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Protecting Social Security
The Case Against Privatization

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Attempts to undermine Social Security have been ongoing since its enactment in 1935. As the Social Security Administration projects trust fund insolvency by 2033 and Congress looks for deep spending cuts, the pressure is mounting for Social Security benefit cutbacks, despite promises from President Trump and House Speaker Johnson not to reduce benefits.

While extending the full retirement age is a focus for benefit cutbacks, some are advocating for a form of privatization (i.e., individual accounts). Elon Musk's reference to Social Security as a Ponzi scheme only serves to undermine the current system and give weight to this ill-conceived idea.

As a former consulting actuary, consultant to the Office of Personnel Management (OPM) during the 1980s studying replacement plans for the Civil Service Retirement System with the private sector in mind, and a consultant to and observer of many corporations' revisions of defined benefit pension plans in favor 401(k) savings or hybrid individual account ("cash balance") plans, I have not observed a single instance when the motivation for program change was to increase benefits for employees. The goal was always to reduce the sponsor cost and/or shift the investment risk to employees.

The reason is simple: replacing all or a portion of a defined benefit program with an individual account plan (without substantially increasing employer cost) shifts financial burden and risk to the plan participants. This move would undermine an already successful program, as there is no more efficient mechanism than a defined benefit plan to deliver retirement, survivor, and disability income in a retirement program, especially if those incomes are indexed to a variable rate such as inflation.

A Brief History of Social Security Privatization

According to a 2005 analysis by the Social Security Administration, in 1981, Chile was the first country to implement individual accounts as part of a mandatory system for retirement income. The goal at the time was to provide improved benefits through the investment process and to keep public costs low. As it turned out, emerging benefits amounted to less than half of the projected, leading to a recent increase in the mandatory contribution rate from 10 to 16 percent (the US OASDI combined employer and employee contribution rate is 12.4 percent).

Argentina, Bolivia, Columbia, El Salvador, Mexico, Peru, and Uruguay followed in Chile's footsteps. While the program benefits and earnings used to calculate contribution rates vary greatly, as of July 2019, the average employee and employer combined contribution rate for these countries was also 16 percent.

Mandatory individual Social Security accounts are not as prevalent in Western Europe as they are in Latin America. In 2019, only Italy, Sweden, and the United Kingdom were identified as having such programs, with an average combined employee and employer contribution rate of 21.6 percent.

Since the CATO Institute advocates for the Swedish Social Security System, it is helpful to note the following:

- National comparisons of Social Security systems are difficult to make given the different economic, political, and social support systems in which countries operate.
- The Swedish government-provided Social Security retirement system is called the National Basic Pension (NBP) and Insurance (which includes a survivor's pension and insurance for health, occupational injury, parental support, and unemployment).
    - Employer contributions for the National Basic Pension program are 31.42 percent, including 3.55 percent for health insurance, 11.62 percent payroll tax, and 5.5 percent for the other benefits combined.
    - Employees contribute 7 percent of their income, but because it is deductible from their income tax, certain employees pay little or nothing on a net basis.
    - The (NBP) program has two parts:

        - 16 percent of salary (not based on contributions) is allocated by the government to a notional account credited with statutory interest based on wage rate growth; and
        - 2.5 percent is allocated to an account under the investment control of the employee.
    - At retirement, the NBP accounts are converted to a fixed (not inflation-adjusted) annuity, based on a unisex table of life expectancy.
    - While NBP replacement rates at retirement appear to be more generous than US Social Security replacement rates, the comparison is apples to oranges because the Swedish retirement benefits are not inflation-adjusted,[1] and disability, survivor, and dependent benefits are not comparable (see the discussion of Social Security benefits below).

In summary, the Swedish Social Security program has higher costs and lower income replacement rates when inflation and dependent benefits are taken into account. What Sweden's program does do, however, like other pension programs converted to an individual account format, is shift investment and inflation risk to plan participants.

Privatization Initiatives in the United States

Multiple proposals have been made to address Social Security trust fund insolvency, many of them including some form of privatization. A summary of the most frequently mentioned advantages of privatization and a brief response for each follows:

1. **Higher investment returns will lead to larger benefits.** This is the selling point upon which most privatizers hang their hats with the implication that higher returns would lead to larger benefit payouts. What is missing from this analysis is that balanced portfolio returns need to be adjusted to reflect the inflation-adjusted benefits provided by Social Security.

[1] The conversion of the account balances to a fixed lifetime annuity using a unisex life expectancy factor without an interest factor implicitly reflects inflation by producing a lower benefit. The appearance of a higher benefit than that provided by US Social Security is achieved by using 18.5 percent of wages credited to the account balances. Had an annuity factor without an inflation adjustment been used, a higher initial benefit would have been produced, subject to deterioration by inflation in real value. In effect, the Swedish government has transferred the inflation risk to the retiree.

