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Privatization: Not the Answer for Social Security Reform

Regina T. Jefferson*

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Introduction

As Social Security faces financial difficulties, few would argue that the program is not in need of change.¹ However, there is much less consensus

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1. Public discomfort about the Social Security program stems from concern that the system is no longer sustainable. There is fear that unless payroll taxes are raised, future bene-

about the manner and degree of change required.² Most proposals that have emerged in the Social Security reform debate involve three basic concepts: pre-funding, investment diversification, and privatization.³ Although these concepts are frequently considered interdependent, they are actually separate and distinct. Pre-funding refers to the requirement that there be sufficient assets accumulated in the trust fund in advance to pay for future retirement costs.⁴ Diversification describes an investment strategy that allocates Social Security reserve funds among different investment alternatives.⁵ Privatization

ficiaries will be forced to accept reduced benefits, relative to the current benefit package. See *Investing Social Security Reserves in Private Securities*, Hearing Before the Subcomm. on Soc. Security of the House Comm. on Ways and Means, 106th Cong. 21-27 (1999) (statement of Robert D. Reischauer) [hereinafter *Investing Social Security Reserves*] ("Because neither the public nor lawmakers have greeted the prospect of higher taxes or reduced spending with any enthusiasm, the option of boosting the returns on Social Security's reserves is worth close examination.").

2. See I U.S. ADVISORY COUNCIL ON SOC. SEC., REPORT OF THE 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY (1997) [hereinafter ADVISORY COUNCIL REPORT] (describing three recommendations for rectifying Social Security funding shortfall). The council could not agree on one solution for the Social Security issue and therefore proposed three separate plans. *Id.* at 25-33. One plan maintains benefits through increased taxation, redirecting the Social Security portion of the Hospital Insurance Trust Fund. *Id.* at 25. The second proposal creates individual accounts in which the individuals may choose from a limited list of investment possibilities, and the central assets of the trust will continue to be invested in treasury bonds. *Id.* at 28. The final proposal creates personal securities accounts. *Id.* at 30. This plan consists of two tiers of individual accounts; the first tier employs a flat dollar retirement benefit covering all workers, and the second tier consists of fully funded individual retirement accounts. *Id.*

Also, immediately before this Article went to press, the President's Commission to Strengthen Social Security released a report on December 21, 2001, detailing three proposals for reforming Social Security. All three proposals recommend voluntary, individually controlled personal retirement accounts. Although the voluntary characteristic of the proposals adds complexity regarding implementation and administration, the voluntary characteristic does not impact the substantive issues surrounding Social Security privatization. However, full consideration of the report is not possible at this time. The President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans* (Dec. 21, 2001), available at http://csss.gov/reports/Final_report.pdf.

3. ADVISORY COUNCIL REPORT, *supra* note 2, at 25-33; see also David Altig & Jagadeesh Gokhale, *Social Security Privatization: One Proposal*, CATO PROJECT ON SOC. SEC. PRIVATIZATION, NO. 9, May 29, 1997, at 8-12 (proposing system of individually owned private accounts for specific generation of retirees, much like 401(k) plans offered today).

4. Kevin Lansing, *Can the Stock Market Save Social Security?*, FRBSF ECON. LETTER, Dec. 11, 1998, at 3 (noting assets in program could be held in individual accounts or Social Security trust fund).

5. Mary C. Daly, *Understanding the Social Security Debate*, FRBSF ECON. LETTER, June 25, 1999, at 3 ("The idea behind diversification is to take advantage of the historical return advantage of common stocks over other financial assets."); Lansing, *supra* note 4, at 3 (discussing whether investment in stock market can provide solution to probable future of social security deficits).

pertains to the creation of individual accounts owned and managed by workers, very much like the accounts of 401(k) defined contribution plans.⁶ Privatization proposals generally are based on either a "carve out" or "add on" approach.⁷ The add on approach funds the individual accounts with new Social Security contributions, whereas the carve out approach diverts portions of current contributions to fund the individual accounts.⁸

Pre-funding and diversification could be implemented under the existing structure of Social Security; however, privatization radically changes both the structure and character of the existing program. Furthermore, the carve out model of privatization presents a questionable trade-off.⁹ On the one hand, workers will have greater investment freedom in a privatized system; on the other, they will be exposed to significantly greater risks. Thus, Social Security privatization has potentially serious implications for retirement income security to the extent that it relies on current contributions.¹⁰ For this reason, privatization is the focus of much of the Social Security reform debate and is the subject of this Article.

6. See Daly, *supra* note 5, at 3 (describing privatization plans); Lansing, *supra* note 4, at 3 (same). The meaning of the term "privatization" can vary significantly; however, it most frequently refers to the use of individual accounts. Alicia H. Munnell, *Reforming Social Security: The Case Against Individual Accounts*, 52 NAT'L TAX J. 803, 806-07 (1999) (describing "privatization").

7. Proposals to privatize in both categories range from partial to full replacement of the current Social Security benefit structure. Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMP. L. REV. 131, 148-49 (1998).

8. See Jacob M. Schlesinger, *Bush Plan to Privatize Social Security Will Face Host of Hurdles*, WALL ST. J. EUR., Dec. 18, 2000, at A24 (describing "add on" proposal); see also AARP RESEARCH GROUP, *INDIVIDUAL ACCOUNTS, SOCIAL SECURITY, AND THE 2000 ELECTION* 15 (Sept. 2000) (detailing carve out approach).

9. See Kathryn L. Moore, *Partial Privatization of Social Security: Assessing Its Effects on Women, Minorities, and Lower-Income Workers*, 65 MO. L. REV. 341, 366 (2000) (concluding that differential returns for participants in privatized social security system would meet program's progressive goals).

10. The fact that over 66% of the current retiree population opposes privatization is very informative. Their opposition presumably demonstrates that they value the guaranteed benefits that the present Social Security program provides and that they prefer not to risk them for privatization. Elizabeth Crowley, *Social Security Reform: The Great Divide*, WALL ST. J., Mar. 11, 1999, at A14. The concerns of opponents of privatization are validated by the compositions of the various groups that withhold support for such proposals. *Id.* Privatization is unpopular among low-income individuals: less than 33% of individuals who earn less than \$20,000 a year support proposals to privatize. *Id.* In contrast, more than 50% of those who earn more than \$50,000 a year support these proposals. *Id.* Additionally, only one-third of non-college graduates support such proposals, as compared to one-half of the professional population. *Id.* But see Daniel Shapiro, *The Moral Case for Social Security Privatization*, CATO PROJECT ON SOC. SEC. PRIVATIZATION, Oct. 29, 1998 (providing one example of privatization reform proposed by CATO Institute).

Specifically, this Article analyzes the impact of privatization on the existing Social Security program. Part I describes the structure and status of the current Social Security program. Part II describes the principal elements of Social Security reform proposals. Part III critiques the private retirement system and its reliance on individual accounts as primary retirement savings vehicles, and demonstrates why this model is inappropriate as a replacement for the existing Social Security program. Part IV explores the impact of privatization on the public welfare function of Social Security and examines some of the weaknesses in many of the privatization proposals. The Article concludes that privatization is a questionable solution for the Social Security debate. Therefore, as policymakers take steps toward implementing a privatized system, they should be mindful of the primary objectives of the existing Social Security program and the relationship of these goals to present societal conditions.

I. The Social Security Program

Social Security is one of the most popular and successful social programs in this country's history.¹¹ In addition to retirement benefits, Social Security provides disability and life insurance protection.¹² The program enjoys a wide base of political support, largely because it provides benefits to all covered workers and their families, regardless of income. Currently, over 90% of the labor force contributes to the Social Security program, and 48 million families receive benefit payments from the program.¹³ Although Congress never in-

11. The Social Security program began as a political response to the economic trauma of the Great Depression. William G. Shipman, *Retiring with Dignity: Social Security Versus Private Markets*, WASH. Q., Jan. 1, 1999, at 119. During this period, real gross national product shrunk by more than 25% and unemployment rose by 22%. *Id.* During this same period, the stock market dropped by 70%. *Id.* Witnessing the despair of the country, President Franklin D. Roosevelt promised legislation that would restore economic security to the nation in his June 8, 1934 address to Congress. *Id.* One year later, on August 14, 1935, Congress passed the Social Security Act. *Id.*

12. DIMITRI B. PAPADIMITRIOU & L. RANDALL WRAY, DOES SOCIAL SECURITY NEED SAVING?: PROVIDING FOR RETIREES THROUGHOUT THE TWENTY-FIRST CENTURY 8-9 (1999 Jerome Levy Econ. Inst. of Bard Coll., Pub. Pol'y Brief No. 55). Social Security consists of several different programs: Old-Age and Survivors Insurance (OASI), the hospital insurance portion of Medicare (HI), Supplemental Medical Insurance (SM), and Disability Insurance (DI). *Id.* OASI and DI are often combined because the financial operations of each program are managed by the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund, both established at the Treasury. *Id.*; see also Catherine Hill, *Privatizing Social Security Is Bad, Particularly for Women*, DOLLARS & SENSE, Nov. 1, 2000, at 18 (noting that regardless of age, when workers become too disabled to work, they are eligible to receive benefits).

13. See Hill, *supra* note 12, at 17 (noting Social Security statistics). The average monthly payment for a retired worker is \$825. *Id.* The maximum monthly benefit is \$1,373 for workers who consistently earned wages equal to or in excess of the wage cap over thirty-five years. *Id.*

tended Social Security to be a primary source of income, today a majority of retired households depend on Social Security for more than one-half of their total income.¹⁴

A mandatory, flat-rate payroll tax funds Social Security benefits. Currently, the tax rate is 12.4% and applies to all cash earnings up to \$80,400.¹⁵ Employers and employees pay the tax evenly; self-employed individuals pay the full tax themselves.¹⁶

The Social Security program has been very effective in reducing poverty within the senior population in this country. When Congress established Social Security in 1934, approximately 50% of the elderly population lived in poverty.¹⁷ Twenty-five years later, although the poverty rate among the elderly fell to 35%, it nevertheless remained higher than that of other groups.¹⁸ However, after Social Security benefits increased in the 1960s and 1970s, the poverty rate within the senior population dropped precipitously.¹⁹ Presently, the poverty rate for senior citizens is below that of children and working-age adults, with only 11% of the elderly having incomes below the poverty level.²⁰

The Social Security Trustees publish an annual actuarial report that assesses the financial status of the Social Security program.²¹ A seventy-five

For this purpose senior households are defined as households with at least one member aged sixty-five or above.

14. *Id.* at 17; see also Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1120 (1997) (stating that "program was never designed to be the sole or major support for retired workers . . . [B]enefits were designed to replace on average only about 45% of the pre-retirement earnings of a worker."); *infra* Part III.B (describing risk of shortfall in defined contribution plans).

15. 26 U.S.C. §§ 3101(a), 3111(a) (1994) (payroll tax); 42 U.S.C. § 430 (1994) (earnings cap). Cash earnings in excess of \$80,400 are subject to a 2.9% payroll tax for Medicare, which also is paid evenly by the employer and the employee. 26 U.S.C. § 3101(b)(6) (1994).

16. See 26 U.S.C. §§ 1401, 1402(a) (1994); see also GARY BURTLESS & BARRY BOSWORTH, *PRIVATIZING SOCIAL SECURITY: THE TROUBLING TRADE-OFFS* (Brookings Inst. Pol'y Brief No. 14, Mar. 1997), available at <http://www.brook.edu/comm/policybriefs/pb014/pb14.htm>.

17. See Jonathan Barry Forman, *Making Social Security Work for Women and Men*, 16 N.Y.L. SCH. J. HUM. RTS. 359, 366-67 (1999).

18. Daly, *supra* note 5, at 3.

19. *Id.*

20. See Forman, *supra* note 17, at 367 (noting poverty rate among various age brackets). According to the United States Census Bureau, the estimated poverty threshold for the year 2000 for a household of two, sixty-five years and over is \$10,414. U.S. Census Bureau, *Preliminary Estimate of Weighted Average Poverty Thresholds for 2000*, Jan. 26, 2001, available at <http://www.census.gov/hhes/poverty/threshold/00prelim.html>.

