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## Privatizing Social Security: Economic and Social Concerns

Sarah Madsen

### **Abstract**

The U.S. Social Security program is in need of reform. One of the most popular solutions to the long-run financing problem is privatization. This paper examines key economic and social concerns about a shift from a public pay-as-you-go system to a privately-funded system. While a privatized system does reduce overall uncertainty and allows for greater returns, its increased risk and high transition costs make it an unreliable strategy.

### **Introduction**

Social Security is greatly valued by Americans. The Social Security Administration estimated about 65 million Americans would receive over one trillion dollars in Social Security benefits for the year 2020. About nine out of ten individuals aged 65 and older receive benefits. Twenty-one percent of married couples and 45 percent of unmarried people who are beneficiaries rely on Social Security for about 90 percent of their income (SSA 2020). With its impressive reach it is easy to see why Social Security is often called the most successive anti-poverty program in the U.S. Still, many Americans are concerned for the future of the program. In a 2015 Gallup survey, 51 percent of non-retired Americans did not believe that the Social Security system would be able to pay them a benefit when they reached retirement (Newport 2015). In various Social Security related polls, Americans consistently agree that they want Social Security benefits retained with no cuts. Many proposed reforms suggest a benefit cut and an increased payroll tax, but privatization plans suggest a complete shift in the program and even offer chances for increased benefits. Does privatization of Social Security truly benefit individuals, and does it increase welfare for current and future generations?

## **Background**

Social Security, signed into law in 1935, was originally structured as a low-cost longevity insurance program. Only about half of the people who entered the workforce in their youth received the program benefits at the age of 65. The program has since transformed into a costly and broad based program. It provides retirement benefits to a majority of the population who enter the workforce in their youth. This change is due to shifts in policy and increased life expectancy. In the beginning, the benefit eligibility age was set at 65, a popular eligibility age among different pension plans. Few people would qualify at such an advanced age so the program could be financed at a low payroll rate. People entered the workforce at earlier ages and only 54 percent of the population was expected to still be alive at the age of 65. On average, benefits were not provided for more than a decade after retirement. Over time, the United States has experienced three fundamental changes that have altered the Social Security Program. The eligibility age was lowered to age 62, life expectancy has increased, and people are entering the workforce at older ages (Turner 2016).

## **The Current Program**

### **A. The Benefit calculation**

In order to be eligible for Social Security workers must pay contributions for 10 years. Unlike other contribution plans, such as 401(k) plans, the benefits for Social Security are based on a formula. Individual benefits are based on average indexed monthly earnings (AIME) which is based on the workers highest 35 years of wage indexed earnings. For workers who work fewer than 35 years, zeros replace the missing years when calculating the average. The benefit calculation for an individual and their spouse is more complex and involves 4 steps. The first step is to calculate AIMEs. Highest wages are indexed or averaged up until age 60. The next step is to calculate the worker's primary insurance amount (PIA). The PIA is calculated from the AIME in three segments or bend points. At the end of the first earnings bend point, AIMEs - which in 2021 are earnings up to \$996 - are multiplied by 0.9. AIMEs in the second bend point, earnings between \$996 and \$6,002, are multiplied by 0.32. AIMEs in the third bend point, earnings above \$6,002, are multiplied by 0.15. The sum of the three segments determines the PIA (SSA 2021b). No other benefits are paid beyond the third 15% segment. This measurement is also

called the 90/32/15 rule. The third step is to adjust for early or late retirement. Retirement benefits can increase or decrease if the age that workers accept their payments is above or below the eligibility age. The fourth step is to calculate any benefits the spouse may have earned and survival benefits. Survival benefits are payments given to the spouse of the deceased worker. Survivor's benefits are the same as the worker's benefits and are raised as the spouse delays claiming (Turner 2016).

### **B. The Progressive Formula**

The benefit formula is a progressive formula where resources are redistributed from high-income workers to low-income retirees. All workers still contribute the same fraction of earnings, but lower income workers receive more generous retirement benefits relative to past earnings. Despite its intent, the formula is not perfectly progressive. The main issues with the formula's progressive intent are the correlations between lifetime earnings and length of life and lifetime earnings and postponement of receipt of benefits. People with higher incomes tend to live longer than people with lower incomes and so receive benefits for longer. People with higher incomes are also able to postpone receipt of Social Security benefits which is rewarded by an increase in benefits (Hunt and Caliendo 2020).

