Privatizing Social Security: The Answer to Retirement Woes or Enron to the Nth Power?

BY ILENE H. FERENCZY

Social Security was enacted to provide working people with a safety net when they retire. The current call to privatize Social Security sounds promising, but does it really deliver?

Social Security reform is a refrain that seems to be sung by everyone in politics—from presidential candidates, to Congressional candidates, to pundits. Despite the fact that Social Security effectively provides retirement income for almost all US workers, the public perception is that the system is flawed economically and, at the same time, that larger benefits would be payable if the money was managed differently. One of the proposed reforms to the Social Security system that has been widely embraced is to "privatize" it. Somewhat of a misnomer, "privatization" refers to the investment of Social Security funds in some sort of equity investment, generally by permitting workers to elect to direct the investment of all or a portion of their Social Security contributions in various options. Commonly, privatization models assume that the decision to do such investing will not be mandatory, but that interested workers will be allowed to elect to direct the investment of some or all of their Social Security.

As attractive as it may sound to give workers a greater role in deciding the investment of their retirement funds, there are significant arguments against privatization that demonstrate that the concept is not so simple. In fact, privatization would likely cost significantly more than the current system, and its ability to provide greater benefits to workers and their families is questionable.

How Social Security Currently Works

Under the current Social Security program, workers and employers make contributions each payroll period. Workers' contributions are made through payroll deduction, and the employer then adds its contribution, and forwards the entire amount to the government. At retirement age, eligible retirees receive monthly benefits based on a high 10-year average of earnings over their working lifetime, up to a maximum amount. Spouses and children of deceased workers may also be eligible for survivor benefits. Social Security also pays benefits to disabled workers and dependents.

Contrary to public perceptions, Social Security contributions are not put into a segregated trust fund and invested. Social Security contributions paid by current workers and their employers are used mostly to pay the benefits of current retirees. If Social Security contributions exceed the required retiree benefits for a period, the funds must be invested only in special government bonds; however, keep in mind that government bonds are really a means by which

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the Social Security system is lending money to the US government, which in turn uses it to pay for current expenses. [Cadette, "Social Security Privatization: A Bad Idea," *www.levy.org/docs/pn/99-10.html,* page 2] Unlike private pensions, which are legally required to put contributions aside and invest them in order to provide benefits when owed, the Social Security system is largely a "pay-as-you-go" venture.

As the baby boom generation ages, there is significant concern that the careful balance between contributions by current workers and their employers and the benefits to be paid to retirees will fall out of kilter. Because fewer children were born in the post-baby-boom generation, the ratio of workers to retirees will drop. According to the Bush White House, the ratio, which was 5.1 workers to each retiree in 1960, has already reduced to 3.4 today and is expected to be 2.1 in the year 2030. ["Modernize and Reform Social Security," *www.whitehouse.gov/infocus/social-security*] Another source indicates that benefits paid out will exceed contributions paid in by 2016. [Thomas, "The Enron Debacle Bolsters the Case for Social Security Privatization," February 5, 2002, Citizens for a Sound Economy, *www.cse.org/informed/issues_template.php?/issue_id=740*] And if inflation does not continue to increase the benefits paid to retirees, Social Security in its current incarnation will clearly be quite expensive in the years to come.

Advantages of Privatization

A significant factor encouraging privatization is the stock market boom of the 1990s and the early part of this decade. At a time when it appeared that anyone could make money in the stock market, it is easy to question whether the Social Security funds would not be better off invested in a broader range of financial products, including equities. Proponents of privatization generally contend that, over the long term, the stock market performs better than bond or other fixed income investments. [*See, e.g.*, Baker & Biggs, "Have Plunging Stocks Killed Private Accounts in Social Security?" *AARP Bulletin*, September 2002; "The Advantages of Social Security Privatization, Fact & Fallacy: Contemporary Issues in Employment and Workplace Policy," Employment Policy Foundation, December 1998, Vol. IV, No. 12, *www.epf.org/ff/ff981208.htm*] (Anyone who has been in a 401(k) enrollment meeting is likely to have seen the illustration of how much less would be available in someone's account if he or she was out of the market during four or five selected days in the past two decades.) As a result, proponents argue, investing Social Security funds in the marketplace *must* provide the opportunity for larger benefits. "A worker retiring today with an account holding only stocks would have received about 6 percent annual returns," states Dean Baker and Andrew Biggs in a position paper for the American Association of Retired Persons. "That's lower than the 7 percent historical average, but still a lot better than the 2.5 percent return an average couple can expect from the current program." [Baker & Biggs, "Have Plunging Stocks Killed Private Accounts in Social Security?"]

