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

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Summary

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

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[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. See also Peter R. Orszag, "The Implications of the Tax Bill for Social Security Reform: The Challenges Facing the Bush Social Security Commission," Testimony before the Senate Budget Committee, August 2, 2001.

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.

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 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]

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[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.

- ***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 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.

Other Center analyses have examined various issues related to individual accounts, generally including administrative costs, risk, and other matters.[5] This analysis focuses on voluntary accounts, exploring the points noted above in more detail.

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[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; "The Feldstein Social Security Plan," December 16, 1998; "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," Rev., October 1998, and "How Would Various Social Security Reform Plans Affect Social Security Benefits? An Analysis of the Congressional Research Service Report," September 1998.

I. Voluntary Individual Accounts Undermine Progressivity and the Social Compact Behind Social Security

The current Social Security system is progressive: It provides a higher "replacement rate" to lower-income workers than to higher-income workers. That is, Social Security benefits replace a larger percentage of pre-retirement wages for lower earners than for higher earners.

For example, for workers currently in their 30s, Social Security income is projected to make up approximately 56 percent of previous wages for a worker with steady low earnings, 42 percent of previous wages for an average earner, and 28 percent of previous wages for a worker with the maximum taxable earnings each year.[6] (It is worth noting that the progressivity of the Social Security system is reduced when factors such as the longer life expectancies of higher earners and the impact of the spousal benefit on high-income couples are taken into account. But recent research suggests that the system is becoming more progressive over time.[7])

Voluntary individual accounts could undermine 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 under Social Security's progressive benefit structure, higher-income taxpayers generally earn a lower rate of return on their Social Security contributions than lower-income taxpayers do, the option to place a portion of existing contributions into an individual account is likely to be more attractive to higher-income workers.

The partial withdrawal of higher-income workers from the Social Security system would leave behind a pool of disproportionately lower-income workers and thereby weaken the system's ability to accomplish redistribution toward such lower-income workers. Allowing higher-income workers to divert into individual accounts two percentage points of their current Social Security contributions would reduce the revenue available to the Social Security system by billions of dollars a year, thereby reducing the resources that Social Security could redistribute to lower-income workers.

Harvard economist David Cutler, a leading scholar on aging populations and their economic implications, has emphasized that contrary to first impressions, the voluntary nature of an individual account system could be harmful. He has written:

> "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

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[6] Ways and Means Committee, *2000 Green Book*, page 57.

[7] See, for example, Karen Smith, Eric Toder, and Howard Iams, "Lifetime Distributional Effects of Social Security Retirement Benefits," presented at the Third Annual Conference of the Retirement Research Consortium, Washington, May 17-18, 2001. One reason for the system becoming more progressive over time is that the spousal benefit, which historically has reduced the progressivity of the system, is fading in importance as more women qualify for retirement benefits on the basis of their own (rather than their spouse's) work history.

security privatization, however, this is 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."[8]

In addition to higher-income workers finding voluntary individual accounts more attractive than lower-income workers, *younger* workers are likely to find the option to make contributions to individual accounts more attractive than *older* workers.[9] Consider, for example, two workers earning $25,000 a year. One worker is aged 60 and intends to retire in five years. The other worker is aged 25 and intends to retire in 40 years. Both are given the option to put two percent of their wages into an individual account. If the older worker puts two percent ($500) of her wages into an individual account and earns five percent per year (after inflation) on the balance in the account, her account will accumulate to $638 (in inflation-adjusted dollars) upon retirement. However, if the younger worker puts two percent ($500) into an individual account and earns the same rate of return per year as the older worker, the $500 will accumulate to more than $3,500 upon retirement because interest will compound for a much longer number of years. If both workers would receive $750 more in lifetime Social Security benefits if they did *not* opt to contribute the $500 to the individual account (which is one plausible way in which traditional Social Security benefits would be affected by the opt-out decision), the older worker should choose not to contribute to the account (since $638 is less than $750) while the younger worker should choose to do so (since $3,500 is more than $750).[10] Individual accounts that are substantially more attractive to younger workers than somewhat older workers could cause increased conflict between generations. Such inter-generational conflict would be particularly damaging to the Social Security system: That system is fundamentally based on an inter-generational compact under which younger workers finance benefits for older retirees, and then, when they retire, have their retirement benefits financed by the next generation of workers.