### **C. Social Security Wealth**

Social Security wealth is an economist's way of measuring the lifetime value of Social Security. Social Security wealth is the present discounted value of expected benefits minus the present discounted value of taxes already paid. This equation does not take into account the utility value of the insurance offered by Social Security. Social Security is provided as an annuity, meaning it provides insurance against outliving one's income. Social Security also provides price indexed benefits, meaning the recipient is insured from the effects of inflationary shocks. While Social Security provides households insurance, the current system also includes political risk. Uncertainty leaves retirees and workers worried that Social Security will not provide currently promised benefits. Regardless of these issues, this is still the best estimate for overall wealth. The aggregate Social Security wealth is estimated to have grown from \$11 trillion in 1989 to \$33 trillion in 2016, a 200 percent increase. In 1989, for the bottom 90 percent of the wealth distribution, Social Security represented 23.7 percent of wealth. By 2016, Social Security had grown to represent 62.2 percent. Even with adjustments for systematic risk, for the

bottom 90 percent, Social Security's representation of wealth rose from only 19.8 percent to 56.8 percent. (Cathrine, Miller, and Sarin 2020). Social Security wealth may not include all aspects of Social Security but it does show the increased reliance of the program.

#### **D. Social Security Trust Funds**

Social Security is financed through a payroll tax paid by most workers in the United States, excluding some state and local government workers. Under this tax, there is a direct link between taxes contributed and benefits received. This payroll tax is called the Federal Insurance Contributions Act (FICA) tax, half of which is paid by the worker and half is paid by the employer. The money contributed into Social Security is paid into a Social Security Trust Fund. The fund buys government bonds and the interest on the bonds is attributed to the trust fund. The money in the fund is used to pay benefits and the administrative expenses. In this way, Social Security is primarily a pay-as-you-go system, with some exceptions. One concern with the trust funds is the lack of diversification. The trust fund only invests in government issued bonds. If the trust fund invested in other forms of equities, such as market securities, the return on investments would increase. The trust fund does not expand investments because of high investment risk. With government bonds, the trust fund is guaranteed a return, even if it is a lower return.

There are two Social Security Trust Funds, Old-age and Survivors Insurance (OASI) and Disability Insurance (DI). Together they are known as the OASDI trust funds. These trust funds were created in 1983 as a temporary solution to the then future increase of retirees from the baby boom. Congress enacted many measures to "prefund" the retirement of the large baby-boom generation. By the end of 2019, the two trust funds held \$2.9 trillion in assets, which amounts to about 14% of GDP as opposed to 1% of GDP in 1983. The government has been drawing from this surplus of funds to pay for benefits that are not covered by current worker inputs. The Congressional Budget Office (CBO) projects that both trust funds will be depleted in 2032. The Social Security Trustees project total depletion by 2034. These values do not take into account any possible changes with the Corona-19 Pandemic (Hungerford 2020).

There are many proposed solutions to this inevitable lack of funds. One solution is to expand the tax base for the Social Security payroll tax. This would include increasing income limits for paying taxes, the current cap is at \$137,000. The tax could include non-labor income, as in capital gains interest.

There can be an end to tax exemptions for local and state workers who opt out of Social Security for government pension plans. There can also be an influx of immigration through laxer immigration laws (Mulvey 2010). Another solution is to raise the retirement age. While this would provide some relief, the bigger issue lies with the worker to retiree issue (Fields and Mitchell 1984). Another solution is to reduce benefits. This would include lowering the 90/32/15 percentages used to calculate PIA or capping benefits for higher income recipients. This is typically accompanied by an increase in the payroll tax (Hunt and Caliendo 2020). This paper will focus on one particular solution, privatization.

### **Privatization**

While there are many different privatization plans, almost all plans have the same basic outline. Unlike the current pay-as-you-go system, privatization plans require workers to pay into individually owned and directed private retirement accounts. The Social Security for the currently retired generation is funded by the current working generation. Workers who put money into the system will receive benefits upon their retirement. The physical dollars they are putting in now will not be the same physical dollars they will receive in their benefits. Instead, it will be the physical dollars of the next working generation. It is an unfunded pay-as-you-go system. A Privatized program would be a fully funded system. This means that the physical dollars that workers put into the system now, will be the same physical dollars they will receive in retirement. Having private individual accounts (IAs) allows workers to withdraw funds when needed. This can be when the worker reaches retirement or if they become disabled. When the worker decides to receive their benefits, some or all of the funds would be converted to a single or joint minimum annuity that would be paid out until the worker dies. It is a joint annuity for a married household. Other plans call private accounts personal security accounts (PSAs). PSAs have limited regulatory constraints and a lump-sum distribution of funds is allowed if the worker chooses. Funds are freely available at the age of 63. Heirs of workers who die before becoming disabled or reaching retirement age may inherit any accumulated funds.

