2006

The Many Definitions of Social Security Privatization

Don Fullerton, *University of Texas at Austin*
Michael Geruso

The Many Definitions of Social Security Privatization

DON FULLERTON AND MICHAEL GERUSO

In the past decade, debate over social security privatization has exploded in the United States. The Bush Administration, think tanks, and academic economists have all pushed cases for privatizing the United States public pension system.

When you look under the hood, though, "privatization" can mean a different thing to almost every advocate. Privatization usually means that workers get individual retirement accounts in their own names, as with a private defined contribution pension. But does privatization necessarily entail all aspects of a private pension? Must contributions be voluntary and accounts privately managed? Must pensioners have choice over investments and receive payouts that are actuarially fair? Or can privatization include plans where government retains control over some of those decisions? In current usage of the term, privatization may mean any of those things.

This ambiguity of the term privatization muddles the public and scholarly debate over changes to social security. Some proponents of privatizing Social Security desire a strengthening of our public old age insurance system, while other proponents of privatization desire the end of it.

Probably worse, it is common for an advocate of reform to bundle together several aspects of privatization and then justify the package by pointing to benefits that could be achieved with much less radical change.

Decomposing Privatization

Seven vectors capture the salient features of most privatization plans. As shown in Table 1, the current system is pay-as-you-go (PAYGO), meaning that funds from current workers are used to pay the benefits of current retirees. It is a defined benefit plan, which means that each retiree's benefits are prescribed in a way that does not depend on funds in a personal account. Workers and employers are required to make contributions to the system through Old Age Insurance payroll taxes, and any receipts in excess of expenditures are held in an aggregate fund managed and invested by the federal government. Benefits are paid only

Don Fullerton is the Addison Baker Duncan Centennial Professor of Economics at the University of Texas at Austin, and Director of the NBER Working Group on Environmental Economics. He has served in the U.S. Treasury Department as Deputy Assistant Secretary for Tax Analysis (1985-87). Michael Geruso is an Engineering Manager at National Instruments, a Truman Scholar, and a research assistant with the Department of Economics at the University of Texas at Austin.

as an annuity (on a monthly basis throughout retirement with no lump-sum payout option). The design of tax and benefit schedules and other rules mean that the system redistributes across demographic groups.

In contrast, looking down the right column of Table 1, a purely private pension would be characterized by full funding and by personal accounts of a defined contribution plan.[1] It would have voluntary levels of contribution, private-sector management, individual investment choice, a lump-sum payout option, and actuarial fairness.

A reform to privatize Social Security might change any one of these seven rows, or attributes, without necessarily affecting any of the others. Complete repeal of Social Security would include all seven. Ignoring potential dependencies, 127 possible plans could be formed from this list (by including at least one, and possibly all seven attributes)!

For example, a fully funded social security trust fund could be invested in equities without changing the prescribed benefits formula or introducing personal accounts. Conversely, a reform could introduce purely notional personal accounts without funding them. And each of those reforms must decide about other options such as whether to have private-sector management or individual choice of investments.

Table 1
Direct Comparison of Seven Attributes

Current Social Security	Typical Private Pension
PAYGO Funding	Full Funding
Defined Benefit	Personal Defined Contribution Accounts
Mandatory Contributions	Voluntary Contributions
Government Management	Private-Sector Management
No Investment Choice	Investment Choice
Annuity Only	Lump-Sum Payout Option
Redistribution	Actuarial Fairness

A reform could shift the current system toward actuarial fairness without added funding, personal accounts, or any other feature listed.

Most actual privatization proposals would reform more than one but not all of the seven attributes. For example, in 2000 Laurence Kotlikoff, a prominent Boston University economist, proposed a plan endorsed by a long list of academicians that has a fully-funded system under which workers make mandatory contributions into personal accounts managed by the private sector. These accounts would offer only a single investment portfolio, and contributions would be matched on a progressive basis to add redistribution. Upon retirement, account holders would have to annuitize their benefits. That plan includes only three of the seven possible attributes of privatization.

Of course, describing privatization as a list of seven binary choices is a massive simplification. Since each attribute is actually a vector, we mean to allow for degrees of adoption. For example, workers may not be given full freedom in choosing investments, but they may be allowed to choose among a constrained set of funds managed by competing private-sector entities, as is done in Chilé.

The Problem with Ambiguity

The definition of privatization matters. The term's ambiguity has led to imprecise analysis and commentary on changes to Social Security. The most striking problems occur when the analysis of just one attribute of privatization is used to justify a much broader schedule of changes. Consider a 1998 Washington Post article by José Piñera, Chilé's former minister of labor and social security, who presided over that country's transition to a private pension system. He proposes a plan to transform the United States Social Security system along the lines of Chilé's system of personal accounts. In this article, Piñera invokes Martin Feldstein's analysis of the benefits of funding to argue that the United States should follow Chilé's example. But in doing so, he twists together several attributes of privatization that are completely separable. The benefits of pre-funding do not require a system of privately managed pension investments in mutual funds. Nor do those benefits necessitate a lump-sum payout option or any other particulars of Chilé's plan. The desire to achieve benefits derived from just one feature of privatization is thus conflated with the need to adopt a whole array of changes.

