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The Case Against Privatization

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In this Speech, Professor Halperin argues against Social Security privatization by presenting and refuting the major arguments in favor of privatization. Professor Halperin concludes that the risks of privatization are far greater than any potential gains and, instead, supports a plan for enhanced government contributions to retirement savings for low-wage earners through separate individual accounts, in addition to the current level of Social Security contributions.

Social Security taxes collected in 2001 exceeded benefits paid out by more than $150 million, adding to the large balance in the Social Security Trust Fund.1 But this will not be true in the long-run. In about twenty-five years, the Trust Fund balance is expected to begin to shrink.2 Moreover, about forty years from now the Trust Fund will not have enough money to pay all the promised benefits.3 Quite simply, since we are retiring earlier and living longer, there are fewer workers paying taxes for each retiree collecting benefits.

The Social Security shortfall over the next seventy-five years, however, is less than two percent of payroll.4 Balance can be achieved by a combination of tax increases (for example, raising or eliminating the wage ceiling, increased taxation of benefits, adding state and local workers to the system) or benefit cuts (for example, increasing normal retirement age, reducing benefits for high earners, adjusting the method by which benefits grow to reflect the increase in prices or wages). These choices are difficult and controversial, and it is important to have a national debate and develop a consensus for action as soon as possible.

Unfortunately, the debate over privatization and individual accounts is an unnecessary distraction. Individual accounts cannot fix the shortfall. Many have noted that, for the current young, Social Security is a “bad deal” and it will be getting worse for future generations.5 Therefore, some people argue that workers

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2 Id. at 14.

3 Id. at 3.

4 Id.

5 See, e.g., Matthew Miller, Uh-Oh, The New Republic, Apr. 15, 1996, at 20 (stating that employees who are under forty years of age would be better off “investing their payroll taxes for their retirement themselves’’).
will do much better if they invest on their own.\textsuperscript{6} But this is false and misleading. Social Security now has unfunded liabilities of about $10.5 trillion (reflecting very high returns for the early generations of retirees).\textsuperscript{7} Assuming the bulk of promised benefits will be paid, it will be impossible for all future workers to get a full market return on their contributions.

While it is possible that under certain political, importantly not economic, assumptions, individual accounts might help reduce the shortfall, the costs of privatization are far greater than the potential gain. In short, I oppose allocating a portion of the current payroll tax to individually managed private accounts either on an optional or mandatory basis. If this is what is meant by privatization, I am against it.

Social Security wisely guarantees a minimum level of retirement income, indexed for inflation, regardless of market performance. It does not give any individual an option to claim the value of his or her benefits at an earlier time. While there is no scientific way to determine the optimal or desirable level of guaranteed benefits, I believe that we should provide full replacement for the lowest earners and, at least, the current level of benefits for others.

The downside of individual accounts is clear. Individual accounts jeopardize benefits by placing the market risk on the employee. Moreover, administrative costs will be significantly higher. In addition, some elements of the current Social Security system, including disability benefits and survivor benefits, in the event of death prior to retirement, will be difficult to maintain.

Thus, individual accounts involve record keeping, processing of investments, and education as to portfolio choice and distribution options. Currently, employers provide information about individual workers to the Social Security Administration only once a year. Most employers file paper returns, many for only one employee. Employers who have 401(k) plans are generally much larger and more sophisticated. Nearly half of all workers earn under $15,000 and would have very small private accounts.\textsuperscript{8} Therefore, unless uniform flat rates are mandated, administrative costs will be prohibitive. No wonder that recent proposals favor voluntary individual accounts—reducing Social Security taxes and benefits only for those who make this choice.


\textsuperscript{7} Howell E. Jackson, \textit{Accounting for Social Security and its Reform}, 41 \textit{Harv. J. on Legis.} 59, 64 (2004).

