The False Charms of Social Security Privatization

Interview with Alicia Munnell

The privatization of social security has been sold as a free lunch. It is not. As this member of the Council of Economic Advisers under President Bill Clinton points out, a little reality is necessary. In a wide-ranging interview on the future of social security, this Challenge *editorial board member corrects the many myths now being floated in one of the most important public debates of our time.*

Q The Bush administration has placed the privatization of social security at the top of its domestic agenda. Why do you think there is so much interest in it now?

A. There is a confluence of events. One, if social security were not facing a financial problem in the future, then I do not think privatization would be on the table. But it is, as you know. The financing problem really is the result of the aging of the population combined with the fixed payroll tax rate. People are looking for a solution to that—preferably one that is painless. To many, the privatization of social security appears to be like a silver bullet—in-

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vest in equities, and you have solved the problem. I will talk in a moment about why it is not.

The other thing that contributed to the enthusiasm for privatization was the extraordinary performance of the stock market between 1982 and 2000. It was not just the stock market boom that occurred in the last part of the 1990s. Stocks had showed extraordinary returns since the early 1980s, except for the collapse in 1987, which was quickly reversed. The rising stock market gave everybody the notion that he or she was a brilliant investor, and the spread of 401(k) plans showed people that they could manage individual accounts they bought. Therefore they had great confidence in the stock market. Now some of that has dissipated with the collapse in 2000.

Q How big is the future financial problem of social security? Many commentators think it is moderate.

A. I certainly fall into the moderate camp. There are two dimensions of the issue to consider. One is to look at the potential financing gap as a percent of taxable payrolls, or gross domestic product (GDP), or something that shows you its size relative to the economy. The second dimension is the period over which you look at it. There is an estimated deficit in social security over the next seventy-five years. Essentially, you take all the benefits promised for the next seventy-five years, discount them to the future, and compare them to the taxes to be collected for the next seventy-five years, which are also discounted to the future. The difference between the two is $4 trillion. We owe $4 trillion more in benefits than we collect in taxes. Now, $4 trillion sounds big, but if you take that as a percent of taxable payroll over the period, it comes out to about 1.9 percent—1.9 percent of taxable payroll. And if you take that as a percent of the economy, of GDP over the period, which is a very sensible way to look at things, it turns out to be less than 1 percent. A lot of other people, who tend to be alarmists, say that you should look at the gap from now to infinity. But infinity is a long time away.

Q. Why do they say that? What is their thinking?

A. Their thinking is that if you only solve the problem for seventy-five years, you will still have a big gap in the seventy-sixth year. So they say: Why not fix it forever?

Q Could you explain that? You said we fall off a cliff in the seventy-sixth year.

A. We have the benefit line and the tax line diverging in the future. We can calculate how much we need to close that to a specific year, but in the next year, the two lines are still apart. Once the period ends, you are back to a world where your taxes and benefits diverge.

Q. So you would have to raise taxes again?

A. You would have to raise taxes again. What they argue is, why not do it to infinity, or else what you are going to have to do is keep raising taxes every fifteen years. There are a lot of responses to that claim. Most important, we certainly do not know what is going to happen in the next seventy-five years. Just think back seventy-five years. No one knew what would happen. You could have a big increase in productivity, or we could have a horrible plague that brings down life expectancy, or an increase in infertility, or any number of things could happen that could change the situation for better or for worse.

Q They come up with a number of the present value of future liabilities as $10.4 trillion, and you think there are just too many unknowns to take that number seriously?

A. I have two reactions to it. There are too many unknowns to try to solve a problem to infinity. What we need to do in the social security debate is to take a step toward restoring balance. If we make a fix now for infinity, we could be way off. Either we will do too much or too little, cut benefits unnecessarily, raise taxes unnecessarily, or the opposite. Better to take smaller steps in that direction until we see what is happening.

That is one reaction. The other reaction is, OK, you want to talk

infinity? What is it to infinity? The problem is . . . can you also take GDP to infinity? And when you do, you are talking about a problem that is only a little bit more than 1 percent of GDP. We can handle that.

Q. In other words, the $10 trillion present value is a little more than the 1 percent of present value of GDP taken to infinity?

A. Yes. 1.23 percent, to be more exact. Even if you take that number, which is extreme, it is not that daunting.

Q Before we get into what steps you think we should adopt to bring things into balance, let us talk a little more about the silver bullet of privatization. It seems so alluring to people.

A. Ah, the silver bullet—the equity returns. It does seem alluring because you invest all your money in equities, and no matter what they do on the traditional side of the social security program in terms of cutting benefits, the claim is that you can make it all back by investing in the stock market. Stocks on average just keep going up over time.

