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RESEARCH ARTICLE

Social security and privatization: a viable combination?

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Privatization involves placing Social Security contributions into individual savings accounts. Recent moves to promote the privatization of Social Security in the United States assume that the Social Security system itself is now in crisis, although the evidence suggests otherwise. Nevertheless, there are real concerns about the future viability of Social Security that should be addressed. The public remains supportive of Social Security and all that appears necessary are minor modifications of the Social Security system, rather than its abandonment to the private sector.

Keywords: social security; privatization; social policy

Introduction

Stock market prices dropped dramatically on 24 October 1929, and collapsed five days later. Banks and businesses closed and the Great Depression ensued. The Gross National Product (GNP), national income, manufacturing output, wages, and employment declined. Emigration outpaced immigration. In the 1930s, Franklin Delano Roosevelt launched New Deal programs to help the United States emerge from the Great Depression. President Roosevelt (1938, p. 291) stated: “If, as our Constitution tells us, our Federal Government was established among other things ‘to promote the general welfare,’ it is our plain duty to provide for that security upon which welfare depends.”

In addition to providing relief for many people, the New Deal demonstrated that the federal government could and would intervene successfully to improve the national economy, which was also helped along by the tremendous war effort. Even in the hard economic times in which Social Security was created, it was not easily established. Political skirmishes surrounded the birth of Social Security, and it represented a major political achievement (Klein, 2003, p. 97). Many elderly persons needed a pension; a savings plan would not have been sufficient for them. As Hacker (2002, p. 107) stated:

The Social Security Act benefited from extraordinary circumstances: a triggering crisis, widespread recognition of the failure of private organizations to provide retirement security, an overwhelming partisan majority led by a powerful president, and the rise of diffuse but potent social pressures for government action. Despite this, passage of compulsory old-age insurance was never certain.

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In more recent times, during the Reagan era (1981–1989), changes in Social Security included the elimination of a minimum monthly benefit amount for Social Security recipients and the phasing-out of college benefits for children of workers who were retired, deceased, or who had disabilities (Kingson & Berkowitz, 1993). These actions, which were designed to put Social Security on a sound footing and represented political compromise, paved the way for subsequent efforts to modify Social Security. In his State of the Union speech on 19 January 1999, President Clinton reported a surplus of \$70 billion. To “save Social Security,” he proposed to commit 60% of the budget surplus for the next 15 years to Social Security and to invest a small portion in the private sector. In seeking his first term of office, George W. Bush espoused partially privatizing Social Security. His plan involved designating part of the payroll tax for individual savings accounts. While President Bush offered to leave Social Security benefits as they were for older persons who were about to retire, he also proposed programmatic changes for younger persons.

Certainly there is a funding challenge:

Over the next 75 years, Social Security costs are projected to rise by about 2.5 percent of Gross Domestic Product (GDP), while revenues are projected to decline slightly as a share of GDP. Social Security’s long-term financial health can be restored through either minor adjustments or major surgery. (Diamond & Orszag, 2005a, p. 11)

How social security issues are framed influences patterns of thought (see Kahneman, Slovic, & Tversky, 1982). Politicians and organizations, including foundations, announced an impending crisis in Social Security funding that created cognitive, emotional and behavioral responses that appear to be designed to goad the public into action. Given the prospect of penury, the responses include alarm, as Social Security provides a considerable portion of income to many persons. Cornman, Kingson, and Butts (2005) suggested that, given the projection of the Social Security trustees that there will be sufficient funds to meet all commitments until 2041, we are facing a financing problem rather than a crisis. If one uses more optimistic assumptions, Social Security will be fiscally sound until 2075 (Krugman, 2003, p. 201). This paper examines the extent to which there is a crisis in regard to its funding and the public’s support, or if indeed this is just another challenge that can be addressed by this existing system.

Advantages of social security

Social Security has been widely heralded as a major social policy achievement. It is the hallmark of every advanced social democracy in the world. It provides basic social protection against earnings losses due to retirement, disability, or death to workers and their families. Social Security is probably the best anti-poverty program that exists. According to the US Bureau of the Census (1988), Social Security has been the primary factor in reducing poverty among the elderly; without it, millions of elderly persons would be impoverished. Indeed, it was not too long ago that significant numbers of elderly persons were poor (Hudson, 2005, pp. 1–19). Social Security is particularly important in preventing poverty among the low-income and the “old-old” elderly population who rely upon it heavily (Liebman, 2002, p. 11).

