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The New Oregon Option: Opting Out of Social Security

Saving Oregonians from the inevitable disintegration of Social Security

by Randall J. Pozdena, Ph.D.

In May, 1997 Oregon's Legislature approved a resolution asking Congress for a waiver system to let states opt out of Social Security and design their own retirement plans for all workers, public and private. The waiver approach was first proposed by Cascade Policy Institute in June, 1996.

Cascade Policy Institute
813 SW Alder, Suite 300
Portland, Oregon 97205
(503) 242-0900

Info@CascadePolicy.org
www.CascadePolicy.org
fax 242-3822

About the Author

Randall J. Pozdena, Ph.D. is Managing Director of ECONorthwest, an economics and finance consulting firm based in Portland, Eugene and Seattle. He is a former research officer in the Federal Reserve System, and a former professor of Economics and finance at the Graduate School of Business, University of California at Berkeley, and the Graduate school of Administration, University of California at Irvine.

Dr. Pozdena is currently a member of the Oregon Investment Council which manages the investment side of Oregon's $25 billion Public Employee Retirement System. The views expressed in this paper are his own and do not necessarily represent those of ECONorthwest, the Oregon Investment Council, or Cascade Policy Institute

About Cascade Policy Institute

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Portland, Oregon 97205
(503) 242-0900

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www.CascadePolicy.org
fax 242-3822

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Executive Summary

Like most flawed public policy, the Social Security system was set up in 1935 with the best of intentions. Unemployment and financial market failures had left many individuals destitute during the Great Depression. Social Security was intended to be a mechanism to force retirement savings. By taxing the wages of workers each year of their working life, a trust fund was to be created to provide retirement income later in life for those who contributed.

Unfortunately, the trust fund was raided a mere four years after Social Security began. In 1939, Congress decided to give benefits to retirees who had not contributed to the fund during their working years, and accelerated payment of all benefits. The Social Security System thus went from a trust fund-like system to a pay-as-you-go financing scheme in which today's retirees depend on today's workers for their retirement income. In 1997, employees and employers each pay 5.26 percent of a worker's earnings (10.52 percent total) for the retirement portion of Social Security (OASI) on incomes up to $64,500, and soon up to 85 percent of benefits will be taxable.

Changing demographics and unfunded increases in Social Security benefits were the undoing of Social Security by the 1970s. The unsound nature of the system was revealed by a slowing rate of population growth, ballooning of the number of retired individuals, and politically-motivated benefit increases. Despite higher tax rates, recent cuts in benefits, and mandated increases in retirement age, it is officially projected that the system will have payouts that exceed income in 2012, and that the accumulated assets of the system will be fully dissipated by 2029.

"Even the average worker retiring in 1996 will need 28.8 years of retirement to recoup the OASI taxes he or she paid[1], at a market rate of interest."

Implications for Oregonians

The primary lesson from the history of Social Security is that Congress should not be entrusted with the role of saving for Americans' retirement. In its zeal to lavish benefits on non-contributors, and to increase benefits without respect for the actuarial economics of the system, Congress has created liabilities that *cannot* be met without either dramatic tax increases and/or substantial benefit cuts. Even with the existing payroll tax burden for Social Security, Oregonians *cannot* expect current Social Security policy to provide them with retirement security commensurate with their contributions. Even the average worker retiring in 1996 will need 28.8 years of retirement to recoup the OASI taxes he or she paid[1], at a market rate of interest. Someone in their late thirties today will need to live 68.1 years *beyond retirement* to recoup the taxes paid to Social Security (plus market interest) over his or her working life.

High tax rates, coupled with the growing sense that Social Security will be unable to provide retirement security, create ominous disincentives in the economy. To the extent that younger workers perceive Social Security taxes as pure taxes on earnings, rather than savings, their willingness to supply their labor in the economy is reduced. This, in turn, means lower incomes, and further exacerbation of Social Security's funding problems. These adverse effects on labor supply are compounded by adverse effects on saving, and inequities across family type, age, race and ethnicity caused by the complex and arbitrary benefit structure of the system.

An Alternative: Personal Retirement Accounts

Under privatization, individuals would be required to place some minimum portion

of their wage and salary earnings in private investment accounts, which would be used to generate income for retirement. In essence, each individual would save for his or her own retirement, rather than rely on taxation of subsequent generations to finance retirement. Social Security's negative effects on labor supply may be effectively reversed as workers save privately for their retirement, and create an estate for their families, instead of losing most Social Security benefits when they die.

Privatization offers distinct advantages over a government-run, pay-as-you-go system like Social Security. First, governments have shown very little ability to manage a retirement program effectively, with problems arising in virtually every country that relies on government-run, pay-as-you-go retirement systems. There is no conceptual reason for government to operate retirement plans; rather, government should just allow private plans to flourish and regulate money managers to control risk, if necessary.

Second, a pay-as-you-go retirement system has an inherently low rate of return. Specifically, unless the system is making promises it will be unable to keep (like Social Security)[2], in the long run the rate of return on contributions cannot exceed the rate of growth of the plan's tax base. In recent years, the return has been only two percent per year, in contrast to the over seven percent return provided by the stock market over long periods.

Third, the private investment management industry is more responsive to the needs of investors than government policy makers. With privatized retirement, workers would have a greater variety of investment alternatives, better tailored to their individual and family circumstances, than is typically provided by government plans. In contrast, under Social Security, all retirees face the inflexible benefit prospects that policy makers choose.

"Beneficiaries of the opt out plan can expect retirement incomes several times that of the Social Security system for the same contribution level, despite market risk."

Lastly, privatization of retirement would have beneficial socio-political effects. Under Social Security, politicians clearly have succumbed to the temptation of earning political points with present beneficiaries at the expense of future generations. Privatization removes political profiteering as a motive for bad retirement plan design.

The First Steps for Oregon

Until recently, states, counties and municipalities were allowed to exempt their employees from Social Security. Those that did, and formed private or other public retirement systems, enjoy greater retirement security than participants in Social Security ever will. In one example, municipal workers in three Texas counties opted out of Social Security in 1981. Their private retirement plans have earned an average annual 6.5 percent return versus the mere 2.2 percent implicit rate of return they would have earned under Social Security.[3]

Trying to shore up the system, Congress banned withdrawals from Social Security in 1983. Consequently, if Oregon wishes to opt out of Social Security, it will require special congressional action to void the prohibitions of the 1983 act. However, Oregon has a track record of seeking exemption from cookie-cutter federal policy, being among the first states to ask the federal government for permission to use welfare monies for its JOBS Plus "workfare" program. Oregon also received permission to implement the Oregon Health Plan, which attempts to economize on public health care spending by limiting the proce-

dures eligible for public subsidy. Opting out of Social Security is an innovation of even greater importance that Oregon should seriously consider.