The problem is that, yes, the stock market has higher returns, but it also has higher risks. There is a very good chance that you are not going to end up with the amounts that you think you are going to end up with. In fact, one quarter of the time, historically, the returns to the stock market have been lower than the returns to the bond market. There is simply this enormous risk associated with equity investment. And the question is, how to deal with that risk. It is becoming, at this point, almost a consensus view that one should not project these high stock returns forward. They have to be adjusted for risk. Certainly, the Congressional Budget Office, when it does its calculations, projects for the balances of individual accounts assuming that they are invested in bonds, because even if they are invested in stocks, they assume that all that additional return is equal to the additional risk. It cancels out. And there is a leaked White House memo that essentially says that if all you do is introduce individual accounts—they refer to this $10 trillion number—you would have a

$10 trillion liability before you introduce the individual accounts and a $10 trillion liability after you introduce the individual accounts.

Q. Why is that?

A. Because introducing the individual accounts and making no other changes does not reduce the liability by one dollar. You reduce the incoming tax receipts by whatever is invested in individual accounts. At the same time, you reduce the social security benefits by that same amount. The exercise does not contribute anything to reducing the deficit in the program.

Q In other words, the investment returns are still not enough to reduce the deficit?

A. The easiest way to think about it is privatizing without changing anything else in the program. Now, of $100 in payrolls, $75 goes out to pay benefits for the elderly and $25 stays in the government trust fund, earning interest. If you want to talk about privatizing now, without doing anything else, instead of investing that $25 to the trust fund, you send it to Fidelity and invest it in bonds. Down the road the trust fund will not have that $25, but it will reduce your benefits by that $25 plus interest. So that $25 plus interest is a wash. You say, well, when I send that $25 to Fidelity, I am going to be able to invest in stocks, not just bonds. Some will make a good return, but unfortunately others will not. You cannot just project this average high return on stocks without considering the risk.

Q Even if the average high return were made, is it not true that not everybody would make the mean? I would argue that not even a majority would make the mean. So the Congressional Budget Office just assumes the average return will be the bond rate. The allure is that you could all make the high returns.

A. That is the allure. But clearly, at a minimum, just projecting into the future the higher return on stocks without making any adjustment for risk is not right. The CBO adjusts for the risk by assuming

any return above the bond rate is the price of the risk. So even the analytics lead you to the conclusion that even if you are invested in stocks, projecting down the road, the bond return is essentially the right return.

Q. Most of these privatization plans that claim they will keep social security solvent for 754 years require a reduction in benefits, do they not?

A. The most popular plan at this stage, and you and I are talking before the president has actually introduced a formal proposal, is what is essentially referred to as Model 2. It came out of the President's Commission to Strengthen Social Security. That is a two-stage proposal. It first cuts benefits compared to current law by doing something that sounds very innocuous—by moving from wage indexing to price indexing.

Q. That sounds logical to most people.

A. Most people, when they think of adjusting incomes to keep pace over time, think just keeping up with prices is fine. So adjusting the social security benefits to prices does not sound like much of a threat. But that is not true. The way things now work is that benefits replace a constant amount of average wages.

Q What exactly is the replacement rate?

A. The replacement rate is the benefit compared to your earnings before you retired. So the way it was set up, the average person would receive about 40 percent of earnings before retirement in 2004, as he or she received 40 percent of earnings before retirement in 1990, and would receive 40 percent of earnings before retirement in 2114. The notion was always that it was an earnings replacement system, and basically you want to replace the same percentage over time. The way to do that was to index the benefit so that it kept up-to-date with wages. The proposal on the table is to index the initial benefit so that it only keeps up with prices. What that means is that the dollar amount that you get in 2014 will be the same as it is today adjusted for the cost of living. But what is going to happen is that wages go up faster

than prices because wages reflect both the increase in the general level of prices and increases in productivity. If benefits only keep up with prices and not wages, over time this ratio of benefits to earnings before retirement is going to decline.

Q. The replacement rate will fall.

A. Yes. The notion is that people are going to measure their benefits compared to their earnings just before they retired. With price indexation, it declines. In fact, it would decline so much according to projections that it would more than close the financial gap under so-called Model 2 for the entire seventy-five-year period.

Q. So if we did that alone, we would not even have to be talking about privatization?

A. That is right.

Q It would be like consigning people to their current standard of living. In the 1950s people did not have TV sets, many people did not have cars, some people did not even have indoor plumbing. Indexing to prices is like saying that would be good enough in the early 2000s. We are consigning future retirees to a standard of living that would be the equivalent of that.

