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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Politics and Privatization of Social Security

The main objective of the current Administration is to privatize Social Security and introduce a system of individual accounts. A Commission to Strengthen Social Security was established in 2001. An idea emerging from this Commission is to divert 4 percent of the 12.4 percent payroll tax into individual accounts and reduce the Social Security benefits by a "carve-out" equivalent to the value of the accumulated value of the diverted contributions. The arguments in favor of individual accounts include the "ownership society" in which individuals own their account balance within Social Security. Critics of the individual account concept have pointed out that individual accounts would do nothing to improve solvency of the system, would involve transition costs to replace the diverted contributions and would expose individuals to the uncertainties of market returns. Supporters of individual accounts stress the advantage of holding assets in an individual account as opposed to relying on the resources of the Social Security trust fund. This implies that the US government might default on the bonds held by the trust fund or that the government might not pay the full future scheduled benefits. Supporters claim that individual accounts would represent pre-funding and create personal wealth accumulation. They assert that pre-funding would moderate the cost of pensions, add to the capital base in the economy and enhance workforce productivity.

The proposals involve two forms of benefit cuts; the first is a reduction in the guaranteed defined benefit, equivalent to the accumulated value of the individual account balance; the second results from changing the present wage-indexing to a price-indexing system. One proposal is for a progressive system under which lower-income workers would continue to receive wage-indexed benefits, higher-income workers would receive price-indexed benefits and middle-income workers would receive a benefit partially wage-indexed and partially price-indexed. Under this proposal, scheduled benefits would be significantly reduced for higher-income and middle-income workers. There are also two major risks that would be faced during retirement: longevity risk and inflation risk. To ameliorate these risks, it is proposed that an individual's account balance be applied to purchase a lifetime inflation-adjusted annuity. Critics point out that the combination of the carve-out and annuitization will likely provide no net gains in aggregate. Another criticism is that investment management fees and annuity expenses would represent additional costs for this arrangement. The proposed individual account structure would mean that achieving superior investment performance and retiring at an opportune time would become a gamble for individuals.

What then are the real political motives for advocating an individual account system, when it is evident that the transition would not improve solvency, would impose risks on individuals and, according to opinion polls, is opposed by a majority of the population? One theory is that the objective is to gain advantage for the Republican Party among younger Democratic voters who may have real concerns about the future of Social Security. There is evidence that political strategists have identified Social Security as a means of winning the votes of the under-40 age group who voted for the Democratic presidential candidate in previous elections. This viewpoint is reinforced by the actions of President Bush who has recently completed a six-week cross-country campaign to bring the issue to local voters. Another explanation is that it would accomplish the political objective of removing the cross-subsidy element in the present system whereby lower-paid workers receive relatively higher benefits, as a percentage of pay, in comparison to higher-paid workers. Many observers expect that the diversion of 4 percent of payroll to individual accounts is only a first step in the transition to an all-individual-account system. As the Social Security system ultimately becomes completely based on individual accounts, the benefits would be determined exclusively on the basis of the value of accumulated account balances, having the effect of eliminating the cross-subsidy feature.

Political motives may also also be observed in the actual sequence of recent Administration actions. The following scenario is an exact chronicle of events that preceded the current political negotiations in the US Congress to develop legislation for historic reforms to the nation's Social Security system. The Administration's scenario begins with large income tax cuts, primarily to benefit the higher-paid. These are estimated to have a 75-year cost of $11 trillion, approximately three times the Social Security deficit. The cuts result in large Federal budget deficits with ongoing tax revenues down to a level of only 16.5 percent of GDP. The scenario then proceeds to proclaim that Social Security is bankrupt and unsustainable, while insisting on no future tax increases to support the system. The Administration then claims that unless future scheduled benefits are cut, it will be necessary to reduce spending on high-priority items such as defense and national security. The scenario then presents individual accounts and privatization as a solution to provide freedom of choice in an ownership society.

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