2. **Reduced government liability.** Privatization could decrease the federal government's long-term financial obligations by transitioning away from a system where it guarantees benefits. While true, this negates the original purpose of Social Security to provide basic income security and the reliance generations of Americans have placed on the system.
3. **Personal ownership and control.** Allowing workers to control their retirement choices and investments appeals to those who value individuals taking responsibility for their own retirement and financial well-being as they do in other aspects of their lives. On the other hand, most workers do not have the experience or expertise to make long-term investment decisions.
4. **Intergenerational fairness.** This aligns taxpayer contributions with benefits earned. Leaving aside the challenges of transition, the federal government cannot prefund future obligations. Intragovernmental debt in the Social Security OASI trust fund merely records a future obligation.

Benefits Provided by Social Security

Public polling and discussion of the efforts to privatize Social Security fail to recognize precisely how individualized accounts are supposed to be used to replace or improve upon the benefits provided by Social Security without incurring substantial risk or additional cost. The false presumption is that market-based investment returns will do the job.

To understand why the arguments in favor of privatization are flawed, it is necessary to understand the benefits provided by Social Security, each of which has a distinct actuarial cost. Here is a summary:

1. Retirement Income Benefits

   Retirement benefits are based on wage-inflation-adjusted career average earnings. Reduced benefits are available as early as age 62.
2. Spousal Income Benefits

   Spouses and certain ex-spouses are eligible for up to 50 percent of their spouse’s retirement or disability income benefit.
3. Disability Income Benefits

   Eligible disabled persons may receive lifetime income.
4. Survivors' Income Benefits

Eligible surviving spouses, children, and dependent parents may receive a lifetime income.

5. Children's Income Benefits
   Children of retirees and disabled workers are eligible for income until age 18, or longer if the child is disabled or a student.
6. Family Income Benefits
   Social Security income benefits for a family may be as high as 150–180 percent of the retiree's income benefit.
7. Supplemental Security Income (SSI)
   Financial support, possibly in addition to the benefits listed above, is available for elderly, blind, or disabled individuals with limited income and resources.
8. Inflation Adjustment
   All income benefits listed above are statutorily increased annually based on the Consumer Price Index (CPI-W).

Why Privatization Will Not Work

The idea that individual accounts invested in public markets can provide better benefits at less cost is false. Here is why:

1. **Transition costs.** With over a trillion dollars of OASI annual tax revenue and a system that operates on a pay-as-you-go basis (the only way it can), any diversion to individual accounts would increase the national debt dollar-for-dollar to continue paying benefits to current retirees.
2. **Impossible benefit replacement.** It is financially impossible to replace the scope of current Social Security benefits in the private market without a substantial increase in cost. Even systems like those in Chile and Sweden—which have introduced individual accounts—have discovered that costs are greater and benefits are reduced unless provided through other programs. Beneficiaries will lose inflation protection or it will come at a great cost to the level of retirement income.
3. **Increased financial risk**. Privatization would subject retirement savings to stock market volatility, potentially leaving retirees with significantly reduced benefits during economic downturns. Adequacy of retirement income when individual accounts are converted to annuities, as in the Swedish system, depends on prevailing interest rates. Retirees with

similar account balances can end up with very different retirement incomes—simply because they retired a few months apart.

4. **Undermining guaranteed benefits.** Private accounts would erode the guaranteed retirement income provided currently by Social Security, leaving some retirees with insufficient retirement funds.
5. **Higher administrative costs.** Privatization would lead to increased fees for account management and brokerage services, draining investment performance and benefiting Wall Street firms at the expense of retirees.
6. **Reduced protection for women and vulnerable groups.** The current progressive benefit structure of Social Security, which provides proportionally higher benefits to lower-income workers, would be weakened or eliminated for women (who make up 60 percent of Social Security beneficiaries), African Americans, and Latin Americans in a privatized system.
7. **Complexity and financial literacy concerns.** Many individuals lack the financial knowledge to effectively manage private investment accounts, likely leading to poor investment decisions.
8. **Adverse selection.** The most financially stable participants or those with no dependent obligations might opt out of the system, destabilizing it for those who remain.

Conclusion

The bottom line is that privatizing Social Security programs has not worked elsewhere, as benefits for many groups have been curtailed where it has been implemented. There is no reason to expect a different result in the US. Any diversion of participant Social Security taxes into self-managed investment accounts would benefit the financial sector but will subject payouts to market instability.

Providing a low-cost, well-managed opportunity for workers to set additional money aside for retirement, similar to the Federal Employees Thrift Savings Plan, would be a good idea. Ultimately, though, Social Security is a public *assurance*, a minimum retirement safety net which only the public sector can provide. As I have argued elsewhere, there are various actuarial and legislative changes that can be implemented to shore up any Social Security shortfall and continue to guarantee retirement security to Americans indefinitely.