If Alan Greenspan Had Bitten the Bullet...

The last great Social Security "rescue" took place in 1983, when a blue-ribbon commission headed by Alan Greenspan recommended a combination of minor benefit trims and substantial tax increases to head off the serious trust fund shortfalls then looming. These changes were supposed to save the system for 75 years. Yet here we are a decade and a half later and Social Security projections are once again showing the program approaching bankruptcy.

Should the Greenspan Commission have proposed something bolder?

Back then, privatization of Social Security was not even on the radar screen, but suppose it had been. What if we could rewind, and start the Commission's work over again, and convince them to privatize at least a small part of Social Security? How would average workers have fared if the Greenspan commission had started us on the path to a system of personal savings?

These questions are much trickier to answer than you might think. A couple of examples will illustrate both the promise of privatization, and the perils of rushing to privatize without thinking through all of the costs and benefits.

First, let's explore the checkbook impact if there had been a partial privatization back in 1983. Let's imagine that just after the Greenspan Commission report was issued, persons turning 65 in 1998 and beyond began redirecting two percent of their income from the Social Security program into a private account, and that their employers matched that contribution, up to the established limits. Let's also assume that these contributions were invested in large-company stocks each year. And let's acknowledge that this redirection would lower the amount of money available to pay existing Social Security retirement benefits. Upon retirement, a hypothetical investor would receive normal Social Security payments (reduced by the same proportion that we reduced their tax contributions to the old system) plus the proceeds of an annuity purchased with the funds in the private account.

Would folks retiring today be better off? We ran the numbers for three fictional workers: Rusty, who earned the median male full-time income each year from 1983 to 1998; Penny, who earned the median female full-time income; and Mad Max, who earned the Social Security maximum taxed income each year. (In 1998, the maximum was $68,400). You will understand why Max is mad when you see the numbers.

For each earnings history, we used the Social Security calculator—available at the Social Security Administration's web site—to calculate benefits under the existing plan. To calculate the annuity payment, we took a sample of annuities available on the internet, and assumed that the individual bought an annuity with the average characteristics of our sample.

The accompanying table gives our results. It shows the monthly payment received by each of our workers under the current Social Security program, and what they would now be receiving if the Greenspaners had launched a partial privatization. All the workers would be significantly better off as well.

These calculations illustrate the case for privatization: More money goes to retirees under most plans. Imagine how much retirement incomes would increase if we privatized the whole system.

Advocacy pieces usually end here, but there is something else you need to know. This example ignores the debt owed existing retirees as we transition to the new system. And even short run "transition costs" can make a very big difference in the long run. A simple example illustrates the point.

Suppose that we live in a world that has one old person (the retiree) and one young person (the worker) alive each period, and that we have a Social Security system that takes $1 from the young person and gives it to the old person each year. The young person—who will be old next year—gives a dollar this year, but gets a dollar next year. (This is a gross simplification of the actual system. Most people today put in a dollar, but can expect to get far less than a dollar out.)

After a while, a reformer goes to the young person and points out what a horrible deal this system is. He is getting a zero percent return! The reformer suggests a privatization plan that allows the young person to put $0.90 in a private account today, and given the prevailing 11 percent interest rate, will give him a dollar tomorrow. By switching to a private plan, the young person's return goes from zero to 11 percent. Societies switches to a private plan. But immediately there is a problem. The

<table>
<thead>
<tr>
<th>Recipient</th>
<th>Current Annual Benefit</th>
<th>2% Privatized Annual Benefit</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rusty (median income male)</td>
<td>$15,024</td>
<td>$18,372</td>
<td>+22%</td>
</tr>
<tr>
<td>Penny (median income female)</td>
<td>11,856</td>
<td>13,800</td>
<td>+16%</td>
</tr>
<tr>
<td>Mad Max (maximum income)</td>
<td>17,088</td>
<td>22,092</td>
<td>+29%</td>
</tr>
</tbody>
</table>

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person who is old today, and expected to receive a dollar from the young person, doesn’t get a dollar. Not being cold-hearted, our hypothetical government hatches a plan. They will issue government debt for $1, and give it to the old person who played under the previous rules. After that “transition,” everyone will be in a plan that gives them an 11 percent return. So in the end, future generations are better off, right?

Not really. Each year, the government must pay the interest on the debt, which, given prevailing interest rates, is 11 percent of $1, or 11 cents. Since taxes are raised from young workers, they pay that amount. Under the old plan, the young workers put in a dollar, and then received a dollar back when they grew old. Under the new plan, they put 90 cents in their private account and pay 11 cents tax today, and still get just a dollar tomorrow!

Milton Friedman rightly points out that the $1 payment is not caused by the privatization—it is a liability that already exists, and privatization merely makes it visible. The unfunded liabilities of our current Social Security system are variously estimated at from $4 – 11 trillion. That breathtaking sum has nothing to do with privatization, it is the result of generations of overpromising by politicians. Just the same, our simple example illustrates the crucial point that you can’t look at only the benefit-payments side of our retirement system and make a rational choice. We’re also going to have to find a way to make Social Security’s huge, looming liabilities go away, and that is going to be costly—perhaps costly enough to wash away many of the nice returns privatization offers.

Does that mean that privatization won’t work? Not at all. But each of the costs and benefits of adopting any particular policy need to be weighed carefully. Privatization plans will vary between better and worse depending on things like the number of already-retired folks versus workers, the rate of return on investments, the interest rate the government has to pay on its bonds, and so forth.

We certainly would be closer to an ideal world today if the Greenspan Commission had inaugurated personal savings plans back in 1983. But even in our current jam, evidence from many countries suggests that the net gains from even partial privatization can be substantial.

Harvard economist Martin Feldstein estimates, for example, that shifting to a privatized Social Security system could lead to an annual gain to the U.S. economy in the range of 1 – 2.5 percent of gross domestic product—a very large sum. The relatively favorable partial privatization experiences in Chile, Argentina, the United Kingdom, and Argentina studied in Feldstein’s book Privatizing Social Security confirm the economic fruitfulness of personal-savings programs.

Moreover, partial privatization is likely to deliver other important benefits. Helping individuals to invest retirement funds gives them a stake in the private economy, and strengthens the connection between individual decisions and rewards. In addition, partial privatization would lessen the political risks of changing Social Security, where reforms are desperately overdue.

So America would be a better place today if Greenspan and company had bitten the bullet and proposed a Social Security privatization back then. But it still wouldn’t be heaven.

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