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TWELVE REASONS WHY PRIVATIZING SOCIAL SECURITY IS A BAD IDEA

BY GREG ANRIG AND BERNARD WASOW

President George W. Bush repeatedly has emphasized that one of his foremost second-term priorities will be to transform Social Security fundamentally. Enacted in 1935 and amended many times since—including major changes in 1983—Social Security provides benefits to workers and their family members upon retirement, disability, or death. Since the program's inception, the size of those benefits always has depended on the earnings of workers over the course of their careers. President Bush wants to change the system so that the amount that each worker collects from Social Security upon retirement instead would hinge on the size of investments in his or her own personal account.

Although the President has not yet endorsed a specific plan, the President's Commission to Strengthen Social Security put forward three proposals in 2002 that likely will form the basis for his plan to create private accounts. An analysis of those proposals showed that paying for new personal accounts while continuing to provide benefits to Social Security's current beneficiaries would require some combination of federal borrowing, tax increases, and benefit cuts **amounting to between $2 trillion and $3 trillion** over the coming decades.

President Bush and others who support private accounts argue that such dramatic changes are necessary because Social Security faces a financing shortfall, according to projections of the system's trustees. The trustees' latest estimates, based on economic and population assumptions they call neither optimistic nor pessimistic, show that Social Security will continue to be able to pay benefits in full until its trust funds are exhausted in the year 2042. After that, funding would be sufficient to provide about 70 percent of currently promised benefits. (The Congressional Budget Office, perhaps more realistically, recently projected that the reserves would last until 2052 and would be able to pay about 80 percent of current benefits thereafter.) Private account advocates also emphasize that while today's retirees generally receive far more from Social Security than they contributed in taxes, the so-called "rate of return" for tomorrow's retirees is projected to be substantially less generous.

Much is at stake in this debate. More than 96 percent of workers pay Social Security taxes and thereby are entitled to collect benefits from the program. More than 47 million Americans today receive checks from the Social Security system. Although the average monthly payment to those individuals is a modest $895, Social Security constitutes more than half of the incomes of nearly two-thirds of retired Americans. For one in five, it is their only income. Like past generations of Americans, today's workers of all ages will need Social Security to protect them against forces beyond their control—economic ups and downs, inflation, fluctuating investment markets, and possible disability or premature death of a family member. That insurance has been essential in even the best of times, and will be all the more important in an increasingly global economy with large and growing federal budget and trade deficits.

Addressing Social Security's potential long-term financing challenges by taking the dramatic step of diverting its payroll taxes to create new personal accounts would represent a radical departure; it also would be a bad idea. Here are twelve reasons why less costly, less risky, and less painful changes should be considered instead:

Reason #1: Today's insurance to protect workers and their families against death and disability would be threatened.

"Rate of return" calculations neglect the value of Social Security's insurance protections. Of the 45 million Americans who collect payments from the Social Security program, over one-third (almost 17 million) are not retired workers. Among those currently receiving Social Security payments are 5 million spouses and children of retired and disabled workers, 7 million spouses and dependent children of deceased workers, and 5 million disabled workers. Proposals to privatize Social Security involve shifting some of the money financing the current insurance program into investment accounts assigned to each worker. But the payroll taxes carved out to pay for personal accounts are resources that are need to support today's payments to recipients of Social Security's survivors and disability insurance as well as retirement benefits. Simple arithmetic suggests that every dollar shifted from Social Security programs to personal accounts is a dollar less to provide guaranteed income to the 37 percent of beneficiaries who are not retired workers.

The three alternatives put forward by the President's Commission to Strengthen Social Security would, in the absence of individual accounts, restore long-term Social Security solvency either largely or entirely through benefit reductions that would apply to all beneficiaries—including the disabled. In the principal proposals put forward by the Commission, **the reduction in disability benefits was draconian**, with cuts ranging from 19 percent to 47.5 percent after the year 2030. The commission itself somewhat disavowed this aspect of its proposals, suggesting that a subsequent commission or other body that specializes in disability policy might revise how its plans apply to the disabled.

