Let Us Count the Ways:

The Costs of Social Security Privatization are in the Details

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EXECUTIVE SUMMARY

- Social Security privatization is once again on the front burner of the public policy discussion. President Bush has indicated that he wants to make it a top priority of his second term to replace part of the existing social insurance with a system of individual accounts.

- Privatization not only exposes workers to additional risks, it also substantially raises the costs of saving for retirement. A number of these costs have been well-documented. Workers would have to pay management fees for their accounts. In addition, they would have to pay insurance premiums to private insurance companies if they want the same level of protection that Social Security offers for themselves and their families. Further, they would have to bear an enormous burden to pay for the transition from one system to the other.

- Another cost of individual accounts – so-called labor market risks – has often been ignored in the public debate. Typically, workers' earnings are below average in a recession, when it would be most opportune to purchase stocks because of a concurrent stock market decline. This risk affects all workers to some degree.

- The exposure to labor market risks is greater for women and minorities than for others. In essence, they accumulate fewer savings for each dollar they invest in their individual accounts compared to men and whites. This is especially pronounced for women, who consequently face costs that are comparable to the costs of turning their savings into lifetime monthly benefits – annuities.

- The link between the labor market and individual accounts essentially punishes women and minorities twice. For one, they have lower lifetime earnings than men and whites and thus proportionately lower savings. Second, they accumulate fewer savings for each dollar they put away because of greater fluctuations in employment and wages.

- Social Security is the only way to reduce the labor market risks. In the current setup, benefits do not depend on the performance of the stock market. Furthermore, Social Security pays proportionately higher benefits to low lifetime earners than to high lifetime ones.

INTRODUCTION

Social Security privatization is back on the policy agenda. After winning a second term, President Bush continues his push to replace part of Social Security's insurance system with individual accounts. Although the specifics are not yet clear, President Bush's Commission to Strengthen Social Security (CSSS) provided three options to privatize Social Security of which one – option II – is often used as a benchmark for what this administration's final proposal could look like.[1]

By replacing part of Social Security with individual accounts, individuals are exposed to greater costs, as workers will bear the risks of saving for retirement and as Social Security's revenue stream will decline. Thus, the additional costs include administrative costs, insurance premiums, and transition costs.

The recent combination of a stock market crash and a recession starkly illustrated another cost. When financial assets are relatively cheap and thus worth purchasing, workers have less money to buy them due to lay-offs, lower wages, or fewer hours. Since this is a regular occurrence during business cycles, workers can ultimately end up saving less than they need for a decent standard of retirement, especially since this labor market risk is not something workers can easily protect themselves from. For instance, it is unrealistic to think that people would split their work time between numerous jobs to avoid large income drops in a recession.

Labor market risks are not limited to the short-term fluctuations during business cycles. For extended periods of time, some workers may experience lower earnings than others, precisely at the time when it would be good to buy stocks, i.e. when prices are low. To compensate for these lost opportunities, workers would have to seek out future careers with above average earnings. However, this would require that workers project where good career opportunities will arise, when they will arise, and what the stock market will do at the same time, and it would also require that workers get those jobs when they want them – an unrealistic expectation.

All workers face this risk, but some more so than others. Women and minorities are more likely to see their wages and their employment fluctuate during a business cycle than their counterparts. The costs that arise are similar in size to other costs associated with individual accounts, e.g. for converting savings into a lifetime annuity. Moreover, these costs are often in addition to already below average earnings histories. Thus, women and minorities are hurt twice: once because of lower earnings than their counterparts that result in less savings, and a second time because of greater fluctuations in their earnings, which result in fewer returns for each dollar invested.

[1] See, for instance, Goolsbee (2004), GAO (2004), and CBO (2004a).

WELL-DOCUMENTED COSTS OF INDIVIDUAL ACCOUNTS

With individual accounts, workers first and foremost face administrative costs that must be paid to the financial firms managing these accounts. The Congressional Budget Office (CBO, 2004b) estimated that the costs for individual accounts, such as 401(k)s, amount to an average of 0.8 percent of assets for large plans and to about 1 percent of assets annually for smaller plans. Also, Goolsbee (2004) reported that the Investment Company Institute put the average fee for equity funds at 1.25 percent of assets and the average fee for bond funds at 0.88 percent in 2002.

