

Why Privatizing Social Security Would Hurt Women:

*A Response to the Cato Institute's
Proposal for Individual Accounts*

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Introduction

Social Security reform is a women's issue. Women make up 60 percent of Social Security beneficiaries, and they depend more heavily on Social Security than men do for their income in retirement. Half of the women aged 65 and older would be poor if not for Social Security. For 25 percent of elderly women who live alone,

Social Security is their *only* source of income. (For an explanation of the benefits for women under the current Social Security system, see Table 1.)

Whether Congress should "reform" Social Security into a system of personal retirement accounts or strengthen it in its current form has

Table 1: Current Social Security System's Retirement Benefits

- ◆ The current Social Security system is a pay-as-you-go system, meaning that current payroll taxes are used to pay benefits to current retirees. In 1983, Congress introduced an element of pre-funding by adopting an increase in payroll taxes that meant that Social Security would take in more tax revenue than it paid out, with the surplus dedicated to supplementing tax revenue when the baby boomers begin to retire.
- ◆ Social Security benefits are based on the 35 years of highest taxable earnings. The benefit formula is a progressive calculation that replaces a higher percentage of earnings for low income workers than for high earners. Benefits are adjusted annually to account for inflation and are paid as long as the recipient lives.
- ◆ Currently, the retirement age for full benefits is 65, and the earliest age at which one is eligible for benefits is 62. Early retirement results in reduced benefits. The eligibility age for full Social Security benefits has been revised from 65 to 67 years of age, to be phased in by the year 2022.
- ◆ Under the current system, a married person is eligible for the larger of either 100 percent of his or her own retired worker benefit or 50 percent of his or her spouse's retired worker benefit. A woman whose benefit based on her own work record is less than or equal to the spousal benefit she could claim is said to be "dually entitled" and does not gain additional benefit from having worked. Men are similarly entitled to benefits from their wives' accounts, but in practice nearly all who use the spouse's benefit are women.
- ◆ Widow(er)s are entitled to 100 percent of the deceased spouse's retired worker benefit, if it is larger than his or her own retired worker benefit.
- ◆ A divorced person who was married for at least 10 years, who is not married at 62 and whose former spouse is still living, is entitled to spousal benefits equal to 50 percent of the former spouse's retired worker benefit (if it is greater than 100 percent of her or his own retired worker benefit). Divorced persons married at least 10 years are also entitled to survivor benefits when the former spouse dies, at the 100 percent rate that applies to widow(er)s.
- ◆ Social Security also provides disability and life insurance to all covered workers.

particular importance to women. Both advocates for and against privatization claim their proposals benefit women. Among privatizers, the Cato Institute has been particularly vocal in courting women's support. Although their early proposals to privatize Social Security did not mention women's issues (Ferrera 1997), more recently, the Cato Institute has circulated a privatization proposal aimed at convincing women that they would be better off with a fully privatized system (Olsen 1998a; Olsen 1998b; Shirley and Spiegler 1998). In a 1998 memorandum to the Institute for Women's Policy Research, the Cato Institute claimed that its proposals meet the National Council of Women's Organizations' (NCWO) "check list" for Social Security reform and hence deserve

NCWO's support (Olsen 1998c).

This report refutes this claim. It begins with a description of the Cato Institute's proposals. Next, shortcomings in their arguments are discussed with particular attention to the most potentially beneficial features of their plans, such as earnings sharing and minimum benefits. Important omissions, such as the cost of the transition from a "pay as you go" system to a pre-paid program and the costs of administering individual accounts, are highlighted (see Table 2). Table 3 responds to the Cato Institute's claims regarding the NCWO's principles for Social Security reform. The report concludes that privatizing Social Security would hurt women and their families.

The Cato Institute's Proposal

At the heart of the Cato Institute's proposal for privatizing Social Security is the establishment of personal Social Security accounts, invested in the stock market by individuals.¹ Because the stock market has historically generated higher rates of return than government bonds (the only assets now held by the Social Security Trust Fund), the Cato Institute reasons, benefits based on these individual retirement accounts would be larger than benefits provided by Social Security. Unlike "carve out" plans, in which part of the payroll tax would be devoted to individual accounts with the balance retained to provide scaled-back guaranteed benefits, the Cato Institute's proposal would phase out the current system of guaranteed benefits entirely and (eventually) devote the entire payroll tax to personal accounts.² Starting with the current payroll tax of 12.4 percent on earnings (6.2 percentage points each by employer and employee), 10 percentage points would be paid into private accounts instead of Social Security with the remaining 2.4 percentage points used to (partially) offset transition costs. In the reports by Shirley and Spiegler (1998) and Olsen (1998a), 7 percentage points of the payroll tax would be dedicated to the individual accounts, with the remaining 5.4 percentage points used to offset new administrative and transition costs as well as to replace the disability and life insurance provided currently by Social Security. Additional sources of revenue to pay for all of these costs include: (1) government borrowing; (2) increased tax revenues from new investments in the stock market (expected due to increased economic growth and profits); (3) cuts in other government spending; and (4) phasing in reduced Social Security benefits. After four or five decades, these additional sources of revenue would presumably no longer be needed, as all workers would have individual accounts. Individuals would receive retirement benefits either by withdrawing funds regularly

from their individual accounts or by using their account balances to purchase annuities in the private market.

The Cato Institute argues that disability and survivor insurance, equivalent in coverage to Social Security, could be purchased in the private market. Ferrara's proposal does not make any allowance for purchasing insurance; however, Shirley and Spiegler (1998) concede that some portion of the payroll tax revenue will be needed for this purpose. Shirley and Spiegler allocate 7 percent of payroll for individual accounts, allocating 5.4 percent of payroll for purchasing disability coverage and life insurance and protecting against market risks (Shirley and Spiegler 1998). As will be discussed below, it is important to note that neither report fully accounts for all of the costs associated with implementing a system of individual accounts.

