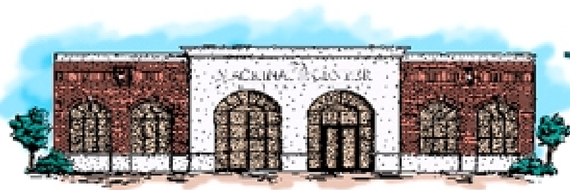

VIEWPOINT ON PUBLIC ISSUES

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Market Holds Little Risk for Privatized Social Security Accounts

by Andrew G. Biggs

Summary

President Bush is proposing that workers be allowed to shift a portion of their Social Security payroll taxes into privately invested personal retirement accounts. Critics point to recent stock market plunges as a reason why this proposal is too risky. Evidence shows, however, that it would take a completely unprecedented stock market disaster to make workers worse off than under Social Security.

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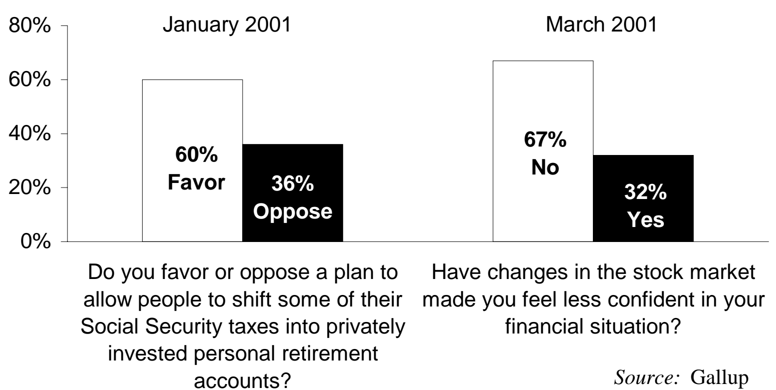
Recent declines in the stock market present a challenge to advocates of Social Security privatization, who want to let workers invest their payroll taxes in personal accounts holding stocks and corporate bonds. Indeed, the Standard & Poor's (S&P) 500's 25-percent drop in the past year prompts critics to ask, "How would you feel about personal accounts if the market dropped like that just prior to your retirement?"

Such questions are reasonable. Privatization advocates owe it to the public to answer them, especially since President Bush is about to convene a commission to design personal accounts.

Supporters of personal accounts saw the market-risk issue well before the markets presented it to them. In 1997, when stock prices were moving ever-upward, Bill Shipman and Melissa Hieger of State Street Global Advisors asked in a study for the Cato Institute, "How far would the market have to crash for a worker to be worse off with a personal retirement account than under Social Security?" The answer: very far indeed.



Two recent Gallup polls found that many Americans favor President Bush's proposal to partially privatize Social Security and that a majority of stockholders remain confident about their finances despite recent market plunges.

Shipman and Hieger modeled a low-wage worker earning $13,365 a year who enters the workforce at 21 and invests his Social Security taxes in a personal account holding only stock mutual funds. Because low-wage workers receive the highest relative benefits from Social Security, they would be the first hurt by a market crash. Under this hypothetical privatization plan, there is no progressivity and no safety net. So how would this worker fare if the market crashed when he retired? Quite well, it turns out, even if the market dropped faster and further than it has in recent months.

On average, low-wage workers with personal accounts could expect a monthly benefit 1.8 times larger than the current system,

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enough to lift millions of older Americans out of poverty. It would take a market crash of between 50 and 70 percent to make these workers worse off than under Social Security. For average-wage workers, the market crash would need to be even bigger.

Is this possible? Anything is possible, but history says such sharp declines are unlikely. A 20-percent decline in the S&P 500, like that of Oct. 19, 1987, or of the month of October 1929, would not have put personal accounts at a disadvantage relative to Social Security. Even the worst three-month period in S&P 500 history, with a 38-percent decline, would not make a personal account pay lower benefits than Social Security.

If offered the chance to earn market rates of return on my Social Security taxes coupled with a guaranteed one-quarter drop in the stock market on the day I retired, I'd take it—and still be richer for it.

Moreover, for workers holding a balanced portfolio of 60 percent stocks and 40 percent bonds, the stock market would need to be practically wiped out for them to be worse off. Even if the stock market went out of business on the day of retirement—if stock investments were literally rendered worthless—the corporate bonds remaining in the average worker's account could still pay higher benefits than Social Security. Over the last year, a 60-40 fund would have lost less than 10 percent of its value, as the 25-percent drop in the S&P 500 was countered by a 13-percent rise in the Lehman Brothers U.S. aggregate bond index. A near-retiree with 70 percent bonds would have made money.

Personal accounts don't produce higher returns because of higher risk, but because they save and invest for the future while the current system does not. Since Social Security pays each year's benefits out of that year's taxes, its "return" cannot exceed the 1.4-percent annual projected growth of payroll tax revenue. Personal accounts rely on the real return on capital, which has averaged 8.5 percent before taxes over the last 40 years. Stock and bond returns vary, but their variations take place at a level well above the baseline set by the current system.

A 1998 report from Michigan's Mackinac Center for Public Policy explained the bottom line: "Although it is true that markets experience short-term fluctuations, retirement savings are invested over a lifetime. Analysis of the performance of stocks shows that since 1800, there has never been a 20-year period in American history when stock market returns on average were not positive."

If offered the chance to earn market rates of return on my Social Security taxes coupled with a guaranteed one-quarter drop in the stock market on the day I retired, I'd take it—and be richer for it. How personal accounts handle market risk is a good question. Proponents of privatization knew it had to be answered. And it has been.

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(**Andrew G. Biggs is a Social Security analyst at the Cato Institute in Washington, D.C.** More information on Social Security privatization is available at **www.mackinac.org**. Permission to reprint in whole or in part is hereby granted, provided the author and his affiliation are cited.)

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