

The **Perils** of Privatization

**Social Security Privatization
Cuts Lifetime Benefits;
Makes Senior Citizens Vulnerable to Poverty**

**The Impact in
Alabama**

August 4, 2008

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Social Security Privatization

Cuts lifetime benefits by as much as \$162,644

Makes 194,000 senior citizens vulnerable to poverty in Alabama.

Institute for America's Future

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Social Security is back in the news. In a town-hall event on July 7, 2008, a young woman asked Arizona Senator John McCain if she was likely to receive Social Security benefits someday. In his reply, McCain lamented Social Security's design and structure and, as he had elsewhere, indicated that he would radically change this successful program.¹ He said, "Americans have got to understand that we are paying present-day retirees with the taxes paid by young workers in America today, and that's a disgrace, it's an absolute disgrace and it's got to be fixed."²

We've been here before. Three years ago, President Bush declared that Social Security faced a financial crisis, and his solution was privatization — taking payroll taxes we all pay into the system and investing a portion of those funds in private stock market accounts. Now John McCain is bringing the idea back. In March 2008, McCain told the Wall Street Journal, "As part of Social Security reform, I believe that private savings accounts are a part of it — along the lines that President Bush proposed."³ The idea became more concrete in July 2008, when McCain named economist Martin Feldstein, the "chief intellectual force behind privatization," as a surrogate on his campaign.⁴ These moves revive an idea that the American people rejected three years ago.

This report updates research published by the Institute for America's Future at that time. It estimates the reduction in Social Security benefits that a typical Alabama resident can expect and the number of seniors exposed to poverty if Social Security were privatized. The main findings are that:

In Alabama, Social Security privatization:

- Cuts life-time benefits by \$162,644
- Makes 194,000 senior citizens vulnerable to poverty.

Social Security Works

Social Security is not a "disgrace." It is a successful social program and a profound intergenerational promise. Every generation pays into Social Security during its turn, and withdraws from Social Security when its time comes. Social Security has been successfully operating that way for over 70 years.

Social Security works. It lifts 1.3 million children and nearly 13 million senior citizens out of poverty.⁵ Social Security provides 73 percent of the typical retiree's income, compared to 17 percent from pensions and 10 percent from savings and other sources.⁶

Before Social Security, nearly half of American seniors lived in poverty. Today, fewer than 9 percent of seniors spend their “golden years” in poverty.⁷ Social Security is especially important now, with private sector pensions disappearing and savings scarce. According to the estimates by the Economic Policy Institute, without Social Security, more than 35 percent of Americans aged 65 and older would be living in poverty.

Real Security. Created Crisis.

Some politicians and conservative privatization advocates have created a myth that Social Security is in crisis. They issue dire warnings and predict imminent bankruptcy. McCain told the young woman in the July town hall event that it was “unlikely” she would receive her benefits. President Bush tells a story of a poll of young people who “think it’s more likely they’re going to see a UFO than get a Social Security check.”⁸ The White House web site elaborates: “If we do not act to fix Social Security now, the only solutions will be dramatically higher taxes, massive new borrowing or sudden and severe cuts in Social Security benefits or other government programs.”⁹

The proclamations work. One poll says that 73 percent of Americans believe Social Security has “major problems” or is in “crisis.”¹⁰

The reality is far different. Social Security currently has a surplus of \$2 trillion. The surplus is projected to increase to over \$4 trillion by 2016, more than four times the amount needed to pay benefits in that year.¹¹ According to cautious estimates by the Congressional Budget Office, the Social Security trust fund would not be depleted until 2046.¹²

Privatization: Risks and Realities

Privatization means diverting deductions from the Social Security trust fund into private accounts run by private investment companies. Conservatives have touted privatization for years as a way to increase returns on investment. Privatization, however, has a variety of problems.

First, privatization would transfer huge administrative fees to Wall Street. Managing large numbers of small accounts is inherently inefficient. Administrative costs for private systems in Mexico, Chile and Argentina are between 1.8 to 2.4 percent of the program total; in England, administrative costs are 3.2 percent. In contrast, administrative costs of Social Security run less than one percent.¹³

Second, diverting funds would cause the trust fund’s surplus to run out much sooner, leading to benefit reductions and retirement insecurity — the opposite of Social Security’s intergenerational promise. The Center on Budget and Policy Priorities estimates that President’s Bush’s plan would have created \$17.7 trillion in additional debt by 2050.¹⁴

Third, and most importantly, privatization replaces the guaranteed floor of economic security with the uncertainty of the stock market. In 2007, Social Security guaranteed economic security to more than 49 million grandparents, parents and children worldwide.¹⁵ Individuals are free, of course, to invest their personal savings in the stock market – but Social Security guarantees a floor beneath which their fortunes will not fall.

