

Privatization of US Social Security: What Are the Real Issues?

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In the USA, social security has become the most hotly debated issue of the second term of President George W. Bush. At stake are fundamental philosophical and political issues about the role of social security in today's economic and social environment. The basic questions forming the framework of the social security debate are as follows:

- Is the system sustainable in its present form?
- Is the system solvent in terms of its actuarial balance between projected asset-income and liability outgo?
- Are the assets in the social security trust funds real or are they mere bookkeeping entries without any solid backing or liquidity?
- Should the system have a greater degree of pre-funding, with less reliance on its pay-as-you-go features?
- Should the system be converted from a guaranteed defined benefit system into a partial defined contribution system with individual account features?
- Should the present cross-subsidy features be preserved whereby benefit levels are relatively greater for lower-income individuals than for higher-income individuals?
- Should the insurance features that provide disability and survivors' income benefits be maintained?
- Should benefits be determined on a wage-indexing or price-indexing basis?

These questions have generated a diverse range of responses that involve not only financial, actuarial, economic and social policy issues, but also an element of political opinion. The rhetoric has sometimes been rational and objective, but at other times it has been characterized by political spin, half-truths, bias and distortions. President Bush has frequently stated that the social security system is bankrupt and is in a state of crisis that requires fixing now. In response,

Democratic leaders in Congress have referred to the official Social Security Trustees' Report¹ and explained that the system is completely solvent until 2041 and can continue to pay a substantial portion of scheduled benefits in subsequent years. The President of the Washington-based Retirement Policy Institute expressed his opinion in a recently published article² that the way in which social security is financed, based on a pay-as-you-go system rather than an advance-funded system, is the way Ponzi schemes and chain letters operate. In the same article, Dwight Bartlett, a former Chief Actuary of the Social Security Administration, stated that, in order to devise a solution to social security's problems, it is essential to have a clearly articulated philosophy about social and economic goals against which proposed changes can be measured.

THE SYSTEM'S FINANCIAL STATUS

A starting point for understanding the financial status of the social security system is the 2005 trustees' annual report. The trustees state in this report that social security revenues currently exceed outgo for benefits and expenses and will continue to do so for several more years. However, in 2017 benefits and administrative expenses are expected to exceed tax income and, in order to continue the full payment of scheduled benefits thereafter, it will be necessary to begin drawing upon trust fund interest income. In 2027 and subsequent years, the amount needed to continue payment of full scheduled benefits and administrative expenses is expected to exceed payroll tax receipts plus interest income on the trust fund assets. This situation will necessitate gradual redemptions of securities held in the trust fund. By 2041, according to the trustees, the social security trust funds are expected to become depleted and thereafter the amounts of payroll tax income will not be adequate to pay scheduled benefits in full. One of the key findings of the trustees' report is that the social security system has a projected long-range actuarial deficit of 1.92% of taxable payroll over the next 75 years. This deficit includes an amount of 0.13% of taxable payroll with respect to a requirement to maintain a minimum balance in the trust funds equal to one year's expected benefits and expenses. Without this minimum fund requirement, the deficit would be 1.79% of payroll. Long-range solvency could be achieved by increasing both the employer and the employee

contribution rates, currently 6.20% of taxable payroll, by 0.90% to 7.10% of payroll. Alternatively, long-range solvency could be achieved by making a uniform reduction in future benefits of approximately 11%. Stated in another way, the system has a solvency ratio of approximately 89% for scheduled benefits over the next 75 years.

The cost of scheduled benefits plus expenses is expected to increase from 4.3% of GDP* in 2005 to 6.4% in 2080. While insolvency is not imminent, long-term sustainable solvency depends on fundamental demographic and economic forces beyond 75 years. Based on the trustees' projections, substantial imbalances are likely to exist between the current tax rate and projected costs of scheduled benefits in 2080 and beyond.