For those persons who do not rely exclusively on Social Security for income, and who have a defined contribution pension, Social Security as it is currently structured serves to lower risks through diversification. Under a fully privatized Social Security plan, if people no longer can readily depend upon another pension plan to provide them with a lifetime income, unless they purchase a lifetime annuity issued by a private insurer, for which the

costs to the insured are often substantial, they are likely to have to turn to family, to charity, or to time-limited public assistance.

As a universal program, rather than a means-tested program, a person only has to meet statutory requirements to be eligible to receive Social Security benefits. It is a program of social insurance that recipients have earned. However, as Social Security uses a pay-as-you-go system, it is also dependent upon the numbers of young workers putting their tax money into the Social Security system at the time that older workers are taking it out. However, this is not the only factor. According to the Board of Trustees of the Social Security system:

The actual future income and expenditures of the OASI and DI Trust Funds depend on many factors, including the size and characteristics of the population receiving benefits, the level of monthly benefit amounts, the size of the work force, and the level of workers' earnings. These factors will depend in turn upon future birth rates, death rates, immigration, marriage and divorce rates, retirement-age patterns, disability incidence and termination rates, productivity gains, wage increases, inflation, and many other demographic, economic, and program-specific factors. (Board of Trustees, 2006, p. 6)

Concerns regarding social security

Initially, Social Security benefits were available to those persons who reached the age of 65 years. Life expectancy in the United States reflects an increase during the past century, with additional increased life expectancy forecast for the twenty-first century (National Center for Health Statistics, 2001). Moreover, it is more likely a person will live to receive Social Security now than when the program was new.

Many of the Social Security recipients were elderly men who left widows with little if any means of supporting themselves. Then, as now, individualism was strong, as was the work ethic. More controversial than the original idea of providing Social Security to older men who had worked for pay outside the home for much of their lives was the idea of giving Social Security benefits to their widows, most of whom had worked at home and, even if they had worked in factories to support the war effort, had not accumulated lengthy paid employment records. Therefore, it was felt that those who worked should receive benefits, and it took years to recognize that those who did not work outside the home tended to work inside the home, and that they too should receive some benefits. Related to this was overcoming the individualistic mind-set and to fully think of families as consisting of many members who supported and were also dependent upon the breadwinner. With the passage of the 1939 Social Security amendments, survivors, namely spouses and dependent children of the covered worker, were covered too (Abramovitz, 1988).

Also excluded, due in part to the types of jobs they had, which tended to be uncovered by Social Security of the time, was the non-white population. They were not well represented in the vocations eligible for Social Security benefits. Moreover, given their lifespan, which tended to be shorter than that of the white population, at least in part because they were more likely to be involved in employment that was physically risky or hazardous to their health, they were less likely to draw Social Security, even when such occupations were finally covered.

A separate insurance plan, although part of Social Security, for workers with disabilities is known as disability insurance (DI). During the Reagan era, DI was at times subject to public criticism as wasteful and excessive – a view that was not shared

by George Ball, who began the DI program in 1956 and subsequently managed it as the Commissioner of Social Security (Parsons, 1984).

What does the public think about Social Security? A major review of public opinion polls has debunked the view that the public's confidence in Social Security is low and declining, support for Social Security is weakening, and that there is growing public support for privatization and incremental reform (Cook & Jacobs, 2002).

Concerns regarding privatization

One of the concerns about privatization proposals is "the slippery slope." While the recent privatization proposal can be seen as modest, a concern is that once the basic concept is accepted and put into practice it is likely to become more drastic or radical in future years as it becomes more entrenched and more rewarding to its sponsors. It is plausible that numbers, eligibility, and benefits will change, and what appeared to be reasonable in its origin subsequently could become a major undoing of Social Security.

Furthermore, it is likely that privatized accounts would have differing consequences for different persons, such that those with existing financial expertise would be more likely to benefit from such a change (be better-off) and those without such expertise would suffer (be worse-off). The Health and Retirement Survey showed that "the better-educated, higher-income, white, and married respondents are more likely to ask for information about Social Security benefits" (Lusardi, 2004, p. 164). Indeed, many people are likely to make disadvantageous investment choices (Odean & Barber, 2000).

