MUST PRIVATIZATION MEAN LESS PROGRESSIVITY?

Eugene Steuerle and Christopher Spiro

Motivated by the belief that private markets function more efficiently than government, some reformers propose depositing workers' Social Security taxes into private accounts, one for each individual. Although critics fear that privatization will erode Social Security's built-in mechanisms for protecting low-wage workers, a reform package could be designed to include individual accounts while maintaining these protections.

Social Security's current benefit structure is progressive: It redistributes income from high-wage earners to low-wage earners. To calculate benefits, the Social Security Administration averages the wages from a worker's 35 highest-earning years. A worker with average annual earnings of $5,112 or less receives 90 percent of those earnings in benefits. A worker with higher average annual earnings receives 90 percent of the first $5,112 but only 32 percent of earnings between $5,112 and $30,804 and only 15 percent of earnings in excess of $30,804 (figure 1).† Thus, a worker with average annual wages of $5,112 receives $4,601 in annual benefits, whereas one earning ten times that average ($51,120) receives only four times as much in benefits ($15,869).

The most simply designed account system, one that puts all Social Security tax into a private account for each worker, would include no such redistribution. Benefits—in this case measured by deposits in accounts—would equal each person's contributions plus whatever is earned through investment.† Workers who earn less would receive no redistribution from workers who earn more.

Some reformers are uncomfortable with so drastic a move away from Social Security's redistribution. They suggest putting only a portion of a worker's Social Security tax into individual accounts and leaving the remainder to finance a traditional benefit structure. But carving out this portion leaves less money for redistribution and therefore could erode some of Social Security's progressivity.

Individual account reform does not have to be less redistributive, however. There are several ways in which such accounts could be adopted while maintaining or even increasing the progressivity of Social Security.

First, in a system with some portion of contributions carved out, the progressive benefit structure for the remainder can be made even more progressive than the current system. In fact, the current benefit structure can already be viewed as a combination of a proportional tier and a highly progressive tier (figure 1). One way to make the remaining benefit structure more progressive would be to add a set of minimum benefits as an alternative to the existing benefit. One caveat, however, is that the larger the carve-out, the less money there is to redistribute.

*The benefit structure for a worker retiring at age 65 in 1998; earnings throughout a work history are indexed to compensate for inflation and real wage growth.

†This assumes that low-wage workers and high-wage workers will be able to earn equal rates of return in the market.
Second, it is possible to free up resources for redistribution to low-wage earners and their spouses by adjusting certain policies that currently provide windfall benefits to high-wage earners and their spouses. For example, Social Security provides nonworking spouses a benefit equal to half of their working spouse’s benefit; thus, spouses of high-wage earners receive more benefits than spouses of low-wage earners, even if no additional contributions were made for those spousal benefits.

A third option is to add a tax, to be paid by workers alongside the existing Social Security tax, that would finance contributions to individual accounts. The add-on would not take anything out of the existing redistribution; it would merely create an additional layer of benefits whose payout is equivalent to the amount put in, plus what is earned through investment.

Finally, while a traditionally designed individual account program would provide benefits directly proportional to contributions, it could also be structured so that the government redistributes benefits to low-wage earners through a subsidy to their individual accounts (paid for by those with higher incomes). Such proposals have been made in various forms by some members of Congress and by President Clinton.

The progressivity of any Social Security reform proposal depends upon how it affects the overall structure of the system. While we have not addressed the administrative or political feasibility of each of these approaches, they demonstrate clearly that individual accounts and progressivity need not be incompatible.

Eugene Steuerle is a senior fellow at the Urban Institute, where his research includes work on Social Security reform. Christopher Spiro is a research assistant at the Urban Institute.