We cannot ignore the promises Social Security has made to retired and soon-to-be-retired Oregonians. In essence, the state must deal with its fair share of the transition costs from the current, pay-as-you-go system to a system of private investment accounts. *An Oregon opt out plan must recognize that, for some period of time, current workers will be required to contribute to the retirement security of others. This is true whether or not Social Security is privatized, however, and should not be an issue in deciding whether Oregon should opt out of Social Security.* However, if Oregonians set up a private replacement for Social Security, the burden of these transition costs can be smaller because of the financial advantages enjoyed by the private investment of retirement funds.

The Oregon Opt Out Plan

This opt out proposal has four basic elements, designed to create a smooth transition from reliance on Social Security to reliance on private saving in Oregon.

1. Employees working in the State of Oregon would no longer be subject to the retirement portion of Social Security taxes.

2. All workers in Oregon would be required to place the share of earnings they would have paid into Social Security (the 5.26% employee tax) into qualified private investment vehicles, of the individual workers' choosing. These will be referred to as Oregon Private Retirement Accounts, or *OPRAs*.

> "Someone in their late thirties today will need to live 68.1 years *beyond retirement* to recoup the taxes paid to Social Security (plus market interest) over his or her working life."

3. Oregon workers born after a certain date (the *Breakpoint Date*) would no longer be eligible for Social Security retirement benefits, but could anticipate private benefits far in excess of Social Security's promised benefits.[4]

4. Current Oregon retirees would continue to receive guaranteed retirement benefits equal to those they now receive, in inflation-adjusted dollars. Those not yet retired, but born before the Breakpoint Date (the *Transition Group*), would be guaranteed to receive no less than they would have received from Social Security at retirement.[5]

OPRA income could only be withdrawn in retirement. For those born after the *Breakpoint Date*, the returns on these private investment vehicles will be their exclusive source of retirement income under the Oregon Opt Out Plan. For those already retired, retirement income will be the same as under the current Social Security system. For workers born between the Breakpoint Date and the birth date associated with current retirement age at the time of the plan, prospective retirement income will be a progressively blended combination of Social Security income and private investment income.

Over time, as the worker population ages, a greater percentage of the work force will, of course, come to be born after the Breakpoint Date, and existing retirees and Transition Group members with Social Security benefit claims will die. Eventually, all Oregonians will rely exclusively on OPRA income in their retirement years. Problems of applying the plan as workers come and go from the state are not insurmountable, as long as the ratio of retirees to workers in

Oregon does not deviate significantly from current and projected trends. We envision full portability of the plan if Oregon workers move to other states.

Financial Analysis

It is possible to analyze the overall financial feasibility of Oregon opting out of Social Security using a computer model that incorporates the necessary demographic and economic assumptions of current and projected age and income distribution statistics for the state. The basic parameters of an actual Oregon opt out plan may then be articulated.[6]

The results of this analysis suggest the following:

1. Transitioning to a private retirement system is financially feasible. The transition to a private system can be financed simply by continuing, for approximately twenty years, a tax equivalent to the employer portion (5.26%) of Social Security on all workers.

2. Beneficiaries of the opt out plan can expect retirement incomes several times that of the Social Security system for the same contribution level, despite market risk.

3. Selecting the appropriate Breakpoint Date is important in determining the financial feasibility of the opt out plan. If the plan is designed so as to require relatively older individuals to opt out, the possibility arises that insufficient working years remain for those individuals to build up their OPRA balances to be able to provide a satisfactory level of retirement income. The preliminary analysis done here suggests that Breakpoint Dates as early as 1955 may be feasible, depending upon expected investment yields. A Breakpoint date of 1965 appears feasible under even pessimistic assumptions about investment yields. Thus, it may be possible to begin the plan for workers who are as old as 44 today, and certainly for workers who are 32 years old or younger.

"Early generations of beneficiaries received tremendous windfalls in benefits. Retirees in 1940, for example, only had to receive benefits for 0.5 years to get their contributions back, with interest. Compared to the 1996 generation of retirees discussed earlier, this is a 56 to 1 difference in treatment."

There are many technical issues to resolve in implementing an Oregon Opt Out Plan. More precise simulation of the plan needs to be done to refine its parameters. It is clear, however, that the longer consideration of privatization occurs, without implementation, the less secure will be the retirement future of Oregonians.

By opting out of Social Security, Oregonians can take control of their retirement future, rather than gambling on the political solutions that the federal government might choose. Concern over the problems of transitioning from Social Security to a private system should not deter Oregonians from considering privatization; Oregonians will bear transition costs whether we stay in the federal system or create our own improved version. It is likely that Oregon can manage these costs better than a federal government which has rung up a $9 trillion Social Security liability on top of a $5 trillion national debt.

Introduction

Like most flawed public policy, the Social Security system was set up in 1935 with the best of intentions. Unemployment and financial market failures had left many individuals

destitute during the Great Depression. Social Security was intended to provide a mechanism for forced saving for retirement. By taxing the wages of workers each year of their working life, a trust fund was to be created to provide retirement income later in life for those who contibuted. The initial tax rate was one percent of earnings, up to $3,000, paid both by the individual and the employer, *for the benefit of the contributing workers*.

Unfortunately, the trust fund was raided a mere four years after Social Security was begun. In 1939, Congress decided to give benefits to retirees who had not contributed to the fund during their working years, and accelerated payment of all benefits. It also decided to create Dependent Benefits, breaking further the link between contributors and beneficiaries.[7] In effect, it changed Social into a Ponsi-like scheme that counted on the next generation to fund the retirement needs of the current generation. In technical terms, the Social Security System went from a trust fund to a pay-as-you-go financing scheme.

The pay-as-you-go approach worked without great stress as the economy grew out of the Depression and war years, and population growth swelled worker ranks. The tax base of the workers' incomes were growing rapidly, making it possible to transfer Social Security tax revenues immediately to the older generation. Nonetheless, tax rates increased by 50% in 1950 (to 1.5 percent each for the employer and employee), and again to 2.0 percent each in 1954.

However, the inflation of the 1970s revealed the true weaknesses of the pay-as-you-go approach. Rampant inflation caused Congress to index benefits to the cost of living at the same time that declining fertility rates threatened to impair the ability of the future workforce to support these benefits. In effect, benefits (indexed to wage rate inflation), were growing faster than the tax base for Social Security. The Ponsi-scheme was coming unraveled.

"...since the life expectancy of poor individuals and minorities is lower than for other groups, Social Security creates unfortunate patterns of social class and ethnic inequity."

Congress' solution for this problem was not to control benefits, however, but to raise Social Security tax rates and the wage base (the maximum earnings level to which Social Security taxes are applied). By 1978, employees and employers were each paying 4.275 pcrcent on worker earnings, with further increases programmed through 1990.

It was not until 1983 that Congress began cutting benefits (in addition to increasing tax rates), first by reducing benefits to those who take early retirement (at age 62), and then by taxing part of Social Security benefits. In 1993, Congress increased the taxable portion of Social Security benefits again. Today, employees and employers each pay 5.26 percent of a worker's earnings for the retirement portion of Social Security (OASI) on incomes up to $64,500, and soon up to 85 percent of benefits will be taxable.[8]

Despite these changes, it is projected that the system will have payouts that exceed income in 2012, and that the accumulated assets of the system will be fully dissipated by 2029.[9] In non-technical terms, Social Security is projected to go broke in 32 years.