Economists Peter A. Diamond (MIT) and Peter R. Orszag (Brookings) have noted that the disabled would have limited ability to mitigate the effects of these benefit reductions by securing income from individual accounts. One reason is that their individual accounts often would be meager, since those who become disabled before retirement age may have relatively few years of work during which they could make contributions to their accounts. Second, under the commission proposals, disabled beneficiaries (like all other beneficiaries) would not be allowed access to their individual accounts until they reached retirement age.

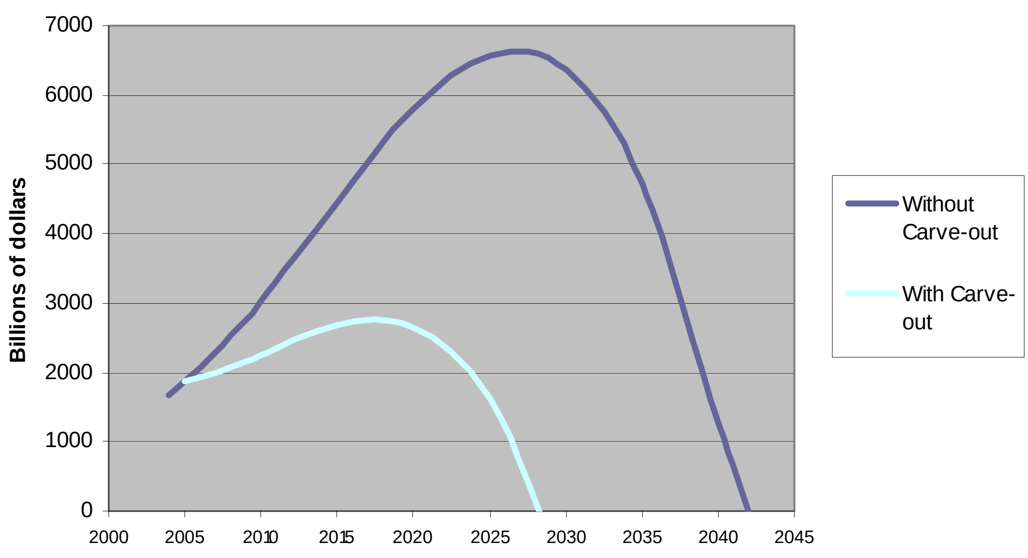
As the Bush commission itself acknowledged, preserving existing disability and survivor's insurance greatly escalates the cost of financing private accounts. It is difficult to imagine how any Social Security privatization plan can avoid significant cuts in those essential protections.

Reason #2: Creating private accounts would make Social Security's financing problem worse, not better.

Social Security is funded by a flat tax of 12.4 percent of each worker's wage income, up to $90,000 in 2005, split evenly between employers and employees. About four out of five of those tax dollars go immediately to current beneficiaries, and the remaining dollar is used to purchase U.S. Treasury securities held in the system's trust funds. Beginning in 2018, well after the huge generation of baby boomers born between 1946 and 1964 begins to retire, a portion of general income tax revenues will be needed to pay interest and eventually principal on those bonds to fully finance benefits. A "crisis" is not forecast to arise until the program becomes entirely "pay as you go" again (as it was throughout its history before 1983) in either 2042 according to the trustees' forecast or 2052 according to the Congressional Budget Office. (By way of perspective, in 2052 the oldest surviving baby boomers will be 106 years old and the youngest will be 88.)

Diverting 2 percent of payroll to create private accounts as proposed by the President's Commission to Strengthen Social Security doesn't sound very radical, but it would shorten significantly the time until current benefit levels could only be sustained by raising taxes. In part, this is because funds now being set aside to build up the trust funds to provide for retiring baby boomers would be used instead to pay for the privatization accounts. The government would have to start borrowing from the private sector almost immediately to be able to meet commitments to retirees and near-retirees. As the figure below shows, the trust funds would be exhausted before 2030 instead of the thirty-eight to forty-eight years projected if nothing is done. In such a short time frame, the investments in the personal accounts will not be nearly large enough to provide an adequate cushion. The upshot: a much larger share of today's workers would confront large benefit cuts, or tax increases, than if no changes were implemented.

Figure 1: The Effect of a 2 percent Carve-out on Trust Fund Assets



Source: Based on analysis in Peter A. Diamond and Peter R. Orszag, "An Assessment of the Proposals of the President's Commission to Strengthen Social Security," The Brookings Institution, Washington, D.C., June 2002.

