates in other countries' partially privatized systems are in excess of 90 percent and assets are growing at greater market return rates.

[9] Jose Piñera, "Empowering Workers: The Privatization of Social Security in Chile," Cato Project on Social Security Privatization, Cato Institute, January 1996.

[10] Daniel J. Mitchell, "A Brief Guide to Social Security Reform," The Heritage Foundation, August 1997.

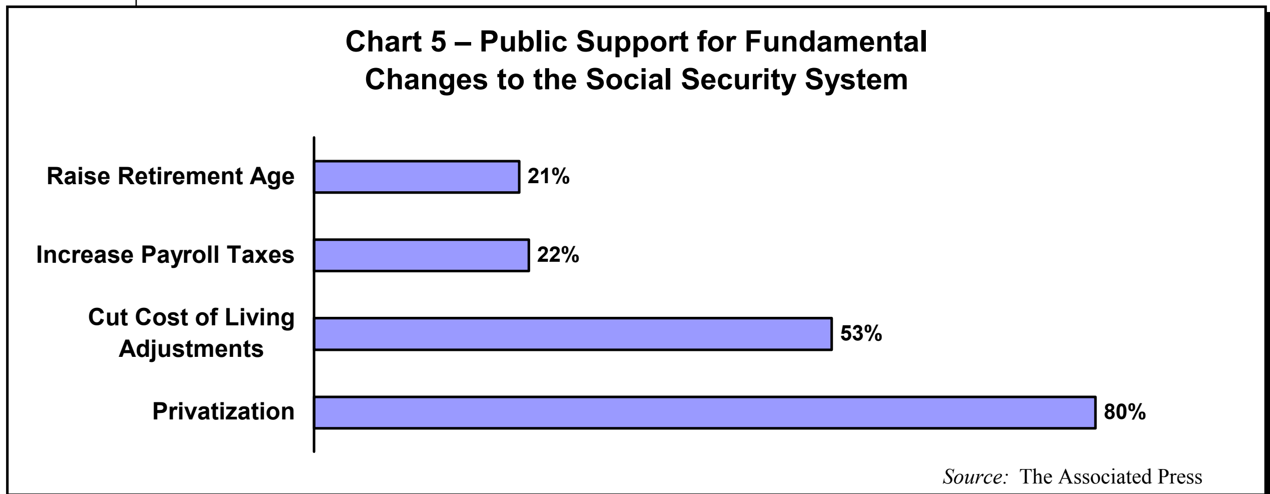
Michigan ranks 40th or below in expected Social Security returns among the 50 states, amounting to a lifetime net loss of almost $580,000 in retirement income per Michigan worker.

III. Recommendation: Privatize Social Security or Allow Michigan to Opt Out

The United States already has 15 years of partial privatization experience with retirement instruments such as IRAs and 401(k) and 403(b) plans. As a result, large numbers of citizens in Michigan and across the country understand this approach, making it a politically popular—as well as sound—Social Security reform idea.

People Are Ready for Change

Polling evidence has been accumulating for several years that shows widespread public support for fundamental Social Security reform. Americans' perception of Social Security has dramatically shifted in the past 10 years. Most recently, a March 1998 Associated Press poll found that 80 percent of respondents supported the concept of privatization—letting workers shift some of their Social Security taxes into personal retirement accounts that they could manage on their own (see Chart 5, below).



Michigan Workers and Retirees Are at Risk

Michigan has an especially strong incentive to favor fundamental reform to the existing Social Security system. The Heritage Foundation has done a state-by-state analysis of expected returns for future retirees. Projected benefits under Social Security were compared with what could be expected if workers were allowed to invest their payroll taxes privately in bond and equity markets. Due primarily to being a heavily urbanized state with a relatively high percentage of lower-wage workers, Michigan ranks 40th or below in expected Social Security returns among the 50 states. The lower returns amount to a net loss of almost $580,000 in retirement income per Michigan worker over a lifetime (see Table 3, next page).

