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Ideas for Privatizing Social Security

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ABSTRACT

There has been considerable interest recently in privatizing Social Security. The ideas are wide-ranging: from adoption of a totally-revamped system of personal retirement accounts, similar to an approach taken by Chile in 1983, to permitting optional earmarking of a portion of existing payroll taxes for personal savings. This report summarizes the proposals that have emerged and the issues surrounding them.

Ideas for Privatizing Social Security

Summary

There has been considerable interest recently in privatizing Social Security. Although dormant for many years, the idea is not really new. It dates back to the system's inception 60 years ago when Congress rejected amendments to delete "old age benefits" from the Social Security Act of 1935 and to exempt workers from the system if their employers provided more generous pensions. The renewed interest is wide-ranging: from adoption of a totally-revamped system of personal retirement accounts, similar to an approach taken by Chile in 1983, to permitting optional earmarking of a portion of existing payroll taxes for personal savings, to using federal budget surpluses to create them. Others suggest that additional payroll withholding be required, over and above today's payroll taxes, for personal savings. Still others suggest that the government should invest the Social Security trust funds in stocks and bonds instead of federal securities.

Many privatization advocates feel that with expenditures approaching $400 billion a year, Social Security has gotten too big. They argue that it is outmoded, that the public is skeptical about its future, and that there would be more economic growth if people saved and invested privately instead. Some take issue with the system's social features, which they contend are inappropriate for a retirement program that workers pay for. They argue for an approach that aligns benefits more closely with what people pay. Still others feel that the system cannot survive for long, as evidenced by Congress' repeatedly having to address its long-run deficits, and that a more "reliable" means of retirement savings must be adopted.

The system's supporters contend that it is not "broken" and that moderate fixes will solve its problems. They fear that privatization would erode the social purposes of the system and tilt it in favor of highly paid workers, and argue that features such as inflation adjustments and the system's disability and survivor benefits are not easily replicated in private plans. They stress that the risks inherent in personal investing are high and may leave many people who made unwise or unlucky choices with inadequate retirement income. They further contend that to the extent that privatization requires foregoing taxes, federal budget deficits would be larger, there may not be enough revenue to finance existing benefits, and drastic benefit cuts may be needed to restore long-run solvency.

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The Range of Ideas

There has been considerable interest recently in privatizing Social Security. Although dormant for many years, the idea is not really new. It dates back to the system's inception 60 years ago when Congress rejected amendments to delete "old age benefits" from the Social Security Act of 1935 and to exempt workers from the system if their employers provided more generous pensions. The renewed interest is wide-ranging: from adoption of a totally-revamped system of personal retirement accounts, similar to an approach taken by Chile in 1983, to permitting optional earmarking of a portion of existing payroll taxes for personal savings, to using federal budget surpluses to create them. Others suggest that additional payroll withholding be required, over and above today's payroll taxes, for personal savings. Still others suggest that the government should invest the Social Security trust funds in stocks and bonds instead of federal securities.

The range of ideas—

Wholesale reform—replace the existing program with a Chilean-like system of personal investment accounts.

Adopt a two-tiered system composed of a flat-rate basic benefit supplemented by a personal savings account.

Earmark one or more percentage points of the existing payroll tax rate for deposit in personal savings accounts.

Mandate additional payroll withholding (over and above existing payroll taxes) for deposit in personal savings accounts.

Use federal budget surpluses to fund personal savings accounts.

Create an investment board to invest Social Security trust funds in stocks and bonds.

Philosophic Debate

The debate about privatizing Social Security actually dates back to the system's inception in 1935, when both the House and Senate considered amendments to delete the "old-age benefits" title from the original Social Security Act. The Senate adopted an amendment by Senator Clark that would have exempted workers from the program if their employers provided more generous pensions on their own. However, in the conference with the House that followed, the Clark amendment proved to be among the hardest issues to resolve, and was dropped. A subsequent attempt was made to restore it in the House, but it too was defeated. Since then, Social Security has evolved as a totally federal system. Federal taxes are levied to finance its benefits; its surpluses are invested in federal securities; and federal employees administer it. Moreover, while designed as a pension that workers pay for, it is very different from a traditional pension system. In particular, it has features designed to meet social goals: it is mandatory to assure that workers have at least a basic pension income, and it has provisions intended to meet anti-poverty goals such as benefit rules that favor low-wage workers.