Furthermore, by exposing workers to the uncertainties of the market, individual accounts reduce the basic level of guaranteed benefits. Many workers may actually receive fewer benefits. Some workers will invest too conservatively. Others will mistime the market in shifting portfolios. If investments are not restricted, some will make unwise investments or will be the victims of fraud. Moreover, retirement benefits will vary substantially for people of different ages, even for individuals who maintain the same investment strategy. It would have been a lot better, for example, to retire in 1999 than in 2002. This is particularly true if you buy an annuity contract, given today’s low interest rates. In defined benefit plans, the impact of divergent investment results can be smoothed across cohorts of retirees.

Moreover, Social Security protects funds for retirement by prohibiting distribution before age sixty-two and requiring indexed annuities. This will not be easy to duplicate in an individual account system. With individual accounts, there may well be a demand for pre-retirement distribution in cases of “hardship,” such as heavy medical expenses or unemployment. This will reduce accumulation for both retirement and national savings. It will also be difficult to require benefits to be annuitized.

These are significant risks and clearly should not be undertaken lightly. I do not believe that we can hope to gain enough from individual accounts to make the risk worthwhile. The arguments for privatization reflect a number of uncertain political judgments, and it is imperative that the public understand them in that way.

The principal argument in favor of privatization is that individual accounts facilitate advanced funding and equity investments. Advance funding will increase national savings, reduce the burden on future generations, and provide a cushion reducing the need for frequent adjustments to Social Security. It is also claimed that investment of the Social Security Trust Fund wholly in Treasury bonds is deficient in that a balanced portfolio would include investment in stocks which, while entailing a greater risk, is justified by the potential for higher returns. Such higher returns could increase benefits without raising taxes. Neither accumulation of funds nor investment in equities, however, necessarily requires individual accounts. Additional amounts could be added to the Social Security Trust Fund which could invest in equities.

It is argued, however, that advance funding requires a tax increase which will not be politically acceptable in the absence of individual accounts. In general, the belief that Social Security will “be there for me” will be stronger with individual accounts. The claim is that while promised Social Security benefits could be reduced, individual accounts are not likely to be taken away. Even assuming a tax increase is politically impossible without individual accounts, however, it does not necessarily follow that you have to shift a portion of old revenue to such accounts, as well.

It is also asserted that advanced funding will not be maintained unless there
are individual accounts. If the Social Security Trust Fund has a surplus, there will
be too much of a temptation to increase benefits or increase spending on other
programs as Congress and the President are doing today.

Further, it is argued that Trust Fund investment in stocks runs the risk of
government interference in corporate governance and pressure for social investing
(e.g., public works) or disinvesting (e.g., tobacco stocks). However, this problem
has been avoided with the Thrift Plan for Federal Workers, where trustees are
subject to strict fiduciary responsibility; investments are limited to broad indexed
funds; and money managers retain voting rights.

Moreover, the idea that individuals can choose their own level of market risk
is a weak argument for voluntary individual accounts. Wealthier investors can
diversify their private portfolios. It is true that some hold their entire wealth in
Social Security, but these individuals are less likely to choose individual accounts
(which is sensible given their lower tolerance for risk in these circumstances), and
less likely to invest wisely if they do. Given the likely distribution of individual
accounts, the proposal by the Bush Commission to subsidize individual accounts
by, in effect, lending money to those who choose this option at below market
rates is clearly inequitable. In short, from the aspect of investment choice,
individual accounts are unnecessary for the well-off and unwise for the rest of the
population.

In any event, even if the supporters of privatization are correct that,
politically, we are much less likely to achieve significant increases in advanced
funding or to permit investment in equities without individual accounts, I still
believe that the potential gains from these moves are not worth the increased risk
that individual accounts entail.

Nevertheless, while I am opposed to creating individual accounts using
current Social Security taxes, I do support the Clinton Administration’s USA
proposal, or its equivalent, for enhanced government contributions for retirement
savings for low earners through separate individual accounts. While both
proposals involve individual accounts, arrangements like the USA proposal differ
from what is usually referred to as privatization for two reasons. First, they are
aimed at enhancing benefits rather than providing for the current level of benefits.
Second, such proposals represent new revenue which, as noted, might otherwise
be difficult to raise.