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As the Social Security debate continues, the full costs of Social Security privatization become clear. These could largely come out the pockets of state and local governments, making privatization the mother of all unfunded mandates. With Social Security privatization, benefits would on average be reduced and involve greater risk due to the volatility of the stock market. When Social Security benefits are too little to offer retirees a decent standard of living, governments will likely have to bail out a privatized Social Security system by increasing expenditures in other social programs. Typically, the vast majority of such programs are the purview of state and local governments. Since the federal government is not budgeting for these costs, privatization could result in a massive unfunded mandate on state and local governments.

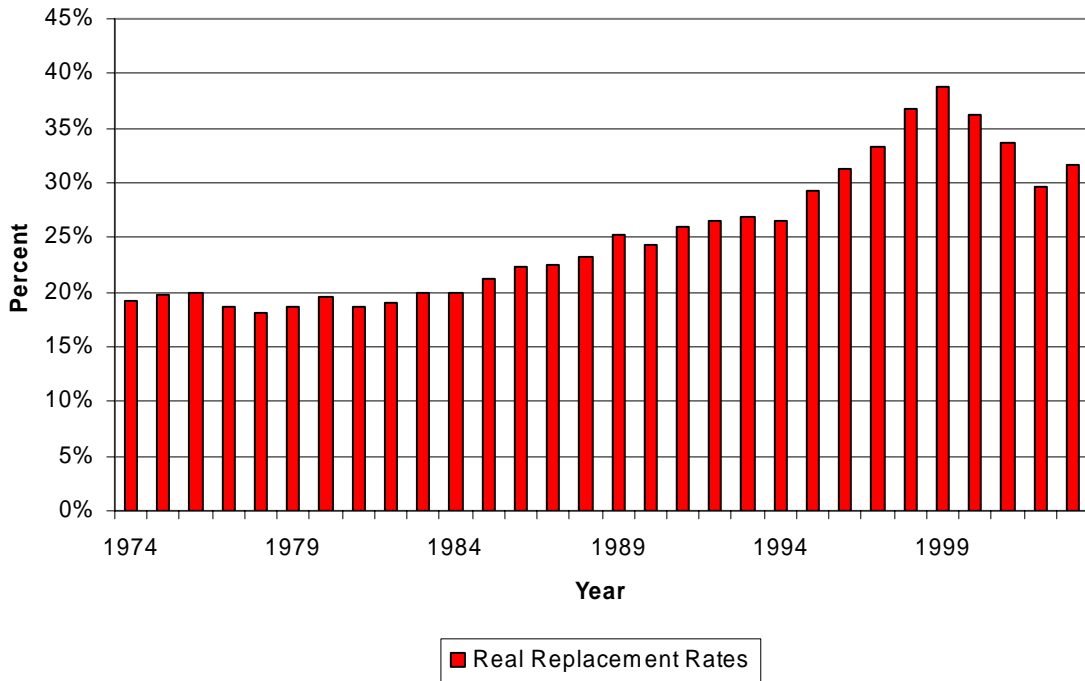
Moreover, it will be hard for state and local governments to plan for the increased costs. Future benefits would depend on the stock market, which can fluctuate widely, leaving entire generations of retirees with too little retirement income. As a consequence, state and local spending on social programs would be highly unpredictable, disrupting long-term outlays for roads, schools and other infrastructure projects.

Privatization Could Prove Costly for State and Local Governments

Consider the effects of benefit cuts that would occur under privatization on government finances. The basic design of a privatized system was included in option II of the President's Commission to Strengthen Social Security (CSSS) (Diamond and Orszag, 2002).¹ If this plan had been in place since 1940, people's retirement income would have fluctuated widely over the years. A common measure for retirement income adequacy is called replacement rate. This rate measures how much pre-retirement income is replaced by retirement benefits. A replacement rate of 50 percent means that retirees have retirement income that equals only 50 percent of what they had before retiring. Typically, a replacement rate of 75-80 percent is considered enough for a decent standard of living in retirement. That is, retirees are expected to be able to sustain a pay cut of 20 percent upon retirement because they have lower costs. Right now, Social Security offers a replacement rate of 42.5 percent to medium lifetime earners who retire at the normal retirement age. Under a privatized system as described above, though, the ultimate replacement rates would have ranged from 18 percent in 1978 to 39 percent in 1999 – far less than the 42.5 percent that Social Security offers (figure 1). Assuming that people expect a replacement rate of 42.5 percent, governments could have had to bail out retirees every single year (Weller, 2005).

¹ The details provided by the White House in recent months reflect the basic design of this plan.

