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UNDERMINING SOCIAL SECURITY WITH PRIVATE ACCOUNTS

Commission's final proposals would lower living standards without fixing shortfall

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The presidential commission charged with offering options to privatize Social Security has completed its work. Seven months in the making, the commission's final report shows clearly that the privatization idea is bankrupt. The proposals outlined during its last meeting on November 29 revealed that privatizing Social Security would require large benefit cuts that are not offset by higher returns from individual accounts. All workers would see declining standards of living if the commission's proposed benefit cuts were enacted. Depending on which of the three proposals is adopted, younger workers would see disproportionate benefit cuts, as would African Americans, women, and lower-wage workers. In addition, the three proposals would require potentially massive infusions of tax dollars to implement.

All three privatization options proposed by the commission would fail to offer the same security that workers currently enjoy:

- Each proposal reduces the standard of living for all retirees through benefit cuts that are not fully offset by savings in individual accounts.
- Under one of the proposed options, workers would face a higher retirement age. This would disproportionately affect low-wage workers, workers in physically demanding jobs, and African Americans.
- The commission violates the spirit of its mandate, if not the letter, when it comes to disability and survivor benefits. Although the commission's mandate stipulates that both programs shall remain intact, the benefit cuts proposed under two of the options would, in fact, substantially reduce disability and survivorship benefits, hurting families who depend on Social Security after the loss of a breadwinner's income.

- Even after cutting benefits, the commission's proposals would still require massive infusions of tax dollars to pay for privatization transition costs.

Three ways to dismantle Social Security

Common to all three of the commission's options is the replacement of part of Social Security with individual accounts, resulting in benefit cuts that vary in severity.

Option I

Each worker can voluntarily contribute 2% of payroll to an individual account. But in exchange, a worker would have to give up "the amount of benefits those payroll taxes (with interest) would have bought from Social Security." Each dollar contributed to an individual account will be replaced by a fixed-dollar reduction in benefits.

Option II

Each worker can choose to contribute 4% of payroll to an individual account up to a wage-indexed maximum of $1,000. As in Option I, Social Security benefits are cut in line with the worker's contribution. Additionally, benefits would be cut across-the-board, regardless of individual account contribution, by indexing them to the rate of inflation rather than the (generally higher) rate of average wage growth. For some workers, part of this benefit cut is compensated for by raising benefits for low lifetime earners and surviving spouses.

Option III

Workers could decide to contribute 1% out of their own pockets to an individual account, and their contribution would be matched by 2.5% from payroll taxes that otherwise would have gone to Social Security. Benefits would be reduced as under Options I and II. Additionally, Option III would raise the retirement age, effectively reducing benefits for everybody. Also, benefits would be reduced for high lifetime earners, but raised for low lifetime earners and surviving spouses.

Clawing back your benefits

Common to all three proposals is the trade-off between Social Security benefits and individual account contributions, or so-called "clawbacks." If workers contribute to individual accounts, the amount they can expect from Social Security would be reduced proportionally. These "clawbacks" represent substantial benefit cuts that expose workers to large risks, with few benefits in return.

A clawback works something like this—for each dollar workers contribute to an individual account, their Social Security benefits are reduced by that amount plus whatever that amount would have generated in interest. Since Social Security is not an investment scheme, the interest rate that each Social Security dollar earns is hypothetical. The commission proposes that Social Security benefits be reduced according to a fixed interest rate: 3.5% under Option I, 2% under Option II, and 2.5% under Option III.

After the clawback from Social Security, workers will be as well off as before only if they can manage to generate the same rate of return with their individual accounts as was assumed in the clawback calculation. This may be easier said than done, for two reasons: rates of return may not be as high as the commission assumes; and the costs associated with individual accounts will need to be deducted from the proceeds.

