THE CENTURY FOUNDATION
Issue Brief

SOCIAL SECURITY PRIVATIZATION: ELEVEN MYTHS

MYTH 1: UNLESS WE DO SOMETHING BOLD, SOON, SOCIAL SECURITY WILL GO BANKRUPT.

It is true that the government projects that the Social Security trust funds, now growing by more than $150 billion a year, will be drawn down to zero in 2042. But those same estimates also show that, after 2042, Social Security payroll taxes will be sufficient to finance about 75 percent of the payments that will be owed to the program's beneficiaries. These projections are made using extremely conservative assumptions about economic growth. If our economy continues to perform well, there is likely to be no shortfall at all. Therefore, what we face is a *possible* shortfall almost *four decades* in the future, not an immediate crisis or impending collapse.

Although the possible shortfall after 2042 is not good news, Social Security has run smoothly with minimal reserves throughout most of its history. In the past, payroll taxes from workers were just enough to cover contemporary payments to beneficiaries. Congress created today's growing Social Security trust funds, financed by the excess of current payroll taxes over payments, in order to partially pre-fund the system in anticipation of the growing future population of retirees.

MYTH 2: WE CAN DIVERT SOME SOCIAL SECURITY CONTRIBUTIONS TO PRIVATE ACCOUNTS WITHOUT JEOPARDIZING THE SOCIAL SECURITY SYSTEM.

The balances accumulating in the Social Security trust funds are earning returns that will help meet future commitments to retirees. If the revenues flowing into the trust funds were diverted into private accounts, there would be fewer resources to pay benefits to future retirees; we would be more likely to face a revenue shortfall in the future. More immediately, we would be unable to use the Social Security surplus to reduce the national debt held by the public. Future debt service obligations would increase. The growing Social Security trust funds reduce the likelihood of a future shortfall of revenue while making it easier for the government to meet future obligations without tax increases or benefit cuts.

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Myth 3: The Social Security system wastes money that will be saved if we introduce individual private accounts.

Exactly the opposite is true. The Social Security system costs far less to operate than private investment funds. Public opinion polls by Roper show that the public guesses the administrative costs of Social Security as a percentage of benefits to be more than 50 percent. In fact, administrative costs for Social Security are less than 1 percent of benefits, compared with average administrative costs of 12 to14 percent for private insurers. Administering millions of small accounts would consume a large fraction of revenues, especially if investors are permitted actively to manage their accounts. To these costs must be added the marketing costs incurred by private funds as they compete for worker's accounts. Net returns on private accounts are reduced by the costs of management fees, account administration, and marketing. Economist Peter Diamond has shown that the administrative costs in countries that have set up individual accounts (Britain, Chile, Argentina, Mexico) reduce benefits by 20 to 30 percent compared to what the U.S. Social Security system would pay given the same resources.

Myth 4: Small private accounts will get a much better rate off return than the Social Security trust funds.

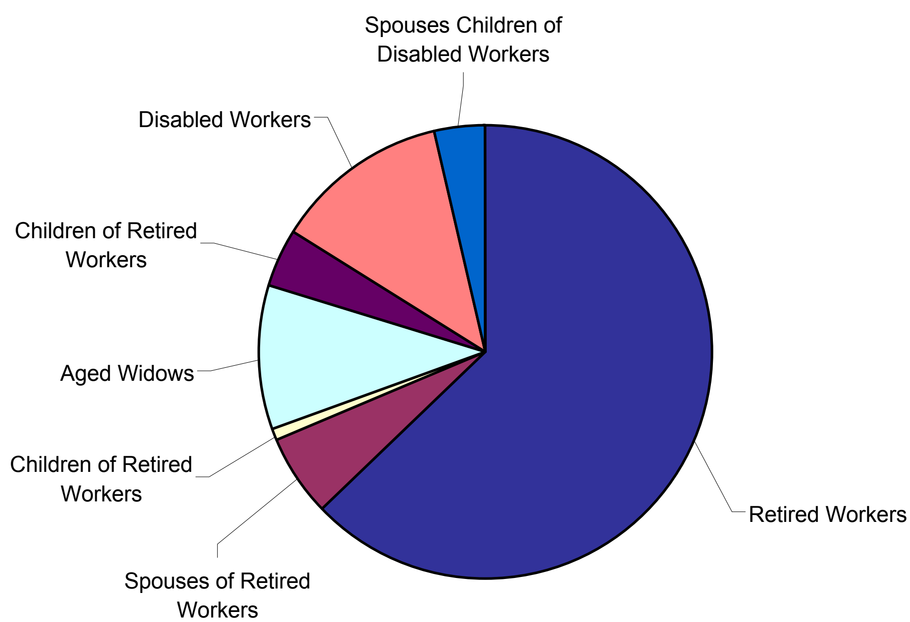
One large account can earn exactly the same rate of return as many small accounts. Historically, investors have not been able systematically to do better than to buy and hold a diversified portfolio of the stocks and bonds offered in major markets. Today the Social Security trust funds earns a modest rate of return because it is invested in the most secure and conservative assets: U.S. government bonds. This policy could be changed. If the trust funds were invested in a diversified portfolio, it would raise the expected rate of return but also the risk. The trust funds could hold exactly the same balanced, "passive" portfolio as private investors, with much lower management costs.