The Cato Institute argues that individual accounts are particularly valuable to working women because accounts could be "shared" between husbands and wives (Olsen 1998a; Olsen 1998b). In an earnings sharing system, the Social Security Administration would combine the annual earnings of husbands and wives and credit each individual with one-half of the couple's earned credits.³ The advantage of earnings sharing is that inequities between one-earner and two-earner couples are eliminated.⁴ In an earnings sharing system, since no one would receive a spousal benefit (presently equal to 50 percent of the higher earner's benefit), one-earner families and two-earner families would get the same "return" on their payroll taxes. In the event of divorce, Social Security credits could be divided like other commonly held property.

Finally, in some reports, the Cato Institute states that a safety net is needed for those whose accounts do not contain some minimum amount at the time of retirement. In some versions, the

safety net would not be less than the amount the person would receive under the current system (Genetski 1999; Olsen 1998a; Olsen 1998b; Ferrara 1997). For future retirees, this presumably means not less than the amount they would receive after the downward revision in benefits (proposed by the Cato Institute) for those who opt to stay with the current system. In the reports focusing on women's interests (Olsen 1998b; Olsen 1998c), a minimum benefit is proposed that would raise everyone above the poverty line (which would be an increase in benefits for approximately 13 percent of retired

women, the proportion currently poor). In one version, the Cato Institute claims that investing 5 percentage points of the current 12.4 percentage points of payroll tax allows for a guaranteed minimum equal to two-thirds of the poverty line, although in other contexts, the 5 percentage points are dedicated to other costs such as replacing disability and life insurance and new administrative costs associated with individual accounts (Olsen 1998a; Shirley and Spiegler 1998). The Cato Institute makes no attempt to provide detailed information on the costs of providing minimum benefits set at current levels.

The Argument Against Privatization

While the Cato Institute's proposals may seem appealing at first glance, serious analysis reveals fundamental flaws. This section begins with an analysis of the most appealing aspects of the Cato Institute's plans (earnings sharing and minimum benefits). Next, flaws in the Cato Institute's approach (or lack thereof) to expected rates of return from the stock market, administrative costs, transition costs, and disability and life insurance are discussed. The final section explains why the Cato Institute's proposal does not meet the principles for Social Security reform established by the National Council of Women's Organization and should not be supported by women's organizations.

Earnings Sharing

Earnings sharing is essential to the Cato Institute's proposal if it is to be at all appealing to women. Since women typically earn less than men, their own individual accounts would often be inadequate unless they can benefit from their husband's earnings. As mentioned earlier, in a Social Security system using earnings sharing, the annual earnings of the husband and the wife would be combined by the Social Security Administration, and each individual would be credited with half of this total for his or her Social Security amount. An individual's benefits would be based on his or her earnings when single, and half of the combined earnings during marriage.

Earnings sharing is not a new idea. Women's organizations have been interested in earnings sharing as a way of solving the one earner/two earner problem since the early 1970s. However, while earnings sharing would indeed eliminate this problem, the solution does not automatically mean higher benefits for the majority of women. Studies by the U.S. General Accounting Office (1996) and Technical

Committee on Earnings Sharing (Fierst and Campbell 1988) found that earnings sharing would result in lower benefits for many women. While homemakers would gain half of their husband's earnings in their own account, they would lose access to the spousal benefit (50 percent of their husband's benefits) that currently exists. Also, if both spouses have low earnings, the current Social Security formula now rewards them with higher benefits; when benefits are determined only by the level of their own contributions, low income workers would lose the benefits of the progressive formula which could easily outweigh advantages attributable to earnings sharing. Because earnings sharing could have a detrimental effect on many low income women, NCWO's Social Security Task Force is exploring other ways to improve equity within Social Security (see Hartmann and Hill, forthcoming).

Another impediment to earnings sharing is the administrative cost of gathering and continually updating information on each employee's marital status. If the employer were required to transfer funds to the private account manager of each employee and each employee's spouse, the burden on employers would be considerable. Earnings sharing, if desirable, would be much less expensive to administer under the current system in which all funds are managed collectively and records of who was married to whom are needed only at the time of retirement. In a new paper on administrative costs, the Cato Institute admits that earnings sharing would be "complex" (and presumably costly) and proposes as a substitute "joint ownership" of each spouse's account (Genetski 1999). In the case of "joint ownership" the couple's account would only be split in the event of divorce and would be inherited by the surviving partner in the event of death. Overall, while the goal of improving equity among different kinds of households is

admirable, the Cato Institute's approach could leave many women worse off than under the current system.

Providing a Safety Net

Most of the Cato Institute's proposals mention a safety net, but do not specify what level of retirement benefits would remain guaranteed. In some papers, the Cato Institute promises to meet the level of benefit the individual would have received under the present Social Security system. In other papers, the Cato Institute suggests that a safety net at the poverty line could be provided (Olsen 1998b; Olsen 1998c). Theoretically, a minimum benefit at the poverty level could be mandated under either Social Security or Supplemental Security Income (SSI), but neither program currently guarantees this much. In 1997, the special minimum Social Security benefit was \$560 per month for workers with 30 or more years of earnings (approximately 85 percent of the poverty line for a single individual). For workers who have less than 30 years of coverage, the special benefit gradually decreases and phases out at 10 years. SSI's maximum benefit for a single individual is even less (about 75 percent of the poverty line) and is subject to means and asset tests (Social Security Administration 1998: 49, 92, 152). Whether such a generous safety net *would* be provided is open to question, especially since the Cato Institute provides no cost estimates for their more generous proposals or explanations of how the costs would be covered. While women's organizations certainly support raising minimum benefit levels, it seems unlikely that Congress would suddenly pass such an expensive improvement. Without further specification of how a generous minimum benefit would be paid for, the Cato Institute's promise is an empty one.

