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Understanding the Debate Over the Privatization of Social Security

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Serious consideration is being given to the merits of privatizing Social Security. Debate over privatization and the future of Social Security gives expression to two differing value systems: the community-enhancing values of the program's defenders versus libertarian values of its critics. This article examines the implications of the debate. Areas of agreement among advocates and opponents of privatization are discussed. Special attention is paid to conflicting views about privatization and to the distributive implications of proposals to address the program's projected financing problem. In shifting much risk from government onto individuals, privatization would undermine basic Social Security protections. And it would complicate the program's financing problems and in the long run weaken political support. Moreover, many alternative benefit or tax changes can address the shortfall without weakening the moral basis of Social Security.

The January 1997 report of the 1994–96 Advisory Council on Social Security kicked-off spirited debate about the future of Social Security.1 Rather than presenting one Social Security reform option as in the past, this Council split into three factions, each with their own set of recommendations. Moreover, for the first time, the advocates of privatizing the program succeeded in assuring that serious consideration will be given to privatization proposals—an outcome guaranteeing complex and heated deliberations.

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47
One proposal would maintain the basic commitments and structure of Social Security. It calls for a number of minor changes and serious consideration of one major change, investing forty percent of the growing Social Security trust fund assets in the stock market via the equivalent of a passively managed index fund. The other two proposals call for the partial privatization of Social Security and the creation of individual IRA-like accounts—fundamental alterations of the program that guarantee much controversy. The most radical proposal calls for gradually transforming Social Security into a two tier scheme with the first tier providing a low flat rate benefit ($410) to all recipients and the second tier based on diverting payroll tax contributions to mandatory IRA-like accounts.

To adequately assess the potential consequences of the unusual departure of contemporary Social Security policy debate from the traditional approaches to reform, we believe policymakers, analysts and the general public need to be well-informed about 1) the origins, goals and benefits of Social Security and 2) the scope of the existing financing problem, the policy choices and their consequences.

Social Security: Origins, Goals and Protections

Today, Social Security—the Old-Age Survivors and Disability Insurance program (OASDI)—is the central institution in the American approach to social protection. But it wasn’t always this way. “Prior to the enactment of the Old-Age Insurance Program in 1935, economic security rested on the ability, discretion, and goodwill of families, charities, and government officials to supplement individuals’ actions” (Kingson and Schulz, 1997, 42). And the county poor house, now little more than an historical footnote, stood as the most feared symbol of indigence in old age.

The rapid growth of an industrializing and capitalizing economy meant that the nation could afford more social protection. Simultaneously, a changed economy placed more workers at risk of loss of income due to economic cycles, age-related obsolescence and disability (Berkowitz, 1991). At the beginning of the 20th century one group of social reformers, looking to the European experience, began to advance the social insurance approach to
economic security. Rejecting the principle of "less eligibility" arising out of the nation's poor laws traditions—the idea that the circumstances of relief should be so unpleasant as to discourage all but the most needy from seeking public benefits—the social insurance approach sought to provide widespread protection against risks considered common to industrial societies, namely income loss due to old age, unemployment, disability, survivorship and health care costs.

Unlike private insurance which protects those who can afford and choose to purchase coverage, the driving purpose behind social insurance is to provide broad protection against identifiable risks across all income groups. Private insurance emphasizes the principle of "individual equity"—that, all things being equal, rates of returns to beneficiaries should be proportional to premium payments. But social insurance—built on the belief that it is in society's interest to provide a rational means of assisting citizens to protect themselves and their families against major economic risks—emphasizes adequacy, the idea that benefits should be sufficient to meet basic needs. (By design social insurance returns must vary across income classes and cohorts, providing proportionately larger returns to those at greatest risk while simultaneously providing somewhat larger benefits to those paying more to a social insurance program. Otherwise the social adequacy goal would not be achieved.) This fundamental difference between private and social insurance led Reinhart Hohaus, actuary and Metropolitan Life Insurance executive, to observe in his now classic 1938 article that social insurance responds to society's need to provide basic protection for the citizenry:

Hence, just as considerations of equity of benefits form a natural and vital part of operating private insurance, so should considerations of adequacy control the pattern of social insurance benefits. Likewise, as private insurance would collapse if it stressed considerations of adequacy more than those of equity, so will social insurance fail to remain undisturbed if considerations of equity are allowed to predominate over those of adequacy (Hohaus, 1960).

