

THE SOCIAL SECURITY NETWORK

What Would REALLY Happen Under Social Security Privatization?

Part I: Solving a Problem by Creating a Bigger One



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Introduction

“I can think of no more important domestic problem requiring resolution than restoring the integrity of Social Security and to do so without penalty to those dependent on the program.” With the Social Security trust funds near exhaustion, in 1982, President Ronald Reagan chose these words to launch the Greenspan Commission on its task of strengthening Social Security.

Today, a new commission, this one created by President George W. Bush, is looking at Social Security. The financing problems the program faces currently are smaller and less immediate than they were in 1982. But while the program is far from a crisis, the Bush Commission nevertheless is expected to advocate diverting payroll taxes that finance the program into personal investment accounts; every member of the Bush Commission has supported this approach. Yet private accounts carved out of Social Security would undermine, rather than restore, the “integrity of Social Security.” And they cannot be introduced “without penalty to those dependent on the program.”

As the baby boom generation begins to retire starting in the next decade, and as the average lifespan of Americans increases, the financial burdens on Social Security will grow. Current forecasts show that in about thirty-seven years, the Social Security system will have insufficient resources to pay for all of the benefits that currently are guaranteed. But a sensible combination of changes similar to adjustments that have been enacted in the past—for example, modest changes in benefit formulas and the income cap for payroll taxes, plus transfers of general revenue to the program—could sustain the system indefinitely. Such reforms would preserve the insurance protections that have helped to reduce poverty rates among the elderly from more than 30 percent before 1960 to around 10 percent today.

Diverting payroll taxes to private accounts, as the Bush Commission will propose, would actually add a large additional financial burden to Social Security instead of alleviating the projected shortfall. That is because the money to create the new accounts would be drained from the income stream that finances the benefits paid to today’s retirees and the trust funds that will support payments in the future. Indeed, the Bush Commission already is considering significant cuts in guaranteed benefits, delays in the retirement age, and reductions in cost-of-living increases for benefits in order to help cover the costs of privatization. Those cuts will have to be far more severe than any reductions needed to sustain Social Security without creating new private accounts.

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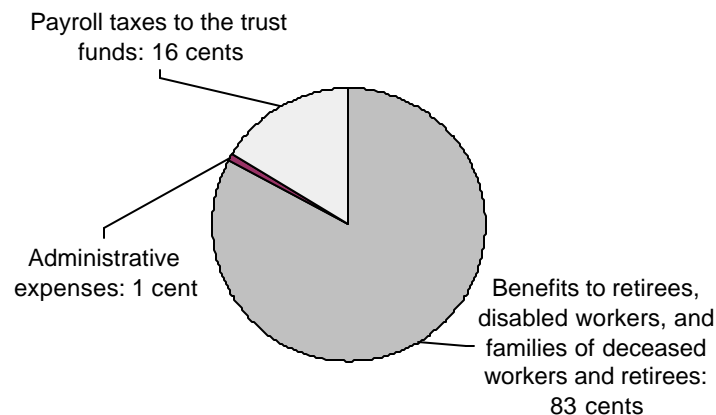
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Why Privatization Would Be a Money Pit

The privatization approach that is the focal point of the Bush Commission's deliberations would be enormously costly, requiring the government to (1) reduce guaranteed benefits to future retirees, and/or (2) increase taxes, and/or (3) raise the national debt. Privatization would cost hundreds of billions of dollars more than alternative measures to ensure the financial security of our existing system throughout the twenty-first century. Privatization would require more resources, not fewer, to honor the guarantees already in place to future retirees, disabled workers, and families of deceased workers who depend on the program.

The best way to understand why privatization would be very expensive is to follow what happens to today's payroll taxes. Many people mistakenly believe that their payroll taxes go into something like a piggy bank in their name, to be returned to them when they retire. But that is not the case. As Figure 1 shows, about 83 cents out of every dollar—about \$5 of every \$6—collected from workers' payroll taxes goes right back out in checks to Social Security beneficiaries. Diverting payroll taxes to create new investment accounts for workers would reduce the pot available to pay beneficiaries today and in the years ahead.

Figure 1. Where Your Social Security Tax Dollar Went in 2000



Source: 2001 OASDI Trustees Report, Table II.B1, Summary of 2000 Trust Fund Financial Operations.

What about the 16 cents of the payroll tax dollar that was added to the Social Security trust funds in 2000? That money is needed to build up the trust funds in preparation for the retirement of the baby boomers. Those trust funds are invested in U.S. Treasury securities, earning more than 6 percent per year, backed by the full faith and credit of the government, just like Treasury bonds owned by individual investors and mutual funds.