21. Using stated economic, interest rate, and demographic assumptions, these reports determine the relationship of tax revenue to benefit pay-outs. The forecasts are made by the Trustees of Social Security and Medicare, the Social Security Commissioner, along with two

year projection period is used to determine the long-run relationship of tax revenue to benefit pay-outs. Recent reports predict a long-run deficit equal to 1.86% of payroll earnings.²² This figure suggests that in order to have sufficient funds to pay the current package of Social Security benefits over the next seventy-five years, Congress must increase payroll taxes immediately by 1.86%.²³

If, however, Congress makes no adjustments to the program, by 2016, tax revenue will no longer exceed benefit pay-outs, necessitating the use of the trust fund reserve to pay for benefits.²⁴ The trust fund reserve could pay full benefits through 2038, but it would then be depleted.²⁵ Depletion of the trust fund would mean that a portion of the benefit package that exists today could not be paid in the future. Specifically, there would be a 27% shortfall in the funding of current benefits if Congress makes no changes to benefits and maintains the current rate of payroll taxes.²⁶ It is this projected 27% gap that has sparked public uneasiness about the future of Social Security, as well as much of the Social Security reform debate.²⁷

additional members who are external to the program. THE 2001 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, available at [ftp://ftp.ssa.gov/put/oact/tr01.pdf](http://ftp.ssa.gov/put/oact/tr01.pdf) [hereinafter 2001 OASDI REPORT]; Edward M. Gramlich, *Mending But Not Ending Social Security: The Individual Accounts Plan*, in FED. RES. BANK OF ST. LOUIS REV. 3, 7 (1998).

22. This figure is down by .03 from last year's report. See 2001 OASDI REPORT, *supra* note 21; see also THE 2000 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, available at [ftp://ftp.ssa.gov/put/oact/tr00.pdf](http://ftp.ssa.gov/put/oact/tr00.pdf).

23. See Munnell, *supra* note 6, at 804 (explaining Social Security's long-term deficit); see also 2001 OASDI REPORT, *supra* note 21 (describing options for overcoming shortfall). The Trustee report also includes a ten-year projection. *Id.*

24. This projection uses intermediate actuarial assumptions. 2001 OASDI REPORT, *supra* note 21. Interest on the contributions has been added. ADVISORY COUNCIL REPORT, *supra* note 2, at 11; Munnell, *supra* note 6, at 804. The trust fund reserve holds the surplus funds when payroll taxes exceed current benefit costs for a given year. ADVISORY COUNCIL REPORT, *supra* note 2, at 11.

25. This statement assumes that benefits remain the same. 2001 OASDI REPORT, *supra* note 21.

26. See Munnell, *supra* note 6, at 807 (noting shortfall).

27. The Social Security program has experienced financial difficulty before. In 1975, payroll tax revenue fell short of benefit pay-outs. The shortfall was covered by using a portion of the reserve. Gramlich, *supra* note 21, at 3. The urgency of the matter heightened when the Old-Age and Survivor Insurance (OASI) portion of the Social Security program borrowed money from the Disability and Medicare portions of the program in order to pay for its monthly expenses in 1982. *Id.* Accordingly, Congress passed legislation in 1983 that was expected to resolve the financial problems of the Social Security program over both the long- and short-run. *Id.* The 1983 legislation used several different tactics to restore financial soundness to the program. It increased taxes, taxed the Social Security benefits of high income beneficiaries,

Although the projected 27% shortfall is useful in defining the extent of the funding deficiency, and therefore policymakers should seriously consider it, the seventy-five year forecast is only a prediction. It is impossible for actuaries to take into account all of the social developments that could affect the payment of payroll taxes and benefits, such as wars, depressions, and recessions.²⁸ Unexpected changes in demographic conditions also could contribute to the possibility of a deviation from the projection.²⁹ Thus, the 27% gap may or may not accurately predict the actual experience of the Social Security program over the next seventy-five years.³⁰

II. Elements of Social Security Reform Proposals

One source of confusion regarding Social Security reform proposals is the presence of three related, but different, concepts: pre-funding, diversification, and privatization. It is important to define and distinguish these three concepts in order to better understand their relationships to each other, as well as to appreciate fully their potential impact on the existing Social Security program. Some commentators have linked privatization with the concepts of advanced funding and diversification. However, these terms are neither synonymous nor dependent. Privatization in this context means only separate accounts and self-direction.³¹ In contrast, pre-funding refers to the accumula-

postponed a cost-of-living benefit adjustment, and broadened the Social Security tax base by extending participation to newly hired federal government employees. *Id.* Although the legislation succeeded at producing large surpluses and improving the short-term financial outlook of the program, in less than ten years, the long-term outlook of the program was again called into question. *Id.* Consequently, in 1994, Congress appointed an Advisory Council to determine the status of the Social Security program, and in 2000, the President's Commission was formed to strengthen Social Security. *Id.* The Advisory Council and the Commission, along with many economists, social scientists, and other policymakers, have proposed numerous plans aimed at restoring the Social Security program to financial health. *Id.*; see *supra* text accompanying note 3 (describing proposed means of reforming Social Security).

28. These events can impact both the labor force and overall production. Benefits in payment status typically increase relative to the Consumer Price Index, while tax revenue increases relative to wage growth. Munnell, *supra* note 6, at 804.

29. Birth and death rates impact the projected shortfall because they determine the payment of payroll taxes and benefits. Phillip O'Connor, *Predicting System's Future Is Risky Business: Some Projections Are for 75 Years from Now*, ST. LOUIS POST-DISPATCH, Oct. 15, 2000, at A10.

30. A greater degree of accuracy could be achieved over a shorter period of time. See generally Kenn B. Tacchino & Cynthia Saltzman, *Should Social Security Be Included When Projecting Retirement Income?*, J. FIN. PLANNING, Mar. 1, 2001 (discussing projected Social Security shortfall).

31. Lansing, *supra* note 4, at 3. Self-direction allows individual workers to make their own investment selections among a range of stocks and bond investment alternatives. See also *supra* note 6 and accompanying text (discussing privatization as meaning creation of individual accounts).

tion of sufficient funds in advance to pay for promised benefits; diversification refers to the ability to invest the Social Security reserve funds in more productive private markets.³² Without privatizing, Congress could significantly reduce the anticipated shortfall in the Social Security program by adopting an advanced funding method in conjunction with more aggressive investment policies.³³

A. Social Security Funding

Four years after it established the Social Security program, Congress voted to operate the program on a pay-as-you-go basis. This was due to Congress's concern that the government would be unable to manage a large trust fund responsibly.³⁴ Under a pay-as-you-go funding arrangement, instead of holding the contributions of current workers to later pay for their future benefits, the system immediately uses the contributions of current workers to finance the benefits of current retirees.³⁵ Thus, under this type of funding scheme, the goal is not to collect amounts in excess of those needed to cover current expenses. There may be de minimis surpluses from time to time, but the program never intentionally creates significant funding reserves. In the event that the payroll taxes collected in a given year exceed the amount necessary to pay for current benefits, the Social Security Administration holds the surplus in the Social Security trust fund.³⁶

When Congress established the Social Security program, the ratio of current workers to beneficiaries made the pay-as-you-go funding arrangement more feasible than it is today. An initially smaller pool of Social Security beneficiaries was followed by increasingly larger ones.³⁷ This relationship allowed the cost of the first group's benefits to be spread across a larger popu-

32. *The Perils of Privatization*, WASH. Q., Jan. 1, 1999, at 10; see also *supra* notes 4-5 and accompanying text (discussing pre-funding and diversification).

33. See ADVISORY COUNCIL REPORT, *supra* note 2, at 25. Under the Advisory Council's proposal for maintenance of benefits, 40% of the Social Security fund would be invested in the private equities, while it is estimated that the rate of return between treasury bonds and the private market differs by approximately 4.7% per year. *Id.*

34. See *Investing Social Security Reserves*, *supra* note 1, at 24-25; Lansing, *supra* note 4, at 3.

35. In contrast, a pre-funded program has sufficient assets to cover the accrued liabilities, and workers would generally receive benefits that equal the actuarial equivalent of their payroll tax contributions. Lansing, *supra* note 4, at 3. For a more detailed discussion on the two funding methods, see CAROLYN L. WEAVER, *THE CRISIS IN SOCIAL SECURITY* 119-23 (1982).

36. See BURTLESS & BOSWORTH, *supra* note 16 (describing use of surplus funds).

37. Donald B. Marron, *Not Privatizing Social Security Is the Biggest Risk of All*, WALL ST. J., May 18, 2000, at A26 (stating ratio of workers per beneficiary in 1935 was twenty-five to one).

lation of workers. However, the combination of program expansions and demographic changes has caused a sharp decline in the current worker-to-beneficiary ratio, making pay-as-you-go funding an impractical arrangement.³⁸ Program expansions have awarded larger benefits to groups who have contributed relatively small amounts.³⁹ Consequently, these expansions have increased the costs that subsequent generations incur for the benefits of prior ones.

Another factor contributing to the decline of the worker-to-beneficiary ratio is the aging of the baby-boom generation.⁴⁰ The baby-boom cohort will be the largest group of retirees covered by the Social Security program since its inception. This group represents a 54% increase in the retired population, taken as a percentage of the total population.⁴¹ The number of baby-boomers alone is sufficient to present financial difficulty for the Social Security program; however, the fact that a relatively small generation of workers followed the baby-boom generation exacerbates the situation. Presently, there are only 3.3 current workers per beneficiary.⁴² Official predictions indicate that this ratio will drop to two workers per beneficiary by 2030, unless demographic and behavioral factors change unexpectedly.⁴³

38. See Daly, *supra* note 5 (noting that program expansions and behavioral changes have reduced current ratio to 3.3 workers per Social Security beneficiary).

39. See Dorothy A. Brown et al., *Social Security Reform: Risks, Returns, and Race*, 9 CORNELL J.L. & PUB. POL'Y 633, 635-36 (2000) (noting tension that exists between goals of "social adequacy" and "individual equity").

40. The baby boomer population was born between 1946 and 1964. Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 987 (2000). Other demographic factors impacting the beneficiary-to-worker ratio were the increases in the number of early retirements, as well as the increases in life expectancies. In 1950, fifteen years after the establishment of Social Security, the average retirement age for males was fifty-nine, and the life expectancy of males who reached age sixty-five was approximately age sixty-eight. Consequently, at that time, the average male could expect to live only nine years after retirement. In contrast, currently a male aged sixty-five can expect to reach eighty-one years of age, and the average retirement age is sixty-four. Thus, currently, the average male can expect to live approximately seventeen years after retirement. See Lansing, *supra* note 4, at 1 (describing aging of baby-boom generation).

41. See Daly, *supra* note 5 (describing demographics of Social Security).

42. *Id.* (noting that smaller generation is frequently referred to as "baby bust" generation).

43. U.S. GEN. ACCOUNTING OFFICE, RESTORING LONG-TERM SOLVENCY WILL REQUIRE DIFFICULT CHOICES 2 (1998). However, it is unlikely that the ratio of workers to beneficiaries will ever increase at accelerating rates again, as it did immediately after the establishment of the Social Security program. Instead, it can be expected that the working population will fluctuate relative to social and economic forces. Demographers explain that uninterrupted growth trends are unlikely because population size is inversely related to the size of previous generations. *Id.* Richard Easterlin explains in his book *Birth and Fortune* that it is predictable that large birth cohorts follow small ones, and that small cohorts follow large ones. See generally RICHARD

To address this situation, Congress passed legislation in 1977 that moved the Social Security program away from a purely pay-as-you-go funding method toward a "partial reserve funding" method.⁴⁴ This legislation was designed to create a substantial Social Security funding reserve; however, because of a sudden down-turn in the economy, the reserve did not materialize as expected.⁴⁵ Therefore, Congress passed additional legislation in 1983 that simultaneously raised payroll taxes and instituted a series of benefit cuts.⁴⁶ These changes have led to a steady growth of the Social Security reserve fund.⁴⁷ The reserve fund reached \$763 billion in 1998, which represented almost twice the amount of annual benefits payable at that time, and at the end of 2000, the reserve fund had reached \$1,049 billion.⁴⁸ However, assuming predictions regarding key variables such as immigration, inflation, and labor force participation are correct, unless Congress makes immediate changes to the program, the surplus will begin to erode when the first of the baby-boomers begin to retire.⁴⁹

B. Diversification

Since the creation of the Social Security program in 1935, the law has required that reserve funds be invested exclusively in securities guaranteed by

EASTERLIN, BIRTH AND FORTUNE (1980) (describing birth trends). He explains that the unexpectedly high living standards cause small generations to produce larger families. *Id.* The larger generation in turn will experience disappointment in its living standards, and consequently will be more reluctant to have large families; thus, population growth does not increase or decrease consistently from one generation to the next, but rather skips generations. *Id.*

44. ADVISORY COUNCIL REPORT, *supra* note 2, at 16; *see also Investing Social Security Reserves, supra* note 1, at 23.

45. *Investing Social Security Reserves, supra* note 1, at 23.