Reason #3: Creating private accounts could dampen economic growth, which would further weaken Social Security's future finances.

Privatizing Social Security will escalate federal deficits and debt significantly while increasing the likelihood that national savings will decline—all of which could reduce long-term economic growth and the size of the economic pie available to pay for the retirement of the baby boom generation. The **2004 Economic Report of the President** included an analysis of the fiscal impact over time of the most commonly discussed privatization proposal by the president's commission. It found that the federal budget deficit would be more than 1 percent of gross domestic product (GDP) higher every year for roughly two decades, with the highest increase being 1.6 percent of GDP in 2022. The national debt levels would be increased by an amount equal to 23.6 percent of GDP in 2036. That means that, thirty-two years from now, the debt burden for every man, woman, and child would be $132,000 higher because of privatization.

One impact of those seemingly abstract numbers after privatization is that interest rates are likely to be substantially higher, raising the cost to the average household of mortgages, car loans, student loans, credit cards and so on. As a result, the economy would be likely to grow more slowly than it would otherwise.

Creating private accounts with increased federal borrowing at first blush would seem unlikely to affect national savings, because additional savings in the new accounts would offset exactly any new government borrowing to pay for those accounts. Economists believe that increased national savings, especially in a country with savings levels as low as they are in the United States, can increase growth by keeping interest rates low and financing investments in productive activities.

But privatization is actually more likely to reduce than increase national savings. **Diamond and Orszag point out** that evaluating the overall effect on national savings requires taking into account the likely responses of government, employers, and households. Historically, neither the government nor businesses have changed their spending levels consistently in response to large changes in deficit levels. But households that consider the new accounts to constitute meaningful increases in their retirement wealth might well reduce their other saving. Diamond and Orszag argue, "If anything, our impression is that diverting a portion of the current Social Security surplus into individual accounts could reduce national saving." That, in turn, would further weaken economic growth and our capacity to pay for the retirement of the baby boomers.

Reason #4: Privatization has been a disappointment elsewhere.

Advocates of privatization often cite other countries such as Chile and the United Kingdom, where the governments pushed workers into personal investment accounts to reduce the long-term obligations of their Social Security systems, as models for the United States to emulate. But the sobering experiences in those countries actually provide strong arguments against privatization.

A **report this year from the World Bank**, once an enthusiastic privatization proponent, expressed disappointment that in Chile, and in most other Latin American countries that followed in its footsteps, "more than half of all workers [are excluded] from even a semblance of a safety net during their old age."

Other cautionary points made in the World Bank report and other studies about the experience in Chile:

- Investment accounts of retirees are much smaller than originally predicted—so low that 41 percent of those eligible to collect pensions continue to work.
- Voracious commissions and other administrative costs have swallowed up large shares of those accounts. The World Bank found that half of the pension contributions of the average Chilean worker who retired in 2000 went to management fees. **The brokerage firm CB Capitales calculated** that when commission charges are taken into consideration in Chile, the total average return on worker contributions between 1982 and 1999 was 5.1 percent—not 11 percent as calculated by the superintendent of pension funds. That report found that the average worker would have done better simply by placing their pension fund contributions in a passbook savings account.
- **The transition costs** of shifting to a privatized system in Chile averaged 6.1 percent of GDP in the 1980s, 4.8 percent in the 1990s, and are expected to average 4.3 percent from 1999 to 2037. Those costs are far higher than originally projected, in part because the government is obligated to provide subsidies for workers failing to accumulate enough money in their accounts to earn a minimum pension.

In the United Kingdom, which began encouraging workers to divert payroll taxes to personal investment accounts in 1978, many citizens were victimized by poor investment choices as well as unscrupulous brokers. The national government was left with substantial new administrative expenses, lost tax revenues, and responsibilities to bail out some failed private pension plans. Indeed, the problems were so wide-ranging that even the most enthusiastic supporters of private accounts now say that the United Kingdom simply did not do it right.

A British government commission headed by Adair Turner reported in October 2004 that Britain had been living in "a fool's paradise" by thinking it had solved its pension problems. According to pension experts at the Organization for Economic Cooperation and Development (OECD), the Adair Turner report has sounded alarm bells. "What looked like a very good idea from a financial perspective in cutting costs has put pensioner poverty, which had been all but eradicated, back on the agenda."

