

# THE SOCIAL SECURITY NETWORK

## What Would REALLY Happen Under Social Security Privatization?

### *Part III: IRAs and 401(k)s You Can Not Control or Leave to Heirs*



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Advocates of Social Security privatization often claim that private accounts would enable workers to own and manage the money they now contribute as payroll taxes. Workers purportedly would have an almost unlimited range of assets that they could buy and sell for their retirement portfolios, whenever they chose. Retirees would be entitled spend their assets as they wish, and to leave their heirs whatever remains. In short, these advocates claim, Social Security would be much like Individual Retirement Accounts (IRAs) or 401(k) plans.

Professor Charles E Rounds Jr. of Suffolk University, a privatization advocate, describes his vision of the property rights that citizens would enjoy with private accounts:

“[W]orkers would have true property rights in individual accounts. Not only would such accounts earn much higher rates of return, and therefore greater retirement benefits, through private investment, but also those benefits would be the worker’s property. Because a worker would own his retirement nest egg, the government...could not chip away at it or take it away altogether...Funds in an individual account would be fully inheritable, like any other property in an individuals estate.”

This has been one of the appeals of Social Security privatization: workers would be able to control their own money instead of turning it over to the government, and ultimately they could transfer their accounts to their heirs upon death.

But the claim of enhanced control and ownership is greatly exaggerated. The details provided in the privatization proposals put forward in Congress to date (in the cases where claims are backed by programmatic detail) demonstrate that workers would actually have little or no control over 1) how the assets are invested, 2) what would happen with the nest egg upon retirement, and 3) what would happen with any remaining assets upon death.

Why do the actual detailed plans differ so much from the rhetoric of privatization promises? To understand why, consider this: who might lose as a result of individual control? Clearly, a worker or retiree’s family will suffer if the worker blows “his” nest egg? And the indirect repercussions of mismanagement don’t stop with dependents of a worker or retiree. Taxpayers stand to lose as well, since we will not permit the spouses and other dependents of those who receive Social Security to sink into poverty.

Individual control is a two-edged sword: the power to manage your nest egg is the power to leave your family impoverished, without the safety net that Social Security provides today. If workers really were given the sort of control over individual accounts that supporters talk about, the safety net for families of workers and for long-lived old people would be significantly compromised. As we emphasize repeatedly in our analyses, Social Security is not just a pension system, it is an insurance system for

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workers and their dependents. The integrity of this insurance system requires limits to ownership, or an alternative safety net with alternative sources or finance.

Table 1 summarizes how plans for a privatized system typically have far more in common with today's Social Security than with IRAs and 401(k)s. In this paper we will develop the idea that such limits on individual accounts to replace Social Security are all but unavoidable.

**Table 1. Social Security, Individual Accounts, And Saving Accounts**

	<b><i>Amount of Contribution per Year</i></b>	<b><i>Investment Assets</i></b>	<b><i>What Happens to Nest Egg at Retirement?</i></b>	<b><i>Retirement Income Depends on</i></b>	<b><i>What Happens at Death</i></b>
<b><i>Social Security</i></b>	<i>No choice.</i> Mandated rate of contribution.	<i>No choice.</i> The SS Trust Fund invests in Treasury Bonds for everyone.	<i>No choice.</i> There is no "nest egg" to manage upon retirement, only a guaranteed monthly annuity income.	<i>History of earnings</i> Pension depends on 35 years with highest earnings.	<i>No bequest.</i> Guaranteed support for survivors.
<b><i>Individual Private Account Replacement for Social Security</i></b>	<i>No choice.</i> Mandated rate of contribution. (Some plans allow extra contributions, but extra saving is possible in any system.)	<i>Very limited choice.</i> A worker could chose, perhaps once each year, among a few, approved investment funds.	<i>No choice.</i> Workers would be required to convert all or most of their nest eggs into guaranteed monthly annuity income.	<i>Value of individual account.</i> Pension depends on earnings history, market returns net of management costs, and market conditions at time of retirement.	<i>No bequest</i> out of nest egg used to provide guaranteed monthly income. (Possible bequests out of excess savings or by workers who die before retirement.)
<b><i>IRAs/ 401(k)s Private Savings</i></b>	<i>Broad choice.</i> No minimum saving rate.	<i>Virtually unlimited choice</i>	<i>Virtually unlimited choice</i>	<i>Value of individual account.</i> Nest egg depends on earnings history plus market returns net of management costs, plus market conditions at time of retirement.	<i>Virtually unlimited bequest options.</i> No guaranteed support for survivors

