income tax rate plus 5 percent average state income tax rate plus 15.3 percent to the Social Security Administration, for a total of over 48 percent tax on every extra dollar earned).

With the payroll tax coming on top of other taxes, this means that the excess burden is far higher than if one looks at the tax in isolation. Economists calculate how much a particular tax discourages work or production and call this cost (over and above what the tax itself takes) the "deadweight cost" of the tax. Martin Feldstein estimates the deadweight cost of the Social Security tax to have been $68 billion in lost economic output in 1995 alone.

The Social Security tax also distorts business decisions. For example, it encourages employers and employees to convert wage income into non-wage income (such as medical or other benefits) because these sorts of compensation escape the tax.

For a long time, economists ignored the economic distortions caused by the payroll tax. For one thing, the tax rate was initially quite low (just two percent on wages up to $3,000), and the number of workers affected by it was much more limited than now. Today, of course, the tax rate is much higher and coverage is virtually universal. The Social Security tax itself is 10.52 percent on all wages up to $62,700, plus a disability insurance tax of 1.88 percent. Then there is an additional tax of 2.9 percent for Medicare on all wages, with no limit. For almost three-fourths of workers, this payroll tax is the single largest tax they pay.

The run-up in the burden of the Social Security tax has actually been even sharper than the rise in tax rates suggests, because earlier workers at least received benefits in return for their withheld pay. But Baby Boomers and all Americans born after them will not only pay far more but also receive a lot less at retirement—a double whammy.

To the extent that privatization increases the financial soundness of the Social Security system, and restores younger Americans' confidence that they are eventually going to get

How Much Does Social Security Really Cost?

By James L. Payne

Old bureaucracies die hard. Now that Americans have started to notice that they can save their own money for their own retirement, they are wondering why they need government to carry out this task for them. Defenders of the existing system are scrambling for an answer. What they have come up with is the idea that Social Security is economically efficient, its overhead costs remarkably low. Social Security Commissioner Shirley Chater is declaring, "every chance she gets" according to her press officer, that Social Security is impressive because "the administrative costs of the U.S. Social Security system are very low—less than one percent of revenues." She claims this compares favorably with the overhead costs of the partly privatized Chilean system, which she says are "in the neighborhood of 15 percent of revenues."

It's too bad that federal regulations about truth in advertising don't apply to claims made by government officials in support of government programs. If they did, Ms. Chater would be facing some stiff penalties. The on-budget cost of running the Social Security bureaucracy is a tiny part of the full cost of operating the U.S. Social Security system. The truth is that Social Security has staggering overhead costs.

These fall into two categories: the overhead costs of raising revenues and the overhead costs of giving out benefits.

Everyone in business and the nonprofit sector knows that it costs money to raise money. When it comes to government programs, however, we tend to overlook fundraising costs. Perhaps this is because it seems that the coercion of taxation is frictionless. You just say, "Your money or your life," and the result is a fistful of currency, quietly handed over.

Yet coercive systems of fundraising have enormous overhead costs; in fact, they are generally less efficient than voluntary systems. Social Security tax monies do not float effortlessly and harmlessly into the Treasury. There is a great deal of agony and waste involved. First, there is the tax compliance cost: all the time citizens spend studying tax rules, keeping records, making calculations, and filling out forms. An IRS study found this consumed 5.4 billion man-hours in 1985; by 1995, the figure had risen to 10.2 billion hours—the equivalent of the entire labor force of Indiana, Iowa, and Maine working all year long.

Then there are disincentive effects—the way taxes discourage economic production. Economists Charles Ballard, John Shoven, and John Whalley have estimated that the cost to the economy of extracting one additional dollar in taxes is 33 cents worth of lost production. A study by Jerry Hausman on the effects of taxing labor (which might be most directly relevant to how Social Security taxes depress individual work) found a disincentive effect of over 28 cents on the dollar.

Other tax system costs include the waste and injury caused by penalty disputes, forced collection actions, tax litigation, and losses attributable to tax-avoidance activities. When all of these different burdens are added together, my calculations suggest that raising one dollar in taxes may entail overhead costs as high as 65 cents (with most of this hidden from view because it is absorbed by the private sector).