Return on Investment

The Cato Institute calculates benefits from diverting 7 percentage points of the payroll tax from Social Security into individual accounts

and applying a 6.2 rate of return on these investments. The Cato Institute compares these returns to Social Security benefits (that blend the returns of a "pay as you go system" that are approximately 1 percent and the return on government securities that are projected to average 2.8 percent) and, of course, finds that returns from individual accounts are higher (Aaron and Reischauer 1998: 46). This comparison is erroneous for three central reasons: an overly optimistic view of returns from the stock market, particularly for low income families that cannot afford to make risky investments, the failure to account for the transition from a "pay as you go" system to a pre-funded system, the failure to account for administrative costs, and the failure to account for the cost of replacing the disability and life insurance currently provided by Social Security.

At the core of the Cato Institute proposals is the assumption that the historically high rate of return of the stock market will continue indefinitely. However, as MIT economist Peter Diamond (1999:3) argues, "a constant 7.0 percent stock return is not consistent with the value of today's stock market and projected slow economic growth." The future value of stocks is notoriously difficult to predict. In fact, the stock market may well be at a peak, and many stocks may be overvalued. Given the slower future economic growth predicted by many experts (including the Social Security Trustees), and the high current valuations of many stocks, it is difficult to see how future rates of return could continue to be so high. Several experts suggest that a 3 to 4 percent per year rate of growth is more likely (Baker and Weisbrot 1999; Diamond 1999; Rappaport 1999).

Ironically, the Cato Institute's contention that high rates of return from the stock market will continue indefinitely is at odds with its argument that there is a crisis in Social Security that demands dramatic measures such as instituting individual accounts. Unless wages fall rapidly (which no one is predicting), future growth in stock values depends on a strongly growing economy. Of course, if the economy continues to perform well, it is likely that wages and hence revenue from payroll taxes will show

strong growth rates and there would not be no solvency problem for the current system, either in the short- or long-term.

Finally, to the extent that equities represent a better investment, workers could benefit from them with less risk and much lower administrative costs if the investments were made collectively (Munnell and Balduzzi 1998; Aaron and Reischauer 1998). The government could accumulate reserve funds in the Social Security trust funds and invest part of these reserves in private stocks and bonds. A "Social Security Reserve Board" modeled on the Federal Reserve Board, first proposed by Robert Ball, former commissioner of the Social Security Administration, could oversee investments (see Aaron and Reischauer 1998: 136-139). While critics, including Alan Greenspan, argue that trust fund investments are a first step toward socialism, there is no evidence that such investments would unduly influence the equities market. For example, recent research by Munnell and

Sunden (1999) found that political considerations have had almost no effect on the investment decisions at the state and local level.

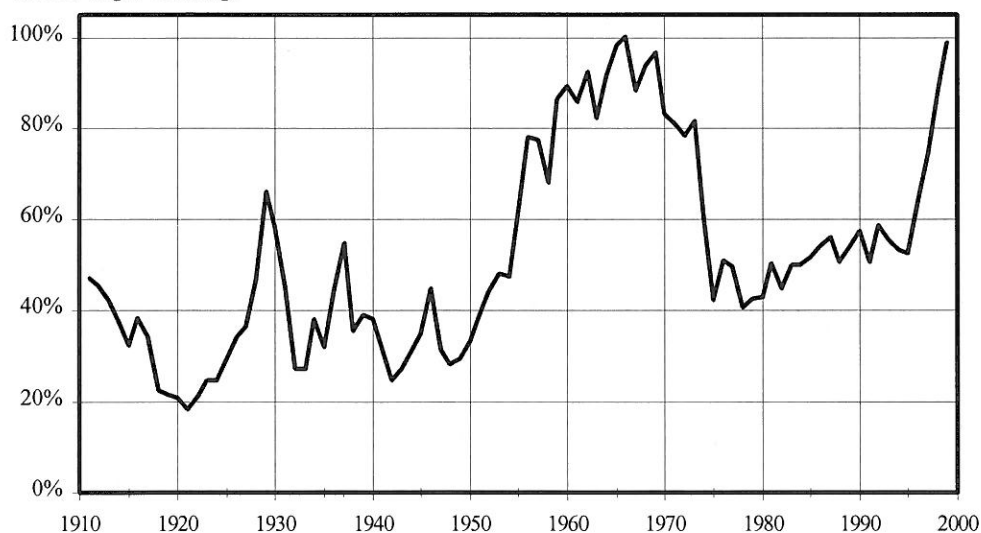
The Cato Institute's use of a single average rate of return is misleading. While experts disagree on what future rate of return to expect, investment returns will certainly vary from year to year and between individuals. While some investors may do well, particularly those with the knowledge and capital to make risky investments, others will do much worse (see Figure 1).

Analysis of the swings that would have occurred in benefits had private accounts been in effect over the past 85 years shows tremendous variability in replacement rates (the amount of earnings replaced by retirement benefits). For example, as Figure 1 shows, a worker who retired between 1975 and 1980 (and withdrew their savings or purchased an annuity) would have achieved less than half of the benefits of a worker who retired between 1965

and 1970. Workers retiring during a stock market slump would have received small pensions that replaced only 20 percent of their earnings, while those retiring in peak years would have had pensions that completely replaced earnings (Aaron and Reischauer 1998: 5). The authors caution that replacement rates would actually be considerably lower than those shown because they did not take into account the administrative costs of fund management or the conversion of the

Figure 1: Replacement Rates of Workers with Forty-Year Careers Who Invest in U.S. Stock Market and Retire over Period 1911-1999

Pension as percent of career-high earnings



Source: Gary Burtless, "Social Security Privatization and Financial Market Risk: Lessons from U.S. Financial History," Center on Social and Economic Dynamics Working Paper No. 10 (Washington, DC: The Brookings Institution, 2000), Figure 3.

