BY ROBERT J. BARR0

PRIVATIZING SOCIAL SECURITY: WHERE BOTH SIDES GO WRONG

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FALLACIES: Advocates err in citing higher yields, and opponents shouldn't assume that private accounts would be more risky

George W. Bush hit on a popular issue in his support for personalized accounts for Social Security. Given this popularity, it was surprising that Al Gore initially opposed the idea. However, Gore seems to have recognized his mistake and is moving to create a plan of his own. Given this broad support, it is worth examining the errors that usually accompany discussions of privatizing Social Security. While privatization makes sense, some of the arguments in favor of it don't. By doing away with them, we can focus attention on the real reasons why privatization is a good idea.

One logical flaw involves comparisons between the likely rates of return on personal accounts and those paid under the current system. In general, any proposition that sounds like a free-lunch opportunity to obtain higher rates of return involves some sort of fallacy. That is the case here.

Compare first the real return under the present Social Security scheme-about 2% per year-with the risk-free yield of 4% that personal accounts could guarantee by holding inflation-indexed U. S. Treasury securities. The return in the existing program is so low only because of the mechanics of a primarily pay-as-you-go system. Today's contributions mainly go to pay for the pension benefits of today's retirees, who were the previous generation of workers. The total return of the Social Security system corresponds to the growth of overall wage income. Thus, the real rate of return in an ongoing system is about 2% if the economy grows at that rate in the long run.

INHERENT DRAG So why is it a fallacy to argue that the 4% yield on personal accounts is better? The return is low in the present system because workers start with a liability-providing for the retirees of the previous generation. If today's workers could get out of their liability to the current elderly, they could earn a rate much higher than 2% even if no personal accounts were introduced. It is this feature of escaping liability-not the personal nature of the accounts-that explains the differences in returns. But, of course, no one wants to reduce benefits to the elderly.

Another questionable argument is that personal accounts can pay more than 4%, almost without risk, by holding stocks. It is true that over the past 80 years, stocks have yielded an average real return of 7%, and this return has not been very risky over holding periods of 10 years or more. It is therefore a puzzle why stockholders have demanded such a high-risk premium-historically, as much as 5%, though perhaps less now-to hold stocks. Nevertheless, policymakers ought to accept the market-risk premium as a guide. In a correct analysis, there is no free-lunch gain from placing part of Social Security funds into stocks. The higher expected return is offset by greater risk.

FORCED SAVINGS? Yet another unproven case for privatization is that it would raise the national saving rate, which in turn would stimulate economic growth. The concept is that creating personal accounts while cutting back on conventional Social Security benefits would force people to save more. But this argument is controversial theoretically and lacks clear empirical support.

That said, opponents of personal accounts have made mistakes, too. They have erred in arguing that the returns would necessarily be more risky than in the current system. That depends on how people invest their money. In most proposed plans, participants can choose to hold their funds in risk-free form, such as inflation-indexed bonds. The risk on this holding is much smaller than anything confronting workers under the present retirement system.

In addition, there are positive reasons to favor personal accounts. One involves property rights. Since the accounts would be owned by individuals, the pension benefits paid would be less subject to the political whims of future Congresses. This feature is threatened by proposals to reduce an individual's return from the current system in line with the amount received from the personal accounts. In this case, the property rights are only partial.

Personal accounts also have an attractive element of choice; in most proposals, individuals can tailor their portfolios to their own preferences about risk vs. return. These opportunities are not available under the present one-size-fits-all system.

In the end, I favor personal accounts for Social Security not because of the possible savings boost or the claimed superiority of rates of return. For me, the crucial points in favor of them are those regarding property rights and choice.

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