With privatized Social Security there is an increase in household portfolio choice. Currently, workers' compensation into the system is added to the OASDI trust funds, run by the government. Under privatized Social Security there are two methods of collection and investment. IA contributions are

collected and managed by a single public or semipublic agency. Workers will have the option to invest in a limited number of investment funds. For example, a worker may decide to invest in a money market fund, a stock market index fund, and a U.S. Treasury bond fund. While the contributor is given more freedom to choose, workers' choices are still limited to certain government-managed index funds. This is done to minimize administrative costs. PSAs leave collection and investment up to private companies, such as mutual fund companies, private banks, insurance companies, etc. This would lead to increased competition between private entities and workers would have more freedom to choose their investments. Unlike with a public or semipublic agency, administrative costs would be higher under this plan (Moore 1998).

Overall, privatized Social Security differs from our current program in two major ways. First, a workers benefit is based on how much they have contributed and to the success of their investment plan. Second, private plan benefits are funded by worker's accumulation of savings while current Social Security benefits are funded mainly through the payroll tax of current workers (Bosworth and Burtless 1997).

## **Criticisms**

### **A. Redistribution**

In practice, a privatized Social Security would be less redistributive. The current system runs on a progressive formula, meaning resources are redistributed from high-income retirees to low-income retirees. As discussed before, Social Security is not perfectly progressive, but it does have many of the characteristics. The Social Security progressive formula favors low income workers, workers with a higher risk of disability, and married couples with one income, all to minimize poverty for the disabled and elderly who have worked a full career.

In some privatization plans, the contributions made to the payroll tax that funds this redistribution all or mostly all goes directly into private accounts. This is not including the transition costs. In order to keep this redistribution, the private system would have to supplement these pensions. This can be done with a minimum tax financed pension or with a public system. The tax would come from the payroll tax. One issue with a public system is it could be labeled as welfare, which has a negative connotation. This can decrease the popularity of this redistribution. The difference between a public and a private plan is clear.

“A public plan offers stronger assurances to low-wage workers, but a private plan is more appealing to average-wage and high-wage workers who want a better return on their contributions” (Bosworth and Burtless 1997).

## **B. Risk**

While the current Social Security program provides insurance, households still face risk. The current system provides insurance against living too long and inflationary shocks. The current system also introduces intergenerational risk and political risk. Since the system is primarily pay-as-you-go, the benefits of the current retirees are positively related to the earnings of the current working population. The ratio of workers to retirees is predicted to decline dramatically in many countries. In the United States between 1974 - 2008, the ratio stayed stable between 3.4 and 3.2. This ratio has since fallen and will continue to decline to 2.0 in the next few decades (Hunt and Caliendo 2020). Intergenerational risk will increase. The political risk is the uncertainty of the program's future. Changes to the taxes and benefits of the program have been made in the past and Congress will continue to make changes. Retirees are worried about their current benefits and young workers are worried that they will never receive the promised benefits. According to a Gallup poll in 2015, 51 percent of non-retired Americans doubt the system will be able to pay benefits at their retirement. Forty-three percent of retirees predict eventual cuts in their benefits. Sixty-six percent of Americans say Social Security is in a state of crisis (Newport 2015). “The economic and welfare effects of policy uncertainty are highly sensitive to households’ beliefs over the path of future policy” (Nelson 2020).

