Privatizing Social Security

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Privatizing Social Security
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Privatization of social security has come a long way. At President Clinton's conference on social security reform, in early December, many participants, representing diverse groups and interests, agreed that some part of social security funds should be invested in private equities -- the stock market. What was once radical heresy has become almost conventional wisdom. Even President Clinton agrees, but his agreement is partial and gives the government a louder voice in the private sector.

The most important fact driving privatization is government mismanagement. Almost every country with an established pension fund has promised benefits far in excess of the revenues it can expect to earn and the taxes to be paid. Germany, Japan, France, Canada, Italy, and many others face the same problem we do. To align future benefits more closely to revenues requires either higher taxes, lower benefits, or higher returns on investment. Part of the appeal of privatization to politicians is that it avoids some of the need for higher tax rates or lower benefits to balance future accounts.

Agreement on privatization, important as it is, is only a first step toward a true reform. Proponents of privatization divide into two broad groups. One favors private choice, private ownership, and personal risk taking. They would let a portion of social security be held in a defined contribution plan. Each participant would have a personal account. Although the government might prohibit very risky investments, workers as owners of the assets could choose the type of
investment and the level of risk they prefer. And they could adjust the risk level as
they age, just as individuals do in their private accounts.

The second group, now led by President Clinton, wants benefits to be fixed
(or defined) by the government, just as in the current social security plan. Benefits
from this government managed account would vary with income and the number
of years worked, just as the present benefit does. Workers would have nothing to
say about the management of their assets, and many would not get the full return
for the risks they take.

Defenders of government managed accounts give two main reasons for
replacing individual choice with collective action. First, they argue that
individuals need protection from error or abuse. They want the government to
protect people from making costly mistakes by making choices for them. This
paternalistic view neglects the fact that most corporate pension plans, thrift plans,
and 401(k) plans permit workers at all levels to choose from a list of mutual funds
and other assets.

The second argument claims that a government managed account is much
cheaper to operate. Peter Diamond, chairman of the committee to evaluate
privatization plans for the National Academy of Social Insurance, estimates that
allowing individual accounts would raise cost twenty fold; for every dollar
received under the government managed plan, a retiree would get only 80 cents
under personal choice. He attributes this difference mainly to economies of large-
scale operation, lower costs of record keeping, and avoidance of the many changes
that individuals would make when adjusting their accounts.

This cost difference seems too large to be true. And it is. Choice may be
costly, but it is not that costly. The table shows the costs of several different funds
managed by TIAA-CREF, one of the largest pension plans in the United States.
TIAA-CREF provides pensions and insurance for employees of universities and
research organizations. Its clientele includes all employees, custodians, cooks, computer operators, and clerks -- not just professors.

<table>
<thead>
<tr>
<th>Fund</th>
<th>Cost as a % of Assets</th>
<th>Size (Assets)</th>
<th>5-Year Average Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>0.31%</td>
<td>$97 billion</td>
<td>15.6%</td>
</tr>
<tr>
<td>Bond</td>
<td>0.29</td>
<td>2.7 billion</td>
<td>6.7</td>
</tr>
<tr>
<td>Indexed bond</td>
<td>0.31</td>
<td>130 million</td>
<td>4.8*</td>
</tr>
</tbody>
</table>

*Since inception 5/1/97. This return is adjusted for inflation.

These returns can be converted to costs as percentage of benefits, to compare to Professor Diamond's calculation, using the approximate ratio of recipients of social security benefits (37 million) to insured accounts (173 million). For each of these accounts, the cost as a percentage of the benefit is about 1.5%, not the 20% widely used by opponents of individual accounts. We get a similar estimate using the average expense ratio for Vanguard one of the largest and most efficient mutual fund companies.

The current social security plan invests only in government bonds, so it has no investment costs. At 1.5% of benefits, the cost of a private plan compares favorably to the 1% cost of social security when allowance is made for the cost of investing and for the superior services provided by private funds. These services include quarterly reports that help people plan for the future, such as regular statements of assets held and the value future pension benefits already earned.
The emphasis on costs hides a different agenda. The current social security system redistributes income both within and between generations. Opponents of full private ownership would like to use the higher earnings from investment in stocks to increase the amounts redistributed. Private accounts and free choice for individuals would prevent that. Of course, Congress could always continue redistribution, but it would have to be done openly and explicitly.

Further, private accounts are a much greater benefit for the poor than the rich. For many people, the government's social security plan is one of many assets they hold. They own savings accounts, bond funds, common stock or equity mutual funds either directly or through private pension plans such as the 401(k) plans. If a reformed social security system offered the option of owning more equities, many would do nothing. They have balanced their portfolios to get the mix of assets they prefer.

Most poor people have no private pension. About 1/3 of all social security recipients have only the government plan. They would gain most from the opportunity to get higher returns, if part of social security is privatized. They would gain most if allowed to choose how they invest, how much risk they take, and to vary the risk as age, family status, and income change.

In addition to the economics of costs and benefits, there are two important political issues at stake: conflict of interest and rate of return.

Government is the main regulator to achieve politically selected social goals. There is a conflict of interest between government the regulator, clearly in a position to effect rates of return and even to ban products, and government as an investor. It is hard to see how government can effectively keep public pressures to regulate and inspect from impacting on its ability to earn a competitive market rate of return.
One need not belabor these points by referring to pressures to prevent investing in companies that sell cigarettes or liquor, or other unpopular products. We can look at what happens. Yale Professor Roberta Romano examined the returns to 50 state pension plans for the years 1985-89. She wrote:

"[P]ublic pension funds are subject to political pressures to tailor their investments to local needs, such as increasing state employment, and to engage in other socially desirable investing.... Their return is typically not commensurate with the risk." These funds avoided investment in companies that reorganized if the reorganization meant a loss of jobs within the state.

A separate study of 200 state and local pension plans for 1968 to 1986 found the public pension plans earned rates of return substantially below those of other pooled funds and often below leading market indexes. Lower average returns have also been the experience of so-called social investment funds that avoid similar kinds of investment.

People should, and do, have the opportunity to invest in funds that try to meet their social goals. The private market provides that opportunity. Full privatization -- ownership of individual accounts -- would give that option to those who want it while not imposing it on the rest of us.

Low returns reduce the benefits of privatization. Old age pensions are too important to people to be left to the government. Proponents of government-run programs overstate the costs of private programs, understate the costs of government programs, and assume without offering any evidence that individuals would have the same benefits from private and government programs. It has not been true, and there is good reason to believe it will not be true in the future. Comparisons of public and privately managed plans err most when they assume, usually implicitly, that both will be managed with the same concern for market value.
Let's not privatize halfway, letting government manage the plan so that it can obscure redistribution. Let's let everyone enjoy one of the great benefits of a market economy -- the right to choose to take or avoid risk and to receive commensurate returns.