What's Next for Social Security?
Partial Privatization?

By John B. Williamson

Current projections suggest that in the absence of some policy changes, the Social Security trust fund will be depleted in about 2038 (Board of Trustees, 2001). Based on these projections as well as related projections about the graying of the nation's age structure (Congressional Budget Office, 2001), many analysts have argued that we are facing a crisis that will require major structural changes in Social Security. The most controversial of the proposed changes is the call for the introduction of funded individual accounts, also referred to as the "partial privatization" of Social Security. Some advocates of partial privatization see the addition of individual accounts as the end goal. Others see this addition as a first step toward eventual full privatization (Ferrara and Tanner, 1998; Peterson, 1999).

The idea of partially (or fully) privatizing Social Security is not new. Analysts associated with the libertarian Cato Institute have been making proposals along this line since the early 1980s (Ferrara, 1983). However, until the mid-1990s such proposals were identified with the radical right and not taken seriously by mainstream policy analysts. This situation changed during the mid-1990s, largely as a result of the attention given to proposals calling for the partial privatization of Social Security by both the Bipartisan Commission on Entitlement and Tax Reform (1993) and the Advisory Council on Social Security (1997). The reports of both these advisory bodies became the focus of the press and many mainstream members of Congress. The more recent report of the President's Commission to Strengthen Social Security (2001) (Strengthening Social Security and Creating Personal Wealth for All Americans: Report of the President's Commission, hereafter the Commission Report), which will be the focus of this article, represents an effort to build further support for the idea of partially privatizing Social Security.

The President's Commission

During the 2000 presidential election, George W. Bush repeatedly promised that if elected he would solve the projected Social Secu-
rity funding shortfall and that his solution would include the introduction of individual, or personal, accounts. Workers would be able to divert a portion of their Social Security payroll tax into individual accounts that they would own, control, and be able to pass along to their heirs in the event of death. In May of 2001, President Bush appointed the President’s Commission to Strengthen Social Security. Half of the sixteen members were Republicans, and half were Democrats, but all were handpicked by President Bush, and all were on record as favoring individual accounts. From the outset, the structure of the commission was controversial. While it did include as many Democrats as Republicans, it did not include any of either party who were critical of individual accounts, and it failed to include representatives acceptable to several important Social Security stakeholder groups, most notably, organizations representing the elderly, organized labor, women, African Americans, and the disabled. Such groups criticized the composition of the commission at the outset and, not surprisingly, were highly critical of the final Commission Report. For a summary of the criticisms from such groups see the various editorials and reports distributed by the Institute for America’s Future at http://www.ourfuture.org.

Why did the president put together a commission that so transparently lacked bipartisan support? This is a question that policy analysts will be debating for several years. One possibility is that he had no intention of using this commission to formulate legislation that he would submit to Congress for action in either 2001 or 2002. Rather, his goal may have been to keep the idea of privatization on the national agenda, to help build political support for the idea, and to discharge a promise to his backers in the 2000 election by at least taking a step toward the introduction of individual accounts. He would not be the first president to have set up a commission to study an issue as an alternative to taking legislative action.

The Commission Report

While the original charge to the commission was to come up with a single individual accounts plan, by October of 2001 the Bush administra-
tion had concluded that it would be bad politics for the commission to get behind a single proposal. The reason seems to have been that in the 2002 election Republican candidates would be forced to take a stand for or against the president’s plan and Democrats would then use it against them. At least in part in response to pressure from the Bush administration, the Commission Report puts forward not one, but three different personal account proposals. For all three plans, participation in the individual accounts would be optional.

Plan One. This plan would allow workers to redirect 2.5 percentage points (out of 6.2) of their payroll tax into personal accounts. At retirement, the Social Security pension based on the regular (defined benefit) portion of the scheme would be proportionately reduced to reflect lower contributions to that part of the system. This plan calls for the addition of about $1.5 trillion in additional funding from general revenues between the years 2016 and 2043 to finance the transition. After 2043 the plan would still run a deficit that would have to be made up in some way, but the deficit would be somewhat lower than that projected for the current scheme.