46. This legislation was initiated by the Presidential Committee appointed by President Ronald Reagan in 1981, headed by Alan Greenspan. WALTER M. CADETTE, SOCIAL SECURITY PRIVATIZATION: A BAD IDEA 3 (1999 Jerome Levy Econ. Inst. of Bard Coll. Pol'y Note No. 10).

47. In 1998, payroll taxes were \$440 billion, and benefits and fees equaled \$382 billion. Daly, *supra* note 5.

48. At that time, the interest earned on the existing trust fund was equal to \$49 billion. *See id.; Investing Social Security Reserves, supra* note 1, at 23; *see also* Daly, *supra* note 5 (noting that overall annual surplus for 1998 was therefore \$107 billion). Under current policies and assumptions, the surplus is expected to close at more than \$2.5 trillion in 2010, which is three times more than the projected annual benefits for that period. 2001 OASDI REPORT, *supra* note 21; Daly, *supra* note 5.

49. *See* 2001 OASDI REPORT, *supra* note 21; *supra* notes 38-43 and accompanying text (discussing factors contributing to expected erosion of surplus). The first of the baby boomers will begin to retire in 2011 when they reach age sixty-five; the youngest of the boomer generation will reach age sixty-five in 2029. However, those electing the earlier retirement age of sixty-two will begin to retire in 2008. *See* CADETTE, *supra* note 46, at 3 (explaining Social Security and expected shortfall).

the federal government.⁵⁰ This restriction can be explained historically. When Congress established the Social Security program in 1935, the United States had just undergone the stock market crash of 1930. Default on the payment of corporate bonds was also widespread.⁵¹ Accordingly, at that time, the public perceived government securities as the safest and most appropriate form of investment for Social Security trust funds.⁵²

As a result of these investment restrictions, most of the trust fund reserve is still invested in special, non-marketable, low-risk Treasury securities.⁵³ Unlike publicly held notes and bonds, whose market values can fluctuate over time, these government securities can be sold back to the Treasury at par value, at any time.⁵⁴ Thus, the restrictions on the investment of the trust fund assets protect them from the volatility of the private market; however, they also cause the funds to experience relatively low rates of investment return.⁵⁵

When the Social Security program operated purely on a pay-as-you-go funding basis, the annual surpluses were small and sporadic. Thus, the lower rate of return on the investment yield of the trust fund reserve had little or no practical effect on the financial status of the program. However, when Congress passed legislation in 1983 that allowed partial reserve financing, the loss of income to the program resulting from investment in low-risk, low-yield instruments has become increasingly significant as the surplus has increased.⁵⁶

50. Both the principle and the interest must be invested in this manner. Altig & Gokhale, *supra* note 3, at 6.

51. See *supra* note 34 and accompanying text (noting concern about government's ability to manage large sums).

52. *Investing Social Security Reserves*, *supra* note 1, at 23.

53. See *id.* (explaining investment of trust fund reserve).

54. "Par value" is the nominal or face value of the stock. BLACK'S LAW DICTIONARY 1145 (7th ed. 1999).

55. See *Investing Social Security Reserves*, *supra* note 1, at 23 (explaining return on trust fund).

56. See *supra* notes 44-46 and accompanying text (describing shift to partial reserve financing); see also *Investing Social Security Reserves*, *supra* note 1, at 23-24. The restrictions placed on the investment of the Social Security reserve also have added additional complexity to the debate over Social Security reform. There is considerable confusion among commentators regarding the impact of more aggressive investment of the Social Security reserve. Supporters of certain reform proposals contend that their plans are better than others because they provide increased returns on Social Security contributions. However, most proposals provide greater returns simply because they do not restrict investment to low-risk, low-yield Treasury securities. *Investing Social Security Reserves*, *supra* note 1, at 23-24. Theoretically, if the reserve funds were invested in the private market, the Social Security Trust fund should earn the same average rate of investment return as individual private retirement accounts. In fact, because of economies of scale, the net investment return of a single public fund actually should

The average annual real rate of return in the private market was 9.4% from 1926 to 1996.⁵⁷ During the same period, the corresponding rate of return on intermediate government bonds was 2.3%. By comparison, the real rate of return received on the Social Security surplus is estimated at 1.3%.⁵⁸ The aggregate rate of return on Social Security contributions is significantly lower than the rate of return for government bonds because the switch to pay-as-you-go funding in 1939 produced a huge windfall for the initial generation of Social Security retirees.⁵⁹ These recipients collected full Social Security benefits, even though they made only nominal contributions to the program; thus, the program acquired an unfunded liability of \$9 trillion.⁶⁰ As a result, this requires every subsequent generation to pay both a portion of the unfunded liability, and the implicit interest costs for the benefits paid to the first generation of Social Security retirees.⁶¹ An estimated 3% of current payroll taxes is devoted to this expense.⁶² Consequently, one-fourth of Social Security contributions receive no positive earnings, while the remaining three-fourths earn the market rate for bonds of 2.3%.⁶³ This allocation produces a net rate of return on aggregate payroll tax contributions of 1.3%.⁶⁴ Therefore, although the trust fund reserve earns the market rate of return for government bonds, due to the large unfunded liability, the real rate of return on the Social Security surplus is much lower than the prevailing rate on government bonds.⁶⁵ For this reason, unless measures are taken to pay off the unfunded liability, investing the Social Security payroll tax contributions in more productive private markets may not result in high returns on aggregate contributions.⁶⁶

be higher than the returns on individual investment accounts. BURTLESS & BOSWORTH, *supra* note 16.

57. See Munnell, *supra* note 6, at 807 (noting rate of return).

58. *Id.*

59. See Dilley, *supra* note 14, at 1136 (noting differential rates of return).

60. Ms. Ida Fuller, the first person to receive monthly benefits from the Social Security program, paid only \$22 in Social Security taxes, but nevertheless collected over \$20,000 in benefits during her lifetime. Lansing, *supra* note 4, at 1.

61. See Munnell, *supra* note 6, at 807 (discussing projected low returns on Social Security under pay-as-you-go system).

62. See *id.* (explaining that early generations received transfers of approximately \$9 trillion and later generations must pay bill).

63. *Id.*; see *supra* notes 15-16 and accompanying text (describing payroll tax).

64. See Munnell, *supra* note 6, at 807 (explaining that higher gains by privatization are offset by increased taxes in order to pay for interest on bonds).

65. *Id.*; see *infra* notes 214-17 and accompanying text (discussing effects of liabilities on switch from pay-as-you-go funding to pre-funded individual account system).

66. See *infra* notes 118-23 and accompanying text (discussing risks inherent in investing funds in private markets).

The aggregate rate of return on Social Security contributions should not be confused with the rate of return earned by individual workers on their payroll tax contributions. The individual rate of return earned by workers on their Social Security contributions is not a fixed number, but varies relative to a worker's year of birth and marital status.⁶⁷ Thus, for example, there is great disparity between the rate of return for average-wage workers born before and after 1930.⁶⁸ Workers born in the 1920s receive a significantly higher return of almost 6% on their Social Security contributions because they paid a payroll tax of only 2% throughout much of their early careers.⁶⁹ The 2% rate was sufficient because there were relatively few retirees eligible for full retirement benefits during this time.⁷⁰ For later cohorts, however, the individual rate of return on Social Security contributions reaches projections as low as 1.7%.⁷¹ Thus, notwithstanding a higher rate of return on the contributions, an increase in current payroll taxes or a reduction in the current benefit package would cause the individual rates of return to further decline.⁷²

C. Privatization

Some form of privatization is an integral part of many of the best-known Social Security restructuring proposals.⁷³ Essentially, there are two different ways of implementing privatization. One approach is to carve the individual accounts out of existing funds. This arrangement is referred to as the "carve out" approach.⁷⁴ Such an arrangement would reduce the current benefit

67. See BURTLESS & BOSWORTH, *supra* note 16 (citing higher returns as argument for privatization). More recently, because the tax rate has increased and provides more generous benefits for a larger number of retirees, the rate of return has continued to decline. *Id.*

68. *Id.*

69. Workers born in the 1920s also benefitted from rapid wage growth throughout their careers. *Id.*

70. *Id.*

71. The 1.7% rate of return applies to average wage earners born in 2004. *Id.* However, this rate does not reflect the additional protection for disability and death, nor does it reflect the indirect benefits of the Social Security program, such as not having to support parents. See generally Gary Burtless, *How Would Financial Risk Affect Retirement Income Under Individual Accounts?*, in CENTER FOR RETIREMENT RES. AT BOSTON C. POL'Y BRIEF NO. 6 (Oct. 2000) (discussing rate of return).

72. See *infra* notes 209-13 and accompanying text (discussing unrealistic expectations of proponents of privatization regarding rates of return of funds invested in private markets).

73. See, e.g., ADVISORY COUNCIL REPORT, *supra* note 2 (summarizing different plans discussed by 1994-1996 Advisory Council on Social Security).

74. See Colleen T. Cangel, *Social Security: Private Accounts Would Help Women, Senators Say; Panel Divided*, 26 Pens. & Ben. Rep. (BNA) 614, 614 (1999) (noting strong support of Senator John Breaux (D-La.) for carve out approach).

package.⁷⁵ Thus, workers would be better off than they are under the current system only if their individual accounts performed well enough to make up the difference.⁷⁶ If the accounts did not perform well, however, workers could receive substantially less than the benefits they are provided under the current system.⁷⁷ The second approach to establishing an individual account program is to add the accounts on top of current benefits.⁷⁸ This approach is referred to as the "add on" approach.⁷⁹ Using this method, new money from the projected budget surplus would fund the additional accounts.⁸⁰ Accordingly, this could guarantee workers the receipt of benefits at least equal to the ones they would receive under the current system. The add on approach is the more popular approach among workers.⁸¹

The presence of these two alternatives adds complexity and confusion to the Social Security privatization debate. Surveys indicate that when the carve out approach is discussed rather than the add on approach, support for privatization drastically declines.⁸² A poll taken by the American Association of Retired People (AARP), an influential senior lobby group, showed that more than 50% of those who support private accounts oppose them when it is clear that the carve out approach would reduce benefits provided under the existing program.⁸³ Also, support for the add on approach drops sharply when these proposals are made in connection with increased taxes.⁸⁴ Thus, much of the enthusiasm about privatization often stems from distortions about its meaning, as well as its true cost.

75. Schlesinger, *supra* note 8, at A24.

76. *Id.*

77. *Id.*

78. See Cangel, *supra* note 74, at 614 (describing both carve out and add on approaches as possible solutions for Social Security shortfall).

79. *Id.*

80. Schlesinger, *supra* note 8, at A24.

81. Seventy percent of individuals polled supported the add on approach, while only 54% supported the carve out method. AARP RESEARCH GROUP, *supra* note 8, at 16, 24.

82. *Id.* at 15 (explaining that specifics of privatization proposals determines level of support that they receive).

83. *Id.* at 16-17. Support for the carve out approach sharply declined when such proposals included the reduction of guaranteed benefits or the creation of a new government agency. *Id.* at 17-18. Support for the carve out approach dropped to 42% and 38% respectively with the introduction of these mitigating factors. *Id.*

84. *Id.* at 25-26. Before the introduction of mitigating factors, 70% of respondents supported the add on approach. *Id.* at 24. When asked whether they would continue to support the add on approach if income taxes were increased in order to pay for government matching funds, only 25% still supported the approach. *Id.*

Most privatization proposals, regardless of form, give workers discretion to invest some portion of their individual accounts in the manner in which they choose.⁸⁵ Although these proposals can impose various restrictions on the level of risk to which the accounts would be exposed, they nevertheless allow workers to have some degree of flexibility.⁸⁶ Accordingly, the proposed accounts closely resemble those established in connection with participant-directed 401(k) plans.⁸⁷ Proponents of privatization believe that if workers have the freedom to invest all or a portion of their individual accounts in more productive private markets, they will receive higher returns on their contributions.⁸⁸ Proponents also believe that this will help resolve the Social Security program's financial problems.⁸⁹

85. See, e.g., ADVISORY COUNCIL REPORT, *supra* note 2, at 28-33 (noting that options two and three recommended by Advisory Council included individual accounts for private investing); David C. John, *Bear Markets Do Not Hurt the Case for Social Security Retirement Accounts*, HERITAGE FOUND. EXECUTIVE MEMORANDUM, No. 742, May 1, 2001, at 1 (defending use of private retirement accounts in light of recent activity in stock market).