Though the commission has not clarified which rate of return it would assume for individual accounts, proponents of privatization generally use a rate of about 7.5%, equal to the long-term rate of return on the stock market. However, this rate is not consistent with the assumptions of future economic growth that underlie the projected shortfall of Social Security benefits after 2038—a projection that was the impetus for the creation of the commission in the first place. In fact, the Social Security trustees assume an economic growth rate of 1.6%, less than half the growth rate of the past 75 years (SSA 2001). Since the economy and the stock market have to grow together, a real rate of return consistent with the lower projected economic growth rate would have to be equally lower, i.e., somewhere between 3.5% and 4.0% (Baker 1997).

The costs associated with individual accounts will also diminish returns. For instance, administrative costs are roughly equal to 1% of the account balances each year. Also, the system will incur transition costs to pay for benefits that have been promised and will be honored under the current Social Security system, even if Social Security receives less income when money is diverted into individual accounts. Consequently, workers would have to pay twice, once for the retirement of current beneficiaries out of new taxes and once for their own retirement out of current payroll taxes. These transition costs could amount to $1 trillion over the next 10 years, $3 trillion over the next 20 (Aaron et al. 2001). Also, to replace Social Security's risk-free, inflation-proof, guaranteed benefits, workers will have to purchase retirement insurance on the private market, a cost that will lower their rate of return another 0.2-0.3% each year. In other words, nearly any gain from individual accounts will be overshadowed by the costs associated with them.

Individual accounts are not only costlier than the current system, they are also riskier. Even if workers on average generate the rates of return assumed by privatization proponents, millions of workers will likely fall below that average and end up with less than they would receive under the current system.

Living like Grandma did

The switch in the indexation of benefits from the rate of average wage growth to the rate of inflation, included in Option II, is a relatively obscure technical change that has large implications, especially for younger workers (Weller 2001a). This would mean that Social Security benefits will stay fixed in real terms forever, never to increase in step with future improvements in living standards. Because wages generally grow faster than inflation, living standards tend to rise from generation to generation. If Social Security benefits are indexed to prices instead of wages, benefits would no longer be tied to rising living standards. In other words, Social Security benefits will continuously decline for anyone retiring after the year in which the change takes effect (presumably 2006). For instance, workers retiring in 2020 would experience a benefit cut of 13%; workers retiring in 2070 could expect a 41% benefit cut. If this indexation method had been a feature of Social Security since its inception, today's retirees would receive a benefit linked to a basic living standard set in 1935, when a large share of households did not even have indoor plumbing.

Between a rock and a hard place

The other across-the-board benefit cut the commission has proposed, in Option III, is "benefit growth…indexed to life expectancy." This change would be equivalent to raising the normal retirement age, since every new genera-

tion tends to live longer than the previous one. Cutting benefits to compensate for the longer life span over which benefits are paid out means that workers will have to work longer to get the same benefit as previous generations.

To compensate for the higher effective retirement age, workers could either work longer or else try to save more. However, for the many workers with poor health, continued work is not an option. This is especially true for workers in physically demanding jobs, low-wage workers, and African Americans. These workers could still retire early, but only with reduced benefits. Moreover, most of the groups of older workers whose declining health prevents them from working longer are the same workers who lack adequate savings. As a result, a large minority of older workers, roughly 20%, will have to retire with reduced benefits. Another group of workers, approximately 15-20%, may be forced to continue working despite their poor or rapidly declining health.

Beating the bank

Will workers be better off with individual accounts than with Social Security, after all benefit cuts are considered? Under Options II and III, workers who forego individual accounts and stick with the system's guaranteed benefit will suffer compared to today's system, either because of the indexation to prices rather than wages or the adjustment for life expectancy. If they opt to go with individual accounts, they will first have to recover the benefits lost to the clawback.

Essentially, the clawback works like a loan. The worker "borrows" from Social Security and "repays" the system, in the form of lost benefits, at a predetermined interest rate by the time he or she retires. If the worker generates a rate of return equal to or higher than the predetermined interest rate—not likely to be an easy task, as discussed above—he or she has earned enough to at least recover the lost benefits. Additional gains are the worker's to keep. These do not add up to much, though.

