



Policy Note

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Social Security Privatization: A Bad Idea

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Would privatization yield sufficient benefits to support low-income retirees and satisfy all others? Does a focus on private management of assets take attention away from the real issues in the future of Social Security?

The demographer Richard Easterlin, in his book *Birth and Fortune*, advanced the proposition that large birth cohorts necessarily follow small ones, and small cohorts follow large. The unexpectedly high living standards that small generations enjoy give rise to relatively large families, and the large generations' disappointment with their living standards leads to reluctance to have many children.

Surely, a host of other forces have shaped family size over the years, but Easterlin's model of alternating generation size holds true for much of twentieth-century America, and it is at the heart of the complex financial problem the nation faces as the baby boom generation approaches retirement age. What is the best means to finance that large generation's Social Security benefits, which ultimately will be paid out of the earnings of the relatively small generation that followed it? How the nation plans to meet this challenge will have a lot to do with the economic well-being of both generations.

In the Social Security debate many have called for some form of partial or even total privatization. Most such proposals are variations on the idea that individuals should be permitted to dedicate part of their Social Security taxes to self-directed investment. I argue that the principle of privatization is bad public policy.

Privatization would undermine the redistributive mechanism that has been at the heart of Social Security since its inception. To the extent that privatization takes payroll taxes out of the common pot and makes them individually owned, it robs Social Security of the financial resources it needs to subsidize benefits for low-income workers.

Privatization exposes to investment risk future Social Security beneficiaries who should not assume that risk. Privatization would have workers invest during their working lives in assets of their own choosing in order to generate higher returns than the system now earns on its reserves (which are automatically invested in special-issue Treasuries). Higher returns are the only reason for being for privatization, but the returns cannot be guaranteed, and there are millions of workers who--because of low income and commensurate low savings--cannot afford to take a chance on the promise of gains. What little savings they have should be in a safe form, not in risky assets.

Privatization will add to the broader fiscal burden that lies ahead as the baby boom ages. Funds will be needed to finance the transition from a public to a privatized system in addition to the funds needed to meet the existing liabilities of the system.

Money's Worth versus Social Adequacy

To fashion conclusions about whether privatization makes sense and, more broadly, about the nature of the challenge facing Social Security, it is useful to recall how the program has been structured. For most of the program's life, benefits have been financed on a pay-as-you-go basis. I pay to finance my father's pension through payroll taxes (and, it should be acknowledged, through the lower wage I get to make up for my employer's Social Security contribution). My son, in turn, pays to finance my pension. In this scheme of things,

Washington is simply an intermediary--a paymaster, if you will, charged only with ensuring adequate liquidity to make timely payments.

The 1983 reforms coming out of a presidential commission headed by Alan Greenspan changed pay-as-you-go financing to some degree, introducing an element of advance funding through a sharp rise in payroll taxes to provide more funds than are needed for liquidity purposes. Although the system has remained largely pay-as-you-go, it has been accumulating reserves. In the fiscal year just ended it threw off a surplus as large as \$125 billion, and that is expected to rise to \$150 billion in the current fiscal year. The surpluses are in special-issue Treasury securities, but there is no vault containing physical securities. Indeed, the surpluses have been spent in the sense that for many years they have financed other government programs in the context of large deficits in the rest of the budget. The surpluses exist, however, as IOUs to the system. Just as ordinary Treasuries are backed by the "full faith and credit" of the federal government, so the special-issue Treasuries are backed by the political will to support the elderly and by the taxing power of Uncle Sam.

The benefits are set by complex formulas, but the principle is straightforward. The more workers put in during their working life, the more they get back in dollar terms during retirement. This satisfies the program's "money's worth" or individual equity objective, which all along has been essential to maintaining broad popular support for the program. The more workers put in, however, the less the percentage return on their contribution. This enables the program to fulfill its social adequacy objective. The benefits are progressive, even as the payroll taxes, calculated as a flat percentage of a maximum wage base, are regressive.