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investment fund into an annuity. In addition, those people unfortunate enough to retire during one of the stock market slumps, which have often been prolonged, would probably find other sources of investment income (such as pensions) reduced as well.

Most Americans have limited experience with managing investments (Aaron and Reischauer 1998:76). Unless financial institutions are authorized and closely regulated, some companies can be expected to use misleading advertisements. For low earners, who have less to invest and are less able to take risks, attaining average rates of return is unlikely.

Transition From a Pay-As-You-Go to a Pre-Funded Program

Privatization proposals all face a difficult obstacle: they must plan for what is likely to be a costly transition period lasting 40 – 70 years. About 90 percent of current payroll taxes are used to pay current retirees, disabled workers, and survivors. As Reischauer (1998) points out, this practice dates back to the founding of the program in the 1930s when Congress decided to provide relatively generous benefits to those who paid payroll taxes for only part of their careers. While this decision helped bring millions of older households out of poverty, it also meant that workers were not saving for their own retirement, since they were paying for current retirees. In essence, if pre-funded individual accounts were to be adopted, the generation(s) living through the transition would have to pay for two systems at once, both the retirement for their parents and grandparents and their own retirement. Any serious plan must explain how to pay current recipients and those who will become eligible before the private system matures, if part or all of the payroll tax is diverted into private accounts.

The Cato Institute recommends different combinations of revenue sources, including: increases in the payroll tax or in other taxes; increases in government borrowing; cuts in other government spending; and phasing in

reduced Social Security benefits. Women should be especially wary of proposals that fund the transition (in part) by reducing other government spending. Past experience shows that benefits to the poor are among the most tempting targets for spending cuts. Even if the safety net for the elderly poor were retained, would this be at the expense of cuts to domestic programs (health, child care, housing, education) that are important to other women? This may well be a case of robbing Jill to pay Jane.

Any comparison of benefits under individual accounts with benefits under Social Security, such as those shown in Table 2 (below), essentially compares apples and oranges – an individual account system that ignores huge transition costs that are necessary to implement the new system and an on-going Social Security system that generates no transition costs. A recent report by Mueller (1999), undertaken in cooperation with the Employee Benefit Research Institute (EBRI), concludes that “for everyone now alive, both average benefits and rates of return are much higher under even a scaled-back Social Security system than could be had from a partly or fully privatized retirement system.” Even some conservatives who favor privatization in principle recognize that it will *not* provide higher benefits when transition costs are taken into account (Geanakoplos, Mitchell, and Zeldes 1998).

Administrative Costs

The failure to fully account for the cost of administering individual accounts is another fundamental flaw in the Cato Institute’s proposals. Despite the popular misconception that government programs are always less efficient than the private sector, Social Security has impressively low administrative costs. Even the Cato Institute admits that, “in several important respects, the present Social Security Administration does a highly efficient job in administering the retirement program” (Genetski 1999:3). It is important to understand that even small increases in management costs that are assessed monthly or annually can result in a large loss of

value over one's lifetime. For example, if the costs of operating a system of individual accounts would be one percent annually (a conservative estimate of the administrative costs of a 401(k) plan), these costs would consume approximately 20 percent of funds in personal accounts over the 40 year career, much more than is currently spent on administration.⁵

Evidence from other countries that have experimented with privatizing Social Security confirms that administrative costs are much higher for individual accounts than for traditional defined benefit style programs (see Congressional Budget Office 1999; Diamond 1998). For example, in Chile, 30 percent of payroll tax goes to pay for administrative costs as well as disability and survivor insurance (Kritzer 1996). In a study of administrative costs for the government funded individual accounts in the United Kingdom, Orzag (1999) found even higher administrative and management costs.⁶

There is a real question regarding the capacity of the private sector to handle what would be the largest undertaking in the history of the U.S. financial services industry (Olsen and Salisbury 1999). Twice as many workers are covered by Social Security as the number of individuals in the United States who own shares in mutual funds (Investment Company Institute, cited in Olsen and Salisbury 1999). Furthermore, as the nonpartisan Employee Benefit Research Institute (EBRI) points out, a Social Security system based on individual accounts is likely to be more expensive than the current costs of private individual retirement plans because Social Security covers workers and businesses that are disproportionately not covered by employment-based plans, such as part-time, migrant and short-term workers (EBRI 1998). As these workers will tend to have smaller accounts, administrative costs will therefore absorb a greater percentage of total value. While financial firms are no doubt eager to take up the accounts of middle and upper income families, will there be takers for the 31 million private accounts for low-income people who would be contributing \$100 or less a year (Quinn 1998)? The Cato Institute's failure to adequately document administrative costs for a

proposal that is at its core a change in financial administration is seriously misleading.

Disability and Life Insurance Coverage

The Cato Institute also fails to account for the full cost of disability and life insurance as well as the variation in these costs for people of different health risks and occupations. Social Security provides life and disability insurance to workers and their families that cannot be easily replicated in the private market. For example, for a married worker of average earnings history with two children, Social Security provisions are equivalent to about \$300,000 in life insurance and \$200,000 in disability insurance (Social Security Administration 1998). This insurance is provided to all workers regardless of age, occupation, or pre-existing health conditions.

