Bush's Privatization Tax:
A Shell Game with Private Accounts

In his State of the Union message, President Bush described the private accounts he was proposing as follows: "The money in the account is yours, and the government can never take it away."

This statement is misleading because it ignores the "privatization tax" that is imposed on the private account. This tax effectively reduces the value of the account by **70 percent**, for a person who earned an average rate of return.

Explanation of the Privatization Tax

This mechanism was described in a background briefing by White House officials and in supplementary materials provided by the Administration. The tax would be extracted from the worker's Social Security benefit, by reducing the amount that the worker would otherwise be paid. The individual does not receive the full value of the account, over and above their full Social Security benefits.

Thus, while the worker might appear to be receiving all of the money in the account, he or she would actually be losing 70 percent of that money in the form of cuts to his or her Social Security benefit. The net effect is a 70 percent reduction in what the individual actually gets to keep from the account.

The only part of the account that the worker actually pockets is the earnings that exceed a rate of return of 3 percent above inflation. All else – the contributions made to the account over the years, plus any interest they earned up to 3 percent – would be taken away by the government, in the form of cuts to the worker's Social Security benefit.

The reason that this tax is included in the President's plan is straightforward: if you invest part of your Social Security contributions in a private account, the Social Security Trust Fund does not receive that money and cannot earn any interest on it. The President's plan would make you repay Social Security for the loss of these contributions and the interest the Trust fund would have earned. (The Trust Fund would have earned 3 percent on the contributions.) This repayment is made in the form of reductions to your Social Security benefit. This is the privatization tax.

Market Fluctuations Determine Privatization Tax Rate

- If a worker earned the average rate of return assumed by the Administration (4.6 percent above inflation on a mixed stock-bond portfolio), the privatization tax would recapture 70 percent of the account.

- If a worker earned a 3 percent rate of return, after inflation, the privatization tax would recapture 100 percent of his account.

- If a worker earned only a 1.5 percent rate of return, the privatization tax would still be based on a 3 percent rate of return. That is, the reduction in her Social Security benefit would exceed the amount in her account, producing an effective tax rate of 139 percent. She would have less combined income (from the account plus the Social Security) than if she had not signed up for an account.

Prepared by the Democratic Staff of the Committee on Ways and Means, February 4, 2005