A. Yes, people receiving their social security benefits would not reflect any increases in the standard of living over time.

Q. People get this confused. It is not just a matter of people being able to avail themselves of luxuries. We may think of them as luxuries now, but twenty-five years from now, they become necessities—you need the car, you need a television set for information, and in the future you will need the latest computers and access to new, expensive drugs. If benefits keep up only with prices, you may not be able to afford whatever the equivalent of those will be in thirty or forty years.

A. Here is what is surprising to people. Eventually, if indexed to prices, social security is going to be trivial—5 or 10 percent of earnings before you retire. Indexation to prices virtually eliminates social security over time.

Q. In fifty years, the numbers I keep seeing are that it will reduce the replacement value from about 40 percent to about 20 percent. In about seventy-five years, I assume it could go down to about 10 percent?

A. Roughly right. In 75 years it would cut the numbers I have in half, from 40 percent to 20 percent. As you go along, the replacement rate is cut further. But the thing I have been thinking recently is that, although people say we need this price indexing to put the system on a stable path, my sense is that it is not going to create a stable path. The reason is that benefits are just going to be too low. Everybody will either acknowledge that and we will have tax increases to support higher benefits, or we will need comprehensive welfare programs to keep people out of poverty.

Q Let us get back to that. So indexing to prices can fix the problem on its own by rather dramatically reducing guaranteed benefits. But then there are private accounts. What do they add?

A. Not much, especially if you adjust for risk. If you assume these higher rates of return from equities without adjusting for risk, then you recover some of the ground lost due to the shift from wage indexing to price indexing.

Q. But it would still be below the return promised by the present system.

A. Yes. But the big effect, of course, is after 2075. Then, no matter what you assume for returns, you are going to see a big decline in benefits from current scheduled levels. Even earlier, even if you assume everyone will make the mean expected return on stocks unadjusted for risk, benefits will be about 8 or 9 percent below scheduled benefits. But by 2075 it is 20 percent below scheduled benefits, even with the higher returns.

Q Some people will do worse, of course. The result is that this is a reduction for the large majority of retirees in social security.

A. That should not be shocking. We have this system that has a financial problem. The law says it is going to pay more benefits than taxes can support. And when you have a system that is in that kind of condition, you can only solve the problem by either raising more money or cutting more benefits. So the approach that the administration takes is to cut benefits, and that is one way to go. The alternative is to put more money in. There is no silver bullet here, there is no painless way. Market returns will not make up for it. And I do not believe wages and taxes will grow so much faster that the economy can simply grow its way out of the problem. I do not believe any miracle is going to happen, from privatization or from rapid growth. This is a problem that requires pain to solve—either pain in the form of retirees having less or pain in the form of current workers having to pay more.

Q And yet the reason it is a shock to some people is the allure, especially when you hear the promises in political campaigns, that privatization will solve the problem.

A. A little truth in advertising would be very helpful here, because this seems like a major policy decision that people should be involved in making. And it is a perfectly reasonable question to ask people—to say, we have this retirement system that has worked very nicely, but we are entering a period where it is going to become more expensive to keep things as they are. What would you like to do? Would you like to end up with a given amount at retirement, not pay more taxes, but work a little longer? Or do you want to keep retiring at the current age, which I do not think is a feasible alternative, and pay more in taxes?

But to suggest that investing in stocks is going to be the easy answer is really misleading and unhelpful.

Q What would you propose we do to the system?

A. I come at the problem as an economist, and I have been looking

at retirement systems generally for the last few years. To answer that properly, you must keep in mind the other sources of people's retirement income. So I look at what is happening to individual savings. People just do not save on their own. You can find evidence of that in the low national savings rate, or you can see that in terms of the assets people have at retirement. They just do not have much on their own. That is human nature. The other way people save is through organized retirement programs. One portion of the organized retirement program is the private pension system. At any moment in time, only half of the people in the country are covered by an employer pension. Even at retirement, there are about 35 percent who have nothing other than social security as income, so only about 65 percent of people have an employer-provided pension system. And on top of that, there have been enormous changes in this system. This has become a 401(k) world instead of the old-fashioned defined benefit world.

Q In other words, many if not most pensions no longer guarantee a certain proportion of your salary for life.

A. People are just not accumulating in these 401(k) accounts the money that we had expected. People are going to be very surprised and disappointed when they look at their $50,000 at retirement and realize how little annual income that is going to buy them. So the savings leg of the stool is very wobbly. The employer-provided pension leg of the stool is very wobbly, and, therefore, social security will be very important to the people in the middle of the income distribution band.

