A Critique of the Case for Privatizing Social Security

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Some changes in Social Security policy will soon be needed to deal with the burden of paying for the retirement of the baby boom generation. In the unlikely event that no changes were made in the current payroll tax levels and pension benefit levels, according to recent projections the cost of these pensions would begin to exceed payroll tax revenues in 2013, the trust fund would begin to shrink in 2019, and the trust fund balance would drop to zero in 2029 (Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1996). Some commentators in the popular press suggest that as of 2029 Social Security may go bankrupt, leaving many old people without Social Security pensions. Although this belief is not held by Social Security experts, it is widely held in the general population. In one recent national poll, only 30% of the respondents reported feeling confident that their Social Security pensions will be paid throughout their retirement (Friedland, 1994; Quadagno, 1996).

The view that the baby boomers may find themselves without Social Security pensions is wrong on several counts. Even if no policy changes were made, after 2029 payroll taxes would still be coming in that would fund pensions at approximately 77% of currently promised levels (Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1996). In addition, it is reasonable to assume that some if not most of the 23% gap that remained would be dealt with by some combination of payroll tax increase and indirect benefit cuts, such as increasing the eligibility age or means-testing benefits for high income recipients. Given the current policy of making periodic adjustments to keep the system in projected balance 75 years into the future, it is reasonable to assume that changes will be made long before 2029 to deal with the projected deficit.

Some of the changes being considered call for relatively minor adjustments, but in recent years we have also begun to hear a call for a much more fundamental change, the privatization of Social Security. Only a few years ago advocacy of privatization was confined to a few analysts, most prominently those linked to the libertarian Cato Institute (Ferrara, 1985), but today this alternative is being seriously discussed in much more mainstream venues. In 1995 Senators Robert Kerrey (D-Nebraska) and John Danforth (R-Missouri) formulated such a proposal in connection with the Bipartisan Commission on Entitlement and Tax Reform (1995). Even more important is the recent release of the report of the Advisory Council on Social Security (1997). The advisory council has offered three alternative policy proposals to the President, two of which call for the partial privatization of Social Security. The third calls for investing a substantial fraction of the Social Security trust fund in the private sector.

Although very few mainstream analysts argue that full privatization warrants serious consideration as a policy alternative for the United States, today partial privatization is being seriously considered. Were such a change made, it would represent one of the most fundamental changes in Social Security since the program was enacted in 1935. The partial privatization of Social Security might have adverse consequences for some, particularly low-wage workers (Quinn & Mitchell, 1996; U.S. Senate, 1995), but it could also become very popular, particularly among the more affluent. Even a partial privatization of So-
Social Security would represent a fundamental shift away from the social insurance approach of the past 60 years. Advocates for privatization of Social Security seek to reduce the government’s role in the provision of pension benefits to elderly persons and to increase the extent to which private sector investments are used to finance old-age security.

The debate over the privatization of Social Security has begun, and there is every reason to believe that it will become even more heated over the next few years. Much of what has been written about the topic has come from advocates of privatization, and there has been far too little systematic effort to respond to their arguments. The goals of the present article are: (a) to describe what commentators mean when they refer to the privatization of Social Security, (b) to present the major arguments that have been made by advocates of privatization, and (c) to respond to these arguments.

What Does “Privatizing” Social Security Mean?

Any assessment of the likely impact of privatization depends on what form privatization takes. Most proposals for privatizing Social Security in the United States call for some form of partial privatization, not full privatization. For some commentators, full privatization would involve doing away with the Social Security program (the suggestion is sometimes to phase it out over a period of decades), leaving it entirely up to individuals to decide whether or not to buy private insurance to provide for death, disability, or retirement (U.S. Senate, 1995).

But to most commentators, the full privatization of Social Security would involve replacing the existing set of Social Security pension programs (old-age pensions, survivors pensions, and disability pensions) with mandatory private insurance alternatives. The old-age pension component would most likely involve contributions to individual investment accounts, something along the lines of a 401(k) account. For most proposals the federal government would not manage the funds, but it would have a role with respect to the regulation of the industry and in some cases would insure at least a portion of workers’ assets in the event of a default. Something approaching the full privatization of Social Security was introduced in Chile in 1981 (Diamond, 1996; Kritzer, 1996; Myers, 1992), but no proposals for so fundamental a change are currently being seriously considered for the United States. Although some would like such a change, even the most ardent supporters of privatization recognize that it would not be politically feasible to make the shift to full privatization at this time. Most would settle for partial privatization today in the hope that it would be a first step toward full privatization at some point in the future (Porter, 1995).

The partial privatization of Social Security could take many forms. One form would be to make participation entirely voluntary (Friedland, 1996; Friedman, 1962). Poortingvliet and Laine (1995) used the term “de facto privatization” to refer to a variety of policies that would produce benefit cuts such as reducing the cost-of-living adjustments, means testing benefits, and increasing the age of eligibility. Such policies would constitute a form of de facto privatization because they indirectly force workers to increase their private savings in an effort to replace the projected cut in Social Security benefits. Friedland (1996) argued that the term “privatization” can also be used to refer to a policy that would have a portion of the Social Security trust funds invested in the private sector. For example, Robert Ball’s Maintenance of Benefits (MB) plan, one of the three proposals outlined by the Advisory Council on Social Security (1997), calls for investing up to 40% of the Social Security trust fund in private sector equity markets, but without the creation of individual investment accounts (Ball & Bethell, 1997). Although some commentators would classify Ball’s proposal as a form of partial privatization, I would not. When I refer to privatization or partial privatization in this article, the reference is to the diversion of payroll tax contributions to individual accounts, which is not the case with Ball’s MB plan.