For some privatization advocates, it is an ideological issue. They feel that with Social Security expenditures approaching $400 billion a year, the government's role has gotten too big. For others, the issue is the apparent lack of confidence the public has about the system. They argue that too many workers do not believe it can survive in its current form, and that a more "reliable" means of savings must be adopted. For still others, it is an economic issue. They contend that the economy would grow faster if people saved and invested privately instead. Finally, there are those who believe the current system is inequitable because it has too many social features. They feel that a worker's retirement benefits should be more closely aligned with what he or she pays for them, and that society's "social" needs should be dealt with through means-tested programs that explicitly measure whether people are in need.

The system's supporters contend that it is not "broken." While acknowledging that a long-range financing deficit exists, they point out that it only represents 14% of the average cost of the system. They argue that moderate fixes would eliminate it. They fear that significant privatization would tilt the system in favor of highly paid workers who already have substantial means to supplement Social Security. They argue that features such as inflation adjustments and the system's disability and survivor benefits may not be easily replicated in private plans. They stress that the "risks" inherent in personal investing are high and may leave many people who made unwise or unlucky investment choices with inadequate retirement income. Finally, they contend that to the extent that privatization requires foregoing existing taxes, the federal budget will be harder to balance, there may not be enough revenue to finance future Social Security benefits, and drastic benefit cuts may be needed to restore long-run solvency.

The "Transition" Problem

The practical issue with privatizing Social Security is determining how to shift from the current system to a new one, and in particular, how to finance the transition from one to the other. Some 44 million people now receive an aggregate 40% of their income from Social Security. Although there are surplus Social Security taxes flowing into the government, the system is still basically pay-as-you-go. If workers were told to put their taxes into private savings plans instead, the question arises of how the government would continue to finance the current system. The cash surplus today (the excess of current revenues to the system over payments from it) is only about $40-45 billion a year. To put this in perspective, foregoing taxes equal to 2% of payroll would result in an annual revenue loss of $70 billion. Even if people were required to take reductions in their eventual Social Security benefits, those reductions would not amount to much until way off in the future and therefore would not slow the system's outgo for many years. However, the revenue loss would be immediate.

A decade's worth of foregoing 2 percentage points of the payroll taxes would result in $1.1 trillion in lost receipts and interest.

Even if it were accepted that the Social Security system could forego these receipts, there would still be the questions of "if" and "how" the government should make up for the revenue loss. Excess Social Security taxes now flow into the Treasury. If the federal budget were running a deficit, the Treasury would receive less revenue and need to borrow more from the public. All that would occur is that money would flow into the Nation's financial markets through worker deposits in personal accounts, only to be borrowed back by the government. If borrowing from the public were not an option, the issue for policymakers is what revenue increases and/or spending cuts should be made to cover the revenue loss. If the federal budget were running a surplus, the question is whether this is the way it should be used (with spending increases and tax cuts being the alternatives).

Early Ideas for Reform

The seeds for today's debate probably date back to the mid 1970s when it became apparent that changing economic and demographic circumstances would strain the financial condition of the existing system. Although there was little congressional interest then in wholesale reform, a new wave of privatizing ideas began to emerge. One proposal, designed and circulated on the Hill in the early 1980s by the Insurance Company of North America, would have permitted workers to contribute up to $6,000 a year to an IRA or some similar plan and then take an immediate income tax deduction for the contribution. For each $1,000 workers deposited in their accounts, 0.5% of their eventual Social Security benefits would be forfeited. Workers who made the maximum $6,000 contribution for 33-1/3 years would forfeit all their benefits.