Reason #5: The odds are against individuals investing successfully.

Privatization advocates like to stress the appeal of "individual choice" and "personal control," while assuming in their forecasts that everyone's accounts will match the overall performance of the stock market. But studies by Yale economist Robert J. Shiller and others have demonstrated that individual investors are far more likely to do worse than the market generally, even excluding the cost of commissions and administrative expenses. Indeed, research by Princeton University economist Burton Malkiel found that even professional money managers over time significantly underperformed indexes of the entire market.

Moreover, a number of surveys show that most people lack the knowledge to make even basic decisions about investing. For example, **a Securities and Exchange Commission report** synthesizing surveys of investors found that only 14 percent knew the difference between a growth stock and an income stock, and just 38 percent understood that when interest rates rise, bond prices go down. Almost half of all investors believed incorrectly that diversification guarantees that their portfolio won't suffer if the market drops and 40 percent thought that a mutual fund's operating costs have no impact on the returns they receive.

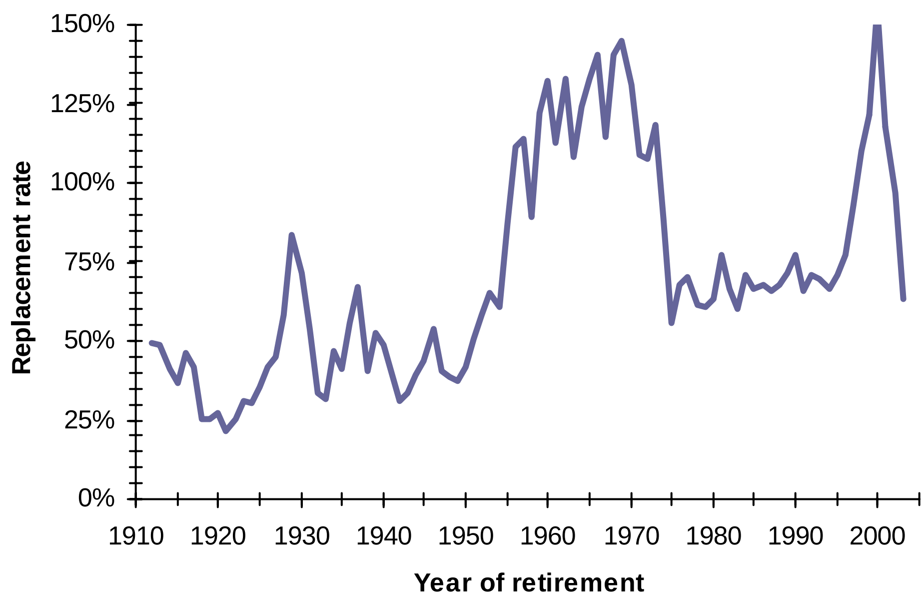
While predictions vary significantly about how investment markets will perform in the decades ahead, it's safe to say that any growth in individual accounts under privatization will be significantly lower than what the overall markets achieve.

Reason #6: What you get will depend on whether you retire when the market is up or down.

In the twentieth century, when stocks generally grew significantly, there were three twenty-year periods over which the market either declined or did not rise. The volatility of investment markets means that it matters a great deal whether you retire during an upswing or downturn. For example, a worker who invested his or her retirement fund in a stock portfolio that matched the Standard & Poor's 500 index and cashed out upon retirement in March 2000 would have a nest egg almost a third larger than someone who retired just a year later using exactly the same investment strategy. Of course, that is because the stock market plunged over those twelve months.

Gary Burtless of the Brookings Institution demonstrated how much timing matters under privatization by examining what would have happened to workers with forty-year careers who retired in each year from 1911 until 2002. Following Burtless's method, the figure below assumes that each worker put 7 percent of his or her earnings in the stock market every year (reinvesting dividends) and earned the actual historical return, year by year. It shows the wide variation in the retirement income workers would have received. Clearly, some workers would do much better than others based simply on when they happened to retire—that would be a major change from today's system.

