CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

August 21, 2001

VOLUNTARY INDIVIDUAL ACCOUNTS FOR SOCIAL SECURITY: WHAT ARE THE COSTS?

SUMMARY

by Peter R. Orszag and Robert Greenstein[1]

Proposals for Social Security reform sometimes include voluntary individual accounts, under which individuals can choose to participate fully in the existing Social Security system or to divert some of their payroll contributions into their own individual accounts. President Bush has endorsed such voluntary individual accounts. One of the Bush Administration's guiding principles for Social Security reform — and for the Social Security commission it has appointed — is that "Modernization must include individually controlled, voluntary personal retirement accounts, which will augment Social Security."

The Bush Administration sometimes argues that voluntary accounts must be beneficial, since no one is forced to contribute to them. That argument may be politically beneficial to the Administration, since it may make the individual account proposal appear eminently reasonable. But the reality is more complicated. Voluntary individual accounts involve difficult tradeoffs, and experience with such accounts in other countries has proven troubling.

Voluntary individual accounts could be financed either from existing Social Security revenue (such accounts are known as "carve out" accounts) or from *non*-Social Security revenue (in which case, the accounts are sometimes referred to as "add on" accounts). As other Center analyses have explained, the combination of the large tax cut recently signed into law and the other initiatives reflected in the Congressional budget resolution (such as a prescription drug benefit) consume virtually all of the surpluses outside Social Security and Medicare Hospital Insurance after 2002, precluding the possibility of financing add-on accounts out of that surplus.[2] This analysis therefore focuses on carve-out voluntary accounts, in which an individual may elect to establish an account financed by diverting a portion of the individual's payroll tax contributions to an individual account. Such an approach was embodied in legislation introduced in 1998 by then-Senator Daniel Patrick Moynihan, who is now one of the co-chairs of the commission appointed by President Bush to recommend changes in Social Security.

> ***Voluntary individual accounts involve difficult tradeoffs, and experience with such accounts in other countries has proven troubling.***

This analysis examines several difficult issues raised by carve-out voluntary individual accounts.

> ***Voluntary Individual Accounts Would Undermine Progressivity and the Social Compact Behind Social Security.*** The existing Social Security system is somewhat progressive: higher-income

The full version of this report is available on the Center on Budget and Policy Priorities website, www.cbpp.org/8-21-01socsec.htm.

workers receive lower rates of return than lower-income workers. Recent research suggests the system is becoming more progressive over time. As a result of this progressivity, higher-income taxpayers would generally have a stronger incentive to partially opt out of the Social Security system than lower-income taxpayers, since Social Security represents a less attractive deal for higher earners than lower earners. Moreover, because of the growing progressivity of the Social Security system, the incentive for higher earners to opt out would become stronger over time. The partial withdrawal of higher-income workers from the Social Security system, however, would leave behind a pool of disproportionately lower-income workers. The partial withdrawal of higher-income workers thus would weaken the system's ability to accomplish redistribution toward lower-income workers. Harvard economist David Cutler has emphasized this point:

> "We typically think that giving people choice is optimal since people can decide what is best for them. Thus, the economic bias is to believe that, if people want to opt out of social security, they should be allowed to do so. In the context of social security privatization, however, this analysis is *not* right. Allowing people to opt out of social security to avoid adverse redistribution is not efficient; it just destroys what society was trying to accomplish....An analogy may be helpful. Suppose that contributions to national defense are made voluntary. Probably, few people would choose to contribute; why pay when you can get the public good for free? Realizing this, we make payments for national defense mandatory. The same is true of redistribution. Redistribution is a public good just as much as national defense; no one wants to do it, but everyone benefits from it. As a result, making contributions to redistribution voluntary will be just as bad as making contributions to national defense voluntary. We need to make redistribution mandatory, or no one will pay for it."[3]

Voluntary Individual Accounts Involve a Number of Difficult and Complicated Administrative Issues. Making individual accounts voluntary would make the administration of individual accounts much more complicated than it would otherwise be. Making the accounts voluntary, for example, would necessitate providing significant resources to help workers decide whether to opt into the individual accounts or not. Such decisions would become still more complicated if it were possible to opt into and out of individual accounts many times over a career (in other words, if workers were allowed to contribute to the accounts in some years but to participate fully in Social Security in others). Making the individual accounts voluntary would significantly increase the administrative costs of running an individual account system. High administrative costs can consume a significant share of the assets that otherwise would accumulate in individual accounts.

Experience From Other Countries With Voluntary Individual Accounts, Especially the United Kingdom, Is Far From Encouraging. The United Kingdom has had a system of voluntary individual accounts since 1988. Its experience with that system has been disappointing. In large part because of the complexities created by individuals having to decide whether to opt into the accounts, administrative costs have proven to be

Making the individual accounts voluntary would significantly increase the administrative costs of running an individual account system. The higher the administrative costs, the smaller the amount of assets that builds in an account, since the administrative costs eat up some of the assets.

very high. Recent research suggests that such costs would consume more than 40 percent of the accumulated lifetime account balance for a typical worker. (In reaction to these high costs, the U.K. government has recently implemented fee caps on the accounts.) The United Kingdom also has suffered from a massive scandal – the so-called "misselling" controversy – in which lower-income individuals were given misleading advice by firms marketing the individual accounts about whether they should choose the voluntary individual accounts instead of other Social Security options.