One of the most common approaches to partial privatization would require workers to pay a portion of their Social Security contribution into 401(k)-like Individual Social Security Retirement Accounts (hereafter ISSRAs; see Appendix, Note 1). The rest of the Social Security payroll tax would be used to pay current Social Security beneficiaries. In some plans aided by a payroll tax increase and benefit cuts, this would help ease the burden associated with a gradual shift from public to private financing during a transition period that could take decades. The remainder, ranging from about 25% to 80% of the worker’s contribution, depending upon the proposal, would be invested in an ISSRA (Bipartisan Commission on Entitlement and Tax Reform, 1995; Schieber, 1996).

One example of this approach is the Personal Security Account (PSA) plan backed by Sylvester Schieber (1996) and several other members of the Advisory Council on Social Security (1997). It calls for the diversion of five percentage points of the employee’s portion of the payroll tax into PSA accounts that would be managed by a wide range of private firms much as is currently the case with IRA accounts. Schieber’s proposal is more far reaching than most as it would eventually replace rather than merely supplement the current Social Security scheme.

Another more moderate example of this approach is the Individual Accounts (IA) plan advocated by Edward Gramlich, chairman of the Advisory Council on Social Security (1997). It calls for the creation of ISSRAs financed by a modest (1.6 percentage points) increase in the workers’ share of the payroll tax that would be managed by the Social Security Administration rather than private sector money managers. Workers would have “constrained investment choices” including equity index funds and bond index funds.

With all such proposals workers would be al-
allowed to invest a portion of their Social Security contributions in the private sector, and in most plans they would be able to switch their holding between asset classes (stocks, bonds, money market funds) in an effort to maximize returns. Some proposals would have the federal government manage these accounts (e.g., Gramlich’s IA plan), but most would have the funds managed by private sector money managers, as is the case with IRA accounts. Some proposals would allow at least a partial lump sum withdrawal of accumulated assets at retirement (Borden, 1995), but most would require that the assets be annuitized or gradually withdrawn over a period of years. Although in some variants of this approach the diversion of Social Security contributions to individual investment accounts would be optional (Ferrara, 1995), in most it would be mandatory. In some proposals the amount of the diversion would be fixed, whereas in others it would be up to the individual worker to decide, within specified limits (Ferrara, 1995).

Many of the partial privatization proposals call for the creation of what amounts to a two-tier Social Security scheme (Peterson, 1996). The first tier would in most cases be a reduced version of the pension available in connection with the existing Social Security scheme. In the PSA plan this first tier would be a flat rate monthly pension of $410 (1996 dollars) which is 65% of the poverty level for a single person living alone. The size of the second tier pension would vary as a function of the amount paid into the ISSRAs, market trends, and investment choices.

Any substantial diversion of Social Security contributions to ISSRAs runs the risk of hastening the emergence of a gap between payroll tax revenues and Social Security benefits, a gap that would begin to open up by 2013 even without partial privatization. Some advocates of privatization acknowledge this and call for increases in Social Security payroll taxes or cuts in benefits to compensate for the added costs; others ignore the issue. Schieber’s PSA plan makes a serious effort to avoid increasing the gap; it even passes the test of being balanced 75 years from now. To this end it includes a 1.52 percentage point increase in the payroll tax. This would be a temporary tax schedule to be in place for 72 years. But even with this tax the Advisory Council on Social Security (1997) projects a $1.3 trillion (1995 dollars) shortfall between 2000 and 2034 to be covered by issuing government bonds that would then be repaid using the excess of tax revenues projected for the 35 years following 2034.

**Why Privatize Social Security?**

Although the various proposals for the partial privatization of Social Security differ in their details, they all call for the creation of ISSRAs, and it is this component of these proposals that will be the focus here. For the purposes of the present discussion, except where specified otherwise, the alternative to privatization is assumed to be the current Social Security system with substantial increases in the payroll tax (estimates range between 2 and 3% on both the employer and the employee) as needed to pay pension benefits during the retirement of the baby boomers. The term “privatization” will typically refer to partial privatization. The 10 arguments listed below can be grouped into those dealing with: (a) national savings and economic growth (arguments 1–3), (b) protection of future generations of retirees and workers (arguments 4–7), and (c) political philosophy and confidence issues (arguments 8–10). The most crucial of these arguments are 1, 4, and 6; if they can be successfully challenged, the core of the case for the privatization of Social Security is undercut. Some of the numbered points that follow include several different but closely connected arguments; it made more sense to group them than to treat them separately.

1. **Privatization Will Increase the Rate of Economic Growth.** — See Poortvliet and Laine, 1995; Schieber, 1996. Essentially the argument is that the privatization of Social Security will increase the national savings rate (Ferrara, 1995). This will increase the rate of investment, which in turn will increase the rate of economic growth making for a larger national product when the boomers retire (see Appendix, Note 2). Many economists argue that the only effective way to reduce the burden of providing for the retirement of the baby boomers is to increase national savings today and therefore national product in the future (Bosworth, 1995). The larger the national product when the boomers retire, the easier it will be to provide for their consumption needs. This argument is made by all advocates of privatization, and it is also accepted by many critics who oppose privatization on other grounds.

