

# What Would REALLY Happen Under Social Security Privatization?

## *Part II: Millionaires One and All?*



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### **The Privatization Calculator**

Suppose you were born in 1971 and you're earning \$35,000 a year. How much would you collect in your retirement if Social Security were privatized? The Cato Institute, the libertarian Washington think tank that has been sounding the drumbeat for privatization for years, offers a handy calculator on its website that will give you an answer with the click of a few keys. Using Cato's default assumptions, if you put your Social Security taxes into a stock fund every month, you would retire with a nest egg of \$1.26 million (in today's dollars), and a monthly income of more than \$10,000.

Americans will be hearing a lot about that beckoning pot of gold in the months ahead. President George W. Bush has created a commission to examine the future of the Social Security program, but the commission is comprised exclusively of members who want to transform Social Security from today's insurance program into something like the collection of private investment accounts touted by Cato.

Unfortunately, the case for privatizing Social Security is built on claims that are either misleading or simply false, which should raise serious questions about the risks associated with a fundamental overhaul of one of the nation's most successful and popular programs.

So what's wrong with Cato's calculator?

- First, it assumes that *all* of your Social Security taxes would be invested. That is impossible. Most of the Social Security payroll taxes you pay today are used to pay today's Social Security beneficiaries. That money cannot be shifted immediately to private accounts without turning off the spigot for older Americans, disabled workers, and their families. Simply put, the price of your private account would be the elimination of your grandmother's or your father's Social Security check. No one, not even the Cato Institute, wants to do that. The small portion of our Social Security taxes that are not paid out immediately are used to bolster the Social Security trust funds that will be needed to meet commitments to the baby boomers, who will soon begin to retire. There is no extra money for private accounts in Social Security taxes. Every dollar, and more, is needed to meet existing Social Security promises. (See Part I of this series.)
- Second, the calculator ignores the turbulence and fluctuations that investors face in the stock market. It mechanically implies that every investor does very well. In reality, in financial markets there always are

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winner and loser. Some workers will draw losing cards, perhaps because they played poorly, or perhaps because of bad luck. If you end up retiring during a market downturn, you may wind up using a calculator to figure out how to make ends meet rather than counting your millions.

- Third, Cato's calculations not only make the questionable assumption that the high past growth rates of stock prices will continue, but also that all of the increased value will go directly to stockholders. Anyone who invests in a mutual fund knows, or should know, that commissions, marketing, and administrative costs significantly reduce what ends up in your bank account. Those fees require a subtraction of tens of thousands of dollars from the calculator's result.

### **Hidden Pitfalls: Administrative Costs and Market Risk**

#### *Where to Find the Real Millionaires: Wall Street*

Brokerage houses, banks, and mutual funds have been very active in the campaign to privatize Social Security. Small wonder, since they stand to gain enormous fees if billions of dollars are shifted each year from Social Security payments into accounts under Wall Street management. Of course, those fees must come from somewhere, namely from the balances in individual accounts.

Among the 100 best stock mutual funds,<sup>1</sup> management fees range from 0.2 percent per year to 1.4 percent of the asset value of an account. The average is near the high end of that range, however, and many mutual funds charge substantially more. Smaller accounts require proportionately larger management fees because many costs such as gathering and mailing out information don't depend on account size. Indeed, most mutual funds actively discourage small accounts by setting a minimum opening deposit of \$1,000 to \$3,000.

From the standpoint of the system as a whole, privatization would add enormous administrative burdens. Instead of the current trust fund accounts, the government would need to establish and track many small accounts, perhaps as many accounts as there are tax-paying workers—147 million in 1997.

Many worker's accounts would be so small that they would be of no interest to profit-making firms. The average taxable earnings of a worker is roughly \$25,000 (in 1997, the last year with complete data, the average taxable earnings of the workers who paid into the system was \$22,400). Two percent of \$25,000 comes to \$500 per year. Francis X. Cavanaugh, who supervised the thrift savings program for federal employees—a program that privatization advocates often point to as a model—argues that the costs of administering so many small accounts would overwhelm any benefits to be gained from the stock market. For example, he estimates that the government would need to hire 10,000 highly trained workers just to oversee the accounts and answer questions from workers.<sup>2</sup>

Experience in the United Kingdom offers a warning about what the future could bring regarding management costs. Workers there have been allowed to open private accounts starting in 1988, since which time management fees and marketing costs among financial intermediaries have eaten up an average of 43 percent of the return on investment.

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<sup>1</sup> As selected by *Consumer Reports* magazine in March 2001.