Workers might not gain much with a system of individual accounts, but how much could they lose? A lot. Individual accounts would bring a great deal of risk, most evident in the loss of many Social Security guarantees:

- Workers' benefits in their retirement years would become tied to the ups and downs of the stock market instead of simply their earnings during their working years.

- Inflation could erode the value of the savings in the retirement accounts, unlike Social Security payments that increase at the inflation rate.
- Workers and their families might no longer be guaranteed the same protections that Social Security provides in the event they become disabled or die during their working years. (See [Part IV.](#))
- Support of spouses and survivors of retirees might no longer be guaranteed.
- On top of all that, paying for privatization would place enormous new financial strains on the entire government as well as the Social Security program (see [Part I](#)).

### **WHY EVEN PRIVATIZERS WON'T LET YOU SINK OR SWIM**

As Table 1 summarizes, a system of individual Social Security accounts still can be expected to impose significant restrictions on the management of individual accounts. These restrictions are necessary not for paternalistic reasons -- to protect a saver from himself -- but to protect his family and the taxpaying public.

Today's Social Security system provides basic insurance for every worker -- a minimal retirement income (the average monthly benefit is less than \$850), and support for survivors, disabled workers, and their families. As the basic source of income protection for the nation's families, Social Security does not have a lot of margin for making mistakes. It provides more than half of the income for 60 percent of households headed by retirees. For an additional 17 million spouses and children who today are dependents of disabled workers or survivors of deceased workers or retirees, Social Security benefits provide essential support.

If that support evaporated for any reason, the nation would face an unimaginable crisis, with millions of old people and children deprived of their basic income. For those reasons, any alternative to Social Security must still provide an adequate safety net, even for the families of workers who are irresponsible, unlucky, or just bad investors.

Because the average taxpayer would have to pick up the pieces, and the tab, if a redesigned safety net were to fail, everyone has a big stake in how people would manage their resources in a privatized Social Security system. That is why "private" accounts would be so heavily regulated in most of the proposals that have been put forward. Plans like IRAs and 401(k)s that provide supplementary retirement income allow much greater flexibility precisely because investors who lose all their money in those accounts have Social Security to fall back on.

Two other countries -- the United Kingdom and Chile -- privatized their national retirement programs in ways that allowed individuals to make a wide range of investment choices with quite limited regulation. In both cases, many thousands of unsuspecting workers lost large portions of their nest eggs, to unscrupulous, high-cost private investment companies. Thousands of others, especially in the U.K. fared poorly because they simply made bad investments.

The unsuccessful experiments in the U.K. and Chile underline the dangers in the appealing rhetoric at the outset of this brief. As a result of this dilemma, in the United States so far, actual privatization plans -- as opposed to privatization rhetoric -- greatly limit individual control. But even highly regulated privatization systems, like the ones being proposed for this country, carry costs that heavily outweigh the potential benefits.

## **RESTRICTIONS ON INVESTMENT CHOICE, ACCESSING THE NEST EGG, AND BEQUESTS**

Table 2 shows for important recent legislative proposals the sort of restrictions that we should expect for individual accounts.