Privatization was embraced by the current President Bush during his first presidential election campaign, and continues to be a focus of his Social Security policy. Early in the administration, the President authorized the President's Commission to Strengthen Social Security. In its report, the Commission points to the federal government's Thrift Savings Plan as an indicator of how privatization has worked before. Under that Plan, federal employees are permitted to invest part of their retirement benefits in a combination of three available funds: a government securities fund, a commercial bond index fund, and an equity index fund. The Commission noted that the rates of return of these funds for the decade of the 1990s ranged from 6.7 percent in the most conservative fund to 17.9 percent for the equity fund, "a singular success," as stated in the Commission's report. The Commission's report goes on to describe three models for privatization of Social Security, and generally recommends that this process be undertaken expeditiously to save the system. [Final Report of the President's Commission to Strengthen Social Security, "Strengthening Social Security and Creating Personal Wealth for All Americans," December 2001, *www.commtostrengthensocsec.gov/reports/Final_report.pdf*] Other proponents cite Chile's success in privatizing its version of Social Security as a positive indicator of the value of privatization. [*See, e.g.*, National Center for Policy Analysis, "A 12-Step Plan for Social Security Reform," June 4, 1998, *www.ncpa.org/ba/ba267.html,* Solomon & Barrow, "Privatization of Social Security," 5 *Kansas Journal of Law and Public Policy* 9 (1995), reprinted in Frolik & Barnes, *Elder Law: Cases and Materials*, 2nd Ed., Lexis-Nexis, 1999, pp. 189, 190]

There are other ancillary benefits of a more participant-directed program, privatization proponents contend. Because Social Security benefits are not related directly to the amount of contributions made by an employee, they discourage savings. A privatized sys-

tem, where more contributions and proper investment increase benefits, turns workers' attention and focus to the value and the need for saving. Increased savings, it is argued, will indirectly stimulate the economy. Another ancillary benefit could be the ability to transfer unused Social Security savings to future generations. Because a participant's benefits in the system would be tied to his or her contributions and market performance, any money left over when the retiree dies could pass to the heirs. ["The Advantages of Social Security Privatization, Fact & Fallacy: Contemporary Issues in Employment and Workplace Policy," Employment Policy Foundation, December 1998, Vol. IV, No. 12, *www.epf.org/ff/ff981208.htm*] This may be a particularly important benefit to lower-income workers who often have no other savings to pass on to the next generation, or to minorities, whose life expectancies tend to be shorter, and who are therefore less likely to use up all their Social Security amounts in retirement. Last, but not least, privatization permits workers to feel that they are in control of the financial aspects of planning for their retirement, even if Social Security is the primary or even the single source of retirement savings.

Disadvantages of Privatization

The enthusiasm for privatization that was present during the presidential campaigns of 2000 has clearly waned in the past four years for several reasons. In addition, many experts disagree as to whether privatization is the salve for Social Security's woes. In fact, the arguments against privatization are compelling.