Basiclly this same argument is sometimes stated in more negative terms as a criticism of Social Security today. Social Security as presently structured is criticized for having a negative impact on economic growth, productivity, international competitiveness, and job opportunities (Ferrara, 1990; Poortvliet & Laine, 1995). A closely related argument is that the current generous Social Security benefit structure undercuts the incentive for individuals to save for old age. It is argued that many workers who might otherwise put personal funds into IRA plans or other forms of retirement savings fail to do so because they believe they will be able to live adequately on their anticipated Social Security benefits. Although many economists argue that privatization of Social Security would increase the national savings rate, which in turn would boost the rate of economic growth, this conclusion must be qualified. It is likely that the actual increase in the national savings rate would be less, possibly substantially less, than the amount invested in the ISSRAs. It is possible that some, if not much, of the increase in savings produced by contributions to the ISSRAs would be offset by reductions in personal savings (Friedland, 1996; Quadagno, 1996; Quinn & Mitchell, 1996). People who would otherwise have been making personal savings in mutual funds and corporate
retirement plans might decrease such savings, particularly if the privatization plan calls for a tax increase, as many do. There is no net gain to the economy if we just substitute one source of savings for another (Bosworth, 1995; White, 1996).

Although most economists argue that an increase in the savings rate will lead to economic growth, many others agree with Robert Eisner (1994, 1995) that, depending on how it is achieved, an increase in the savings rate may or may not produce any increase in economic growth rate. To the extent that the increase in savings is achieved by cuts in public spending on infrastructure (roads, bridges) or human capital (education, training), it may produce a decrease rather than an increase in long-term economic growth. Similarly, cuts in personal consumption in response to an increase in the payroll tax called for to finance privatization may decrease rather than increase economic growth, particularly during recessionary periods.

Also important is what happens with respect to other closely related government taxation and spending decisions in response to privatization (White, 1996). Most proposals for privatization call for the diversion of some of the revenues now flowing into the Social Security trust funds into the new ISSRAs (see Appendix, Note 3). But as the federal government has been using these revenues to fund general government spending, something would have to be done to deal with the increase in the federal deficit (U.S. Senate, 1995; see Appendix, Note 4). One response might be to cut spending (see Appendix, Note 5). This could be cuts in Social Security benefits or cuts in spending on other government programs. Cutting spending is the response that most advocates of privatization support. The gap could also be filled by a tax increase, most likely an increase in the payroll tax or the federal income tax. Some have even suggested the introduction to a new consumption tax (Peterson, 1996; Schieber, 1996; U.S. Senate, 1995). A third alternative would be to borrow the difference, increasing the federal deficit and national debt.

A likely result would be some combination of spending cuts, tax increases, and increasing the deficit. The relative emphasis among these three alternatives would be very important. By far the politically easiest alternative would be to add the gap to the deficit, but to the extent that this is done any potential gains in the national savings rate would be undercut (White, 1966).

2. Privatization Will Help Protect Social Security Contributions From Being Spent to Finance Current Government Consumption. — See Borden, 1995; Porter, 1995; Stephenson, Horigacher, and Colander, 1995. This can be considered a variant of the preceding argument as decreasing government consumption is one way to increase the savings rate. Many advocates of privatization argue that the 16% or so of Social Security contributions not immediately paid out to cover pension benefits to current recipients is being used to finance government consumption, with very little of it being invested in ways that contribute to long-term economic growth. Sometimes the claim is that the money is being spent on the day-to-day cost of running the government, leaving the trust funds for all practical purposes empty as they contain nothing but IOUs.

Such claims greatly oversimplify what actually happens and do not give adequate attention to the elaborate institutional structures that are in place for the investment and management of these funds. These funds are invested in a special category of bonds that are just as secure as other U.S. Treasury bonds, with interest rates comparable to those paid on other long-term government bonds (Ross, 1997).

Sometimes the argument is that if a portion of this money were diverted to private sector investments, this would produce an increase in the level of national investment, which in turn would contribute to economic growth and a larger gross domestic product (GDP) at the time when the boomers retire.

However, this goal would probably not be achieved if much of all of the gap produced by the diversion of funds to private sector investments were filled by the government simply selling more bonds (Bosworth, 1995). Although a partial privatization of Social Security might function as an important component of a package of policy changes that would have the effect of protecting the trust fund money that is now being used to finance current government consumption, it would have to be part of a package that also included tax increases or spending cuts, or both. In addition, depending on what spending is cut and on the impact of any tax increase on personal consumption, this package of policy changes could add up to less rather than more economic growth (Eisner, 1995).

A closely related argument is that privatization will force Congress to deal more honestly with the federal budget deficit (Friedland, 1996). Many attempts have been made to build a firewall between the Social Security trust funds and the general federal budget for the purposes of calculating the size of the federal deficit, but this effort has not been successful (Quadagno, 1996). The argument is that if a portion of Social Security contributions were diverted to private sector investments, this would reduce the extent to which the Social Security trust fund assets were used to disguise the size of the federal deficit (see Appendix, Note 6).

