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2007

Can Small Investors Survive Social Security Privatization?

Elisabeth Brooke Harrington, *Copenhagen Business School*



Available at: https://works.bepress.com/brooke_harrington/19/

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W. W. Norton & Company
New York London

2007

Brooke Harrington

Can Small Investors Survive Social Security Privatization?

It has become nearly axiomatic in this country to argue that everything would be better if it were run like a business. In response, government has shifted its mission: If it used to operate like Super Glue, bonding Americans to one another, it is now working more like WD-40, minimizing friction in the pursuit of individual (and corporate) profit.

Social Security is not only the largest government program but the embodiment of the Super Glue approach to politics: the ultimate test case for privatization. The Bush administration proposes to allow contributors to invest a portion of their public Social Security pensions in the stock market. What a coup that would be for the WD-40 contingent.

Privatization proponents rest their proposal on three claims: Social Security funds are comparable to private investments, like IRAs; since most Americans manage their own IRAs, there is no reason they shouldn't manage their public pensions as well; and given the average returns on American stocks, we'd all have much more money at retirement if we could take some of our Social Security fund out of government bonds and put it into the stock market. This shift could be interpreted as the financial equivalent of "bowling alone," Robert Putnam's much-quoted phrase about the decline of community life in the United States. Or you could think of it as the 401(k)-ification of America: The defined-contribution plan has shifted our view of retirement into something that is purely an individual matter, rather than a collective one.

A *New York Times* poll conducted earlier this year indicates that many Americans are increasingly persuaded by these ideas. Despite the market downturn, there has been a marked increase in the percentage of Americans who expect to rely only on their own savings—rather than private pension plans or Social Security—in retirement. Only 15 percent now believe that Social Security will be a primary source of their retirement funds. As one survey participant put it, "These decades to come are going to be more about what you do for yourself, as opposed to what you allow other people to do for you. It's not pro-government, not anti-government, just me myself and I." But while Americans

may think they are well prepared to give up a piece of their social safety net, the evidence from recent economic studies suggests otherwise.

The prospect of higher returns is the main attraction of privatization, despite the seemingly insurmountable problems of logistics, costs, and implementation it poses. Belief in this claim seems to be curiously robust, even in the face of the recent stock-market decline and attempts to explain the costs, risks, and problems associated with privatization. People have dollar signs in their eyes, and nothing seems able to dislodge them.

In part, this can be attributed to the increasing displacement of belief in the public good by belief in the marketplace. The movements to bring market forces to the management of public schools, Medicare, and electrical-power transmission are among the most visible recent examples.

The central problem facing these hybrid public-private organizations is “information asymmetry”: Market forces can’t bring efficiency if there are large information differences among sellers and buyers. The classic example is the purchase of a used car. The seller has more information than the buyer and has no incentive to tell the buyer the truth. Therefore, the buyer may end up (1) buying a lemon or (2) spending a lot of time and money on research, both of which offset the savings from getting a “bargain” on the price.

When you introduce market forces into a formerly public service, you run into all of these problems of information asymmetry and opportunism. Thus, the key question for success in any hybrid is: Are citizens prepared to act as informed consumers?

In the case of Social Security, support for a privatized system rests entirely (and often implicitly) on assumptions about public knowledge and competency with regard to stock investing. But recent studies by economists and finance scholars suggest that Americans really don’t understand the risks associated with stock investments and stand a good chance of doing worse financially under a hybrid system than under the current one.

Risk, Return, and Transaction Costs

In the language of finance, the benefits of a privatized Social Security system depend upon the “equity premium.” This is the increased return that investors can get for investing in risky securities such as stocks as opposed to risk-free securities such as Treasury bonds. Investors are compensated for assuming risk; the higher the risk, the greater the compensation.

During the century that just ended, the return on U.S. stock investments has averaged about 11 percent per year. The U.S. Treasury bonds in which Social Security funds are invested returned much less—averaging more like 5 percent per year. Offered a choice between the two investments, the answer seems obvious: Take the higher return.

But of course there is a catch—two catches, in fact. The equity premium is not guaranteed (if it were, there would be no risk). It is just an average return, and some individual investors will actually lose money on stock investments. Not only are the risks of any individual stock unpredictable, but the historical-average return of U.S. stocks may not apply in a given time period. A grinding bear market or high inflation around the time you retire could mean that you have to cash out your portfolio when it's under water. In any case, the historical-average returns involve periods much longer than the relevant individual time frame, which is basically the forty-odd years between the start of one's working life and retirement. That means many of us will not be able to capitalize on long-range returns; as Keynes put it, "in the long run, we are all dead."

