Social Security Privatization – A Bad Idea

President Bush insists that Social Security faces insolvency, is “broken”, “bankrupt”. His “fix” is partial privatization of Social Security. He proposes to allow or require workers 55 and younger to divert about one-third of their Social Security payroll taxes into private accounts invested in the equities market. These private accounts would not be insured against high service fees, losses from market fluctuations, bad investment decisions, or malfeasance of investment brokers. Moreover, unlike Social Security’s guaranteed income, private accounts could run out in old age. It is important to debate the wisdom of this kind of radical change in an outstandingly successful program that has served this nation efficiently for 70 years without fail. Does Social Security face insolvency? Is partial privatization a prudent solution to the alleged problem? Is there even a problem?

We believe, on the basis of the following analysis, that Social Security does not face a financial crisis and that privatization is an unwise and destructive proposal. Because there is much confusion about what Social Security is and does, we start by describing the current situation.

How Social Security works

The Social Security Trust was enacted in 1935 in the Roosevelt administration in response to the dire financial condition of the vast majority of retired workers and others unable to work. It is an insurance program, not a private investment or pension program; thus one’s Social Security taxes are for the benefit of all and are not private in any sense. It has the singular advantage that its benefits cannot run out with time or infirmity in old age. Social Security represents a social contract among the generations of American workers to provide partial replacement of previous wages or salaries for disabled and retired workers and for the dependents of deceased workers. Not only is Social Security based on the finest religious principles, it also benefits the economy by allowing millions of persons to work who otherwise would be unpaid care-givers at home. It is thus both good for the economy and socially altruistic.

The program at the end of 2003 provided benefits to 32 million retirees, survivors of 7 million deceased workers, and 8 million disabled workers. The monthly benefits (typically $500-$2000) are low relative to those provided in other highly developed countries. Retirement benefits are scaled with career income to ensure that the working poor receive a modest but sustainable income. Social Security is financed on a pay-as-you-go basis, with payroll taxes ($632 billion in 2003) from 155 million workers being largely transferred to beneficiaries. The excess of taxes over benefits is placed in a trust fund in anticipation of future needs. The trust fund has accumulated about $1700 billion since 1983 in special issue treasury notes, and is expected to grow to about $4000 billion by 2018.

The special importance of Social Security today

Retirement funds are traditionally derived from pensions, savings, and Social Security. Currently, about half of American workers participate in some kind of employer retirement plan, largely of the defined contribution type -- 401k, 403b, etc. However, for the vast majority of workers, these plans are too small to provide an adequate stipend over the retirement years.

Even among upper income workers, the savings rate is extraordinarily low in the US, in part because we lack universal health care, free or low-cost higher education, and other benefits available in other developed countries. The 25% of Americans who earn $10 an hour or less cannot save. The median wage of all US workers is only about $14.50 an hour. Due to low savings and inadequate pensions, Social Security has become the primary source of retirement income for almost two-thirds of retirees. Even in spite of Social Security, about 10% of those over age 65 live in poverty. Without Social Security, that rate would be 50-60%.

Arguments to privatize Social Security

President Bush has offered three substantive arguments for Social Security privatization: 1) Social Security faces future insolvency due to economic and demographic factors; 2) the Social Security trust fund is an accounting fiction; 3) private accounts will do better than Social Security in supporting retirement. Each of these arguments is highly doubtful.

Does Social Security face insolvency?

In order to assess the impact on Social Security of the retirement of "baby boomers" born in the 1950s and 1960s, the Social Security Administration (SSA) and Congressional Budget Office (CBO) made computer projections in 2004 extending 75 years into the future. Three widely publicized projections from these sources are summarized below.

SSA's "intermediate" projection assumed a wage growth, the source of additional Social Security taxes, of only 1.8% and projects 2018 as the year during which Social Security income equals outlay and 2042 as the year for exhaustion of the Social Security trust fund. After 2042, income would support 70% of promised benefits. The cost over 75 years to maintain full benefits (the shortfall) was calculated to be $5000-6000 billion.

The CBO projection used a wage growth of 2.2%. The years for fiscal break-even and trust fund exhaustion were 2028 and 2052, respectively, after which Social Security income could support 81% of promised benefits. The shortfall over 75 years would appear to be $2000-3000 billion.

SSA's "optimistic" projection used a wage growth of 2.4% and predicts that the trust fund would never be exhausted and full benefits could be paid over the span of 75 years.

What is the historical record? From 1960 to 2000, wage growth in the US has averaged almost 3.9%, far greater than the assumptions used in the three projections cited above. If wage growth continues near this historical level, or at least at or above 2.4%, Social Security will remain solvent indefinitely.

The 75-year projections of SSA for 2005 were announced on 3/23/05 and are substantially the same as those for 2004.

President Bush makes use of SSA's "intermediate" projection to argue for an impending Social Security crisis. But even granting the validity of this pessimistic projection, the $5000-6000 billion shortfall in funding could be remedied by actions that separately would strengthen and broaden Social Security and restore its long-term solvency. These include: raise the salary limit for Social Security taxation from $90,000 to $150,000; restore the estate tax on estates over $3.5 million and target that money to Social Security; bring newly hired state and local government workers into the Social Security system; make capital gains and other unearned income largely subject to Social Security taxation; increase the minimum wage from $5.15 an hour to about $7.

