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Social Security

Securing Social Security for the Future

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Summary

The funding troubles of Social Security have been greatly exaggerated in an effort to push a privatization agenda. Privatization has laudable goals—increased choice and higher returns—but few would choose to risk their secure retirement income and unfortunately higher returns cannot be achieved without risk. Regrettably, if private accounts really do offer a lot of choices, many people who cannot afford to do so will unwittingly risk their incomes; and, in many cases, a combination of this risk and high transaction costs will consume what should be their core retirement income. When the government picks up the pieces, the funding troubles will be worse, not better.

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Introduction

Some seventy-five years ago, America adopted a new program to ensure the well being in retirement of Americans who had worked hard their entire lives. As a result, less than 12 percent of America's aged are living in poverty today—a number that would be four times larger otherwise.

When Social Security began, relatively few people lived much beyond retirement age. Now, advances in health care have made it possible for us to enjoy long lives, which makes the Social Security system more important than ever and yet also makes it more expensive to fund. Luckily, these funding problems are not imminent as some would suggest—in fact, they don't come for several decades.

Even the future problems have been greatly exaggerated. The system could easily have been put on sound footing for the next seventy-five years, for example if only a fraction of the money spent on tax cuts—which disproportionately went to the very rich who have done so well during the past three decades—had been spent on Social Security. Moreover, if productivity grows as rapidly as it has in recent years, and we can manage to maintain the economy at its potential, the funding problems too will greatly diminish, and could even disappear.

President Bush announced in his 2005 State of the Union address that privatization (or at least partial privatization) is his plan, although the key details are still missing. This comes as no surprise, of course, as both the Social Security Commission that President Bush appointed during his first term and his Council of Economic Advisers in their annual report advocated privatization.

Privatization is being touted as promising increased choice and higher returns, both laudable goals. However, the real question is whether privatization actually will enhance the well being of retired Americans—does it really promise more secure incomes for America's elderly? A closer look at America's social security system and experiences elsewhere suggests not.

The Benefits and Costs of Choice

When it comes to ice cream, choice is valuable because we all like different flavors, and we get to repeat our choice over and over. If we pick a flavor we don't like, it's no big deal because the next day we can pick another

flavor. Very quickly, we find a flavor that we like better than one the government would choose for us.

The choice of how much to save for retirement and where to invest it is very different. Basically, we only get one chance to choose. We won't know whether we have made good choices, whether we have saved enough or invested in overly risky assets, until it is too late and we are facing our own retirement. We can't even learn much from our elders because the world today—both public and private pension programs, life expectancy, and so on—is so different from the world of yesterday. If we get it wrong, we are in big trouble. One of the very reasons that we have a public social security program is that we believe that all individuals should have a basic level of income when they retire, income they should not gamble away.

The problem is compounded by a widespread lack of information—most individuals do not know the difference between a stock and a bond—and without enough information, they are likely to make bad decisions and be open to exploitation by companies that prey on their ignorance. In some countries that have experimented with privatization, this has led to the excessive churning of investments, with transaction costs eating away potential retirement incomes. Governments haven't found a way of curtailing this exploitation, other than restricting choices to a more limited set of investments.

Investors are often led to believe that they can get higher returns, but in well-functioning markets, higher returns come at a price—higher risk. Investors see the promises today, and then feel the consequences of the risk tomorrow. Moreover, none of the choices typically offered provide insurance against some of the risks against which social security provides protection—like inflation.

If people with lots of money—people who can afford to take greater risks—want to take greater risks, they can do so without privatization by simply allocating a larger fraction of their private portfolios to riskier assets than they otherwise would. Moreover, if there is a broad consensus that the elderly should be able to bear somewhat more risk than they do under the current program, that too could be accommodated within a public social security program, simply by creating investment options (all T-bills or 90 percent T-bills, for example) within the social security system. The more fundamental question is not choice, but privatization of the *core* retirement program. Would it enhance efficiency, equity, or fiscal soundness?

America's Private Pension System

Privatization by itself is no solution—witness America's private pension system, which is in trouble *today* and appears to be headed toward a government bailout. Some estimate the shortfall between assets and liabilities of these pension funds at several hundred billion dollars. To make life easier for the corporations—and to postpone the day of reckoning—President Bush and Congress have adopted changes in accounting practices that likely will make the magnitude of the eventual bailout larger than it otherwise would have been.

There was a time when individual savings accounts seemed so much better than Social Security. After all, Social Security was invested in treasury bills, yielding a much lower return than riskier investments. Advocates of privatization predicted a return of 9 percent, arguing that the funds would do so much better if invested in stocks. This was, of course, the view while stocks were soaring. But, what goes up often comes down; that is the nature of risky investments.

The market does not guarantee returns; it does not even guarantee that the value of stocks will keep up with inflation. In fact, the poor performance of stocks over the last five years is responsible for most of the private pension system's troubles.

Social Security Reduces Risk for Recipients

America's Social Security system insulates individuals against the vagaries of the market. It attempts to provide a minimum income with very low risk. Advocates of privatization often ignore the fact that high returns cannot be achieved without risk. The low returns within the social security system are not due to inefficiency, as transaction costs within the public social security system are much lower than in private pension programs.

