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Just Say 'No' to Personal Accounts**

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ENTITLED TO NOTHING: WHY AMERICANS SHOULD JUST SAY ‘NO’ TO PERSONAL ACCOUNTS

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I. Introduction

The issue of Social Security, long considered the untouchable “third rail” of American politics, was avoided by both Clinton and Dole in their bids for the presidency in 1996.¹ The current President, in contrast, seems to sense that, for the first time in 60 years, the political climate is right for the restructuring of this once-unassailable program. At least part of the credit for this ‘climate change’ can be traced to President Reagan’s successful campaign to promote self-reliance and personal responsibility and discourage a sense of entitlement among America’s working class. But even Reagan never attempted to dismantle the largest, most successful and most widely supported entitlement program of our time.² And he could have made a strong case for doing so.

In the second year of Reagan’s presidency, the Trustees of the Social Security Administration projected that the Trust Funds would be exhausted by the end of his third year in office. Based on this forecast, virtually everyone believed that Social Security was on the brink of insolvency and that the system was in imminent danger of collapsing. Then, as now, crisis rhetoric dominated the airways and filled the legislative chambers. And yet there were no serious proposals to abandon the system or even to overhaul it in any fundamental way. Instead, lawmakers salvaged the system in an eleventh-hour,

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¹ The *Washington Post* reported that Wall Street interests sent ‘briefing papers’ to both the Clinton administration and the Dole campaign, urging the candidates to steer clear of the issue until after the election (Dreyfuss, 1996). Later, during his second term in office, Clinton reportedly abandoned a serious plan to pursue some form of privatization when it became clear that he was going to be impeached (Birnbaum, 2005).

² Reagan endorsed privatization as early as 1964 but never pushed the agenda during his tenure as president. Still, he was no “friend” of the system. He favored converting Social Security to a needs-based program, primarily designed to help those who became poor, through no fault of their own. For more on this, see Skidmore (1999).

bipartisan deal brokered by former House members Jake Pickle (D-TX), Claude Pepper (D-FL) and Senator Bob Dole (R-KS). Through their collective powers of persuasion, both the Senate and the House agreed on a series of reforms – a hike in the payroll tax, benefit cuts, and a gradual increase in the retirement age³ – that were supposed to keep the system solvent for roughly 75 years.⁴ President Reagan signed the reform bill just two months before the Trust Funds would have been depleted.

The 1983 compromise is often touted an example of the kind of progress that can be made when bi-partisan leadership supplants routine legislative partisanship. But the changes that were made in the name of “solvency” in 1983 were no more necessary than the sweeping reforms that are being proposed today. Then, as now, politicians, pundits and (most) economists incorrectly linked the government’s ability to pay scheduled benefits to the balance in the Social Security Trust Fund.

Today, the debate is not so much over whether Social Security faces a financial crisis – both sides concede that it does – but whether now is the time to enact sweeping reforms. Democrats emphasize that the Trust Fund is solidly in the black and that deficits aren’t even projected for another thirteen years.⁵ And even then, they stress that the shortfall can be covered for another 24 to 34 years, as Social Security draws down its massive surplus – projected to stand at \$3.7 trillion by that time. Thus, with the current system projected to honor its benefit commitments in full and on time until somewhere between 2042 and 2052,⁶ Democrats deny that immediate changes are needed. They believe there is plenty of time to devise solutions to address the long range problems facing Social Security.

Republicans, in contrast, insist that the long range problems require a short range solution.⁷ To make their case, they emphasize the \$3.7 trillion shortfall⁸ the Trustees have

³ Benefits also became subject to income tax, which really amounts to an additional cut.

⁴ The Commission that studied Social Security’s problems in the early 1980s was headed by Alan Greenspan, who brokered the compromise that extended Social Security’s solvency.

⁵ It should be noted that Social Security has run deficits – i.e. paid out more in benefits than the government collected in payroll taxes – in 14 of the past 47 years, including 1975-1983.

⁶ The Social Security Trustees forecast solvency through 2042, while the Congressional Budget Office (CBO) forecasts an additional decade of solvency. By either measure, the system is in better financial shape than at almost any time in its history.

⁷ Obviously, not every member of the Republican Party supports the president’s agenda to act swiftly to privatize part of Social Security, just as Democrats are not entirely united in their opposition. On the Republican side, Bill Thomas, Chairman of the House Ways and Means Committee, described the president’s proposal to reform Social Security as a “dead horse”, implying that it would never survive a Congressional vote. In the main, however, the line in the sand has been drawn along fairly obvious party lines.

⁸ President Bush likes to call it an \$11 trillion shortfall, which he arrives at by rounding (up) the \$10.4 trillion shortfall the Trustees project over an *infinite* time horizon.

projected over the next 75 years, arguing that we must change the system today, so that we do not pass the burden of tackling tough problems on to our children and grandchildren. In their view, waiting is not only irresponsible but, ultimately, more costly, since an additional \$600 billion is added each year the problem is not addressed. In short, they argue that the Trust Funds are becoming insolvent and that we cannot afford to wait to react to the crisis.

It is tempting to give this paper over to a detailed elaboration of the flaws inherent in both positions. Specifically, it would be easy to demonstrate that payroll tax withholdings do not actually finance retirees' benefits and that it is meaningless to speak in terms of Trust Fund "insolvency" or to engage in hand wringing over the balance in the Social Security Trust Fund. The problem, of course, is that almost no one understands or accepts these facts, making it virtually impossible to turn their attention away from the looming financial crisis they are all hell-bent on resolving, either now (Republicans) or at some future date (Democrats). Thus, I shall leave this task to others⁹ and confine my attention to an analysis of the Bush proposal. Specifically, this paper seeks to: (1) examine the President's plan to offer private retirement accounts; (2) consider the counterarguments that have been raised by opponents of the president's plan; and (3) reflect upon the British and Chilean experiences to highlight some of the difficulties workers in those countries have faced in retirement. The paper concludes with the argument that Americans should reject the president's plan and insist upon the preservation of Social Security as we know it.¹⁰

II. Have I Got a Deal for YOU!

In a memorandum dated January 27, 2005, House Republican Conference Chairman, Deborah Pryce, and Senate Republican Conference Chairman, Rick Santorum, provided Senate and House Republicans with a 'playbook', outlining the GOP position on Social Security reform. Included in the roughly 100-page document were: a set of talking points for communicating the President's message on Social Security; a summary of the Trustee's projections; two sample speeches, one tailored to younger audiences and one designed for crowds over 50 years of age; PowerPoint presentations to assist them in their national crusade to convince Americans of the merits of the president's plan; and links to dozens of privatization-friendly websites to help embolden the party's agenda. The 'playbook,' entitled *A Guide to Social Security Reform*, begins by laying out the broad principles that President Bush has outlined as part of his reform proposal:

⁹ I have tackled this elsewhere (Bell and Wray, 2003), and others have argued these points as well. Interested readers should consult Eisner (1998) for an excellent (and highly accessible) summary. Mitchell and Mosler (2005) also persuasively debunk the notion that Social Security faces a financial crisis that will leave the government *unable* to make payments to future retirees.

¹⁰ How, exactly, we ought to go about preserving the system is the subject of a forthcoming paper.