Over the course of a lifetime, this amounts to a substantial loss in savings. Assuming annual contributions of 2 percent of earnings, total account balances would be reduced by 21 percent over an entire working life for large plans with average fees of 0.8 percent of assets and by 30 percent under small plans with 1.0 percent of assets in annual fees (CBO, 2004b).

The windfall for financial service firms in the form of additional fees resulting from Social Security's privatization would be substantial. Goolsbee (2004) estimated that financial service firms could reap fees totaling a net present value of $940 billion if CSSS's option II were enacted.[2]

Further, with privatization, workers lose part of a guaranteed, inflation-adjusted, lifelong monthly benefit. To compensate for this loss, workers would have to purchase private insurance. The respective insurance products would be a lifetime inflation-adjusted annuity upon retirement and minimum investment guarantees.

The costs of these insurance products are substantial. The costs of a lifetime annuity amount to an average of about 5 percent of total savings, with smaller account balances accruing larger costs (Poterba and Warshawsky, 2000). This means that for a person retiring at 65 with an average life expectancy, private annuities are about 15 to 20 percent less than they would be without the costs of purchasing the insurance (CBO, 2004, 1998; Poterba and Warshawsky, 2000; Geanakoplos et al., 1998, 1999).

The costs of guaranteed minimum benefits are also non-trivial. To guarantee the rate of return on bonds with a balanced portfolio (50 percent stocks and 50 percent bonds) over a 40-year period, investors would have to spend 16.1 percent of their contributions to their accounts on the guarantee (Lachance and Mitchell, 2003a, 2003b).

In addition, current workers have already earned benefits under Social Security, many of which will still be honored. At the same time, though, workers' funds are diverted away from Social Security, creating a financing gap. To cover this shortfall, Social Security will require transition funds from the general government.

[2] CSSS' option II would allow for the diversion of an average of 2% of payroll into individual accounts, and of 4% of payroll up to the first $1,000.

The sheer size of transition costs is enormous. Diamond and Orszag (2002) estimated that the general revenue transfers required to finance the transition costs of option II of the CSSS would equal 1.2 percent of payroll for the next 75 years. Thus, Social Security's expected financial shortfall would grow by more than 60 percent over 75 years due to the transition costs. To cover the additional costs, Social Security would need an estimated transfer of $2 trillion in net present value terms.[3]

These additional costs would not be a problem if workers could expect to have higher savings as a result of Social Security privatization. This is not the case as calculations based on the CSSS's option II show. With privatization, workers end up with substantially fewer benefits. For a medium wage two-earner couple retiring in 2075, Social Security benefits would be reduced by 46 percent compared to current law benefits. The savings in the individual account would compensate for part of this loss, leaving workers with 21 percent fewer monthly benefits (Diamond and Orszag, 2002).

Such comparisons likely understate the actual reductions that people would face in a privatized system. For one, the costs included in these calculations underestimate the actual administrative fees and insurance costs (Goolsbee, 2004; Diamond and Orszag, 2002). Also, the rates of return that are assumed for the hypothetical individual accounts contradict other economic assumptions underlying the projections for Social Security's future. Economic logic says that the rates of return that can be expected on the stock market will depend on profit growth, which in turn depends on economic growth. However, the actuaries of Social Security assume that economic growth will be much slower in the future than in the past. Thus, the rates of return on the stock market should be much lower than they were in the past (Baker, 1997). As a result, privatization will result in large costs that are not offset by comparable gains.

ONE MORE RISK: LABOR MARKET RISKS

The drain on workers' savings does not stop there. Much of the discussion has ignored the fact that the labor market, and thus people's wages, fluctuates along with the stock market. Employment and wage growth tend to be lower when stock prices are down and stock purchases would be opportune. This is considered labor market risk.

In the world of financial economics, risks can be reduced through diversification. Workers could reduce their labor market risk by splitting their work time over a number of jobs. This is clearly unrealistic. Workers hence get stuck with the costs associated with this additional risk.[4]

While this is true for workers on average, it is also true that this risk impacts some workers more than others. The labor market experience of workers differs by

[3] Net present value is exactly the amount today that, with interest, would cover the shortfall in the future.
[4] See Weller and Wenger (2004) for a summary of the relevant literature.

demographic characteristics. For some groups, unemployment levels rise faster and employment and wages fall faster or rise slower during recessions than for other groups.