Privatization offers the possibility of better rates of return than the current system, but this is not guaranteed. Under privatization, workers are subject to economic or investment risk. This means retirement benefits are tied to the performance of the workers portfolio in the market. Those in favor of the PSA privatization plan and similar plans claim, “workers will receive a rate of return consistent with the average historical long-term rates of return on equities” (Moore 1998). Future returns do not always reflect historical returns. Over short periods of time, the average real return on stocks in the United States is volatile. Under the PSA privatization plan where there is limited regulation on investment choices, a worker may have substantially different returns than the average return. An individual index, such as the Standard and Poor 500 index, may have positive returns, but the returns of individual stocks within the index vary from positive to negative. One positive to the PSA privatization plan is its

ability to ride out market shocks. The IA privatization plan does not share this benefit because of the required annuitization of a worker's account at retirement. Market fluctuations could have a dramatic effect on a worker's return depending on the year they retire and take out these annuities. Another problem is the overall increased demand for equities. This could cause long-term rates of return on equities to decrease (Moore 1998).

Success of household portfolio choices not only depend on market performance but also on a worker's financial literacy. If workers have limited knowledge on risk and return, the added freedom of choice can be detrimental to benefits. The degree of harm depends on the privatization plan and the control a worker has on their portfolio. For example, in the IA privatization plan a worker is limited to a government-managed index fund run by a public entity. This is much less risky to an uninformed investor compared to a PSA privatization plan where an investor chooses individual equity investments through a private company. It is important to note that the added control on investments can improve financial literacy. This would be a benefit in the long-run and propose issues in the short-run (Mitchell and Zeldes 1996).

Privatization creates risk but it also mitigates and eliminates risks created by the current system. Privatization greatly reduces political risk. Under privatized social security, workers benefits are based on their investment performance, not an amount set by the government. Along with reduced political risk is the elimination of intergenerational risk. Since a private plan is fully funded and not pay-as-you go, a retiree's benefits are not reliant on the next generation of workers. Overall, privatization gives workers an assumed constant held mean of future income which reduces household uncertainty. This reduction in uncertainty is a substitute for the created economic or investment risk. The net effect of risk under privatization is therefore ambiguous (Mitchell and Zeldes 1996).

### **C. Minorities**

The current system offers many advantages to minorities. Many minorities are in the lower income bracket and benefit greatly from Social Security's progressive formula. Those in favor of privatization often argue that the current system is harmful to minorities because of differences in life expectancy. Non-minorities tend to live longer than minorities and so receive benefits for longer (Beach and Davis 1998a, 1998b). Not all minorities have a shorter life expectancy. While African Americans after the age of 65 do have lower life

expectancies than other races, Hispanics tend to have a higher life expectancy at age 65 and 75 (SSA 2021a). While certain minorities are disadvantaged by life expectancy, the advantages of the current system partially or totally offset this disadvantage.

Proponents of privatization also argue minorities benefit under a private system because of increased returns (Beach and Davis 1998a, 1998b). While high returns are possible, there is also an increase in investment risk. Minorities, specifically African Americans, tend to be risk averse and are more conservative in their investments compared to whites. Those in the lower income bracket (African Americans and other minorities) may not be as willing to risk their retirement savings on the market. These conservative investments tend to have yields lower than the current Social Security benefits (Nwafor 2005).

#### **D. Transition Costs**

The biggest issue for privatization plans is the generational gap between the new and the old Social Security Program. If the United States were to switch from a public to a private system, current retirees and those close to retirement would still need to receive Social Security benefits for the next several decades. There are different solutions to fund the total transition cost. One solution is to raise consumption taxes and to gradually cut benefits for new retirees. Another is to issue “recognition” bonds to participants who have a loss of promised benefits. This in turn will increase taxes on the current working generation but benefit cuts will be less severe (Mitchell and Zeldes 1996). Another solution is to do a stylized partial privatization. Benefits are reduced slowly over time, protecting the initial elderly and eventually reaching benefits that are 50% of their original value. Payroll taxes for younger workers will also decrease over time, but the effective labor income tax rates will rise over their lifetime. This would finance a large part of the transitional benefits. In all cases, the current working generation is seeing an increased tax rate and the current retirees are seeing decreased benefits (Nishiyama and Smetters 2007). A big concern is that a large deficit and increased costs to current generations created to finance privatization is not enough to justify future benefits. Any welfare gain will be canceled out by the cost of transitioning.

Conesa and Garriga (2008) researched the welfare loss between current and future generations by using an optimal fiscal policy approach. Their research focuses on the literature across the entire policy space, rather than comparing

specific exogenous policies one to one. (Conesa and Garriga 2008). Transition policies measured were constrained to the Pareto frontier, a graphic measurement of all Pareto efficient or optimal allocations. Pareto efficiency or optimality is an economic state where the reallocation of resources to make an individual better off cannot occur without making another individual worse off (Lotov 2008). In this case, the better off individuals are future working generations and the worse off individuals are the current working generation and retired generation.