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[8] 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.

[9] The voluntary individual account system in the United Kingdom includes a provision intended to offset this effect: older workers receive a larger contribution for opting out of the Social Security system than younger workers.

[10] The figures in this example are merely illustrative and do not provide any guide to the likely outcomes under a a system of individual accounts. For example, the figures do not reflect the costs (in terms of continuing to pay current benefits) of the transition to a system of individual accounts.

Another reflection of how voluntary accounts would damage the social compact behind Social Security is that such accounts would effectively allow some individuals to escape the financial obligations that result from the decision the nation made many years ago, at Social Security's inception, to cover the initial retirees under Social Security. As a society, we decided to provide benefits to those early retirees despite the fact that they had made little if any payroll contributions. This resulted in these retirees' receiving exceptionally high rates of return. It also established Social Security as largely a pay-as-you-go-system, under which the payroll tax contributions of today's workers finance the benefits of today's retirees. As a society, we cannot escape the obligation this decision created to support current retirees out of current payroll taxes, which has been handed down from generation to generation. It is inequitable to allow some individuals to escape part of this obligation. We should not allow some members of society — those likely to be best informed and to possess more financial sophistication — to escape this responsibility partially and thereby compel others to bear the burden to a greater degree.

In summary, voluntary individual accounts could at least partially undermine the social compact that has supported Social Security throughout the past 65 years. Depending on how they are designed, voluntary accounts could produce divisions between higher-income and lower-income workers and between younger and older workers.

II. Voluntary Individual Accounts Involve Difficult Administrative Issues

Voluntary individual accounts would involve a variety of complicated and difficult administrative issues. Space constraints do not permit a full examination of all the issues. The following discussion provides an illustrative sample of some of the thorny administrative issues that would be involved:

- ***Administrative costs.*** Operating individual accounts entails various costs that reduce the account balances. The level of administrative costs in a system of individual accounts would depend on a number of factors, including: how centralized the system of accounts was and how limited the investment choices were; the level of service provided (e.g., whether individuals enjoyed unlimited telephone calls to account representatives, frequent account balance statements, and other services); the size of the accounts; and the rules and regulations governing the accounts. The higher the administrative cost, the lower the ultimate benefit a worker would receive (all else being equal), since more of the funds in the accounts would be consumed by administrative costs and less would be left to pay retirement benefits.

  According to the Investment Company Institute, a financial market organization that undertakes research on mutual funds and other financial assets, the average administrative cost for mutual funds is 1.49 percent per year.[11] Over the course of

[11] John D. Rea and Brian K. Reid, "Trends in the ownership cost of equity mutual funds," Investment Company Institute, *Perspective*, Volume 4, Number 3, November 1998. It is worth noting that the 1.49 percent per year figure

a lifetime, such costs reduce the ultimate balance in an account by roughly 30 percent.[12] (The average cost for index funds, which are designed to track a broad market average and do not allow the investor to choose individual stocks, is much lower than the average for all mutual funds. An important tradeoff exists between the degree of investment choice allowed within an individual account system and the average administrative cost.)

Administrative costs are likely to be substantially higher for voluntary accounts than for mandatory accounts, since voluntary accounts involve administrative complexities not present in a mandatory system. For example, voluntary systems require tracking which workers have opted into the individual account system; a mandatory system can instead rely on comprehensive worker records. Voluntary systems also require the provision of more advice to beneficiaries, since beneficiaries need to decide whether to opt into individual accounts (and to opt partially out of Social Security). Evidence from the United Kingdom shows that the voluntary individual account system there has produced significantly higher administrative costs than under mandatory individual account systems in other countries (see below).