The Cato Institute argues that individuals can purchase disability and life insurance from private insurance firms. However, evidence from other countries' experiments with privatization suggests that insurance similar to Social Security would be costly. For example, in the Chilean system, which requires purchase of these benefits, 30 percent of the payroll tax goes to pay for disability and survivor benefits and administrative costs, leaving only 70 percent to go into the private investment accounts (Kritzer 1996). A study by the U.S. General Accounting Office (1999) of three Texas counties with private plans for government workers reached a similar conclusion.

The Cato Institute's proposals also do not recognize the enhanced retirement benefits that Social Security provides for the disabled. For example, if the disabled person reaches retirement age, her or his retirement benefit is calculated based on earnings *at the time the disability began* and thus is not averaged over the usual 35 years of highest earnings; this calculation also applies to the survivor or dependent benefits for the spouse and children of the disabled worker. Social Security also provides benefits to dependent children and spouses caring for children

under 16 if the worker is retired, becomes disabled, or dies. Women represent 98 percent of the spouses or survivors receiving these benefits. It is unlikely that companies would be willing to offer such extensive coverage at affordable prices. For people with pre-existing conditions, private insurance may not be available at any price.

The Cato Institute also fails to account for the cost of purchasing an inflation-adjusted annuity comparable to Social Security benefits. At present, a private annuity would cost 10-20 percent of savings *without* inflation adjustment, which would probably cost at least an additional 10 percent and probably more. As noted in Table 2 below, plans that do offer protection

**Table 2: Monthly Income for a Single Woman Making \$12,000 Annually:
Comparison of an Individual Account System with the Current Social Security System**

Monthly income from an inflation-indexed annuity purchased with funds from an Individual Account assuming varying rates of real return on the stock market.	Full Career (35 years)	Interrupted Career (25 years)
Real return of 3 percent	\$345	\$208
Real return of 4 percent.	\$425	\$240
Real return of 5 percent.	\$526	\$278
Real return of 6.2 percent.	\$685	\$332
Monthly Social Security benefit	\$613	\$521

Notes:
 These calculations depend on a number of assumptions including the following:

1. According to Shirley and Spiegler (1998) seven (7) percent of payroll is available for investment in individual accounts. This accounts for the cost of purchasing disability and life insurance for an "average" individual as well as *partially* covering transition costs. It is assumed that the bulk of transition costs will be funded from other sources of revenue such as increased taxes.
2. The real rates of return on the stock market used in this illustration vary between 5 to 3 percent. The Cato Institute argues that a 6.2 percent return is possible. However, other economists such as Diamond (1999) and Baker and Weisbrot (1999) argue that a 3 percent return is more realistic, especially net of administrative costs estimated conservatively at one percent. As noted elsewhere in the paper, the Cato Institute does not document its assumptions regarding the cost of administration, purchasing disability and life insurance, and other costs associated with individual accounts (such as regulation and public education to prevent fraud).
3. Funds from Individual Accounts are converted into a (limited) inflation-indexed annuity using the formula

$$\text{Monthly benefit} = (\text{Principle}) / 1,000 * \$6.60$$
 This calculation is based on the formula for Single Life Annuities used by the Federal Retirement Thrift Investment Board (1997). This rate is indexed to inflation up to 3 percent annually; if inflation is higher, the real value of benefits will fall. The formula is gender-neutral; as private companies are likely to charge women more for annuities because they live longer, the monthly benefits available to women would be smaller than those shown. This formula is used for a simple, individually held account; monthly returns for a joint and survivor annuity would, of course, be lower.
4. In 1999, the Primary Insurance Amount (PIA) paid to a beneficiary equals 90 percent of the first \$505 of the worker's average indexed monthly earnings (AIME), 32 percent of the amount between \$505 and \$3,043, and 15 percent of the amount over \$3,043.

against inflation usually limit coverage. For example, the Federal Retirement Thrift Investment Program offers an annuity indexed to inflation up to 3 percent annually. However, during periods of high inflation, the real value of the benefits will fall, albeit more slowly than an annuity that is not indexed to inflation. Moreover, most private annuities offer only partial inflation adjustment, so that in periods of rapid inflation (over 3 percent annually), the value of benefits drops. As the loss of value is cumulative, these losses disproportionately affect women because they live longer. Unless required to use sex-neutral life tables in calculating annuity amounts, private annuities also are likely to penalize women for their longer life expectancies.

A Hypothetical Comparison

Without more detailed information from the Cato Institute on the expected mechanism for administering individual accounts and paying for transition costs, a realistic comparison of the benefits resulting from individual accounts and the existing Social Security program is not possible. However, close scrutiny of a hypothetical example is useful for demonstrating the sensitivity of the Cato Institute's claims to market returns (see Table 2). For example, the Cato Institute reports that a single woman earning \$12,000 a year for 40 years (paying \$1,488 in Social Security payroll tax annually and allocating 7 percentage points to an individual account) would retire with \$936 monthly with a private account earning a 6.2 percent return annually. Recalculating the Cato Institute's claim of a 6.2 percent return for a more realistic 35 years of employment would result in a monthly benefit of \$685, rather than the current \$613 per month she would receive under Social Security. However, even if it is assumed that transition costs can be funded elsewhere by decreasing other government spending or raising taxes — and that 5.4

percentage points will be adequate to pay for life and disability insurance, administrative costs, and other new costs — it is clear that strong market performance is necessary to achieve higher benefits under privatization. A low-income single woman would still not see higher benefits even if the market performed moderately well. Table 2 shows how a woman making \$12,000 a year for 35 years and for 25 years would fare given different assumptions about market performance. For a woman working with a 35 year career, even with a return of 5 percent, her monthly income from an individual account is less than her monthly benefit from the current Social Security system. Further, if the rate of return on money invested is more realistically estimated to be 3 or 4 percent, her monthly benefits from an individual account are between 55 and 70 percent of her guaranteed Social Security benefit.⁷ And if the woman worker has an interrupted career, working only 25 years (in 1995, 42 percent of all women who had reached age 61 worked less than 26 years in paid employment), then our average woman worker has a benefit from her individual account that is always lower than her Social Security benefit. It should be noted that while single women often do work more continuously than married women, they are not immune to their family's needs; they may care for elderly parents, for example. (The example presented here focuses on single women because the Cato Institute's estimates of relative benefits for married women from individual accounts compared with Social Security are vastly overstated for a variety of reasons, as detailed in Manella 1998.)

