MARKET RISK VERSUS POLITICAL RISK:

Why Social Security Faces Greater Risk Under Privatization

by Kilolo Kijakazi and Robert Greenstein

One of the greatest challenges to proponents of fully or partially privatizing Social Security is the market risk that could result in retirees and beneficiaries losing some or all of the savings they invest in the stock market. In an attempt to counter this challenge, some supporters of privatization have argued that the current Social Security program faces political risk — the risk that Members of Congress can change the Social Security program at any time. This attempt to equate the market risks faced under a system of individual accounts to the political risks under Social Security overlooks a key factor: Social Security participants can exercise influence over politicians, and thereby greatly reduce any political risk, that they cannot exercise over the market.

Privatizing Social Security would involve diverting a portion of payroll taxes away from the Social Security trust funds, where these taxes now flow, into individual accounts that could be invested in the stock market, corporate bonds, or government bonds. The intent is to achieve a higher rate of return on these funds than they would earn in the Social Security trust fund where they are invested in Treasury securities as required by current law. During periods when the stock market turns down, however — such as the past two years — some funds invested in the market can be lost rather than earning a higher rate of return. The possibility of such losses places workers and beneficiaries at risk of having insufficient savings to support themselves or their families when they retire or if they become disabled or die.

The potential of losing money invested in the stock market is a strong argument against privatizing Social Security. The downturn in the market since March 2000 highlights the risk inherent in privatization proposals. Many individuals have experienced significant losses in their holdings in the market, and a number of news accounts have reported on people near retirement who have sustained substantial losses and must continue working rather than retiring at the time they had planned. There also have been reports of retirees who lost a sizeable portion of the investments they kept in equities and no longer have the level of savings on which they planned to live. In fact, according to a recent Congressional Research Service analysis, a worker who contributed to an individual account for 41 years and retired in 2001 would receive a monthly annuity check that is more than 40 percent smaller than the monthly check a similar worker who retired just two years earlier, in 1999, would receive.1

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In response, proponents of privatization often argue that workers and Social Security beneficiaries do not own their payroll tax contributions or have a right to program benefits and consequently face risk that politicians may cut these benefits in the future. The court case of Nestor versus Fleming is often cited to support this argument. That case established that Social Security participants do not have a property right to benefits and that Congress has the right to change the program, including the benefit levels the program provides.

The argument that Social Security faces significant political risk is an argument borrowed, in part, from the experience of government pension funds in some developing countries. In some of those countries, benefit and other rules have been changed sharply in mid-course.

The analogies to these countries are of dubious value, however; the United States is not a developing country, does not face the political and economic instability that characterizes many of those countries, and does not face mismanagement and even corruption in the handling of government pension funds, as has occurred in some of those nations. Analogies to experiences in developing countries consequently are not especially relevant to assessing risk under the U.S. Social Security system.

Moreover, the attempt to equate political risk under Social Security to market risk under individual accounts does not stand up under scrutiny. Social Security participants can write, call, and visit their Members of Congress to express their views on Social Security and how members should vote. Member of Congress who support changes in Social Security that their constituents do not favor can be voted out of office. The electorate has demonstrated its willingness to do so more than once. There is probably no other issue on which Members of Congress are more sensitive to their constituents’ concerns than Social Security.

Furthermore, the argument that Social Security beneficiaries in the United States face significant political risk is essentially an argument that beneficiaries risk being dominated by other, more powerful political constituencies that succeed in inflicting benefit cuts on beneficiaries in order to claim a larger share of budget resources for themselves. But given past history — under which the Social Security constituency has been one of the most potent in the nation, leading Social Security to be termed the “third rail” of American politics — and given the demographic trends that will cause the number of Social Security beneficiaries to mushroom in coming decades as a proportion of the voting population, the risk of beneficiaries being dominated by other constituencies seems rather slim.

Indeed, in a recent speech, Federal Reserve Board Chairman Alan Greenspan observed: “If the Social Security Trust Fund is depleted, the law requires that benefits be paid only to the extent that they can be financed out of current payroll tax receipts. But I cannot imagine a viable political scenario in which full payment of benefits will not be forthcoming. Does anyone doubt that Congress would prevent benefits from being curtailed if the trust fund were depleted?”

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This is not to say the political risk is zero. But it is small. The notion that the political risk to Social Security is somehow equivalent to the risk that substantial numbers of beneficiaries will face stock market losses if funds are diverted from Social Security to private accounts is not plausible. The market risk far outweighs the political risk.

As noted above, a worker who contributed to an individual account throughout his or her career and retired and converted his or her account to an annuity in 2001 would receive a reduction of more than 40 percent in his or her monthly annuity check, compared to what a similar worker who retired two years earlier would get. The magnitude of these fluctuations far exceeds the size of any benefit cuts that Congress would realistically consider. This further highlights the extent to which the market risk attached to individual accounts surpasses the political risk attached to Social Security benefits.

It might be argued in response that while there is likely to be little political risk to the Social Security benefits of those who, at any point in time, are current beneficiaries, there may be somewhat greater political risk to the benefits of those who have not yet retired. Although this is probably true, the political risk to the benefits of those who have not yet retired itself seems modest, given the strong unfavorable public response that any proposal to cut Social Security benefits in a major way would be likely to elicit, including proposals to cut the future benefits of current workers.

(Moreover, to the degree that there might be modest political risk to the Social Security benefits of future retirees, there also likely would be political risk to the income derived from individual accounts under a partially privatized Social Security system. If the federal government faced serious budgetary problems, it could alter rules governing the degree to which income from individual accounts was transferred to and retained by the Social Security system rather than passed on to account-holders, rules regarding the tax treatment of income from the individual accounts, or annuitization rules that prescribed how much of an individual account must be paid out each year to an account-holder. In the case of individual accounts, any such political risks would be in addition to the market risk that account-holders already would face due to the uncertainty surrounding the future performance of stock-market investments.)

The bottom line is that individuals have little or no power over forces at play in the stock market. One places one’s savings in the market at his or her own peril. The upward climb of the market during the 1990s lulled many investors into a false sense of security. The downturn in the market has proved to be a rude awakening for a good number of these investors. It can be argued that over the long term, the market always goes up. Individuals who are near retirement or have already retired and left a substantial portion of their savings in equities, however, may need their savings long before the market recovers from a downturn or a prolonged period of stagnation. This also is true of retirees who face a need to purchase annuities now and cannot safely wait an extended period of time before doing so. Indeed, those who have lost savings intended for retirement over the past year or two may be grateful that their Social Security benefits had not themselves been partially converted into private accounts that were affected adversely by the market’s recent gyrations.