

Privatizing Social Security: A Third Option (Part 1 of 2)

Part One: Basic Rationale

C. Eugene Steuerle

"Economic Perspective" column reprinted with permission.

Copyright 1996 TAX ANALYSTS

Document date: December 09, 1996

Released online: December 09, 1996

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

The debate over social security has taken a sharp turn in recent months. Many proposals that have recently come to the forefront would "privatize" a portion of social security. For the most part, these proposals really don't privatize the system, but mandate that individuals deposit some fraction of their wages -- either a share of the existing social security tax or some new share of their wages -- into private accounts.

Unfortunately, almost none of the privatization options currently being discussed say much of anything about the current private pension system, its advantages and limitations, nor the ways that new, mandated, private accounts would be integrated with private accounts already existing. If proposals for privatization of social security move to a more mature second stage, then reform of the private retirement system should be considered at the same time.

Here I suggest how one option might work. The basic notion is that a slight reduction in mandated contributions or taxes to the government would be allowed when a significant portion of earnings is put into a private, portable pension account by either the employee or the employer on behalf of the employee. Several other adjustments are also required to make this option a viable one. In particular, to ensure that there is no loss in income for lower-income individuals who might not participate directly or through their employers, I also suggest that minimum social security benefits be increased for low-wage workers and their survivors. Overall, however, benefits within the direct social security system would have to be reduced for most workers -- essentially "flattening" or making more level the social security benefit amount received by all retirees. Private accounts, even more than under current law, would provide add-ons to a basic floor of government-provided benefit.

A paring of social security benefits, including increases in the retirement age, is required simply because the system is already out of balance. The option suggested here really adds little to that requirement since the potential revenue loss due to the tax cut is at best moderate relative to the cost of the rest of the system. It is the dramatic drop in workers to retirees, combined with built-in growth in future benefits per retiree, that leaves social security and Medicare promises of future benefits seriously out of line with projected revenues.

To deal with long-run shortfalls, both benefit cuts and tax or mandate increases have been favored by every member of the 1995-96 Social Security Advisory Council -- ranging from those who basically wanted to maintain the current system to those who wanted to privatize the system the most. The option we're presenting here differentiates itself by offering a way to enhance the private system without necessarily going all the way toward requiring that all earners pay some new mandate or tax.

One reason we are led to consider this alternative is the simple arithmetic of reform. Most reformers -- once again, including all members of the Social Security Advisory Council -- do not want to increase taxes or mandates very much. Yet the existing social security tax rate is sufficient to maintain only a modest benefit level once the number of taxpayers drops so dramatically relative to number of recipients. If one wants additionally to encourage significant portions of wages to go into private accounts in a mandated system, one either has to increase taxes or mandates substantially, or reduce basic benefits to near-poverty levels. That is, between the constraints of minimum benefits and few new taxes or mandates, there is not a lot of room to maneuver.

Social security law and private pension law are such complex areas that the tendency is to consider them separately. In the end, however, government rules applying to private pensions, such as discrimination rules, really are aimed at some of the same long-run goals as social security -- in particular, ensuring that minimum levels of income are available even to lower-wage workers when they retire.

The adequacy of private pension policy, moreover, has recently been called into question. First, the rate of saving in private pensions declined significantly in the 1980s. Some of this is due to the maturation of private pension plans, while the recent stock market boom led many plans toward full funding even without many additional deposits made on behalf of employees. Nonetheless, the savings occurring in private pensions pays for only a modest fraction of the retirement costs of most individuals.

Second, private pension plans do not seem to provide much support for those in the bottom half of the income distribution when they retire. Projections into the future usually obtain a similar result. From 1940 to 1970 the proportion of full-time private wage and salaried workers covered by private pensions rose from 17 percent to 52 percent. Since 1970, however, the coverage rate has not changed by a significant amount.

