

## Will Privatizing Social Security Really Raise Returns?

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Support for privatizing Social Security has snowballed during the past year. The famous “third rail” of politics has lost its voltage. Across the political spectrum, advocates of privatization are busy devising plans that would allow Americans to invest some or all of their payroll-tax contributions in stock and bond markets. Although details of these plans differ, all aim to raise the payoff to future retirees by offering a higher rate of return on contributions invested privately compared with the return on contributions paid into Social Security. But this “free lunch” of higher returns is an illusion because it ignores both the importance of financial-market risk and the sizable cost of paying benefits already owed to current retirees and workers.

As is well known, the rate of return on contributions to Social Security has fallen sharply over time as the system has matured. The decline occurred because the system’s pay-as-you-go financing allowed retirees in early years to reap benefits disproportionate to their contributions. For those born this year, Social Security is projected to return an average of only 1.5 percent after inflation.

Advocates of privatization argue that the projected low rate of return on Social Security would be easily outpaced by returns on stocks and bonds. They commonly cite average returns over long historical periods to support their view. Indeed, a quick look at returns on stocks and bonds shows that from 1926 to 1996 the average annual return was about 7 percent for the S&P 500 and about 2.5 percent for government bonds.

A simple comparison of average returns over long time horizons, however, ignores the risks associated with fluctuations in stock and bond prices for investors whose “effective” time horizons are much shorter. Under virtually all privatization schemes, contributions to private accounts would occur throughout one’s working years so that rates of return in early years get applied to smaller dollar amounts than rates of return in later years. In other words, returns in later years are much more important in determining the ultimate size of the retirement nest egg. Accordingly, the “effective” investment horizon for a 25-year old is significantly shorter than the 40 years until age 65.

For example, a 25-year old who contributes equal amounts to a retirement account each year until age 65 would face an “effective” horizon of only 20 years, and a 25-year old who contributes steadily increasing amounts could face an “effective” horizon of 10 or fewer years! Under most privatization proposals, contributions would rise over one’s working life because the amount would be figured as a proportion of wages (similar to the present payroll tax). Thus, for most people, the appropriate investment horizon would be significantly shorter than 40 years and likely on the order of about a decade.

Data for the average annual return on the S&P 500 over successive 10-year periods since 1936 illustrate the risk such investors would face (see chart). During more than a quarter of these periods, the 10-year return was less than 2.5 percent, and sometimes negative. Clearly, a “one-out-of-four” chance of poor returns over any

given ten-year period represents substantial risk. If such a period happened to fall in the years just prior to retirement, it would have a disproportionate effect on the size of one's nest egg.

One way to limit this risk is to move money out of stocks and into "safer" assets, such as government bonds, prior to retirement. But such a strategy also limits the disproportionate upside potential of returns in later years. In the end, no strategy can avoid the risks of the stock market while still enjoying the potential gains. The higher long-run average return on stocks merely compensates for the significant chance of substantial losses. Efficient financial markets ensure that returns on stocks, adjusted for risk, are equal to returns on bonds.

Supporters of privatization sometimes argue that if stock risk worries people, then at least relatively safe government bonds could offer a return higher than Social Security at about the same low degree of risk. But the cost of benefits owed to current retirees and workers would reduce the net return to private accounts invested in government bonds. This unfunded liability, which currently totals \$9 trillion, must be paid for regardless of whether Social Security continues as currently structured or is privatized.