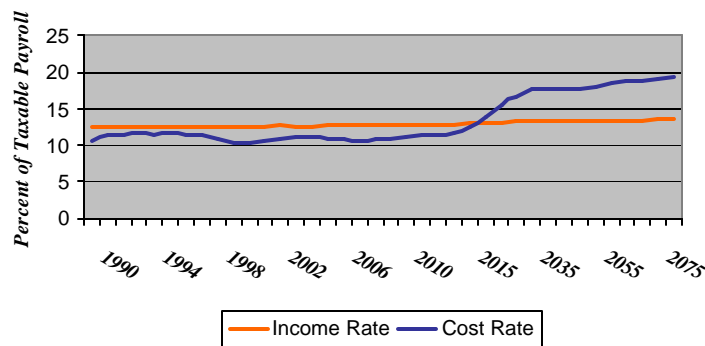
1. The current system cannot afford to pay promised benefits to younger workers.
2. Benefits will not change for those already retired or for those near retirement.
3. The President will not support any proposal that includes higher payroll taxes.
4. Workers should have the option to save some payroll taxes in a personal account.
5. Personal accounts will give Americans the opportunity to share in the benefits of economic growth by participating in markets through sound investments.

Let us briefly examine each of these broad principles.

1. Why the President Says We Can't Keep Our Promise to Younger Workers

Anyone who has followed the debate over Social Security reform has heard it said – It's simply a matter of numbers. The numbers that are of primary concern are the 'cost rate' and the 'income rate' which, on balance, reflect the system's ability to meet projected payment commitments.¹¹ Currently, the income rate exceeds the cost rate so that the Trust Fund continues to add to its massive surplus. But, as Figure 1 shows, the cost rate is projected to overtake the income rate in 2018 and to fall significantly behind from about 2010 to 2030, as the baby-boom generation reaches retirement age. Thereafter, the cost rate is projected to rise steadily, though more slowly, reflecting the Trustees' assumptions that death rates decline and birth rates remain relatively low.

Figure 1: Estimated Annual Income Rates and Cost Rates for OASDI



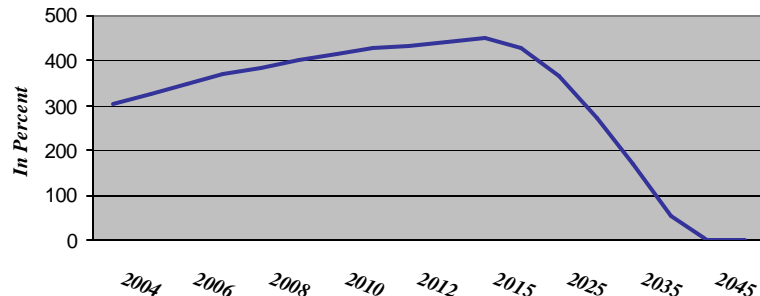
Source: *The 2004 Annual Report of the Board of Trustees*

Thus, the argument is that as income from payroll taxes begins to fall short of payment commitments in 2018, the system will need to begin drawing on the Trust Fund in order to continue to pay full benefits to retirees. Unfortunately, as Figure 2 depicts, the surplus in the Trust Fund will not last forever, making it impossible to continue paying

¹¹ The annual income rate is the ratio of projected income from payroll tax contributions and the taxation of benefits to the OASDI taxable payroll for the year. The annual cost rate is the projected ratio of the cost of the program to the taxable payroll for the year.

full benefits once it is depleted. According to the Trustee’s “best estimate,” the Trust Fund will have depleted its entire surplus by 2042.

Figure 2: Estimated Trust Fund Ratio, Intermediate Assumption



Source: *The 2004 Annual Report of the Board of Trustees*

If nothing is done to reform the system, the Trustees project that it will be possible to pay post-2042 retirees only about 73 percent of the benefits they have been promised. Put simply, we have a numbers problem – too few dollars are projected to come in and too many dollars are projected to go out. Consequently, the President tells us, the government cannot “afford” to honor all of its commitments to future retirees. The numbers simply don’t allow for it.

2. The Impact on Benefits for Retirees and Near-Retirees

The President insists that the benefits of those who are already drawing Social Security and those who are near retirement (i.e. those 55 and older) are fully protected under his reform plan.¹² The system can meet its commitments to these cohorts, but it is not in a position to pay promised benefits to our nation’s younger generation of workers.

3. The Case against Raising the Payroll Tax

The Social Security payroll tax rate currently stands at 12.4 % of taxable income, a burden that is shared equally among workers and their employers (i.e. each contributes 6.2%). According to the Trustees of the Social Security Administration, “[f]or the trust funds to remain solvent throughout the 75-year projection period, the combined payroll tax rate could be increased during the period in a manner equivalent to an immediate and permanent increase of 1.89 percentage points” (*Annual Report of the Trustees*, 2004, p. 3). This means that if workers and their employers each contributed an additional 0.945%, the system could be made solvent until at least 2080. This “fix” involves shifting the

¹² Sawicky (2005) argues that current retirees and near-retirees are “in danger of benefit cuts in the coming years, despite the president’s assurances to those groups that their benefits are safe.”

'income rate' (Figure 1) upward so that it remains above the 'cost rate' over the entire 75-year period.

But the president is adamant about holding the line on payroll taxes. He insists that he will not sign any legislation that calls for higher taxes, arguing that such a change would jeopardize the recovery by hurting workers and employers.

4. The 'Option' to Invest in Personal Accounts

Having ruled out a hike in the payroll tax as a way of staving off benefit reductions to future retirees, the president insists that the best way to protect America's younger workers is through the (partial) privatization of Social Security. "As we fix Social Security, we also have the responsibility to make the system a better deal for younger workers. And the best way to reach that goal is through voluntary personal retirement accounts" (Bush, 2/2/05).

Although the White House has not released the full details of the plan, the president has explained that his proposal would allow workers under the age of 55 to divert up to 4 percent of their current payroll tax contribution into their own retirement accounts.¹³ Workers who decided to participate would then depend upon benefits from two sources: (1) the (now lower) guaranteed benefit they continue to receive from Social Security and (2) the market benefit that accrues in the form of gains in their personal account.¹⁴ Those who decide not to establish a personal account are told that they "could stay entirely in the current system" and that their "benefits are fully protected" (*A Guide to Social Security Reform*, Speech 1, p. 3).

5. The 'Opportunity' to Come Out Ahead

Under the President's plan, workers are told that they will come out ahead as long as their personal account earns a rate of return that exceeds the rate of return on the Trust Funds:

The way that the election is put before the individual in a personal account structure of this type is that in return for the *opportunity* to get the benefits from the personal account, the person foregoes a certain amount of benefits from the traditional system.

¹³ In its first year of implementation – 2009 – people born in 1965 would be permitted to contribute up to \$1,000 annually, and an additional \$100 per year thereafter. In 2010, those born in 1978 and earlier would become eligible to participate, and everyone else would be permitted to establish a personal account beginning in 2011.

¹⁴ Clearly, the more they divert into private accounts, the less they will receive in the form of a guaranteed benefit and, hence, the more they will rely upon gains in financial markets.