Moreover, if the market performs badly in the beginning of our average woman's career, she incurs even deeper losses. Finally, if the time she took out of the paid labor force to care for children or elderly parents (as most women do) occurred early in her career, her returns on a private account would be significantly lower than the benefits guaranteed in the current Social Security program.

Women and Privatization:

Why the Cato Institute's Proposals do not meet the principles for Social Security Reform adopted by the National Council of Women's Organizations

Individual accounts have a number of characteristics that are particularly negative for women. Table 3 summarizes central arguments against individual accounts, refuting the Cato Institute's claim that their proposals meet the principles for Social Security Reform adopted by the National Council of Women's Organizations (NCWO). Politicians and policy analysts involved in the debate on Social Security reform often ignore implications of their proposals for women. In part this omission stems from the perception that women's relationship to the paid labor force is increasingly becoming more like men's. Certainly, the past three decades have seen a dramatic increase in the number of women working in the paid labor force. However, most women still have very different working lives than men. Women who work full-time, year-round earn only 75 percent as much as men. For example, in 1996, only half of women aged 25-44 worked full-time, year round (compared with three quarters of men). If part-time workers are included, women earn only 60 percent as much as men. Women also remain much more likely to take time out of the labor force to care for children and elderly relatives. Shorter, and less lucrative, careers result in lower incomes in retirement for women.

Despite women's increased participation in the labor market, researchers predict that poverty among elderly women will be as high in the 2020s as it is today (Smeeding, Estes and Glasse 1999). This is partly due to the fact that more retired women in the future will be

divorced, separated, or single and therefore much more vulnerable to poverty. In other words, while future generations of women will be economically disadvantaged for different reasons, they are not likely to fare much better than their mothers and grandmothers. For the foreseeable future, women face a higher likelihood of poverty and near-poverty in old age and have special reasons for protecting and enhancing Social Security.

There are several reasons why the existing Social Security benefit structure is particularly valuable to women. As noted above, women tend to live longer and therefore would pay more for annuities in a privatized system. As women (on average) have lower wages than men, the progressivity of the current Social Security system that gives proportionally larger benefits to lower wage workers would be another important loss for women. As women would tend to have smaller accounts, it is also likely that the yield on their investment will be below average as women investors (appropriately) would likely avoid risk. Finally, replacing the spousal benefit with earnings sharing would lower benefits for many women. As Alicia Munnell (1998) succinctly notes, "the present Social Security system offers a range of protections – progressive benefit formulas, dependents' benefits, lifetime benefits, and inflation adjustment – that are of great importance to women and are not duplicated by any of the proposals to privatize the system."

Table 3: A Response to the Cato Institute's Proposal based on the National Council of Women's Organizations (NCWO) Principles for Social Security Reform

Preface: Central arguments

Cato Institute's claim

- ◆ "Virtually every woman – single, divorced, married, or widowed – would probably be better off financially under a system of fully private, personal retirement accounts, the earnings of which could be shared by spouses" (Olsen 1998a).

Why the Cato Institute is wrong

- ◆ The core of the Cato Institute's argument is that an average 6.2 percent rate of return is feasible. As a recent Enrolled Actuaries Report notes, "a real rate of return of 6.2 percent over a lifetime is extremely high, particularly for individually chosen investments" (Rappaport 1999). Moreover, a high rate of return on stocks in the coming decades is inconsistent with the economic forecast made by the Social Security Board of Trustees.
- ◆ The Cato Institute does not account for administrative costs. Evidence from other countries that have experimented with privatizing Social Security confirm that administrative costs are much higher for individual accounts than for a defined benefit system (like the existing Social Security program).
- ◆ The Cato Institute does not account for the cost of the transition from a "pay as you go" to a pre-funded system that essentially doubles the cost of Social Security for the next 40-70 years. Generations living through the transition must pay for two systems at once, both their parents' and grandparents' and their own.
- ◆ The Cato Institute's plan does not account for the cost of replacing the life and disability insurance now provided by Social Security.
- ◆ Most of the improvements for women in the Cato Institute's plan come from earnings sharing rather than individual accounts. Because some women lose under earnings sharing, it is not the best approach to improving benefits for women, and in any event, is not exclusive to a privatized system.

Principle 1: Help lower life-time earners

Cato Institute's claim

- ◆ "Even taking into account Social Security's "progressive" benefit structure, all categories of women would still get more for their money under a fully private plan" (Olsen: 1998a, 10).

