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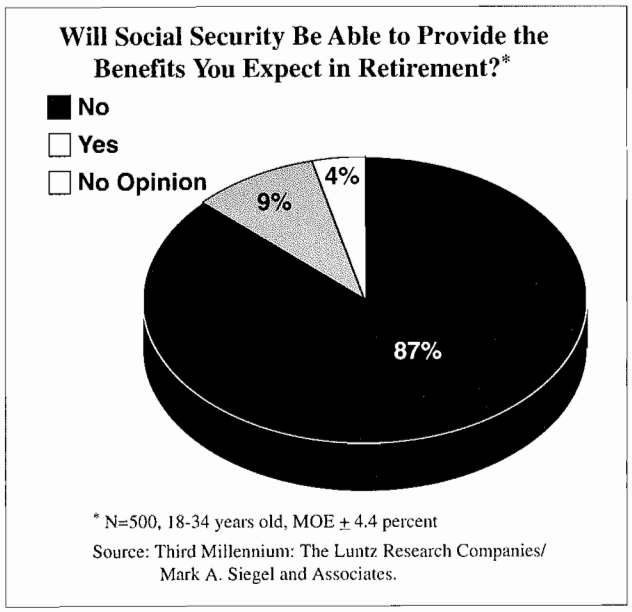
A 12-Step Plan for Social Security Reform

Social Security privatization is the single most important political reform sweeping the globe today. Following Chile's highly successful move to private pensions in 1981, Argentina, Peru and Colombia privatized their social security systems in the early 1990s. Mexico privatized in 1997. Estelle James, lead economist of the Policy Research Department at the World Bank, predicts that every Latin American country except Cuba will have privatized by the year 2000.

Farther from home, Singapore has had an extensive private system since the 1950s, and Britain has allowed individuals or employers to opt out of the state system since the 1970s. Hong Kong recently copied the Chilean system, Hungary plans to do the same and Australia recently instituted its own form of pension privatization.

In the United States, President Bill Clinton and members of Congress have also concluded that reforming the Social Security system is both economically imperative and politically feasible. [See the figure.] The Social Security trustees' most recent report confirms that by the year 2013 the Social Security trust fund will begin paying out more in benefits than it receives in payroll taxes — meaning that the government will have to raise taxes, borrow the money to pay the difference or cut benefits.



Recognizing the impending crisis, President Clinton has called for town hall meetings to discuss the problem, and members of Congress have proposed expanding private savings options. Adhering to the 12 principles that follow will assure the success of the reform.

1. Guarantee benefits to current retirees. Because they have counted on the existing Social Security system and incorporated it into their retirement planning, current retirees and those nearing retirement should be guaranteed the benefits they were promised.

Younger workers who voluntarily choose to remain in Social Security should not receive the same guarantee. The cost of their benefits could be controlled by: (1) increasing the retirement age, which is already scheduled to rise gradually to age 67 for those born in 1960 and later, and indexing it to increases in life expectancy; (2) using a more realistic price index to adjust benefits for inflation; and (3) including Social Security benefits in retirees' taxable income.

2. Give workers a choice between the public system and a private plan. People working and paying taxes into the system should have the option of remaining in Social Security or moving to a private plan. Those who choose to do the latter would have to deposit a part of their Social Security payroll taxes — currently 12.4 percent of payroll — into their private retirement account. These funds would be invested in stocks, bonds and real assets that would fund the workers' retirement and other benefits covered by Social Security. In the case of death, private account balances would become part of the deceased's estate.

3. Give workers credit for Social Security taxes already paid. Workers who choose the private option should receive full or partial credit for the money they have already contributed to the Social Security system. One way to do that would be to give them "recognition bonds" backed by the full faith and credit of the government. These nonnegotiable bonds could be cashed in at retirement to supplement their income from the private accounts, as was done in Chile. Alternatively, workers choosing the private option could receive Social Security benefits in amounts based on their previous contributions in addition to their private accounts.

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4. Sunset the existing program. Although the current generation of workers could choose between public and private options, Congress should establish a time at which anyone entering the labor market would have to participate in the private system. Thus the number of those in the public system would slowly decline, and when no one was left, the public system would end.

5. Make contributions mandatory. The traditional argument for compulsory Social Security is that if contributions were optional some people would spend all of their income during their working years and be dependent on the rest of society during retirement. Whether or not this argument is valid, contributions to either the public or the private system should be mandatory — at least during the transition.

6. Include life and disability benefits in private plans. In addition to retirement income, Social Security provides disability income for individuals who are injured and cannot work, as well as a death benefit and survivors' benefits for widows and widowers age 60 or older and children under 18. Those who choose the private option should be required to purchase life and disability insurance as part of their plan. Participating insurers would have to accept all applicants.

The experience of three Texas counties that opted out of the Social Security system in 1981 and 1982 is instructive. Under the plan adopted by Galveston, Brazoria and Matagorda counties, public employees receive a life insurance benefit three times the worker's salary (with a minimum benefit of $50,000 and a maximum of $150,000); by contrast, Social Security pays a one-time death benefit of $255 to a surviving spouse plus survivors' benefits to those who qualify. Disability insurance under the counties' private plan pays 60 percent of an individual's salary until age 65 or until the individual returns to work.

7. Protect spouses. Deposits to the private accounts should be divided equally between husband and wife at the time they are made. In case of death, the surviving spouse would gain control over both accounts. In case of divorce, each spouse would retain his or her account.

8. Offer a choice of private plans. The key to consumer satisfaction in creating such private and individual retirement accounts is competition. The law should permit a number of federally approved private-sector plans to compete to manage workers' private pension accounts. (Chile currently has 13 plans.)

9. Require investment funds to maintain diverse portfolios. To insure that private accounts grow enough to pay minimum benefits in retirement and that workers' contributions are financially secure, private plans must hold diversified portfolios. Workers would not choose among individual securities or be allowed to make highly speculative investments.

10. Require retirees to purchase minimum-income annuities. To ensure that retirees do not deplete their retirement funds too quickly, individuals should be required to purchase an annuity at retirement that would pay a fixed monthly amount— say, 60 percent of their preretirement income — for the rest of their lives. Funds above the amount needed to purchase the annuity would not be restricted. After they purchased the annuity or set aside funds for its purchase, they would not have to make further contributions.

11. Guarantee that private account holders don't lose. While there is every reason to believe that all workers would be better off, government should guarantee that no one will be worse off for having opted out of the public system. At least during the transition period, the federal government should be prepared to "top up" the personal retirement account of any retiree so that the retiree could purchase a minimum-income annuity comparable to what would have been paid by Social Security.

12. Let people choose their own retirement age. As long as individuals have sufficient funds in the account — including the credit for those who are partially under the old system — to purchase a lifetime annuity, they should be allowed to retire whenever they choose.

Conclusion. Given Social Security's shaky financial status and the baby boomers' impending retirement, the question is not *whether* to reform Social Security, but how. Legislation that includes these basic principles — many of which have already been tested in other countries — would solve the financing problems while ensuring the safety and solvency of seniors' retirement accounts.

This Brief Analysis was prepared by NCPA Vice President of Domestic Policy Merrill Matthews Jr.