

Privatizing Social Security: A Third Option (Part 2 of 2) Part Two: Specifics of a Voluntary Alternative

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Social security reform is coming. Many would like to see a reform that might help increase private saving. They, therefore, are willing to consider adding to our public and private retirement systems a pillar that would involve a mandate for private saving. At first they try to take that mandate out of the existing social security tax rate. Given the large decline in workers to retirees, however, there are not a lot of revenues to take out of the existing system and still guarantee some minimum level of benefits. Next they consider adding a mandate on top of the social security tax rate. In this case, however, they are unwilling to raise combined tax and mandate rates very high, so the amount of mandated saving for many workers would still be fairly small.

In no small part, this was the dilemma of the Social Security Advisory Council. Caught between Scyllia of minimum benefits and the Charibdis of few new taxes or mandates, they offered several plans, no one of which could obtain a majority. Their mandate, moreover, restricted them from considering private pension reform at the same time. If mandates or subsidies for private accounts are created, however, there inevitably needs to be some integration between social security and private plan rules.

Here I provide details on one voluntary option that might allow navigation in these treacherous waters -- potentially raising the rate of contribution to private accounts by a significant amount, but without a substantial increase in mandates or taxes. I am by no means wedded to all details suggested here, and provide them partly to demonstrate the difficult considerations when attempting the necessary integration between government rules for public and private plans.

Consider the following approach as an alternative:

Basic Incentive

Instead of mandating a savings account for all workers, the government would increase the incentives for maintaining minimal private accounts. For instance, it might offer a 1 to 2 percentage point lower social security tax rate for employers and employees who set up employee accounts meeting a number of designated criteria. For our purposes below, we will use a 1.5 percentage point reduction as our example.

Matching Contributions to Private Pension Plans

The government contributions must be matched by contributions from the employee, employer, or both of at least 8 to 10 percent of pay. For our purposes below, we will use 8 percent minimum contribution as the example.

Payouts as Retirement Annuities Only

These moneys must be kept in the account or rolled over into a new account until retirement, or permanent and total disability. At time of withdrawal they must be converted to a lifetime annuity.

Spousal Sharing

All moneys put into accounts must be shared equally with spouses at time of deposit. Upon divorce or separation each spouse would be entitled to his or her own account.

Portability of Defined Benefit Plans

Employers would be allowed to fold this option into an existing defined benefit plan by guaranteeing that when an employee left the plan, he or she could walk away at least with the full value of all minimum contributions (for instance, a combined 9.5 percent of pay from both the 1.5 percentage point social security rate decrease

and the private contributions of a minimum 8.0 percent of pay that would have been made otherwise to defined contribution plans). Moreover, a rate of interest -- say, the rate of return on five-year indexed government bonds -- would also be guaranteed over that period.

A defined benefit plan might well offer higher levels of benefits, and it might well invest some moneys in stock or other markets, but would receive the additional tax reduction subsidy only if the minimum requirements were met. In effect, this proposal creates a type of portability for private pension benefit plans that has been hard to legislate under current law.

Relationship to Slower Growth in Social Security Benefits

To bring the social security system back into balance, the growth rate of benefits is almost inevitably going to be slowed down over time. The exact extent of slow-down would need to take into account the availability of the additional saving in subsidized accounts, as well as any decline in revenues. Unlike some proposals being put forward by the Social Security Advisory Panel, no account benefits would be assumed to accumulate at a stock market rate of return. If returns are higher than an interest rate, then some savers would receive higher private annuity payments, just as current retirees with private pension plan benefits have benefited from recent gains in the value of the stock market. The design of social security, however, cannot be made contingent on such returns.

Rationale for a Differential Tax Rate

Some individuals would not benefit from the 1 to 2 percentage point differential -- that is, they would not work in places where the incentive were accepted nor would they save themselves. The differential tax rate they would pay can be viewed as a charge or insurance premium on the greater risk they are posing on social insurance schemes such as Medicaid long-term care and Supplemental Security Income.

Taxability of Accounts

It would seem easiest to allow the accounts to be taxed as normal Individual Retirement Accounts. All deposits would be deductible and tax would be deferred on accumulations. All withdrawals, including the value of the government subsidy, would then be fully taxable. To achieve this, however, might require some tinkering with a current rule that denies deductibility for employee contributions or taxes that go directly into social security rather than into private accounts. Other arrangements, however, are also possible.

Discrimination Rules

The 1-2 percentage point social security differential would be available to all individuals earning less than \$30,000 per year, regardless of the commitment within their place of employment to set up such a plan. In each firm, however, the differential would be available to higher-income employees only as long as all employees were fully covered. This coverage requirement entails defining "employee" and whether or not it would include part-time employees and temporary help with total compensation greater than some minimum. Broader issues of independent contractors and contracted work are not examined further here.

For employers maintaining such subsidized accounts, most other discrimination rules applying to private plans would be eliminated. There would still be some cap required for total contributions and/or benefits by or for any single employee.

Source of Private Contributions

Private contributions could come either from the employer or the employee since in low-wage firms it may be very difficult for employers to raise compensation enough to make deposits to these plans. (One might also allow payments by employers to count toward the minimum wage.) Perhaps a majority voting rule could be used to require contributions from all employees if the workers elect to take advantage of the new subsidy. Employers then could automatically withdraw the appropriate percentage from all employees once the firm and its employees decided to participate fully in the new system.

Maintenance of Social Security Progressivity

To ensure that the net impact of the reformed system would maintain progressivity and would not involve a transfer to higher-income individuals who might be more likely to save, the social security benefit formula would be changed to increase minimum benefits to low-income individuals. As already noted, however, the benefits to high-income individuals would gradually be reduced.

The combination of a higher minimum and a lower maximum might further be arranged in a way that would move the basic social security benefit toward a flat or equal-level benefit after a few decades, that is, after a full build-up of private accounts could occur over a working lifetime. Any flat benefit -- or minimum benefit in a flatter system -- would need to be higher than that suggested by a group within the Social Security Advisory Council, which is attempting to "privatize" a much larger portion of the social security tax rate. Their low minimum social security benefit, unfortunately, is an Achilles heel of their plan. Any minimum benefit or flat benefit should also be designed with the explicit purpose of moving all elderly -- especially the older elderly -- out of poverty in the near future.

Conclusion

Social security reform is inevitable in the near future. It will require some combination of benefit cuts and tax increases simply to get into balance. If one additionally wants to increase private saving and funding for retirement, the upcoming growth in the number of retirees to workers does not leave a lot of room to achieve

that goal by reducing significantly the existing social security tax rate.

One alternative worth considering is an additional government subsidy for the establishment and maintenance of sizable, portable, private pension benefits for all workers in the firm. To make this alternative work, one must still deal with a variety of other issues, such as the minimum guarantee provided under social security and the ways that discrimination and other private pension rules would be amended. None of this would be easy. There is no simple fix.

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