Myth 5: Well managed private accounts need not be risky.

All private investing is risky. If a person had acquired a broad index of stocks over his working life, retired and sold these stocks on October 18, 1987, he would have realized 18 percent less income per year in retirement than the person who had behaved exactly the same in every respect, except that he exited the market *one day* earlier. Private bonds, too, can be risky. In 1982, a thirty-year AT&T bond would have been worth barely a third of what it was worth when issued in 1977. Between May 1999 and May 2000, the Nasdaq index has varied by more than 100 percent, and the S&P 500 index by more than 25 percent. Day to day fluctuations can be smoothed by selling stocks over a period of time. But if the market falls and remains low for some time, those who sold before the fall will do much better than those who sold after, even with sales spread over time. A worker who accumulated the stock market steadily for forty years and retired in the early 1970s would have a nest egg almost twice as large as a worker ten years younger who had followed exactly the same strategy (retiring in the early 1980s).

A social insurance fund pools risks, balancing out gains and losses among individuals. Social Security guarantees the level of retirement benefits. Retirees are fully insured against market risk. Our Social Security system also provides life insurance to support survivors of workers who die young, disability insurance for workers whom health forces to leave the labor force, and inflation insurance through indexation of benefits. All of these essential social insurance features of Social Security would be at risk if we directed revenues into private accounts. The debate about privatization tends to treat Social Security as if it dealt exclusively with individuals who work and then retire. But the program's broader social insurance functions are very important to millions of Americans. In January 2004, 29.6 million retirees received Social Security benefits based on their earnings. To this number, we must add 2.6 million spouses and nearly 0.5 million dependent children of retirees. Survivors of deceased workers and retirees are among the people most dependent on Social Security: 4.6 million widows and 1.9 million dependent children of deceased workers received benefits. (These numbers include ex-wives of divorced workers and retirees.) Another 5.9 million disabled workers, with more than 1.6 million dependent children received Social Security benefits. All told, more than a third of Social Security beneficiaries are not retired workers. The risk to retirees' incomes posed by privatization is small in comparison to the risk to dependents of workers and retirees, whose future is barely mentioned in most discussions.

Social Security Beneficiaries



Myth 6: Privatization would make almost everyone better off after seventy-five years.

It is true that "pre-funding"—putting resources aside today to earn returns until we retire—could make almost everyone better off after 75 years. But between now and then, we would feel the squeeze from saving for future retirement. What is more, prefunding is not the same thing as privatization. We could pre-fund future retirement through the Social Security trust funds instead of through individual accounts. The result in either case would be higher saving today and more secure claims by future retirees on the future economic pie.

Today, the great bulk of our Social Security contributions are needed to pay current retirees. If, on top of paying for these retirees, we sought to accumulate large enough balances in the trust funds or private accounts to pay future retirees, current workers would have to pay that bill, too. Like buying a house, pre-funding of retirement looks good after the mortgage has been paid off, but it requires sacrifice in earlier years.

The transition from a pay-as-you-go to a fully pre-funded system would take many years to complete. Even the strongest advocates of private accounts—who make very optimistic assumptions about returns to assets—acknowledge that payroll taxes would have to exceed their current levels for nearly 25 years, and would not reach their long-run levels for another half century thereafter. More cautious assumptions about returns on investment suggest that much higher contributions will be needed and the transition will require more time.

Today, the Trust Funds contain assets equal to roughly three years worth of benefits. A pre-funded system would require assets equal to 14 to 19 years worth of benefits (depending on the rate of return, economic growth and demographics). The transition to a fully funded system requires taxpayers to continue providing benefits to retirees under the old system while at the same time building up assets on that scale to support their own retirement. That is why even optimists say it will take 75 years.

Myth 7: Private accounts give the average household a chance to get rich.

A system of private accounts would shift risk from the government to retirees. But it would not offer opportunities to get rich. There would not be many investment decisions left to workers in a privatized system. The investment options offered to individual investors would have to be strictly limited, for two reasons: First, in order to control administrative costs, the number of investment options for each account would have to be very few. Second, in order to prevent workers from losing their retirement funds, most high-risk and novel investments would have to be ruled out.

Such paternalistic measures are necessary unless we are willing to let people who mismanage their retirement accounts die hungry and cold. The taxpaying public needs to protect itself against workers who may be tempted to gamble with their retirement funds, hoping to become rich, only to require greater public assistance in old age. So privatized accounts will not offer many investment opportunities. In limiting the chance to lose everything, and, on the flip side, the chance to become rich, regulation of private accounts will require all workers to behave very similarly and conservatively.