Why the Cato Institute is wrong

- ◆ The Cato Institute uses examples for low earners based on 40 years of full-time work at wages that are at or above the bottom third for all workers; an interrupted career is defined as

Table 3. continued

<ul style="list-style-type: none"> ◆ “The freedom to choose is particularly important to low-wage women who do not earn enough to save and invest on their own. That inability to invest is largely due to high payroll tax rates. Forcing women to stay in a system that takes 12.4 percent of their wages only to cheat them of a secure retirement is simply unjust” (Olsen 1998a, 11-12). 	<p>35 years of full-time work (Olsen 1998a, footnote 24 and 27, p. 17; Shirley and Spiegler 1998). However, of workers retiring in 1996, the median woman had worked 27 years over her lifetime. Thus, the income (and retirement contributions) of the Cato Institute’s “low lifetime earners” is unrealistically high.</p> <ul style="list-style-type: none"> ◆ The Earned Income Tax Credit offsets payroll taxes for many low earners in the current Social Security system. ◆ Because low earners have less money to invest and cannot afford risky investments, it is likely that they will have lower rates of return on their individual accounts.
<p>Principle 2: Maintain cost-of-living adjustments (COLAs)</p>	
<p style="text-align: center;">Cato Institute’s claim</p> <ul style="list-style-type: none"> ◆ Women could buy inflation-adjusted annuities. 	<p style="text-align: center;">Why the Cato Institute is wrong</p> <ul style="list-style-type: none"> ◆ Inflation-adjusted annuities, if available at all, would be very expensive. Moreover, women would pay more for annuities than men because they tend to live longer. A woman who is 65 today can expect to live to 84, while a 65 year old man can expect to live only to 81 years of age.
<p>Principle 3: Protect and strengthen benefits for wives, widows, and divorced women</p>	
<p style="text-align: center;">Cato Institute’s claims</p> <ul style="list-style-type: none"> ◆ The Cato Institute has proposed earnings sharing or joint ownership of private accounts to improve women’s benefits and to address the inequities between traditional one earner households and dual earner couples (Olsen 1998c). 	<p style="text-align: center;">Why the Cato Institute is wrong</p> <ul style="list-style-type: none"> ◆ Earnings sharing requires the elimination of the spousal benefit. ◆ Earnings sharing proposals may impoverish those divorced wives who would only benefit from the husbands’ earnings for the period they were married. Children would also be eligible only for the benefits earned during their parent’s marriage. ◆ Earnings sharing would increase administrative costs. ◆ There are other avenues for improving equity among different kinds of households (see Hartmann and Hill, forthcoming).

Table 3. continued

Principle 4: Preserve disability/survivor benefits	
Cato Institute's claim	Why the Cato Institute is wrong
<ul style="list-style-type: none"> ◆ Individuals can purchase disability and life insurance in the private market. 	<ul style="list-style-type: none"> ◆ Private insurers may not offer policies to people whom they consider "high risk" for disability or death such as those with known health risks or workers in dangerous occupations. ◆ Premiums for disability and life insurance, when it is available, may be prohibitively expensive for many low income workers.
Principle 5: Protect the most disadvantaged workers from across-the-board cuts	
Cato Institute's claim	Why the Cato Institute is wrong
<ul style="list-style-type: none"> ◆ Because benefits from individual accounts would be determined by the market rather than by Congressional edict, benefits are better protected for everyone. 	<ul style="list-style-type: none"> ◆ Individual accounts expose workers and their families to market risks. ◆ Political risks remain for disadvantaged workers who would have to depend on the safety net because their personal accounts would be too small. Eligibility for such means-tested support, and the level of support, would definitely be a political matter.
Principle 6: Insure that women's guaranteed benefits are not reduced by individual account plans that are subject to the uncertainties of the stock market	
Cato Institute's claim	Why the Cato Institute is wrong
<ul style="list-style-type: none"> ◆ The stock market has performed consistently well (Shirley and Spiegler 1998). Risks are manageable and there is no reason to assume that women won't be able to invest as well as men (Olsen 1998b). ◆ Minimum benefits will protect workers. 	<ul style="list-style-type: none"> ◆ Cato presents average returns; returns on individual counts will, of course, vary. Evidence from the experience with privatization in the United Kingdom suggests that misleading advertising is a serious problem. Regulation of the industry is another cost to government not accounted for by the Cato Institute. ◆ Minimum benefit levels may not be enforced or may be reduced over time. No realistic accounting of the cost of providing guaranteed minimum benefits has been put forward by the Cato Institute.

Table 3. continued

Principle 7: Address the care-giving and labor force experience of women	
Cato Institute's claim	Why the Cato Institute is wrong
<ul style="list-style-type: none"> ◆ The Cato Institute argues that earnings sharing or joint ownership of individual accounts would fairly reward women's care giving work in the family, as the default division of credits would be 50/50. 	<ul style="list-style-type: none"> ◆ Earnings sharing rewards women who marry (and stay married for a long time) to men who make high incomes, as do current spousal benefits. Earnings sharing and individual accounts do nothing for single mothers or gay couples, and little for women who are married for short periods of time.
Principle 8: Reduce the number of elderly women in poverty, especially women who live alone	
Cato Institute's claim	Why the Cato Institute is wrong
<ul style="list-style-type: none"> ◆ "All serious proposals for privatization include a safety net feature that would ensure that everyone's retirement income is at least at or above the poverty line" (Olsen 1998b, 2). 	<ul style="list-style-type: none"> ◆ Not all of the Cato Institute's privatization proposals include such a minimum. Furthermore, it is unlikely that Congress would pass such a dramatic improvement in benefits. Currently Social Security's special minimum is approximately 85 percent of the poverty line. For workers who have less than 30 years of coverage the benefit gradually decreases and phases out at 10 years. SSI's maximum benefit for a single individual is even less (about 75 percent of the poverty line) and is subject to means and asset tests. ◆ A minimum benefit at or above the poverty line is, of course, desirable. However, the Cato Institute has provided no estimate of the cost of such a minimum.
<p>Note: The order of the National Council of Women's Organizations principles has been changed to improve the flow of the discussion. The content of the principles has not been altered. See NCWO's web site (http://www.womensorganizations.org) and the web site of its Task Force on Women and Social Security (http://www.women4socialsecurity.org) for further discussion of these principles. All Cato publications can be found at http://www.cato.org.</p>	