With the exception of the state by state enactment of workman's (now called worker's) compensation laws, social insurance programs made little headway during the first third of the
twentieth century. But in the context of the economic collapse of the 1930s, the Social Security Act of 1935 was passed. Ironically, Old-Age Insurance, the program we have come to know as Social Security, was neither large nor initially very popular as it required collecting a new payroll tax and did not promise to pay out benefits until the early 1940s. In fact, Social Security did not emerge as the dominant source of public old age income protection until passage of the 1950 amendments to the Social Security Act. But even before that, beginning in 1939 when survivors and selected dependent protections were added to OAI, a pattern of incremental expansion of Social Security was established with disability insurance added in 1956, Medicare in 1965, real benefit increases in the late 1960s and early 1970s and the cost of living adjustment in 1972 (Berkowitz, 1991).

This pattern of incremental expansion came to an end in the mid-1970s as the nation’s politics changed and as Social Security began to face financing problems brought on by short-term economic downturns in the mid-1970s and early 1980s and by changing demographics. Financing amendments followed in 1977 and 1983, and today it is once again clear that legislation will be needed to address a projected shortfall. But for the first time since the implementation of the program, serious consideration is being given to proposals to privatize and/or means test OASDI, approaches which would change the nature of “Social Security as we know it,” departing radically from the principles which have guided the program since its inception.

Indeed substantial ideological differences bound contemporary Social Security debate. To some on the right, the system’s financing problems provide opportunity to tug at the foundation of social welfare in the U.S. by framing the projected financing problem as a cause of budget problems, requiring radical reform. This approach is connected to a strategy to deligitmate the program by advancing the argument that Social Security is undermining savings and the well-being of future generations. Moreover, they often argue, Social Security is just one part of a larger, homogeneous entitlement problem, which includes Medicaid, Medicare, Medicaid and other entitlement spending.

Proponents of the existing program generally suggest that the projected shortfall can be addressed through a reasonable
combination benefit reductions and/or payroll tax increases. As for other problems such as population aging and large health care costs, though viewed as obviously important and related, proponents suggest they are separate from the OASDI financial shortfall. Unfortunately, where those advocating radical change are attaching their arguments to a vision about what is best for the future, the proponents of social insurance sometimes seem mired in the technical details of how to address the financing problem and fail to give sufficient attention to clarifying the values at stake in the debate. Hence, they often avoid important questions about the kind of society we wish to be and the role of Social Security in achieving a positive vision.

As discussions proceed on how best to address the shortfall and on the advisability of the more radical approaches to reform, it will be important not to lose sight of Social Security as a practical ideal which has provided the building block that has transformed old age. It is the only pension protection available to six out of ten working persons in the private sector. For those who are relatively well off, say the roughly 4.8 million elderly households with incomes between $18,732 and $31,179 in 1994, Social Security provides nearly half of the total income going to their homes. For the 60 percent of the elderly households (14.6 million) with incomes under $18,731 in 1994, Social Security provides over 70 percent of all income (U.S. Department of Health and Human Services, 1996). Indeed, absent Social Security, the poverty rate among the old would increase to roughly 50 percent. And importantly, the security of beneficiaries is protected by cost-of-living protection which assures that benefits, once received, maintain their purchasing power into advanced old age—the point in time when elderly persons, especially widows, are often at greatest economic risk.

The program also provides widespread and basic protection to America's families and employees. It is also the main source of disability and survivors protections. For a 27 year old couple with two children under age 2 and with earnings equal to average wages, it provides the equivalent of a $300,000 life insurance policy; a $207,000 disability policy; or, looked at another way, the equivalent of $12.1 trillion dollars in life insurance protection, more than the entire value ($10.8 trillion) of all the private life
insurance protection in force. Included among its 44 million beneficiaries are three million children under 18 who receive benefits each month. In short, a program with an expansive reach, Social Security has become a central societal institution.

The Financing Problem: Dimensions, Choices and Consequences

In addition to recognizing the historical and political context giving rise to Social Security, today's debate about the implications of the Advisory Council report and the future of Social Security should recognize:

- We are facing a financing problem, not a crisis
- Privatization does not address the Social Security financing problem
- Important areas of agreement exist, despite some strong disagreements
- Privatization shifts risks from the government to individuals
- Privatization creates winners and losers
- Many reform options exist
- Conflicting values are at the core of this debate.