ASSUMPTIONS AND PLAUSIBLE OUTCOMES

Many analysts have pointed out that it is difficult to make reliable predictions of the economic and demographic factors over as long a period as 75 years and that the degree of accuracy inherent in the projections declines as the length of the projection period is extended. The results of the projections are in fact subject to a range of plausible outcomes and are sensitive to changes in the assumptions adopted for the various economic and demographic factors involved. While these are very important considerations in interpreting the results of the trustees' report, in practice they are often overlooked by policymakers who tend to regard the 75-year projections not merely as best estimates, but as absolute and reliable indicators of the long-range financial condition of the system. However, the trustees prepare three alternative sets of projections in order to capture the range of plausible outcomes; these are designated as "intermediate", "low-cost" and "high-cost". Compared with the deficit of 1.92% of taxable payroll for the intermediate best estimate projection, the low-cost and high-cost projections produce results ranging from a surplus of 0.38% to a deficit of 4.96%, representing a range of plausible outcomes amounting to 5.34% of payroll, or as much as 2.78 times the intermediate best estimate of 1.92%.

The reason for the magnitude of the divergence of the low-cost and high-cost projections from the intermediate best estimate is that the values of the key economic and demographic assumptions underlying the projections show a broad range of plausible outcomes that have a significant impact on the results of the projections. For example, the productivity growth rate for the US economy ranges from 1.3% to 1.9%; the unemployment rate varies from 4.5% to 6.5%; the fertility rate varies from 1.7 to 2.2 children per woman; the average annual reduction in mortality rates varies from 0.33% to 1.23%; annual net immigration varies from 672,500 to 1.3 million; life expectancy at birth in 2079 for males varies from 78.3 to 86.2 years and for females varies from 82.2 to 89.3 years; the annual change in average wages varies from 3.4% to 4.4%; the annual change in the Consumer Price Index varies from 1.8% to 3.8%; and the annual labor force growth rate ranges from a negative 0.3% to a positive 0.6%.

PRE-FUNDING AND UNFUNDED OBLIGATIONS

Although US social security is essentially a modified pay-as-you-go system, with a small element of pre-funding that was introduced in 1983 to strengthen its

financial viability, some observers have chosen to assess its financial status as though it were a funded system with benefits being pre-funded in a manner similar to a private pension plan for employees of a corporation. Based on this premise, these observers seek to focus attention on a measure of the system's unfunded obligation, representing the amount of additional assets necessary to be held in reserve in order for all scheduled benefits expected in the future to be paid. Social security's long-term unfunded obligations may be expressed in several ways. One way is to place a dollar value (on a present value basis) on the excess of the future cost of scheduled benefits and expenses over the current trust fund's balance plus future income from payroll taxes and other sources. A better way is to express the unfunded obligation as a percentage of the present value of future taxable payroll. This percentage represents how much the combined employer and employee tax rate, currently 12.4% of taxable payroll, would need to be raised to eliminate social security's long-term deficit. The unfunded obligation may also be expressed as a percentage of GDP. Based on the 75-year projection period, the social security trustees indicate that the system's unfunded obligation is US\$4.0 trillion†, representing 1.79% of taxable payroll or 0.6% of GDP over the period. As mentioned earlier, many observers question the reliability or usefulness of calculating social security's unfunded obligation over 75 years. A particular point of contention has been the trustees' decision to produce a measure of the system's unfunded obligation projected over an "infinite time horizon" in order to capture the effect of projected deficits beyond 75 years. The system's unfunded obligation on an infinite future basis is US\$11.1 trillion, representing 3.5% of taxable payroll or 1.2% of GDP. Although many critics dismiss the concept of infinite projections as being meaningless and unreliable for policymaking purposes, this US\$11.1 trillion unfunded obligation has been used by some critics, whose political objective is to reduce the scope of social security, to claim that the unfunded obligation is so large as to make the system unsustainable.

SOLVENCY AND SUSTAINABILITY

While significant demographic trends, mainly reduced fertility and improving mortality, unquestionably will make the sustainability of the system relatively more expensive in the future than it has been in the past, it is feasible to make a number of adjustments to the system to ensure its solvency and sustainability over a reasonable projection period, such as 50 or 75 years. Some of the adjustments that have been proposed are:

- to increase the normal retirement age at which unreduced social security benefits commence to 68 (this change is already partly provided by the present social security law with scheduled increases to age 67);
- to increase the payroll tax rate by a small amount, such as 0.25%, for both the employer and the employee;

* gross domestic product

† £1 = US\$1.74; €1 = US\$1.19 as at 8 July 2005

- to increase the present limit (US\$90,000) of taxable payroll to which the tax rate applies;
- to invest part of the social security trust funds in marketable securities, such as stocks and bonds, to achieve enhanced rates of return; and
- to broaden the scope of coverage to include certain groups of employees currently excluded, such as those working for state and municipal governments.