One of the most significant arguments against privatization relates to the manner in which Social Security is funded. As noted, Social Security contributions are not set aside and invested. The lion's share of the contributions collected is used to provide benefits

Exhibit 1. Summary of Privatization Pros and Cons

Pros	Cons
• Participants benefit from the larger returns available in a broader investment marketplace. • Privatization encourages personal savings, which in turn stimulates the economy. • The balance in the privatized account can be left to the participant's heirs. • Participant control over retirement benefits is more fair and more representative of the American approach to such matters.	• The ability to select investments involves a risk that the earnings will produce accounts that are insufficient to provide amounts equal to the guaranteed benefits currently available. • Privatization requires a set-aside of contributions. Because the current system is a combination of pay-as-you-go and lending money to the government, privatization requires more capital outlay. • If there are insufficient assets at retirement, the participant can outlive his or her benefit. Furthermore, sufficient funds may not be available at early disability or death. • A decrease in the market may occur on the eve of retirement, significantly decreasing the participant's expected retirement benefit. • The ability to elect in and out of the privatized system can cause adverse selection, which will increase costs. • If elections into or out of the system are irrevocable, participants may be required to make that decision when they are too young to appreciate its ramifications. • Workers are not properly educated about making investments. • The administrative costs of a privatized system are high and the potential for errors is greater than under the current system. • If participants get the benefit of positive returns but are protected from the downsides of privatization, the system is more costly than current Social Security.

to current retirees, and the balance is used for other government needs. If privatization occurs, funds need to be taken from these two uses and set aside for investment at the direction of current workers. Current Social Security costs would increase exponentially, because of the need to fund existing Social Security benefits and future benefits concurrently. Either contributions would need to go up, or current benefits would need to be cut. [*See, e.g.*, "Bush Plan to Privatize Social Security Would Cut Benefits—And More," AFL-CIO, *www.aflcio.org/news/2002/0701_ss.htm*; Cadette, "Social Security Privatization: A Bad Idea," p. 4] One specialist estimates that the subsidy to support privatization would be "huge—some $2 to $3 trillion over the next couple of decades." [Duke & Carlson, "Social Security Privatization Wouldn't Be Cheap," quoting Henry Aaron, *AARP Bulletin Online*, February 2002, p. 2, *www.aarp.org/bulletin/departments/2002/social_security/0205_social_1.html*] The problem is further exacerbated by the unavailability of the Social Security surplus to fund other governmental expenses, increasing the general budget deficit and requiring another source of governmental borrowing.

The second argument against privatization has to do with the increased public insecurity with the stock market. Privatization became a large part of the public debate during the 1990s, when the stock market was still strong. Other models of savings and investment, such as private employers' 401(k) plans, were performing extraordinarily, and many Americans looked forward to early retirement. Social Security participants wanted to share in these large gains.

The years 2001 and 2002 brought September 11th and the corporate scandals at Enron and WorldCom. With them came the bear market and a revised cynicism about Wall Street's performance. 401(k) plans are no longer seen as the last word in retirement savings, and many pundits are now calling for a return, at least in part, to guaranteed benefits such as those offered in defined benefit plans and traditional Social Security. [*See, e.g.*, Valenti, "Pension Envy: Dwindling 401(k)s Make Stodgy Pension Plan Returns Look Positively Exciting," July 25, 2002, *more.abcnews.go.com/sections/business/dailynews/pensions_020726.html*; Frieswick, "Honey, I Shrunk the 401(k)" (The bear market has clobbered 401(k) accounts—and could spark a revival of defined benefit plans.), *CFO Magazine*, August 1, 2002, reprinted at *www.cfo.com/article/1,5309,7507,00.html*] This highlights the downside of participant-directed investment: People can lose money. Such a potential loss can be particularly critical for those low-income individuals who are unable to save a significant pension nest-egg outside of Social Security. A market decrease can be disastrous to those whose privatized Social Security accounts represent their only source of income. "The market rarely returns its long-term average," says a consultant at Watson Wyatt Worldwide. "Instead, that average is almost always a combination of highs and lows. How long your money lasts will depend greatly on whether the highs come first or last in a particular period … I would hate to be a [401(k)] retiree from two years ago." [Crenshaw, "Playing 'You Bet Your Life Savings'," *Washington Post*, July 28, 2002, reprinted at *www.washingtonpost.com/ac2/wp-dyn?pagename=article&node=&contentID=A859*] This phenomenon is no surprise to individuals who planned in the 1990s to retire early in the new century and have had to extend their working years because their portfolio decreased when the stock market suffered its reverses. A down market is tolerable for those in a position to "ride it out." If not, then the problems are significant.