- ***Consumer protection and financial advice.*** Another issue is how to ensure that workers make good decisions about whether to opt out of the current system. Would financial advisors be liable for the advice they proffer? In the United Kingdom, individuals were misled as to the benefits of individual accounts (see below), and financial advisors are now being forced to pay compensation. The U.K. experience suggests that allowing advice to be provided by the financial firms themselves may cause significant problems, even in the presence of comprehensive and good-faith regulation. In the United States, would there be regulation and oversight of the types of advice that could be given on whether to opt out of the current system? This matter could be of particular importance if advice is provided by firms that stand to profit if the individual chooses to opt out

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is based on an average account balance of $15,000. Given a two percent contribution rate, it would take years, if not decades, for many workers to accumulate that large an account. In addition, the 1.49 percent per year figure excludes brokerage fees, which could add an additional 0.12 percent per year. See Estelle James, Gary Ferrier, James Smalhout, and Dimitri Vittas, "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in a Social Security System?" NBER Conference on Administrative Costs of Individual Accounts, December 4, 1998. On the other hand, it is worth noting that the Investment Company Institute figures indicate that the average cost (excluding brokerage fees) has declined significantly over time: It was 2.45 percent per year in 1981 and declined to 1.49 percent per year in 1997. The decline was primarily attributable to reductions in the payments to sales professionals for advice and service.

[12] With a 1.5 percent annual charge on holdings in accounts, a dollar deposited in an individual account in the first year of a 40-year career will be subject to the 1.5 percent fee 40 times, while a dollar deposited in the final year before retirement will be subject to the fee once. On average, dollars in the account will be subject to the 1.5 percent annual charge roughly 20 times, suggesting that approximately 30 percent of the account will be consumed by these charges. The precise figure depends on wage growth and the rate of return, as well as the time profile of contributions and fees over the worker's career.

and invest with them. If there is regulatory oversight, what government agency would provide it? The costs of providing the advice should not be underestimated. Even in the United States, financial literacy levels are surprisingly low. For example, according to the Securities and Exchange Commission, more than half of all Americans do not know the difference between a stock and a bond; only 12 percent know the difference between a load and no-load mutual fund; only 16 percent say they have a clear understanding of what an Individual Retirement Account is; and only 8 percent say they completely understand the expenses that their mutual funds charge.[13]

- ***Temporary or permanent opt-out choices.*** If workers are allowed to partially opt out of Social Security, is the choice a permanent one? Or would an individual be allowed to opt out in some years and opt back in others? Either approach has potential problems. Making the choice irrevocable could strand some workers who realize they made a mistake in opting out. But allowing workers to move back and forth between the two systems could increase the opportunities for gaming both systems (e.g., by contributing to individual accounts while young and then opting back fully into the Social Security system later in a career). It also would increase administrative burdens and costs for the Social Security Administration, which would have to track the choices that workers made each year regarding whether to divert payroll contributions to individual accounts or to remain within the pure Social Security system.

This discussion of potential implementation issues is intended to highlight a few such issues rather than to be exhaustive (see footnote 5 for references to papers that discuss other potential problems with individual accounts, including implementation problems). Actual implementation of a voluntary approach to individual accounts would raise a broader array of questions.

III. Experience From Other Countries With Voluntary Individual Accounts, Especially the United Kingdom, Is Not Encouraging

The United Kingdom has had a system of voluntary individual accounts since 1988. Its experience with that system has been particularly unhappy: administrative costs have proven to be surprisingly high, and a major scandal — the so-called "misselling" scandal — erupted when individuals were given misleading advice about whether they should choose the voluntary individual accounts instead of other Social Security options.[14]

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[13] Arthur Levitt, Speech at the John F. Kennedy School of Government, Harvard University, October 19, 1998.

[14] For further discussion of the U.K. experience, see Peter Orszag, "Voluntary Individual Accounts: The Lessons from the U.K. Experience," Testimony before the Ways and Means Committee, Subcommittee on Social Security, U.S. House of Representatives, July 31, 2001.