Just as there are massive overhead costs in collecting Social Security monies, so there are large costs in giving it out. The expense of running the Social Security Administration is a fairly trivial aspect of the burden. The private sector burden of compliance is much larger: all the time citizens and their representatives spend filling out forms, entering over three million new claims each year, attempting to correct errors with the Social Security Administration, and litigating for benefits.

something out of the system, the burden of Social Security taxes will in effect fall even if the tax rate remains unchanged. As Professor Laurence Kotlikoff of Boston University explains, privatizing Social Security immediately links money extracted in youth to money received in old age, and thereby reduces the total burden on labor. This will stimulate additional work, leading to increased output, saving, and capital formation.

An American Model of Privatization's Benefits

What would a privatized Social Security system look like? Many advocates point to foreign examples like Chile. It turns out, however, that an excellent example of Social Security privatization already exists in the U.S. According to a recent study from the National Center for Policy Analysis, workers in three Texas counties in effect privatized Social Security for themselves in 1981. At that time municipal governments could opt out of Social Security (a provision eliminated in 1983).

Under the Texas system, workers in Galveston, Brazoria, and Matagordo Counties contribute about 6 percent of their pay, matched by a somewhat larger "contribution" from the county, for a total tax of just under 14 percent. Of this, about 10 percent goes into a worker's retirement account, which pays 6.5 percent interest compounded daily. The remainder pays for disability and life insurance premiums. Workers continue to pay the Medicare tax and will be eligible for Medicare benefits at retirement.

First Financial Benefits, the company that created and administers the plan, estimates that someone retiring today at age 65, with 40 years of deposits and an annual salary of $20,000, would have $383,000 in his retirement account. Someone who earned $50,000 per year over 40 years would have $956,000 in his account. The first worker's assets would be sufficient to buy an annuity paying $2,740 per month for the rest of his life, com-

In 1994, the public made 64.7 million telephone calls to the Social Security Administration on its toll-free number. Just the time spent waiting for Social Security to pick up, an average of 6.2 minutes per call, meant a waste of 6.7 million hours for the callers. The average value of labor in 1994 was $15.09 per hour, so the value of this wasted time alone amounts to $100 million. If one then assumes that each of these telephone calls takes an average of two hours of before and after involvement on the part of the caller or his representative, then the private sector burden reflected in just these calls is $2 billion. The Social Security Administration, reluctant to admit that it forces Americans to do work for their benefits, doesn't acknowledge the cost of any of this.

Another disbursement cost is the disincentive to work. Many seniors would like to work after retirement. It would be good for them, and good for the economy. But Social Security benefits are given out under a formula that reduces payments if too much wage income is earned. This discourages work and makes seniors and society poorer. Estimates of this disincentive effect vary widely. One study by the Social Security Administration claimed a total of $2 billion in lost earnings. A study by Gary Burtless and Robert Moffitt suggests the figure was more like $25 billion in 1994.

Probably the largest disbursement burden is the "benefit inflexibility cost." A person who controls his own retirement money has the freedom to use it in the amounts, and at the times, that best serve his needs. Social Security funds, on the other hand, are doled out monthly in fixed amounts. Since money is more useful when it can be applied in a lump sum if necessary, the monthly payment system causes a less than optimal use of retirement funds. For example, a senior who would like to prepay a rent or utility bill on a quarterly basis cannot do it if he depends on Social Security—even if that would save him money overall. He cannot make a loan to his children, even when this would benefit both the children and the retiree. He cannot use Social Security money in lump-sum form to invest in a business, or buy a cheaper house in the country. In all such cases, an economic price is paid in not allowing people to spend "their" money as best suits their needs.

It is a sign of how little we notice the real costs of Social Security that no one has calculated the total Social Security disbursement cost. It could easily amount to scores of billions of dollars in compliance work, lost economic production, and limited economic choices.

If the overhead costs of disbursement and tax collection are added together, the total could hardly be less than about 60 percent of benefits, and could be a good deal higher. That amounts to hundreds of billions of dollars a year.