Now, the way that election is structured, the person comes out ahead if their personal account exceeds a 3 percent real rate of return, which is the rate of return that the trust fund bonds receive. So, basically, the net effect on an individual's benefits would be zero if his personal account earned a 3 percent real rate of return. *To the extent that his personal account gets a higher rate of return, his net benefit would increase as a consequence of making that decision*

. . . the specific *trade-off* that you're making in opting for a personal account is based on your decision that *you think you can beat the 3 percent* real rate of return (my emphasis; White House, Senior Administration Official, 2005).

But what about the risks? Investing in a personal account means foregoing a portion of the benefits that otherwise would have been received under the traditional system. In addressing these concerns, Republicans have emphasized the prospects for higher returns and downplayed the risks associated with market investment:

Personal accounts will provide Americans who choose to participate with an opportunity to share in the benefits of economic growth by participating in markets through sound investments. Any proposal will include limitations on the risk of investments permitted in personal accounts . . . (*A Guide to Social Security Reform*, 2005, p. 2).

Despite the existence of risk, Republicans insist that it is still easy to see the benefits of personal accounts, maintaining that "individuals opting for a personal account can expect to receive higher benefits than those choosing not to have an account" (*A Guide to Social Security Reform*, Appendix I, A.1). To make their case, they emphasize the stock market's *long-run* performance, citing a study that shows that rates of return on stocks – over the last 200 years – were almost 7 percent a year, after correcting for inflation. Thus, their audiences are told that while short-run fluctuations are inevitable, "investment experts agree that in the long-term the trend is positive" (*A Guide to Social Security Reform*, Speech #1, p. 11).

Thus, in stump speeches across the nation, Republicans are asking a simple question: Do you want "your" money in a Trust Fund that earns a 3 percent real return, or would you prefer to invest it in a personal account that might yield nearly 7 percent after inflation? Using these figures, they hope to persuade Americans that the answer is fairly obvious. Personal accounts offer better prospects for growth and, ultimately, a more comfortable retirement. This is especially true in the case of younger workers, explains White House spokesman Trent Duffy, because they can get in early and experience "the magic of compound interest" (quoted in Vandehei, 2005).

Finally, personal accounts are said to enable average Americans to participate in an “ownership society,” creating millions of “worker-capitalists with a direct interest in sound economic policy” (*A Guide to Social Security Reform*, Case Studies, p. 21). And, since workers “own” their private accounts, the government is prevented from spending their contributions. Moreover, any portion of the account that isn’t used for retirement can be passed on to one’s heirs. It is a plan that sounds almost too good to be true: ownership, higher anticipated returns, protection from government, and something to bequeath to one’s survivors.

III. If It Sounds Too Good To Be True ...

While the president and his allies have emphasized the potential gains that might accrue through investment and the magic of compound interest, they have downplayed many of the less pleasant aspects of moving toward a partially privatized system, including: cuts for those under 55 years of age, administrative fees that cut into total returns, the costs of financing the transition, and the windfall that might accrue to financial middlemen at the expense of those who choose private accounts. The purpose of this section is to ask whether, in the face of these downside aspects, personal accounts are a good choice for Americans.

The Real Story on Benefit Cuts: Bush’s Dirty Little Secret

Anyone who has heard the president discuss Social Security reform knows how important the images of “choice” and “freedom” have been in the marketing of private accounts. The president has emphasized time and again the voluntary nature of his plan, stressing that it gives workers the freedom but not the obligation to choose a reduction in guaranteed benefits. But, as two Treasury officials pointed out in a memorandum to former Treasury Secretary Paul O’Neill, workers are likely to suffer *involuntary* cuts as well:

Regarding “voluntary,” it is clear that some players in the White House had believed (and some still do) that “voluntary” means that people could, if they chose, stay in the current Social Security with no increase in payroll taxes and no cuts in benefits. One problem with that approach is that it would leave Social Security on an unsustainable course. The other competing understanding of “voluntary” involves a two-step approach originally proposed by Glenn Hubbard. The first step would involve a benefit cut for everyone – i.e. regardless of participation in personal accounts – in order to put Social Security on a sustainable [path] on its own. The second step – and where voluntary becomes relevant – would give people the choice to receive an additional benefit reduction in exchange for allowing them to divert some of their payroll taxes to personal accounts (Smetters and Smith, 2001).

Thus, the plan would be truly “voluntary” only if the White House chose not to address Social Security’s long-term financing gap by imposing an across-the-board reduction in benefits. But this is not what the president’s team is calling for.

The president’s Commission to Strengthen Social Security has sketched out the most up-to-date and comprehensive description of the (still nebulous) White House reforms. The framework, known as “Plan 2”, proposes two key changes to the current system: 1.) the introduction of personal accounts and 2.) a change in the formula used to calculate retirees’ benefits. While the merits (and demerits) of the former are routinely examined, the implications of the latter are frequently overlooked. Let us consider these implications.

Currently, Social Security benefits are calculated in four steps:

1. The Social Security Administration (SSA) keeps track of wage history and converts your past earnings into a single number – your Average Indexed Monthly Earnings (AIME).
2. A formula is used to convert your AIME into a monthly benefit
3. If you decide to retire early, the monthly benefit is reduced
4. Upon retirement, benefits are adjusted annually by a Cost of Living Allowance (COLA)

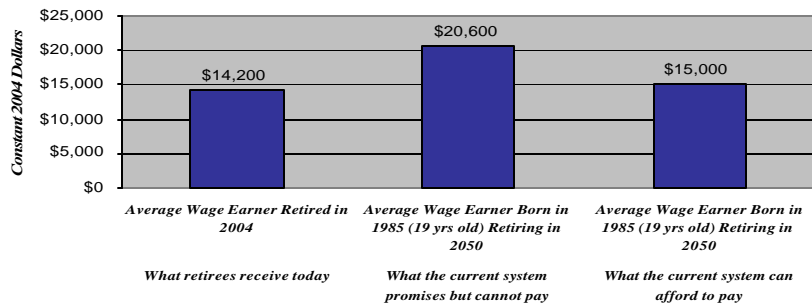
The second step requires closer examination.

The formula used to convert AIME into a monthly benefit is:

90% of your first \$629 of AIME, *plus*
32% of your next \$3152 of AIME, *plus*
15% of AIME over \$3,779.

The “bend points” – the \$627, \$3,152 and \$3,779 – are indexed each year to reflect growth in nominal wages so that when the economy does well, retirees are permitted to share in the benefits economic growth. And, since nominal wages tend to grow over time, the system promises higher benefits to future generations of retirees than it pays to current retirees. But the President and the members of his Commission contend that Social Security cannot afford to pay these higher promised benefits, due to the forecasted shortfall in payroll tax revenue. Figure 3 shows what current retirees receive, what future retirees are promised and what the system can afford to pay retirees, based on projected payroll tax receipts.

Figure 3: Current and Promised Benefits at Today's Tax Rates



Source: A Guide to Social Security Reform

Benefits promised to an average wage earner who retires in 2050 are a full 69% higher than the benefits that were paid to the average retiree in 2004. Republicans argue that these increases are too substantial and that the system promises a full \$5,600 more than it can *afford* to pay to retirees in 2050. To deal with this problem, “Plan 2” calls a change in the way future benefits are calculated.