Defined contribution plans -- individually based pension accounts that operate like mutual funds or savings accounts owned more directly by the worker -- have certainly increased in importance in recent years. The evidence to date, however, is that many working individuals will not have accumulated more than a modest sum in these accounts by the time they retire. Remember also that we have come to expect almost two decades of retirement support because most of us now retire long before we are expected to die.

Third, there is a serious problem with withdrawals prior to retirement in many of the 401(k), profit-sharing, and other defined contribution plans. Such withdrawals are a threat to the long-term viability of these savings vehicles as retirement protections.

Finally, many defined benefit private pension plans -- those plans that promise benefits based on salary levels and years of work -- cannot be carried easily from one job to the next. They really are not very portable. A major reason is that defined benefit plans typically do not index promised benefits from the time a worker leaves a firm to the time that he or she retires. After a person leaves a firm for a decade or two, inflation erodes the value of the annual benefit drastically toward zero. The rate of payment, after all, is based on something close to the nominal wage level of the employee when last with the firm.

A private pension reform sometimes suggested in the past was that employers be mandated to maintain some minimum pension accounts even for the most mobile workers. Viewed closely, these proposals are very similar in kind and form to what is now being proposed as privatization of social security.

The obstacles to those requirements, by the same token, have been the same as to mandates constructed around social security reform. Any minimum requirement is viewed by many as simply another tax. If the requirement is large, then the required mandates plus tax rates may rise to objectionable levels. If the requirement is not large, then the size of accounts created may be relatively small. If the mandate involves only a percentage point or two of wages, some would argue that it may not be worth the administrative hassle. A worker earning \$10,000 a year for instance, accumulates only \$100 for each percentage point of mandate.

What I suggest here is that there may be a way out of this dilemma. Suppose that government would grant to taxpayers a modest reduction in their social security tax if they or their employers add to private accounts minimum deposits equivalent to say 8 or 10 percent of salary. A savings account of this size avoids problems associated with small-size accounts. This type of proposal would also likely lead many employers to reform their private pension plans to create much more portable accounts for those who leave the firm and move on to other jobs over time.

The differential in tax payments, by the way, might be viewed as a rough charge for those who do not save. Nonsavers increase significantly the probability that they will be dependent on the government either for direct cash assistance in old age, or for larger amounts of help in paying for such things as long-term care.

The reduction in tax for those who maintain minimum accounts might come out of the existing social security tax rate. It might be an additional tax that can be avoided if one meets the requirements. Or it might also be some combination: for instance, as opposed to a 15.3 percent social security and Medicare tax rate in current law, taxpayers without pension saving would pay 16.0 percent; those meeting minimum retirement saving standards would pay 14.6 percent. The choice depends largely on how far social security reform goes in adjusting age of retirement, growth rates in future benefits, and so forth.

Because this "privatization" would be voluntary, it skirts the political issue of whether a mandate is or is not a tax. Taxes paid to social security would be counted as taxes, but the minimum contributions of 8 to 10 percent of wages paid into private accounts would be treated as voluntary.

This suggested option is not designed to be a cure-all. There are still many decisions to be made within social security such as how fast benefits can grow over time. Within the private pension system, other rules and tax subsidies deserve serious scrutiny. This type of proposal simply offers one mechanism for integrating concerns for both the social security system and the evolution of the private pension system.

Other Publications by the Authors

- [C. Eugene Steuerle](#)
-

Usage and reprints: Most publications may be downloaded free of charge from the web site and may be used and copies made for research, academic, policy or other non-commercial purposes. Proper attribution is required. Posting UI research papers on other websites is permitted subject to prior approval from the Urban Institute—contact publicaffairs@urban.org.

If you are unable to access or print the PDF document please [contact us](#) or call the Publications Office at (202) 261-5687.

Disclaimer: *The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Copyright of the written materials contained within the Urban Institute website is owned or controlled by the Urban Institute.*

Source: The Urban Institute, © 2012 | <http://www.urban.org>