Figure 1: Real Replacement Rates after 35 Years, CSSS Option II

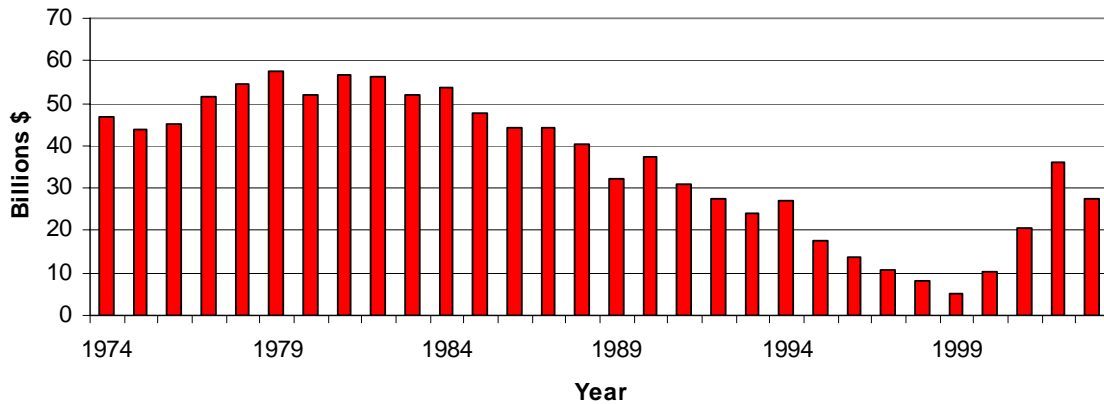


Source is Weller (2005)

What does this mean for government finances? Under reasonable assumptions, governments would have had to face costs of \$1.1 trillion in 2004 dollars over the past 30 years (Weller, 2005). For a number of years, the bailouts would have exceeded \$50 billion (in 2004 dollars) annually (figure 2). At their lowest point, the bailouts would still have cost \$5.1 billion in 2004 dollars.

The costs of these bailouts would have disproportionately and increasingly fallen onto state and local governments. About 80 percent of social programs relevant in this case are state and local government programs, and this share has risen over time. While state and local governments spent about twice as much as the federal government on social programs in the early 1980s, they spent up to three and half times as much since the 1990s (figure 3).

Figure 2: Cost of Government Bail-outs, CSSS Option II, Constant 2004 Dollars

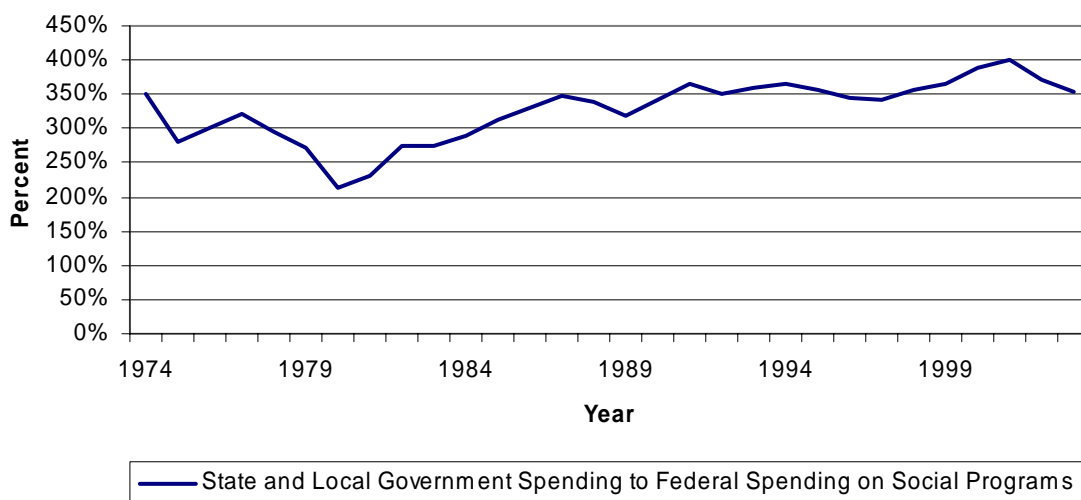


Notes: All figures in billions of 2004 dollars. CPI is used as deflator. Source is Weller (2005).

If the costs of such bailouts had been distributed between the state and local governments and the federal government the same way costs for other social programs were distributed, the costs for social programs for state and local governments could have risen by more than 40 percent (figure 4).