86. See NAT'L ACADEMY OF SOC. INS., *EVALUATING ISSUES IN PRIVATIZING SOCIAL SECURITY: REPORT*, WASHINGTON, D.C., 1998, at 46 (explaining that investment options could vary widely in individual account in privatized system); Nina Mojiri-Azad, *Social Security Benefits to Widows: The Ongoing Favoritism of Single-Earner Families and the Impact on Elderly Women*, 17 LAW & INEQ. 537, 550 (1999) (discussing oversight by qualified investment firms with individuals retaining ability to direct investments).

87. In a participant-directed 401(k) plan, the employee elects first to participate in the retirement plan and, typically, then further elects how to invest the funds. See JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* 50-52 (3d ed. 2000) (discussing distinctive traits of 401(k) plans); Altig & Gokhale, *supra* note 3, at 9 (comparing their privatization proposal to 401(k) plan). However, proposals to privatize Social Security can often impose greater investment restrictions than those generally found in 401(k) plans. See Lansing, *supra* note 4, at 3 (comparing privatization plans to participant-directed 401(k) plans).

88. Proponents are especially assertive in advancing their cause, appearing on talk shows and publishing newspaper editorials across the nation. For example, the Economic Security 2000 sent representatives to more than 500 radio stations to discuss the topic of privatization and placed more than 200 op-ed pieces in newspapers throughout the country advocating some form of privatization. Christopher Georges, *Social-Security 'Privatization' Effort Makes Headway*, WALL ST. J., June 22, 1998, at A24. Notwithstanding the visible efforts of supporters, however, survey polls suggest that the public is narrowly divided on the topic, with those opposed having a slight lead. In a study conducted by the Wall Street Journal and NBC, 44% of the population was in favor of some form of privatization, while 51% was opposed. Elizabeth Crowley, *Social Security Reform: The Great Divide*, WALL ST. J., Mar. 11, 1999, at A14. Also, the CATO Institute and Heritage Foundation have published numerous articles in support of privatization. See, e.g., Daniel Shapiro, *The Moral Case for Social Security Privatization*, CATO INST., Oct. 29, 1998, at 1 ("A privatized Social Security system gives individuals more freedom to run their lives, is fairer, provides more security, and creates less antagonism between generations, fostering a greater sense of community.").

89. Michael Tanner, *"Saving" Social Security Is Not Enough*, CATO PROJECT ON SOC. SEC. PRIVATIZATION, No. 20, May 20, 2000, at 7.

D. Impact of the Elements

The stock and bond markets are more stable and efficient today than they were sixty-five years ago. Thus, the concerns that caused Congress to place the existing restrictions on the Social Security trust fund are no longer relevant.⁹⁰ Although higher returns alone would not resolve the long-term fiscal problems of Social Security, they could make the problem much more manageable.⁹¹ A change in the investment strategy for the Social Security reserve would make the return on Social Security contributions more consistent with those received in the private market. However, privatization of the program is not necessary to accomplish this result. The fact that a program is publicly managed does not prevent it from being financially sound and sustainable. In fact, the publicly managed retirement programs of thousands of state and local governments have successfully employed advanced funding methods.⁹² Furthermore, if diversification were implemented in conjunction with advanced funding, this would make larger amounts of funds available for investment in the more productive private markets.⁹³

For numerous reasons, a critical evaluation of the private retirement system suggests that the individual account model, without guaranteed minimum benefits, is inappropriate for Social Security.⁹⁴ First, the recent trend in the private sector of using 401(k) plans, rather than traditional defined benefit plans, shifts the risk of accumulating insufficient assets for retirement from the employer to the employee, exposing the participants to a greater risk of short-fall.⁹⁵ Second, the replacement of the existing Social Security model with individual accounts would disproportionately impact low-income workers

90. See *supra* note 34 and accompanying text (noting Congressional concern that government could not manage large trust fund responsibly).

91. See Adam B. Norlander, *Privatization of Social Security: An Acceptable Risk*, 1999 L. REV. M.S.U.-D.C.L. 959, 975-76 (discussing low risk of relying on long-term stock market investment).

92. See Gary Burtless & Barry Bosworth, *Privatizing Social Security: The Troubling Trade-offs*, WASH. Q., at 205-07 (Winter 1999) (noting that millions of employees of state and local governments have advance-funded pensions that are publicly managed). Also, advanced funding could increase national savings, whether the assets were publicly or privately managed. *Id.* at 212.

93. See *Investing Social Security Reserves*, *supra* note 1, at 25 (discussing advantages of diversified investment strategy and higher returns); see also Burtless & Bosworth, *supra* note 92, at 205-07 (noting that 9.3% projected return is most optimistic rate assumed by Actuary's report and that intermediate assumption is closer to 7%).

94. Regina T. Jefferson, *Comment to Employers and Individuals Must Do More Today to Allow Retirement Tomorrow*, in FRAMING THE SOCIAL SECURITY DEBATE 106 (R. Douglas Arnold et al. eds., 1998).

95. See *infra* Part III.B (discussing participants' exposure to risk of shortfall in defined contribution plans).

because it would expose them to additional risks and substantially reduce or possibly eliminate the redistributive function of the Social Security program.⁹⁶ Finally, although proponents predict an increase in returns adequate enough to address the projected shortfall, that level of increase is doubtful in light of the full cost of implementing such a system.

III. Risk and the Private Pension System

A. Structure of the Private Retirement System

Although the private pension and the Social Security systems are separate and distinct programs, lessons learned from the private retirement system are relevant to discussions of Social Security reform.⁹⁷ Therefore, a critical evaluation of the private retirement system's reliance on individual account plans as primary retirement savings vehicles is particularly useful as proposals to privatize the Social Security program are contemplated.⁹⁸

There are two primary categories of retirement plans used in the private sector: defined benefit and defined contribution. The distinguishing characteristic between the two is risk allocation.⁹⁹ A defined benefit plan pools the plan assets into an aggregate trust fund and guarantees a fixed amount to participants at retirement, regardless of investment performance.¹⁰⁰ In a defined benefit plan, the employer is liable for the payment of the promised benefits, and therefore, bears the risk of accumulating insufficient assets.¹⁰¹ To protect defined benefit plan participants in the event that an employer becomes insolvent, the Pension Benefit Guaranty Corporation (the PBGC) insures a limited accrued benefit in these plans.¹⁰² The defined benefit plan structure is currently

96. Although, theoretically, redistribution is maintainable in a privatized program, because of the structure of an individual account program, it is politically and practically more difficult to accomplish. See *infra* notes 176-79 (explaining that inexperienced investors who suffer under private system would face same problem under Social Security privatization).

97. Alicia H. Munnell, *The Economics of Private Pensions* 7, 13-19 (1982), in LANGBEIN & WOLK, *supra* note 87, at 34-36 (noting implication of systems for development of private plans).

98. See Jefferson, *supra* note 94, at 106 (discussing private retirement accounts).

99. See Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century*, in SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY 159, 184 (Jack L. VanDerhei ed., 1987) (noting that defined contribution plans potentially differ from defined benefit plans only in risk).

100. See Peter T. Scott, *A National Retirement Income Policy*, 44 TAX NOTES 913, 919-20 (1989), reprinted in LANGBEIN & WOLK, *supra* note 87, at 42-43 (summarizing features of defined-benefit plans).

101. *Id.*

102. The PBGC is required to pay the vested accrued benefits of plan participants up to a guaranteed amount when a plan terminates with insufficient assets. ERISA limits the "basic

used by the Social Security program, with the government effectively guaranteeing the delivery of the promised benefits.

In contrast to the single trust in a defined benefit plan, a defined contribution plan assigns each participant an individual account.¹⁰³ At retirement, the participant receives the entire account balance, including the contributions and investment earnings. The relative success or failure of the plan depends on how well the assets in the accounts are invested. Therefore, in a defined contribution plan, it is the participant, rather than the employer, who bears the investment risk.¹⁰⁴ Advocates of Social Security privatization propose this structure for Social Security.¹⁰⁵

Since the passage of the Employment Retirement Income Security Act of 1974 (ERISA), the private sector has seen a discernable movement toward using defined contribution plans as primary retirement savings vehicles, rather than traditional defined benefit plans.¹⁰⁶ This trend is explainable by numerous defined contribution plan features and characteristics. Defined contribution plans are less expensive and administratively simpler for employers to main-

guaranteed benefit" payable by the PBGC to the lesser of average monthly gross income determined by a participant's highest compensation in any consecutive five-year period, or \$750 per month, adjusted by the cost of living. § 26 C.F.R. 4022.22 (1999).

103. ERISA § 3(34), 29 U.S.C. § 1002(34) (1999) (defining defined contribution plan as "pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income . . . which may be allocated to such participant's account").

104. See Jay A. Soled & Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth*, 2000 BYU L. REV. 587, 591-93 (2000) (contrasting traditional defined benefit plans with defined contribution plans).

105. See Tanner, *supra* note 89, at 7.

106. The Employee Retirement Income Security Act, better known as ERISA, is a massive piece of legislation. ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of Title 26 and 29 U.S.C.). It originated in 1962 during the presidency of John F. Kennedy. President Kennedy commissioned a special cabinet-level task force to evaluate the impact of private retirement programs on the nation's economy and public policy, as well as to evaluate the investment policies of these programs and whether they were sufficient to provide promised benefits to participants. See 120 CONG. REC. S15, 743 (1974) (statement of Sen. Javits). More than a decade later, President Ford signed ERISA into law on September 2, 1974. The Act completely revised the legal framework of the qualified pension plan as it previously existed. The most significant innovations of ERISA concerned participation, vesting, and funding standards. At the time ERISA became effective in 1975, the number of private pension plans sponsored by private employers was 311,000; by 1990, the number more than doubled to 712,000. In 1975, 103,000 defined benefit plans were in existence, the number of defined benefit plans peaked in 1983 at 175,000, but then decreased to 113,000 in 1990. In contrast, the total number of defined contribution plans increased from 208,000 to 599,000 between 1975 and 1989 and remained at 599,000 in 1990. CELIA SILVERMAN ET AL., EMPLOYEE BENEFIT RESEARCH INST., EBRI DATABOOK ON EMPLOYEE BENEFITS 139 (1995).

tain than defined benefit plans.¹⁰⁷ This is especially true for 401(k) plans, in which contributions typically are made only on behalf of individuals who elect to contribute portions of their earnings to the plan.¹⁰⁸ Also, employers seeking to insulate themselves from fiduciary liability often adopt defined contribution plans in which employees are required to make all investment decisions.¹⁰⁹ These plans, known as participant-directed plans, represent the fastest growing type of defined contribution plan in the private retirement system.¹¹⁰

Defined contribution plans also have characteristics that are especially appealing to employees. Defined contribution plans provide greater portability because the accrued benefits in these plans are not reduced when participants terminate employment prior to retirement.¹¹¹ This characteristic allows participants to roll-over benefits from their current plans either into new employer plans or into individual retirement arrangements (IRAs) without losing benefits when they change employment prior to reaching retirement age.¹¹² Also, defined contribution plans more frequently provide pre-retirement and lump sum distributions that give workers early access to their retirement funds.¹¹³

107. See Soled & Wolk, *supra* note 104, at 591-93 (discussing advantages of defined contribution plans); see also LANGBEIN & WOLK, *supra* note 87, at 52 (describing benefits attributed to 401(k) defined contribution plans); Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 614 (2000) (noting that in defined contribution plans, there is no need to pay PBGC premiums, and there are no fees for actuarial services).

108. Section 401(k) plans cost approximately one-third as much as traditional plans because contributions are made on behalf of only the employees who can afford to contribute to the plan first. Karen Ferguson, *Plans Benefit the Wealthy*, USA TODAY, Nov. 25, 1997, at 13A.

109. In regular participant-directed plans, plan fiduciaries have a limited obligation to make sure that plan participants are protected against losses owing to their investment decisions. However, in section 404(c) "safe harbor" participant-directed plans, employers and other plan fiduciaries are essentially shielded from all liability. For a more detailed discussion on fiduciary liability in defined contribution plans, see Jefferson, *supra* note 107, at 627-28.