Conclusions

The Cato Institute's claim that a Social Security system based on individual accounts will yield a superior "return on investment" is simply untrue. However, a *minimum* of 30 percent of the payroll tax (and probably more) would likely have to be diverted to pay for administering individual accounts, replacing worker's disability and life insurance, and purchasing an inflation-adjusted annuity at retirement. Furthermore, the cost of the transition from a "pay as you go" system, whether it is funded within Social Security or from general revenues, essentially doubles the costs of Social Security for the next four to five decades. This doubling of costs is not included in the Cato Institute's calculations of the "rate of return." A full accounting of all of these costs must be undertaken before any proposal for individual accounts is seriously considered.

While the concept of *replacing* Social Security with individual accounts is fundamentally flawed, proposals to *add* incentives for retirement savings through supplementary personal accounts, such as the Clinton Administration's Universal Savings Account (USAs), are promising. Similar to proposals by analysts such as Robert Kuttner, Robert Ball and Robert Eisner, USA accounts would encourage people to save

for their retirement by offering convenient and tax-favored accounts, in which individual savings would be matched by the government in a centralized system modeled on the Federal Thrift Savings Program. The amount of the match could be scaled to match a larger portion of the dollars saved by low and moderate-income people, redressing the existing inequities in tax policy for savings. Not only do low- and moderate-income households have fewer resources to invest, they are less likely to have pension plans through their employers and less likely to take advantage of IRA accounts, Keogh accounts, 401(k) plans, and other tax-favored incentives used by middle- and upper-income families. Linking USA accounts to earned income tax credits is one proposal that appears promising. In principle, providing incentives to encourage people to save for retirement is clearly desirable. Until the details of the USA accounts proposal are put forward, however, it is not possible to fully evaluate its implications for women.

In sum, individual accounts can supplement the existing Social Security program, but they cannot replace it without causing harm to women and their families.

Endnotes

- ¹ The Cato Institute has not put forth a single, internally consistent plan for privatizing Social Security. Rather, the Cato Institute has released several papers, not all of which are consistent in their assumptions and recommendations. Therefore, this report addresses several papers published by the Cato Institute (see Genetski 1999; Olsen 1998a; Olsen 1998b; Olsen 1998c; Shirley and Spiegler 1998; and Ferrara 1997).
- ² While “carve out” plans are less radical because they leave many of the guaranteed benefits in place, they are regarded by many as a first step in the direction of full privatization. If individual accounts were widespread, future cuts in guaranteed benefits could become more politically feasible. Add-on programs such as Universal Savings Accounts, as proposed by the Clinton Administration, are potentially more promising. These programs do not use any part of the payroll tax but encourage individuals to set up individual accounts through matching programs or other inducements.
- ³ Whether to adopt earnings sharing is a separate issue from whether or not Social Security should be privatized. In fact, it would be administratively easier to adopt earnings sharing in the current Social Security system because records of marriages, divorces and deaths could be established at the time of retirement, rather than on a monthly or annual basis. If individual accounts were subject to earnings sharing, marriage records would need to be recorded at least annually, so that husbands and wives (and ex-spouses) could make independent decisions about how to invest the funds in their accounts.
- ⁴ Inequities between one- and two-earner couples are an unintended consequence of the spousal benefit provision. Married women (and men) are entitled to either a Social Security benefit based on their own earnings or half of their spouse’s benefit, whichever is higher. A woman whose benefit based on her own work record is less than or equal to the spousal benefit she could claim is said to be “dually entitled” and does not gain additional benefit from having worked. A couple with the same total income (and taxes paid), but all earned by the husband, would have considerably higher retirement income (both while married and widowed) than the couple where both contributed.
- ⁵ For a worker investing in an individual account over a forty-year career, a one-percent annual charge on holdings in an account would result in a loss of 20 percent of the value of the money invested. The first dollar invested by the worker would be subject to a one-percent fee 40 times, while the dollar invested in the final year would be subjected to the administrative fee once. On average, the principle would be subjected to an administrative fee of one percent, meaning that 20 percent of the value of the account is used for administrative costs.
- ⁶ In a study based on data generated by financial providers, Orszag (1999b) found that, on average, 40 percent of the value of individual accounts in the United Kingdom is consumed by fees and costs. Administrative costs, including accumulation costs (administration and fund management, including advertising and marketing), consume 25 percent of the value of individual accounts in the United Kingdom. Alteration costs (incurred when account holders switch financial providers and/or enter and depart from the paid workforce) consume 15 percent of the value of individual accounts in the United Kingdom. Annuity costs (incurred in converting an account into a lifetime annuity) consume approximately 10 percent of the value of a typical account.
- ⁷ Final holdings in individual accounts were calculated as follows:
 $A_{\text{total}} = P \sum_{i=1, n} (1+r)^{n+1-i}$ where A_{total} = total accrued at the end of n years of investment; n = total number of years; P = principle invested each year; r = annual rate of return (e.g. = .0625); and $i = 1 \dots n$. Holdings were converted into inflation-indexed annuities based on the rate of \$6.60 per thousand dollars, used by the Federal Retirement Thrift Investment Board. This rate is gender neutral and calculated for a single individual’s lifetime. Joint and survivor coverage, of course, would result in lower monthly payments. It should also be noted that this rate allows for only partially indexing to inflation; inflation over 3 percent annually is not covered.

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