In rebuttal, Andrew Biggs of the Cato Institute, a libertarian organization, points out that the 401(k) losses relating to the Enron scandal were caused by traits that are more consistent with the current Social Security system than with the proposals for privatization. "Lack of diversification, opaque accounting, and imminent bankruptcy. These terms describe Social Security much as they do Enron's foggy finances," notes Biggs. [Biggs, "Don't 'Enron' Social Security?" February 16, 2002, *www.cato.org/dails/02-16-02.html*] While this may be true, it does not address the real concerns caused by a potential decrease in a privatized Social Security portfolio on the eve of retirement, death, or disability.

The risk issue has another element. Whereas Social Security benefits are currently guaranteed to last the worker's lifetime (and sometimes longer, depending on the nature and age of the worker's dependents), a privatized account can pay out only benefits that have accumulated. As noted before, accounts that perform better than expected may create a legacy for heirs; on the other hand, insufficient accounts will be depleted during the retiree's lifetime, leaving him or her with no retirement income at all in the later years. This may have a most acute effect on women, who have both longer life expectancies than men (requiring more funds at retirement in order not to outlive their savings) and often shorter work histories (meaning that their privatized Social Security accumulations

may be smaller than those of their male counterparts). ["4 Ways to Win the Privatization Debate & Strengthen Social Security for Women," National Council of Women's Organizations, *www.women4socialsecurity.org/priv.htm*]

If a participant's benefits are limited to those in his or her privatized account, many family members may be significantly impacted. Under current Social Security rules, a nonworking spouse of a worker is entitled to benefits despite divorce from or death of the worker. Underage children of deceased workers are also entitled to benefits. Disabled workers receive benefits in the period during which they would otherwise be working, as well as after normal retirement age. Under a privatized system where all that is available is what has accumulated, these additional benefits may be nonexistent or cut short while the need for them is greatest. If, on the other hand, such ancillary benefits are retained in a privatized system, they must be underwritten with additional funds, increasing the cost of the system. In truth, most Americans would like to keep the benefit of good investments, but be protected to some extent from bad investment options or unexpected bad luck or disasters. This desire to be in a "win-win" situation ensures by its very nature that privatization would be more costly than the current system.

Most proponents of the privatization system assume that workers will elect whether to participate in the traditional Social Security program or to privatize their accounts. If the election option is utilized, there is some question about whether the election will be irrevocable. If it is not, adverse selection is likely: When the market is good, workers will elect to privatize, and will similarly opt to return to the guaranteed system when the market is bearish. This is an expensive possibility, increasing the costs of the traditional program when it can least be afforded. ["Issue Brief: Social Security Reform: Voluntary or Mandatory Individual Accounts?" Section IV, September 2002, American Academy of Actuaries, p. 4] Alternatively, requiring workers to decide irrevocably to privatize may create hardships, as well. If a worker must make that election at the early part of his or her career, he or she may be too young to have the experience or information needed to consider adequately the retirement ramifications. (Imagine, for example, high school students flipping burgers at their first part-time job making an irrevocable decision about their retirement income.) Furthermore, benefits decisions are rarely irrevocable in the workplace: Employees are accustomed to changing their minds about benefits such as health care on annual basis at open enrollment.