110. Marlene Givant Star, *Participants in a Quandry about Plan Options*, Pens. & Inv. Rep. (BNA) 19, 19 (1994).

111. The retirement benefit in a traditional defined benefit plan generally is based on a final pay formula in which average compensation and service are used. Therefore, an increase in any one year will increase the value of the benefit accruals for previous years. As a result, in defined benefit plans, a substantial portion of the benefit can accrue in the final years of employment. For this reason, the termination of employment prior to reaching normal retirement in defined benefit plans can significantly reduce a participant's expected retirement benefit in such plans. In contrast, the retirement benefits in defined contribution plans accrue much more rapidly. Thus, these plans are especially appealing to younger, more mobile members of the labor force. Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513 (2001).

112. *Id.*

113. Qualified 401(k) plans generally do not permit distributions prior to an employee's severance from employment, death, disability, or attainment of age 59.5. However, such plans

Therefore, the reasons for the popularity of defined contribution plans in the private sector suggest that they are more convenient for employers and employees alike, not that they are the best way to maximize retirement income security.¹¹⁴ Because defined contribution plans shift the risk of accumulating insufficient assets for retirement from the employer to the employee, many participants will not receive the retirement benefits that they expected and on which they have relied. Consequently, notwithstanding their popularity, the use of defined contribution plans as primary retirement savings vehicles has serious implications both for the private pension system and for the retirement income security of individual plan participants.

B. Risk of Shortfall in Defined Contribution Plans

1. Participant-Directed Plans

One reason defined contribution plans may fail to accumulate sufficient amounts for retirement is inadequate investment information. The prevalence of participant-directed plans that require employees to decide whether to participate, how much to contribute, and how to invest their funds, makes it more likely that some participants will experience shortfalls in their expected retirement benefits.¹¹⁵ In employer directed plans, a plan administrator or an investment professional usually controls the plan investments. The investment professional is required to invest the assets in a manner that protects participants against inflation, market fluctuations, and unfavorable market conditions.¹¹⁶ Investors should use the same investment strategy in participant-directed accounts, but often do not because inexperienced investors have insufficient training to achieve this objective.¹¹⁷

are permitted to make distributions on account of financial hardship. I.R.C. § 401(k)(2)(B)(i) (1994); Patricia E. Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 IND. L.J. 355, 412 (1999).

114. See Jefferson, *supra* note 94, at 107 (noting contemporary financial concerns of employers and changing work patterns of employees as primary reasons for popularity of defined contribution plans).

115. See *id.* at 108 (discussing appeal of 401(k) plans to employers).

116. See 29 C.F.R. § 2550.404a-1(b)(2). Appropriate consideration is defined as the "determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or where applicable, that portion of plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action." *Id.*; Joseph R. Simone & Glen E. Butash, *Statutory Framework, "Language" and Fiduciary Responsibility Provisions of ERISA*, 385 PLI/TAX 7, 24-27 (1996).

117. *Diversification Is Key to Success of Section 401(k) Investments, ASPA Told*, 17 Pens. & Inv. Rep. (BNA) 1243, 1243 (1990) (citing insufficient investment training as most frequently referred to reason for overly conservative investment strategy).

The modern portfolio theory of investment explains that an adequately diversified portfolio should include an appropriate balance of stocks, bonds, and stable-valued funds.¹¹⁸ This is because a more balanced investment portfolio provides an appropriate relationship between risk and return.¹¹⁹ A high concentration of stable-value, low-yield investments will generally produce insufficient income over a participant's working life to provide financial security at retirement.¹²⁰

As a rule, those who lack investment experience tend to disproportionately select low-risk, low-yield investment instruments.¹²¹ An individual who disproportionately invests in low-yield instruments would have to save significantly greater amounts to be in the same position at retirement as a participant who sufficiently diversified her investment portfolio.¹²² For this reason, the use of an overly conservative investment strategy can be as dangerous as the use of an overly aggressive one.¹²³

Inexperienced investors are not only less likely to adequately diversify their portfolios, but they are also less likely to recognize the financial indicators on which trained professionals rely when deciding to transfer funds from one investment to another.¹²⁴ Therefore, the untrained investor may fail to make changes when they are warranted, or in other situations may react too quickly.¹²⁵ For instance, in sudden market down-turns, these individuals may sell high-risk, high-return investments too hastily, although professional investors generally believe that such investments perform best over the long-

118. See J. Michael McGowan, *Watching Your Basket: Keys to Nurturing a Successful Investment Portfolio*, 78 A.B.A. J. 97 (Nov. 1992) (discussing "investment grade ratings" applied to stocks, bonds, and mutual funds).

119. *Id.*

120. Inflation and the increase in life expectancy present further problems for conservative investment strategies. Inflation, which has averaged 4% over the past decade, diminishes the purchasing power of retirement income, and increases in life expectancies force plan participants to stretch the value of their assets even farther. Alexander Sussman, *The Investment Horizon: How Can Employers Assure Adequate Retiree Benefits in the Coming Years?*, 28 COMPENSATION & BEN. REV. 73, 73 (1996).

121. See *id.* (discussing investment practices).

122. Regina T. Jefferson, *The American Dream Savings Account: Is It a Dream or a Nightmare?*, in TAXING AMERICA 261 (Karen B. Brown & Mary Louise Fellows eds., 1996).

123. Younger participants are especially vulnerable when they use overly conservative investment strategies because the compounding of their returns occurs over a much longer period of time. Conversely, older participants are more vulnerable when they use overly aggressive strategies, because there is insufficient time to recover from sudden downturns. See Moore, *supra* note 9, at 354.

124. John R. Keville, Note, *Retire at Your Own Risk: ERISA's Return on Investment?*, 68 ST. JOHN'S L. REV. 527, 545-46 (1994).

125. *Id.*

run.¹²⁶ Thus, the success or failure of participant-directed plans ultimately depends on the individual participant's ability to allocate plan assets properly.

Notwithstanding the complexity of making prudent investment decisions, ERISA imposes no additional education or notification requirements on employers who sponsor participant-directed plans. Only the general fiduciary standards of ERISA govern these plans.¹²⁷ Accordingly, employers who sponsor participant-directed plans are not responsible for the investment decisions made by plan participants as long as the plan provides a broad range of investment options.¹²⁸ Therefore, in participant-directed plans, the employer's liability for poor investment performance as a plan fiduciary is reduced substantially. This reduction renders many of ERISA's general fiduciary rules irrelevant.¹²⁹ For this reason, participant-directed plans raise serious questions about the adequacy of ERISA's fiduciary rules.¹³⁰

126. Judy Greenwald, *Investment Education Raises Employer Liability Questions: When Does Information Become Advice?*, BUS. INS., Oct. 31, 1994, at 2.

127. The general fiduciary standards were included under ERISA in response to concern about "kickbacks, embezzlement, outrageous administrative costs, and excessive investments in the securities of plan sponsors/employers." Elaine McClatchey Darroch, *Mertens v. Hewitt Associates: The Supreme Court's Dismantling of Civil Enforcement Under ERISA*, 1994 DET. C.L. REV. 1089, 1092; see also Joseph R. Simone & Glen E. Butash, *Statutory Framework, "Language" and Fiduciary Responsibility Provisions of ERISA*, in UNDERSTANDING ERISA: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT BENEFITS 18 (1996) (explaining adoption of provision was to protect interest of participants in employee benefit plans).

128. See 29 C.F.R. § 2550.404(c)-1(a)(1) to 1(b)(3) (2001). This section notes that a plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary a reasonable opportunity to: (A) materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject; (B) choose from at least three investment alternatives: (1) each of which is diversified; (2) each of which has materially different risk and return characteristics . . . at any point within the range normally appropriate for the participant or beneficiary; and (4) each of which when combined with investments in the other alternatives tend to minimize through diversification the overall risk of the participant's or beneficiary's portfolio.

Id.

129. See Simone & Butash, *supra* note 127, at 28 ("If a participant . . . exercises control over the assets in his account, the fiduciaries of the plan will not be liable for any loss or for any breach of fiduciary duty which is the result of the participant's exercise of control.") (citation omitted).

130. See Jefferson, *supra* note 107, at 628. Section 404(c) safe harbor plans raise even greater concerns regarding the adequacy of ERISA's fiduciary rules as they apply to participant directed plans because these plans almost entirely insulate the employer from fiduciary liability for the investment decisions made by plan participants. *Id.* ERISA § 404(c)(1) provides that in the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a

Some employers voluntarily provide education for their employees to enable them to make prudent investment decisions; however, many employers choose not to provide these programs because they are costly.¹³¹ Privatization of the Social Security program will compound the effects of inadequate financial training. Inexperienced investors will be required to make investment decisions regarding all three of the primary sources of retirement income: private pensions, Social Security, and personal savings.¹³²

2. A Gap in Insurance Protection

Another reason defined contribution plan participants are more likely to experience shortfalls in their retirement benefits is that the insurance program for retirement plans has a gap in its coverage. The PBGC insures defined benefit plans against losses owing to plan failure but does not insure defined contribution plans.¹³³ Section 3(34) of ERISA provides that PBGC protection is unavailable to plans in which the level of benefit for each employee fluctuates depending upon the experience of the individual accounts.¹³⁴ Because the contribution and investment performance of each separate account determines retirement benefits in defined contribution plans, defined contribution plans are excluded from coverage.¹³⁵ Although there is reluctance on the part of policymakers to insure investment experience, as opposed to definite retirement benefits, the effects of poor investment performance in defined contribu-

participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) (A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and (B) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

ERISA § 404(c)(1), 29 U.S.C. § 1104(c)(1) (1994); see also MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS § 16.3, at 787-88 (1996 student ed.) (discussing participant-directed individual account plans). Section 404(c) does not apply in situations where the plan fiduciary conceals material nonpublic facts, employs improper influence, or follows the instructions of an employee who the employer knows to be legally incompetent. 29 C.F.R. § 2550.404(c)-1(c)(2)(i) to (iii) (2000).

131. See Moore, *supra* note 9, at 364-66 (explaining importance of education programs).

132. Derek C. Bok, *Emerging Issues in Social Legislation: Social Security*, 80 HARV. L. REV. 717, 741 (1967); see LANGBEIN & WOLK, *supra* note 87, at 23 (noting that three most important sources of income for Americans aged sixty-five and over in 1995 were Social Security (43.7%), private and public pensions (18.6%), and income from personal savings (17.8%)). *Id.*

133. ERISA §§ 4002-03 establishes PBGC. ERISA § 4022 governs payments of benefits.

134. ERISA § 3(34), 29 U.S.C. § 1002(35) (1994); see *supra* note 102 and accompanying text (describing PBGC insurance).

135. 29 U.S.C. § 1321(b) (1994).

tion plans and defined benefit plans are actually quite similar.¹³⁶ Thus, the distinction between insuring defined contribution plans and insuring defined benefit plans is based primarily on perception.¹³⁷

The similarity of the impact of poor investment performance in defined contribution and defined benefit plans can best be illustrated by considering a defined benefit plan in which all of the actuarial assumptions used in the funding process are correct over the life of the plan, except for the interest rate assumption.¹³⁸ If this plan terminates with insufficient assets, the potential for benefit losses would be solely attributable to the unfavorable investment performance of the plan assets. Therefore, to the extent that the PBGC guarantees payment of the retirement benefits in such a plan, it effectively insures an average investment return over the life of the plan.¹³⁹ By comparison, there is presently no protection against less-than-average investment performance in defined contribution plans. In these plans, when shortfalls in the expected retirement benefit occur because of unfavorable market conditions, the participant alone bears the loss.¹⁴⁰

The Executive Life crisis of 1988 is a real life example of the disparate impact of market downturn on defined benefit and defined contribution plan participants resulting from the gap in insurance protection. During the 1980s, the Executive Life Insurance Company held a significant amount of pension assets and was invested heavily in junk bonds.¹⁴¹ When the market crashed in the late 1980s, Executive Life was unable to pay its contracts and ultimately filed bankruptcy. Although all of the assets held by Executive Life had negative earnings, the company's collapse was more devastating for some plan participants than for others.¹⁴² Participants in defined benefit plans were insured by the PBGC against losses, whereas those in defined contribution plans were

136. Under the pension insurance program, the PBGC provides substantial protection of defined benefit plan benefits, but not of defined contribution plan benefits. Section 3(34) of ERISA specifically provides that PBGC insurance does not cover individual account plans. 29 U.S.C. § 1002(34) (1994). Because the retirement benefit in defined contribution plans is dependent on the contributions and earnings of each individual account, all defined contribution plans are excluded from ERISA's insurance program. 29 U.S.C. § 1321(b) (1994); Jefferson, *supra* note 107, at 640.

