

Applying the Concept: Privatizing Social Security

President George W. Bush spent much of the winter of 2005 traveling around the country trying to convince people that the Social Security system needs to be reformed. Unless something changes, in 30 years or so the current system will not be able to make the promised payments to the retirees. The President has suggested solving this problem by moving to a system of private accounts. Countries as dissimilar as Chile, Sweden, Mexico, Poland and Singapore have such mandatory systems of private accounts. What would it mean to make such change in the U.S.?

When thinking about retirement, it is important to keep two things in mind. First, someone has to bear the risk of providing income to the elderly; and second, the way in which we do it affects the size of the economy and productivity.

Risk-bearing and insurance are central to any pension system. Insurance allows us to engage in productive activities we would otherwise avoid. But sometimes the government needs to get involved. One example of this is unemployment insurance. Most people agree that we should all have a guaranteed level of income for at least a short period of time if our jobs disappear, so that we can find another job without completely exhausting our financial reserves. But private insurers will not sell unemployment insurance for two reasons: policyholders could misbehave at work, increasing the odds of collecting on the policy (this is the moral hazard problem described in Chapter 11); and in the event of an economic depression, the private fund would not be able to make the necessary payments. That is why the government provides unemployment insurance.

The possibility of living a long life creates a risk that one's savings will be exhausted before dying. Who should bear that risk? Should we each bear it alone, or is it better for us to insure each other and bear the risk collectively?

A system of private pension accounts shifts this income risk from the population as a whole back to individuals, eliminating the insurance component of the system entirely. This is the argument for a government-sponsored system; one that insures against elderly poverty.

But how should such a system be financed? Current government-sponsored pensions systems are "pay-as-you-go": taxes on working people finance payments to retirees.* One of the biggest problems with a pay-as-you-go system is that individuals treat their tax payments as retirement savings. Politicians encourage Americans to think of Social Security as equivalent to a private pension system in which payments accumulate in an account that is converted into an annuity at retirement. As a result people do not save. This lower private saving in turn lowers investment and leaves the economy less productive.

A well-designed government pension system must insure the incomes of the elderly in a way that does not reduce economic growth. That means moving away from pay-as-you-go. Is privatization the answer? At first glance, the answer would seem to be yes – partial privatization with a safety net to insure retirees didn't starve. But political realities suggest that such a system will break down. While our discussion in Chapter 8 suggests that long-run investments in the stock market aren't that risky (see Figure 8.4 on page 194) the day could come when some pending retirees' private accounts do poorly, so benefits fall short of expectations. Then, the government becomes the insurer of last resort. In other words, when the stock market produces high returns, account holders win, and when the market does poorly, taxpayers lose.

An alternative is for the government-run system to accumulate a real trust fund, one invested in privately issued stocks and bonds. That is, create a transition to what is called a "fully-funded" system and meet the two objectives of encouraging economic growth and guarding against the elderly become poor.

* The Social Security System was founded in 1935. At the time, the country was slowly recovering from the Great Depression, so it was important to begin making payments immediately. This meant that it was impossible to establish a funded system in which individuals make contributions while they work in order to build up a fund for that can finance their retirement incomes later.