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A Simple Proposal for Privatizing Social Security

by David Altig and Jagadeesh Gokhale

Official government projections show that with no change in policy, the U.S. Social Security system will be bankrupt in the year 2030. Lawmakers generally take the approach that meeting future benefit obligations will require a gradual increase in contribution rates or a reduction in future outlays—both politically unpalatable moves. But there is a third, more efficient alternative—privatization—that could protect the benefits of current and soon-to-be retirees while ensuring a secure old age for younger workers and their children.

In an area as contentious as federal budget policy—witness the tortuous road to the just recently settled budget for fiscal year 1996—lawmakers agree about one thing: The Social Security system as we know it is unsustainable in the long run. Unfortunately, this recognition has yet to yield any concrete action. The system remains the proverbial third rail of budget politics—touch it, and your political life is over.

These observations would be of minor interest if Social Security amounted to small fiscal potatoes. Obviously, such is not the case. The Social Security system today stands as the largest single element of U.S. fiscal policy. Yet, despite its size, the program has received scant mention during recent budget and election-year debates on the nation's economic priorities, and is nowhere to be found in the budget-balancing proposals emanating from Congress and the President.

It would be grossly inaccurate to interpret this lack of attention as evidence that all is well. Far from being on secure financial footing, Social Security's long-term prospects seem shaky at best. Because the program is largely based on a pay-as-you-go setup, most current worker contributions (that is, payroll taxes withheld) are immediately transferred to current retirees in the form of benefits. Furthermore, because the limited surplus of trust fund income relative to benefits that *does* exist must, by law, be exclusively invested in government securities, the excess revenue is essentially available for current government spending.[1] Under such a structure, all current contributions are consumed (by either the government or Social Security recipients), rather than invested in private productive assets. In essence, the pay-as-you-go nature of the system makes future retirees dependent on the willingness and ability of future tax-paying generations to provide retirement support by sustaining the system at whatever cost.

That the cost will be high in the coming years is almost guaranteed by the impending retirement of the baby boom generation. Indeed, its oldest members are expected to begin retiring just 12 years hence. Although official projections show that the system will not be bankrupt until the year 2030, its unfunded nature implies that taxes will have to be increased or benefits reduced much earlier to match trust fund incomes with outlays. To compound the problem, as discussed in earlier issues of this *Economic Commentary* series, the current setup may be contributing to lower domestic saving and investment rates and hence to slower productivity and wage growth.[2]

Neither of the two commonly considered methods of restoring the trust fund to long-term solvency seems attractive. The option of gradually increasing contribution rates to meet future benefit obligations would probably result in impossibly

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high burdens on younger workers as the progressive retirement of the baby boomers commences early in the next century. The other option, of course, is to reduce future outlays by cutting benefit levels or increasing the normal retirement age. With either of the latter alternatives, however, current workers unfairly receive low (or even negative) returns on their past contributions.

Is there a third way out of the Social Security quagmire? Surprisingly, the answer is yes: Shifting to a privatized, funded, and contribution-based system may be a way of providing undiminished benefits to current retirees while simultaneously preserving the promise of a secure retirement for today's workers and their descendants.

This *Economic Commentary* presents such a proposal. The plan itself incorporates the "no harm, no foul" principle; that is, reforming the U.S. Social Security system is feasible only if all participants can reasonably anticipate that they will be at least as well off under the alternative plan as they are under the existing system.

■ "No Harm, No Foul": The Pareto Efficiency Principle

In everyday language, the idea of efficiency is related to the absence of waste. In the language of economics, waste is defined by the answer to this straightforward question: Is it possible to reallocate resources in such a way as to make at least one person better off without harming anyone else? If the answer is yes, there is scope for improving individuals' well-being by putting the economy's scarce resources to more efficient use.

Such welfare-enhancing reallocations are considered to be "Pareto improving," a label derived from Vilfredo Pareto, the Italian economist who developed this principle of economic efficiency. An equilibrium—which is really just a statement about the allocation of resources given a particular set of prices for goods and services—is said to be "Pareto efficient" exactly when it is *not* possible to shift resources so as to make at least one person better off without making anyone else worse off.

This definition of efficiency means much more than merely expanding output or increasing the average worker's income. From an economic perspective, inefficient fiscal policies offer the opportunity for a free lunch. From a political point of view, they suggest the possibility of reform in which there are no necessary losers. Pareto-improving policies thus have the dual advantage of being economically sound and politically feasible.

Is a Pareto-improving reform of the U.S. Social Security system possible? We suggest that it is, with one caveat: We adopt the position that, at its core, Social Security is a pension system. This is an admittedly restrictive view, because Social Security also plays a role in redistributing income from rich to poor households of the same generation and in providing public insurance against macroeconomic shocks across generations.[3] We treat these goals as auxiliary to the central purpose of Social Security and assume that, to the extent they are desirable, these needs can be met through alternative fiscal programs.

■ The Problem with an Unfunded System

Consider the case in which Social Security is strictly a pay-as-you-go proposition—that is, there is never any excess of current taxes over current transfers. (As explained earlier, this for the most part describes the U.S. system.) The rate of return on worker contributions is then tied to the growth rate of the payroll tax base. More specifically, the return that can be sustained depends on the growth of both wage income and the working-age population relative to the retired population.

Given that the share of working-age individuals relative to retirees is projected to decrease over the next several decades —and recognizing that this trend is not likely to be offset by an acceleration in wage growth—the return that future retirees can expect to realize from Social Security is significantly lower than what they could earn from private pension contributions.

These observations were discussed in more detail in a previous *Economic Commentary*.[4] The authors of that article calculate that, under reasonable economic and demographic assumptions, the inflation-adjusted rate of return for future beneficiaries of the current system will fall below 2 percent. This is much lower than, say, the real return on long-term government securities. Simply put, recent and prospective developments make participation in an unfunded pension system a bad deal for both current and future workers.