137. Jefferson, *supra* note 107, at 680 (comparing defined contribution and defined benefit plans).

138. There are other assumptions used for mortality, disability, turnover, salary scale increases, and early retirement.

139. See Jefferson, *supra* note 107, at 618.

140. See LANGBEIN & WOLK, *supra* note 87, at 53 (discussing drawbacks of defined-contribution plans); Jefferson, *supra* note 94, at 109 (same).

141. Gary M. Ford, *Defined Contribution Plan GIC Litigation, Annuities Legislation, and PBGC Legislation*, C996 A.L.I.-A.B.A. 183, 187 (1995) (describing Executive Life collapse).

142. See *id.* (explaining that PBGC insurance only applies to defined benefit plans).

not. Because the payments of the defined contribution plan benefits varied with state insurance laws, some defined contribution plan participants received as much as 70% of their retirement benefits, while others received nothing at all.¹⁴³ The Executive Life crisis should serve as a reminder that as long as there is no insurance protection for defined contribution plans in the private pension system, there is a possibility that defined contribution plan participants may not receive their expected retirement benefits.¹⁴⁴

Insurance for defined contribution plans is a controversial subject because it is widely believed that insuring investment performance presents difficult measurement problems. However, designing a defined contribution plan insurance program that provides insurance protection comparable in amount and objective to that which exists for defined benefit plans is a feasible concept.¹⁴⁵ Thus, defined contribution plan insurance should be available to all participants who rely on the use of individual account plans to provide their retirement benefits.¹⁴⁶ Similarly, in the event the Social Security program is privatized, there should be guaranteed minimum benefits or some other form of protection available, to avoid significant benefit losses when sudden market fluctuations occur, or when financial institutions become insolvent.

3. *Early and Lump-Sum Distributions*

Another reason participants may not receive the benefits they expect in defined contribution plans is because of the availability of early, or lump sum, distributions.¹⁴⁷ In-service distributions, or lump sum payments at termination of employment, may encourage some individuals to spend portions of their retirement savings for non-retirement purposes.¹⁴⁸ Although the law permits the tax-free rollover of lump sum distributions received prior to retirement into other qualified retirement plans, or into IRAs, most individuals who receive these distributions do not reinvest them in this manner.¹⁴⁹ The Congressional Research Service reports that only 33% of recipients who

143. *See id.*

144. *See id.*

145. *See* Jefferson, *supra* note 107, at 651-66 (proposing Hypothetical Account Defined Contribution Plan Insurance Program to ensure that defined contribution plan participants receive minimum benefit at retirement); *see also* Jefferson, *supra* note 94, at 110 (noting that defined contribution plan insurance is possible to develop).

146. *See* Jefferson, *supra* note 107, at 651-66.

147. *See* Jeffrey R. Brown, *How Should We Insure Longevity Risk in Pensions and Social Security*, in CENTER FOR RETIREMENT RES. AT BOSTON C. POL'Y BRIEF NO. 4 (Aug. 2000), at 6 ("Lump-sum withdrawal is the most common distribution option available.").

148. *Id.*

149. EMPLOYEE BENEFITS RESEARCH INST., FACTS FROM EBRI: ROLLOVER RATES, available at <http://www.cbri.org/facts/0300fact1.htm> (last visited Oct. 10, 2000).

receive lump sum distributions reinvest them in retirement savings arrangements.¹⁵⁰

Regardless of age, almost all employees choose lump sum payments whenever they are available.¹⁵¹ Some employers report that upon termination of employment, employees often ask them to distribute their lump sum payments directly to business establishments, such as auto repair shops.¹⁵² To the extent that participants receive but fail to reinvest pre-retirement distributions, they will have less money available to receive the tax benefits accorded funds in qualified retirement plans.¹⁵³ This makes it less likely that these individuals will accumulate sufficient amounts for their retirement income security.

Many employers express concern that they lose a key benefit when employees spend their retirement savings on current consumption because the employees are less likely to have retirement income sufficient to allow them to retire at the appropriate time.¹⁵⁴ As a result, some companies do not allow lump sum distributions from the defined contribution plans that they sponsor. Nevertheless, lump sum distributions are the most common form of distribution in 401(k) plans and in other defined contribution plans as well.¹⁵⁵

By contrast, the normal form of payment in both traditional defined benefit plans and the existing social security program is annuities payable at retirement.¹⁵⁶ Life annuities provide protection against unexpected longevity and are one of the most effective methods of ensuring that individuals do not out-

150. U.S. GEN. ACCOUNTING OFFICE, CASH BALANCE PLANS: IMPLICATIONS FOR RETIREMENT INCOME, HEHS-00-207, Sept. 29, 2000, at 31 [hereinafter GAO REPORT 2000]. Younger workers are less likely than older workers to reinvest their lump sum payments in other retirement savings vehicles. *Id.* Only 27% of workers between the ages of twenty-five and thirty-four reinvest their retirement funds in other retirement savings vehicles, as compared with 42% of those between the ages of forty-five and fifty-four. *Id.* at 32. The Congressional Research Report is based on its analysis of the Census Bureau's Survey on Income and Program Participation. *Id.* at 32 n.26.

151. See Elizabeth A. White, *PBGC: Official Predicts PBGC Surplus Will Grow Again for 1999 Fiscal Year*, 26 *Pens. & Ben. Rep.* (BNA) 2439, 2439 (1999).

152. GAO REPORT 2000, *supra* note 150, at 31.

153. Qualified plans receive substantial tax advantages. The first advantage is that employer contributions are deductible by the employer when made, but are not taxed until they are distributed to the employee. I.R.C. §§ 402(a)(1), 404(a)(1)-a(3) (1988 & Supp. IV 1992). The second is that the income earned on the accumulated contributions is not taxable until distribution. *Id.* § 501(a).

154. White, *supra* note 151, at 2439.

155. Only 27% of the 401(k) plans in existence in 1997 offered life annuity options. The figures for other types of defined contribution plans are similarly low. Brown, *supra* note 147, at 6.

156. See LANGBEIN & WOLK, *supra* note 87, at 580 (noting that most popular annuity is 50% joint and survivor annuity).

live their assets.¹⁵⁷ In addition to solving the asset allocation problem, life annuities also prevent retirement assets from being used for current consumption.¹⁵⁸

In a defined contribution plan, it is difficult to determine with any degree of certainty the level of savings necessary for retirement income security. The failure to consider the effects of inflation or increasing life expectancies can significantly overstate the value of one's expected retirement benefits.¹⁵⁹ Thus, the availability of lump sum distribution at termination of employment, or in-service distributions prior to retirement, may encourage some individuals to spend portions of their retirement savings for non-retirement purposes, erroneously believing that the remaining amounts are sufficient for retirement.¹⁶⁰ If Social Security were privatized without an annuitization requirement, and if workers were given access to their funds prior to retirement, the same tension between current consumption and retirement savings would exist in the Social Security system that now exists in the private system.¹⁶¹

Therefore, the prevalence of 401(k) plans in the private pension system is not ideal. Accordingly, the private sector's trend of using individual account plans as primary retirement savings vehicles should not be replicated in the Social Security program without addressing some of the weaknesses of these plans, such as the absence of both minimum guaranteed benefits and protection against longevity. Moreover, the Social Security program and the private pension system are inherently different; consequently, many of the characteristics of defined contribution plans that have made them popular in the private sector are irrelevant to the Social Security program.

For example, unlike Social Security, the private pension system is voluntary and is comprised of many different employer-sponsored plans. This makes responding to the preferences of employers and employees essential.¹⁶² The

157. Brown, *supra* note 147, at 4. The value of a life annuity lies in its ability to solve a retiree's wealth allocation problem. It is impossible to accurately predict when any retiree will die; therefore, a life annuity solves the issues of retirees' conserving too much money before death or consuming too much money before death, thereby depleting all retirement savings. *Id.*

158. See Jonathan Barry Forman, *How Federal Pension Laws Influence Individual Work and Retirement Decisions*, 54 *TAX.LAW* 143, 150-51 (2000); see also Jefferson, *supra* note 111.

159. See Brown, *supra* note 147, at 5 (describing difficulty of predicting life span); see also *supra* note 120 (describing effects of inflation and increased life expectancies on retirement planning).

160. Jefferson, *supra* note 94, at 110. Even when workers spend their retirement savings prematurely for essentials, such as the purchase of a house, education, or medical expenses, their retirement security can be adversely impacted if there are insufficient amounts remaining for retirement.

161. See Forman, *supra* note 158, at 181-83 (advocating mandatory pay out of pension assets in form of annuity).

162. See *supra* notes 100-02 and accompanying text (describing characteristics of defined contribution plan).

use of 401(k) plans in the private sector is not easily avoided, however, because profit margins, market competition, and employee preferences must factor into an employer's decision about what type of plan, if any, to offer.¹⁶³ Furthermore, because the private retirement system is voluntary, it is appropriate that cost sensitive employers be encouraged to establish these plans as less expensive retirement savings alternatives rather than to forgo having any plans at all. It is also appropriate to encourage employees to participate in these plans with features such as more flexible distribution rules and greater investment discretion.¹⁶⁴ In contrast, the Social Security system is a mandatory program consisting of a single universal plan.¹⁶⁵ It is both unnecessary and unwise for the Social Security program to appeal to the individual preferences of employers and employees at the expense of retirement income security.

IV. The Impact of Privatization on Public Welfare

A. Goals and Objectives of the Program

In addition to risk-related issues, there are also public welfare issues that should be considered in connection with Social Security reform. Social Security was established as a social insurance program with two primary objectives.¹⁶⁶ First, the program is to provide a minimum standard of living to the elderly, the disabled, and their dependent survivors.¹⁶⁷ This objective reflects a humanitarian view that covered workers and their dependents should not live in abject poverty, and that society has a responsibility to provide them at least a subsistence standard of living.¹⁶⁸ The humanitarian aspect of the program is based on the "social adequacy" principle and has been extremely successful in eliminating poverty among the elderly population.¹⁶⁹ The second

163. There are at least three different types of participant-directed plans: the § 401(k) plan, the § 457 plan, and the § 403(b) plans. CAN WE SAVE ENOUGH TO RETIRE? PARTICIPANT EDUCATION IN DEFINED CONTRIBUTION PLANS 3 (EBRI Issue Brief No. 160, Apr. 1995).

164. See *supra* notes 127-30 and accompanying text (discussing participant-directed plans).

165. See Dilley, *supra* note 14, at 1135-37 (describing expansion of coverage).

166. See Lewis D. Solomon & Geoffrey A. Barrow, *Privatization of Social Security: A Legal and Policy Analysis*, 5 KAN. J.L. & PUB. POL'Y 9, 14 (1995) (noting that two objectives of Social Security are welfare and insurance).

167. See FINAL REPORT OF THE 1937-1938 ADVISORY COUNCIL ON SOCIAL SECURITY 12-13, reprinted in C. EUGENE STEUERLE & JON M. BAKIJA, *RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY* 16 (1994) [hereinafter 1937-1938 FINAL REPORT]; Brown et al., *supra* note 39, at 636 (noting that "redistributive features [of social security] are grounded in considerations of 'social adequacy,' which aims to provide adequate protection for all workers against loss of earnings due to retirement or disability").

168. See JOSEPH A. PECHMAN ET AL., *SOCIAL SECURITY: PERSPECTIVES FOR REFORM* 55 (1968) (discussing purposes of Social Security).

169. See *supra* notes 17-20 and accompanying text (describing changes in poverty rate in elderly population).

objective of the program is to help moderate the decline in living standards when the loss of wages occurs on account of retirement, disability, or death.¹⁷⁰ The income-replacement function of Social Security operates independently of need and is available to all covered workers regardless of income. This function adheres to the principle of individual equity, requiring that there be some relationship between benefits and contributions.¹⁷¹ As proposals to restructure Social Security are contemplated, the impact of reform on both functions must be considered seriously.