The basic laws of nature cannot be repealed—even by a powerful president. If there is risk, someone must bear it. If social security funds are moved to stocks, then ultimately that risk must be borne by either taxpayers or social security recipients. Economists like to say there is no free lunch. President Bush and the economists supporting social security reform do all of us a disservice by ignoring this unpleasant reality.

In the end, the government will bear some of the risk—just as it is likely to do with private pension systems. It is almost impossible for any government to let

millions of elderly people suffer from the consequences of mismanaged pension systems or of a stock market crash that leaves them in poverty. This will be all the more true if the government encourages the move into stocks to get higher returns.

Of course, if the stock market *guaranteed* high returns, say 9 percent, there would be an easy way of fixing the social security deficit—simply have the government switch its money into indexed stocks, for example. Walla! The social security deficit would disappear. In fact, the entire U.S. debt would disappear in a few years if we could float enough bonds at current rates and invest the money at a 9 percent return. Alas, the reason no one is advocating this is that no one really believes in a safe 9 percent return.

Ironically, while social security is a low risk system, advocates of radical change have been trying to convince the American people that their retirement income is at great risk in the current system because the system is going broke.

Social Security Has Much Lower Administrative Costs than Private Accounts

A remarkable fact about social security is how efficiently it is run. Administrative costs are a fraction of the costs of the average mutual fund; a fact that may seem strange to those who believe that markets are always better than the government. It is actually understandable: Private firms spend an enormous amount on advertising, high salaries to managers, and transactions; and someone has to foot the bill. A recent study by Austan Goolsbee of the University of Chicago calculates that the present discounted value of future transaction costs from the central proposal of the Bush Commission would be just short of $1 trillion, and that these costs alone would lower benefits by some 20 percent from what they otherwise would be. The transaction costs of private fund management might not be so bad if there was an actual return on all their buying and selling of stocks, but the overwhelming evidence is that the investment managers do not consistently beat the market.

It looks like the Bush proposal will likely attempt to solve this problem in part by giving retirees a choice among a very few low-cost plans. This solves one problem—administrative costs are brought into line—but takes away one of the main arguments for privatization, which is choice. One could easily modify the current social security system to allow limited choices of the kind being contemplated.

What is remarkable about the Bush Commission's plan is that it increases administrative costs—another way of saying it gives enormous revenues to the financial industry—but it doesn't protect retirees or the solvency of Social Security. The president's own Council of Economic Advisers estimates an increase in the deficit as a result of the plan in the range of *2 trillion dollars* over the next decade alone. Peter Diamond of M.I.T. and Peter Orszag of the Brookings Institution estimate that the Bush Commission's plan adds more than 50 percent to the Social Security funding gap. Further, the independent Congressional Budget Office estimates that the Bush Commission's plan will lead to enormous reductions in retirement income—including what will be received under individual retirement accounts. For those born in the 1980s, the reduction is 23 percent, but for those born this decade the reduction is 45 percent.

Is this a problem of faulty design? Would a little bit more tinkering with the details of the reform proposal by the Bush Administration solve these "glitches"? The answer is no. The problems, unfortunately, are inherent. You can't divert money that is supposed to finance the retirement of today's elderly into private accounts for tomorrow's elderly without increasing the financial problems of the social security system just as you couldn't divert other tax revenues from the public coffers into private hands without exacerbating the fiscal deficit. There is no way that the Bush Administration can square this circle.

The Myth of a Free Lunch

Part of the reason that returns on social security "contributions" seem low is not just the false arithmetic of booking the high returns from stocks while ignoring the risk. Part is because of the pay-as-you-go nature of our current social security system, where the current generation pays for the previous. However, there is no magic in going from a pay-as-you-go to a fully funded system: Someone has to pay for today's retirees who were promised benefits. This problem, the so-called transition problem, is enormous. It means that, if we were to quickly switch, the current generation would have to pay twice, both for the current elderly and for themselves. Either the retirees will have their benefits cut or the current workers will have their contributions increased, or both. Again, there is no escaping the arithmetic. A gradual switch will only spread out this cost. Of course, if the social security system were vastly inefficient, one could claim that the switch would save so much money that everyone would be better off; but, to the contrary, as we have noted, transaction costs are likely to be larger with privatization, not smaller.

Finally, part of the reason that the returns on social security contributions seem low, especially for upper-income Americans, is that there is embedded in the social security program a modest amount of redistribution. The poor get back more than they otherwise would, the rich less, and this may be part of the hidden agenda of the Bush Administration—to reduce the extent of redistribution. However, we must face what that means—either we provide support for the poor through other channels or there will be more poverty among the elderly.

America's Social Security system is not perfect, but it has worked well for this country for many years, and its problems can be fixed rather easily with slightly higher retirement ages or slightly higher taxes. Scaring the American people into thinking the problem is dire and unfixable within the present system is an irresponsible way to get radical change. It is even more irresponsible to believe that privatization is an opportunity for a free lunch. Some may benefit from privatization—especially the managers of private investment funds—but more will lose. There is a real risk that there will be many more losers than winners—the losers being the poor elderly and average retirees and taxpayers.

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