Table 3 – Projected Lifetime Social Security Taxes and Benefits Compared with Accumulation from Private Investments for Double-Earner Couple Born in 1967 with Two Children, in 1997 Dollars

		1	2	3	4	5	6
		Current Social Security System		Private Investment Accumulated by Year of Retirement		Loss under Current Social Security Compared with Private Investment	
Rank by Column 6		Taxes Payed	Benefits Received	30 Year U.S. Treasury Bonds	50% Equities/ 50% U.S. Treasury Bonds	30 Year U.S. Treasury Bonds	50% Equities/ 50% U.S. Treasury Bonds
1	District of Columbia	$478,128	$412,063	$1,004,196	$1,503,013	$592,133	$1,090,950
2	New York	395,017	505,564	829,896	1,242,400	324,332	736,836
3	New Jersey	385,178	506,616	809,261	1,211,547	302,645	704,931
4	Connecticut	392,260	528,834	824,114	1,233,755	295,280	704,921
5	Massachusetts	363,526	503,832	763,852	1,143,650	260,019	639,818
6	Alaska	347,581	470,457	730,372	1,093,549	259,914	623,091
7	Illinois	334,881	457,934	703,706	1,053,644	245,771	595,710
8	Delaware	328,703	445,599	690,733	1,034,231	245,134	588,632
⇨ 9	Michigan	337,440	473,712	709,078	1,061,684	235,366	587,972
10	California	340,154	486,737	714,778	1,070,214	228,041	583,476
11	Maryland	324,200	440,563	681,279	1,020,083	240,716	579,520
12	Pennsylvania	309,968	429,836	651,396	975,364	221,559	545,528
13	Georgia	293,942	385,762	617,745	925,008	231,983	539,246
14	Virginia	299,490	416,088	629,395	942,440	213,307	526,352
15	Nevada	297,193	415,309	624,572	935,224	209,263	519,915
16	Texas	300,869	427,871	632,290	946,774	204,419	518,903
17	Ohio	297,053	416,690	624,278	934,783	207,588	518,093
18	Washington	308,951	461,219	649,260	972,168	188,041	510,949
19	Colorado	305,082	449,384	641,135	960,010	191,751	510,626
20	Minnesota	308,857	470,436	649,063	971,874	178,627	501,437
21	New Hampshire	296,148	438,311	622,378	931,940	184,066	493,628
22	Rhode Island	290,790	424,010	611,128	915,105	187,118	491,095
23	Missouri	284,475	411,382	597,867	895,261	186,485	483,878
24	Tennessee	277,520	391,899	583,263	873,406	191,364	481,507
25	Indiana	283,052	410,528	594,879	890,790	184,352	480,262
26	Louisiana	262,052	349,227	550,785	824,805	201,558	475,578
27	Alabama	269,073	372,055	565,527	846,865	193,472	474,810
28	Oregon	288,981	434,994	607,328	909,419	172,334	474,425
29	South Carolina	256,779	342,178	539,713	808,235	197,534	466,057
30	Arizona	282,085	423,688	592,848	887,751	169,160	464,063
31	Florida	274,034	409,532	575,945	862,455	166,412	452,922
32	Kentucky	261,334	372,012	549,279	822,550	177,267	450,539
33	Wisconsin	278,147	425,171	584,580	875,377	159,409	450,206
34	West Virginia	257,153	363,562	540,499	809,412	176,937	445,850
35	Hawaii	292,600	475,498	614,928	920,792	139,430	445,294
36	Vermont	261,522	396,852	549,672	823,138	152,820	426,287
37	Kansas	262,926	410,221	552,620	827,550	142,399	417,329
38	Maine	254,741	386,375	535,434	801,833	149,060	415,458
39	Oklahoma	249,125	373,214	523,641	784,185	150,427	410,971
40	Utah	262,520	419,376	551,768	826,276	132,392	406,900
41	New Mexico	253,296	391,578	532,401	797,294	140,823	405,715
42	Mississippi	232,877	332,861	489,526	733,132	156,665	400,271
43	Arkansas	237,963	352,325	500,205	749,114	147,880	396,789
44	Iowa	252,897	402,180	531,562	796,039	129,382	393,859
45	Nebraska	248,716	395,149	522,783	782,900	127,634	387,752
46	Idaho	249,384	400,985	524,185	784,999	123,200	384,014
47	North Carolina	227,104	334,922	477,405	714,994	142,483	380,072
48	Wyoming	244,173	388,603	513,243	768,625	124,640	380,022
49	Montana	225,591	361,236	474,227	710,239	112,991	349,003
50	North Dakota	226,627	377,885	476,402	713,494	98,517	335,609
51	South Dakota	221,041	360,901	464,674	695,944	103,774	335,043

Note: The calculations assume a couple earning the average wage by state and having the average life expectancies by state. Ranking is based on the loss under Social Security compared with private investment of 50% equities and 50% Treasury Bonds.