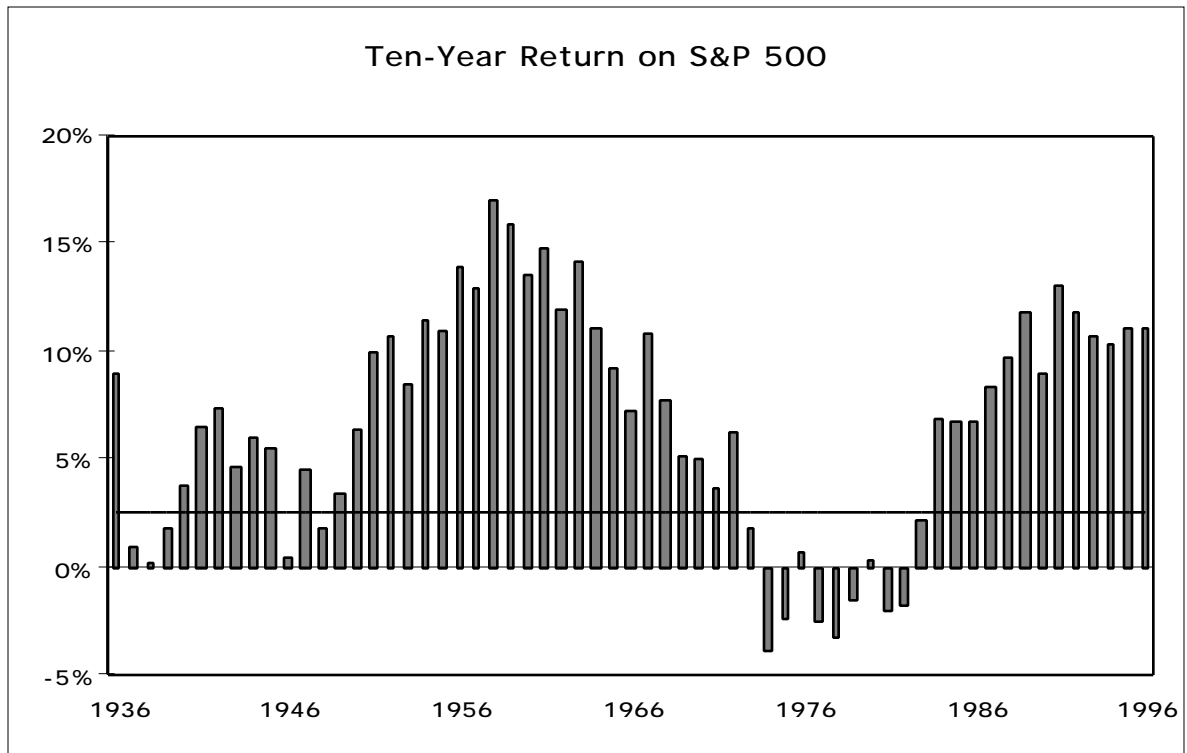
Assuming the financing cost of Social Security's unfunded liability is spread over current and future generations, it would reduce the return to a privatized government-bond account by roughly the same amount that it now reduces the net return to bonds implicitly held by the Social Security system. As a result, the expected net return on a privatized government-bond account would be about the same as the projected return on Social Security. The apparent gain from investing in government bonds vanishes after accounting for the cost of financing Social Security's unfunded liability.

Alternatively, if the unfunded liability were completely paid off by taxing generations currently alive, then the expected net return on an investment in government bonds eventually would be higher for future generations. But the gain to these future generations would come at the expense of much lower net returns for those currently alive. In the end, somebody (or everybody) has to pay the cost of financing the unfunded liability. The tyranny of the financial arithmetic shows that privatization can not produce a "free lunch" of higher returns for all.

Change will come to Social Security. The retirement of the baby boomers starting about a decade from now will lead to rapidly rising benefit payments supported by a smaller number of workers per beneficiary. Under current law and projections, taxes will fall short of benefit payments starting around 2013 and Social Security's trust funds will be exhausted in 2032. Adjustments will be needed to put the system on a firm footing for the 21st Century.

The "third rail" may have been switched off, but the laws of risk and return have not been repealed. The claim that privatization will raise rates of return is misleading and should not be used to choose among options for reform. Whether or not reform ultimately includes private investment accounts should be decided instead by careful consideration of other criteria such as the usefulness of such accounts in opening investment opportunities to low-income Americans and their potential to boost national saving.

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Note: Returns include reinvested dividends and are adjusted for consumer price inflation. Line shows average annual return of 2.5% on U.S. Government bonds over the period 1926-1996.

Source: Global Financial Data and author's calculations.