The Dimensions of the Financing Problem

While an excellent political strategy for those seeking to shrink the public sector, the alarmist view that Social Security is going "belly-up" is wrong on several counts. Even if no policy changes were made, after 2029 anticipated revenues would still be sufficient to meet about three-quarters of the program's promises according to Social Security's Board of Trustees. Given the nation's 60 year tradition of making periodic adjustments to keep the system in projected balance seventy-five years into the future, it is reasonable to assume that some of the roughly 25 percent gap that remained would be made up by moderate benefit reductions and payroll tax increases well in advance of 2029. No doubt this represents a real financing problem and should be addressed soon, but the timing and magnitude of the problem hardly calls for pressing the panic button in 1997.
Very importantly, there is nothing about Social Security's financing problems that cries out for privatization as a solution. If anything, privatization proposals complicate program financing and make the goal of achieving actuarial balance more difficult. Privatization would require both a large roll-back of the traditional Social Security benefit package and additional taxes to establish individual "savings" accounts. If a portion of current Social Security benefits are diverted to IRA-like private accounts new revenues must be found to finance Social Security pensions to all current and many future recipients. For at least the first several decades privatization would make it more difficult to finance Social Security.

Areas of Agreement

In spite of the splits in the Council, the members unanimously agreed that there is a financing problem, that it can be addressed and that it should be done sooner rather than later. They also unanimously agreed that some redistribution to low income persons should be maintained in any Social Security program, that means-testing Social Security is a bad idea, that full COLA protection is essential to the economic well-being of beneficiaries and that any "sacrifice in bringing the system into balance should be widely shared and not borne entirely by current and future workers and their employers." All three plans improve the rate of return for future beneficiaries through some form of investment of the growing Social Security trust fund assets in the private sector. All three call for increased tax revenues or their equivalent. All three would continue a mandatory and universal retirement, disability and survivors program.

Council majorities supported extending coverage to all new state and local workers; reducing benefits by roughly three percent through a technical change in the benefit formula; taxing Social Security benefits in roughly the same manner as income from contributory defined-benefit plans and adjusting the COLA to reflect the Bureau of Labor Statistics estimate that the Consumer Price Index over-adjusts for inflation by 0.21 percent. And there was majority support for a proposal to accelerate the planned increase in the normal retirement age to 67 in 2011 instead of 2022, and to index it to changes in life expectancy thereafter.
Taken, together, these five changes address seventy percent of the projected financing problem—arguably a pretty substantial down-payment on the projected shortfall.\textsuperscript{5}

\textit{Areas of Disagreement}

Of course, it is the differences between the plans that are generating the greatest controversy. The proposal which would basically maintain the existing structure and commitments of the present program—the Maintain Benefits plan—is supported by six of the 13 members of the Council, including Robert Ball, a former commissioner of Social Security and the labor representatives among others. While this proposal calls for giving strong consideration to gradually investing 40 percent of trust fund assets in the stock market via something along the lines of a passively managed index fund, it does not call for the creation of individual IRA-like accounts. Because the government bears the risk, it insulates individuals and their families from poor investments and market fluctuations. If government investment in index funds yields a real rate of return of seven percent over the next 35 years, the Maintain Benefits plan would help ease the burden of providing for the retirement of the boomers—significantly decreasing by roughly 35 percent the need to cut benefits or generate additional federal revenues through tax increases. Of course, if the stock market experiences an extended period of decline or stagnation, the plan would compound the problem of paying for the boomers.\textsuperscript{6}

The more moderate of the two partial privatization schemes—the Individual Account (IA) plan—is supported by two members, including the Council’s chairman, Edward Gramlich, dean of the University of Michigan’s Institute of Public Policy. The IA plan would establish small defined contribution accounts for each worker by mandating a new contribution—arguably an indirect tax increase—of 1.6 percent of covered payroll to individual investment accounts. Workers would have a few investment options, but far fewer than envisioned in the Schieber plan. The administrative costs of the individual accounts would be relatively low since the individual accounts would be publicly managed. Benefit reductions, especially for middle and high-income workers, would help bring the public portion of the
Privatization

revised Social Security program into long run actuarial balance. "The combination of the reduced growth in benefits, the increased age of eligibility for full retirement benefits, and the proceeds of the individual accounts would leave total benefits on average at about the levels of present law for all income groups."