Importantly, the years during which state and local governments would have seen fairly small demands on their budgets are unlikely to repeat themselves regularly. After 35 years, there is a 7.9 percent chance that retirees will see a replacement rate of more than 40 percent (Weller, 2005). But there is a 50.9 percent chance that the average replacement rate will be below 30 percent, therefore requiring massive bailouts.

Figure 3: State and Local Government Spending to Federal Spending on Social Programs



Notes: Federal social programs are food stamps, earned income tax credit, and others, such as payments to nonprofit institutions. State and local government social programs include Medicaid and other medical care programs, family assistance, general assistance, energy assistance, and other programs such as Temporary Assistance for Needy Families (TANF). Source is BEA (2005).

Another way to put the size of these bailouts into perspective is to compare them to another unfunded mandate. According to the National Priorities Project, authorized funding for No Child Left Behind (NCLB) legislation was \$36.7 billion in fiscal year 2005, with an unfunded portion of \$13.1 billion (NPP, 2004). In seven of the past 30 years, the real bailout costs for state and local governments would have been larger than NCLB’s authorized costs, and in 25 years the real bailout costs would have exceeded NCLB’s unfunded portion of \$13.1 billion.

Moreover, the size of the unfunded mandate that Social Security privatization would constitute has to also be considered in the context of other shared responsibilities between state and local governments and the federal government. The recent budget discussion with respect to Medicaid has highlighted that the funding of more and more social safety net functions has fallen onto states and that support from the federal government is fickle (Irons, 2005). That is, states could see large bail-out costs associated with Social Security privatization in the future, while having to handle other large outlays at the same time.

Future Costs are Large and Unpredictable

The costs associated with the bailout of a privatized Social Security system are also unpredictable. Over the long-term, the bailout costs of just the privatized retirement benefits of Social Security would add hundreds of billions of dollars to the costs of privatization. Assuming that the bailout costs would equal \$601 billion in present value for the next 75 years (Weller, 2005), and assuming that state and local governments would bear 80 percent of these costs, state and local governments could face costs equal

to \$480 billion in present value for the next 75 years (Weller, 2005). They would need this amount today to cover, together with interest, all likely shortfalls in the next 75 years.

There is substantial variation in bailout costs. The amount of Social Security benefits received by each state varies widely. Assuming that the bailout costs would vary with each state's share of Social Security retirement benefit receipts in 2003, some states face bailout costs of less than \$1 billion – such as Washington, D.C., and Wyoming – whereas others could see total bailout costs in the tens of billions of dollars, such as New York, California, Pennsylvania, and Texas (table 1). These costs could also be substantially larger. There is a 20 percent chance that bailout costs will be 67 percent larger than \$480 billion (Weller, 2005). Social Security privatization is a big gamble for state and local finances, given the large variation in possible outcomes.

To be prepared for a \$480 billion shortfall, state and local governments could establish large trust funds. To do so, states would have to save all federal money they receive in grants and aid for the next 16 months. If they want to be prepared for the 1-in-5 case when the bailout costs could be much higher, they would have to save all federal grant and aid money for the next 27 months (table 1).

Table 1
Distribution of Bailout Costs

| State | Share of Social Security retirement expenditures (2003) | Share of \$601 billion bailout (net present value in 2004 dollars) | 20 percent chance of costs being greater than | Memorandum: Federal grants-in-aid in 2004 |
|----------------------|---|--|---|---|
| Alabama | 1.5% | 8.4 | 14.0 | 5.4 |
| Alaska | 0.1% | 0.6 | 1.0 | 2.2 |
| Arizona | 1.9% | 8.9 | 14.8 | 6.5 |
| Arkansas | 1.0% | 5.0 | 8.4 | 3.6 |
| California | 9.6% | 44.7 | 74.6 | 42.7 |
| Colorado | 1.2% | 5.6 | 9.4 | 3.9 |
| Connecticut | 1.5% | 6.5 | 10.9 | 4.1 |
| Delaware | 0.3% | 1.5 | 2.6 | 0.9 |
| District of Columbia | 0.1% | 0.6 | 1.1 | 3.4 |
| Florida | 7.5% | 34.0 | 56.7 | 16.0 |
| Georgia | 2.3% | 11.5 | 19.3 | 8.3 |
| Hawaii | 0.5% | 2.0 | 3.3 | 1.4 |
| Idaho | 0.4% | 2.1 | 3.5 | 1.5 |
| Illinois | 4.3% | 20.1 | 33.6 | 12.9 |
| Indiana | 2.3% | 11.0 | 18.3 | 5.8 |
| Iowa | 1.2% | 5.6 | 9.3 | 3.1 |
| Kansas | 1.0% | 4.7 | 7.8 | 2.6 |
| Kentucky | 1.3% | 7.4 | 12.3 | 5.5 |
| Louisiana | 1.2% | 6.9 | 11.6 | 6.0 |
| Maine | 0.5% | 2.5 | 4.1 | 2.2 |
| Maryland | 1.7% | 7.9 | 13.1 | 5.9 |
| Massachusetts | 2.3% | 11.0 | 18.4 | 9.1 |