As the number of retirees increases rapidly in the next decade, Social Security will need to draw on these reserves. After 2016, the Social Security Trustees expect payroll taxes to fall short of Social

Security benefits. For the twenty-two years following that, the surplus that will have been built up in the trust funds will make it possible to continue to meet all of Social Security’s commitments. From 2038 onward, according to current projections, the trust funds will be exhausted and payroll tax income will be sufficient to pay about 74 percent of benefits if no changes are enacted between now and then.

Privatization would take away money that pays current benefits and feeds the trust funds, so it would accelerate the dates when there would be insufficient resources available to meet commitments (see Table 1). If two percentage points of payroll taxes (about one-sixth of the 12.4 percent payroll tax that finances Social Security) are diverted into private accounts, two dates that have received a great deal of attention from the commission would be moved up: first, the year in which payroll taxes no longer are sufficient to cover all of the benefits that have been promised; and second, the date when payroll taxes plus the trust funds are insufficient to meet 100 percent of commitments. These dates correspond to the date that the Social Security system first dips into the trust funds and the date when the trust funds are exhausted. The first of these, to which the Bush Commission pays close attention, would arrive only six years from now if payroll taxes were diverted into private accounts—far too soon for any growth in the accounts to make a difference.

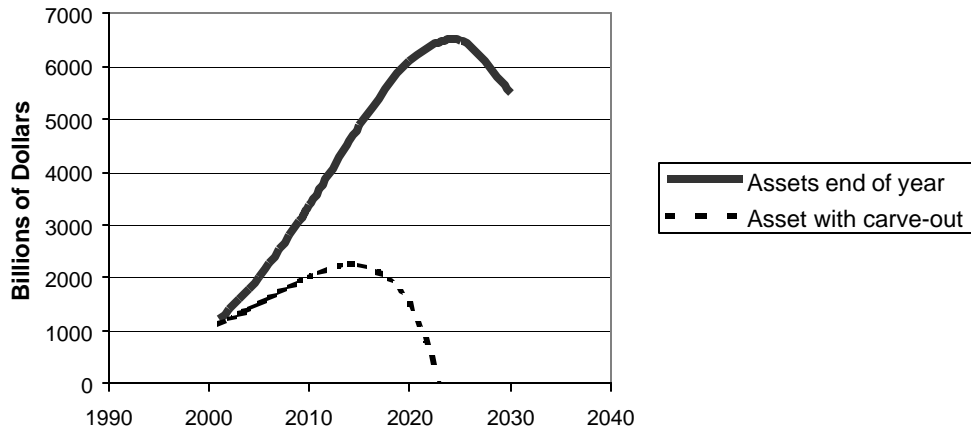
Table 1: With Private Accounts, Financial Problems Arrive Much Sooner

	Current Social Security system	System with two percentage points of payroll taxes diverted to private accounts	Privatization speeds up the shortfall by
Turning Point #1: Benefit commitments exceed payroll tax revenues available to pay them	2016	2007	9 years
Turning Point #2: Trust funds are exhausted	2038	2023	15 years

Source: Calculated by Century Foundation staff from the 2001 OASDI Trustees Report.

As Figure 2 shows, the two percentage point “carve-out” of payroll taxes to private accounts would rapidly drain the program’s assets and would deplete the trust funds by 2023, *fifteen years sooner* than would happen under current law. Far from fixing the long-term problem facing Social Security, privatization would make the problem worse.

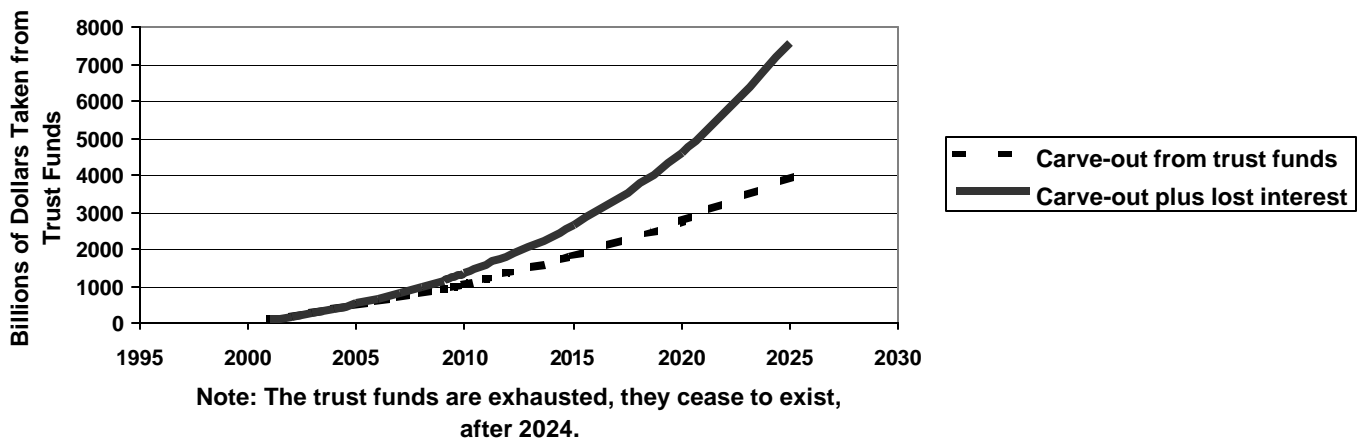
Figure 2: Effect of Diverting Two Percentage Points of the Payroll Tax on Trust Fund Assets, 2001-2030