The most radical privatization proposal—the Personal Security Accounts (PSA) plan—calls for a partial privatization of Social Security and is supported by five members and identified with Sylvester Schieber, an executive with a benefits consultant company and Caroline Weaver, an economist at the American Enterprise Institutes and former advisor to former senator Robert Dole. It calls for gradually transforming Social Security into a two tier scheme with the first providing a low flat rate benefit ($410 in today's dollars) and the second tier based on contributions made to mandatory IRA-like accounts. Additionally, the value of disability benefits would be reduced and retirement eligibility ages increased. Five percent of the current payroll tax would be diverted into these privately-held and managed defined contribution accounts. Those with high earnings and those who make better investment decisions (or are just plain "lucky") would end up with larger second tier benefits. This proposal would be financed by a 72 year "transition" payroll tax of 1.52 percent and by borrowing $1.9 trillion dollars from general revenues to be repaid using the projected excess of tax revenues between 2035 to 2075.

Shifting the Risks: Winners and Losers

Privatization—especially large scale privatization such as that proposed under the PSA plan—may be a bad idea. But it is not necessarily so for everyone—at least if we assume that the most well-off do not have a stake in promoting the well-being of the rest of society. Affluent workers would likely do better under privatization plans—at least in so far as they do not experience serious declines in their earning capacities during middle age. Such workers would be well provided for even if the stock market were to stagnate or decline just prior to retirement. But the biggest winners would be the banks, mutual funds and investment companies who stand to benefit from the millions of transactions and
trillions in private sector investment that would follow even a small partial privatization.

It may be economically rational for the affluent to accept the risks associated with privatization. But not so for most middle and low-income persons. The primary risks are market risk, investment risk, inflation risk and political risk.

Privatization places low- and moderate-income workers at significant political risk. As Social Security is currently structured low-income workers get a better return than high wage workers on their contributions, a factor that keeps millions of the elderly out of poverty during their retirement years. With privatization, upper-middle and high-income wage workers would have less reason to maintain the purchasing power of the basic benefit that low-income workers are especially dependent upon. Hence, in separating out the interests of higher-income workers from the public portion of the program, privatization schemes ensure erosion of political support for the program’s redistributive role—an outcome which would further increase the economic and social distance between rich and poor. Even a modest privatization scheme such as the IA plan risks the inadvertent undermining the program’s social adequacy goal.

Middle and low income workers would face especially serious market risks. Long run returns on stock market investments have generally been quite favorable. But no promises can be made about what will happen to an individual’s nest egg in the few years, months or even days before retirement.

Low- and even many middle-income workers cannot afford good investment advice. They are more likely to make poor investment decisions, for example, investing too conservatively during early working years or taking unacceptably high risks just prior to retirement. And after retirement, beneficiaries would receive much less protection against inflation under the Schieber plan, yet another example of how privatization plans often shift risk from government to the individual. The affluent are better positioned to seek financial advice and tolerate such risks, but the impact on low and middle income retired persons could end up being devastating.
Other Options Exist

When the focus of Social Security reform moves towards the legislative process, policymakers and the public would be well advised to look beyond these three plans. Certainly, the "consensus" recommendations in the Advisory Council report provide a reasonable basis for starting the policy discussion, although each should be carefully assessed especially in terms of their costs and benefits for different population groups. But other options must be (and are being) considered.

One approach would eliminate the taxable maximum ceiling for the employer, set at $65,400 in 1997, thereby requiring the employer to pay the Social Security payroll tax on all wages that are paid. As the nation's income distribution has become more unequal, the proportion of wages covered by the payroll tax dropped from roughly 90 percent to 88 percent, and it is projected to drop to 85.5 percent ten years from now. Subjecting 100 percent of the employer's payroll to FICA taxation would effectively eliminate almost 1/2 of the projected financing problem. Yet another tax ceiling approach would restore and maintain the proportion of wages covered by the payroll tax at the 90 percent level by 2000, addressing about 14 percent of the projected financing problem. And there are many other possibilities.