What Social Security's problems mean for Oregonians

The primary implication of the history of Social Security is that Congress should not be entrusted with the role of saving

for Americans' retirement. In its zeal to lavish benefits on non-contributors to the system, and to increase benefits without respect for the actuarial economics of the system, it has created liabilities that cannot be met. Even with the existing (some would say, exhorbitant) payroll tax burden for Social Security, Oregonians cannot expect current Social Security policy to provide them with retirement security.

Even an average worker retiring in 1996 will need 28.8 years of retirement to recoup the OASI taxes he or she paid[10], plus a market rate of interest. (Unfortunately, the post-retirement life expectancy for those retiring in 1996 is only 15.4 to 19.2 years, respectively, for men and women!) The picture is almost incomprehensibly bleaker for young workers. A worker retiring in 2025 (i.e. someone in their late thirties today), will need to live 68.1 years *beyond retirement* in order to recoup the taxes paid to Social Security (plus market interest) over his working life. And the burden on workers in 2025 will be staggering; there will be only about 2.3 workers per beneficiary at that time, compared to 5.1 workers per beneficiary in 1960.[11]

Social Security Taxes and the Willingness to Work

Social Security policy is endangering the future economic growth that is necessary for everyone's retirement security. This is happening for several reasons. First, there is growing recognition that Social Security's benefits are miniscule relative to workers' tax contributions. The direct tax burden is compounded by the fact that taxpayers pay income tax on Social Security taxes (since income taxes are paid on income gross of Social Security taxes).

> "Despite the claim that Social Security is an equalizer of retirement opportunity, analysts now believe it is a particularly raw deal for the poor."

For anyone earning additional income subject to Social Security taxes, the result of double taxation is to raise the effective marginal tax rate by about 5 percentage points. Coupled with Oregon's high marginal tax rate, even taxpayers with as little as $23,000 in taxable income can experience an effective marginal tax rate of nearly 35 percent.

The implications of such tax disincentives are ominous for the economy, to say the least. To the extent that younger workers perceive Social Security taxes as pure taxes on earnings (i.e. taxes without offsetting future benefits), their willingness to supply their labor in the economy likely will be reduced. This, in turn, means lower incomes, and further exacerbation of Social Security's funding problems.

Social Security Taxes and Private Saving Behavior

The second adverse effect of Social Security is on saving and investment behavior. Although more difficult to demonstrate empirically than the effect on individuals' willingness to work, economists believe it is no less important than Social Security's effect on labor markets. Unlike a true insurance or trust fund, the moneys collected from Social Security taxes are mostly used to pay existing beneficiaries, rather than being invested in the marketplace. During periods (like the present) when the income of the fund exceeds its immediate benefits obligations, the U.S. Treasury credits the OASI trust fund by posting additional, interest-bearing Treasury securities to the trust fund's account. In essence, the federal government uses the net inflow of funds to create new obligations to itself. There is no attempt to place the funds in private credit markets.

Although Social Securi ty collections thus are not forced "saving" that serves to fuel productive in-

vestment in the economy, they probably retard private saving. For one thing, the expectation of Social Security benefits likely reduces the incentive of private individuals to save privately for their own retirement. In addition, the sheer burden of Social Security taxes reduces the share of earnings that is available for private saving and investment, a phenomenon known as "crowding out". Harvard economist Martin Feldstein has estimated that this "crowding out" effect costs at least $300 billion per year, or about 4 percent of gross domestic product (GDP).

Inequity

Social Security not only introduces significant inefficiency into the economy, but also is patently inequitable, particularly across generations. Early generations of beneficiaries received tremendous windfalls in benefits. Retirees in 1940, for example, only had to receive benefits for 0.5 years to get their contributions back, with interest. Compared to the 1996 generation of retirees discussed earlier, this is a 56-to-1 difference in treatment. Relative to the 2025 generation, this is a staggering 136-to-1 difference in treatment.

Significant inequities also occur because, unlike private savings, Social Security benefits are not inheritable. Thus, depending upon one's life expectancy, the actual benefits received by a beneficiary can vary significantly. And since the life expectancy of poor individuals and minorities is lower than for other groups, Social Security creates unfortunate patterns of social class and ethnic inequity. Despite the claim that Social Security is an equalizer of retirement opportunity, analysts now believe it is a particularly raw deal for the poor.[12]

> "In the author's view, both government management of the system, and the pay-as-you-go approach, should be eliminated as soon as possible. Both have insidious, degenerative effects on the performance of the system, and are best replaced with privatized, actuarily sound alternatives."

Further inequities are introduced by the selective dependent and survivor benefits aspects of Social Security. Non-working spouses, for example, accrue claims to Social Security through the working spouse's accrual of pension credits. Such households receive high retirement benefits during the life of the working spouse, and entitle the surviving spouse to continuation of benefits after the death of the working spouse. The estate of a single working individual, in contrast, enjoys no benefit after the death of the worker, despite potentially making exactly the same contributions to Social Security over his lifetime.

Similarly, single, retired individuals who marry lose their individual Social Security benefits, sharing instead the single benefit of their spouse, which is lower. This encourages a surprising number of elderly couples to live together, unmarried. These benefit structures may serve some useful social purpose, but in the process inequities are created in family wealth, family and community social structure is distorted, and any pretence of the actuarial integrity of Social Security is lost.

What can be done? The privatization alternative

In the past twenty years, most Social Security reform has focussed on "saving" Social Security as a government-run, pay-as-you-go retirement scheme. It is argued that Social Security is a highly popular public policy, and that tinkering

can be done, but the basic structure of the program should be not be changed because of its popularity.

Although privatization alternatives are under consideration, it is fair to say that Congress is unlikely to deal truthfully with the American public about the condition and prospects of Social Security, and will proceed as it has done, manipulating benefits and confusing the public about the financial state of the system.

In this author's view, both government management of the system, and the pay-as-you-go approach, should be eliminated as soon as possible. Both have insidious, degenerative effects on the performance of the system, and are best replaced with privatized, actuarily sound alternatives.

Why is Government involved in the first place?

To many economists, it is ironic that a case needs to be made for privitization, given the embarassingly weak performance of government social security programs everywhere in the world. However, it must be said that, to some, government management is believed to offer some distinct advantages over privately-managed retirement schemes. First, by mandating participation ("forcing saving"), government could avoid the social dilemma of having to care for people whose private investment plans went awry. Second, through universal participation, some of the adverse selection problems that plague providers of income annuities could be resolved. And third, loosening the link between individuals' contibutions and their benefits, government could better serve its goal of progressive redistibution of income into retirement, as well as in the working years.

> "With privatized retirement, workers would have a greater variety of investment alternatives, better tailored to their individual and family circumstances, than is typically provided by government plans."

In reality, however, none of these goals requires a government-run system like the Social Security system. In fact, it is very hard to think of any compelling reason for the level of government involvement reflected in the Social Security system. Take, for example, the issue of forced saving. Although most economists agree that some forced saving is in society's interest, this could be achieved simply by requiring employee participation in private pension or investment plans. A government-run saving scheme is not necessary.