Source: Calculated by Century Foundation staff from the 2001 OASDI Trustees Report.

Figure 3 shows how much revenue would be lost to Social Security from transferring two percentage points of the payroll tax to private accounts. Without such a transfer, in 2025 the trust funds would have \$4 trillion more from taxes alone. With such a transfer, the trust funds would have already disappeared in 2024. Adding in the foregone interest that these funds would earn over that time, the total lost resources to Social Security would amount to \$7 trillion.

Figure 3: Cost of Individual Account Carve-outs on the Social Security Trust Funds, 2001-2025

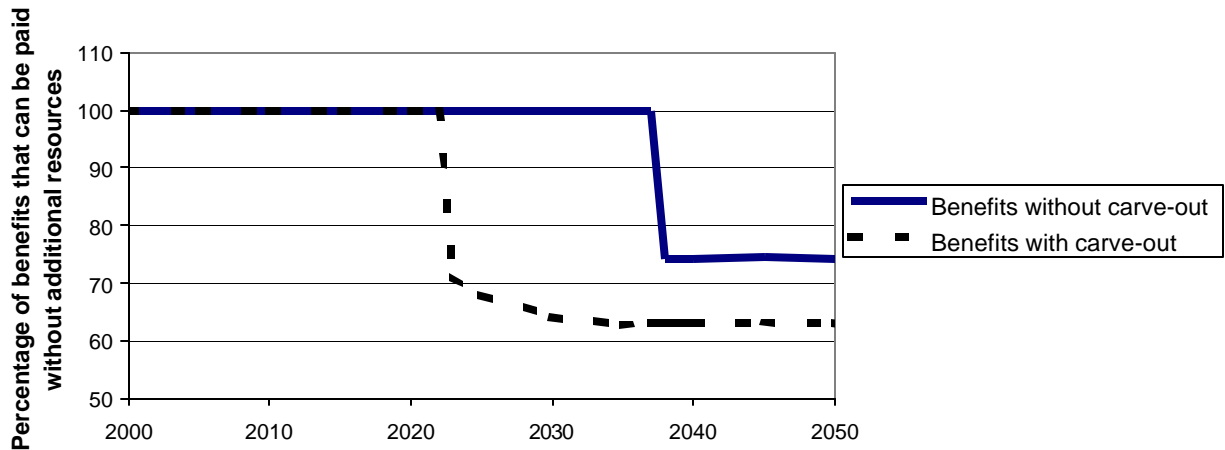


Source: Calculated by Century Foundation staff from the 2001 OASDI Trustees Report.

Not only would the trust funds disappear sooner under privatization, but after the trust funds are gone,

the portion of payroll taxes designated for individual accounts would continue to be unavailable to pay guaranteed benefits. Thus, benefits would be substantially lower, as Figure 4 demonstrates.

Figure 4: Effect of Diverting Two Percentage Points of the Payroll Tax on Benefit Payments, 2001-2050



Source: Calculated by Century Foundation staff from the 2001 OASDI Trustees Report.

If no changes are enacted, retirees would receive all of their guaranteed benefits until 2037, after which they would receive about three-quarters of the levels that are currently promised. That shortfall certainly needs to be remedied. But under privatization the problem becomes much worse: today's guaranteed levels could be sustained only until 2023, and after that, beneficiaries would get just 63 percent of the benefits provided under current law.

Conclusion

Privatization would replace the trust funds with up to 147 million private accounts, most of them very small. There would be substantial new costs from managing so many accounts. More importantly, there would be no guaranteed retirement, survivor, or disability benefits from individual accounts. As we will show in other issue briefs in this series, private accounts are not only risky, the claims about their returns have been grossly exaggerated.

The fundamental source of the Social Security financing problem is that we are living longer, and we have the baby boom generation moving toward retirement. Social Security provides the basic guaranteed income for old people, disabled workers, and their families. This is the foundation on which retirement planning is based. Some additional resources are needed to strengthen this foundation. Private accounts would *subtract* resources from that foundation, undermining rather than strengthening the program.