Why we shouldn't privatize social security

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The idea of privatizing Social Security largely thrives on the fringe of American politics. The far left wants you to believe that Wall Street wants to denude the Social Security with fees and market risk. ("Oh my! Bankers at Tara!") The far right wants you to believe that your retirement is being stolen by Congress to pay for limo-riding welfare queens.

For all of the impassioned exchanges, the privatization of Social Security is a dead issue. The conversion of Social Security into a system of personal accounts would cost more than $10 trillion. It is now actually more expensive to privatize the system than to allow it to deteriorate under current law, which will automatically reduce benefits once the Trust Fund is gone.

To privatize Social Security, someone would have to pay $10 trillion in some type of incremental taxes in order for anyone to keep their 12.4% payroll taxes. Does anyone really care what the government calls the tax when you will lose more than you get to keep?

Neither of the extremist views is serious and both arguments ignore the obvious: privatizing Social Security is a bad idea – even if we could afford it.

From a policy perspective, privatization transforms Social Security from insurance into a system of forced-savings. Insurance is an expense designed to manage risk. Savings is an investment meant to profit from taking risk. These are not the same thing.

Social Security is theoretical insurance, a hedge against the cost of the unknown. We don't know how long we will live so we get a pension like Social Security. Similarly, we don't know how many auto wrecks we will have, so we buy auto insurance. Pooling risk is simply a better way to deal with the cost of the unknown.

The math is not complicated. In a system of personal accounts, every person must save sufficient wealth to fund how long a retirement might last. In an insurance model, the system needs only to create enough wealth to fund how long the collective retirement actually lasts. If savings were the best way to manage risk, we would all have personal auto wreck accounts.

Insurance pools risk to manage the cost of the outliers. The argument for personal accounts on the other hand is framed for the average person. Yes, an average person might have more money at retirement. In the same way, the personal auto wreck account funded with insurance premiums would offer more than the auto insurance policy – provided that you don’t have an accident in your car.

Michael Tanner of Cato Institute illustrates the problem. He claims, "…even in the worst case scenario – a low-wage worker who invested entirely in bonds – the benefits from private investment would equal those from traditional Social Security." Understand that his worst case is someone making roughly $25,000 in a career that lasts forty years. This isn't remotely close to the worst case.

Privatizing Social Security is not a good idea and doesn’t fix the problems of the system, which are baked in from the past. Personal accounts can adjust the direction of the future, but they cannot change the promises of the past. Until you have $10 trillion, or the willingness to tell existing retirees to pound sand, the issue of privatization of Social Security is simply a distraction.