An important distinguishing factor is gender. For instance, Hoynes (1999) showed that earnings and employment fluctuated more for low-skilled women than for high-skilled men relative to business cycle fluctuations. Also, Abraham and Shimer (2001) found that the unemployment rate for women has fallen, while their unemployment duration has increased. Further, Blank (1989) found that, while earnings differentials across demographic groups shrank with persistent economic growth, women saw smaller benefits from economic growth than men.

Labor market outcomes also vary by race. Stratton (1993), among others, found that there is a substantial and persistent unemployment difference between blacks and whites. Further, Hoynes (1999) suggested that nonwhites are likely to see greater variations in employment and earnings than whites in line with the business cycle.

Wages and individual account accumulations are also linked in the long-run. Specifically, women and minorities have only gradually closed the gap in earnings relative to their counterparts. In the past, this meant that women and minorities had comparatively lower earnings exactly at a time when stock prices were low. Inversely, their earnings rose at a time when stock prices rose, too. Over the course of a lifetime, this has meant that women and minorities have bought disproportionately more stocks than men did when stock prices were relatively high. Thus, the account balances per dollar invested should be lower for women and minorities than for men.

A FEW ILLUSTRATIVE FIGURES

We can illustrate labor market risks arising from fluctuations in unemployment rates and in earnings based on real life figures. We use unemployment and wage data from the Current Population Survey (CEPR, 2003). Specifically, we consider the labor market outcomes by gender and race.

Unemployment rates vary substantially (Table 1). Minorities have a much higher probability of being unemployed than whites and the variation of unemployment rates is larger for blacks than for whites, indicating a much more tenuous labor market experience. In addition, blacks earn substantially less than whites.

In comparison, the unemployment rates for men and women do not differ much. However, women have on average lower earnings than men and women's earnings fluctuate more than men's, again reflecting a more tenuous labor market experience.[5]

[5] Formal statistical tests show that the fluctuations are also linked to the business cycle. See the technical appendix for details.

To see what these labor market fluctuations mean for savings in individual accounts, we first create age-earnings profiles for a number of hypothetical workers. These earnings histories allow for continuous employment but adjust wages downward based on the group's unemployment experience.[6] It is further assumed that individuals save 4 percent up to the first $1,000 and 2 percent of the rest of their earnings – similar to the proposal in CSSS option II. All savings are allocated in a balanced portfolio, i.e. half stocks and half bonds. Equities are assumed to increase at the rate of the S&P500 and to receive the S&P500 dividend yield. Bonds are assumed to earn interest equal to the interest paid on Moody's AAA corporate bonds. All calculations are in 2002 dollars.

Table 1
Summary Statistics for Unemployment Rates and Wage Rates, by Demographic Characteristic

Total	Men	Women	White			Black		
			Total	Men	Women	Total	Men	Women
			Unemployment rates					
6.3	6.4	6.4	5.2	5.2	5.1	12.6	13	12.2
(1.6)	(1.7)	(1.5)	(1.4)	(1.6)	(1.4)	(3.2)	(3.5)	(3.2)
			Earnings					
2,408	2,871	1,878	2,524	3,053	1,920	1,985	2,211	1,772
(124)	(120)	(169)	(158)	(159)	(197)	(102)	(118)	(127)

Notes: Unemployment rates are in percent and earnings are in 2002 dollars. Standard deviations are in parentheses. Source is the Current Population Survey, various years, and the Bureau of Labor Statistics, Consumer Price Index.

Our main focus is each hypothetical worker's dollar accumulation per dollar invested, which highlights the importance of timing of investments. For illustrative purposes, we also report the amount of total savings in real 2002 dollars.

[6] We calculate earnings for each subgroup using age-specific unemployment rates and wages. To maintain robust unemployment rate estimates for each group, we use 10-year age ranges. The profile is aged each year by one year, so that by 2002, the age group under consideration contains people between 55 and 65. More precisely, we define age-group specific, average monthly earnings as: $AME_{it} = (1 - UR_{it}) * wage_{it}$ where the real average monthly earnings, *AME*, for age-group *i* in time period *t* are equal to four times the real average weekly earnings of group *i*, *wage*, times the age-specific share of the labor force that is employed. All real variables are indexed to 2002 by using the CPI.