The retirement system with the lowest cost is one based on individual freedom and personal responsibility. When the worker completely controls the inflow and outgo of his own retirement savings, there are no economic disincentives and the only compliance costs are the costs of administering his chosen investments.

Legislators are unlikely to give workers complete freedom in managing their retirements. The point is that the closer we get to individually directed retirement accounts, the lower the total overhead costs to society will be.

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pared to today's Social Security benefit of $775 per month. The second worker could have an annuity of over $6,800, compared to $1,300 from Social Security.

Overall Benefits Can Pay for the Transition

If the gains to privatization are so great, what are the barriers? The simple answer is the cost of transition. If our Social Security system were being started from scratch right now, there would be no sensible argument against a mostly private system as outlined above. But thanks to Franklin Roosevelt's legacy, today's retirees now depend on the taxes of current workers for their benefits. It obviously would be impossible to simply end Social Security benefits for existing retirees in order to start from scratch with a privatized system. And it will take some effort to make it possible for current workers to save for their own retirements while they simultaneously pay taxes to support current retirees. The question becomes how to construct a system that moves toward privatization without endangering current benefits.

Martin Feldstein believes that the gains from even partial privatization are potentially so great that the transition from the current system to a private system would be far less costly than previously imagined. In the short run, workers would have to continue to pay the Social Security tax as well as contributing an additional 1 to 3 percent to their own private retirement. But in the long run, Feldstein estimates that a tax of just 2.1 percent under a privatized system would provide the same benefits as the current 12.4 percent tax, due to the higher rate of return on privately invested saving.

From Radical Idea to Common Sense

Three decades ago Barry Goldwater was castigated for even suggesting the idea of privatizing Social Security. This year the Social Security Administration's own official advisory council was virtually unanimous in recommending movement towards privatization. So the principle of privatization now appears to have official sanction.

It is not possible to estimate with any degree of accuracy what the full benefits of a privatized Social Security system would be. It's obvious, though, that any reform that leads to a sharp reduction in the payroll tax and a significant expansion of private saving cannot help but enormously increase the size and health of the U.S. economy over time.

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Personal Savings Accounts Would Strengthen Families

By Allan Carlson

Right from the beginning, the Social Security system in America has been linked to the idea of family failure. In 1933 a massive government study entitled *Recent Social Trends* argued that "the decline of the institutional functions of the family" and a "permanently" low birthrate had made families unreliable as social units, particularly for providing security in old age. The New Dealers endorsed this assumption, along with the view that it was proper to further reduce the power of the family through taxation of income and wealth.

During the latter third of this century, these New Deal principles became self-fulfilling prophecies. Working through our Social Security system and other parts of our government, these ideas directly undermined the economic and social circumstances that had sustained the family-centered "Baby Boom" of the 1950s.

Is it possible that privatizing Social Security at the turn of the millennium could affect the American family in the opposite way? Could giving economic resources and social authority back to family members reinvigorate society's most basic building block? I suggest that if we established fully owned individual accounts that could be inherited and divided among descendants, the effect could be profound.

Linking the Generations

In the pre-industrial, land-focused, and family-centered world of early nineteenth-century America, the aged used their control of financial resources to maintain their status and security. Elderly men and women used gifts and bequests to bind their children to them. Transfers of land and other tangible assets rode on the loyalty of children to the family line. As historian James Henretta has put it, parents of the time raised children to "succeed them," not merely to "succeed." With wealth tied principally to inherited land, duties and rights criss-crossed the generations. The decisions and actions of youth were conditioned by their acceptability in the eyes of parents. Henretta again: "The line was more important than the individual; the patrimony was to be conserved for lineal reasons."

A privatized Social Security system should create a new sort of patrimony, one rooted in equities, bonds, and other investments rather than in land. Regular workers at even low levels of compensation would own enormous assets on retirement, a large share of which could ultimately be transferred to children through loans, gifts, and bequests. Inter-generational sentiments and bonds, once again reinforced by broad economic incentives, should grow in importance, and the multi-generational family should flourish.