A similar plan, authored by Peter Ferrara and promoted by the CATO Institute in the mid-1980s, would have given workers an income tax credit of up to 20% of their Social Security taxes for equivalent deposits in what he called "super IRAs." Upon retirement, the worker's Social Security benefits would be reduced by an amount related to some proportion of the lifetime Social Security taxes that had been refunded through the credits.

Another plan devised by former Council of Economic Advisers chairman, Michael Boskin, and promoted by the National Federation of Independent Business, would not have privatized any part of the program per se, but transformed it into two-tiers with the second tier fashioned after a traditional annuity plan. He proposed that the government administer it. Representative Archer offered this proposal in a House Ways and Means Committee markup on the 1983 Social Security Amendments, but it was defeated.

In recent years a number of Members have come forward with other ideas. In 1986, Representative Gingrich developed a plan to eliminate the payroll tax and have workers under age 40 contribute to IRAs instead. Older workers were to be grandfathered under the old system and a new retirement trust fund was to be created to raise the income of all seniors above the poverty level. A value added tax was to be levied to provide the needed revenues.

In the 102nd and 103rd Congresses, Representative Porter introduced bills to privatize Social Security surpluses by mandating that 2 percentage points of the 12.4% Social Security tax be deposited in IRA-type accounts. Initially, these proposals were viewed as an alternative to a Social Security tax cut idea offered by Senator Moynihan in 1990. Although not specified in his bills, Representative Porter envisioned an eventual reduction in Social Security benefits in recognition that people would be saving through these IRAs. Former Senator Symms introduced a similar proposal.

The Chilean Model

The Chilean system represents another model. In 1981, Chile engaged in a sweeping reform of its Social Security system. Private retirement accounts managed by pension fund companies were established to replace much of the government-run system. Beginning in 1983, new labor force entrants were brought into the new system and existing workers were given strong inducements to join through an 18% mandatory salary increase and so-called recognition bonds that reflected the accrued value of the benefits they earned under the old system. Employers were relieved of any payroll taxes. Workers were required to make at least a 10% of pay contribution toward retirement and 3.3% for survivor and disability protection. The government regulates the investment companies and requires a minimum investment return. It also runs the old system for those who remain in it and guarantees a minimum benefit under the new one. Some 90% of the workforce is under the new system. Many analysts attribute a considerable portion of the economic growth that Chile experienced over the past decade to the new system. In part, Chile's reform was aided by the presence of a military government, existence of a substantial budget surplus, and a high degree of public dissatisfaction with the old system.

Ideas Emerging from the 1996 Social Security Advisory Council

A range of ideas was proposed in January 1997 by three different factions of a 13-member legislatively-mandated Social Security Advisory panel. It was charged with examining various ways to restore the system to a sound financial footing. One faction suggested revamping Social Security into a two tiered system — the first would provide flat-rate benefits based solely on years of covered employment and the second would be a private savings account, similar to an IRA, into which 5 percentage points of the existing Social Security tax would be deposited. The plan called for a 1.52 percentage point payroll tax increase and $2 trillion in public borrowing to help defray the "transition" costs of maintaining the existing system for those already in or nearing retirement. A second faction proposed a new mandatory payroll deduction of 1.6 percentage points on top of existing Social Security taxes to finance personal retirement accounts, similar to 401(K) plans. The assets that would build up in these accounts would be expected to compensate for the cuts in Social Security benefits needed to restore the system to long-range solvency. A third faction suggested that Congress consider creating an investment board, similar to the federal employees' thrift investment board. This board would invest part of the Social Security trust funds in the financial markets, perhaps through stock and bond "index funds" rather than the direct purchase of stocks and bonds. All three factions of the Advisory Council proposed other measures that in conjunction with their "privatization" proposals would restore the Social Security system to long-run solvency.

Current Proposals

One of the most significant policy question with creating private accounts is how to fund them. Thus far, three generic approaches have been suggested: (1) carve out a portion of existing Social Security taxes, (2) withhold more from workers' earnings, or (3) use projected budget surpluses.