In 2000, Sweden partially privatized its Social Security system similar to President George W. Bush's plan (Cronqvist, 2006; Cronqvist & Thaler, 2004). Through a multi-million-dollar advertising campaign, Swedish participants were encouraged to choose their own portfolio by selecting up to five funds from an approved list. Participants who were not well informed and well motivated were unlikely to benefit from having many investment choices. Fund advertising was mostly uninformative in a way that would help participants make sound investment choices; affected portfolio choices even if the advertisements provided no useful information; was associated with higher fees and lower net-of-fee returns; increased risks through higher exposure to stocks, more active fund management, and more local concentration of fund choices; and did not lead to higher post-advertising, risk-adjusted returns. Given its experiences, including participants' overwhelming choice of the default option, Sweden recently discontinued its efforts to encourage active investment choices by the public.

Many concerns exist regarding Social Security privatization. The greatest concern is that privatization has the potential to bring about economic harm and suffering to large numbers of persons. This is especially due to the large and perhaps unmanageable financial market risk in a private retirement system (Burtless, 2002). The chief advantage of a public system is that it is able to spread risks over a much larger population of contributors and beneficiaries.

Two: Social Security serves as a counterweight to more extreme, even revolutionary, social change, which could undermine democracy. This belief underlied FDR's proposals (Fisher, 1980).

Three: Social Security represents a way of compensating for the inherent shortcomings of charity and provides an alternative to it. Social Security can provide lifelong income to a greater degree and with greater regularity than charity, contributions to which are remarkably prone to the vicissitudes of sentiment. The privatization proposals to

Social Security threaten to undermine universalistic and socially egalitarian social welfare (Esping-Andersen, 1990). While privatization proposals are universalistic on their surface, in consequence they would probably be particularistic; highly differentiated levels of income would probably ensue. Experience with privatization in the United Kingdom suggests that it increases income inequality and leads to lower pension benefits for many low-wage workers, especially women (Budd & Campbell, 1998; Williamson, 2000).

Four: despite its prevalence, to many people poverty is no longer considered a significant social problem in the United States. According to the *Washington Post* (Eberstadt, 2006), “a greater portion of families and children live in poverty in America today than three decades ago . . . [there has been] a prolonged failure of national policies to address poverty in the United States.” Diamond (2002, p. 51) noted that the poverty rate for elderly widows is at least three times as much as it is for elderly couples. With all the affluence, including the great rise in the number of very wealthy persons, there is, once again, an unawareness of the persistence of poverty. Even now, there is an indifference to poverty (Maharidge, 2006).

Five: the move to privatization represents an undoing of one of our society’s great social policy achievements (Berkowitz, 2003). In effect, it will probably reduce social cohesion and exacerbate Social Darwinism. It will take a great social program and reduce it to one which promotes individualism.

Six: in the 1930s, the term “social security” and its meaning gained renown through the writings of Abraham Epstein and Isaac Max Rubinow, who advocated for a comprehensive, national system of social insurance to help people cope with childbirth, disability, illness, old age, supporting a large family, and unemployment (Klein, 2003, p. 80). The proposed changes would in effect lead us to develop a program that would be Social Security in name only; it would neither be truly social, nor would it really provide needed security.

Seven: the offering of, as well as the responses to, privatization proposals are politicized. The reading of the situation or “crisis” of Social Security and the proposed solutions imply an objective reality that is more predictable than is actually the case. Even the ranges reported by the Social Security Board of Trustees (2006, p. 45) “won’t necessarily define reality, which may emerge beyond it.” The ability to predict the long-term stability of the Social Security trust funds is questionable (Karger, 1996, p. 28).

One of the arguments put forth is that the private sector is more efficient and effective than the public sector. However, private pension funds have their own risks and inefficiency. In reality, with the costs of administering Social Security at only about 1% of total expenditures, it is a highly efficient program. Inevitably, individual accounts would have higher administrative costs than Social Security trust investments, thereby reducing investment return (Diamond & Orszag, 2005b). A feature of privatization is that of worker choice of investments; however, choice is directly associated with higher administrative costs (Diamond, 2002) that are likely to be paid for by reduced benefits for recipients.