**Table 2. Recent Privatization Proposals<sup>1</sup>**

	<b><i>Amount of Contribution per Year</i></b>	<b><i>Investment Assets</i></b>	<b><i>What Happens to Nest Egg at Retirement?</i></b>	<b><i>Retirement Income Depends on</i></b>	<b><i>What Happens at Death</i></b>
<b>Archer-Shaw</b>	2 percent of taxable payroll, paid out of general revenues	50 pre-approved investment vehicles, each comprised of 60% indexed equities and 40% corporate bonds with fees limited to 25 basis points	Annuity purchase required at retirement	Annuity or SS guarantee, whichever is larger	Balances of retirees transferred to spouse or returned to Trust Fund to finance survivor and disability benefits. Bequests possible in case of death before retirement. <sup>2</sup>
<b>Gregg-Kerrey-Breaux-Grassley (S. 1383)</b>	2 percent of taxable earnings carved out of SS taxes, plus up to \$2000 additional voluntary contributions	Modeled on Federal Thrift Savings Plan (TSP) for government employees. Initially, investment options would include a stock index fund, a bond index fund, and a fund invested in Treasury securities. TSP has five index fund options:  G-government bonds  F-diversified bonds  C-common stock  S-small capitalization stocks  I-international stocks	Annuity purchase required at retirement to provide family with poverty-level income. Any excess accumulation may be disposed of as desired.	Annuity income, plus SS income based on pre-reform SS contributions, adjusted for annuity income. New benefit formula tilted more to low-income retirees.	No bequest from annuity. Excess accumulation and accumulation before retirement may be bequeathed.

<sup>1</sup> A number of other bills are similar to these. Kolbe-Stenholm (HR1793) is similar in almost every respect to Gregg-Kerrey-Breaux-Grassley (S. 1383). On the issue of disposition of the nest egg, all the bills we have studied, including Sanford (HR. 249), Smith (HR. 3206), and Porter (HR. 874) require purchase of an annuity to provide the family at least poverty level income.

<sup>2</sup> It is not made clear how any bequeathable balance would exist in an annuity, since the annuity payments to those who live long are only possible because others die young. The Archer-Shaw proposal never was introduced as legislation, so we consider this contradiction a loose end.

## No Wheeling and Dealing Allowed

The public has an interest in preventing individuals from putting their safety net savings into pork belly futures or even shares only of NASDAQ high flyers. For other saving, every family can sail or sink its own boat -- but not for safety net saving. That is why actual privatization proposals such as those in Table 2 require that families be given a choice of a few large investment funds. Even when a larger number of options are offered -- as in the case of the Archer-Shaw plan -- the quantity is illusory because all of the funds have roughly the same asset allocation. All the funds would be variations of index funds; no stock picking would be permitted by either individuals or portfolio managers. The selection would be far more limited than brands of breakfast cereal.

With individual investor's savings pooled and all invested in similar assets, we would have a system very similar to one in which everyone's assets were held in a Trust Fund and invested in a broad index of stocks and bonds. That is basically what we have today, except that the law requires the Social Security Trust Fund to hold only bonds.<sup>1</sup>

If workers were to be given freedom to choose not only index funds but riskier investments as well, the public would have to be prepared to provide income for those families that lose their nest eggs. That would open a Pandora's box: families could take wild risks with their retirement funds, knowing that they can only win, because taxpayers will support them if their investments fail.

## The Untouchable Nest Egg

Because of the danger that families will lose their safety net saving, privatization plans typically require everyone, upon retiring, to use their nest egg to guarantee a monthly income for the remainder of their lives. If this were not done, retirees could outlive their nest eggs, or even squander them, requiring taxpayers to bail them out. To provide adequate income for the rest of each retiree's life, each worker who retires must use all or part of his or her nest egg to purchase an *annuity* -- a financial contract (sold by insurance companies) that delivers monthly checks for as long as someone lives in exchange for a lump-sum payment today.

The annuity market is very thin now, with relatively few bought and sold. But such a market would probably develop under privatization, possibly leading to the creation of annuities guaranteed against inflation. In the best case, the system after privatization would deliver a stream of income that behaves similarly to what we have today with Social Security.