Research Findings

In Alabama, 934,770 count on their earned Social Security benefit every month.¹⁶ In addition to the benefits that Social Security provides to Alabama families, it also provides a stable level of individual income that fuels Alabama's economy. Thousands of businesses, and the state government, also depend on the Social Security guarantee. Fully \$10.5 billion in individual income flows into Alabama's economy from Social Security each year – roughly \$871.9 million every month.¹⁷

Privatization would cast many seniors below the poverty line. According to the U.S. Census Bureau, the number of people from Alabama living in poverty in 2006 was 742,064.¹⁸ In 2005, 267,000 Alabama seniors relied on Social Security checks for at least half of their total income. 135,000 of these individuals depend on these benefits for almost all – 90 percent or more – of their total income.¹⁹ Today, the average Social Security check for individual retirees in Alabama is \$1,041 per month.²⁰ But \$867 per month is needed just to stay above the federal poverty line. These individuals are close to the edge, and vulnerable to swings in the cost of food, housing or energy.

The Center on Budget and Policy Priorities calculated in 2005 that if a Bush-style privatization plan were enacted, children born around the time the plan started would have their annual guaranteed benefits cut by 50 percent when they retire.²¹ If that were to happen to current-day senior citizens in Alabama, people with incomes up to 200% of the current poverty line would no longer have a guarantee that they would avoid poverty.²² Social Security would have failed in its promise of security. 194,000 senior citizens in Alabama would be left behind.²³

Second, benefits would be reduced even among people not plunged into poverty. Under a Bush-like privatization plan, a person born today in Alabama who retires at the current full retirement age of 67, would see a lifetime benefit cut of \$162,644 in today's dollars.²⁴ This is the benefit cut an Alabama resident would suffer even *after* accounting for earning an average 4.35 percent return on their private account investment.²⁵

The Solution

Social Security is not going bankrupt. But we do need to pay attention to the impact the retirement of the baby-boom generation is having on the program. The solution is to strengthen the existing structures, not to reinvent them or privatize them. Currently, the Social Security payroll tax currently applies only to the first \$102,000 a worker makes — any earnings above that are tax-free. One simple solution is to apply the tax to some or all earnings above \$102,000. Lifting that cap is a fair and minor adjustment that could prevent any shortfall after 2046.²⁶

— *Dean Baker, Co-Director of the Center for Economic and Policy Research, contributed technical assistance to this report.*

ENDNOTES

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² Charles Babington. "Road Still Bumpy for McCain's Retooled Bandwagon." *Associated Press*. 12 July 2008.

<http://ap.google.com/article/ALeqM5gYfclM-O18cICsF6qDZZJXZTkH9wD91SO1000>. John McCain on Social Security. <http://www.youtube.com/watch?v=ugN8Rn5baqM>.

³ Bob Davis. "McCain's Economy Platform: Big Tax Cuts, With Caveats." *Wall Street Journal*. 3 March 2008.

http://online.wsj.com/public/article_print/SB120451614688707083.html.

⁴ Carolyn Lochhead. "Friedman's 'heresy' Hit Mainstream: Private Social Security Accounts were His Idea." *San Francisco Chronicle*. 5 June 2005. <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2005/06/05/ING9QD1E5Q1.DTL>. Feldstein is widely acknowledged as the "chief intellectual force behind privatization" of Social Security. He wrote *The Case for Privatization* (<http://www.foreignaffairs.org/19970701faessay3782/martin-feldstein/the-case-for-privatization.html>) and *Privatizing Social Security: The Ten Trillion Dollar Opportunity* (<http://www.cato.org/pubs/ssps/ssp7.html>).

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¹¹ National Committee to Preserve Social Security and Medicare. "Myths and Realities about Social Security and Privatization." February 2008. <http://www.ncpsm.org/news/archive/myths/>.

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¹³ For analysis of Latin American Social Security privatization administrative fees; see: Barbara E. Kritzer. *Social Security Privatization in Latin America*. Social Security Bulletin. Vol.63. No.2. 2000.

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²³ Calculation made by applying the percent over poverty line to Census Bureau data on numbers of senior citizens over the poverty line (official data available in quartiles from 100 to 200 percent; linear estimates made between quartiles). United States Census Bureau. Current Population Survey (Table Creator)-Annual Social and Economic Supplement. Data compiled 24 July 2008. http://www.census.gov/hhes/www/cpstc/cps_table_creator.html.

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(http://www.cepr.net/calculators/calc_benefits.html). The Institute for America's Future aggregated the monthly totals provided by the Center for Economic and Policy Research to derive lifetime totals. Total benefit cuts were adjusted to 2008 dollars.

²⁵ The stock return consistent with Congressional Budget Office (CBO) projections and a steady price-to-earnings ratio is 4.35 percent. Following CBO, this analysis assumes a portfolio consisting of 50 percent stocks, 30 percent private bonds and 20 percent Treasury bonds. The total real return from such a portfolio would be 3.97 percent before fees.

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