■ Why Privatize?

From a purely theoretical perspective, the problems inherent in an unfunded pay-as-you-go plan could be resolved by fully funding future payments, but retaining the public character of the system. In such a world, trust funds would continue to accumulate in the form of government securities. Because the return to such securities is determined by the market, future recipients would be guaranteed fair compensation (adjusted for risk) for their Social Security contributions.

Two problems arise with such a plan. First, because the system has until now been essentially unfunded, there remains the issue of satisfying the claims of those who are currently retired (or who will be retired in the near future). Second, for future retirees to actually receive the return implied by the trust fund investments, the government must use the accumulated income wisely. If trust fund contributions are employed merely to finance more current consumption—as opposed to being invested in productive public assets—the tax base will not expand sufficiently to honor the debt at existing tax rates. The result will be a greater future tax burden on all citizens. Some of this burden may fall on future retirees, representing a back-door taxation of benefits.

Private saving vehicles, such as equity or corporate bonds, do not suffer from this weakness. The investments that they back are visible, and private firms do not have the generalized power of taxation that could, even inadvertently, obscure losses resulting from unwise choices. Furthermore, well-diversified portfolios of private assets have an established track record. For this reason, we believe that a funded, privatized system is the only viable option in the long run. The balance of this article sketches the outline for such a reform.

Can We Do It?

The problem that has to be resolved is, how do we determine the appropriate cutoff age below which workers are shifted to the privatized plan? The "no harm, no foul" principle prescribes two conditions that must be satisfied in converting to a private system. First, because retirees and those close to retirement have already passed the bulk of their high earning and saving years under the assumption that they would receive Social Security benefits, most of them would be unable to adjust their future saving behavior to ensure retirement security if that promise were abrogated. Hence, efficiency requires that the current system's obligations to today's older generations be met under the new plan. A portion of these obligations can be financed from the contributions of older workers who are in their pre-retirement years and who are still contributing to the system. The remaining obligations must be met out of the contributions of younger workers who will be shifted over to the new plan.

The second condition is that the accumulated value of young workers' future contributions to the privatized plan (net of the amount devoted to older generations) must, at the time of retirement, at least equal the present value of benefits that they would receive under the current system. Satisfying this condition is essential to conform to the "no harm, no foul" principle.

For an individual starting from scratch, the rate of return from a funded system will clearly exceed that of the unfunded scheme. However, if the cutoff age below which individuals are shifted to the privatized system is too high (say, 55), some workers would not have enough remaining years to exploit the increased private returns, leaving them worse off than before.

Lowering the cutoff age provides younger generations with more years to accumulate their contributions at the higher private rate of return, but that must be traded off against the fact that the liabilities to those who remain in the current system (which increase as the cutoff age is decreased) must be financed out of the contributions of those who are shifted to the new plan. Choosing the appropriate cutoff age requires balancing these concerns.

Calculations using the current distributions of Social Security benefits by age and sex (assuming a 1.8 percent internal rate of return on the contributions of those included in the present system, and an 8 percent return on investments in private capital markets) suggest that 42 is the appropriate cutoff age. With this as the dividing line, 18 percent of the contributions of those age 42 and younger would be sufficient to provide those age 43 and older with benefits at least equal to those received under the current system.[5] For younger workers, future benefits may be *greater* than those offered by the current system, because their contributions will reap the higher private rate of return for an even longer period.[6]

A Plan Worth Pondering

The plan described above suggests that the objective specified at the outset of this article is indeed possible: a structural reform of Social Security that places the system on solid ground in the long run, and that honors the obligations to existing beneficiaries. The numbers may be quibbled with, but the basic arguments provide a sensible framework for addressing one of the most important fiscal issues facing the U.S. economy.

It is worth noting that apart from placing Social Security on a stronger economic foundation without reneging on current obligations, privatization will render other, indirect benefits. Current tax and benefit rules generate several types of income and wealth redistributions both within and across generations. This weakens the link between worker contributions and benefits received, harming people's incentive to work. Transition to a privatized system would restore this link.

Moreover, under privatization, worker contributions are guaranteed to be invested in private productive assets rather than being consumed. The better saving and investment outcomes that would follow are likely to enhance future productivity and economic growth, and to translate over time into higher living standards for young and old alike.

Footnotes

1. In 1994, workers and employers deposited about $380 billion in the Social Security trust fund. Of this, almost $325 billion, representing 21 percent of total federal spending, was disbursed as benefits to the elderly.

2. See Jagadeesh Gokhale, "Should Social Security Be Privatized?" September 15, 1995; and Jagadeesh Gokhale and Kevin J. Lansing, "Social Security: Are We Getting Our Money's Worth?" January 1, 1996.

3. Because benefit payments do not rise proportionately with contributions, the system implicitly contains an element of progressive taxation. In addition, benefits for wealthier recipients are taxed explicitly.

4. See Gokhale and Lansing, "Social Security: Are We Getting Our Money's Worth?" (footnote 2).

5. Our calculations suggest that the rate of return on U.S. private capital has averaged about 8.5 percent since 1961, but to be conservative, we have chosen to use 8 percent. Contributions of workers above the cutoff age are assumed to be invested in government securities, while those of younger workers, including the portion devoted to paying off the current system's liabilities, are discounted at the higher, private rate of return. This, again, is a conservative position, since discounting these amounts at a higher rate implies a lower present value of contributions and hence a higher rate at which young workers' contributions have to be diverted to pay off the system's future liabilities.

6. This is true despite the diversion of 18 percent of their contributions to those age 43 and older.

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