A similar line of reasoning can deal with the more subtle issue of adverse selection in private annuity markets. Many retired individuals prefer the certainty of an annuity over a lump sum distribution that must be self-annuitized. And, it also is true that individuals with the longest life expectancy are likely to self-select into annuity schemes because they will enjoy the annuity longer, in the process making it uneconomic for insurers and other to offer such plans privately. If, however, the participation in a (private) annuity scheme is mandated, the difficulties with adverse selection disappear. One does not need the Social Security system to achieve annuitized retirement income.

Finally, the issue of social progressivity also is a red herring. First, as pointed out earlier, Social Security is a horror of inequities by generation, by income class, by ethnicty, by family structure, and many other dimensions. If government is truly concerned that there would be overly-wide disparaties in retirement income without government intervention, it can use its ubiquitous income taxation powers to progressively tax retirement income. Thus, government operation of a social security system is not necessary to achieve this goal, either.

The Case for Privatization

Even if there were some logic for government operation of retirement programs, the disadvantages of public management of retirement investment assets gives the nod to privatization. First, government has a uniformly terrible track record in investment management. Countries as disparate as Sweden, Italy, and England with government-run retirement systems confront the same, looming bankruptcy.[13] Indeed, the only retirement systems in the world that are acceptably funded are private and state and local pensions in the United States, Australia, and the newly privatized Chilean social security system.

Second, a pay-as-you-go retirement system has an inherently low rate of return. Specifically, unless the system is making promises it will be unable to keep (like Social Security), the rate of return on contributions cannot exceed the rate of growth of tax base of the plan, a fact pointed out by the economist Paul Samuelson over 40 years ago. Consequently, in an economy like ours, with slow population and wage growth, the real rate of return that can be offered by a pay-as-you-go plan is only one or two percent per annum. In contrast, a plan that invests in corporate equity and debt can enjoy the greater overall return that accrues to capital in the economy. From 1925 to the present, the average real rate of return on corporate equities in the United States has exceeded seven percent. As a consequence of these higher returns, a worker can achieve a given level of retirment security with a much smaller sacrifice of current earnings.

> "In Oregon as of 1991, 10 percent of the total workforce was not covered by Social Security. (Most of these uncovered workers are in public employment, and enrolled in a public employee retirement plan."

Third, the competitive, private investment management industry is more responsive to the needs of investors. With privatized retirement, workers would have a greater variety of investment alternatives, better tailored to their individual and family circumstances, than is typically provided by government plans. In contrast, under Social Security, all retirees face the same benefit prospects; it is a plain vanilla plan that fits the retirement needs of many households very poorly. In technical terms, the expansion of investment alternatives (expansion of the *investment frontier* in economics parlance) under privatization increases retirement well-being, even if the *aveage* return to retirement contributions is unchanged. Social Security, for example, has rigid benefit structures that have the effect, among other things, of favoring families with a non-working spouse. Individuals and two-earner households, in effect, must accept an inferior benefit scheme.

Finally, privatization of retirement would have beneficial socio-political effects. Forging a tighter link between individuals' contributions and their benefits, privatization not only encourages greater work effort during the working years, but also gives workers an increased stake in the performance of the economy overall, rather than just their individual job or industry. This, in return, should discourage them from supporting political actions that imperil the good health of the economy. Under Social Security, politicians clearly have been unable to resist the temptation to earn political points with present beneficiaries at the expense of future generations of workers, especially those unborn and new workers whose interests are poorly represented in the electorate.

The case for Oregon opting out

Ideally, Social Security reform that phases out government involvement would occur at the national level, permitting all Americans to enjoy the benefits of more efficient, responsive, and less costly retirement security. Some members of the recent President's Commission on Social Security Reform advocated just that— replacement of government-run Social Security with privately-directed investment accounts to which workers contribute for their own, not others', retirement security. This plan called for the establishment of so-called Personal Social Security Account (or PSSAs). As argued above, however, the degenerative political incentives that dominate congressional thinking about Social Security reform are unlikely to result in full privatization of Social Security any time soon.

There is no reason, however, why Oregonians could not begin enjoying the benefits of reform on their own, if the federal government were to permit Oregon to opt out of Social Security.[14] The notion of opting out of Social Security is not new or radical. For most of its history, large groups of employees have been neither taxpayers to nor beneficiaries of Social Security. Initially, only 60 percent of the total workforce (workers in commerce and industry) was covered by Social Security, for example.

Until 1983, in fact, states, counties and municipalities were allowed to exempt their employees from Social Security. As a consequence, many public employees are exempt from Social Security contribution requirements in their public employment. In Oregon as of 1991, 10 percent of the total workforce was not covered by Social Security. (Most of these uncovered workers are in public employment, and enrolled in a public employee retirement plan such as OPERS. As of 1990, public workers not in an alternate public retirement system are mandated to participate in Social Security, whether new employees or not.)

> "...it will be necessary for Social Security in the near future to either reduce benefits to current retirees or raise taxes on current and future workers."

Most of these public employers set up localized pay-as-you-go, or defined benefit public pensions as the alternative to Social Security, rather than privatized alternatives. In the 1980s, however, a few counties in Texas decided to allow their employees to leave the Social Security system and set up privatized alternatives. Congress, in its zeal to keep the current system in place, passed legislation in 1983 that stopped all voluntary departures from the system, but the Texas workers lucky enough to have participated in the privatized alternative have enjoyed rates of return on their investment of 6.5 percent since 1981, versus the mere 2.2 percent implicit rate of return they would have earned under Social Security. Consequently, retiring employees of Galveston County, for example, can anticipate retirement benefits of over $5,000 per month, in contrast to the $1,000 per month that Social Security recipients with the same work experience can expect.[15]

To opt out of Social Security, the Oregon delegation in the U.S. Congress will have to prevail upon Congress to recant on its 1983 decision to block voluntary withdrawals from Social Security —a daunting, but not undoable task. Oregon has a track record of seeking exemption from cookie-cutter federal policy, being among the first states to ask the federal government for permission to use welfare monies in a "workfare" program. In addition, Oregon also got permission to implement the

Oregon Health Plan, a program that attempts to economize on public health care spending by limiting the procedures eligible for public subsidy.

The Oregon legislature also would have to hear the opponents raise the spectre of stock market crashes, sleazy investment salesmen, and other scary scenarios of privatization. Though, as is discussed below, none of these factors is an issue with a well-designed privatization program, they will be raised nonetheless out of ignorance, and by those with a vested interest in a politically-manipulable government run program.[16]

The Challenge to Opting Out: The Transition Problem

There is, however, a real economic issue that confronts any reform of Social Security, including opting out for a privatized system —namely, how to manage the transition from the pay-as-you-go Social Security system to an individual retirement scheme. Because the Social Security system essentially uses the next generation's income to fund the current generation's retirement, conversion to a system in which individuals save for their *own* retirement necessarily creates what is called the *transition problem*. Namely, for the period of one generation, either (1) current retirees have to be cut off from some or all of their benefits, (2) the current and next few generations of workers have to carry the burden of both their own retirement and that of current retirees, or (3) some combination of the two.