| State | Share of Social Security retirement expenditures (2003) | Share of \$601 billion bailout (net present value in 2004 dollars) | 20 percent chance of costs being greater than | Memorandum: Federal grants-in-aid in 2004 |
|----------------|---|--|---|---|
| Michigan | 3.8% | 18.6 | 31.0 | 10.6 |
| Minnesota | 1.7% | 7.9 | 13.1 | 5.3 |
| Mississippi | 0.9% | 4.9 | 8.2 | 4.6 |
| Missouri | 2.1% | 10.4 | 17.4 | 6.6 |
| Montana | 0.3% | 1.6 | 2.7 | 1.3 |
| Nebraska | 0.6% | 2.9 | 4.8 | 1.9 |
| Nevada | 0.7% | 3.4 | 5.7 | 1.8 |
| New Hampshire | 0.5% | 2.2 | 3.7 | 1.3 |
| New Jersey | 3.5% | 15.5 | 25.9 | 9.4 |
| New Mexico | 0.6% | 2.8 | 4.6 | 3.5 |
| New York | 7.1% | 32.8 | 54.8 | 40.2 |
| North Carolina | 2.9% | 14.2 | 23.7 | 9.3 |
| North Dakota | 0.2% | 1.1 | 1.8 | 1.1 |
| Ohio | 4.2% | 20.2 | 33.8 | 12.2 |
| Oklahoma | 1.2% | 6.1 | 10.1 | 4.4 |
| Oregon | 1.4% | 6.2 | 10.4 | 4.4 |
| Pennsylvania | 5.4% | 25.4 | 42.4 | 15.4 |
| Rhode Island | 0.4% | 2.0 | 3.3 | 1.7 |
| South Carolina | 1.4% | 7.2 | 12.1 | 4.5 |
| South Dakota | 0.3% | 1.3 | 2.2 | 1.3 |
| Tennessee | 2.0% | 10.3 | 17.2 | 7.5 |
| Texas | 5.6% | 27.6 | 46.1 | 22.5 |
| Utah | 0.6% | 2.6 | 4.4 | 2.2 |
| Vermont | 0.2% | 1.1 | 1.8 | 1.1 |
| Virginia | 2.2% | 11.0 | 18.3 | 5.7 |
| Washington | 2.1% | 9.5 | 15.8 | 6.9 |
| West Virginia | 0.7% | 4.1 | 6.8 | 3.1 |
| Wisconsin | 2.1% | 9.8 | 16.3 | 6.3 |
| Wyoming | 0.2% | 0.8 | 1.4 | 1.3 |

Notes: All figures are in billions of dollars, based on 2004 present values, unless otherwise specified. Share of Social Security expenditures refers to share of retirement benefits paid to residents of each state in 2003. State shares do not add to 100 percent since overseas areas are not reported here. Bailouts assume that benefit cuts already scheduled will take place and will not be offset by increased government spending. Distribution of federal grants-in-aid to state and local government is from Census (2004) and applied to the annual total for 2004 (BEA, 2005). Sources are BEA (2005), Census (2004), SSA (2004), Weller (2005), and author's calculations.

Alternatively, state and local governments could hope for the federal government to fund the necessary social expenditures. Another option would be to allow Social Security beneficiaries to shoulder the burden of the reduced benefits and the reduced standard of living that will result from Social Security privatization, a result that will undoubtedly pose difficult moral and political questions.

This leaves state and local governments with the unattractive possibility of waiting until demands arise and then funding the necessary social programs either by raising taxes or cutting expenditures elsewhere. Because of the sheer size of these demands, they could be very disruptive to the fiscal and economic health of states and localities.

Conclusion

As Social Security privatization is debated at the federal level, the above data indicate that it is an issue that could have significant implications for future state and local budgeting. Social Security privatization will result in fewer benefits and greater risk. Future governments will likely face higher social expenditures to help those retirees who end up with too few benefits. The costs of such bailouts would be large, they would fall disproportionately onto state and local governments, and they would be unpredictable. The size and unpredictability of this massive unfunded mandate could adversely impact the economic and fiscal health of states and localities.

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