These factors suggest that *voluntary* carve-out individual accounts pose unique challenges, which is why most proponents of individual accounts would make such accounts mandatory. Voluntary accounts also share many of the drawbacks associated with any system of carve-out individual accounts, including mandatory systems. For example:

By Themselves, Carve-out Individual Accounts Worsen Social Security's Financing Problems and Require Larger Benefit Cuts Within the Traditional Program. By themselves, individual accounts do nothing to improve Social Security's financial condition. In and of itself, allowing Social Security revenue to be diverted into individual accounts — as a system of carve-out individual accounts would do — reduces the funds available for Social Security and thereby exacerbates the financial imbalance within Social Security. For example, establishing individual accounts by diverting two percentage points of the current payroll tax for all workers would accelerate the date on which the Social Security trust funds are exhausted — and Social Security revenue is sufficient to pay only about 70 percent of promised benefits — from 2038 to 2024. To *reduce* the actuarial imbalance within Social Security rather than to increase it, carve-out individual accounts must be tied to benefit reductions within the traditional Social Security program, and those benefit reductions must more than make up for the reduced revenue flowing into Social Security.

Individual Accounts Do Not Produce Higher Rates of Return When Properly Measured. Individual accounts appear to produce substantially higher rates of return than Social Security, a point that proponents of individual accounts often make. That comparison, however, is misguided. Simple rate-of-return comparisons neglect two factors: First, more than 80 percent of current payroll tax revenue is devoted to paying for current Social Security benefits; this is the principal reason that Social Security rates of return are not higher.[4] Allowing individuals to divert revenue away from Social Security would force policy-makers to find some other source of financing for current benefits (or else the benefits would not be paid). The cost of that financing must be reflected in the rate of return claimed for the individual accounts, but individual-account advocates often fail to include this cost. Second, the higher returns claimed for individual accounts partially reflect the riskiness of the stock market. To be done properly, rate-of-return comparisons must adjust for differences in risk since people generally dislike risk. Such adjustments are difficult to implement, but in general they would further reduce any difference in rates of return between carve-out individual accounts and the current system. Proponents of individual accounts rarely take note of differences in risk when comparing rates of return.

Under a system of voluntary accounts, the misleadingly high rates of return that the individual accounts may be widely (but mistakenly) thought to generate could induce more people to opt out of Social Security. That would further exacerbate Social Security's financing problems and further undermine the social compact underlying Social Security.

The experience in the United Kingdom should serve as a warning. Vulnerable members of society were given misleading advice regarding the benefits of individual accounts, while high administrative costs have sharply reduced the retirement benefits that those with such accounts will receive. The fact that accounts are voluntary does not mean they may not be harmful.

Other Center analyses have examined various issues related to individual accounts.[5]

Conclusion

Voluntary individual accounts could attenuate the social compact behind Social Security by allowing higher-income workers to opt out of part of the system, thereby leaving the rest of the Social Security program with fewer resources to redistribute toward lower earners and a relatively larger burden to bear in honoring the Social Security commitments made to retirees and older workers. Voluntary accounts also would involve a variety of difficult administrative issues.

Experience from other countries that have experimented with voluntary accounts is not encouraging. The experience in the United Kingdom should serve as a forceful indicator of the potential problems associated with voluntary individual accounts. The United Kingdom has witnessed a scandal in which vulnerable members of society were given misleading advice regarding the benefits of individual accounts. The United Kingdom also has suffered from high administrative costs under its voluntary individual account system. These costs sharply reduce the retirement benefits that those with such accounts will eventually receive.

It also is important to remember that voluntary individual accounts do nothing in and of themselves to improve Social Security's financial condition. To the extent that they divert current revenue away from Social Security, they could exacerbate the Social Security shortfall.

Policy-makers considering a system of voluntary individual accounts in the United States should carefully examine the potential costs involved. The fact that the accounts are voluntary does not mean they are not potentially harmful.

---

1. Peter Orszag is a senior fellow in economic studies at the Brookings Institution. Robert Greenstein is the executive director of the Center on Budget and Policy Priorities.

2. Richard Kogan, Robert Greenstein, and Joel Friedman, "How Much of the Surplus Remains After the Tax Cut?," Center on Budget and Policy Priorities, June 2001, and Peter Orszag and Robert Greenstein, "Financing Individual Accounts in the Aftermath of the Tax Bill: The Challenge Facing the Bush Social Security Commission," Center on Budget and Policy Priorities, June 2001.

3. David Cutler, "Comment on Gustman and Steinmeier, 'Privatizing Social Security: Effects of a Voluntary System'", in Martin Feldstein, editor, *Privatizing Social Security* (University of Chicago Press: Chicago, 1998), page 358.

4. Benefits represent a somewhat smaller percentage of *total* Social Security revenue, including interest on the bonds held by the Trust Fund.

5. See, for example, the following Center reports: "All That Glitters Is Not Gold: The Feldstein-Liebman Analysis of Reforming Social Security with Individual Accounts," April 26, 2000; "Archer-Shaw Social Security Proposal,"April 28, 1999; "Administrative Costs in Individual Accounts in the United Kingdom," March 16, 1999; "Individual Accounts and Social Security: Does Social Security Really Provide a Lower Rate of Return?" March 9, 1999; "Social Security Plans That Reduce Social Security Retirement Benefits Substantially Are Likely to Cut Disability and Survivors Benefits as Well," December 15, 1998; "African Americans, Hispanic Americans, and Social Security: The Shortcomings of the Heritage Foundation Reports," October 1998, and "How Would Various Social Security Reform Plans Affect Social Security Benefits? An Analysis of the Congressional Research Service Report," September 1998.