Even some critics of privatization would agree that privatization might help Congress deal more honestly with the federal budget deficit, but this does not mean Congress would necessarily take measures to reduce the size of that deficit. Although privatization would put pressure on Congress to reduce the size of the deficit through some combination of spending cuts and tax increases, we cannot be sure that this pressure would result in substantial spending cuts or tax increases. It is often politically easier to increase the size of the deficit than to cut spending, and to the extent that this were to occur, some, if not much, of the fiscal benefit of privatization could be lost.
Another closely related argument is that privatization will decrease entitlement spending (Peterson, 1996). Many analysts have emphasized the need to control the rapidly increasing costs of entitlements as part of any effort to bring the size of the federal deficit under control (Bipartisan Commission on Entitlement and Tax Reform, 1995; Peterson, 1993; see Appendix, Note 7). The three largest of the federal entitlement programs are Social Security, Medicare, and Medicaid. Although Social Security is only one of many entitlement programs and its long-term growth appears to be less problematic than Medicare, those calling for cuts in entitlement spending do not mean to exclude Social Security. One strategy that has been proposed to reduce government spending on Social Security is to partially privatize it. In the long run this would reduce pension demands on the federal government. Many of those who have been expressing great concern about projected long-term trends in entitlement spending have in mind trends in spending on Social Security, Medicare, and to a lesser extent Medicaid (Peterson, 1996). Most experts agree that projected spending on Medicare poses a much greater and more immediate problem than Social Security. Even the long-term problem with respect to entitlement spending is due much more to projected increases in spending on health care than on Social Security. The practice of grouping Social Security together with these other health care related programs is sometimes used as a rhetorical device for undercutting confidence in the long-term viability of Social Security based on statistical trends that are more appropriate for analyzing projected trends in health care spending. When the two categories of programs are grouped together, important differences in the magnitude of the problem are blurred. References to the “crisis in entitlement spending” often make inappropriate use of a problem the nation faces with respect to the financing of health care to attack an entirely separate program, Social Security.

3. Privatization Will Increase the Nation’s Competitiveness in the Global Economy. — See Poortvliet and Laine, 1995. The high cost of pension and health benefits makes it more difficult for American corporations to compete with producers in other nations that not only pay lower wages, but also spend much less on benefits. By partially privatizing Social Security, American producers will be able to lower their prices, making them more competitive in international markets. This in turn will contribute to long-term economic growth, making it easier to support the retirement of the baby boom generation.

Critics of privatization respond by pointing out that relative to most industrial nations the United States already has a competitive advantage because it spends so little on public benefits for workers, relative to other industrial nations (International Labour Office, 1992, 1994; see Appendix, Note 8). Although cuts in Social Security spending due to privatization might well produce further gains with respect to the nation’s competitiveness, these gains would have their costs. One likely cost would be increased spending on Supplemental Security Income (SSI); another would be increased pressure on adult children to provide economic support for parents. There would most likely be higher old-age poverty rates and greater income inequality.

Another quite different response from critics is to point to the arguments made by many economists that in the end most if not all of the payroll tax is passed along to workers in the form of lower wages. If this is true, then any reduction in payroll taxes associated with privatization would in the long run translate into higher wages and would not be expected to have much impact on the cost of production or international competitiveness.

4. Privatization Will Increase the Rate of Return on Social Security Contributions. — See Beard, 1996, and Schieber, 1996. A partially privatized Social Security scheme would produce a return on contributions that corresponds more closely to a fair market rate of return (Stephenson et al., 1995). Many advocates of privatization argue that one of the most serious problems with the Social Security system today is the projected low rate of return on contributions for those retiring in the years ahead (Steuerle & Bakija, 1994; see Appendix, Note 9).

Privatization would increase the individual equity of Social Security pensions (Ferrara, 1995). Pension benefits would more closely reflect contributions over the years. There would be less redistribution and as a result many workers, particularly high-wage workers, would receive benefits that more accurately reflected the contributions they had made; they would get something closer to an actuarially fair rate of return on their contributions.

A related argument is that it is unfair to expect workers to get a rate of return on their contributions that is so much below current market rates of returns (Ferrara, 1990). The Advisory Council on Social Security (1997) estimates an average long-term real (after adjusting for inflation) return of 2.3% for investments in U.S. Government bonds, the securities Social Security contributions are currently invested in, as opposed to a real return of 7% for investments in the stock market.

Many rate of return comparisons carried out by advocates of privatization make the assumption that the 7% average real rates of return for the stock market over the past 75 years is a reasonable estimate of what the return will average over the next 75 years. A problem with this assumption is that many of these same analysts also argue that the economy’s rate of growth will drop from an average of approximately 3.5% over the past 75 years to an average of 1.5% over the next 75 years. If we assume that economic growth is going to decrease this much, this assumption should be reflected in much more modest projections about future stock market returns (Baker, 1997).

Another problem with many rate of return com-
Comparisons is the tendency to compare the return for Social Security with that for the stock market (Stephenson et al., 1995; U.S. Senate, 1995). Very few workers would invest all of their ISSRA contributions in equities; it is likely that many, particularly those with lower incomes, would put much of their money in more conservative alternatives such as bonds, which have lower returns. Although the average rate of return for contributions to Social Security may be 2.3%, in contrast to an average of 7% for stock investments, the return after administrative expenses is likely to be in the range of 3.6% (not 7%) for a balanced portfolio of stocks and bonds.

The Social Security Administration estimates administrative costs at approximately 1% of the Social Security payroll taxes collected. Diamond (1996) suggested that the cost could be double this figure, but even at 2% it is far below the comparable insurance industry average of 11.6%. Some critics of privatization point to the example of Chile, where administrative costs run approximately 20% of revenues, but this is not a fair comparison. There are many ways in which Chile is different, and many of these differences contribute to its high administrative costs. Expenses tend to be a larger share of revenues in nations with lower wages. Chile also has a large number of very small accounts further adding to administrative costs (Diamond, 1996). Relative return estimates for the proposals outlined by the Advisory Council on Social Security take into consideration differences in administrative costs, but many discussions of privatization in the popular press ignore the issue. According to estimates prepared for the Advisory Council, the increase in administrative costs would reduce the yield on accumulated assets by .005% for the MB plan, .105% for the IA plan, and 1% for the PSA plan.

David Koitz of the Congressional Research Service appropriately noted that statements about what average returns have been in the past often ignore what can and will happen to individual workers who invest unwisely or for other reasons do not experience what have been the historical returns on equity investments (U.S. Senate, 1995). The fact that historically the stock market yield has been a specified figure does not mean that everyone will be able to enjoy that yield, even if they invest exclusively in broad equity index funds.