The risk element of privatization may be further exacerbated by the challenge of educating workers sufficiently to permit them to make informed decisions about how to invest their privatized account. The need for proper participant investment education and advice has been a matter of significant debate in the private pension industry. [Congress previously considered two pieces of legislation designed to permit some amount of investment advice to be provided to 401(k) and other qualified plan participants: H.R. 3762, sponsored by Rep. Boehner, and S. 1677, introduced by Sen. Bingaman. Neither was enacted. The situation continues to concern legislators and regulators alike, and is likely to be the subject of future Congressional action.] In its Issue Brief, the American Academy of Actuaries notes that "employees often are not sufficiently informed to make these decisions in a rational way." ["Issue Brief: Social Security Reform: Voluntary or Mandatory Individual Accounts?" Section II, p. 2] Privatization may put the decision making regarding retirement fund investment in the hands of those who are the least savvy financially.

The administrative costs of privatization would be significant. The AFL-CIO estimates administrative costs will be in double digits, compared to the current 1 to 2 percent spent by Social Security on administration. The AFL-CIO further asserts that Chile's much-heralded system pays 15 to 20 percent in investment company fees. ["What's Wrong with Individual Investment Accounts," *www.aflcio.org/socialsecurity/inv_acct.htm*] Naturally, the potential cost is even higher if both the traditional and the privatized Social Security systems must be maintained simultaneously. A Congressional Budget Office study also notes that administrative costs are directly related to such factors as how many funds are offered to participants and whether the administrative system is government-run or based on contracts with outside providers. ["Administrative Costs of Private Accounts in Social Security," CBO Study, March 2004] The CBO study indicates that the cost of a defined contribution-type privatized fund could be as high as 15 times that of the current Social Security system. [*Id.*, page 2]

The argument against privatization goes further than simply pointing out the increased cost of administering a privatized program. Opponents note how complex and error-prone defined contribution admin-

istration is for qualified plan sponsors. The existence of the IRS's broad Employee Plans Compliance Resolution System (EPCRS) [Rev. Proc. 2003-44, 2003-25 I.R.B. 1051] to assist employers in repairing plan errors testifies to how common these mistakes can be. Errors also occur in the current Social Security program. Imagine, opponents say, how widespread and expensive errors will be if the government is administering a program under which participants make individualized elections with regard to investments and benefit forms.

The interest in Social Security privatization is caused in large measure by a desire to invest the funds associated with this retirement program more lucratively. While current law requires the investment of excess Social Security funds in government securities, this law could be changed (significantly more easily than full privatization could be enacted). Perhaps investment of existing Social Security funds in a more mixed portfolio would result in better returns that would shore up the current system or even provide increased benefits to recipients.

Conclusion

Privatization of Social Security is certainly a controversial subject. While privatization can increase benefits for many employees, as well as a possible nest egg to pass to one's family if a relatively early death occurs, this result is not guaranteed. The law of averages dictates that some people will be better off with privatized accounts, and others will be worse off. The question then becomes whether the risk is worth the reward. Proponents of privatization note that permitting workers to elect to privatize their Social Security accounts permits them to decide their future for themselves, and to take the risks that they deem proper; however, opponents point out that these decisions may not be fully informed, and may need to be made at a time when the workers are not sufficiently mature to understand the ramifications.

The level to which the government and we, as a society, are willing to go to protect the financial security of individuals who choose poorly will be a critical part of the analysis. Social Security was enacted to provide a future safety net for people. Privatization puts that safety net at risk for at least some sector of the population. Are we willing to let our fellow citizens suffer the financial results of a down market when they retire, particularly if a large percentage of retirees are affected by the downturn? Will a society that heralded the advent of Social Security following the Depression turn its back on its poor if they chose privatized accounts and lost that wager?

Problems with privatization extend beyond the "some win, some lose" concerns. The cost of the program will be significantly more than that for the current Social Security system, particularly if participants are offered a choice between privatizing or not. Administrative costs, including the fees associated with service providers if the government outsources recordkeeping or fundholding tasks, plus the increased potential for errors would be overwhelming in a privatized system. Furthermore, Americans' desire to be protected under Social Security against economic downturns, disability, or death would require the maintenance of certain protections that would no longer be partially paid by participants who outlive their actuarial lifetimes or by investment returns that are better than expected. Individual retirees' win-win result will likely cause the nation to lose-lose. ■