If the President succeeds in redefining the formula, the “bend points” will be calculated using an inflation index instead of the current wage index. At first glance, this might seem like a relatively innocuous adjustment. After all, the historical trajectory for prices is also upward, so benefits will still tend to increase over time. But prices tend to rise more slowly than nominal wages – over the long run – so benefits would increase less rapidly under inflation-indexing.

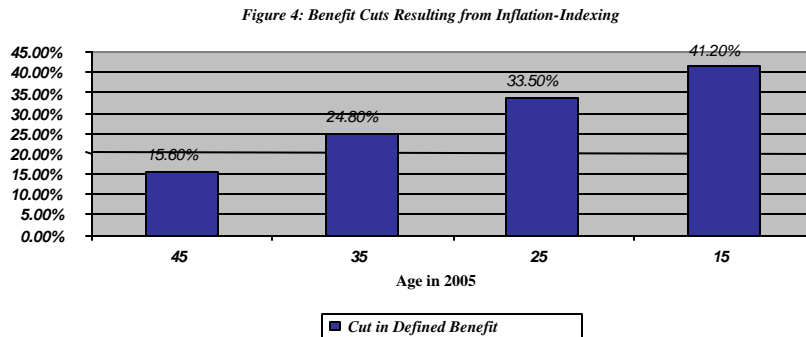
To see the full impact of switching to inflation indexing, consider the benefits that would be due to a hypothetical 20 year-old worker who enters the labor force in 2005, earns the average wage throughout her working life (roughly \$36,500) and retires at age 65 in 2050.¹⁵ Using Congressional Budget Office (CBO) projections, she would be scheduled to receive benefits of roughly \$22,000 (in today’s dollars). Thus, *under the current system*, she would receive \$459,800 in guaranteed benefits over the course of her retired life (estimated at 20.9 years).

Now consider the impact of indexing to inflation rather than nominal wage growth over this same period. During the relevant period, the CBO projects that nominal wage growth will outpace inflation by 1.2 percent (i.e. real wages will grow at 1.2 percent). With the “bend points” indexed to inflation beginning in 2009, this worker will lose 1.2 percent of her scheduled benefit in each of the 39 years (2009 to 2047) included in her benefit calculation, leaving her with only 62.8 percent of her scheduled (2050) benefit.¹⁶ This amounts to a reduction of \$8,184 in her scheduled benefit ($0.628 \cdot \$22,000$), which translates into a \$170,000 reduction over the course of her lifetime!

¹⁵ This example draws heavily on Baker and Rosnick (2005).

¹⁶ To see what might happen to your scheduled benefits, visit <http://www.cepr.net/pages/sscalculator.htm> and enter your relevant information.

Baker and Rosnick (2005) estimate the impact of inflation-indexing on other generations of workers. Figure 4 shows their staggering projections.



Source: Baker and Rosnick (2005)

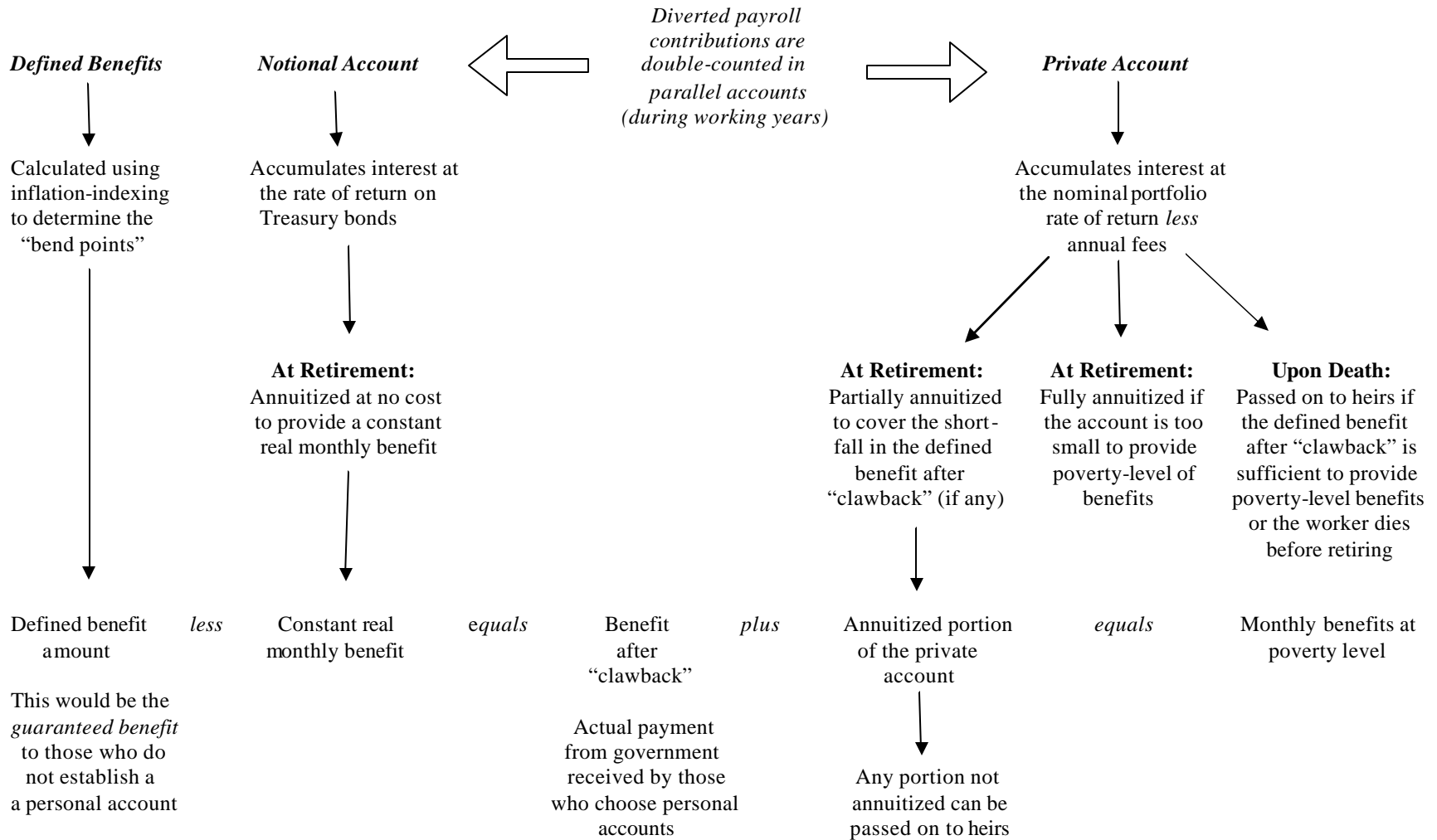
As Figure 4 reveals, inflation-indexing would sharply reduce the level of defined benefits for all future retirees. Indexing to inflation of, say, 2% instead of nominal wage growth of, say, 3.2%, means that workers must forego the 1.2% real wage growth that previously increased the “bend points” and raised their defined benefits. The longer a worker must endure increases at the (lower) inflation rate, the more severe the cuts will ultimately be. Thus, America’s youngest cohort of workers would be most adversely affected by the President’s plan to introduce inflation-indexing.