Figure 2: Value of Annuity Purchased At Retirement With Individual Account Invested In Stocks



Note: Assumed contribution rate is 7 percent of wages. Author's tabulations of U.S. equity and bond return data supplied by Global Financial Data (March 2003).
Source: Gary Burtless, Personal communication.

Reason #7: Wall Street would reap windfalls from your taxes.

Brokerage houses, banks, and mutual funds have been very active in the campaign to privatize Social Security. Small wonder, since they stand to gain enormous fees if billions of dollars are shifted each year from Social Security payments into accounts under Wall Street management. Of course, those fees must come from somewhere, namely from the balances in individual accounts.

Among the one hundred best stock mutual funds, management fees range from 0.2 percent per year to 1.4 percent of the asset value of an account. The average is near the high end of that range, however, and many mutual funds charge substantially more. Smaller accounts require proportionately larger management fees because many costs such as gathering and mailing out information do not depend on account size. Indeed, most mutual funds actively discourage small accounts by setting a minimum opening deposit of $1,000 to $3,000.

Experience in the United Kingdom offers a warning about what the future could bring regarding management costs. Workers there have been allowed to open private accounts starting in 1988, since which time management fees and marketing costs among financial intermediaries have eaten up an average of 43 percent of the return on investment.

Reason #8: Private accounts would require a new government bureaucracy.

From the standpoint of the system as a whole, privatization would add enormous administrative burdens. Instead of the current trust fund accounts, the government would need to establish and track many small accounts, perhaps as many accounts as there are taxpaying workers—147 million in 1997.

Many workers' accounts would be so small that they would be of no interest to profit-making firms. The average taxable earnings of a worker are roughly $25,000 (in 1997, the last year with complete data, the average taxable earnings of the workers who paid into the system were $22,400). Two percent of $25,000 comes to $500 per year. Francis X. Cavanaugh, who has supervised the thrift savings program for federal employees, a program that privatization advocates often point to as a model, **has argued** that the costs of administering so many small accounts would overwhelm any benefits to be gained from the stock market. For example, he estimates that the government would need to hire 10,000 highly trained workers just to oversee the accounts and answer questions from workers. In contrast, today's Social Security has minimal administrative costs amounting to less than 1 percent of annual revenues.

Reason #9: Young people would be worse off.

Social Security privatization is often sold to young adults as a much better deal for them than the current system. But two recent studies show that if Social Security is converted to a system of private accounts, younger generations will be the ones who bear the costs of transforming the program. The added costs arise from the huge increases in federal borrowing needed to finance the new accounts while continuing to direct payroll taxes toward existing benefits for current retirees. According to the **Congressional Budget Office**, "to raise the rate of return for future generations by moving to a funded system, some generations must receive rates of return even lower than they would have gotten under the pay-as-you-go system."

A July 2004 **Congressional Budget Office analysis** of a private account proposal by the President's Commission to Strengthen Social Security compares it with the existing system. It looked at two scenarios for the traditional Social Security system, one with payments continuing in full indefinitely and the other with the trust funds becoming depleted in a few decades and payments shrinking to three-fourths their current level. In both scenarios, nearly all birth cohorts at all income levels born from the 1940s through the first decade of the 21st century on average do worse under the proposed system of private accounts. Only individuals in the lowest earning quintiles from the 1950s and the 1990s do slightly better, on average. Even assuming a worst case scenario where the trust funds evaporate and benefits are cut substantially, cohorts from the 1960s to 2000s would see reductions with private accounts between 1 percent and 17.5 percent on average, depending on their income and birth year.

An earlier analysis by economists Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag used the broad outlines of then-Governor Bush's Social Security privatization proposals to compare retirement benefits under current law to those if private accounts were introduced. They found that benefits for an average earning worker who retired in 2037 at age 67 (someone aged 34 today) would be 20 percent lower than they are now given historical rates of return over a fifty-year period.

Reason # 10: Women stand to lose the most.

The Social Security system is gender-blind. None of its provisions treat women differently from men. But that does not mean that the results are gender-neutral. Various cultural and biological differences add up to the fact that **Social Security is much more essential, and a much better deal, for women than for men**. Of all groups, none has more to lose from the privatization of Social Security than women. Compared to the average man, the average woman

- works fewer years outside the home,
- earns less per year, and
- lives longer after retiring.

