Investing Social Security Assets in Equities:
A Debate with Peter Diamond

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The current social security system offers no choices. Everyone must participate. Everyone pays part of their wage or salary income to the government and, at retirement, receives a fixed (but adjustable) payment based on the amount paid in. Although Congress can change the benefit (and has in the past), the plan is misleadingly called a defined benefit plan. Anytime you ask, the Social Security Administration can tell you how much you would receive at retirement, based on your past and expected future wage earnings and current law. Of course, these benefits can and do change.

I am going to use my opening statement to do three things. First, I will compare a private system to the no-choice government system just described. Second, I will point out who gains from privatization and what they gain. Third, I will discuss a major technical issue that arises with privatization and sketch how it might be resolved.

One of the main issues raised by opponents of privatization is the cost and benefit of private choice. Later, in rebuttal, I will discuss where the opponents of privatization err when comparing the costs of private and public plans. I will ignore transition costs and whether tax rates will be raised or benefits reduced. Transition costs can be large, but they have no direct bearing on the subject of today’s debate.

The first choice a person has to make is whether he or she wants a defined benefit plan or a defined contribution plan, so I began by comparing these two types. A defined benefit plan has some of the characteristics of a bond. For the privatized plan, think of the bond as a promise to pay a fixed sum, adjusted for inflation, at regular intervals from age 65 (or thereabouts) until you die. You buy the bond with a fixed percentage of your wage or salary income during all your working years, and you receive a fixed payment (adjusted for inflation) during all your retirement years.

This privatized plan is similar to the government’s social security plan in some respects but not others. In a private defined benefit plan you buy a bond. It’s yours, so the income on the bond pays for your retirement. There are no bonds in the public plan. The government’s promise is financed by a tax on the wages of those who work to pay benefits to those who are retired. When the number of workers declines relative to the number of retired persons, the government has to raise the tax rate or reduce the benefits. This introduces uncertainty about the tax rate and
the benefit; it is the source of the problems with the government plan and is the major reason for current interest in reform. Of course, the government could eliminate these uncertainties by purchasing bonds, just as in the private plan. Some proponents of a government-operated plan assume this will be done in the future.

For today's purpose, think of a defined contribution plan as a purchase of shares of stock or equity (corporate shares). You pay the regular monthly amount as in the case of the bond, but you get the dividends and capital gains that your investment pays. You may get more or less than the interest on the bond, but you expect more. And you are right to do so, not just because we live in a growing economy with rising wealth, but because equity returns have been 3 to 4 percentage points higher than bond returns over long periods.

Your first choice, then, is whether you want to bear the additional risk of a defined contribution plan to get the additional expected return. Which choice should a person make, looking ahead over an entire lifetime? There is no single correct answer. That is a main reason why choice is important. Those who are very averse to risk would choose to keep all or most of their investment in bonds. They would choose a defined benefit plan. At the opposite extreme, some would put all of their pension into equities to receive the higher expected return that rewards risk-takers.

In practice, many people would choose an intermediate position. In practice, they own saving accounts, bond funds, common stock or equity mutual funds either directly or through 401(k) plans and other privately managed retirement accounts. They also own assets like houses that combine a fixed monthly return with uncertain future value. They have a mix of assets that pay a defined benefit and assets that don't.

This brings me to my second point, who gains from privatization? For many people, the government's social security pension plan is one of several assets, part of a portfolio. If a reformed social security system offered the option of a defined contribution plan in partial replacement of a fully funded defined benefit plan, most of us would do nothing. We have the mix of pension assets that we prefer, so we would keep that mix.

I have allowed two qualifications to slip in. One is the term "fully funded". The other is "most of us". Let me explain why those qualifications are important.

The government's plan is "pay as you go". There is no fixed contract, no sum that is guaranteed as suggested by the term "defined benefit". And there is no legal right to a "defined
benefit”. The government can change the benefit, and it has done so numerous times. Many of the changes have been increases, but extending the age at which benefits can be received decreases the value of the defined benefit. Further, increased benefits are paid for by current and future generations, so some may wish to opt out of the government’s plan, to avoid these additional costs, if given the opportunity.

The second qualification, "most of us," recognizes that all of us are not equally endowed and do not face the same opportunities. For some the government’s pension is their principal, perhaps only, retirement asset. Unlike the broader public, the poor do not have a preferred mix of equities and bonds. About 1/3 of all recipients have only the government plan. They would gain from the opportunity to hold equity claims as part of a mixed portfolio.

Why should poor widows or the working poor be forced to take what the government offers? Allowing part of their contributions to go to the mix they choose gives them the option that most of the rest of us have--to choose how much we want to allocate to equities (defined contributions) and how much to debt (defined benefits).

Much of the discussion of pension reform assumes that one size fits all. One of the main benefits of privatization is that it allows more choice to those who have the fewest assets and are therefore constrained by the present system to a sub-optimal position.

This benefit is a gain for the poor, but it has a social cost. Given the opportunity to have higher expected returns when retired, many would choose to spread their gain over their present and future lifetime by spending part of their higher future income today. Because they spend more, private saving is smaller than in a fully funded defined benefit plan. Investment and the capital stock are smaller also, so future generations have less capital and less income.

This is a cost to society of a defined contribution plan. The alternative is that society decides to force the poor into a defined benefit plan--in effect taxes the current poor--to benefit future, richer generations.

I do not regard this as either just or sensible public policy, so I am prepared to defend the change on its merits. Note, however, that there are additional benefits of privatization. The reason is that the privatized plan increases the capital stock.

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Government debt and private capital, or claims to private capital, are substitutes in portfolios. Both earn equal, risk adjusted returns. But government debt and private capital are not substitutes in production. More private capital yields more output and more tax revenue; more government debt requires higher future taxes with no additional output.

Privatization gives the poor choices which they did not have. They are the principal beneficiaries because they gain freedom to invest for retirement as they choose. The rest of us gain from privatization because the current government program would be replaced by a fully funded plan invested in bonds or equities that are claims to real capital. The stock of real capital would, therefore, increase.

The third problem I discuss is called adverse selection. It is a major problem for the choice of pensions or annuities in defined benefit plans.

To appreciate the problem, suppose we allow people to choose the way their retirement income is paid to them. Those who expect to live longer than average will choose a defined benefit plan. Those who expect shorter than average life spans would want to avoid a defined benefit plan. If we allow everyone to choose, the costs of the defined benefit plan will rise because it will have many more people who expect to live a long time. This is adverse selection.

Because of adverse selection there is some benefit in requiring everyone to participate in a defined benefit plan for some fraction of social security assets. The government is likely to impose a restriction of this kind in any case. Since length of life is not the only reason for choosing defined benefit plan, the remaining cost of adverse selection seems bearable. I see no reason why this cost should dictate 100% participation in a defined benefit plan. Differences in willingness to take risk are important and so is the opportunity for the poor to increase their expected retirement income.

As before, the non-poor can balance their portfolios between defined benefits and defined contributions. A reduction in the mandated proportion of defined benefits from the current 100% would increase freedom of choice for some. This gain is an additional offset to the remaining loss from adverse selection.

I have presented some of the benefits of a privatized replacement for social security. There would be greater freedom of choice and more opportunity, particularly for the poor. There would be a larger capital stock and higher income as we move from a government plan to a fully funded private plan. And there are transition costs that I have not discussed. They are not part
of today’s topic and they exist in any transition that repairs the underfunding resulting from past government mismanagement. The higher the system’s returns however and the larger its asset base, the smaller the transition costs become.