If the Social Security program is privatized in a manner that eliminates, or significantly reduces, its ability to provide subsistence-level benefits for covered workers, the program will have abandoned its public welfare function. This will leave a tremendous void for many individuals who rely on Social Security benefits for their retirement income.¹⁷² As many as one in seven families rely entirely on their social security benefits for income, and as many as 60% of retired households today depend on Social Security for more than 50% of their income.¹⁷³ Without Social Security, one-half of the nations entire population over age sixty-five would live in poverty.¹⁷⁴ Whether these individuals would accumulate sufficient amounts for retirement in their individual savings accounts would be determined by an element of chance.¹⁷⁵

In the private sector, the retirement benefits earned under defined contribution plans are similarly left to chance. Workers who are lucky, or who have

170. See PECHMAN ET AL., *supra* note 168, at 55 (noting objectives behind Social Security program).

171. See 1937-1938 FINAL REPORT, *supra* note 167, at 17 (noting that ensuring fair return on contributions adheres to principle of individual equity, which means that workers should get their money's worth).

172. The provision of minimum benefits in the Social Security program advances the anti-poverty goal of the program. The public retirement system is uniquely able to deliver a minimum level of benefit to all participants regardless of their level of contribution, not only because of its humanitarian focus, but also because its benefits are backed by the government's power to tax. Consequently, the Social Security program is able to spread risk across a broader population, including workers who have not entered the labor force. Burtless, *supra* note 71, at 4.

173. U.S. GEN. ACCOUNTING OFFICE, SOCIAL SECURITY: RESTORING LONG-TERM SOLVENCY WILL REQUIRE DIFFICULT CHOICES, T-HEHS-98-95, Feb. 10, 1998, at 5. The minimum Social Security benefit for a single worker is only 42% of the poverty threshold, and 50% for married couples. Timothy M. Smeeding, *Income Maintenance in Old Age: What Can Be Learned from the Cross-National Comparisons*, 3d Annual Conference of Ret. Research Consortium, May 17-18, 2001, at 11 n.14; see Dilley, *supra* note 14, at 1120 (discussing reliance on Social Security benefits).

174. Kathryn L. Moore, *Redistribution Under a Partially Privatized Social Security System*, 64 BROOK. L. REV. 969, 990 (1998) (noting success social security has had in assisting elderly without developing same problems that exist in public welfare program).

175. See Senator Don Nickles, *Retiring in America: Why the United States Needs a New Kind of Social Security for the New Millennium*, 36 HARV. J. ON LEGIS. 77, 105 (1999) (describing stock market as risky).

better than average investment skills, are rewarded with larger retirement benefits.¹⁷⁶ As a result, individuals who may have similar earnings and service histories, but who are unlucky or unsophisticated in their investment skills, ultimately may receive significantly smaller benefits.¹⁷⁷ However, this result is extremely inappropriate for Social Security. As a mandatory social insurance program, Social Security should not be structured to reward the most fortunate, or best-informed, members of society. This is particularly true because high-income workers are more likely to have the financial skills to maximize their investments or to have access to professional advisors that perform this service for them.¹⁷⁸ Also, because it is advisable for individuals with fewer assets to use more conservative investment strategies than those with greater assets, low-income workers would not have the same opportunity to achieve the higher rates of return as would high-income workers.¹⁷⁹

B. Redistribution

The Social Security payroll tax is assessed on one group of the population while another group receives the benefits.¹⁸⁰ Therefore, to determine accurately the distribution of the burdens and benefits of the Social Security program by income class, it is necessary to consider separately the impact of the payroll tax from that of the receipt of benefits. If this distinction is not made, the aggregate of taxes and benefits by income class can be inaccurate or misleading.

The payroll tax is levied against low and medium wages up to the earnings cap, but it is not levied against higher wages in excess of the cap.¹⁸¹ Consequently, when considered relative to wages alone, the payroll tax is extremely

176. See *supra* notes 121-26 and accompanying text (discussing effects of investment experience on potential returns).

177. See Hill, *supra* note 12, at 19 (noting that people who are unlucky or unwise risk losing money); Moore, *supra* note 9, at 354-56 ("Common sense suggests that the relative lack of investment experience of the at-risk groups [women, minorities, low-income workers] is likely to result in their receiving lower rates of return under a partially privatized Social Security system.").

178. U.S. GEN. ACCOUNTING OFFICE, 401(K) PLANS: MANY TAKE ADVANTAGE OF OPPORTUNITY TO ENSURE ADEQUATE RETIREMENT INCOME 9 (1996) (noting that more educated and higher-income workers are more aggressive investors and are more likely to invest in stocks than are less educated and lower-income workers).

179. See Moore, *supra* note 9, at 354-60 & n.59 (finding that lower-income workers are risk averse and would likely receive lower rates of return under privatization).

180. See Kathryn L. Moore, *Redistribution Under the Current Social Security System*, 61 U. PITT. L. REV. 955, 960 (2000) (explaining that working generation distributes income to retired generation).

181. See *supra* notes 15-16 and accompanying text (describing payroll tax and earnings cap).

regressive.¹⁸² However, Social Security replaces a greater proportion of low-income workers' pre-retirement income than it does of high-income workers'.¹⁸³ The average rate of return on Social Security contributions for individuals having lifetime earnings in the bottom 20% is between 4% and 5%. In contrast, the rate of return for those with earnings in the middle range is between 1% and 2%. Those in the highest earnings category receive a return of less than 1%.¹⁸⁴ Thus, the benefits paid by Social Security are highly progressive. Most commentators believe that the progressive effect of the benefit formula more than offsets the regressive effect of the payroll tax.¹⁸⁵

Therefore, the Social Security program is explicitly designed to redistribute income from high-income workers to low-income workers.¹⁸⁶ Many proponents of privatization, who would prefer awarding benefits solely on the basis of contribution, have sharply criticized the redistributive characteristics of the Social Security program.¹⁸⁷ However, it would appear that some level of income redistribution is necessary and desirable for the Social Security program to achieve both its anti-poverty and income replacement objectives.¹⁸⁸

Redistribution benefits not only low-wage earners but also women.¹⁸⁹ Redistribution on the basis of gender occurs primarily for three reasons. First,

182. Another reason the payroll tax has a regressive effect is because, unlike the federal income tax, the Social Security tax does not differentiate on the basis of ability to pay. The payroll tax is assessed against gross wages without adjustment for family size, major health expenses, or casualty losses. Thus, the Social Security payroll tax is also regressive with respect to the incomes or ability to pay of those who are subject to the tax. See PECHMAN ET AL., *supra* note 168, at 178 (noting that payroll tax is proportionate to taxable limit and regressive thereafter).

183. Kevin Lansing, *Rates of Return from Social Security*, FRBSF ECON. LETTER, Nov. 12, 1999, at 1.

184. See *id.* (noting returns for higher-income workers).

185. See Dilley, *supra* note 14, at 1123-26 (describing features of Social Security); Moore, *supra* note 9, at 384-86 (stating that progressive benefit program tends to benefit at-risk groups).

186. See Lansing, *supra* note 183, at 1 (noting that low-paid workers are awarded higher fraction of pre-retirement income).

187. See Joan T. Bok et al., *Restoring Security to Our Social Security Retirement Program*, in ADVISORY COUNCIL REPORT, *supra* note 2, at 105 (arguing that benefits of privatization would exceed those of Social Security); see also *supra* note 88 and accompanying text (discussing support of privatization).

188. Moore, *supra* note 180, at 954.

189. See *id.* (noting that progressive benefit formula of Social Security program benefits women and minorities because both groups generally tend to be low-paid, and therefore, both groups benefit from redistribution of income from higher-paid earners to lower-income workers). Thus, a privatized Social Security program would disadvantage these groups because as investors, they would have fewer resources to invest. This would make it advisable for them to select less aggressive investment instruments, also causing the yield on their accounts to be smaller. Hill, *supra* note 12, at 19 (noting that low earners who are less able to take risks will be less likely to attain average rates of return).

women generally have lower earnings than men; as a result they benefit from income redistribution.¹⁹⁰ Second, women have longer life expectancies than men, and they therefore collect benefits longer after retirement.¹⁹¹ Third, women are more likely to elect spousal benefits than men, which allows women to collect amounts in excess of the benefits that they otherwise would receive.¹⁹² The spousal benefits of the Social Security program entitle individuals to receive the larger of either 100% of their own benefits or 50% of their spouses' benefits once they reach age sixty-five, regardless of the amount of their contribution.¹⁹³ If the spouse dies, the widow or widower is entitled to receive 100% of the larger benefit. A divorced spouse who does not remarry is entitled to the same spousal benefit provided that the marriage lasted for at least ten years.¹⁹⁴

Although numerous commentators have sharply criticized the spousal benefit, this form of redistribution is not unique to Social Security.¹⁹⁵ Since 1984, the government has required private pensions to make similar awards to non-employee spouses that result in distribution of income from one spouse to another.¹⁹⁶ As a means of providing equitable protection to individuals who

190. See Moore, *supra* note 180, at 957-58 (noting that women are among groups most vulnerable to poverty).

191. An average sixty-five year old man in the year 2000 can expect to live an additional 16.4 years, while an average sixty-five year old woman can expect to live an additional 19.6 years. However, as many as 31% of women will live to age ninety or above, as compared to only 18% of men. Brown, *supra* note 147, at 5.

192. In 1997, 13% of women beneficiaries claimed spousal benefits as compared to only 2% of men. Hill, *supra* note 12, at 19.

193. "Women who are survivors of qualified workers are entitled to survivor benefits at age 60, and at an earlier age if they are caring for a child who is under the age of 16, or disabled." CTR. FOR WOMEN POLICY STUDIES, EARNINGS SHARINGS IN SOCIAL SECURITY: A MODEL FOR REFORM 18 (Edith U. Fierst & Nancy Duff Campbell eds., 1998). Another feature of the existing Social Security program that is particularly valuable to women is the life and disability insurance, which provides benefits to spouses caring for children under the age of sixteen, if the wage earner retires, becomes disabled, or dies. *Id.* This portion of the Social Security program provides a significant benefit. The disability policy has an estimated value of \$230,000, and the life insurance policy has an estimated value of \$354,000 for the typical worker. *Id.* If privatization eliminates or reduces this benefit, women would be impacted disproportionately because they provide the bulk of care-giving in our society. Hill, *supra* note 12, at 18, 35.

194. STEUERLE & BAKIJA, *supra* note 167, at 212-13.

195. One of the primary reasons the spousal benefit has been criticized is because it redistributes income from singles and two earner-couples to one-earner couples. See *id.* at 256 (criticizing practice of giving nonworking spouses of high-income workers greater benefits); see also Moore, *supra* note 9, at 397 (describing inequities in treatment of dual-earner couples as compared to single-earner couples).

196. Retirement Equity Act of 1984 (REA), Pub. L. No. 98-397, 98 Stat. 1426 (codified as amended in scattered sections of 26 and 29 U.S.C.). Congress passed REA in an attempt to

have been full or part-time homemakers, the Retirement Equity Act of 1984 (REA) significantly expanded the entitlements of the non-employee spouse.¹⁹⁷ In the event of death, the legislation provides that the non-employee spouse receive benefits in the form of a life annuity.¹⁹⁸ In the event of divorce, REA prescribes conditions for enforcing state-court decrees that divide pension property under arrangements known as Qualified Domestic Relations Orders (QDROs).¹⁹⁹

Congress imposed survivorship rights retroactively under REA, and thus transferred substantial assets from one group to another. In fact, commentators have described these rights as the largest wealth transfer in American history.²⁰⁰ Because women disproportionately represent the homemaker population, REA transferred many assets from men to women.²⁰¹ Arguably, the same concerns that caused Congress to redistribute large amounts of income from men to women in the private sector – to protect the non-partici-

rectify the apparent gender gap created by the private pension system. See Dana M. Muir, *From Yuppies to Guppies: Unfunded Mandates and Benefit Plan Regulation*, 34 GA. L. REV. 195, 216-23 (1999) (describing provisions of REA).

197. See LANGBEIN & WOLK, *supra* note 87, at 577-78 (discussing entitlements REA provides to non-employee spouses). Prior to the enactment of REA, the rights of the spouse of a pension plan participant to share in the participant spouse's pension benefits were limited substantially. *Id.* A distinction that is present between the two spousal benefits is that in the private system, there is an actuarial reduction made for the benefits of the non-participant spouse, while in the Social Security system, there is not. Also, in the private pension system, there is a direct transfer from one spouse to the other, whereas, in the Social Security program, there is not. See *supra* note 192 and accompanying text (noting that greater numbers of women claim benefits).