Total savings vary widely. On the low end, black women could expect to have accumulated $21,153 in inflation-adjusted dollars after 24 years. In comparison, white men could expect to save about twice as much with $40,751 (Table 2).

The accumulation per dollar invested differs considerably. For instance, men accumulated $0.05 more for each dollar they invested than women. This may not seem much, but over a span of 24 years, this amounted to more than $600 dollars in foregone savings for women, or a 2.7 percent loss. The difference between white men and white women is even more pronounced. Compared to white men, white women accumulated $0.06 less for each dollar invested, which amounted to a total of $734 over 24 years, or the equivalent of 3.2 percent of total savings. Although the variations are largest by gender, blacks also tend to have lower accumulations than whites for each dollar invested.

Table 2
Total Accumulations and Per-Dollar Accumulations

Total accumulations

Total	Men	Women	White			Black		
			Total	Men	Women	Total	Men	Women
30,948	38,472	22,316	32,451	40,751	22,741	24,305	27,776	21,153
Per-dollar accumulation								
1.91	1.92	1.87	1.91	1.92	**1.86**	1.90	1.92	1.88

Notes: Calculations are based on age specific earnings profiles. Minimum in bold. All figures are in 2002 dollars. A balanced portfolio over the period from 1979 to 2002 is assumed.

To illustrate the full labor market risks for each group of workers, we compare a situation with risk with one of no risk. First, we eliminate labor market risks that arise from variances in unemployment rates. We simply compare a worker with certain demographic characteristics and respective earnings and unemployment history to a worker who is constantly employed at the appropriate wages. Next, we eliminate the labor market risks associated with fluctuations in earnings. To do this, we estimate the average trend earnings for all workers and use these as the earnings history for all workers, regardless of demographic characteristics. At the same time, though, we allow the unemployment rate to vary with demographic characteristics. Third, we create a hypothetical profile that assumes no unemployment and no earnings risks.

The numbers are quite stark (Table 3). They show that women do indeed face labor market risks, while men barely do. For example, labor market risks reduce the amount a

woman can expect to save per dollar invested in her account by $0.06, most of which is a result of fluctuations in earnings.

Blacks also face labor market risks as their total accumulations are $0.02 lower for each dollar invested due exclusively to above average fluctuations in unemployment rates. However, this masks the difference between black men and black women. Black women are equally harmed by above average fluctuations in the unemployment rate and their wages. In comparison, black men are hurt by above average fluctuations in the unemployment rates, but they benefit from more stable earnings histories.

According to our calculations, women and minorities face greater labor market risks than their counterparts. Due to labor market risks, white women lose $0.07 for each dollar invested and black women lose $0.05 for each dollar put into an individual account. Without labor market risks, white women would have had $856, or 3.8 percent more, in real savings. Black women would have had $563, or 2.7 percent more, in total savings.

Table 3
Per-Dollar Accumulations Differences between No Risk and Average Risk Scenarios

Total	Men	Women	White			Black		
			Total	Men	Women	Total	Men	Women
No unemployment risk								
1.0	1.0	1.0	0.0	0.0	1.0	2.0	2.0	2.0
No earnings risk								
1.0	1.0	5.0	2.0	1.0	6.0	1.0	-1.0	3.0
No unemployment and earnings risk								
2.0	2.0	6.0	2.0	1.0	**7.0**	3.0	1.0	5.0

Notes: All figures are in 2002 cents. All figures are defined as the difference between the per-dollar accumulation with no risk minus the per-dollar accumulation with risk. A balanced portfolio over the period from 1979 to 2002 is assumed.

CONCLUSION

Social Security privatization is a costly undertaking without offsetting benefits. In the end, workers will face fewer benefits and lower standards of living in retirement. A number of costs associated with privatization have been well documented, such as administrative fees, insurance premiums, and transition costs.