<sup>2</sup> Francis X. Cavanaugh, Statement before the Senate Budget Committee, July 21, 1998.

### *Timing Is Everything*

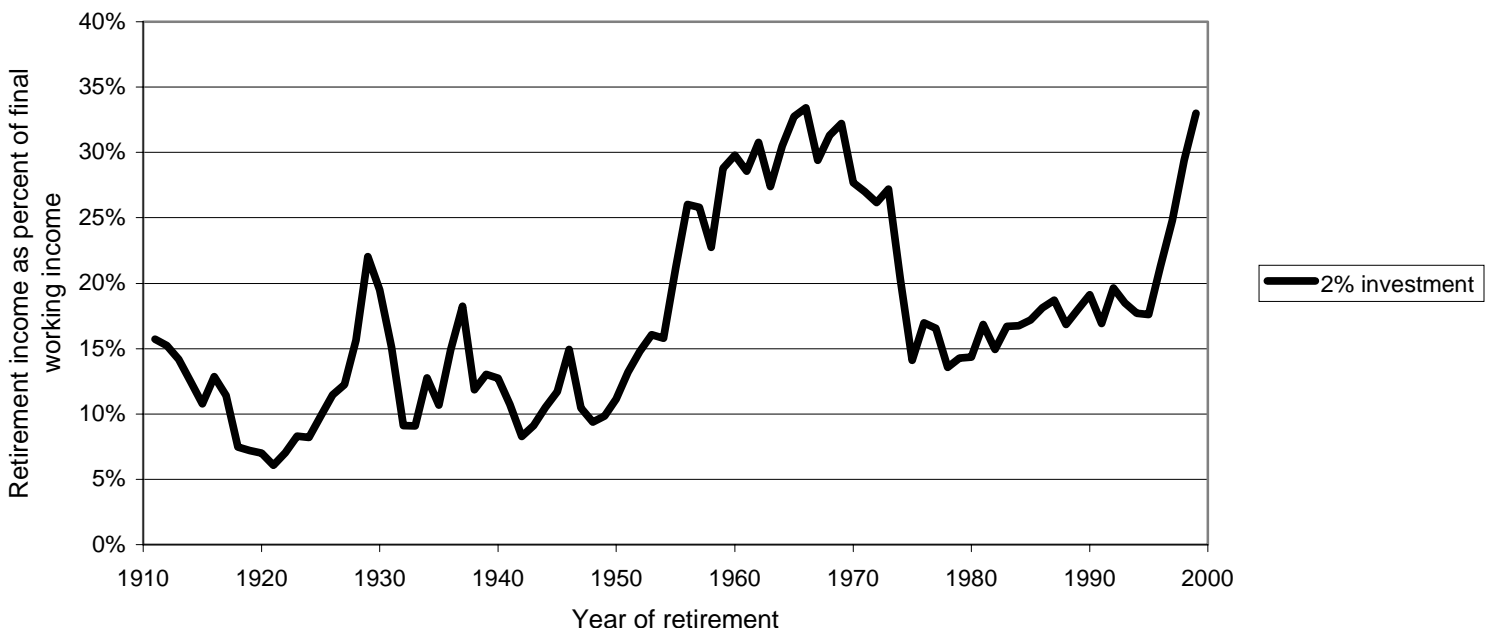
Besides being costly, individual accounts would be risky. In the unlikely case that Americans need to be reminded, stock market returns are not a sure thing. A worker who invested his or her retirement fund in a stock portfolio that matched the S&P 500 index and cashed out upon retirement in March 2000 would have a nest egg almost a third larger than someone who retired just a year later using *exactly* the same investment strategy. Of course, that is because the stock market plunged over those twelve months.

Market volatility means that it would matter a great deal whether you retired during an upswing or downturn. Gary Burtless of the Brookings Institution demonstrated this by examining what would have happened to workers with forty-year careers who retired in each year from 1911 until 1999. Following Burtless' method, Figure 1 assumes that each worker put 2 percent of his or her earnings in the stock market every year (reinvesting dividends) and earned the actual historical return, year by year. The figure shows the wide variation in the retirement income workers would have received. Clearly, some workers would do much better than others based simply on when they happened to retire.

Because of the volatility and unpredictability of stock market returns, it is difficult to compare directly what any given worker would receive under privatization versus the current system. Today, a low wage-worker who retired would receive Social Security benefits equal to 90 percent of preretirement income, while a worker making the average wage would receive 42 percent.