When the argument about relative rates of return is made, many commentators neglect any mention of the portion of the Social Security contribution spent on disability and survivors insurance (U.S. Senate, 1995; Whelehan, 1996). Unless an adjustment is made, comparisons of rates of return overstate the projected increase in return associated with privatization. Those who do attempt to take into consideration the need to provide disability and survivors insurance, do not always take into consideration that Social Security insures many who might otherwise be uninsurable (Chen, 1995). The privatization plans presented by the Advisory Council on Social Security (1997) do take into consideration the need to provide for disability and survivors insurance. For the PSA plan the projected returns are very favorable even for low-wage workers if we assume a continuation of historical trends with respect to stock market appreciation. The Advisory Council’s treatment does not, however, fully answer my concerns about the consequences of highly conservative investment choices, poor market timing, or the possibility that the market might fall substantially short of its historical trends for a prolonged period such as the 45% drop in real terms between 1968 and 1978 (Baker, 1997).

There are a number of other factors that may also reduce the gap between returns under Social Security as currently structured and those made possible by partial privatization. Although it is likely that this infusion of new money into the stock market would drive up equity values prior to the retirement of the baby boom generation, there might well be another strong market trend in the reverse direction as the baby boomers sell these equities during their retirement. This downward movement could have an adverse impact on what had looked like substantial long-term returns, just at the time the boomers need to cash in these investments to maintain their standard of living (U.S. Senate, 1995). With privatization some workers would do better and some would do worse. One likely outcome would be an increase in the proportion of the elderly dependent upon public assistance in the form of SSI benefits. For those who do not become dependent on SSI, some of the higher investment return enjoyed as a result of privatization might be offset by an increase in tax rates linked to increased spending on SSI and other social welfare programs for the elderly poor (U.S. Senate, 1995).

Why is it problematic if the proportion of the elderly dependent on SSI increases as a result of a partial privatization of Social Security? Wouldn’t it be more efficient to increase SSI benefit levels if necessary and then allow the number on SSI to increase? One advantage of such an approach that some advocates of redistribution might appreciate is that SSI is paid for by the progressive federal income tax rather than a flat payroll tax. But this line of reasoning ignores the politics of social welfare policy. It ignores the historical evidence that it is hard to get political support for programs that benefit only the poor. If we restructure Social Security in such a way that the benefits associated with the public component (or, in the case of the PSA plan, the flat rate component) offer few if any benefits to the affluent, over time we should anticipate an erosion of the standard of living provided to the low-income recipients. The redistributive structure of Social Security is not the most efficient way to provide for the low-income elderly, but it has certainly been an effective strategy.

When an argument about the superior rate of return for private sector investments is presented, it is typically made in the aggregate. It becomes an argument about the return for those who earn the average wage. However, this neglects the evidence that privatization would potentially work to the advan-
tage of most high-wage workers, but to the detri-
ment of low-wage workers. Although many
advocates of privatization would be unwilling to accept
the argument that low-wage workers would be hurt
by privatization (Beard, 1996; Ferrara, 1995), there is
good reason to believe that high-wage workers
stand to gain more than low-wage workers as a re-
result of privatization (American Academy of Actuar-
ies, 1996; see Appendix, Note 10).

Due to the redistributive structure of Social Secu-
rity, low-wage workers get a much better return on
their contributions than do high-wage workers
(Friedland, 1996). Partial privatization would most
likely make the system less redistributive (American
Academy of Actuaries, 1996). This would benefit
many high-wage workers, but it could hurt many
low-wage workers (see Appendix, Note 11). Al-
though the reduction in the extent of redistribution
is most likely one of the major reasons that privatiza-
tion is getting so much attention, advocates of
privatization generally frame the argument in terms
of the overall rate of return rather than in terms of
doing more for high-wage workers at the expense
of low-wage workers. In addition, some proponents
of privatization believe that higher returns on the
ISSRAs will more than compensate low-wage work-
ers for any losses as a result of the shift to a less re-
distributive scheme (Whelehan, 1996; see Appendix,
Note 12).

For reasons outlined earlier, it is likely that partial
privatization would increase the number of low-
wage earners forced to depend on the SSI program
for support during retirement. It is likely that a por-
tion of the gap between what pension benefits
would be under Social Security as it is presently
structured and what they would be after privatiza-
tion would be absorbed by the low-wage earners in
the form of lower benefits. But it is also likely that it
would be necessary to fill at least part of the gap
with increased spending on the SSI program, which
in turn could translate into higher federal income
taxes. Any such trend would reduce the after-tax
gap between Social Security and the privatized alter-
native.

5. Privatization Will Help Protect Future Genera-
tions of Workers Against Sharp Increases in Social
Security Payroll Tax Rates When the Boomers Retire.
— If we were to make no structural changes in So-
cial Security and each year set the combined payroll
tax to exactly the level needed to pay promised
benefits, projections suggest that over the next 35
years the payroll tax needed to keep the trust funds
in balance would increase from 11.6 to 17.1% (see
Appendix, Note 13). By 2070 an increase to 18.8%
would be needed (Board of Trustees of the Federal
Old-Age and Survivors Insurance and Disability In-
surance Trust Funds, 1996). It is likely that a partial
privatization of Social Security would eventually
help reduce the payroll tax burden on the children
and grandchildren of the baby boomers.

