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# The Shortcomings of Individual Accounts

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Approaching demographic changes and the subsequent long-term shortfall in the Social Security trust funds have prompted a number of policymakers and analysts to propose diverting some part of Social Security payroll taxes into individual accounts. Proponents of this approach typically extol the potential for higher rates of returns on savings in these accounts in comparison to the rate of return on assets in the Social Security trust funds. President Bush recently named a commission to develop a set of recommendations to reform Social Security and their recommendations must include voluntary individual accounts. When the shortcomings of individual accounts are understood, however, it becomes clear that this approach to Social Security reform is problematic for workers in general and for low-wage workers in particular.

**Transition Costs**. Social Security is largely a "pay-as-you-go" system: the payroll taxes of workers currently in the labor force pay the benefits of current retirees. Thus any payroll taxes that would be diverted into individual accounts would have to be replaced in the Social Security trust funds by raising taxes, increasing the federal debt, or reducing benefits more than would otherwise be necessary. For example, diverting two percentage points of the Social Security payroll tax from the program's trust funds to individual accounts more than doubles the Social Security deficit from 1.86 percent to 3.8 percent, and moves the first year of insolvency from 2038 to 2024. Since the principles that President Bush set forth to guide the Social Security commission preclude an increase in taxes, the most likely means of closing such a gap would be to reduce the guaranteed Social Security benefit more than would be necessary in the absence of the individual account proposal.

**Risk**. Beneficiaries would receive income from their individual accounts to supplement their Social Security benefits. For some beneficiaries, this might offset the Social Security benefit reductions. But that would not be the case for other beneficiaries. How much a beneficiary would receive from his or her individual account would be uncertain. While Social Security provides a "defined" — or guaranteed — benefit, individual accounts are "defined contribution" plans in which the income the accounts generate is *not* guaranteed and is subject to market risk. How much income an individual would receive from an account would depend on how the markets performed, how lucky or wise the individual was in his or her investments, and on what portion of the account was consumed by administrative costs. A Century Foundation study has shown that even under the most favorable conditions, a 30-year old worker who earns an average wage would receive a combined retirement income from Social Security and his or her individual account that is 20 percent lower than the benefits to which the worker would have been entitled under current law.

**Administrative and Annuity Costs and Complexity**. These costs cover the expense of managing individual accounts and of converting accounts to annuities when workers retire. Estimates from two eminent economists, Henry Aaron of the Brookings Institution and Peter Diamond of M.I.T., indicate that between eight percent and 40 percent or more of the amounts saved or earned under individual account systems could be consumed by administrative, management, and (where applicable) annuitization costs and fees. A related problem with individual accounts is that they could be difficult to administer, especially for small businesses. The Employee Benefit Research Institute warned that individual accounts cannot be administered like 401(k) plans, with contributions made each pay period through payroll deductions, without adding significant employer burdens, especially on the small-business sector.

**Political Sustainability of Social Security with Individual Accounts.** Plans that replace part of Social Security with individual accounts risk destabilizing Social Security over time. Under these plans, retired workers generally would receive considerably lower Social Security benefits than under current law. Because people would seem to be paying substantial payroll taxes to Social Security and getting back lower benefits from it, Social Security would likely appear to much of the middle class and more-affluent segments of the population to be a bad deal. It would seem to provide them with a poor rate of return compared to what their private accounts were paying. These disparate rates of return would, in substantial part, reflect the fact that the Social Security trust funds would bear all of the responsibility of financing the benefits of workers who had already retired or were near retirement when the individual accounts were established. The trust funds also would bear all of the responsibility of providing more adequate benefits to low-wage retirees, low-earning spouses and divorced women, and covering widows, the disabled and the children of disabled and deceased workers. Although this is not obvious to many workers, a sizeable portion of the Social Security payroll tax is essentially an insurance premium for the disability and life insurance protection that Social Security provides. The private accounts, by contrast, would bear *none* of these responsibilities, which would make them appear to be a better deal to the average worker. For these reasons, the broad-based support for Social Security could lessen and generate strong pressure to shift more payroll contributions from Social Security to individual accounts.

**Low-Wage Workers**. For several reasons, low-wage workers would be likely to receive lower rates of return from individual accounts than other workers. Some administrative costs are fixed dollar expenses and would consume a greater proportion of small accounts than large ones. Also, lower-wage workers generally would not be able to afford as good investment advice, would have less investment experience, and would be more likely to preserve their limited savings by investing conservatively. It appears that claims individual accounts would lead to wealth accumulation for low-wage workers are not well founded.

**Conclusion.** Upon first glance, individual accounts may appear to be a potential solution to the long-term imbalance in the Social Security system. A more in-depth understanding of individual accounts, however, brings to light inherent problems that could result in a lessening of retirement security for workers and their families.