Together, these differences mean that women depend more than men do on spousal and survivors' benefits, they collect benefits for more years than men do, and a greater proportion of their total retirement income comes from Social Security.

Since women on average work fewer years at lower pay, they contribute less in payroll taxes over their lifetimes than do men. But in their various roles as retirees, spouses, and widows, women collect Social Security benefits for more years than men. The result is that women get more net benefits over their lifetimes than do men.

There are fourteen women for every ten men aged 62 or older. Above age 85, this ratio reaches twenty-four women per ten men. Consequently, 60 percent of all Social Security beneficiaries are women. Among those receiving survivor and disability benefits, women and children constitute 85 percent. Women also depend more on Social Security. Older women who are not part of a couple (either widows, divorcees, separated, or never married) get 51 percent of their income from Social Security, and 25 percent of them have no income but Social Security. For men in the same situation (a far smaller proportion of the total), the figures are 39 and 20 percent, respectively.

The poverty rate for older women is almost twice that of older men (in 1997, 13.1 percent versus 7.0 percent). For older women who are not in a couple, the rate gets much higher: more than one in four lives below the poverty line. Fewer than half of them had incomes in 1997 above $1,000 per month. Without Social Security's guaranteed benefits, the already marginal income security for older women would be much worse.

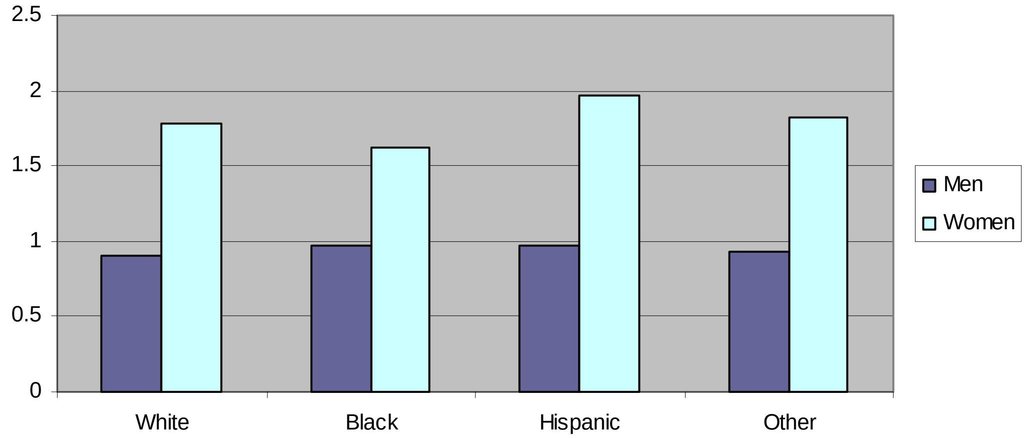
In spite of the improvement in employment opportunities for women, the role of homemaker and primary parent still falls unequally on wives and mothers. Private accounts would jeopardize income that wives, widows, and divorcees now receive under Social Security. The more individual control that passes to workers, the fewer rights their dependents will retain to secure retirement income. If the guarantees and redistributive features of Social Security are replaced with a system that provides benefits according only to how much a worker earns over that worker's lifetime and how fortunate that worker is in financial markets, the average woman, especially the average widow, will lose security and income from already low levels.

Reason #11: African Americans and Latin Americans also would become more vulnerable under privatization.

Privatization advocates often claim that converting Social Security to a system of private accounts would disproportionately help African Americans and Latin Americans because those groups are purportedly shortchanged by the current system. But in fact there is almost no difference in Social Security's payback by race. And because both of those groups on average earn lower lifetime earnings than whites, those minorities would be at greater risk of facing poverty in their retirement under privatization.

African Americans on average have two characteristics that are disadvantageous under Social Security: shorter life expectancy and a lower marriage rate. But **they also have traits that lead to greater benefits under Social Security**: a higher disability rate, more survivors receiving benefits, and lower average wages. Latinos also have relatively low incomes on average, but **a longer life expectancy and fewer average years in the workforce**. As the figure below shows, the bottom line is that there is almost *no difference* by race in the benefits per dollar of Social Security taxes paid.