However, many privatization proposals call for an
increase in the payroll tax. Schieber's (1996) pro-
posal calls for a 1.52% “transition” payroll tax in-
crease scheduled to last 72 years. In some cases, for
example Peterson's (1996) scheme, the increase in
payroll tax (4 to 6%) called for to help finance the
transition turns out to be a substantial fraction of
the increase that will be called for if no structural
changes are made in Social Security. Privatization
alone would not do much to assure lower taxes on
post boomer generations unless combined with
spending cuts to make up for the Social Security
revenues currently being used to finance a portion
of general government spending.

6. Privatization Will Help Protect Baby Boomers
Against Sharp Reductions in Their Social Security
Benefits. — See Schieber, 1996. The argument is that
if nothing is done now and it proves to be politically
impossible to introduce substantial increases in the
payroll taxes when the boomers retire, it will be
necessary to make a sharp reduction in their Social
Security pension benefits. The extent of such cuts
would depend in part on how much it was possible
to increase the payroll tax. The greater the increase,
the fewer benefits would need to be cut. If steps are
taken now to partially privatize Social Security, any
cuts called for when the baby boomers retire would
be modest. This privatization will potentially protect
Social Security pensions from sharp cuts for two
reasons: (a) It will contribute to a larger national
product, making it easier to pay for the public por-
tion of Social Security benefits; and (b) it will result
in the creation of a privatized portion of Social Secu-
rity, thus reducing dependence on public funding.

Critics argue that privatization is likely to reduce
the redistributive component of Social Security to
the benefit of high-wage earners and the detriment
of low-wage earners (Mitchell & Zeldes, 1996;
Quinn & Mitchell, 1996). It may well help to protect
the Social Security benefits of the average-wage
worker and it would most definitely help protect
the benefits of high-wage workers, but it is not clear
that it would help protect the benefits of low-wage
workers. Some argue that low-wage workers would
be better off with some combination of payroll tax
increases and benefit cuts introduced as needed
when the boomers retire.

7. Privatization Will Make Social Security Pension
Benefits Less Politically Vulnerable, Particularly Dur-
ing the Retirement of the Baby Boom Generation.
— See Mitchell and Zeldes, 1996; Schieber, 1996. As
currently structured, benefits are politically vulnera-
table to decisions by Congress to change the formula
used to calculate the worker's monthly benefit at
retirement, to modify the formula used to adjust
benefits for changes in the cost of living, to delay
annual cost of living increments, and to make out-
right benefit cuts.

It is generally agreed, even by critics, that the pri-
vatized portion of the Social Security pension
would be less vulnerable politically. However, to
the extent that partial privatization reduces the im-
portance of the nonprivatized portion of Social Se-
curity to middle- and upper-income wage earners, it would make that portion of the program politically vulnerable to subsequent cuts over the years (Ball & Bethell, 1997). Taxpayers are less likely to support cuts in programs (or parts of programs) from which they personally benefit.

8. Privatization Will Contribute to Greater Freedom and Autonomy for American Workers. — See Ferrara, 1985 and 1995. Senator Alan Simpson (R-Wyoming) argued that privatization of Social Security would empower Americans by giving them more control over their retirement incomes (U.S. Senate, 1995). This argument is largely based on political philosophy (see Appendix, Note 14). The reasoning here is that with most proposals for partial privatization would come choices about how at least a portion of one’s Social Security contributions were invested. Depending on the specifics of the actual privatization plan selected, workers might have a very broad range of options, as do IRA investors.

Critics of privatization point out that along with this freedom of choice comes risk, and many workers, particularly low-wage workers, may end up being harmed by this freedom. The freedom to choose among investment options may do more harm than good to those who are not well informed about how to invest their money (Quinn & Mitchell, 1996). Some, possibly many, will invest very conservatively, failing to take advantage of the higher long-run returns on stock markets (see Appendix, Note 15). They may do as well as Social Security with its investment in government bonds, but not as well as advocates of privatization project. Others may end up taking too much risk during the years just prior to retirement, jeopardizing much of their retirement nest egg (Ball & Bethell, 1997). Privatization may increase autonomy and control for the primary wage earner in a family, but it may also result in increasing the risk and decrease protection for a spouse who is economically dependent upon the primary earner (Williamson, 1997). Although some would want to manage their ISSRA assets, many would not want to (Chen, 1995). More to the point, many would prefer the safety of a defined benefit plan backed by the United States government to the risks of a defined contribution plan.

9. Privatization Will Make it Possible for Those Who Die Before Retirement To Pass at Least a Portion of Their Retirement Savings on to Their Heirs. — See Ferrara, 1995, and Porter, 1995. Many privatization proposals have provisions making it possible to add the ISSRA assets to one’s estate and in so doing extend the philosophical concept of property rights to Social Security benefits. Unlike Social Security, under many partial privatization plans workers would own at least a portion of their retirement assets, and these assets like any other assets could be disposed of as the deceased wished at death. Taking the Advisory Council on Social Security’s (1997) PSA plan as an example, assets accumulated in the worker’s PSA would at death become part of his or her estate.

Many analysts argue that the survivors benefits under Social Security are at least as valuable as the combination of death and survivor benefits available in connection with various privatization schemes. When a comparison is drawn between Social Security and a privatized alternative, it is common in popular press accounts to neglect mention of the survivor’s insurance coverage that is part of Social Security. This coverage provides benefits to surviving dependent children and for an aged surviving spouse.