Plan Two. This plan would allow workers the option of redirecting 4 percentage points of their payroll tax into personal accounts, but there would be a cap of $1,000 per year on the amount that could be so diverted. And at retirement the benefit from the defined-benefit portion of Social Security would be greatly reduced to reflect this redirection of funds. After 2009 benefits would be further cut because of a shift from wage indexing to price indexing of earnings prior to retirement. To help protect low-wage workers, this plan would provide a guaranteed minimum pension. If the worker’s combined income from the defined-benefit component and the personal accounts component were to fall below 120 percent of the poverty line, the difference would be made up by the government, using general revenues. The plan calls for an infusion of about $900 billion between 2015 and 2029 in additional funding from general revenues to finance the transition.

Plan Three. This plan would allow workers to redirect 2.5 percentage points of their payroll tax into personal accounts subject to a cap of
Generations

$1,000 per year, but they must also add another 1 percent of their wages to these personal accounts. The defined-benefit portion of the eventual pension would be reduced because of the diversion of funds into the individual accounts. These pensions would be further reduced because of a shift from wage indexing to price indexing of preretirement wages. The penalty for early retirement would be increased (this change would affect a lot of people) and there would be added incentives for those who delay retirement (this change would affect relatively few people). There would be a guaranteed minimum pension set at 100 percent of the poverty line. This plan would call for the infusion of approximately $400 billion in new money from general revenues between 2015 and 2028 to pay for the transition. After the transition, a gap would still exist between benefits and revenues, but the gap would be less than that under current Social Security legislation.

Analysis of the Commission Report

The following analysis focuses on plans two and three (as outlined in the Commission Report), as plan one is at best a very partial proposal that makes almost no attempt to close the projected gap between Social Security revenues and pension payments, despite a huge infusion of new money. While both plans two and three have their flaws, they also include a number of innovations.

One innovation is to make participation in the individual accounts voluntary. Based on the British experience, it appears that this would help protect the many low-wage workers who will most likely stick with the defined-benefit option (Williamson, 2000). Most prior privatization proposals would make participation in the individual accounts mandatory. However, there is a catch. Both plans two and three call for other changes that add up to benefit cuts that would affect all workers, not just those who elect the individual accounts option.

Another important innovation is the inclusion of a rather generous minimum pension for plan two (and a slightly less generous minimum pension for plan three). A minimum pension of 120 percent of the poverty line could go a long way toward protecting many of the most economically vulnerable. However, here too there is a catch; this minimum pension would only become available after thirty years of participation, thus excluding many of the most vulnerable. Another concern is that in any final legislation, the minimum pension would be cut and possibly eliminated entirely. One reason is that the groups benefiting most from this provision are unlikely to be well represented behind the closed doors when the final deal is cut. Another reason is that the need for huge sums to pay for the cost of the transition is likely to produce intense pressure to cut benefits, and it is a lot easier to cut proposed new benefits than to cut benefits that people have been receiving (or promised) for years.

One of the proposals, plan three, calls for splitting pension assets in the event of divorce. This innovative provision would benefit some women, particularly those married for many years to high-wage spouses. However, it would not be of much help to women in low-wage households, particularly those not legally married to their partners.

According to projections presented in the Commission Report, on average, low-wage workers should do better in 2032 under any of these three plans than under current Social Security legislation. It is possible that this situation would be true for many low-wage workers who retire with at least thirty years of coverage. However, those with less than thirty years would be ineligible for the minimum pension and as a result would most likely do less well than they do under the current scheme. Many low-wage workers, particularly female and minority workers, reach retirement age with less than thirty years of coverage.

The Commission Report gives short shrift to the issue of market risk and potential consequences of being subjected to a sharp market correction during the years just prior to retirement. While it is true that the ups and downs of the stock market do tend to average out over the long run, risk is a big issue, particularly for low-wage workers. These workers are often so close to the poverty line as retirees that even a modest drop in benefits may push them into poverty. Also, they are much more dependent
upon Social Security for their retirement income (Williamson, 1997).

Each of the three plans calls for a large infusion of funding from general revenues for a period of about fifteen to twenty-five years to pay for the cost of the transition. Extra funds would be needed to meet Social Security obligations to the currently retired and disabled while diverted payroll taxes were being used to build up individual accounts. From a look at the British experience, it is safe to assume that in the long run partial privatization would reduce the burden on the government (Liu, 1999), but in the short term (fifteen to twenty-five years, depending on the plan) the burden would substantially increase.

The proposed shift from wage indexing to price indexing of preretirement earnings would add up to a major cut in Social Security benefits. When the extent of these cuts is made explicit, it is going to create major political problems for those attempting to build support for these privatization proposals. While a delay until 2009 would in a technical sense not violate President Bush’s promise to avoid subjecting those very near retirement age to lower benefits, this technicality is a nicety that would get lost in the debate once the extent of the cuts implicit in this provision became widely known.