If the President succeeds in changing the way defined benefits are calculated, *all* workers will suffer a cut in future benefits. On top of these cuts, “Plan 2” gives workers the *option to further reduce* their defined benefit by diverting a portion of their payroll taxes into a personal account – a choice that *seems* to make sense for those who expect their personal account to earn a rate of return that exceeds the rate of return earned on Treasury bonds (held in the Trust Fund). But does it? Let us look more closely at the implications of diverting withholdings into personal accounts. Chart 1 shows the role of personal accounts in offsetting guaranteed benefit reductions.

When a worker agrees to establish a personal account he is effectively asking the government to lend him part of his Social Security tax so that he can invest it in the stock market.¹⁷ The government would monitor these loans and investments by establishing parallel accounts, a ‘notional account’ to keep track of the loan and a ‘personal account’ to keep track of the investment. Thus, diverted payroll contributions would be double-counted, and each account would be credited, over time, with interest – the notional account would accumulate interest at the rate of return on Treasury bonds, and the personal account would accumulate interest at the nominal portfolio rate of return, less annual fees.

¹⁷ Investing everything in a government bond fund would be fruitless, since they earn the same rate of return as the Trust Funds.

Chart 1: The Role of Private Accounts in Offsetting Benefit Reductions



To make the argument concrete, consider a highly simplified example. Suppose an individual's notional account would equal \$100,000 at retirement. If this person's life expectancy at retirement is 20 years and the annuity draws zero interest and comes at zero administrative costs (simplifying assumptions), the annuity on this account would be \$5,000. This sum – the “clawback” – would be *deducted* from the defined benefit amount, to arrive at the “benefit after clawback”. If the defined benefit (calculated using an inflation-index) would have otherwise been \$12,000 per year, it will now be \$7,000. Now, if the poverty-level of income is \$16,000, this individual's personal account will need to be sufficiently large (well above \$100,000) to allow an additional (lifetime) benefit of \$9,000 per year through annuitization.

As time goes on, the size of the clawback would grow, relative to the benefit, because the clawback would be proportional to wages, whereas the defined benefit would be fixed in real terms (i.e. indexed to prices). This would make workers increasingly dependent on the annuitized value of their personal accounts. Moreover, workers will have to pay a fee – to financial firms – to annuitize their individual accounts, a cost that could absorb as much as 10 to 20 percent of their savings (Baker and Rosnick, 2005).¹⁸

With the size of the after-clawback benefit projected to *decrease* over time, it is likely that the *whole* private account will need to be annuitized. And, unless the stock market performs incredibly well, there is a good chance that the annuitized value of the private account will be insufficient to sustain many Americans in retirement.

The groups who are most vulnerable to this kind of shortfall are women and minorities, who make up a disproportionate share of America's low-wage workers. This has been emphasized by Diana Zuckerman, president of the National Research Center for Women and Families, who argues that “[w]omen depend more on Social Security than men do, because women are less likely to have their own private pensions when they retire” (2004). And, even when they do have pensions, “their pension checks are, on average, half as large as men's are” (ibid.). Thus, our nation's low-wage workers are particularly vulnerable because they are less likely to have other forms of saving, pensions, etc., to supplement Social Security in retirement.

Democrats are particularly worried about the impact of privatization on low-income workers.¹⁹ In their view, the president's plan would shift a disproportionate share of risk onto low-income workers, who may not survive through retirement if their personal accounts lose money. Indeed, some Democrats have argued that these groups would be better off under the current system, which can only pay 73% of promised benefits, than they would be under a partially privatized system that might result in much larger cuts.

¹⁸ Under the current system, annuities are established at no cost upon retirement.

¹⁹ In 2002, more than 60 million Americans between the ages of 25 and 64 reported incomes of less than \$25,000. And, according to government statistics and polling results, many of them are already worried about how they will survive their retired years. This is not surprising, since many low income workers are unable to build up sufficient savings during their working years and tend to have small or no pensions when they retire.

In response, supporters of the Bush plan like to argue that even *pre*-2042 benefits cannot be guaranteed since the government replaced Social Security surpluses with government IOUs that are “all trust and no fund” (Rich Tucker, Heritage Foundation).²⁰ Such assertions are designed to scare workers into believing that the government has spent its hard-earned retirement money and replaced it with pieces of paper that the government may not be able to redeem when the time comes:

The idea that the problem does not start until 2042 depends on sleight of hand. For several decades, the program, in anticipation of the retirement of Baby Boomers, has collected more revenues than it pays out. The surplus has been banked in a Social Security trust fund. The liberal argument is that when payouts start to outstrip revenues, in 2018, the program can just draw on the trust fund – and it can keep drawing on it until 2042, when it is scheduled to run out. . . [But these folks] know perfectly well that the trust fund is a ledger-book entry, and will do nothing to save politicians from having to raise taxes or cut benefits to meet the promise of the old-age retirement program (*A Guide to Social Security Reform*, Articles, pp. 9 and 24).

It is true that the Trust Fund is a ledger-book entry but it is inaccurate to suggest that the Trust Fund can play no role in funding post-2018 benefits because it is full of empty promises. Against the asset known as the Social Security Trust Fund sits a liability of the U.S. government – a stockpile of non-marketable, interest-bearing government securities. The notion that the government might have trouble redeeming these securities in 2018 – when the revenue shortfall begins – is utter nonsense. The system endured cash deficits when payroll taxes were insufficient to cover benefit payments in the past, including the period from 1957 to 1964 and again from 1971 to 1983, and it can do so again simply by retiring some of the Trust Fund bonds (Sawicky, 2005, p. 11).

The government does not need outside buyers for these bonds. Indeed the bonds are non-marketable, which means that the government cannot look to private citizens, institutions or foreigners to purchase them. Only the U.S. government can buy them back, and it will do so simply by reducing both its liability – the non-marketable bond – and the balance in the Trust Fund.²¹ It would, quite literally, take an act of Congress to prevent this from happening.²²

²⁰ The president has made the same kind of argument, arguing that moving toward private accounts has the added benefit of “replacing the empty promises of government with the real assets of ownership” (Bush, 2/08/05).

²¹ Note that these are precisely the opposite entries that are made when the government increases (i.e. credits) the balance in the trust fund by issuing non-marketable debt. See Bell and Wray (2003).

²² Congress would have to vote to default on its debt in order to prevent the retirement of Trust Fund bonds in the customary fashion.

And, as David Kaiser, Professor of Strategy and Policy at the Naval War College, has emphasized, such an act would probably be unconstitutional. As he points out, Section 4 of the 14th Amendment to the US Constitution reads:

The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned (2005, p. 1).

Thus, Kaiser suggests that “[i]f the Trust Fund should ever have trouble collecting on its assets, the AARP, or some other citizens’ organization, should file suit under this provision to force the Supreme Court to reaffirm the validity of the Federal Government’s obligation to the Trust Fund” (ibid.)

In sum, the president’s plan calls for both voluntary and involuntary reductions in benefits. The former are incurred only by those who choose personal accounts, but the latter are envisioned for all as inflation-indexing replaces wage indexing in the calculation of defined benefits. Americans must understand that if “Plan 2” succeeds, they *will* suffer benefit cuts. Indeed, if the president’s plan succeeds, the guaranteed benefits of every worker under age 55 will be lower in the future – and this is true whether they opt for a personal account or not.