Since it provides the only example of voluntary individual accounts among the advanced industrialized countries and since it is broadly similar in culture and general outlook to the United States, the United Kingdom may offer trenchant lessons for the debate here. About one-quarter of workers in the United Kingdom have partially opted out of the state-run Social Security system and into individual accounts. The government's payroll tax rebate finances contributions into individual accounts that are roughly equivalent to three percent of average annual earnings for American workers covered by the U.S. Social Security system. (Those who have these accounts can contribute an additional amount on top of the government rebate; some do, and some do not.) As a result, the contributions deposited in individual accounts in the United Kingdom are at least as large as those being considered for individual account plans in the United States.

The British experience with voluntary individual accounts has been anything but inspiring.

- ***Misselling scandal.*** When individual accounts were introduced in 1988, few analysts thought these individual accounts would present regulatory difficulties. After all, the UK financial services industry was, by and large, a reasonably safe place to invest, and the 1986 Financial Services Act had established a system of self-regulation combined with heavy penalties for conducting investment business without authorization.

  As it turned out, the United Kingdom experienced substantial difficulties. In what has become known as the "misselling" controversy, high-pressure sales tactics were used to persuade workers to switch into unsuitable individual account plans. Sales agents had often sought too little information from potential clients to provide proper advice. The U.K. regulatory authorities began an investigation of this mis-selling phenomenon after the problem became apparent in the early- to mid-1990s. As a result of this investigation, financial firms are being forced to repay amounts estimated at more than $15 billion to the individuals who were given misleading advice. In addition, regulators have adopted a more aggressive enforcement stance for the advice offered to individuals. If voluntary individual accounts were adopted in the United States, careful attention would have to be given to ensuring that individuals were given responsible advice regarding whether they should opt for such accounts.

- ***High administrative costs.*** Administrative costs under the UK individual account system have proven to be very high, at least in part because the system is voluntary and therefore requires significant levels of financial advice to enable individuals to make appropriate choices. A recent study found that administrative costs in the United Kingdom reduced account balances for the typical worker by *43 percent* relative to the balances that would have accrued in the absence of administrative costs.[15] Other studies by actuaries and financial analysts in the United Kingdom have reached similar conclusions.[16] (The 43 percent estimate includes the cost of converting the account balance to an annuity upon retirement. Without such annuitization costs, the administrative costs in the U.K. system would reduce account balances for the typical worker by 36 percent.) In response to such high costs, the U.K. government has recently adopted reforms that include a fee cap on the amount that can be charged by individual account providers. (The costs under the new system of regulated fees will be lower than under the previous unregulated system. But over a lifetime, the cumulative effect will likely still be substantial.)

- ***Annuities and opportunities for bequests.*** The state-run Social Security program in the United Kingdom automatically provides an inflation-adjusted annuity to beneficiaries. Systems of individual accounts often mandate that accounts be converted into an annuity upon retirement (in other words, the account value is exchanged for a monthly or annual payment that is made as long as the retiree or the retiree's spouse is alive) to ensure that individuals avoid outliving their savings (and becoming dependent on the government at that point). The regulations governing when an annuity must be purchased in the United Kingdom are complicated. They require that the portion of an individual account funded by tax rebates (as opposed to any additional contributions) must be fully annuitized. The annuity must be purchased at some point between age 60 and age 75. The portion of an individual account funded by additional contributions (beyond the tax rebate) does not have to be entirely annuitized. In particular, up to 25 percent of the accumulated balance from this component of the individual account can be withdrawn tax-free in a lump sum. If workers die before annuitizing their account, the balance of the account enters their estate.

  Many supporters of individual accounts highlight the potential of such accounts to provide payments to heirs. It is crucial to realize, however, that providing a payment to heirs requires that a retiree receive a lower monthly annuity payment and have less to live on in old age. The iron laws of finance demand such an outcome, since the same dollars can be used for only one purpose. Thus, each dollar that a pensioner can bequeath to heirs means a dollar less to support retirement income, because the pool of funds available to finance retirement

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[15] Mamta Murthi, J. Michael Orszag, and Peter R. Orszag, "The Charge Ratio on Individual Accounts: Lessons from the U.K. Experience," Birkbeck College Working Paper 99-2, March 1999 (University of London), available at http://www.sbgo.com/papers.htm. For a summary, see Peter Orszag, "Administrative Costs in Individual Accounts In The United Kingdom," Center on Budget and Policy Priorities, March 1999, available at http://www.cbpp.org.