Source: The Heritage Foundation, Center for Data Analysis. Calculations are based on data from the Social Security Administration, U.S. Bureau of Labor Statistics and National Center for Health Statistics.

Recommendation: The Michigan Legislature Should Ask Congress to Privatize Social Security or Grant a Waiver for the Purpose of Opting Out of the System

The Michigan Legislature should adopt a resolution similar to the one passed by Oregon in 1997 asking Congress to either

- Partially privatize the existing Social Security program by allowing workers to shift all or part of their current 5.26 Social Security retirement payroll taxes into privately owned and managed accounts up to the allowable limit of $10,000 per year; or

- Grant the state of Michigan a waiver to opt out of the federal Social Security system and design a sounder and more beneficial retirement plan for its citizens.

The existing federal Social Security system is streaking inevitably toward fiscal insolvency. A long-term solution is partial privatization that allows workers to take control of their own retirement planning.

Conclusion

The existing federal Social Security system is streaking inevitably toward fiscal insolvency. Its financial problems can only be resolved—temporarily—by raising taxes and cutting benefits. But a fundamental and long-term solution is a system of partial privatization that allows workers to take control of their own retirement planning.

Many countries have already turned to private investment to restore fiscal soundness and improved retirement benefits to their government pension programs, increasing retirement security for millions of citizens. With a strong economy and government surpluses forecast for the next decade, the United States is in a strong position to successfully move to a privatized pension program that stimulates economic growth, promotes private savings, and restores individual freedom.

Appendix A: Answers to Common Questions about Social Security Privatization

Countries including Chile, Great Britain, and Australia have had great success with their partially privatized pension programs. Nevertheless, a number of concerns have been raised against the idea of privatizing Social Security. This appendix answers some of the more common concerns about Social Security privatization.

Why does Social Security need a drastic overhaul? Can't it just be fixed the way it has been in the past?

Past changes made to Social Security were designed to postpone the final "day of reckoning" and they included cutting benefits, hiking payroll taxes, and raising the retirement age. The trouble is that the day of reckoning is here. Longer-term trends, starting about 2012, show that Social Security will be taking in less money per year than it must pay out in benefits to retirees. Changes in demographics (there will soon only be two workers to support every one retiree, down from the 16-to-1 ratio when Social Security began in 1935) will make earlier fixes not only unpopular but also unfair and immoral. Any payroll tax increase will have to be confiscatory to meet the coming burden, and raising the retirement age still further will only cheat more workers out of ever seeing a return on their lifetime of taxes paid into the system. Dramatic and systemic change is needed.

Since 1800, there has never been a 20-year period in the United States when stock market investment returns were not positive.

Why is "privatization" the best alternative for Social Security reform?

There are three main reasons why privatization of pension funds is the best alternative to the failing government-funded system. The first is that market-based investment returns have historically been much higher than those of Social Security, which means that retirees can enjoy greater benefits in their golden years. The second reason is that privatization does not rely on an unstable "pay-as-you-go" pyramid scheme where current taxpayers are forced to subsidize current retirees rather than save for their own retirements. Privatization instead allows each worker to own and control his own retirement savings account. Third, increased private investment and savings will provide the economy with new sources of capital, which fuels growth and job creation.

Isn't private investment in the stock market too risky? Wouldn't I stand to lose my nest egg if I invested my retirement funds for myself?

Investment—whether in savings accounts or bond and equity markets—always carries with it some risk. However, the essential point regarding retirement accounts is that they are invested over an entire working lifetime, which means that short-term economic fluctuations are less important factors. Over longer periods of time, investments do well: Since 1800, there has never been a 20-year period in the United States when investment returns were not positive. For bond markets, the average 20-year return has been 3 to 4 percent while stock market returns have averaged an impressive 7 percent. Keep in mind that this century has had several major upheavals including the two World Wars, the Great Depression, and many weather-related catastrophes including earthquakes, storms, floods, and droughts. All of the long-term investment gains take these disruptions into account.

But couldn't I lose it all during a stock market crash like in 1929?

That is unlikely. Workers are far more likely to suffer poor returns from Social Security than they are to suffer huge losses in their private investments. Over a working lifetime of 30 to 40 years there will be some ups and downs in markets as well as the economy. Recessions, wars, depressions, and economic stresses from temporary factors such as fires and floods are part of history, and neither markets nor government programs are immune from them. Lifetime planning can yield compounding growth rates of 4 to 7 percent on investment returns and provide tremendous increases despite short-term disruptions. Government-sponsored pensions, by contrast, never promise more than two percent returns, which is even less than long-term inflation rates.