This *transition problem*, it should be pointed out, exists whether the remedy for Social Security is privatization or not. And it exists for Oregonians whether Oregon choses to opt out, or whether Oregonians stay in the system and bear their share of any national reform. That is, even if it were attractive for some reason to retain the current system, it will be necessary for Social Security in the near future to either reduce benefits to current retirees or raise taxes on current and future workers. The difference is that when Social Security policy reform of this kind is done, it still faces the problems of low inherent rates of return, inflexible retirement options, and continued susceptibility to political manipulation at the expense of the fiscal integrity of the system.

> "Because of the long term problems with Social Security, Oregonians are better off biting their own bullet now, rather than waiting for federal reform which will probably be more expensive, less complete, and have a less desirable long-term outcome."

Thus, the transition problem should not be a factor in Oregonians deciding whether or not to opt out of Social Security. Because of the long-term problems with Social Security, Oregonians are better off biting their own bullet now, rather than waiting for federal reform which will probably be more expensive, less complete, and have a less desirable long-term outcome. This will require that Oregonians bear their fair share of the long-term "fix" for Social Security. But by opting out today, they will more quickly enjoy the benefits of higher private market returns on their savings, the opportunity to tailor retirement plans to individual needs, and reduced political risk to retirement benefits. In the end, the net cost of the transition problem will be less for Oregonians if they take on the problem themselves.

The Oregon Opt Out Plan

What would a specific Opt Out Plan for Oregon look like? As we shall see, there are many nuances to an opt out plan that need to be developed before the plan is implemented. The basic features of the opt-out plan are simple, however.

Opting out

The opt out proposal has four basic elements, designed to create a smooth transition from reliance on Social Security to reliance on private saving in Oregon.

1. Employees working in the State of Oregon would no longer be subject to the retirement portion of Social Security taxes.[17]

2. All workers in Oregon will be required to place (at a minimum) the share of earnings they would have paid into Social Security into qualified private investment vehicles, of the individual workers' chosing. For brevity, these will be referred to as Oregon Private Retirement Accounts, or *OPRAs*.

3. Oregon workers born after a certain date (call it the *Breakpoint Date*) would no longer be eligible at all for Social Security retirement benefits, though they can expect benefits far in excess of those amounts.[18]

4. Existing retirees in the State of Oregon would be assured that they will continue to receive Social Security benefits equal to those they now receive, in inflation-adjusted dollars. Those not yet retired, but born before the Breakpoint Date (call them the *Transition Group*), also would be guaranteed to receive no less than they would have received from Social Security at retirement. This creates a transition cost that needs to be financed, equal to the difference between the guaranteed amount and the amount accrued in the workers' OPRAs. It also creates the need for a mechanism for honoring such guarantees.[19]

> "Oregon's departure from the Social Security system thus would not affect materially the overall Social Security fund balance."

The income of the OPRAs can only be withdrawn in retirement. For those born after the *Breakpoint Date*, the returns on these private investment vehicles will be their exclusive source of retirement income under the Oregon Opt-Out Plan. For those already retired, retirement income will be the same as under the current Social Security system. For workers born between the Breakpoint Date and the birthdate associated with current retirement age at the time of the Plan, prospective retirement income will be a progressively blended combination of Social Security income and private investment income.

Over time, as the worker population ages, a greater percentage of the work force will, of course, come to be born after the Breakpoint Date, and existing retirees and Transition Group members with Social Security benefit claims will die. The end result will be that all Oregonians will be relying exclusively on OPRA income in their retirement years. To be fully achieved, this will take an amount of time approximately equal to the life expectancy of those born on the Breakpoint Date.

Dealing with the transition problem

If the existing Social Security system were actuarially sound, dealing with the transition to full privatization would be trivial. Oregon could simply take custody of the portion of the Social Security trust funds dedicated to current retirees, and the accumulations-to-date for the Transition Group. It would then deposit these funds *pro rata* in the OPRA accounts of the respective individuals, and the OPRA income would yield the current retirees and the Transition Group their appropriate level of Social Security benefits. In the case of the Transition Group, their accumulations-to-date would be less than needed to fund the full Social Security benefit

level, but it would be augmented by their own contributions into their OPRA between the opt-out date and their retirement.

Unfortunately, of course, there is no true Social Security trust fund (despite the existence of a fund-balance accounting concept with the same name), and the monies necessary to create such a trust balance for Oregon workers have not yet been collected. Consequently, Congress is unlikely to allow Oregon workers to withdraw from paying Social Security taxes unless Oregon also assumes its fair share of the liability for the *pro rata* Social Security benefits of existing and soon-to-be-retired Oregonians. In essence, unless Congress were willing to underwrite an "Oregon experiment" in Social Security reform, or Oregon was willing to force current and soon-to-be retirees in Oregon to accept lower benefits, Oregon will have to devise its own plan for creating the necessary OPRA balances needed to compensate the current retired population and the Transition Group for the loss of Social Security benefits.[20]

KEY FACTORS AFFECTING TRANSITION STRATEGIES

Before presenting the details of how Oregon might deal with the transition problem, it is worth identifying the key factors that affect the transition strategy. First, the size of the transition problem depends on the size of the unfunded liabilities of the Social Security system to the Transition Group and current retireds (which, in turn, depends on the projected benefits of the current system, life expectancies, and so on). Put differently, if Oregon were to take custody of its fair portion of the Social Security "trust fund", how much more revenue would need to be collected, and invested in OPRA accounts of Oregon workers, to achieve the goals set out above? And by what means would these funds be collected?

"Opting out of Social Security means opting out of both taxes *and* benefits; hence , if a state with worker-beneficiary ratios similiar to the national ratios opts out, Social Security simply shrinks in size, with the unfunded liability per remaining beneficiary unchanged."

A second factor, related to the first, is the size of the retired and soon-to-be-retired population relative to the working population. This ratio, called the *coverage* or *worker-beneficiary ratio*, presently is about 3.2 for the nation as a whole. The higher the coverage ratio for Oregon (i.e. the fewer retirees relative to workers), the smaller is the transition problem because that many more workers still have the opportunity to begin their own saving, and the less burdensome it would be to have these workers continue to pay for the current benefit of retireds and the Transition Group. Conversely, the lower this ratio, the larger is the transition problem.

At a first order of approximation, Congress' willingness to permit Oregon to opt out will depend on the relative size of the Oregon coverage ratio and the national coverage ratio. If the Oregon coverage ratio is higher than the national one, an opt out by Oregon would eliminate Social Security tax revenues that, implicitly, can be used by the Social Security system to support non-Oregon retirees. Conversely, however, if the Oregon coverage ratio is lower than it is nationally, Oregon may be able to justify some continued greater-than-pro-rata contribution by Congress to the OPRA plan to account for the fact that Oregon has to accommodate more than its fair share of retirees.