Transition Costs and the Explosion of Debt

The portion of current payroll taxes that gets diverted to personal accounts won’t be available to pay current retirees. As a consequence, the government recently announced that it would borrow huge sums in order to help pay for adding personal accounts to Social Security.²³ These costs – estimates range between \$1 and \$2 trillion dollars – are considered “transitional” because, as current retirees begin to die, costs decline, disappearing altogether (along with beneficiaries) over the longer term.

Both those critical of and those supportive of the president’s plan have raised concerns about the costs associated with transforming the system to include personal accounts. Critics (mainly Democrats) argue that the president's privatization scheme is fiscally irresponsible because it adds hundreds of billions to the federal deficit and, ultimately, trillions to the national debt.²⁴ Tom Davis R-VA offered a less hostile critique, suggesting that “[f]loating a bond issue of a trillion dollars is not the message you want to send to the markets right now” (Fromkin, 2004).²⁵ Finally, Alan Greenspan, who has been generally

²³ Specifically, the government would issue bonds that would be repaid 20 years later.

²⁴ Michael Tanner of the Cato Institute disagrees, arguing that while it may cost roughly \$2 trillion to cover the transition to personal accounts, the creation of these accounts “will reduce the unfunded liabilities of social Security by as much as half” (2004, p. 1).

²⁵ Davis estimates that about 10 percent of House Republicans oppose Bush’s proposal to partially privatize Social Security.

supportive of the president's plan to introduce private accounts, has admonished the White House, arguing that increased spending to finance the transition to personal accounts may put the federal budget "on an unsustainable path, in which large deficits result in rising interest rates and ever-growing interest payments that augment deficits in future years" (quoted in Hays, 2005).

Others have simply questioned the logic of selling bonds to help facilitate the purchase of stocks, noting that when the government floats bonds in order to finance the transition to a partially-privatized system, it means that investors are exchanging stocks – those being sold to individuals who will hold them as assets in their personal accounts – for newly-issued Treasury debt. This begs the question: why would investors agree to add over \$1 trillion in long-term government debt to their portfolios if the stock market is expected to outperform government bonds over the long haul? The implication, as Krugman points out, is that "politicians are smart – they know that stocks are a much better investment than bonds – while private investors are stupid, and will swap their valuable stocks for much less valuable government bonds" (Krugman, NYT, 2005).

The Short-Run Bubble Effect and Longer-Term Prospects for Stock Market Growth

While it is not difficult to envision stocks outperforming bonds over the long-haul, it is quite conceivable that stocks will generate even larger short-term gains, as tens of millions of Americans begin buying shares for their personal accounts. The prospect of a sudden surge in the demand for shares has raised concerns about the possibility of a short-term bubble in stocks prices – a consequence of too many dollars chasing too few shares.²⁶ If privatization puts upward pressure on stock prices, those who already own shares of large cap stocks and those who manage the transactions would reap significant gains, while today's youth would suffer lower rates of return, as they buy into the market in the midst of a stock-price inflation. Thus, as Kenneth Apfel, Social Security commissioner from 1997-2001 suggests, Bush's proposal calls for "a radical restructuring that's not in the interests of the young and old alike" (Apfel, 2005).

But the young need relatively high rates of return in order to compensate for the cuts they would suffer under the president's plan. And the president insists that the stock market can deliver these rates, telling Americans that "[p]ersonal accounts are a better deal," because "your money will grow, over time, at a greater rate than anything the current system can deliver" (State of the Union Address, 2005). Specifically, the White House has projected a 6.5 percent real return on private accounts. At this rate, private accounts

²⁶ The Bush administration disagrees, arguing that two percent of payrolls can be diverted to the stock market (annually) without appreciably raising stock prices. However, Michael Hudson argues that a bubble is just what Bush seeks to manufacture, one "bankrolled by the last safe pile of cash in America today" (2005). Here, the idea is that a coordinated surge in demand is needed to prevent baby boomers from suffering capital losses as they begin liquidating massive quantities of stock in retirement.

are projected to yield returns high enough to cover projected fees plus inflation, thereby raising the income and consumption of future retirees.

But, as his critics point out, retirees may actually end up with less if the stock market fails to perform the way the Administration implies that it will. For example, Paul Krugman, a vocal opponent of Bush's plan, points out that equity serves only as a *potential* source of future revenue. Equity is a claim on corporate income that provides gains when: (1) the corporation pays cash dividends or initiates stock buybacks, or (2) rising stock prices yield capital gains. Thus, Krugman notes that the Administration's projected 6.5 percent return is possible only if, in addition to the 3 percent currently coming from dividends and buybacks, inflation-adjusted stock prices increase by 3.5 percent. In the short run, Krugman admits that this is clearly possible. But the Bush plan requires these high rates of return "for at least the next 75 years" (Krugman, 2005, NYT). The problem, he points out, is that the Trustees' own assumptions about growth, inflation, etc. make this a highly dubious outcome.

If, as the Trustees project, the economy slows from its historic 75-year average growth rate of 3.4 percent to a rate of only 1.9 percent over the coming 75-year period, it will be virtually impossible for shareholders to earn an inflation-adjusted 6.5 percent rate of return in the stock market. With such low growth rates – and hence low profit growth²⁷ – cash dividends and stock buybacks will account for an increasingly small portion of the total yield on stocks. This, of course, places an ever increasing burden on the portion derived from capital gains. But this would require an increase in stock prices that outstrips profits for the next several decades, something that would push the average price-earnings (P/E) ratio to five times its current level.²⁸ Thus, based on the Trustees' predictions about the future course of U.S. growth, Krugman argues that an after-tax annual rate of return on the order of 6.5 to 7 percent "is mathematically impossible" (ibid.). He is also quick to point out the irony in this conclusion: "if the economy grows fast enough to generate a rate of return that makes privatization work, it will also yield a bonanza of payroll tax revenue that will keep the current system sound for generations to come" (ibid.).

Administrative Costs and the Windfall for Wall Street

Under the current system, less than one cent out of every dollar paid into Social Security benefits goes to pay administrative costs. In contrast, privately managed retirement accounts, like those in Chile and England, "waste 15 cents of every dollar paid out in benefits on administrative fees" (ibid.). Thus, critics maintain that the costs of

²⁷ Over the long term, profits tend to grow at the same rate as the economy.

²⁸ The price-earnings ratio, currently around 20, has a historical average of roughly 14. According to Dean Baker and David Rosnick (2004) of the Center for Economic and Policy Research, the P/E ratio would have to rise to around 70 by 2050 and top out at over 100 by 2060 in order for stock returns to hit the Administration's projected average of 6.5 through 2080.

administering more than 100 million small, private accounts “could dwarf Social Security’s administrative overhead, which currently amounts to less than 1 percent” (Dreyfuss, 1996, p. 3).

The president insists that his plan would contain these costs, estimating that only about 5 cents of every dollar paid out in benefits would go to money managers. But even if the president succeeds in limiting the fees that financial intermediaries can charge to administer personal accounts, Wall Street stands to gain \$940 billion or more (in present value terms), according to University of Chicago business school professor Austan Goolsbee.²⁹ Goolsbee’s findings fueled criticism from Democratic Presidential Candidate John F. Kerry, who claimed that the president was pushing privatization in a quid-pro-quo move designed to benefit Wall Street donors who contributed generously to his campaign – a claim that does not appear to be farfetched.