Lower-income people who do not have any private savings today will be the greatest beneficiaries under privatization.

How do we know privatization works?

Several countries such as Chile, Great Britain, Australia, and even Sweden have already made the change to either partially or totally privatized pension programs. The results have met or exceeded expectations, with retirees under the new plans seeing greatly increased benefits and earnings. In the United States, three counties in Texas opted out of the Social Security system in 1981 and designed their own privatized pension plan. County employees now enjoy retirement benefits three times greater than what Social Security would have paid. Likewise, private retirement savings plans such as IRAs or 401(k) and 403(b) plans routinely outperform Social Security.

Won't poor people who can't afford to save any money lose under privatization?

No. Lower-income people who do not have any private savings today will be the greatest beneficiaries under privatization. Here's why: 5.26 percent of their pay is currently taken for Social Security taxes. Because that money is immediately transferred to current retirees, there is no nest egg being built up for the low-income taxpayer. If instead all or part of that 5.26 percent were privately invested on behalf of the worker, he would own and control his own retirement account and could count on greater returns for his money. Those people who have no savings would be able to accumulate funds for their own retirement without any noticeable difference in their paychecks.

How can I find out more about what privatization of Social Security would mean for myself, my family, and my retirement?

The Cato Institute, a Washington, D. C.-based public policy research institute, has studied Social Security privatization for the past several years. Research from their Project on Social Security Privatization can be found on the Internet at **www.socialsecurity.org**. The interactive Web site features a calculator tool that allows you to input personal data such as age and income level to calculate what you stand to gain if your Social Security taxes were invested in a privately managed retirement account under your control.

For further reading, please see Appendix C on page 21 for a bibliography.

Appendix B: May 1997 Resolution of the Oregon Legislature

Oregon Senate Concurrent Resolution 2

Sponsored by Senator Gene Derfler

SUMMARY

Urges Congress to enact legislation amending Social Security Act to authorize issuance of waivers to states allowing design and implementation of alternative retirement plans.

To the Senate and House of Representatives of the United States of America, in Congress assembled:

We, the Sixty-ninth Legislative Assembly of the State of Oregon, in legislative session assembled, respectfully represent as follows:

Whereas Social Security is a federal program that does not recognize the individual retirement needs of many Americans; and

Whereas Social Security tax revenues alone will be insufficient to pay current benefits as early as the year 2012, and

Whereas the Social Security Trust Funds may be completely exhausted by the year 2029; and

Whereas the investment return on Social Security contributions made by many workers today is significantly below that available from other sources; and

Whereas Oregon workers deserve the opportunity to invest more productively for their own retirements; and

Whereas more retirement investment alternatives might dramatically increase Oregonians' savings rate and retain more young adults who otherwise would leave the state for jobs elsewhere; and

Whereas the federal government has recognized Oregon's ability to develop successful alternatives for managing programs at the state level through waivers for the Oregon Health Plan and the welfare-to-work JOBS Plus program; now, therefore,

Be it Resolved by the Legislative Assembly of the State of Oregon:

(1) The Congress of the United States is urged to enact legislation amending the Social Security Act to allow the issuance of waivers to the states that will permit the design and implementation of alternatives to Social Security.

(2) A copy of this concurrent resolution shall be sent to each member of the Oregon Congressional Delegation.

Adopted by Senate March 14, 1997

/s/ Secretary of Senate

/s/ President of Senate

Adopted by House May 5, 1997

/s/ Speaker of House

Appendix C: Bibliography

For further reading, please see the following papers on Social Security privatization, available from the Cato Institute's Project on Social Security Privatization at **www.socialsecurity.org**.

William Shipman, "Retiring with Dignity: Social Security vs. Private Markets," August 14, 1995.

Michael Tanner, "Privatizing Social Security: A Big Boost for the Poor," July 26, 1996.

Michael Tanner, "Public Opinion and Social Security Privatization," August 6, 1996.

Krzysztof M. Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," January 14, 1997.

Peter J. Ferrara, "A Plan for Privatizing Social Security," April 30, 1997.

Melissa Hieger and William Shipman, "Common Objections to a Market-Based Social Security System: A Response," July 22, 1997.

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About the Author

Kent Davis, a retiree with 36 years of managerial experience in industry, is a senior advisor to the Mackinac Center for Public Policy, and is the author of Mackinac Center *Viewpoints* and articles.