The True Cost of Privatizing Social Security

By Howell E. Jackson


Some time soon, the Bush administration is expected to make good on the president’s campaign pledge to reform Social Security by establishing individual accounts for younger workers. A likely component of the president’s plan will be the transfer of some payroll taxes away from the Social Security Trust Funds and into the individual accounts of participating workers. Those transfers could be substantial — perhaps on the order of $100 billion a year or more. Critics of the president’s proposal will undoubtedly seize on those transfers as a “cost” of privatization that the country cannot now afford. That criticism is somewhere between simple-minded and just plain wrong.

Social Security has for many years been running on the federal government’s credit card. To be sure, since the mid-1980s, the Social Security Trust Funds have been taking in more revenue than is paid out to beneficiaries each year, generating an annual cash flow surplus of roughly $150 billion and accumulating reserves of slightly more than $1.5 trillion as of the end of 2003. But while trust fund reserves have grown, so too have the Social Security system’s statutory obligations to workers and their families. For every dollar of payroll taxes paid into the Social Security Trust Funds, workers accrue valuable retirement benefits under the Social Security Act. The growth in the value of those promised benefits has vastly outstripped the system’s accumulating reserves.

The explosion of Social Security’s unfunded statutory obligations has been scrupulously bipartisan. During the last three years of the Clinton administration, the unfunded obligations of the Social Security system increased by $2.2 trillion. During the first three years under President Bush’s watch, those obligations grew another $1.8 trillion. As of January 1, 2004, the system’s total unfunded statutory obligations stood at $13.5 trillion — 125 percent of the gross domestic product and on a path to grow faster than our economy for years to come.

Let’s return now to the president’s plan. If his Social Security reform proposal calls for $100 billion a year to be transferred into individual accounts, there will almost certainly be a comparable reduction in the amount of new Social Security benefits promised to participating workers each year. That’s the basic logic of individual accounts: Participating workers accumulate retirement savings in their individual accounts, but earn lower levels of traditional Social Security benefits. Transfers of payroll taxes to individual accounts are not a total loss to the federal government but rather a change in the way the government pays for the retirement security of current workers. Rather than putting the entire cost of future Social Security benefits on the government’s credit card, the government will start paying some of those costs up front and in cash.

Instead of focusing on transfers to individual accounts, the public should evaluate President Bush’s Social Security plan against four financial yardsticks that do provide meaningful measures of the fiscal merits of the proposal.

Instead of focusing on transfers to individual accounts, the public should evaluate Bush’s plan against four financial yardsticks that do provide meaningful measures of the fiscal merits of the proposal.

First, to what extent does the plan address the system’s long-term fiscal imbalance? In and of themselves, individual accounts do almost nothing to improve the system’s solvency. But individual account legislation is an excellent opportunity to adjust the terms of the Social Security program, particularly for those young workers who will be eligible for individual accounts. A critical question is how much the Bush administration will propose to reduce the system’s $13.5 trillion in unfunded statutory obligations. Those reductions cannot be imposed on current retirees or near-retirees, but it is entirely appropriate to alter the terms of traditional Social Security benefits for those in their early fifties (like me) and younger.

Second, the public should pay close attention to the manner in which the president proposes to reduce traditional Social Security benefits for those who participate in individual accounts. If the offset of traditional benefits for those workers is substantially less than dollar-for-dollar, then the creation of individual accounts will harm the long-term financial solvency of the Social Security Trust Funds, putting traditional benefits at risk for current retirees and unfairly jeopardizing the capacity of the system to pay promised benefits in the future.

Third, the public should consider the impact the president’s proposal can be expected to have on the growth of unfunded statutory obligations of Social Security over the next decade or two. As things now stand,
those obligations are projected to grow faster than the overall economy, making the crisis in Social Security finances worse with each passing year. Properly constructed, Social Security reform should slow the growth of unfunded statutory obligations and perhaps even tap new sources of revenue. Together, those changes should reduce the size of the system’s unfunded statutory obligations in relationship to the overall economy, lessening the burden of our public pension system on future generations and leaving fiscal capacity to deal with other pressing problems like skyrocketing Medicare costs.

Finally, a reformed Social Security system should have adequate and clearly identified sources of liquidity to meet its statutory obligations over the next 75 years, the traditional time horizon for the long-term actuarial balance of social insurance programs. While it is possible that the trust funds may need to engage in temporary borrowing for some of that period to finance the transition to individual accounts, that borrowing should be repaid in full and the system’s actuarial balance should be restored within the 75-year time frame.

If the president’s plan measures up on these four financial yardsticks, the plan will make fiscal sense notwithstanding substantial transfers to individual accounts over the next few years.