Under privatization, timing obviously would matter a great deal in determining who would win and who would lose compared to the current system. So would the unknown amount of any guaranteed benefit that might be offered over and above the assets accumulated in the private accounts. But because most privatization proposals do not identify how any guaranteed supplement to the private accounts would be financed, it is unsafe to assume that they would bridge the gap between the horizontal line and the jagged line. Again, paying for

**Figure 1. Retirement Income from Investment in the Stock Market**



new private accounts out of payroll taxes requires reducing the promised payments to current and future beneficiaries.

### *A Rose-Colored Crystal Ball?*

In spite of market ups and downs, stocks were on average an excellent investment over extended time frames in the twentieth century. The Social Security Administration's chief actuary has used the high returns over the 1926–98 period as the basis for official forecasts, projecting an annual return of seven percent above the rate of inflation.

But will the next seventy-five years look like the past seventy-five years in stock market performance? Not very likely. In spite of the market's significant decline since its peak early in 2000, stocks still are very high priced, based on measures such as historical price-earnings ratios and dividend levels. This alone suggests that the stock market will have difficulty generating 7 percent annual gains in the foreseeable future.

Moreover, experts such as the chief actuary himself project modest and declining economic growth. Professor Peter Diamond of the Massachusetts Institute of Technology suggests that 4.0 percent to 4.5 percent per year is a much more realistic forecast of stock returns over the next seventy-five years.<sup>3</sup> Another expert, Dean Baker of the Center for Economic and Policy Research, has calculated that returns of 3.0 percent to 3.6 percent is the range that future profit growth would support. Even at 4 percent per year, stocks would be a good investment, outperforming bonds. But stocks still would be much more risky. The idea that, win or lose, a worker would do better in the stock market than under Social Security is nonsense. Individual accounts on average are likely to have a modest rate of return and a great deal of risk. On average, taxpayers will not gain much for giving up the "security" in Social Security, and many families surely will lose out.

## **Other Bugs in the Privatization Calculator**

### *Special Risks to Women*

In today's Social Security system, a spouse—almost always the wife—who leaves the paid workforce to raise children is still entitled to a benefit upon retirement equal to half her husband's benefit. Even a divorced spouse outside the workforce has pension rights today under Social Security. But under most detailed privatization plans, a woman outside the paid workforce would have no pension rights at all—nothing beyond what her husband might give her from his personal account.

Moreover, because women have longer life expectancies than men, the assets accumulated in their accounts need to be stretched out over a greater number of years to sustain them. In essence, that reduces the value of every dollar in their accounts relative to those of men. In contrast, projected life spans do not affect benefits under today's Social Security because monthly payments are guaranteed for life and are based entirely on the best thirty-five years of past earnings.

Finally, women earn less than men, on average. That implies that they would make smaller contributions to their individual accounts, leaving them with relatively less upon their retirement. In contrast, today's Social Security replaces a higher share of the past earnings of retirees who had lower incomes.

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<sup>3</sup> Professor Diamond believes that a market correction followed by resumption of more rapid growth is a likely scenario. Such a correction might take the form of a decade during which real stock prices would not increase.

## *Taking Your Lumps*

Most Americans have no idea what an annuity is. A product of the insurance industry, an annuity converts a lump sum of money today into a stream of monthly payments in the future.<sup>3</sup> For example, in the best-case scenario presented in Table 1, a nest egg of \$104,858 converts into an annuity paying \$870 a month.

Because annuities seem obscure and technical, they do not come up in most discussions of individual accounts. But they are essential. Almost every proposal for individual accounts to replace Social Security includes a section about annuities. It would be extremely unwise to replace Social Security with a system that did not include mandatory annuitization. If retirees had full control of their nest eggs, what would happen to their families if they exhausted the savings in their accounts, either through mismanagement or perhaps through deliberate overspending? Requiring workers to purchase annuities when they retire ensures income for the rest of their lives not only for them but for their families. More fundamentally, annuities protect taxpayers from footing the bill if a retiree drives his family into poverty.

Today, few annuities are sold to retirees because Social Security serves as their basic monthly support. Moreover, no annuity product offers the protection against inflation that Social Security provides. Every year, Social Security benefits are increased for everyone by a percentage equal to inflation in the previous year. Annuities, in contrast, provide a payout that does not rise with inflation—so inflation eats into their value. (This is one more element of privatization that threatens those who live to an old age, notably women.)

It is difficult to predict what annuities with inflation adjustments would cost under privatization, since the demand for them would suddenly explode. But experts estimate that converting a lump sum into an annuity would probably cost more than 10 percent of the value of the account. In today's thin market, the cost of annuities without an inflation adjustment can even exceed 15 percent of the value of the lump sum.