Third, the size of the transition problem depends on the rates of return that might be expected on OPRA investments. The greater the rate of

TABLE 1:
OREGON AGE AND WAGE DISTRIBUTION, 1990

Age Group	Oregon Population	Percent of Total	Income ($m.)	Percent of Total
0- 4	212,044	7.2%	0	0.0%
5-9	220,440	7.5%	0	0.0%
10-14	215,473	7.4%	0	0.0%
15-19	194,109	6.6%	375	1.3%
20-24	180,766	6.2%	1,618	5.5%
25-29	205,622	7.0%	2,905	9.8%
30-34	240,537	8.2%	4,154	14.0%
35-39	254,710	8.7%	4,963	16.8%
40-44	227,797	7.8%	4,987	16.8%
45-49	173,596	5.9%	3,803	12.8%
50-54	135,647	4.6%	2,735	9.2%
55-59	123,697	4.2%	2,041	6.9%
60-64	127,792	4.4%	1,280	4.3%
65-69	130,847	4.5%	417	1.4%
70-74	108,651	3.7%	171	0.6%
75-79	86,206	2.9%	99	0.3%
80-84	53,557	1.8%	39	0.1%
85-89	25,895	0.9%	20	0.1%
90 and over	12,615	0.4%	5	0.0%
Total	**2,930,000**	**100.0%**	**29,612**	**100.0%**

Source: Author, from 5%, 1990 U.S. Census sample

return, the more likely it is that the Transition Group can finance its own retirement through OPRA accumulations, and demand less assistance from the next generation of workers. The rate of return is called the *OPRA Yield*.

Finally, the size of the transition financial problem depends on both the *Breakpoint Date*, and the retirement age permitted under the OPRA plan. The earlier the Breakpoint Date, the greater are the number of workers in the Transition Group and, thus, the greater the financial requirements of meeting the minimum retirement income promises to the Transition Group. Conversely, the greater the retirement age, the more opportunities the Transition Group will have to build up its OPRA accounts to satisfactory levels.

FISCAL ANALYSIS OF THE OREGON OPT OUT PLAN

Detailed statistics on the actuarial condition of the Social Security system on a state-by-state basis are not available. Nevertheless, it is possible to infer the scope of the Social Security funding problem in Oregon by examining current and projected age and income distribution statistics for the state. From this, it is then possible to speculate on what the basic parameters of an actual Oregon opt out plan would be like.

Table 1 shows the age distribution of the Oregon population as reported in the 1990 Census. Oregon has one of the nation's largest retired populations (relative to total population). As a consequence, the aged dependency ratio is 0.25 versus 0.21 for the nation as a whole. However, Oregon also has a relatively large number of young workers. As a result, the aged-dependency ratio over time is forecast to evolve toward the national figure. Indeed, the State of Oregon forecasts that

by as soon as 2003, the aged-dependency ratio will fall to 0.215, close to the national figure projected for that time.

Oregon's departure from the Social Security system thus would not affect materially the overall Social Security fund balance. Although the departure of Oregon workers from the system would affect inflows into the fund adversely, it also would remove a *pro-rata* share of the liabilities, on average, over the next 30 years.

Simulating the Oregon Opt Out Plan

Using the current and projected age distribution for Oregon, it is possible to simulate, in a rough-and-ready sense, the financial effects of privatization of Social Security in Oregon. Several additional factors must be assumed or projected, however, including the real (inflation-adjusted) growth in wages, and the per annum yield received on contributions to OPRAs. It is then possible to model the effects of various contribution rates, transition dates, and other program factors on the financial feasibility of the Oregon Opt-Out Plan.

Two characteristics of the Plan will determine its basic feasibility. First, does the Plan generate sufficient income to finance the promised retirement income for all groups? This feature is referred to here as the Plan Balance issue. If the net present value of obligations exceeds the net present value of revenue sources, the Plan Balance will be negative. Conversely, if the Plan generates more than enough revenue to finance itself, the Plan Balance will be positive.

> "Workers and their employers in the United States have been dutifully paying sufficient Social Security taxes to finance their own retirement. Unfortunately, their retirement saving was used, instead, by policy makers to buy the votes of other generations."

Second, can the Plan generate income to the first generation of non-Social Security retirees that is at least as great as what Social Security provides (in inflation-adjusted dollars)? The first generation to be entirely dependent on its OPRA earnings in retirement must have the prospect of getting retirement income at least as great as promised by Social Security, if it is to be accepted politically.

In order to examine these issues, a computer simulation model was constructed by the author that permits manipulation of a variety of Plan characteristics and economic conditions, from the present to the year 2040. In the simulations presented here, the following assumptions are employed in addition to the basic assumptions of the Oregon Opt Out Plan as described above:

1. Real wage growth is assumed to be 2.0 percent per annum over the period 1997 to 2040.

2. The revenue from the employer portion of the current Social Security tax is continued until the year 2020, and made available to finance the aforementioned guarantees to current retireds and the retirement of the Transition Group, as needed.

3. All individuals choose to retire at age 65.

Table 2 reveals several things about the opt-out plan:

1. *The opt-out plan's transition costs can be financed easily under the assumed conditions of the Plan.* This can be seen by the fact that the Plan Balance is positive under most scenarios. In particular, by continuing the employer portion of the current Security System taxes for 23 years and taking Oregon's *pro rata* share of the current Social Security

Table 2: Plan Balance and Minimum Monthly Retirement Income

Breakpoint Date	Investment Yield (in excess of inflation) 1%	2%	3%	4%	5%
	Net Plan Balance (1997 present value, $B				
1950	(3.6)	0.2	2.6	4.2	5.1
1955	(7.8)	(1.8)	2.1	4.7	6.3
1960	(6.6)	0.5	5.0	7.9	9.7
1965	(1.1)	6.1	10.5	13.1	14.5
1970	8.0	14.1	17.6	19.4	20.1
1975	19.8	24.0	25.9	26.4	26.1
1980	34.0	35.1	34.7	34.0	31.8
Minimum Monthly Benefits as Percent of Current Soc. Sec. Average					
1950	42%	47%	53%	59%	67%
1955	67%	76%	88%	101%	117%
1960	81%	94%	110%	130%	154%
1965	102%	120%	143%	172%	207%
1970	110%	131%	158%	192%	236%
1975	126%	152%	185%	227%	282%
1980	140%	171%	209%	259%	323%

Source: Author's simulations. See text for assumptions

fund balance[21], and using these funds to support the benefit guarantees of the Plan, an endowment of assets is provided to the Plan to help seed OPRA activity. Hence, by selecting the appropriate Transition Date, and investing all funds at market rates, the present value of total sources of funds under the Plan will exceed the Plan's obligations to retirees. This is the basic financial feasibility test.

2. *Expected retirement income levels equal or exceed the levels offered by Social Security.* If the Transition Date is 1960 or later, the projected earnings in retirement of the first generation of non-Social Security recipients will exceed current average Social Security benefits, in inflation-adjusted dollars.