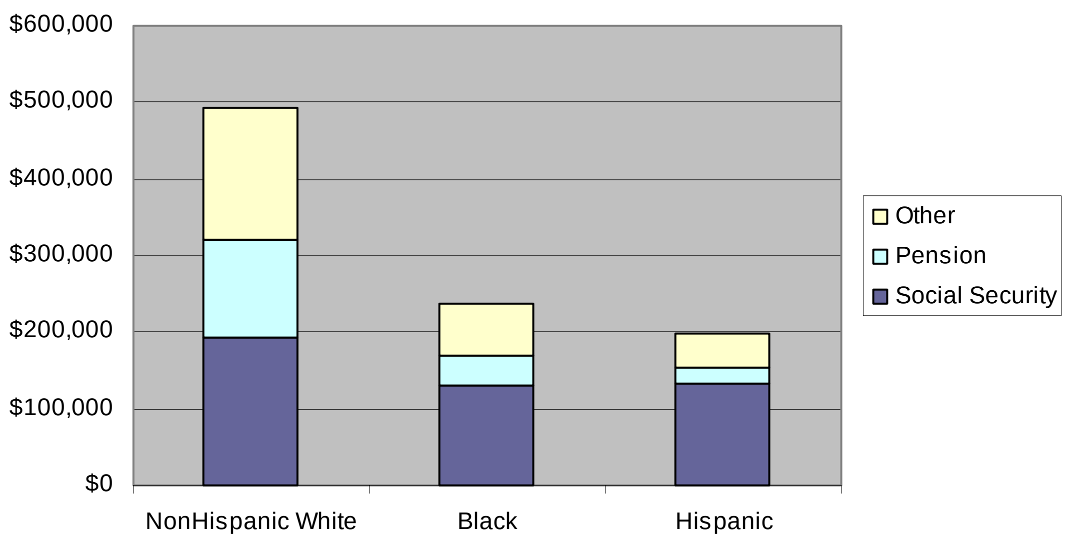
Figure 3: Benefits Received per Dollar of Payroll Taxes, by Race and Ethnicity



Source: Lee Cohen, C. Eugene Steuerle, and Adam Carasso, "Social Security Redistribution by Education, Race, and Income: How Much and Why," paper presented at the Third Annual Conference of the Retirement Research Consortium, "Making Hard Choices about Retirement," Washington, D.C., May 17–18, 2001. A 2 percent discount rate is used, which tends to reduce the benefits per dollar of taxes. The numbers are for those born between 1956 and 1964.

But because African-Americans and Latinos on average have substantially less wealth upon retirement than whites, they are far more dependent on Social Security. Converting the program into a system where their retirement income would be more dependent on investment markets would make those groups even more vulnerable to poverty.

Figure 4: Median Wealth at Retirement by Race and Ethnicity



Source: Marjorie Honig, "Minorities Face Retirement: Worklife Disparities Repeated?" in *Forecasting Retirement Needs and Retirement Wealth*, B. Hammond, O. Mitchell, and A. Rappaport, eds. (Philadelphia: University of Pennsylvania Press, 1999), Table 4. The data are for 1992 adjusted to 2001 prices.

Reason #12: Retirees will not be protected against inflation.

Social Security privatization plans, including all three recommended by the President's Commission to Strengthen Social Security, require retirees to convert the lump sums in their personal accounts into annuities that provide them with monthly payments until their death. The reason for that is that otherwise retirees could outlive their nest eggs, or even squander them, requiring taxpayers to bail them out.

The market for annuities, which are financial contracts sold by insurance companies, is very thin now, with relatively few bought and sold. Such a market would probably develop under privatization, but **it is unlikely that those annuity payments would increase in line with inflation, as today's Social Security benefits do**. Without inflation protection, the purchasing power of retirees' pensions would fall precipitously during times when prices are rising rapidly. Because insurance companies would bear significant new risks for offering inflation protection, they would be likely to charge very substantial fees over and above the already steep 10 percent that they now charge.

Conclusion

Current Social Security insurance protections have served the country well for decades. Diluting those protections in exchange for new accounts poses all kinds of new risks while making the relatively manageable long-term challenges confronting Social Security far more immediate and severe.

Notes

Introduction
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