Under assumed conditions, they found a Pareto neutral reform that can be implemented through the creation of Social Security implicit and explicit debt. The implicit debt is the difference between government debt under the current program and government debt under a new privatized program. This is also the opportunity cost of the transition. The explicit debt is the pay out of pocket amount for financing the transition. Using these two factors, Conesa and Garriga found an optimal Social Security reform. This reform includes “compensatory transfers to the initial old (almost as large as their social security entitlements) financed with debt and lowering labor income taxes on impact in order to increase them later on.” (Conesa and Garriga 2008). Overall, their suggested Pareto neutral reform supports the claim that overall welfare gain of the future generation is canceled out by the cost of transitioning. There are issues with Conesa and Garriga’s research. They do not account for demographic considerations and they assume away annuity markets, making Social Security a substitute. Their work is continuation of many transaction associated research, particularly that of Auerbach and Kotlikoff.

Unlike the Conesa and Garriga model, the Auerbach-Kotlikoff model (AK model) from 1987 focuses on individual transition policies. Although it was created almost 25 years ago, the AK model has been the basis for many privatization research. The model is popular for its flexibility and easy use. The main purpose of the AK model in Kotikoff’s research is to quantify alternative proposals to reform social retirement arrangements. The model tests how tax and transfer policies affect total consumption and welfare distributions when individuals are free to arrange their own plans under set government policies. There are two assumptions with this model. The government respects a budget constraint and households respond to government policies with purpose and not at random. Kotikoff’s simulation with this model shows there is welfare gain for future generations. This only holds true if the privatization plan includes a compensation to the current generation. If there is no compensation, then the long run gains in output and living standards will largely

be at the expense of the current generation. Kotikoff explains the AK model under different scenarios that deal with the transition cost of privatizations.

Under specific conditions (consumption taxation is used to finance social security, the initial tax structure features a progress income tax, and benefit leakage is low) there is a 4.3 percent welfare gain to future generations. If these specific conditions do not hold, the overall gains are likely to decrease, possibly even negative. In a specific example where income tax finances transition benefits, there is a 30 percent leakage and there is full compensation to initial generations, future generations experience a 1.2 percent welfare decline. The actual welfare gain is expected to be somewhere between the two extremes of positive and negative welfare returns. Since future policies are unknown and hard to predict, the overall welfare gain or loss from privatization is unknown. Although the AK model is a valuable analysis, there are some issues with Kotikoff's findings. The model assumes a perfectly certain environment. Risks such as investment risk, political risk, life-span risk, and labor-income risk are not included in these findings.

Although the AK model can include this analysis, Kotikoff did not expand the model when finding this conclusion. Kotikoff's conclusion is also misleading. Kotlikoff simplifies privatization by calling it progressive, even though the model fails to recognize certain risks.

### **Conclusion**

Privatization of Social Security's benefits to individuals and welfare effects on current and future generations are nonexistent at best or negative at worst. Privatization reduces political and intergenerational risk and may provide increased returns, but privatization also creates negative effects that offset benefits to households. The limited financial literacy of individuals and the creation of investment risk reduce the probability of higher returns. The removal of the progressive formula makes privatization less redistributive. While policy reforms to privatization such as a payroll tax financed public pensions can reduce this issue, the overall success of a sperate public pension is unknown. Minorities benefit more from the current progressive system than a privatized system. With increased investment risk, a decrease in financial literacy, and majority conservative investment practices, minorities' benefits in a privatized system are less than the benefits provided in the current system.

The transition costs to a privatized system make any welfare gains ambiguous. The generation during the transition will be negatively affected and the increased welfare of future generation is dependent on specific government policy. If this certain policy is not met, the welfare effect is unknown and possibly even negative. There are too many unknown variables in privatization to justify any of these risk or decreased benefits.

While privatization is not the solution, there are many other possible reforms that are beyond the scope of this paper. It is important to reform the Social Security program sooner rather than later. “Clearly, the longer we wait, the greater will be the required adjustments, and the more of the burden we will pass on to future generations” (Murphy and Welch 1998). Social Security is considered to be America’s greatest anti-poverty program and serves millions of individuals each year. Any loss in Social Security benefits would harm lower income individuals.

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