3. *The results are relatively sensistive to the Breakpoint Date.* Not unexpectedly, pushing back the Breakpoint Date (i.e. eliminating Social Security benefits for older Oregonians) reduces both Plan solvency and the monthly benefits that can be supported by the Plan for the initial group of Plan retirees. This is not unexpected because if the Plan is designed so as to require relatively older individuals to opt out, the possibility arises that insufficient working years remain for those individuals to build up their OPRA balances to be able to provide a satisfactory level of retirement income.

4. *The results are senstive to the assumed OPRA Yield.* Monthly income increases more or less directly with the assumed yield. This, too, is not unexpected. Indeed, the main way that privatization can bail out the unfunded liabilities implicit in the Social Security system is through more rapid accretion of retirement wealth. The Social Security system can only accrete retirement wealth at the rate of growth of the wage base. The Plan

Balance is less sensitive to the assumed yield because, although yield increases, the appropriate financial discount rate for those earnings also rises. This suggests that the net financial social risk to implementing the Opt Out Plan will not be affected significantly by generally lower yields in the stock or bond markets.

Questions and Answers about the Oregon Opt Out Plan

It is clear from the fiscal analysis presented above that the Oregon Opt Out Plan is financially feasible. Feasibility would be further increased if benefits to existing retirees or Transition Group workers were reduced, or if the OPRAs performed extraordinarily well. Feasibility would be impaired by increases in life expectancy of current retirees or untimely reductions in the wage base (say, because of unemployment or a slowing rate of growth of new workers).

While it is easy to model the broad features of the Oregon Opt Out Plan, there are many issues that would need to be thought through in greater detail. In this section, a few of the likely questions that would be raised by the plan are addressed.

If every state implemented a similar plan, wouldn't Social Security go bankrupt?

No, in fact, this would be the best possible means of transitioning away from Social Security and its problems. Opting out of Social Security means opting out of both taxes *and* benefits; hence, if a state with worker-beneficiary ratios similar to the national ratios opts out, Social Security simply shrinks in size, with the unfunded liability per remaining beneficiary unchanged. The only complexity arises when a state with a substantially lower or higher worker-beneficiary ratio choses to opt out; in those cases, there is a net increase or decrease, respectively, in Social Security's ability to fund its liabilities to employees in the remaining states. It would be a simple matter to make the appropriate adjustment to the trust fund transfers at the start of the plan to account for this imbalance on a state-by-state basis.

"It is frequently argued by opponents of privatization that an advantage of the Social Security System is its low administrative costs, and the safety of its government backing. These are hardly advantages, however, if the end result is a mere 2 percent rate of return on participant contributions, and even those benefits are at risk."

What happens when Oregon residents move to other states that do not have opt out plans?

For non-working, retired Oregon residents, it is not an issue. Their benefits under the Oregon Opt Out Plan are completely portable.

What about Oregon *workers* who move to another state? One possibility is that they would again be subject to Social Security taxation, and accrue credits toward Social Security retirement benefits, in addition to their Oregon OPRA accumulations. To avoid an unfair increase in its liabilities, Social Security could chose to integrate its benefits with the OPRA income available to the retiree. Alternatively, Social Security could agree to permit former Oregon workers to continue in the Oregon OPRA, contributing at the same rate. Any transition cost assessments that Oregon might have levied could be levied in the new state and credited to Oregon.

What happens when non-Oregon residents move to Oregon?

Workers who move to the state of Oregon from Social Security states, similarly, could be treated in one of three ways. First, they could remain enrolled in Social Security, and continue to be taxed and accrue benefits under the Social Security system's rules. Alternatively, new residents of Oregon could either be given the choice, or mandated, to join the opt out program.

In the first case, there would be no impact on either Social Security system liabilities or the finances of the Oregon Opt Out plan. In the latter cases, however, the effect depends on the types of people moving to Oregon. Younger workers would be attracted by the greater retirement potential of the opt-out plan. Retired workers and Transition Group individuals would be at most indifferent to the Oregon plan (since it guarantees at least the same benefits as Social Security), but may have a slight preference if the opportunity to create an OPRA and enjoy yet higher benefits is appealing.

As long as the worker-to-beneficiary structure of the entire Oregon population trends near the average of the Social Security system as a whole, there should not be serious fiscal impacts on either Social Security or the finances of the Oregon opt out plan. It is likely that Oregon will become a somewhat more attractive place to work for younger workers, however. This will tend to strengthen the Oregon program (by providing a broader base over which to spread the transition cost burden).[22]

Isn't it risky to gamble workers' retirement income on the stock market and other market investments?

"...there have been few private investment products introduced in the economy on the scale of and as unsound as Social Security itself."

In order for OPRA accounts to generate market returns, the OPRA balances must be invested in instruments that provide market returns. Along with market returns comes a certain amount of risk. However, from the long-term perspective of a retirement account, the general market return more than compensates for the market risk exposure. Beneficiaries of the opt out plan can expect retirement incomes several times that of the Social Security system for the same contribution level, despite market risk. Also, as the Social Security system has amply demonstrated, pay-as-you-go systems are not without their own financial risks. And it is important to note that these risks are completely out of the control of the individual plan beneficiary. Workers and their employers in the United States have been dutifully paying sufficient Social Security taxes to finance their own retirement. Unfortunately, their retirement saving was used, instead, by policy makers to buy the votes of other generations. Moreover, in the case of the opt out plan, beneficiaries can chose investments that provide downside protection if they wish. Under Social Security, there are no choices.

It is true, however, that society has a hard time not coming to the rescue of its citizens in trouble. Recognizing this fact, it is probably appropriate to constrain somewhat the menu of investments permitted in the OPRA accounts, to avoid very high risk and very low yield investments.

Won't plan participants become prey to costly and even unscrupulous investment services?

It is frequently argued by opponents of privatization that an advantage of the Social Security system is its low administrative costs,[23] and the safety of its government backing. These are hardly advantages, however, if the end result is a mere 2 percent rate of return on participant contributions, and

even those benefits are at risk. Under privatization, investment in the necessary variety of market instruments may well involve somewhat higher administrative and transactions costs; in return, however, plan participants will enjoy higher returns on their contributions. Not all workers are sophisticated investors, however, and some screening and accreditation of investment products and managers may be needed to weed out unscrupulous vendors and bogus investment products. Again, however, there have been few private investment products introduced in the economy on the scale of and as unsound as Social Security itself.

What if benefits initially exceed the available revenue?

Under the opt out plan, it is likely that the cash needed to finance the promised benefits to existing retireds will initially be insufficient. That is, the revenue available from the temporary extension of the employer tax levies initially will be less than the benefit payout requirements. However, as the system matures, and income from OPRA balances begins providing some or all of the promised benefits to retirees, the available revenue will be *more* than is needed on a current cash flow basis. With proper elucidation of the actuarial behavior of the Oregon Opt Out Plan, it should be possible for the Plan to issue revenue bonds to make these funds available sooner, when they are needed.

Will benefits of the plan be adjusted if inflation suddenly increases?