It is also important to look at just how much people really get from social security. The average guy retiring gets $1,200 a month—that is about $14,000 a year. Even before we start reforming social security some more, that amount is going to go down at least in today's terms. The age at which you are entitled to the full benefit is in the process of increasing from age sixty-five to age sixty-seven. This is a cut in benefits for those who retire at sixty-five or sixty-two, which is when people generally retire today.

The other thing is that this interacts with the Medicare system. The Medicare premiums that we pay for Part B and now the new drug benefits are automatically deducted before the social security check goes in the mail. Projections are that Medicare benefits are going to increase dramatically as a portion of social security benefits over time, so a bigger and bigger chunk is going to come out of the social security benefit. And finally, under our current tax system, social security benefits are taxable, but today the average person does not pay tax because there are thresholds in the law that say you do not have to pay any taxes until benefits exceed $28,000 for a single individual. But those thresholds are not adjusted for inflation or wages, so more and more people are going to find themselves above the threshold and paying taxes. The net benefit from social security under current law is therefore going to go down. I calculate that this $1,200 that I talked to you about is actually going to get closer to $850 in today's terms.

Q When do you hit the $850 mark?

A. In 2030. And that is before we make any of the kind of changes now being discussed. The question in my mind is, given the wobbly private saving and the disappointing performance of 401(k) plans, do you want to cut the $850 even further, as is now being discussed? I do not think that would be a good idea, but that makes it incumbent on me or anybody who advocates that position to say, well, then how would you pay for it? You cannot just say, I want more. There are real costs here.

The plan that is the simplest to talk about is one put forth by Robert Ball, who is a former commissioner of social security. He basically does three things: One, he raises the taxable wage base. Payroll taxes are only levied on earnings up to about $90,000. That ceiling could be increased, and that gives you more money. He also has a proposal to retain rather than phase out the estate tax, though with large deductions, much larger than we have had in the past, and to dedicate the amount to social security. And then he has a proposal for adjust-

ing the consumer price index downward to reduce benefits. Finally, he puts in an additional tax around 2055.

Then, of course, you can develop proposals somewhere in between—you can cut the benefits a little, and raise taxes a little less—that is totally a value judgment. I personally do not see any merit in reducing the basic benefit provided under social security further and replacing that with an individual account. But that does not mean that I am against private accounts. We have too little of everything. If you put it all together, people are just not going to have enough money going forward. So there is a lot of room for private accounts. Therefore, the privatization argument is just a diversion for people to put you in a position where you say, Are you for or against private accounts? It is the wrong discussion to have.

Q You mean you favor private accounts extending to 401(k)s and IRAs, and all that?

A. The Clinton administration had the USA accounts, which would actually be a good idea. There is a lot of room for such private accounts. It is not that I am against private accounts; I am against reducing the basic benefit guaranteed under social security.

Q People keep talking about the trust fund. Let me clarify that. In 2018, we more or less get to a point where incoming payroll taxes do not equal the outlay for benefits. The classic response has been: We have the trust fund and do not worry, because the government is not going to renege on debt. That trust fund finances social security for many more years. But, in reality, of course, there will be a lot of pressure on the budget in 2018 to pay off that debt. Somebody could come along and say, Now we must reduce social security benefits, or they could say we will raise taxes, or some combination.

A. That is an important point to bring up. At some point, before the trust fund is exhausted, the taxes are not going to be enough to

pay benefits, and the social security commissioner is going to have to take over its $1,000 bond to the secretary of the treasury and say, "I'd like to redeem this bond, please, because I want to send out benefits." At that point the secretary of the treasury does not have $1,000 lying around, and he or she will have to do one of three things: cut back on other government spending, like the FBI salaries, or defense, or social policies; or raise taxes; or float debt. That has led some people to say the trust fund is meaningless, and it is going to have to be paid out of revenues at that time. What that argument ignores is the fact that since 1983 workers have contributed more to social security than has been paid out in benefits. So we have asked these people for the last twenty years to pay taxes higher than was necessary to pay benefits. And the effect of that, in my view, has been to increase national saving. So when the secretary of the treasury in, say, 2030 may have to turn around and raise taxes, he or she will be raising taxes in a much stronger economy than we would have had otherwise. Now, opponents then say, Ah, but we are not convinced that the higher taxes paid by these workers since 1983 have really increased saving; we think Congress has had an eye on these surpluses and has changed its behavior as a result so that it raised less money or spent more than it would have otherwise because these surpluses were there. There is no evidence to support that position. There is no evidence really on any side, so it comes down to a political assessment of what went on. In my view, what happened is that we had the big Reagan tax cuts, and almost from the get-go we were then trying to cut that deficit and get spending back under control. So it was not as if we were even close to zero. There was always pressure to keep spending down in these years, regardless of the social security surplus. My sense is the fact that we were running some surpluses really did not alleviate that pressure at all.

