

Privatize? Let's Be Clear Why.

The debate over the privatization of Social Security is confusing all of us.

Politicians and even many economists in favor of privatization are promising a rosy future with a US GDP so large that taking care of our elderly will be a breeze. To get to this nirvana, we only need to divert retirement funds from bonds that have historically paid low returns to stocks that have paid much higher returns.

Sorry, this is flim-flam. Privatization will have virtually no effect on the future US GDP. But there is a very important political reason why we should privatize, sooner rather than later.

Logically, the argument in favor of privatization must rest on one of three ideas:

1) Better Investments: Privatization will improve the choice of investments, making the economy grow more rapidly, and creating a bigger "pie" in the future from which retirees can have their slice.

2) More Savings: Privatization will make the "pie" bigger not because of better investment choices but because we will save more.

3) Less acrimony: Privatization will transfer the responsibility for retirement from the Federal Government to private individuals, thus eliminating the agonizing discussion over just how big a piece of the national pie retirees deserve.

So which is it? Better investment, more savings or less acrimony?

Surprise. It isn't better investments, or more savings. The real value of privatization is that it will take the determination of benefits out of the political arena, and halt the intergenerational political conflict that is already here and sure to get worse.

Most commentators suggest that privatization will work because it will allow us to make better investments. The discussion usually begins with a comparison of rates of return on stocks (10%) versus bonds (2%). It is argued that if we allow retirement savings to be invested in the stock market, then we can expect a huge increase in the return on our savings. This is faulty thinking. We have a very sophisticated financial system that does a superb job picking the best allocation of new savings to buildings and to equipment and to research and development. The choice of projects does not depend very much on whether firms finance new investments with debt or equity. Therefore with privatization, the economy will make the same investments and have the same amount of corporate earnings to split between bond holders and equity investors. The diversion of financial assets from bonds to stocks will only lower the return on stocks and raise the return on bonds just enough of each to keep the total payout unchanged.

Although it is highly unlikely that privatization will have much effect on the rate of return to US savings, it is possible that total US savings will increase. This would be a good thing. After all, net private savings are now nearly zero. If we don't save, we don't grow, and our future is starting to look pretty bleak, especially when the baby boomers are all retired and demanding benefits. (I am not buying into the New Economy proposition that "thinking" of new websites, not savings out of current income, is what causes growth.)

There is, however, a real and important benefit from privatization. It would take a very difficult income distribution question out of the hands of the government. We let the private market largely decide the distribution of income among members of the same generation, but we choose politics not economics to decide how much you and I contribute to the welfare of our aged parents. This creates intergenerational

conflict that seems relatively quiet now only because the politics of aging are better understood by the old than by the young – there is an AARP but no AAWP, “W” standing for working.

When the baby boomers retire, their numbers will overwhelm, and the focus on the elderly is sure to increase. We have been there before. California in the 1930s had a large and politically active “elderly” population who put on the ballot the “Ham and Eggs” initiative that would have granted everyone over the age of fifty “thirty dollars every Thursday.” This generous transfer to the elderly was more than twice California per capita income at the time, and it attracted 45% of the vote in 1938.

Thus, don’t be misled by the promise of high returns in the stock market. Privatization will surely not mean better investments for the US overall. The core issue is a familiar one – personal versus public responsibility. Privatization will take retirement planning out of the public arena and put the burden on those with the greatest personal stake – future retirees and their families.

Edward E. Leamer is the Chauncey J. Medberry Professor of Management and Director of the UCLA/Anderson Business Forecast, which is hosting a conference on “The Economics of the Presidential Campaign” on September 27. For details consult <http://www.anderson.ucla.edu> or call 310/206-1495.