The serious push for privatization began over a decade ago, with a coalition of conservative ideologues (neo-cons) and Wall Street money managers, determined to dismantle Social Security and replace it with a system of individual retirement accounts. Around this time, the *Washington Post* predicted that “[b]y 2010, more than \$4 trillion a year could be pumped into the stock market from Social Security account plans, generating as much as \$44 billion in annual fees for Wall Street under the personal security account plans” (Fromson, 1997). State Street Bank & Trust, a little-known Boston firm, which specializes in the management of smaller accounts, was one of the many firms that wanted a piece of the action. It had its own privatization agenda, but it also began to seed “other research groups with about \$100,000 in grants – including about \$20,000 to the libertarian CATO Institute’s privatization project” (IAF, 2001). The mutual-fund industry, which was also poised to capitalize on this opportunity, began “funneling millions of dollars in seed money to think tanks, ‘grassroots’ organizations, and politicians friendly to the ideas of privatization” (Dreyfuss, 1996).

To realize their goal of privatization, these investment companies needed two things – politicians willing to promote their cause and the capitulation of the American public. In the run-up to the 1996 Presidential election, fund managers and heads of major investment banks began greasing the palms of the Democratic and Republican nominees.³⁰ And, while neither candidate adopted privatization as part of his political agenda in the mid-nineties, Wall Street brokers were not dissuaded.

²⁹ And the administrative costs don’t end at retirement. Workers who live long enough to reach retirement will be required to purchase an annuity – monthly payment that ceases only upon death. But financial firms typically take another substantial bite out of workers, charging anywhere from 10 to 20 percent of accrued savings to set up the annuity (Baker and Rosnick, 2004).

³⁰ Merrill Lynch gave a reported \$472,930 in political donations in 1996, including \$27,150 to Bill Clinton and \$36,300 to Bob Dole, while Fidelity Investments and T. Rowe Price began to openly call for Social Security reform (Dreyfuss, 1996).

In the run-up to the 2000 election, Charles Schwab, Dan Cook³¹ (Goldman Sachs) and Richard Gilder (a stockbroker) were busy “pouring money into the presidential campaign of George W. Bush” (Silverstein, 2001, p. 1). And so were scores of other brokers and money managers. In total, Wall Street shelled out \$10 million in campaign cash to the GOP (ibid.). By June 18, 2001, Treasury Secretary Paul O’Neil was on board, throwing his shoulder into Wall Street’s push for private accounts. At a luncheon high atop the World Trade Center, he served as keynote speaker, helping participants such as Citigroup Inc., Deutsche Bank AG and Morgan Stanley raise money for a \$20 million campaign to support the privatization of Social Security (IFA, 2001).

While Republicans insist that Wall Street does not stand to reap extraordinary benefits from privatization, security brokers and investment managers clearly see things differently, doling out staggering sums to politicians, conservative think-tanks and grassroots privatization campaigns, in the hopes that their dream of charging fees and commissions on nearly 100 million new accounts might one day be realized. And when the conservative *Wall Street Journal* characterizes the privatization of Social Security as potentially, “the biggest bonanza in the history of the mutual fund industry,” you can be sure there is something to the claim (Dreyfuss, 1996a).

IV. Evidence from Chile and the UK: (Big) Brother Can You Spare a Dime?

It is sometimes said that a fool learns from his mistakes, while a wise man learns from the mistakes of others. In recent years, a number of countries around the world have converted their government-sponsored retirement programs into systems that rely, in whole or in part, on private accounts. The purpose of this section is to examine some of the problems that have emerged as a consequence of privatization. Because Chile and the United Kingdom have had the most experience with privatization – each has had private accounts in place for over a decade – they will be our focus.

The Chilean Experience

Bush’s proposal is modeled on a Chilean reform program put in place almost 25 years ago under the authoritarian government of General Augusto Pinochet. The Chilean experiment ended the multi-contributor insurance program in which individuals, their employers and the government each made financial contributions toward an employee

³¹ Cook, a partner at Goldman Sachs, gave \$151,000 to Republican campaigns. He also sits on the board of the National Center for Policy Analysis in Dallas. In October 2000, the center ran a nationwide television campaign, touting the benefits of privatizing the *entire* Social Security system (Silverstein, 2001).

pension. In its place, stands an private system that requires³² workers to devote 10 percent of their salaries to private investment accounts which they control.

Twenty five years after its introduction, the first generation of Chileans to depend on the new system is beginning to retire, and, despite the relatively strong returns workers have earned on their investments, many of them are finding it impossible to survive on the money accumulated in their private accounts. The clear winners are the Chilean money managers, who charge large commissions and hidden fees for their services. Many middle-class workers, on the other hand, have found that these fees have eaten into as much as a third of their original investment (Rohter, NYT). For example, Dagoberto Saez, a 66-year old laboratory technician, who could have remained in the old system, opted to participate in Columbia's privatization scheme:

Colleagues and friends with the same pay grade who stayed in the old system, people who work right alongside me are retiring with pensions of almost \$700 a month – good until they die. I have a salary that allows me to live with dignity, and all of a sudden I am going to be plunged into poverty, all because I made the mistake of believing the promises they made to us back in 1981 (Rohter, 2005).

His experience is not unique. Inelia Pardo Acevedo, a 64-year-old retired nurse is looking for a part-time job to supplement the \$225 a month she draws under Chile's privatized system. "They fooled me," she said, angered by the fact that her colleagues who stayed in the old system get "three times as much, guaranteed for the rest of their lives" (Dickerson, 2005). Like Acevedo, hundreds of thousands of Chile's retirees and near-retirees are discovering that they would have been better off under the old system.

Even Chile's government officials have conceded that there are serious problems with the new system. For example, Ricardo Scolari, the Minister of Labor and Social Security, admits that "it is absolutely impossible to think that a system of this nature is going to resolve the income needs of Chileans when they reach old age" (quoted in Rohter, 2005). As a result, the government routinely spends billions of dollars in supplemental aid, assisting those whose incomes were not large enough to ensure some minimum security in retirement.

The British Experience

While Americans can learn from the problems that have arisen in a developing country such as Chile, it may be more instructive for them to draw lessons from a large developed country such as the United Kingdom. It is also easier to draw comparisons with the British experience because the U.K. introduced *voluntary* "personal pensions" as part of a

³² Since 1981, contributions have been mandatory for everyone entering the Chilean labor force. Those who entered the labor force *prior* to 1981 could *voluntarily* establish a private account.

partial privatization scheme. Additionally, the British government switched benefit indexing from the *higher* of inflation or wage growth to inflation only. Thus, the British framework more closely resembles the model the U.S. government is trying to put in place at home.

The British retirement system has two tiers: a first tier and a second tier. Under both tiers, benefits go to men at age 65 and to women at age 60. The first tier provides mandatory flat-rate weekly benefits (paid by the government) which are *independent of earnings*. This level of benefits was put in place in 1908 to ensure minimum (i.e. poverty level) benefits to retirees. The second tier, introduced in 1961, provides *earnings-related* benefits from *either public or private* pensions.