Given that there are a number of reasonable combinations of these adjustments that would restore the solvency of the system over the next 75 years, the real question is why there has not been a bipartisan agreement to make the required adjustments, declare a victory and move on to other more troublesome issues. One such issue is the far more serious financial condition of the Medicare program that has a projected deficit of US\$20 trillion – approximately five times the size of the social security deficit. Another issue is the potential need for a significant bailout of the Pension Benefit Guaranty Corporation (PBGC) so as to ensure that it can meet its obligations to provide a safety net for underfunded pension plans in the private sector. The PBGC reported a deficit of US\$23.5 billion at 2004 year-end with assets of US\$40.1 billion and liabilities of US\$63.6 billion.³

The answer to the question as to why there has been no bipartisan agreement lies in the fact that the debate over the future of social security has been politicized and is more about different philosophical and political viewpoints than about technical, financial and actuarial refinements relating to solvency. The real political issue is privatization of social security and the creation of a system based on individual accounts to replace the existing structure.

PRIVATIZATION AND INDIVIDUAL ACCOUNTS

President Bush has made it the highest-priority objective for the second term of his Administration to privatize social security and introduce a system of individual accounts. He previously established a Commission to Strengthen Social Security – in 2001 – at the beginning of his first term in office. The Commission was given a number of guiding principles, one of which was a requirement to introduce individual accounts into the social security system. Only experts who supported the President's views on individual accounts and privatization were appointed to the Commission. It was therefore hardly surprising that one of the Commission's recommendations was to introduce a system of individual accounts, the main idea being to divert 4% of the 12.4% payroll tax into individual accounts and to reduce the basic traditional social security benefits by a "carve-out" equivalent to the notional value of these accumulated contributions, with interest credited at an annual rate of real return above inflation of 3% p.a.

The arguments presented in favor of a system of individual accounts include the concept of an "ownership society" in which individuals would own their own account balance within social security in exchange for a part of the guaranteed social security benefit equal to the notional accumulated value of the account.

Critics of the concept have pointed out that the introduction of individual accounts would do nothing to improve the system's solvency position; would create massive transition costs to provide funding to replace the contributions that are diverted away from paying benefits to pensioners and beneficiaries; and would place individuals at risk in terms of the uncertainties of market returns.

To illustrate the extreme variability in returns and the extent of the investment risk that individual accounts would impose on employees, Watson Wyatt Worldwide studied the effect of investing 6% of pay in the US stock market for 40 years followed by the purchase of an annuity.⁴ The results, expressed in terms of the percentage of income replaced by the accumulated account balance, varied from 19% to 103%, with widely different outcomes depending on the year of retirement.

Supporters of the individual account concept stress the advantage of holding assets in this way as opposed to relying on the resources of the social security trust funds to provide future benefits. This line of reasoning effectively implies that there is a risk that the US government might default on the special issue bonds held by the trust funds or that the government might not pay the future scheduled benefits that correspond to the unfunded obligation. Supporters claim that individual accounts would represent pre-funding and create personal wealth accumulation. They assert that pre-funding is important because it moderates the cost of pensions, adds to the capital base in the national economy and enhances workforce productivity.

To provide individual accounts as a feature of social security, the President's proposals would involve two distinct forms of benefit cuts. The first relates to the reduction in the guaranteed defined benefit that is equivalent to the notional accumulated value of the individual account balance. The second relates to the radical change from a wage-indexing to a price-indexing system. One proposal is for a modified progressive indexing 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, with the index weightings determined according to income level. Under this proposal, benefits would be significantly reduced from their current scheduled level for higher-income and middle-income workers.