The need to provide annuities also would create the need for an entirely new regulatory framework and bureaucracy. Would it be legal to offer lifetime annuities at a lower cost to people with shorter life expectancies? This is unlikely to be tolerated by the public. Most likely, different prices for men and women, as well as various racial and ethnic groups, would be deemed discriminatory and unacceptable.<sup>4</sup>

## **The Bottom Line**

Let us take out a calculator of our own and figure out what would happen to a worker beginning a career at the the average taxable income of \$22,400, if wages grew at 2 percent per year above inflation, and 2 percent of his or her earnings were put into an individual account. The table below shows the results using two sets of assumptions.

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<sup>3</sup> Think of an annuity as an upside-down life insurance policy: instead of paying periodically for an uncertain number of years and getting a lump sum in the end, with an annuity, the customer pays a lump sum at the beginning to receive a stream of periodic payments of uncertain length.

<sup>4</sup> Without restrictions, for a given initial payment, annuities would tend to offer men higher monthly income than women, and African Americans higher income than white Americans. Annuity payments would vary inversely with life expectancy.

**Table 1. Results with Private Social Security Accounts**

	Assumptions				Results		
	Return on Stocks	Management Costs	Years Worked	Cost of Annuity	Nest Egg at Retirement	Monthly Payment	Replacement Rate
<i>Best case</i>	7%	0.15%	40	5%	\$104,858	\$870	22%
<i>Realistic case</i>	4.5%	1%	35	10%	\$35,850	\$237	7%

If everything goes ideally—the return on investment really is 7 percent above inflation, expenses are only 0.15 percent of asset value, the worker’s career is forty years, and he or she can convert his or her nest egg into a single life annuity at a minimal 5 percent cost -- then the worker will accumulate about \$105,000 for retirement, which will produce income of \$870 per month, about 22 percent of his or her final rate of pay.<sup>5</sup> That’s much less than today’s guaranteed benefit, recognizing that some supplement may be offered under privatization plans.

Now suppose that the real rate of return is 4.5 percent per year, management expenses are 1 percent, the worker is in the labor force only thirty-five years, and the annuity costs 10 percent of the nest egg. In this very plausible case, our worker will receive only \$237 per month, or just 7 percent of his or her final paycheck.<sup>6</sup> That is well below what Social Security now offers. Such a plan also carries tremendous risk, and not only from market fluctuations. Neither in this case, nor in the best case, are there any provisions for survivors. An annuity that offers survivor protection would offer monthly payments considerably lower than these.

Advocates of individual accounts claim to be offering a windfall. But a full accounting of their plans suggests they may be leading today’s workers simply to a long, painful fall.

### *Conclusion*

Compound interest is a wonderful thing. If we gave up feeding our children dinner and instead put \$5 per day into a high-yielding account, it would be much easier to pay for their college educations. It is not rocket science to recognize that when we save money, instead of spending it today, it does build up. By the same token, if we took all the money intended for current retirees and put it into our own accounts, it would easily fund our retirement. But, to return to our children, they would do poorly without dinner tonight. And our parents need

<sup>5</sup> The best case is very unlikely; it assumes not only that stock returns are high and costs minimal, but that 100 percent of the worker’s assets are in stocks. In reality few would choose such a risky portfolio. A lower share in stocks would mean lower average returns. It further assumes that the annuity would continue to earn 7 percent, rather than reflecting a low-risk strategy by the issuer of the annuity. The replacement rate is relative to earnings at retirement.

<sup>6</sup> These figures pool all annuitants. If private insurers could issue annuities differentiated by gender, then women, who live longer than men on average, would receive only \$837 and \$225 in the best and realistic cases, respectively. Men would receive more, \$908 and \$250, respectively. These figures vary only life expectancy, assuming the same earning history for men and women; in reality, women on average earn less per year than men and spend fewer years in the paid labor force.

their pensions as well. Diverting payroll taxes to individual accounts would starve the Social Security trust funds, hastening the day when they would be exhausted.

If one downplays responsibilities to today's retirees and older workers, assumes a high enough return on saving, ignores investment risk, ignores management costs, ignores almost everything except compound interest, privatization of Social Security can promise fabulous wealth. But this is no program, it is a mirage.

Without sensational luck in stock returns, and great innovation in financial markets, diverting two percentage points from Social Security payroll taxes to establish private accounts would be entirely inadequate to meet future retiree's minimal needs. The result would be a gutted Social Security system coupled with grossly inadequate private accounts. The idea that private accounts would make us all rich is a siren song that can lead hardworking people onto financial rocks that will shatter their retirement dreams.

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