Another set of proposals would reduce the fringe benefits exemptions from payroll taxation. As fringe benefits have grown, the proportion of total compensation (cash earnings and fringes) subject to payroll taxation has shrunk. This represents a very substantial loss to the trust funds which could be partially offset by treating some portion of fringes as taxable for Social Security's purposes. At the extreme, subjecting 90 percent of all cash and fringe benefit compensation to the payroll tax would address roughly 45 percent of the projected financing problem. Similarly, Edith Fierst, a member of the Advisory Council, notes that Social Security's actuaries estimate that taxing "the cost of employer-provided group health and life insurance... as though it were cash compensation" would address roughly one-third of the predicted shortfall. The distributive consequences are progressive because the burden of this change would fall primarily on higher
income workers who generally receive relatively and absolutely larger amounts of their total compensation in the form of non-taxable fringe benefits. And there are many other reforms on both the benefit and tax sides of the ledger that could address Social Securities financing problems without radically altering the program.

Senator Moynihan accepts the findings from another commission headed by economist Michael Boskin that the CPI overstates inflation by much more, perhaps 1 to 1.5 percent. The Boskin commission suggests that the CPI does not provide an accurate basis of measuring changes in overall living standards because it does not account for improvements in quality or the changing purchasing habits of Americans (e.g., buying in discount stores and purchasing substitute goods (e.g., oranges) when the price of another good (e.g., grapefruits) rise. Writing in the New York Times, the Senator calls for a 1.1 percent reduction in annual COLAs. The advantage—namely a quick and fair fix to roughly 70 percent of the projected deficit—is obvious.

The danger is that a new approach to approximating changes in the cost of living would understate the effects of inflation for some vulnerable groups. No one wants to provide a COLA that increases benefits in excess of price increases. However, there are serious questions about the type of price index that should be used. It is important to use an index that adequately and fairly assesses increases in the cost of living for those living at the economic margins including such subgroups as very old widows. It is not enough that an index provides an accurate measure of increases in the cost of living for the population as a whole.

Values at Stake

There is a disturbing tendency to reduce Social Security discussions to mere accounting exercises of the financial cost of the program, overlooking its value as a source of national social cohesion and as an expression of the contributions and obligations of each member of the national community. It has stood as a symbol of the kinds of programs that the federal government has been able to do well.

But even many of Social Security's staunchest defenders have focused on technical changes to the relative neglect of the
profound debate that is taking place between two very different value systems: the community-enhancing values of the program's defenders versus libertarian values of its critics, values that call for shrinking the size of the government as well as shifting risk burdens and responsibility from the national community to the individual. This debate is fundamentally about our sense of responsibility to each other; about the basic protection that each working American should be assured of for themselves and their families in old age, disability or on the death of a loved one; about the mix of public and private efforts we should encourage to assure that security. And this debate is also about the real consequences to the well-being of individuals and families of various possible changes.

Certainly, all Americans should be encouraged to save. But in shifting much of the risk from government onto individuals, privatization would undermine the basic retirement, disability and life insurance protections of all Americans—an outcome that would be unfortunate when the economic transformation of the American economy is rendering employment and living standards less secure.

Indeed, there is nothing about the current financing problem of Social Security that requires such radical and unprecedented change. And there is much to argue for addressing the financing problems in a way that assures that our children and theirs will receive basic protections from this program which for sixty years has served as an expression of the nation's concern for each member of the national community.

The moral basis of Social Security rests on the assumption that we, as a people, have a stake in the well-being of our family and neighbors. Along with Social Security, this value is worth preserving.

Notes

3. Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (1997)
6. See Advisory Council on Social Security (1997). Also see National Academy of Social Insurance (1996). Also, it is important to note that under the other two plans, market declines would translate into lost benefits for millions of boomers.
9. Consistent with the social insurance goal of providing a floor of protection for all Americans, the Social Security benefit formula provides proportionately higher benefits to workers who have worked consistently at lower-paying jobs. It replaces about 58 percent of average monthly earnings for persons retiring at age 65 with yearly earnings equal to one-half of average wages, compared to about 28 percent for workers whose earnings equaled the maximum subject to payroll taxation. So while higher income workers receive larger monthly benefits than low and middle income workers, these monthly benefits replace a smaller proportion of pre-retirement earnings.
10. See Bipartisan Commission on Entitlement and Tax Reform (1995)
12. See United States Senate Committee on Finance (1996).
13. See Stewart and Pavalone (1996) for evidence that the current CPI underestimates increase in the cost of living for those age 62 and over. The problem gets worse for the very old. Also see Baker (1996) and Madrick (1997) for critical assessment of the conclusions reached in United States Senate Committee on Finance (1996).

References