However, there are death-related situations in which a partially privatized scheme would have some advantages relative to Social Security as currently structured. For never-married workers with no dependents, even those with decades of contributions to Social Security, at death nothing is added to their estates based on these contributions. In contrast, with the PSA plan the assets in the PSA account would be added to the estate. These funds could be used to help provide for a domestic partner, friend, or relative not covered by Social Security. Alternatively, they could be donated to a charity of particular interest to the deceased. In short, there would be at least something to show for all of those years of contribution. Although the current provisions help target Social Security benefits to survivors most likely to be in need of support, in the context of nontraditional households this goal is not always achieved.

The flexibility of the PSA plan would represent an improvement over Social Security for some categories of survivors, but a reduction in coverage for other categories. The flexibility to designate who would get PSA assets would leave some widows worse off. Many divorced spouses would also do better with Social Security as it is; they would, for example, no longer be able to benefit from the after-divorce earnings history of a former spouse (Williamson, 1977).

Some analysts have argued that the partial privatization of Social Security would be beneficial to African American workers because they have shorter than average life expectancies (Ferrara, 1995). Due to higher mortality rates, African Americans are less likely than Whites to live to an age at which they become eligible for Social Security old-age pension benefits, and on average they spend fewer years receiving Social Security pensions (Ferrara, 1995). Although there is some merit to this line of analysis, those making it typically do not emphasize the redistributive aspect of Social Security for those African Americans who do become eligible for pension benefits. It would seem that analysts making such a claim should also be checking for and reporting on race differences with respect to the receipt of Social Security disability and survivor benefits. After reviewing the results of a number of studies on the topic, Chen and Goss (1997) concluded that the net effect of the worker’s race on the progressivity of Social Security is still in dispute.
A related argument is that workers with AIDS, cancer, and some other terminal diseases might be able to tap their ISSRA assets prior to death as a way to help ease the economic stress associated with the last few months or years of life. Depending on how the plan was structured this might be possible, and for some medical conditions it would be a major benefit. Presently it is possible to borrow against 401(k) assets under some circumstances and it is possible to withdraw IRA assets early, albeit with a stiff penalty. These programs point to what might be possible.

However, if the privatized component of Social Security were set up in such a way that it was possible to borrow against retirement savings, there would be the risk that some and possibly a substantial fraction of low-wage workers would end up outliving their retirement savings, something that cannot happen with Social Security as presently structured. Workers living close to the economic margins are more likely to be faced with economic emergencies forcing them to tap into their retirement assets. Those most likely to tap into these assets prior to retirement would also be those most dependent upon pension benefits derived from these assets during retirement. The result could be a lot of people who are worse off in old age than under the present scheme or a sharp increase in spending in connection with the SSI program, or both (American Academy of Actuaries, 1996).

10. Privatization Will Increase Confidence That Current Contributions Will Become the Source of Eventual Social Security Pension Benefits. — See Beard, 1996; Ferrara, 1995; and Schieber, 1996. There have been a number of public opinion polls suggesting that in recent years only 30 to 40% of adult Americans feel confident about the integrity of the Social Security system (Quinn, 1996; Reno & Friedland, 1997). Workers will have more confidence that they will eventually receive a Social Security pension if they have individual accounts and receive periodic statements providing current account balances. The parallel to personal IRA and 401(k) accounts would be obvious. The freedom to shift between various investment options would further contribute to that confidence.

Currently the Social Security Administration sends out statements to those requesting them, providing estimates of eventual pension benefits, but they do not report individual account balances. Soon these statements will be automatically sent to all covered workers once a year. This may increase confidence that Social Security pension benefits will eventually be forthcoming. Would workers have more confidence in the integrity of Social Security if they received actual account balances for their PSA accounts as many do on a quarterly basis for their 401(k) plans? It is not obvious that they would.

Partial privatization and the associated quarterly or annual reports would probably increase confidence in Social Security if the stock market were to continue to perform as it did for most of the period between 1982 and 1996, but what will happen to confidence when workers are faced with a prolonged bear market — such as the 48% decline between 1973 and 1974, which was followed by a recovery that took nearly 10 years? After the Crash of 1929, the stock market did not return to its 1929 high until 1954. Given that we have not experienced a prolonged bear market in recent years, it is reasonable to ask questions about how much confidence people are likely to have in a partially privatized variant of Social Security in the event of a prolonged market decline. Even if we assume that in the long run the stock market will recover from any correction or bear market, and that workers can attempt to delay retirement for a few years in the event of a major market drop, it is possible that for many workers the resulting delay of retirement may be longer than health permits.

Conclusion

In recent years the idea of partially privatizing Social Security has come to be viewed as an innovative strategy for dealing with the impending retirement of the baby boom generation. This approach is consistent with a more general shift in social welfare policy that the nation has experienced in recent decades, a shift away from policies based on the values of social adequacy and shared risk embodied in the concept of social insurance to alternative policies emphasizing self-reliance and individualism. This shift can be traced back to the taxpayers’ revolt that began in California in the late 1970s with Proposition 13 and the emergence of the generational equity debate during the 1980s (Kingson, 1988). It was also strongly reflected in the Contract With America that received so much support from Congressional Republicans during the mid-1990s. Although advocates for downsizing the American welfare state have typically not had increasing the level of economic inequality in American society as a goal, they have not hesitated to push for policies that many analysts believe will have this effect.