In addition to the investment market risk that individual account holders would bear during the accumulation phase, there are two other significant risks that would be faced during the retirement payout phase: longevity risk and inflation risk. Individual accounts offer no protection against these risks. Account holders would potentially have to shoulder the risk of outliving their account balances and the risk of declining purchasing power in an inflationary environment. To ameliorate these risks, supporters of individual accounts have proposed annuitization on either a voluntary or a mandatory basis whereby an individual's account balance would be used to purchase a lifetime inflation-adjusted annuity, exactly like the benefit that social security provides. Critics point out that the combination of the carve-out feature and

annuitization will likely provide no net gains in aggregate compared with the existing social security system. Moreover, individuals will be subjected to investment market risk during the accumulation phase. Another criticism is that investment management fees and annuity expenses would represent significant additional costs for the carve-out and annuitization arrangement. The proposed individual account structure would effectively mean that the chance of achieving superior investment performance and retiring at an opportune time (when interest rates are relatively high and annuity rates relatively favorable) would turn retirement planning into a potential gamble for individuals.

POLITICAL MOTIVES

Many commentators have speculated as to the real political motives for advocating the transition to an individual account system, particularly when it has become evident that the transition would not improve the solvency of the present system; would impose significant risks on individual account holders; and, most importantly, according to several opinion polls, is opposed in principle by a majority of the population.

One plausible theory has been widely discussed and analysed as a possible explanation for the high priority accorded to social security rather than the more immediate problems of Medicare and the PBGC. This theory is that the real objective is for the Republican party to gain political advantage among younger Democratic voters who, according to opinion polls, have real concerns and doubts about the future viability of the social security system and who believe that their own personal best interests would be better served by ownership of an individual account rather than relying on a system that has regularly been described as bankrupt. Political strategists have identified this issue as a potential means of winning over the under-40 age group who voted for the Democratic presidential candidate in the 2000 and 2004 elections. This viewpoint has been reinforced by the actions of President Bush who recently completed a six-week cross-country campaign to take the issue to voters at the grass-roots level in a manner that parallels an election campaign.

Another explanation for the advocacy of individual accounts is that it would accomplish the political objective of removing the cross-subsidy element that exists in the present system, whereby lower-paid workers receive relatively higher benefits as a percentage of pay, in comparison with higher-paid workers, even though all workers pay the same tax rate of 6.20% as their contribution to social security under the Federal Insurance Contributions Act. Many observers expect that the diversion of 4% of payroll to individual accounts is only a first step in the transition

BOX 1

The US Administration's Position on Social Security: A Scenario-Based Explanation

A political campaign begins with large income tax cuts, primarily to benefit the higher-paid, and is estimated to have a 75-year cost of US\$11 trillion, approximately three times the social security deficit. This results in record-high and increasing Federal budget deficits with tax revenues at a historically low level of only 16.5% of GDP. From a position of permanent structural deficits, the Administration proceeds to proclaim that social security is bankrupt and unsustainable in its present form. It reinforces the rhetoric with an insistence on no tax increases to support social security and proclaims that, unless radically changed and unless future scheduled benefits are reduced, the cost of social security will crowd out essential Federal spending on high-priority items such as defense and national security. It then presents individual accounts and privatization as a solution to the crisis, thereby providing individuals with freedom of choice in an ownership society.

to an all-individual account system, with the benefits being determined exclusively on the basis of the equivalent benefit value of the notional accumulated account balances, which would have the effect of eliminating the cross-subsidy feature.

Edward Crane, a prominent thought-leader in Washington and President of the conservative think-tank, the Cato Institute, neatly captured the philosophical aspect of the social security debate in an editorial in *The Wall Street Journal* in which he stated that this was about "liberty and opportunity."⁵ He was in fact articulating the view that social security should provide individuals with a freedom of choice to manage their own affairs. He stated that the debate is not a call for "actuaries to the barricades" to debate the finer points of solvency, sustainability and actuarial assumptions and methods, but represents an opportunity to make a break from the traditions and practices of the last 70 years and to empower individuals to take charge of their own destinies and financial affairs with respect to retirement planning and savings.

In addition, the current debate on social security may be interpreted from the actual sequence of the Administration's actions. This line of thought has led to a scenario-based explanation for the Administration's position on social security (see BOX 1 above). Whether or not this scenario is acknowledged as the official strategy, it is nevertheless a precise description of what has unfolded. The future of US social security is about to enter the serious phase of political negotiations in Congress which could result in historic reforms. Ω

References

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