Orszag and Stiglitz (2001) critiqued the World Bank (1994) report *Averting the Old Age Crisis* for recommending one solution – privatization – for every country around the world, despite major differences in society, culture, and economy. They also critiqued the report for tending to judge public Social Security systems as having systemic problems, and private systems as having remediable problems. They also said that doing nothing to reform Social Security was also acceptable. Orszag and Stiglitz presented 10 myths about Social Security, as follows:

- (1) Individual accounts increase national saving.
- (2) Rates of return are higher under individual accounts.

- (3) Declining rates of return on pay-as-you-go systems reflect fundamental problems.
- (4) Investment of public trust funds in equities has no macro-economic effects.
- (5) Labor market incentives are better under individual accounts.
- (6) Defined benefit plans necessarily provide more of an incentive to retire early.
- (7) Competition ensures low administrative costs under individual accounts.
- (8) Corrupt and inefficient governments provide a rationale for individual accounts.
- (9) Bailout policies are worse under public defined benefit plans.
- (10) Investment of public trust funds is always squandered and mismanaged.

Ironically, the federal government might be subject to greater costs under privatization. Given that privatization is unlikely to be fully functional for all people, the government, which is beholden to the public, would probably have to intervene to cover shortfalls by creating new social programs (Weller, 2006). In privatized Social Security it would not be inconceivable that the government would be the provider of last resort, assuming the costs of taking care of some persons who do not actually receive the Social Security benefits to which they are entitled.

Traditional annuities, including those under either defined benefit or defined contribution plans, are not protected against the effects of inflation (Bodie, 2003, p. 29). This is a risk for employer-sponsored plans. Losses to recipients are even more likely if companies attempt to offer inflation-protected plans. One can imagine the scenario if, under such a plan, inflation rises quickly and the invested funds do not maintain commensurate value. The company is bound to provide inflation-indexed benefits. Either the private company or the recipient, or both, would be hurting. Given that sufficient funds would be unavailable from the investments, the company would have to absorb the losses in the short term, raise its fees, or seek redress from the federal government to meet its obligations.

Nationally, according to the Board of Trustees (2006, p. 90) for Social Security, there has been a “trend away from defined-benefit pension plans that often provided incentives to retire and toward defined-contribution plans...” Consequently, there has been additional upward pressure on labor force participation rates. At the same time:

the aging of the population is expected to both increase the demand for workers and, through improved health associated with greater life expectancy, improve the ability of the older population to work. Longer life expectancy will also increase the amount of assets that will be needed to live comfortably through retirement years, also influencing workers to stay employed longer. (Board of Trustees, 2006, p. 90)

Introducing a defined-contribution plan for Social Security seems to be no different from what is occurring in other social insurance and pension programs. However, in contrast to defined-benefit plans, defined-contribution plans contain two substantial sources of risk: the much-greater risk of outliving one’s resources, and the investment risk. While investing for retirement is a long-term matter, the vicissitudes of the stock market, whose volatility in the short term is well known, can readily harm the financial well-being of investors and pensioners. Under privatization, money would be invested without voting shares in the business. This is undemocratic and undermines the discipline of the marketplace as there would be no adequate fiduciary responsibility. An individual dissatisfied with the current governance of a company can sell out or speak up at the stockholders meeting. Large sums of money would be invested under privatized Social Security without adequate control.

Conclusion

Social Security is not in a crisis *per se*. Incremental policy changes should be adequate to handle the projected financial shortfall in the future. To substitute individual savings accounts for Social Security is likely to widen social and economic class differences, and result in financial hardship for the most vulnerable members of society – those who are unable to take care of themselves, financially and otherwise. The transition costs of transferring to such a system would be in the trillions of dollars and would have to be borne by generations of taxpayers, with dubious financial benefits to the public (Hacker, 2006). Privatization advocates have been remarkably quiet about such costs, giving the appearance that they are truly not interested in saving Social Security as we know it (Hardy & Hazelrigg, 2007, p. 163). When Social Security has experienced challenges in the past, it has been reformed by a series of legislative acts that improved its coverage and equity. With relatively modest changes, Social Security will continue to be viable. Basic, structural change is unnecessary for Social Security and has the potential to harm many people. It is debatable whether recent proposals would allow Social Security to continue to serve the public.

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