**IS PRIVATIZATION DEAD?**

There seems to be a general consensus that there will be no effort to take legislative action on the partial privatization of Social Security at least until after the 2002 congressional elections. While it is possible that an effort will be made to enact such legislation in 2003, it is more likely that such action will take place after the presidential election of 2004. However, it is very possible that the issue of partial privatization will be back on the national agenda, but only if and when at least most of the following conditions are met: (1) the Republicans have firm control of both the House and Senate, (2) the major stock market indices experience at least a couple of years of steady gains and again start attaining all-time highs on a regular basis, (3) the recession ends and the prospect for long-term economic growth starts looking good, (4) memory of the Enron scandal fades, (5) the national mood of fear and anxiety about terrorism recedes, and (6) the federal budget again starts to run large surpluses.

**ALTERNATIVES TO PRIVATIZATION**

While the serious financing problems are still decades away, it does make sense to make some change in Social Security policy now as opposed to waiting another ten or twenty years. Social Security can be reformed and very likely will be reformed without the introduction of individual accounts. However, many of the structural changes that have been proposed and no doubt will be considered have the potential to do much harm to those who are most economically vulnerable and most dependent on Social Security for retirement income, particularly low-wage workers, women, minorities, and the disabled (Kingston and Williamson, 2001).

Examples of the structural changes that would tend to put a disproportionate share of the burden on the economically vulnerable are the following:

- Increasing the number of years of work history used to compute pension benefits from 35 to 38.
- Shifting to a less generous formula for annual cost-of-living adjustments.
- Taxing all Social Security distributions the same way distributions from private pensions are taxed (because the Social Security benefits of many current low-income retirees are not subject to federal taxation).
- Shifting from wage indexing to price indexing when computing the original pension benefit.

Some changes would tend to put the burden on the more affluent, for example, increasing the cap on wages subject to the payroll tax (for 2001 the cap was $80,400).

A number of changes are more neutral or require more study to determine the likely distributional impacts. Examples of these changes follow:

- Extending coverage to all state and local employees not currently covered by Social Security.
- Increasing the minimum age of retirement.
- Increasing the penalties for retiring at the current minimum age.
• Increasing the normal age of retirement (currently on its way up from 65 to 67) to 68 or 70, with the possible addition of automatic increases linked to future increase in life expectancy.

For an assessment of the distributional impact of many proposed reforms see Fontenot (1999).

CONCLUSION

If the Republicans win big in either 2002 or 2004, it is likely that the issue of partial privatization will be back on the table, and we may end up with some version of individual accounts that will be influenced by one or more of the proposals formulated by the President's Commission. However, the closer we get to 2030 without the introduction of individual accounts, the less likely it is that partial privatization will be enacted. The major reason is that it will be much more difficult as we move closer to 2030 to both pay for current pensioners and divert a portion of Social Security payroll taxes into individual accounts.

It would be a mistake for those who see themselves as looking out for the old-age security interests of people who are the most economically vulnerable to continue to focus almost exclusively on the debate over the partial privatization of Social Security. It is time to shift attention to questions about who will be put at risk in connection with the many other reforms that are under consideration.

Some liberals would, no doubt, suggest that we limit ourselves to policies that would put most if not all of the additional burden on those workers who can most afford to pay, the affluent. But this suggestion does not make sense for two reasons. One is that it does not take into consideration the political influence of this segment of the population. A second reason is that many changes will be required to bring revenues into line with benefits during the retirement of the boomers. Some of the most effective will inevitably favor the affluent, while others will favor the poor. Broad-based sharing of the burden is the only option that will be politically viable.

Given projected levels of retirement income for low-income workers and given the lack of ability to precisely specify the distributive impact of any set of policies in advance, it of course makes sense to err on the side of selecting a set of structural changes that put more of the burden on those who can most afford to pay. At a minimum, the final set of changes should not end up asking those who can least afford to pay to bear a disproportionate share of the burden. However, unless we keep close track of the likely net distributional consequences of whatever is included in the total package of changes made, there is a high risk that the most vulnerable will be hit particularly hard because so many of the changes currently under consideration would affect those with the lowest incomes most adversely.

John B. Williamson, Ph.D., is professor, Department of Sociology, Boston College, Chestnut Hill, Mass.

REFERENCES