The potential conflict between money's worth and social adequacy was muted in the past because of favorable demographics. The first beneficiaries paid into the system for only a few years and at minimal tax rates, and thirty years ago there were four workers paying into the system for every retiree withdrawing benefits. Disproportionate poverty was ended among the elderly at the same time that all beneficiaries received a handsome return on their input, with generous retirement benefits and disability and survivor benefits to boot. Indeed, they got more than their money's worth.

As we look ahead, however, the conflict between the objectives is intensifying. Contrast the large returns to past pensioners, in both absolute and percentage terms, to the situation facing today's thirtysomethings. They have paid into a mature system from the time they started working and at the sharply higher tax rates enacted after the Greenspan commission. The ratio of workers to retirees has fallen to three to one, and it will become two to one when the baby boom's retirement is in full swing.

The coming demographics force Social Security to give primacy to its social role. Net subsidies cannot be extended to all beneficiaries as they were in the past. The system simply cannot serve the interests of young workers as a group--if those interests are measured by money's worth--anything like the way it has served the interests of their parents and, even more, their grandparents. Net subsidies, instead, must be confined to those with relatively low lifetime earnings. This is not a fault of the system; it is the inevitable result of the shift from favorable to unfavorable demographics.

How large is the actuarial imbalance Social Security faces, given those demographics? The answer is sensitive to small changes in assumptions about such key variables as inflation, labor force participation, and immigration. The overarching variable is the growth of economic activity. Growth will raise the amount needed for pension benefits, tied as they are to lifetime earnings, but it also will enable the nation to pay a relatively large Social Security bill and still provide a satisfactory rise in living standards for all.

Middle-of-the-road assumptions about these variables made by the trustees of the Social Security system point to a long-term actuarial shortfall of about 2 percent of payroll. If benefit formulas and tax rates are kept unchanged, some 30 years from now the reserves will be exhausted and the system will be able to pay only about 75 percent of benefits out of current receipts, with progressively smaller percentages thereafter.* In effect, the intergenerational compact that I pay for my father and my son pays for me would be broken.

Privatization is a response to that eventuality. It is no accident that privatization is in vogue now, after almost 20 years of a spectacular run on Wall Street. Valuation measures have gone off the charts, and risk premiums seem to have fallen to zero, if not below the line. The underlying premise is that there will be no need to raise taxes or reduce benefits if monies are channeled not to special-issue Treasuries but to higher-yielding assets, equities in particular. Many proponents of privatization would also reduce benefits, but the essence of the argument is the large prospective return on equity investment.

Many Could Lose

It is not investment in equities per se that distinguishes privatization plans. The federal government could do such investing, just as state governments do for pension funds. The distinguishing feature is individual ownership and control of assets. Most plans retain a public program, to provide a relatively small basic benefit to all, but split off the rest into self-directed private accounts, much like 401(K) plans. The benefits from the private program would be highly variable. It is not hard to imagine that many people would be unlucky or timid in their investments. They are apt to be people with little experience as investors, typically low-income workers with little or no prior savings. They are also the ones with the most to lose since Social Security is apt to be their major if not only source of retirement income.

Even many of those who do well in their investments might not enjoy a better retirement than they would under the present system if the privatized accounts are treated as individuals' money to be disposed of freely. Such a plan would have several consequences.

- If there is no requirement for annuities, some people would outlive their nest egg and have to fall back on the modest basic benefit of the public program.
- If defined benefits, which permit people to take risks with other saving, could no longer be counted on, most people would have to change their risk-return calculation on the investment of personal wealth other than the private account.
- Saving for retirement could be pushed aside by other legitimate personal needs. It would be heavy-handed of the government to tell a 55-year-old grandfather that he could not use his privatized Social Security account to pay for a grandchild's needed heart surgery.