The privatization of Social Security, if done in such a way as not to add to the federal deficit, could help ease the burden of providing for the retirement of baby boomers. However, there is a risk that privatization, by itself, would do little or nothing to ease the burden of providing for the retirement of the boomers, and it could make the experience a lot worse for the most vulnerable of the boomers, particularly low-wage workers. Even if a privatization scheme is designed so as to give a substantial boost to the American economy and to ensure that the average worker would be better off than under the current Social Security scheme, it is possible that many workers, particularly low-wage workers, would end up worse off. Many would invest in bonds with yields similar to those in the Social Security trust funds, but due to the higher administrative costs associated with privatized accounts would end up with lower returns. Some, due to either lack of access to good investing advice or bad judgment,
would make poor market timing decisions, leaving them with long-term returns substantially below those for the stock market as a whole. But the greatest risk to the low-wage worker would be the potential loss of political support for the redistributive aspects of Social Security as currently structured. In this era of individualism and free market solutions, it is possible that in the long-run, concern for the retirement income needs of low-wage workers would atrophy.

References


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Appendix

1. There is no agreement as to what to call these accounts. Among the other names that have been suggested are super IRAs, personal retirement accounts, personal investment plans, personal security accounts, and individual retirement savings accounts.

2. Most economists agree that sustained productivity growth requires investment, but there is some disagreement as to how dependent the United States is on domestic investment as there are foreign investors willing to put up investment capital for projects in this country (Perez, 1995). Some take the position that the globalization of capital markets decreases our dependence on domestic savings. However, the view that the nation's long-term growth prospects are not highly dependent upon domestic savings rates is currently a minority position.

3. Social Security is made up of four separate trust funds. Two relate to pensions and two relate to Medicare. The two pension-related trust funds are Old Age and Survivors Insurance (OASI) and Disability Insurance (DI). Together they are often referred to as OASDI.

4. Some federal spending, such as on roads, bridges, education, and the like, is a form of investment and does
contribute to economic growth (Munnell & Ernsberger, 1990; Stephenson et al., 1995), but most government spending is not in this category.

5. If Social Security contributions were to flow into the stock market and not directly into government bonds, this would increase the cost of government borrowing, which in turn might reduce the government's willingness to borrow. In this context, privatization advocates ask why those who contribute to Social Security should continue to subsidize government borrowing.

6. There are two ways to measure the federal deficit, with and without including Social Security. Not all economists would agree with my assessment that emphasis on the version that includes Social Security contributions is evidence of disguising the size of the deficit.

7. The federal deficit peaked in 1983 at 6.3% of GDP. Since then it has declined considerably and was at 2.3% in 1995 (Council of Economic Advisors, 1996). Between the early 1970s and 1995 there was not much of an increase in the size of the federal budget relative to GDP. What did change dramatically was the composition of the budget, with an increase in the share of spending on entitlement programs such as Social Security, Medicare, and Medicaid and a decrease in the share on spending on other categories, particularly defense (Quinn, 1996).

8. In 1991 the average Social Security pension benefit in the United States was $6,539, which was higher than the $4,450 average for the United Kingdom, but below average relative to other industrial nations such as Germany ($13,333) and the Netherlands ($8,299; International Labour Office, 1994).

9. Steuerle and Bakija (1994) did some projections suggesting that as of 1995, OASDI contributions exceeded expected lifetime benefits for high-wage single men, but not other categories of workers. However, between 1995 and 2005 the situation will change and contributions will exceed expected benefits for several other categories of workers, including average-wage single men, high-wage single women, and high-wage two-earner couples. Schieber (1996) pointed out that for the average wage worker born in 1960 who is single or married to a spouse who is also an average wage worker, expected lifetime benefits are projected to be between 75 and 90% of the value of contributions made. For quite some time analysts have warned that when younger and more affluent workers come to realize that they would not get the generous benefits received by earlier generations, the near-universal support for the program would weaken (Burkhauser & Warlick, 1981).

10. It is possible, but unlikely, that pension benefits in connection with a partially privatized scheme would exceed current Social Security levels even for low-wage workers (American Academy of Actuaries, 1996).

11. The Advisory Council on Social Security (1997, p. 200) presented projections suggesting that under the PSA plan low-wage workers would get a better return on their contributions than they would under present law or with the MB plan. This conclusion is based on models making a number of assumptions that I do not accept. I do not accept the assumption that we can infer how low-wage workers would allocate assets between stocks and bonds based on the behavior of those currently enrolled in 401(k) plans, a group that tends to have more education and higher incomes than minimum-wage workers. I also do not accept the assumption that the equity portion of these portfolios will over the long run yield the average rate of return since the turn of the century, despite the evidence that in recent years the rate of growth in real GDP and labor productivity is down. Carolyn Weaver made a persuasive case that these projections must be interpreted with a great deal of caution as the models greatly oversimplify — small changes in some of the model parameters produce big differences in projected outcomes (Advisory Council on Social Security, 1997, pp. 160–162).

12. Whelehan (1996) projected a monthly pension benefit of $2,490 for low-wage earners under a privatized scheme, as opposed to $631 under Social Security as currently structured for those born in 1950 and retiring at age 65. This projection is based on the (optimistic) assumption that low-wage workers would earn average yearly returns of 10% on their contributions.

13. The 11.6% figure is the rate that would be needed to finance current benefits without any surplus.

14. Friedman (1962) is sometimes mentioned in this context given the emphasis he placed on individual freedom. However, Friedman's book advocates doing away with mandatory retirement savings of all sorts; this includes Social Security as it stands and would also include partially privatized alternatives.

15. Studies have been done comparing the investment returns for pension plans where the employer made the investment decisions with the returns when the employee made the investment decisions. On average, plans where the employer made the investment decisions (and bore the investment risk) had yields that were greater by 1.5 to 2.5%. Investment yield may be higher in connection with a partially privatized scheme than with Social Security as it is presently structured, but it is not reasonable to assume that the average returns in connection with a privatized scheme would be as high as that for pension plans in which the employer makes the investment decisions or as high as for the stock market as a whole (American Academy of Actuaries, 1996).