The "carve out" approach: Currently, 12.4% of a worker's first $68,400 in annual earnings is paid in taxes by employees and employers (6.2% by each) to finance the Social Security system.[1] In recent years, the most prominent approach suggested to setting up private accounts would require or allow workers to use part of these taxes to do so. Such an approach is incorporated in one of three alternative plans proffered by the 1994-1996 Advisory Council on Social Security.[2] Its sponsors proposed that 5% of pay be carved out of the current Social Security tax rate for the creation of so-called "Personal Security Accounts" or PSAs.[3]

The carve out approach also is reflected in a number of bills introduced in the 105th Congress, including, S. 321 (introduced by Senator Gregg), calling for a mandatory 1% of pay set aside, and H.R. 2782 (introduced by Representative Sanford), which is similar to S. 321. A voluntary approach is reflected in H.R. 2929 (introduced by Representative Porter), calling for a 10% carve out (5% for employee and employer, each) for those electing to switch from the existing Social Security system to new individually-based accounts. A similar voluntary approach, calling for an 8% carve out (4% for employee and employer, each), is reflected in H.R. 2768[4]

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[1] More than 90% of workers have earnings below this annual threshold ($68,400 in 1998); thus, most workers pay the Social Security tax on all of their earnings. Another 2.9% tax rate (1.45% on employee and employer, each) is levied on all earnings (i.e., there is no annual maximum) to help finance the Medicare Hospital Insurance (HI) trust fund. The total Social Security and Medicare tax rate that the vast majority of workers and employers pay on all their earnings is 15.3%.

[2] The council was a legislatively-mandated body whose primary purpose was to make recommendations to resolve Social Security's long-range financing problem. Its report was issued in January 1997.

[3] Supported by 5 of the 13 members of the council, this plan (sometimes referred to as the Schieber/Weaver plan, named for two of its authors, Sylvester Schieber and Carolyn Weaver) also would have increased FICA taxes on workers by 1.52% of pay for 72 years. Hence, it represented a combination of a "carve out" and "add on" approach — on balance the net carve out from the two was to be about 3.5% of pay. The plan also envisioned converting the traditional government-run program into a flat-rate benefit system as well as making other changes to restore the program's long-run solvency. The authors contended that the combination of benefits from the new private accounts (the PSAs) and the scaled down government system would equal or possibly exceed the benefits payable from the current Social Security system (i.e., assuming the current system were able to pay the benefits prescribed under the benefit rules of current law).

[4] It also provides for additional voluntary contributions—i.e., an "add on" above the 8%

(continued...)

(also introduced by Representative Sanford).[5] Yet another approach is reflected in S. 1792 (introduced by Senator Moynihan) that, among numerous other changes it would make to Social Security directly, would allow workers and employers to each have a 1 percentage point Social Security tax cut. If the worker used it to create an individual retirement savings account, his or her employer would have to match it.

Obviously, if it is projected that the taxes that finance the system are insufficient to pay for future promised benefits, earmarking some of them for the buildup of private accounts would make this problem worse.[6] It would mean that to restore the system to solvency future tax increases would have to be larger or benefits cut deeper. Some proposals address this issue by asking workers to forego or forfeit a part of their Social Security benefits in exchange for the option to build private accounts — the premise being the larger the amount of taxes that they forego, the greater the forfeiture. In effect, the burden of reduction is placed on those who have made the greatest use of the carve out. The goal of these proposals is not to make the current system's problems worse, but to replace it. With these measures, the key financing question is one of timing. The larger the amount of foregone tax revenues, especially in the near term, the less money there is to meet current expenditures. The commitments to people currently receiving benefits or nearing retirement would have to be met, so to some extent the amount of the potential tax carve out is constrained, at least in the early years of such a proposal, by the need to keep the existing system going.

Withholding more from earnings — the "add on" approach: Some have suggested that instead of carving out existing taxes, today's workers could be asked to set aside an "additional" part of their incomes to build private accounts. One faction of the recent advisory council suggested that an additional 1.6% of pay be mandatorily set aside.[7] A similar, but voluntary, approach is reflected in H.R. 1611 (introduced by Representative Petri), which would permit anyone eligible for a "deductible IRA" under current law to make a contribution to a new personal "Social

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[4] (...continued)
required of those who switch.