198. The non-employee spouse can waive the benefit. See LANGBEIN & WOLK, *supra* note 87, at 580-94 (providing detailed discussion of types and amounts of survivor benefits, including Qualified Joint and Survivor Annuities, Qualified Preretirement Survivor Annuities, and Qualified Domestic Relations Orders).

199. Child support may be included in a QDRO. REA § 104 (codified at 29 U.S.C. § 1056(d) et seq. (1994)) (identifying "alternate payee" as "any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant").

200. See LANGBEIN & WOLK, *supra* note 87, at 577-78 (noting this description).

201. In introducing the bill, Congresswoman Geraldine Ferraro stated:

Women are shortchanged by private pension plans because the system does not truly recognize the contributions that women make to the economy or take into account women's unique work patterns, patterns which revolve around childbearing and other family responsibilities. [The homemaker] is dependent on her husband and his earnings and at the mercy of death or divorce.

LANGBEIN & WOLK, *supra* note 87, at 578 (quoting *Pension Equity for Women, Hearings Before the Subcomm. on Labor Management Relations of the House Comm. on Education and Labor*, 98th Cong., 1st Sess. 26 (1983) (statement of Rep. Ferraro)).

pant spouse – justify maintaining some support for the non-working spouse in the Social Security system.²⁰²

Notwithstanding the redistribution of income from men to women in the Social Security program and the private pension system, there is still a substantial gender gap in aggregate retirement income.²⁰³ The largest differential is found in accumulated pension wealth and personal savings.²⁰⁴ This disparity suggests that Social Security in its current form is an especially important source of income for women because they generally enter retirement with fewer economic resources.²⁰⁵ In 1998, older women had a poverty rate of 13%; older men had a poverty rate of 7%.²⁰⁶ Twenty-five percent of all women over age sixty-five who live alone depend on Social Security as their only source of income.²⁰⁷ Thus, the redistribution of income from men to women under the existing Social Security program only partially offsets the gender gap in retirement income security in this country.²⁰⁸

C. Weaknesses in Privatization Proposals

Proposals to privatize Social Security not only raise risk-related and public welfare concerns, but also practical ones. Proponents of privatization proposals rely on the theory that the average rate of return on Social Security contributions in the capital market would significantly exceed the risk-free rate currently paid on Social Security funds.²⁰⁹ However, because proponents have not adequately considered certain assumptions and costs, it is doubtful

202. Some commentators have expressed additional concern that the current Social Security spousal program provides larger benefits to the non-working spouses of high-income workers than to the non-working spouses of low-income workers and that this result can not be justified. STEUERLE & BAKJA, *supra* note 167, at 256. Thus, even if the spousal benefit were retained, measures should be taken to ensure that non-working spouses at all income levels are treated more consistently, such as by instituting a flat-rate benefit. *Id.*

203. Retirement assets traditionally consists of Social Security benefits, personal savings, private pension benefits, and post retirement employment. Hill, *supra* note 12, at 19.

204. *Id.*

205. *Id.* at 35; see also Moore, *supra* note 9, at 19 (finding that many women rely heavily on Social Security benefits to avoid poverty).

206. Hill, *supra* note 12, at 19.

207. *Id.* at 17. Minority women are especially at risk for poverty during retirement. *Id.* at 19.

208. Hill, *supra* note 12, at 19 (noting that spousal benefit is imperfect acknowledgement of unpaid caregiving by women).

209. See Howell E. Jackson, *Comment to Theodore J. Angelis, Investing Public Money in Private Markets: What Are the Right Questions?*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 94, at 336 (noting assumption that privatization plans would beat returns on current Social Security contributions); see also *supra* Part II.B (discussing rates of return on Social Security contributions).

that privatization will raise the overall rate of return on payroll tax contributions to the extent that proponents of privatization anticipate.

The actual increase in the average rate of return on Social Security contributions is unlikely to be as high as expected because the projected rates of return used by proponents are unrealistic. Some proposals use the 9.4% estimated return for the private market as a bench mark for the rate of return that participants could expect to receive in a privatized Social Security system.²¹⁰ This expected rate of return is much too high. If workers were given discretion in the investment of their accounts, they would be ill-advised to invest all of their contributions in the stock market. Instead, workers should be encouraged to allocate some of their investments to stable-value funds to properly diversify their portfolios.²¹¹ This allocation would reduce their average expected rate of return.²¹² Also, the expected rate of return is unrealistically high because it assumes the stock market will perform as well in future decades as it has over the last one. However, many economists predict that the stock market reached its peak in 2000 and have advised individuals to invest accordingly.²¹³

Another reason privatization may not provide the increase that proponents expect is because the transition from a pay-as-you-go, public defined benefit plan system to a pre-funded, individual account system would be very expensive.²¹⁴ Because the existing Social Security program is funded on a pay-as-you go basis, there are presently large liabilities for the cost of benefits paid to the earlier generations of retirees.²¹⁵ These liabilities will not disappear with privatization. Therefore, even if the U.S. government adopted a privatized approach to Social Security, current and future workers would still have to pay the existing debts in order to honor the benefits promised to previous generations.²¹⁶ The government could raise additional money either by increasing payroll taxes or by reducing benefits; however, either of these

210. See *supra* note 57 and accompanying text (stating private market average rate of return from 1926-1996).

211. See *supra* Part II.B (discussing rate of return on Social Security contributions).

212. See *supra* notes 118-20 and accompanying text (discussing impact of diversification on rates of return).

213. Jonathan Clements, *Avoid Those Pesky Mental Mistakes*, WALL ST. J., Mar. 20, 2001, at C1. Most commentators agree that the stock market reached its peak in March 2000. *Id.*; see also Mark Maremont & John Hechinger, *If Only You'd Sold Some Stock Earlier*, WALL ST. J., Mar. 22, 2001, at A1 (noting that NASDAQ exchange reached its peak on March 10, 2000).

214. See *supra* Part II.A (discussing methods of Social Security funding).

215. See *supra* notes 37-39 and accompanying text (describing inequities of pay-as-you-go funding arrangement).

216. See Hill, *supra* note 12, at 18 (stating that transaction costs are hidden flaw of privatization); see also *supra* notes 94-96 and accompanying text (detailing risks of individual account plans).

methods would decrease the effective rate of return on current worker's contributions.²¹⁷

The third reason that privatization is unlikely to achieve the projected rate of return on Social Security contributions is that it understates additional administrative costs. Social Security is currently a single, centralized system in which the average administrative cost is relatively small, estimated at approximately \$16 per individual per year.²¹⁸ However, the conversion from a single plan to a program containing 150 million individual accounts would significantly increase this cost.²¹⁹ Even a small increase could result in significant losses over a worker's lifetime. For example, an increase of as little as 1% per year in administrative costs would deplete an individual account by approximately 20% over a forty-year period.²²⁰

One possible effect of increased administrative costs would be a lowering of the average investment return of all individual accounts in the program by the same percentage. However, higher administrative costs also could cause variations in return relative to a worker's wealth and investment experience.²²¹ In the financial industry market, it is customary for service providers to reduce fees to attract wealthier clients to whom other products can be marketed.²²² Consequently, wealthier workers may receive more favorable rates than other workers.²²³ Additionally, the cost of managing smaller accounts more likely would be higher as a percentage of assets than the costs of managing larger accounts.²²⁴ As a result, low-income workers actually could pay more in

217. See CADETTE, *supra* note 46, at 3 (noting that if benefits and tax rates remain unchanged, reserves will be exhausted in thirty years).

218. Hill, *supra* note 12, at 19; cf. Robert Genetski, *Administration Costs and the Relative Efficiency of Public and Private Social Security Systems*, CATO PROJECT ON SOC. SEC. PRIVATIZATION, Mar. 9, 1999, at 3 (stating overall administrative costs of Social Security program).

219. Experts have estimated that average administrative costs would increase between \$25 and \$50 per worker, per year if Social Security were privatized. Hill, *supra* note 12, at 19; see also Genetski, *supra* note 218, at 3 (comparing cost of maintaining individual accounts with administrative costs of operating private retirement accounts that would average between \$30 and \$50 to maintain).

220. See Hill, *supra* note 12, at 19.

221. See Jackson, *supra* note 209, at 337 (noting that administrative costs accrue due to direct fees paid to account managers, as well as indirect costs, such as commissions from brokerage accounts).

222. *Id.*

223. Also, individuals with prior investment experience will presumably have more information enabling them to shop for lower fees. See *id.* at 337 (noting that sophisticated participants are in better position to search for lower-cost providers than are those lacking investment experience).

224. *Id.*

administrative costs than high-income workers under a privatized Social Security program.

Finally, the fourth reason the projected increase in the rate of return for a privatized system is unrealistically high is because it fails to account for the full range of benefits and protection provided by the existing Social Security program.²²⁵ Proponents of privatization often compare the average rate of return in the Social Security program to that of the private pension system or to the private investment market.²²⁶ However, these comparisons treat Social Security as if it were exclusively a retirement program.²²⁷ This is misleading and distorts the results of such comparisons. The existing Social Security program provides disability and life insurance in addition to retirement benefits.²²⁸ The fair market value of these benefits is substantial, with estimated values of \$230,000 and \$354,000, respectively.²²⁹ Accordingly, many of the benefits awarded by Social Security are not retirement payments.²³⁰ Thus, it is inappropriate to view the program exclusively as a retirement savings plan. Doing so significantly understates the effective rate of return on Social Security contributions under the current system.²³¹

It could be very costly for workers who desired disability and life insurance to purchase, in their individual capacities, this protection from the private sector. Insurance companies are able to give more favorable rates to companies and other large groups because the risk of the insured event occurring is spread over a larger population.²³² For example, with respect to disability protection, the premiums paid by healthy individuals in a group who continue working subsidize the cost of the unhealthy members of the group who become too disabled to work.²³³ Because risk spreading in this manner is not possible with individual policies, the cost for such policies could be prohibitively

225. See STEUERLE & BAKIJA, *supra* note 167, at 212 (explaining benefits under program).

226. See Thomas F. Siems, *Reengineering Social Security in the New Economy*, CATO PROJECT ON SOC. SEC. PRIVATIZATION, Jan. 23, 2001, at 10-12 (suggesting that market-based portfolios generally outperform returns from Social Security contributions by wide margin).

227. See Hill, *supra* note 12, at 18.

228. See *supra* note 193 and accompanying text (reporting value of these benefits).

229. See *id.* (noting that Social Security taxes fund disability and life insurance as well as retirement benefits).

230. See *id.* (suggesting that privatizers only compare return from Social Security to return from private savings, ignoring disability and life insurance benefits).

231. *Id.*

232. See Linda J. Blumberg & Len M. Nichols, *Health Insurance Market Reforms: What They Can and Cannot Do*, at <http://www.urban.org/pubs/hinsure/insure.htm> (last visited June 1, 2001) (stating that "[t]he principle behind insurance is to spread individual risks across a group").

233. *Id.*

expensive. Thus, the added expense for additional insurance protection could significantly lower the net rate of return on Social Security contributions. Furthermore, for individuals with pre-existing conditions, private disability and life insurance may be unavailable at any cost.²³⁴

Conclusion

Although Congress needs to make changes in the current Social Security system, the government should not abandon the primary goals and objectives of the program. As a social insurance program, Social Security is intended to provide all insured workers with a safety net that protects them against loss of wages due to retirement, disability, or death.

While privatization may generate greater returns for some individuals relative to the returns that they could expect to receive under the existing program, the privatization of Social Security is problematic in numerous respects. Unlike the fixed benefits in the existing social security program, the benefits from a privatized system are highly variable. Individuals who are unlucky or who choose unwise investment strategies could lose benefits under such a model. The replacement of the defined benefit plan model with individual accounts would transform Social Security from a social insurance program to a savings program. This change would expose all workers to significantly greater risks. It also would fail to ensure a minimum standard of living for low-income workers. Even those who have prior experience with the financial market may not receive a greater return on their contributions if the market does not perform favorably or if there are little or no restrictions placed on the timing, use, and form of payment from the privatized accounts. For these reasons, steps towards privatizing Social Security should be taken very cautiously, and efforts should be made to ensure that all covered workers continue to receive adequate benefits under the program.

234. See Hill, *supra* note 12, at 19.