It is not just the losers, by the way, who could wind up disappointed. Virtually all proposals for privatization make the extrapolation that the long-term, inflation-adjusted rate of return on equity investment of 7 1/2 percent will hold into the future. Some proponents acknowledge the volatility of stock prices (some of them even remember the slump of the 1970s), but they stick by the 7 1/2 percent, vesting it with an almost talismanic quality because it captures history as far back as the 1920s.

For equities now to render a comparable return, economic activity would have to advance more rapidly than the economy's long-term growth potential, which is unlikely to be significantly higher than 3 percent a year at a time of relatively small increases in the labor force and only the most tentative evidence that the productivity growth trend has accelerated. Stepped-up productivity has to be tested over a business cycle, not just in a cyclical expansion. Alternatively, profits would have to rise to implausibly high levels as a share of national income (and wages sink to implausibly low levels) or price-earnings ratios, now at unheard-of heights, would have to rise still further. Prospective returns get almost no help from current dividends, which are at an unprecedented low.

Finally among the cautions about returns, broadly defined, is that someone is going to have to finance the transition from a public to a privatized system. Devoting part of the Social Security tax to private accounts will mean that the current workforce will have to fund its own pension as well as its parents'. The existing liabilities of the system will not go away with privatization. New money would have to be raised to meet those liabilities and to fund private accounts--hardly the kind of thing the privatizers have in mind when they argue that benefits need not be cut nor taxes raised because the golden egg stock market will make it all turn out right. Transition taxes, by the way, are the only means by which privatization would add to national saving. Any tax increase would do the same, provided--a big "if"--the increase did not affect economic activity adversely.

The Context of Overall Fiscal Policy

Discussion of privatization requires some thought about the broader fiscal background. Even the best of economic forecasters would have to admit surprise at the dramatic shift in the overall budget from deficit to surplus. The outsized deficits of the Reagan years seem in hindsight to have had a chilling impact (some would say quite deliberately) on government expenditures, and the extraordinary prosperity of recent years has had a powerful impact on revenues. Although Social Security theoretically is an off-budget agency, it is counted in the budget's bottom line, and it has been running large surpluses. The age demographics (the worker-to-retiree ratio) will not turn negative until the baby boom generation starts to retire in large number. And the rest of the

budget, no longer in deep deficit, is expected to start showing surpluses, barring a major tax cut or spending initiatives.

The issue in the headlines now is how to allocate the expected surplus. Should it be returned to taxpayers in the form of tax cuts? Should it be used to meet national needs in education and infrastructure that have grown during long years of restricted public spending? Before looking for answers to such questions, it is important to recognize that, in a time frame of several years, there really is no surplus ahead. Yes, for a while revenues will exceed expenditures, but the demographics alone indicate that situation will not last. The horizon that is troublesome is much closer than the 30 years from now when Social Security will not be able to meet its current commitments at current tax rates. Social Security benefits will start to exceed payroll taxes in about 10 years. The system will have to draw on the interest on the reserves that are building now, and then it will have to draw on the principal. At that time the nation will have to repay the Social Security system for all the net lending it will have done for several decades. The system's financial health is intimately linked with the financial health of the budget as a whole.

This longer-term perspective on the budget ought to caution us against tax cuts now and against major expenditure initiatives, unless, like public capital investment, they can be justified as raising the economy's growth potential. The long-term perspective should also arouse deep concern about the continual climb in the nation's current account deficit, which implies that an ever-growing share of national output will have to be dedicated to foreign claimants. When Social Security has to start spending the interest on its reserves and later the principal, the nation will be well served if in the meantime it has drawn down both its foreign and domestic debt. Minimizing the federal revenue that must be dedicated to interest expense and minimizing the share of GDP leaking out to foreign claimants are the real ways to deal with the problem of financing Social Security. These--along with the living standards the economy is able to generate in the meantime--are the real issues, not private management of assets. It would be a shame to undermine a program essential to the welfare of the relatively low-income elderly in the guise of saving it.

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