Consider the specifics of Option II. Assume that a 35-year-old worker invests the full 4% of payroll in an individual account, and she generates a rate of return of about 4% (after inflation) over the next 30 years until she reaches age 65. At that point she will have to "repay" every dollar "borrowed" from Social Security, plus interest of 2% (the rate proposed by the commission for Option II). Only the cumulative 2% in excess of the predetermined interest rate is the gain that she can apply to cover the benefits lost from the across-the-board benefit cut (the switch in indexation from wages to prices). This benefit cut is about 18.2% in 2032 (as calculated by Koitz et al. 2001), which equals about $244 in monthly benefits in today's dollars for an average wage worker who earns $33,680 in 2001. Only $106 a month can be recovered with individual accounts.

Losing insurance value

The proposed changes in retirement benefits will also bring about reductions in disability and survivorship benefits. Social Security is a social insurance program that offers workers and their families wage insurance in case they lose their main source of income due to a worker's retirement, disability, or death. About one-third of Social Security's benefit payments go to recipients of disability and survivorship benefits; in 2000 these recipients included 3.3 million children (Weller and Bragg 2001). Because the disability and survivorship benefit formulas are connected to the way in which retirement benefit cuts are calculated, benefits under both programs will be cut if retirement benefits are reduced. This cut will especially hurt African Americans, who depend disproportionately on disability benefits, and women, who depend more than men do on survivorship benefits.

Hidden costs

The commission's proposals leave unsolved an important issue with serious fiscal consequences: how to cover the transition costs associated with switching from the current system to a privatized system. Given that the government's surpluses are gone—due to both the large tax cuts enacted early in 2001 and the spending increases enacted in the wake of the September 11 attacks—the cost of honoring the promises made to those who are already retired and those close to retirement (about $1 trillion in the next 10 years and about $3 trillion over the next 20 years) will have to be financed through higher taxes or increased government debt.

A better option

The commission set out to cover the expected financing shortfall in Social Security after 2038. While this projected shortfall rests on rather pessimistic assumptions, it seems nevertheless prudent to consider real options to cover the shortfall in the event it actually materializes. Yet none of the commission's options actually solves the anticipated shortfall over the next 75 years (Aaron et al. 2001). Rather than reducing benefits, which would leave millions of workers without adequate retirement income, proposals to address the shortfall should include options for generating new revenues. For instance, the arbitrary cap above which earnings are exempt from the Social Security payroll tax could be raised or eliminated, a method for increasing revenue that has even found some support within the commission (Kirchhoff 2001). The complete elimination of the cap—currently at $80,400—would affect fewer than 7% of wage earners, but it would cover more than three-quarters of the expected shortfall. Before policy makers pursue the kinds of draconian steps laid out by the commission in its three options, they should give serious consideration to the simpler and fairer reform of removing this cap.

Conclusion

The president's commission set out to privatize Social Security while improving its ability to provide a safety net and filling the anticipated shortfall after 2038. As the commission concludes its work after seven months, it is clear that it has failed on both counts. The commission's proposal to introduce individual accounts is a costly proposition, and workers will pay those in different ways. All three types of Social Security benefits—retirement, disability, and survivorship—would be cut, weakening the value of Social Security as a social safety net. Low-wage workers, blue-collar workers, men, and African Americans are disproportionately affected by an increase in the retirement age. A change in indexation method will hurt younger workers more than older workers. Cuts in the levels of disability and survivorship benefits will disproportionately affect women and African Americans. In addition to the proposed benefit cuts, taxes will most likely have to be raised to finance the transition costs. Lastly, all of the commission's options leave large financing gaps between 2038 and 2075 that will require additional tax increases to fill.

Instead of seriously addressing the real issues, such as inadequate retirement income for a large share of low- and moderate-income workers, the commission has offered a raw deal to workers.

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