A second, related catch is that once investors capture the equity premium, they have to be careful not to give it away to their brokers. Trading stocks incurs transaction costs: Each buy or sell order means paying a commission. These costs can easily eat up all the gains from a profitable investment. Unless the government wants to become the world's first no-commission broker, transaction costs are going to be a serious issue in a privatized Social Security system.

The entire proposition that Social Security participants will come out ahead financially in a privatized system depends on their knowledge of and ability to manage investment risk and transaction costs. The evidence on this subject is not encouraging.

For example, polls conducted to examine Americans' attitudes toward Social Security privatization have shown that it is alarmingly easy to reverse support for the proposal by simply mentioning risk. When questions about privatization are phrased so that they don't mention risk, about 58 percent of Americans support the proposal. But if the questions are rephrased so that they mention risk in any way, the results are reversed: 59 percent of respondents *oppose* privatization.

Studies of actual investor behavior support the polls. Ordinary individuals seem to have a polarized response to risk; they become either very conservative

or very risk-seeking. Unfortunately, neither strategy is profitable. Though *on average* risk is compensated by return in the stock market, some risks don't pay off. Rather than being a linear relationship, in which more risk always pays off with higher returns, the risk-return relationship is more like an inverted U-shaped curve: Risks pay off up to a certain point, after which they become a waste of money. As with gambling, most of the fun in investing consists of locating that fine line between risks that pay off and those that don't.

Unfortunately, the vast majority of people guess wrong. Finance professor Terrance Odean has found that the portfolios of average American households and of investment clubs underperform the stock market by about 4 percent annually. In addition, Odean found that Americans trade their accounts excessively, creating high transaction costs. Apparently unaware that they were giving away their profits in the form of commissions, American households turned over their portfolios—that is, sold existing stocks and bought new ones—at the astronomical rate of 75 percent per year. Investment clubs weren't far behind, with a 65 percent annual turnover rate. At the end of the day, they mostly made money for their brokers. There is no reason to expect that Americans would fare any better or trade any less in a privatized system.

Of course, an ultraconservative approach to investing doesn't provide much of an alternative. Several economic studies indicate that the populations most likely to need Social Security in old age—people of color and women—are also the least likely to benefit from a privatized system. For example, a study by economists Nancy Jianokoplos and Alexander Bernasek indicates that women invest too conservatively, putting only 40 percent of their investment dollars into stocks, compared with 46 percent for men. This conservatism doesn't pay off: If a man and a woman start with equal amounts of investment capital (which is of course a highly stylized assumption in itself) and invest it according to the averages over a twenty-year period, that 6 percent difference in allocation results in the woman having 47 percent less money in her retirement fund than the man has. Thus, conservative behavior in a privatized system may not result in more retirement dollars for everyone. For the people who need a nest egg most, privatization may be no better, and perhaps worse, than the current public system.

This difference doesn't have anything to do with innate characteristics of men and women—or of blacks and whites—but rather with lack of exposure to investment opportunities, such as working the kind of job where you get a 401 (k) plan that forces you to learn something about investing. That's how

most Americans got into investing in the first place. But the investing bandwagon that swept the country during the 1990s left behind large numbers of women, people of color, and the poor. To correct this problem, the government would have to create a national investor-education program—an undertaking so costly that the Social Security trustees warned against it in 1999, saying that the expenses incurred would almost certainly outweigh the gains from privatization.

Privatization: Ready or Not?

Historically, Social Security has served multiple purposes, providing savings, insurance, and income redistribution in a single program. Privatization would shift the program away from redistribution and toward individual savings. This is part of the larger trend toward distrust of government and detachment from notions of the common good. In this sense, after years of erosion of public-sector institutions and faith in their mission, Americans *are* well prepared for a hybridized Social Security. More than twenty years of retreat from the notion of entitlement has changed our expectations and led many of us to accept the notion that we should individually bear most of the risk and responsibility for funding our retirements.

But all of us are vulnerable to the possibility of bad luck. Privatization would introduce a lottery-like element into the system that undercuts security for everyone. There is no guaranteed profit in the stock market: neither risk seeking nor conservatism reliably pays off, and neither investment professionals nor ordinary Americans have been successful at guessing where stock prices would go. Americans may think that they know something about investing—remember when everyone agreed that you couldn't go wrong in dot-com stocks?—but their confidence, and the confidence of policy makers, is not supported by the evidence.

The evidence suggests that the people who would be most likely to see financial benefit from privatization in the Social Security system are white, male, affluent, and young. Unfortunately, recent polls indicate that these are also the people most likely to say they don't need Social Security and would like to drop out of the program entirely.

The end of Social Security in its purely public form would mean losses for Americans that are not just economic but social. In abandoning the largest and most popular public program that binds us together through its benefits, we

would lose an institutional and economic linchpin of our political community. When stacked up against the uncertain financial gains from privatization, the benefits of a public Social Security system look increasingly priceless.