The introduction of this second tier marked the first phase of privatization, because it gave employers the option not to participate in the *public* portion of the second tier and, instead, establish a *private* second tier known as an “occupational pension”.³³ In 1978, the British government introduced the State Earnings-Related Pension Scheme (SERPS), which improved the second-tier *public* pension by replacing a higher percentage of contributed earnings. Thus, upon retirement, British workers would either receive (1) a small, first tier pension plus a second-tier pension through SERPS or (2) a small, first-tier pension plus an employer-sponsored occupational pension. Under either scenario, workers were protected under a defined benefit plan.

The second phase of privatization came in 1988, when the government allowed workers to voluntarily opt out of either the public SERPS or the employer-sponsored occupational pension and set up tax-deferred, individual accounts.³⁴ Those who chose to opt out of the second-tier coverage would draw only their small, first-tier pension plus whatever their personal accounts could provide when annuitized.³⁵ Thus, the U.K. system currently resembles the model envisioned by President Bush, where workers would continue to draw a portion of their benefits from Social Security but would rely more heavily on the annuitized value of their personal accounts.

If we were to measure the success of the British reform simply in terms of worker participation, we would have to conclude that the second phase of privatization was a great success.³⁶ Roughly 3.1 million people opted out of the SERPS during the first year.

³³ Thus, the second-tier was, from the very beginning, a partially privatized pension scheme.

³⁴ The legislation creating private accounts was pushed through by British Prime Minister Margaret Thatcher.

³⁵ Though still technically considered a defined contribution plan, benefit amounts would depend on the contributions paid in, together with the returns earned on the accumulated funds. Importantly, the account holder bears all of the investment risk.

³⁶ Britain’s Actuary Department forecast that private accounts would only be beneficial for the very young, who would reap the benefits of compound interest over a longer time-horizon, and for the very rich, who are not dependent upon a government pension for the

And, by the end of the fifth year, another 2.3 million people had joined them in establishing “personal pensions” (Department of Social Security, 1998, Table 26.0). But, of course, success is not so easily judged.

With the passage of time, workers have discovered many of the system’s flaws. First of all, they have come to realize the detrimental effects of inflation-indexing.³⁷ Since inflation typically increases about one-and-one-half to two percent *more slowly* than wages, workers who remain in the second tier can expect benefits that are forty to fifty percent *lower* than they otherwise would have been. Worse, opting out of the second tier hasn’t proven to be much of a safeguard.

Scandals and fraud have plagued Britain’s money managers, delivering a black eye to the very idea of privatized public pensions. In exchange for their services, financial middlemen often gouged workers, charging “not only an initial fee (including a percentage commission and a lump sum), but also an annual fee on invested funds and a monthly flat fee that is generally indexed according to price or wage increases” (Liu, 1999, p. 36). In some cases, these charges were more than 20 percent of contributions. For an estimated 30 to 40 percent of account holders, fees and commissions are so high that workers never earn enough to recover their principal (ibid.).

To reap these fees and commissions, money managers aggressively marketed their services, indiscriminately recommending personal pensions to every generation of workers. In 1992 a random sample of accounts was audited by the Securities and Investment Board. The audit, which was performed against the objections of the insurance industry, revealed that “a staggering percentage of pensions had been sold to those who would be worse off in retirement as a result” (Cohen, 2005, 3).³⁸ The findings resulted in a scandal that generated enough of a public outcry that the government was forced to act. In the end, some 1.7 million people “sought and received compensation that ultimately cost the insurance industry £12 billion. In addition, hundreds of millions were paid out in fines and penalties. It was the biggest financial scandal in the United Kingdom to date” (ibid.).

Nearly half of British retirees now qualify for additional benefits under a separate welfare program for the elderly. To avoid this fate, more than 500,000 people decided to opt back into the state plan³⁹ in 2002-03, and another 500,000 joined them in 2004.⁴⁰ Another 250,000 are expected to opt back in this year, a trend that is expected to continue into the future. There is a lesson here for Americans. As Robin Ellison, Chairman-elect of the

bulk of their retirement income – roughly 500,000 in total. Five years after personal accounts were introduced, ten times that many people had opted for them.

³⁷ When inflation indexing was implemented in 1980, it generated little political fanfare.

³⁸ Older workers, who would have fewer years to allow their contributions to accumulate compound interest, were most disadvantaged.

³⁹ The state plan, formerly SERPS, is now known as State Second Plan (S2P).

⁴⁰ Many of those opting back into the state system are doing so on the advice of private account managers, who did not want to risk further allegations of improper advising.

National Association of Pension Funds in the U.K. recently noted, “[i]t is curious that as we’re moving towards one system, the United States appears to be thinking and moving to the system we’re moving away from” (National Public Radio, Record Number: 200502171004). Perhaps failing to learn from the mistakes of others will make us the greatest fool of all.

VI. Concluding Remarks

As Americans, we used to be entitled to certain things – government-sponsored health insurance, education, and various forms of welfare protection. Increasingly, the government is telling us that we are entitled to nothing. Current and previous Administrations have weakened welfare, unemployment and after-school programs and pushed school vouchers, medical savings plans and private Social Security accounts. And, so far, there has been little resistance to many of these reforms. In particular, younger Americans seem unafraid to “go it alone,” perhaps reflecting a shift in their attitudes toward dependency, work and worthiness.

But before America’s youth throw their support behind the president’s plan, convinced of their ability to provide for themselves in their retirement, they should remind themselves that, they, like their forefathers have done the work, paid into the system and earned the right to receive the benefits they have been promised. And they should recognize that some of their security has already been sacrificed, as scores of our nation’s employers continue to replace guaranteed pensions with 401(k) plans. Acquiescing to the president’s plan would simply remove another leg of the stool, reducing their guaranteed benefits and placing their future security in the hands of indifferent market forces.⁴¹

Social security is a social insurance system, designed to guarantee a minimum income to our nation’s elderly in retirement. It was never intended to help Americans build financial wealth or create “worker capitalists.” Before they allow the prospects of large financial returns to persuade them to support a plan that may significantly undermine their future well-being, America’s youth should remember that “more than half of seniors receive a majority of their retirement income from Social Security” (Tanner, 2004, 1). If this trend persists, odds are, today’s worker will eventually depend heavily on the benefits paid by Social Security. And, if the British experience has taught us anything, it is that the costs and risks associated with private accounts far outweigh the value of the returns they are likely to generate.

⁴¹ Unlike the large brokerage houses that manage their accounts, workers can lose big when the market swings against them; the profits of the financial middlemen tend to be more buoyant, rising even when the market turns bearish. This happened in Chile in 1995, when a lull in the stock market caused workers to lose 4 percent of their investments. At the same time, the firms that managed their accounts earned profits of more than 20 percent (Dreyfuss, 1996).

But the current debate should be about more than narrow self-interest. It should be about the kind of society we want to have. Are we willing to ensure the security of America's elderly and disabled or are we content to place their fate in the hands of capricious markets? Will we sit idly by as more and more Americans slide into poverty or will we be forced to act when future retirees find it impossible to survive on the annuitized value of their personal accounts plus their reduced benefit payments? In an ideal world the answers would be obvious – Americans would reassert their commitment to our nation's largest and most successful entitlement program and just say 'no' to the president's plan.

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