Definitions also differ among academic economists. In his 1996 analysis, Laurence Kotlikoff considers a privatization plan that sounds like repeal of social security, and he measures efficiency gains from improved labor supply and saving incentives. Yet these gains do not require repeal. His results depend on funding, but they do not require changes in any other row of Table 1, even that assets be held in personal accounts! Martin Feldstein's (1998) definition of privatization also calls for funding, but he would have mandatory contributions to individually managed accounts. In contrast, a 1998 paper by John Geanakoplos, Olivia Mitchell, and Steve Zeldes characterizes privatization as the creation of a system of individual accounts, but this definition does not require funding, nor that individuals choose investments. Thus, even though each author has a consistent definition of privatization, the same term is used to denote incompatible concepts.

Justifying a privatization plan on the basis of expected benefits requires that we make explicit the source from which those benefits are expected to flow. In general, anyone who aims to show gains to economic efficiency from privatization should specify which attributes of Table 1 are key to the results. In many economic models, Social Security's full privatization will increase national savings. But the gains to national savings might have nothing to do with putting investment decisions in the hands of individuals and everything to do with fully-funding the system. In other words, repeal in such a case is not necessary to achieve the desired benefits.

We may have good reasons for funding our nation's Social Security system. And we may have good reasons for keeping contributions to the system mandatory, or keeping investments under government management, or keeping benefits redistributive. Fortunately, the choice to fund Social Security does not constrain our choices along any of these other vectors.[2]

Likewise, if we fear the prospect of retired Americans ending up penniless and desperate in old age, then perhaps giving workers full control over their retirement savings presents a risk too great to bear. But the desire to preserve this form of social insurance no more rules out Social Security's privatization than full-funding requires Social Security's repeal. Like Singapore's Central Provident Fund, a privatized United States pension system could restrict retirement investments to relatively safe options such as government bonds and government-managed savings accounts.[3] Thus, before Wall Street brokerage firms become too enamored of the idea of privatization, let's ask whether Wall Street should be directly involved in a privatized system at all.

Conclusion

Describing a plan to change Social Security as privatization gives precious little information. In order to distinguish clearly among the many possible formulations of privatization, research papers and policy briefs that mention privatization must define what specific subset of the seven attributes they intend.

Deliberately specifying these attributes will make explicit the connection between proposed changes and supposed benefits. This protects against having some desirable effect of privatization become the hostage of a broader set of changes that are not necessary to achieve it. The alternative to this type of deliberate exposition is an increasingly muddled debate in which one analysis of Social Security's privatization is incommensurable with the next.

Letters commenting on this piece or others may be submitted at

http://www.bepress.com/cgi/submit.cgi?context=ev

References and Further Reading

Feldstein, Martin, 1998, "Preface", in Privatizing Social Security, Martin Feldstein, ed., Chicago: University of Chicago Press for NBER, pp. ix-x.

Geanakoplos, J., O.S. Mitchell, and S.P. Zeldes, 1998, "Would a Privatized Social Security System Really Pay a Higher Rate of Return?", in Framing the Social Security Debate: Values, Politics, and Economics, R.D. Arnold, M.J. Graetz, and A.H. Munnell, eds., Washington, DC: Brookings Institution, pp. 137-157.

Kotlikoff, Laurence, 1996, "Privatization of Social Security: How It Works and Why It Matters," Tax Policy and the Economy, vol. 10, Cambridge, MA: MIT Press for NBER, pp. 1-32.

Kotlikoff, Laurence, 2000, "Privatizing Social Security the Right Way," The Independent Review, vol. 5, no.1, Summer, pp. 55–63.

Piñera, José, 1998, "In Chilé, They Went Private 16 Years Ago," The Washington Post, March 22, 1998.

Acknowledgments

The authors are grateful for suggestions from Jeff Brown, Aaron Edlin, and Kent Smetters.

---

1 A private pension need not be a defined contribution plan, just as a social security system need not be a defined benefit plan. Still, the dichotomy in the second row of Table 1 best highlights a key aspect of the current debate: the switch from our current defined benefit system to "personal accounts" of a defined contribution plan. Most importantly, such a reform could shift investment risk to retirees who would then gain from extraordinary returns but suffer from unusually low returns.

2 If putting social security surpluses into a government-held trust fund leads to larger deficits in other government spending, then social security is not truly funded. If personal

accounts are necessary to achieve true funding, then the two issues are not practically separable.

3 See <http://www.cpf.gov.sg>. Singapore's fund also shows how a government can exercise considerable control in a privatized system. In particular, it is invested largely in public housing.