But the requirement that lump-sums accumulated in retirement accounts be converted into annuities further undermines that claim that privatization would provide new freedom and flexibility to retirees. In practice, most retirees shopping for annuities would be likely to envy today's arrangement. Instead of seeing 10 percent or more of the value of their nest egg disappear in annuitization fees under privatization, workers today collect payments virtually undiluted by administrative expenses, marketing costs, or profit margins.

Moreover, the purchasing power of annuity payments under privatization will greatly depend on such factors such as interest rates at the time of retirement, life expectancies, and inflation. None of those unpredictable forces influence a retiree's monthly Social Security check today. Under today's Social Security, monthly payments are based entirely on what you earned during your working years, plus increases during your retirement to protect you against inflation.

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<sup>1</sup>If the law were changed, the trust funds could be invested partly in a broad index of stocks. Diversification of the Social Security trust funds into index funds of stocks would deliver the same returns as private accounts that hold these funds, but with much lower management costs. Whatever returns may be available to investors through stock market index funds, the Social Security trust fund could reap them too.

## No Need to Rewrite Your Will

An important attraction of private accounts is the prospect of leaving an inheritance, whatever might remain of the nest egg upon death. But a look at the fine print of specific privatization plans shows that retirees would have little or no such opportunity. That's because the requirement of converting the lump sum in the account to an annuity leaves nothing to pass on to your heirs, even if you live for only a short time. Your monthly payments would expire when you expire.

The reason for this is that the price of an annuity reflects the fact that some people die young and some old. If retirees who die young were permitted to leave their annuity to survivors, where would the money come from to continue payments to those who die old? A worker who dies before retirement might be permitted to bequeath the balance in his retirement nest egg. But when a worker retires and buys an annuity, the risk of death is pooled with others the company sells, and no bequests are allowed.

It's important to note that when a retired husband or wife dies under today's Social Security, the surviving spouse continues to receive a reduced benefit that may be substantially more than what he or she would have collected had they never been married. Most privatization plans developed to date give no indication of the extent to which they would replace lost benefits to a retired surviving spouse. Although legislative proposals to privatize Social Security have generally included mandatory purchase of annuities, none of those plans have built in a joint annuity, which would provide income not only to the retiree but to the surviving spouse. Such an annuity would deliver substantially lower monthly income for the same nest egg.

## **CONCLUSION**

So what are we left with? Table 2 details the specifics of a few privatization proposals. As it shows,

- the owner of a privatized Social Security account would be allowed to choose from among a few large investment funds;
- at retirement, he or she would be required to buy a contract guaranteeing a monthly income;
- on a retiree's death, the annuity would stop without any specified protection for the surviving spouse; and
- there would be little or no bequest from a retiree's individual account.

Apart from the dubious privilege of bearing the risk of rising and falling markets, and therefore the insecurity of how much retirement income they will receive, retirees get pretty much what they get today from the standpoint of independence and control. Of course, any saving and investing outside of Social Security would remain in the hands of each worker with or without privatization.

A shift from Social Security to private accounts would by no means make every family part of the propertied classes. In those cases where rhetoric has been supplemented with detail, the systems of private accounts proposed as substitutes for Social Security would have so many restrictions that they would be much closer to our current Social Security system than to other private savings such as 401(k) plans. These restrictions are included in the details of proposals for private accounts in order to protect workers' families and the taxpaying public from the consequences of mismanaged private accounts. But even as they introduce only very limited new individual control, private accounts would introduce substantial new risks: erosion of insurance protections against disability and death, the risks of boom and bust in investment markets, increased vulnerability for retirees to inflation, and added pressure on the finances of

the federal government.

“Independence,” “freedom,” and “control,” are attractive ideas to Americans, and advocates of Social Security privatization have exploited those words to sell their proposals. But the fine print of those plans makes clear that they offer no more, and perhaps ultimately less, of each virtue than Social Security already provides.

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