President Bush argues that Social Security is unsustainable, because the ratio of workers to retirees has dropped from 5.1 in 1960 to 3.4 in 1998, and is projected to fall to 2.1 in 2030. There may not be enough workers to support all the retirees. These numbers are, however, misleading. The relevant number is the ratio of workers to all non-workers. This ratio has changed little over several decades; it was 1.05 in 1960 and is projected to increase to 1.27 by 2030. The near constancy of this ratio means that an increase in retirees is being offset by a decrease in children and other dependents. Society clearly has the demographic means to provide for retirees well into the future.

Some worry that the increase in longevity of retirees will cripple Social Security later this century, but the SSA and CBO projections cited above take longevity into account.

Is the Social Security trust fund a fiction?

Because the trust fund is invested by law in special treasury notes, some assert that it is really part of the national debt and has, in this sense, already been spent. Nevertheless, Social Security notes are just as redeemable as government notes issued to private investors and foreign governments. To renege on the liquidation of US treasury notes would place the nation in bankruptcy, with devastating economic consequences. Default has never happened in this country and few seriously believe that it will. Treasury notes are as good as gold and in some ways better.

Privatization could place a ruinous burden on Social Security

The plan of President Bush, insofar as we now know it, will allow workers 55 and younger to divert 32% of their Social Security taxes into private accounts invested in the equity and bond markets. This will place an immediate, great strain on Social Security at least for the first 45 years of its tenure, because Social Security will lose up to 32% of income but retain its obligation to pay promised benefits. In consequence, the trust fund will need to be liquidated earlier and then replaced by direct supplements from other federal funds to support needed benefits. These supplements under the Bush plan are projected to cost $2000-3000 billion during the first decade and $10000-15000 billion total over a span of 45 years. Supplements would be needed over several decades, because private accounts will not be liquidated until younger workers of today retire 12-45 years hence. The $10000-15000 billion would need to be met through government debt obligations, placing great strain on bond markets.

Will private accounts do better than regular Social Security?

In an attempt to diminish the need for these federal supplements, President Bush proposed to index future benefits from Social Security to prices (basically inflation) rather than wages, as is now the case. This change is expected to cut future Social Security benefits in half by mid century. Thus, a retiree under privatization would receive in 2050 a stipend roughly 34% of what that retiree would receive today, plus whatever proceeds are available from his private accounts. To break even, the private accounts would need to compensate for an effective loss of 66% in Social Security benefits. Without this, retirees would fall farther and farther behind those still working.

It's true that if wage and economic growth continue into the future at historic 3% levels, many equity investments could realize yields sufficient to compensate for lost Social Security benefits. But at 3% wage growth, Social Security funding faces no crisis or shortage. On the other hand, if wage growth is 1.8%, according to one SSA projection, equity investments will yield poorly due to low stock earnings. In that case, young workers will not recoup the loss of benefits from regular Social Security, and, in addition, Social Security will encounter the financial problems and need for bailout described above. Thus, at low growth rates, privatization will not work and Social Security will require large supplements. At historic or at least plausible growth rates, Social Security will require no supplements and privatization is not needed. President Bush assumes high economic growth to sell privatization, but low growth when he alleges a future shortfall in Social Security funding. He cannot have it both ways.

The Bush plan also proposes to allow early withdrawals from private accounts prior to retirement, as is now the case with 401k and related pension plans. This feature has the potential to shrink pensions greatly, because urgent, short term needs usually trump those of the long term.

Furthermore, it is difficult to see how privatization might benefit disabled workers and survivors who may require years or decades of wage replacement.

Privatization would favor the rich and disfavor the poor

The experience of England, Chile, and Argentina, where partial privatization of pensions has been tried, confirms that fees and charges on private accounts can greatly diminish portfolios by the time of retirement (the administrative cost of Social Security is remarkably low, <1%). In addition, investment outcomes vary widely due to market conditions at the time of retirement and the long-term success of a person's investment choices. The smallest accounts held by the poorest workers perform poorly relative to the larger portfolios of the wealthy that can afford better advice and pay relatively smaller fees. Thus, privatization would bias retirement benefits toward the rich instead of the poor, exactly the opposite from the way Social Security is now structured.

Strengthening Social Security or chipping away at it? Two world-views

Social Security is a compact between the generations -- a way of giving dignity to the life and work of every citizen in our country. This is a world-view that, while it does not hold out the prospect of a free lunch, does say that we all have some responsibility for each other, and that this responsibility ennobles us all.

On March 28, President Bush proposed a means test for Social Security – benefits would diminish as one's independent retirement income from pensions and savings increased. This would turn Social Security from a program that benefits us all into a welfare program, and thus weaken the nearly universal support it now enjoys. (In fact, savings from a means test would be small if applied only to the wealthy, and damaging if applied to the middle class.)

We believe President Bush's intention is not to strengthen Social Security -- which is not at all in dire straits -- but to chip away at it, to erode its broad base of support, and ultimately to do away with it. He is motivated by a second world-view, which holds that social compacts are bad.

When some people say, "It's my money. I should be able to decide how to invest it, not the government", they are reflecting this world-view.

President Bush's "ownership society" is another reflection of this world-view. You would "own" your retirement, rather than being "dependent" on "big government." We say, however, that Social Security helps people be less dependent on government and charity.

Social Security is not a program in crisis. It is the most wildly successful social program in history. It needs to be strengthened and extended, not restricted or "reformed".

We ask our Congressional leaders to reject the Bush plans for Social Security, because of the considerable deficiencies and uncertainties of those plans and the central importance of Social Security to the life and well-being of this nation.