Q So you say it would be justified to raise taxes in that environment in 2018 given that the economy is stronger than it would otherwise be?

A. It will be easier to raise taxes in 2018 than it would have been if social security had not run surpluses.

Q. Is it possible they could cut social security benefits at that point, saying we just cannot meet this liability?

A. You are in this predicament. Nobody is going to cut benefits to those already retired, or even those fifty-five and over. So it is hard to get any immediate relief from doing anything fast on social security.

Q You were saying there is no free lunch, but there is a plan about which we need some clarification. It is sponsored by Senator Sununu and Congressman Ryan. It would seem to guarantee benefits promised by the present system while moving to larger private accounts as well.

A. That is where you take essentially half the payroll tax and send it to Fidelity instead of to the Treasury.

Q. It sounds to people like it is a free lunch, but is it?

A. It is the same issue. They would put more money into equities, but that means extra risk. When you are trying to figure out what it is going to do to the system, you should subtract that extra risk before you make your adjustment.

Q. In the sense that the government's guaranteeing the present system provides benefits all the way down the road, the social security system itself is taking the equity risk?

A. And there is no social security system—it is us.

Q Then, of course, there is the issue of transition costs. We have to raise money somehow to pay for the taxes being diverted from paying present benefits. These transition costs are not just a trillion or even $2 trillion, they continue to be high, do they not, over time?

A. It depends on the particular plan. I think, several trillion dollars. And they last for an enormous period of time, forty or fifty years.

Q. It is not just the next ten years. There is some impression that it is.

A. The contention is, well, that does not really matter because that is debt that the government had down the road in the form of future social security benefits that it will not have to pay now, and that it really does not make any difference to financial markets whether the debt is made explicit today or exists down the road. I do not find that credible, and when you look at comments by those on Wall Street, they just scoff at that notion. It will matter a lot whether we put another $2 trillion of debt in the market and ask the Japanese and the Chinese to buy it up. That will just put further pressure on the dollar and on interest rates that we are going to have to pay abroad. So this transition cost and also the price indexation—while they sound like minor issues—are, in truth, major issues.

Q Two more issues: The privatization is often sold as a way to raise national savings. Does it raise national savings?

A. Certainly not in the short run. Whatever you put in the individual accounts, you are then increasing government dis-savings by that much because it will have to borrow the difference. It does not seem like a very effective way of increasing national saving at all.

Q. What is the argument that they claim it will? I have never understood the argument about how it will increase national savings.

A. It is moving the system in theory from a pay-as-you-go system to a funded system. Let us say the government was going to start to fund the social security system by bringing in more in taxes than it paid in benefits. That would be plausible, if the government were going to go from a balanced budget to a surplus—you could increase national saving that way. But these proposals are so far from that simple idea. That is a very important part of the debate.

Q My last general question: These privatizations plans have been tried elsewhere. Chile claims a lot of success with it; Britain

seems to be having a big problem with some form of it. What do you read from the international experience?

A. I find it galling in some ways that people hold out Chile as a model that you should look to. The Chilean social security system had collapsed. They really did not have highly developed financial markets, and so there were a lot of reasons that the type of reform that was undertaken in Chile might make sense for Chile. But we have a system that works. With the UK experience, you have seen all the problems that arise with individual accounts. You had the mis-selling scandal, where people got poor advice regarding what plan they should be in. We do not have to look to other countries to assess how well people might do in these types of arrangements. We have 401(k) plans in the United States, and I just wrote a book that came out last January called *Coming Up Short: The Challenge of 401(k) Plans*. Investing is hard for individuals, people with busy, complicated lives. Making investment choices is not something that they do very well. We have a lot to learn from the 401(k) experience where people essentially make mistakes every step along the way and do not enjoy the experience. They are sort of happy when the employer comes and says, We will provide you with some guidance here. It is a burden on individuals to have to be responsible for all their investment activities.

Q Do you think some form of privatization will pass?

A. My best guess is no because you cannot do it without borrowing, and I do not think the borrowing is going to fly. It is too bad, not that the privatization will not pass, but that it is going to stymie any type of solution. Really, we should do something to restore balance to the social security system. People depend on it enormously. It makes a lot of people worry and makes them feel insecure about future benefits. I would like to see solvency restored, and the earlier you start, the smaller the required change. It would be nice to see something done on the social security front.

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