Myth 8: For most retirees, Social Security benefits are a welcome but not an essential source off income.

Without Social Security, which in January 2004 provided households an average benefit of $863 a month (around $10,000 a year), about half the elderly in America would fall below the poverty line. A significant proportion of the elderly depend on Social Security to survive: in 2001, more than 60 percent of the elderly in America relied on Social Security for at least half their total income. Largely because of Social Security, poverty rates among the elderly have declined from 35 percent in 1959 to about 10 percent in 2004.

Myth 9: African Americans have especially much to gain from privatization.

This argument is based on the fact that African Americans have shorter life expectancy than whites and therefore collect retirement benefits for fewer years, on average. But African Americans also have lower average earnings than whites. Because Social Security's retirement benefits replace a larger share of past earnings for low-income versus high-income beneficiaries, African Americans receive a higher annual payoff in comparison to their past tax contributions than whites. African Americans also own fewer assets, and have less extensive pension coverage than whites, so they are more likely to be highly dependent on Social Security benefits. Moreover, the flip side of African Americans' shorter enjoyment of retirement benefits is their greater dependence on the life insurance and disability features of Social Security. African Americans constitute 12 percent of the U.S. population, but 25 percent of the children receiving deceased worker benefits in 1996, and 18 percent of the workers receiving disability benefits.

The claim that African Americans have especially much to gain from privatization overlooks a further feature of privatization proposals: annuitization. Every serious proposal to replace part of Social Security with private accounts includes limits on the way individuals may dispose of their retirement nest egg. To prevent a retiree from mismanaging the nest egg, jeopardizing his or her family, every retiree must obtain an annuity upon retirement, converting the nest egg to an income stream over the rest of the expected life. This process would create a system that is very similar to the present system, from the worker's point of view. The retiree would receive an income until death, at which time survivors would receive support. There would be no additional bequest from the privatized retirement account.

Myth 10: Privatization is equally good for high-income and low-income workers.

Privatized accounts would carry into retirement income inequalities among workers. Unlike the Social Security System, which replaces a larger proportion of the income of low-wage than high-wage workers, there would be no redistribution of income to low wage workers in a privatized system. In 2002, 40 percent of American families earned total incomes of less than $35,000, and 12.1

percent of all Americans—34.6 million people—lived below the poverty line. People with such low income from work would be unable to save enough to finance their retirement under a privatized plan and a disproportionate amount of whatever they salt away in individual accounts would be consumed by administrative expenses. In a giant step backwards, they would become dependent on whatever welfare system were devised for the elderly poor. Privatization would create winners (those who command high wages and salaries during their working years) and losers (those who don't).

Myth 11: Privatization is equally good for women and for men.

Privatization would penalize women because they earn less, live longer, and interrupt their working careers more frequently than men.

A Widening Gender Gap

According to one study, if male and female workers invested 5 percent of their payroll taxes in private accounts for forty years, the current gender gap between men's and women's benefits would actually widen, based on women's lower incomes and more frequently interrupted careers. Because women also tend to invest more conservatively than men, another study estimates that after thirty-five years in a retirement plan, the value of the average man's investment portfolio would be 16 percent greater than the average woman's.

A Longer Life Means Smaller Benefits

A woman who turned sixty-five in 2002 had an average life expectancy of 19 years, compared to 15.9 years for men. Therefore, when she retires and converts her accumulated savings into an annuity, nearly every woman would receive a smaller monthly benefit than a man who has earned the same amount of money in an equally long career. Social Security guarantees the same earnings-based benefits for life, regardless of life expectancy. COLAs, which privatization would reduce, are also more important to women because inflation takes a greater toll on the dollar's value over longer periods of time.

Unpaid Leaves

Every worker who takes time out to raise a child or care for an aging parent would suffer reduced benefits upon retirement, because she or he would not have contributed to a personal retirement account during that period. The lion's share of such discontinuous workers will be women.

Experts estimate that only 30 percent of women but 60 percent of the men retiring in 2021 will have worked for thirty-eight or more years.

A Penalty for Marriage

Social Security guarantees a retired woman who has been married for ten or more years her own working benefit or half the amount her husband (or ex-husband) receives, whichever is larger. But many privatization proposals would impose a "marriage penalty." The National Commission on Retirement Policy plan, for instance, would cut the spousal benefit significantly, reducing the benefit from half the husband's benefit to one third, hurting many women, especially those who stayed home to raise children.

A Demerit for Divorce

Privatization would hit divorced women particularly hard, because most plans make no provision for ex-wives to receive a portion of their former husband's savings. Social Security, on the other hand, entitles a former wife to some of her ex-husband's benefits if their marriage lasted ten years or longer.

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