Funding Social Security
A Strategic Alternative

Funding Social Security contributes to the debate on Social Security reform that is taking place in many countries around the world. This book describes and explains “funded Social Security,” a middle position between pay-as-you-go (PAYGO) Social Security and privatized Social Security. Funded Social Security has two distinct components: fund accumulation and portfolio diversification. Funded Social Security uses a mix of payroll taxes and portfolio investment income to finance benefits; the federal government contracts with private investment firms to manage the portfolio of the Social Security trust fund. Like the current U.S. system, funded Social Security is a defined-benefit plan without any individual defined-contribution accounts, so that all risk is pooled; each retiree’s benefit (an inflation-adjusted annuity) is linked by a legislated formula to that retiree’s own wage history. Funded Social Security differs solely, but crucially, in the financing of the system.

Funding Social Security
A Strategic Alternative

LAURENCE S. SEIDMAN
For Jesse and Suzanna
Contents

Acknowledgments xi

1 Funding Social Security: An Introduction 1
   Funding Social Security versus Alternative Fundamental Reforms 10
   The Objective of This Book 16

2 Funded versus PAYGO Social Security 19
   A Defined-Benefit Annuity Plan with Inflation Protection and Partial Redistribution 21
   The Yield on Social Security Saving 25
   Feldstein’s 1975 Article 26
   Feldstein’s 1996 Article 29
   The Case for Raising the National Saving Rate 31
   The Case for Raising the Yield on Social Security Saving 33
   Fund Accumulation versus Portfolio Diversification 34
   The Yield on Stocks, Bonds, and Corporate Capital over the Long Run 37
   Caution Concerning the Stock Market 43
## Contents

- Funded Social Security and the Financing Mix 44
- The Importance of Excluding Social Security from Official Budget Reports 45
- The Feasibility of Managing a Social Security Portfolio 48
- Protecting the Social Security Fund from a Raid 55
- The Transition 57
- Criticisms of Funded Social Security by PAYGO Advocates 64
- Appendix 2A: The Yield on PAYGO Social Security 67
- Appendix 2B: An Example of Funded versus PAYGO Social Security 69
- Appendix 2C: Social Security in a Two-Period Life-Cycle Growth Model 73

### 3 Funded versus Privatized Social Security 83

- Ferrara's Case for Privatization 85
- Feldstein’s 1998 Article 89
- The PSA Plan of Five Members of the Advisory Council on Social Security 92
- Criticisms of the PSA Plan 93
- The Problem of Voluntary Annuities 95
- The Risk for Elderly Widows 96
- The Kotlikoff–Sachs Privatization Plan 97
- The PSA Advocates’ Opposition to Funded Social Security 99
- The World Bank Report 103
- Would Privatization Eventually Lead to the Termination of Social Security? 108
- Distortion of Labor Supply 109
Contents

Can Workers Manage Their Own Individual Accounts? 112
Nine Basic Principles for Social Security 117

4 Funded versus PAYGO Social Security with Individual Accounts 123
   Publicly Held Individual Accounts 125
   Criticisms of the Individual Accounts Plan 131
   Recent Proposals for Supplemental Individual Accounts 138
   Would Supplemental Individual Accounts Lead to Privatization? 145

5 Funded versus Means-Tested Social Security 147
   The Case for Means Testing Social Security 149
   The Case against Means Testing Social Security 152

6 Questions and Answers 159

References 179

Index 185
Acknowledgments

I am indebted to the many authors of the articles, books, and reports that are cited or quoted in this book, as well as to the reviewers and editor for their constructive suggestions.