[5] Similar "carve out" measures introduced in the 104th Congress include bills by Senators Kerrey, Simpson, and Robb (S. 824 and 825), and Representatives Porter (H.R. 2953), Thomas (H.R. 2971), and Nick Smith (H.R. 3758).

[6] Under the Social Security trustees' 1997 intermediate forecast, the Social Security system is projected to have an average 75-year deficit equal to 2.23% of taxable payroll under current law. This amount is equal to about 14% of the average cost of the system over the period. In terms of today's taxable payroll, this would be equal to $75 billion per year.

[7] This "add on" was included as part of the so-called "Individual Accounts" or IA plan, sponsored by the Advisory Council Chairman Edward Gramlich and member Marc Twinney. The plan included other measures to raise the income of the Social Security system and reduce its expenditures. As with the PSA plan, the intent was to give recipients the approximate combined benefits from a constrained Social Security program and individual accounts as they would have received under current Social Security benefit computation rules.

Security investment account."[8] The motives here are not to replace the existing system, but to offset some of the benefit reductions that may have to be put in place to restore solvency with accumulations of private assets.

Earmarking budget surpluses: Yet another possibility would be to have the government use surplus federal revenues — assuming unified budget surpluses eventually arise — to make deposits in new individual accounts. This approach would envision neither a tax carve out nor a new form of withholding, but would be contingent upon budget surpluses arising and not being used for numerous other politically popular purposes (i.e., new spending initiatives or lower taxes). Such an approach is partly reflected in H.R. 3082 (introduced by Representative Nick Smith), under which the Secretary of the Treasury would allocate one-third of any annual budget surplus to personal retirement accounts established for workers covered by Social Security (each worker would receive a "pro-rata" share of the surplus).[9] A related proposal, introduced by Representative Kasich, H.R. 3456, would dedicate budget surpluses for the creation of "Social Security Plus accounts" for Social Security taxpayers who had annual earnings of $2,800 or more (the amount deposited would be based on a worker's earnings). Similar proposals have been suggested by Senator Roth and Speaker of the House Gingrich. Support for the Roth proposal was reflected in passage on April 1, 1998 (by a vote of 51-49) of a Sense of the Senate resolution on H. Con. Res. 86 calling for Senate passage of such a measure this year.

Investing the Social Security trust funds in the stock market — Representative Solomon has proposed yet another variant — creation of a Social Security investment board with authority to invest surplus Social Security funds in stock and bonds as well as government securities (H.R. 336 in the 105th Congress, H.R. 164 and 491 in the 104th Congress, and H.R. 2152 in the 103rd Congress). This approach, also reflected in a third Advisory Council proposal, would not create new personal savings accounts but would attempt to use equity investments to bolster the return of the Social Security trust funds.

Related CRS Products

Report 95-839, *Social Security: The Chilean Example*, by Geoffrey Kollmann.

Report 97-990, *Social Security in the United Kingdom: A Model for Reform?* by Geoffrey Kollmann.

Report 94-593, *Social Security Taxes: Where Do Surplus Taxes Go and How Are They Used*? by David Koitz.

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[8] This bill also includes a provision prescribing that $1,000 be transferred from the general fund of the Treasury to each "Social Security investment account" established pursuant to the bill (presumably to be financed by the sale of "federal assets" to be recommended by the President).

[9] Among numerous other measures to constrain the long-run cost of Social Security, the bill also would permit additional voluntary contributions, carved out of workers' social security taxes, up to $2,000 a year. In turn, they would receive lower Social Security benefits in recognition of the amounts they accumulate in these new private accounts.

Report 91-129, *Social Security: Investing the Surplus*, by Geoffrey Kollmann.

Report 87-14, *An Analysis of a Proposal to Authorize "Super IRAs" as an Alternative to Social Security Benefits*, by David Koitz.