No, not by formula. But account holders will find the financial marketplace capable of offering investments that provide such protection. OPRA investments can be structured to include inflation hedges, providing protection to retirees depending on their OPRA balances. In addition, to the extent that the wage base inflates, the transitional employer tax on the wage base will generate additional revenue that can be used to finance the gurantees offered the other retirees.

> "...the longer consideration of privatization occurs without implementation, the less secure will be the retirement future of Oregonians."

Can the financial markets absorb the increased demand for market investments?

Clearly this is not an issue for the Oregon plan by itself. Oregon's current total wage and salary income is approximately $29 billion per year. Even assuming that all of that income would be in the hands of OPRA holders, this means that five or so percent of that amount ($1.5 billion) would be invested in the market each year. This amount is dwarfed by the overall scale of the financial marketplace. If all states were to follow Oregon's example, the demand for marketplace investment opportunities would be significantly greater, but still small relative to the scale of the global financial marketplace.[24] The economic growth stimulated by privatizing Social Security would help create investment opportunities, as well.[25]

Has something like the Oregon Opt Out Plan ever been implemented?

The implementation in the United States has been limited to those few state and local governments who chose to opt out of Social Security when it was permitted. Chile privatized its pay-as-you-go system successfully in 1981. The demographics of the Chilean situation were somewhat better than our own,[26] so that the transition cost issues have not taken as long to resolve as would likely be the case in Oregon or other US states. The Chilean experience does confirm, however, that an entrenched system can be reformed (Chile's social security system was even older than our own), and that workers are better off taking their retirement into their own hands. It confirms

the beneficial economic effects of reform as well; the gross Chilean saving rate doubled in the first five years after privatization, to 18.6 percent.[27] Britain and Australia have embarked on limited (supplementary) privatization schemes different from that proposed here, and virtually all countries facing similar or worse demographic realities than our own are considering privatization. Most reform efforts are, like are own, frozen in a political gridlock of conflicting promises and expectations.

These and other questions, of course, deserve more extensive articulation than can be provided here. In particular, the simulation model results will benefit from refinement and the use of more detailed information on the Social Security status of individual Oregonians than is presently available to private analysts. It is clear, however, that the longer consideration of privatization occurs, without implementation, the less secure will be the retirement future of Oregonians.

Endnotes

1. Or were paid by the employer. Economic analysis clearly demonstrates that most of the employer tax is generated from reduced wages to the employee.

2. A high rate of population growth can temporarily permit high rates of return for retirees, but ultimately risks abrupt insolvency as population growth slows, resulting in fewer workers funding retirement benefits.

3. "A Widow Thanks God for Private Social Security", Guest Editorial, Stephen Glass, *Investors Business Daily* 4-17-97.

4. Indeed, it is likely that insurance companies or other investment management firms would provide guarantees of such returns.

5. This paper presents a proposal to provide benefits to all workers that are at least as great as current promised Social Security benefits, adjusted for inflation. It is, however, doubtful that Social Security will be able to pay this promised level of benefits.

6. With more data on individual workers and retirees in Oregon, the approximate analysis presented here may be refined to enable a detailed proposal suitable for federal waiver approval.

7. Even more benefits were added later. Disability insurance and hospital insurance were added in 1956 and 1965, respectively.

8. Another 2.4 percent, each, is assessed for disability and hospital insurance, with no wage base limit. This study does not discuss reform of these aspects of Social Security, though reform is sorely needed here, too.

9. Board of Trustees of the Social Security Administration, *Annual Report*, 1996.

10. Or were paid by the employer.

11. U.S. Congress, House Ways and Means Committee, *1996 Green Book*, Table 1-35.

12. Michael Tanner, "Privatizing Social Security: A Big Boost for the Poor," Cato Institute, SSP No. 4, July 26, 1996.

13. World Bank, *Averting the Old-Age Crisis*, various reports, L. J. Kotlikoff, "Privatizing Social Security at Home and Abroad," *AEA Proceedings and Papers*, Vol. 86, No. 2.

14. In May 1997, the Oregon State Legislature passed a resolution asking its representatives in the U.S. Congress to seek thispermission.

15. Stephen Glass, "A Widow Thanks God For Private Social Security," *Investor's Business Daily*, April 17, 1997.

16. In Texas, "union officials predicted that all the money [in the privatized system] would be squandered in bad investments and encouraged their members to change jobs so they wouldn't lose their retirement," according to Glass, *ibid.*

17. The issue of reform of the disability and hospital insurance portions of Social Security, though important, are a different matter and not discussed here.

18. These workers should need no formal guarantee that they will do better than Social Security, since the private investment returns over their long, remaining working life will dwarf anything that Social Security currently offers, in inflation adjusted terms. But because of this, it would be inexpensive for someone (most desirably financial management firms in the private market), to make such guarantees in return for the opportunity to manage workers' OPRA balances.

19. Precisely who offers this guarantee is a detail for plan implementation. It could be the State, although that may create, at a state level, the same political temptations that have destroyed Social Security at the federal level. It is preferable, and likely, that private sector money managers would be willing to make such guarantees if they were given the authority to manage individuals' OPRA contributions and transition revenues. The important point is that, with proper financing and market investment of employee and employer contributions, it will be economically feasible for such guarantees to be offered. Precisely who offers the guarantee is a financial engineering issue of no consequence to the discussion of feasibility.

20. Alternatively, Oregon could declare that it was opting out of Social Security for workers born at some time sufficiently distant in the future that the net fiscal impact on the Social Security system (i.e. benefit liabilities minus expected taxes on earnings) would be small.

21. That balance is approximately $615 billion, of which Oregon's share would be $6 to $10 billion, depending upon the method of apportionment.

22. From the standpoint of the Social Security program, this may constitute adverse selection to some degree, depending upon whether the loss of those young workers from Social Security roles results in a net gain or loss in the present value of the liabilities of the system.

23. Peter A. Diamond, "Proposals to Restructure Social Security,"*Journal of Economic Perspectives* , Vol 10 No 3.

24. William B. Conerly, "Get Ready for Social Security Reform", *The Business Journal,* Portland, May 23, 1997 p. 59.

25. There is a technical debate among economists whether additional investment in equity simply represents a rearrangement of the claims on a fixed quantity of capital income. (See for example, R.P. Mariger, "Social Security Privatization: What it Can and Cannot Accomplish," *finance and Economics Discussion Series,* No. Z.11, Federal Reserve Board of Governors, 1997.) Implicit in rearranging ownership of these claims, however, is the very real possibility that disincentives to work will be reduced, and that corporate governance would improve by engaging private interest in the performance of the business sector. Both of these effects would increase capital income. However, even if privatization only rearranged capital income claims from the government to private individuals, and from one generation to another, there are many who believe that the elimination of the political moral hazard that would result would yield more appropriately-structured, and less politicized, retirement scheme.

26. Chile had nearly twice the number of workers per retiree that the United States had at the time. In addition, Chile had a budget surplus to help finance transition costs without continuing burdens on existing workers.

27. S. J. Schieber and J. B. Shoven, "Social Security Reform: Around the World in 80 Ways," *AEA Papers and Proceedings*, Vol. 86, No. 2.