However, one cost is often overlooked. Workers typically experience a drop off in their earnings at the time when it would be best to purchases stocks, i.e. when stock prices are low, as recessions and stock market declines tend to go hand-in-hand. This cost is substantial, especially for women and for blacks. In effect, it adds a cost not unlike that of turning savings into lifetime annuities to individual accounts. Specifically, women face labor market risks because their earnings vary more than those of men and blacks face labor market risks because their unemployment spells vary more than those of whites.

As a result, women and minorities are hurt twice. They already have lower lifetime earnings than their counterparts and thus tend to have lower savings, all else equal. However, with labor market risks, they also receive less in return for each dollar invested.

There is no easy way to reduce this cost in individual accounts. Labor market fluctuations are part of the business cycle, as are stock market fluctuations. Further, differences in unemployment rates and earnings by demographic characteristics have persisted for a number of reasons for decades and are only slowly declining.

Social Security offers a simple solution to the labor market risk, since benefits do not depend on the performance of the stock market. In addition, workers with lower lifetime earnings receive comparatively higher benefits than those with higher lifetime earnings. In other words, the two drawbacks of individual accounts arising from differential labor market experiences either disappear, such as labor market risks, or are reduced, such as lower lifetime earnings, under Social Security.

TECHNICAL APPENDIX:

To test for links between earnings and financial market returns, we regress the change in earnings on excess returns, net of the difference between stock market and risk free returns, in this case the 10-year U.S. Treasury bond yield (Campbell et al., 1999).

$$\Delta wage_{it} - \overline{w}_i = \beta(R_{t+1} - r_t - \overline{\mu}) + \varepsilon i_t \quad (1a)$$

$$\Delta UR_{it} - \overline{u}_i = \beta(R_{t+1} - r_t - \overline{\mu}) + \varepsilon i_t \quad (1b)$$

$$(1 - UR_i)(\Delta wage_{it} - \overline{w}_i) = \beta(R_{t+1} - r_t - \overline{\mu}) + \varepsilon i_t \quad (1c)$$

where *wage* is the average real monthly wage for group *i* in period *t*, $\overline{w}_i$ is the average real wage change from 1979 to 2002 for the group and ΔUR_{it} is the change in group-specific unemployment rate at time t. The real monthly wage is arrived at by multiplying average weekly earnings by four and deflating it by the CPI. R_t is the total real rate of return of stocks based on the S&P500's capital appreciation and dividend yield in a given month. r_t is the real interest rate on 10-year treasury bonds, and $\overline{\mu}$ is the average difference between the real rate of returns on stocks and on treasury bonds. Equations 2 and 3 are similar except that we test for a relationship between unemployment and excess returns (eq. 2) and the combined effects of wage gains and unemployment in equation 3.

We find that there is a positive relationship between excess returns in the equity market and changes in wages and a negative relationship between excess returns and the unemployment rate, i.e. as equity returns increase, unemployment declines (Table A-1). The effect of excess returns on our combined measure is somewhat larger, indicating that excess returns play a part in both the price and quantity of labor.

Table A-1
Changes in Earnings and Unemployment Rates and Excess Stock Market Returns

		Dependent Variable		
		Change in Weekly Earnings	Change in Unemployment Rate	Change in Weighted Average Earnings
(1)	Total	0.05**	-0.002	0.06**
		(2.21)	(1.09)	(2.35)
(2)	Men	0.05	-0.002	0.06*
		(1.44)	(1.23)	(1.76)
(3)	Women	0.03*	-0.001	0.04*
		(1.76)	(0.28)	(1.89)
(4)	Whites	0.06	-0.001	0.06*
		(1.71)	(1.05)	(1.91)
(5)	Blacks	0.03*	-0.003**	0.04*
		(1.99)	(2.20)	(1.95)

Notes: * denotes significance at the 10%-level, ** denotes significance at the 5%-level, and *** denotes significance at the 1%-level. (F-statistic in parentheses). All regressions include 6-month lags.

In particular, women and blacks experienced considerably smaller impacts of excess returns on their above trend wage growth, while white men did much better. The effect of excess returns on unemployment was significant only in the case of black workers. Overall, these results show that there are important relationships between financial market returns and both wage and unemployment outcomes; and importantly, these relationships are sensitive to gender and race.

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