[16] See John L. Shuttleworth,, "Operating costs of different forms of pension provision in the U.K.," Coopers & Lybrand, June 27, 1997, and John Chapman, "Pension plans made easy," *Money Management*, November 1998.

> benefits is reduced. This iron law holds for all pensions — Social Security, private pensions, and individual accounts.
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> Annuities in the U.K. illustrate this tradeoff. To ensure adequate retirement income, the tax rebates accumulated in individual accounts must be annuitized using a basic annuity, under which the payments end with the death of the annuitant or the annuitant's spouse. In other words, following annuitization, non-spousal heirs receive *nothing* from the portion of individual accounts that have accumulated from tax rebates.
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> For those who made additional contributions to their accounts (beyond the tax rebates), other options are available. For example, more complicated annuities offer a guaranteed payment period. Under these annuities, the heirs receive some payment if the annuitant dies before the end of the guaranteed period. In the U.K. market, for example, a 65-year-old single man who had accumulated a £100,000 account could turn that balance into an annuity payment of about £9,000 per year for as long as he lived.[17] That would leave nothing for his heirs. To obtain a 10-year guaranteed payment period, he would have to accept a lower annuity payment per year for as long as he lived. In the U.K. market, his annuity would be reduced by about £550 per year, or roughly 6 percent.[18] And this approach would provide a payment to his heirs only if he died before age 75. If he died after age 75, the annuity payments would remain at the reduced level and would end with his death, with the heirs receiving nothing. The U.K. market data highlight the unavoidable tradeoff between the provision of retirement income and the provision of a bequest to heirs.

Given the United Kingdom's poor experience with voluntary individual accounts and the cultural and other similarities between the United Kingdom and the United States, it seems surprising that voluntary accounts would be given serious consideration here.

IV. Voluntary Individual Accounts, By Themselves, Exacerbate Social Security's Financing Problems

The intermediate estimates from the most recent report of the Social Security Trustees suggest that over the next 75 years, the Social Security system faces an actuarial imbalance of 1.86 percent of taxable payroll. Those estimates also suggest that the Social Security Trust Fund will be exhausted in 2038, at which point tax revenue would be sufficient to pay for about 70 percent of current-law benefits.

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[17] See http://www.annuity-bureau.co.uk/rates.html.

[18] See http://www.annuity-bureau.co.uk/annuity-optional.html

To improve Social Security's financial condition, four basic options exist: increase revenue, reduce benefits, raise the returns the Social Security Trust Fund earns on its reserves, or transfer funds to Social Security from the rest of the budget. Individual accounts, in and of themselves, do nothing along these four dimensions and therefore do not improve Social Security's financial condition.

Indeed, by themselves, carve-out individual accounts make Social Security's financial condition more adverse. The reason is that they divert revenue away from Social Security, creating a larger financing gap. Consider voluntary individual accounts that allowed individuals to divert two percentage points of their Social Security contributions into individual accounts. If *all* workers chose to divert their contribution, the actuarial imbalance within Social Security would rise from a little under 1.9 percent of taxable payroll to a little under 3.9 percent in the absence of other changes. Furthermore, the Trust Fund would be exhausted starting in 2024, rather than 2038.

Only if individual accounts are linked in some way to benefit reductions within the traditional Social Security system, which is likely to be part of any individual account proposal (although proponents often do not highlight that feature), could they help to put the system on a sounder footing. For example, Professor Martin Feldstein of Harvard University has proposed that each dollar taken out of an individual account be offset by a reduction of nearly a dollar in Social Security benefits. A linkage of this type is necessary for individual accounts to have the potential to improve Social Security's long-term financial condition.

V. Voluntary Individual Accounts Do Not Produce Higher Rates of Return When Properly Measured

President Bush and various other proponents of individual accounts have said that individual accounts would raise the rate of return to Social Security. Such an argument, however, is misleading as a recent, important set of papers by three leading economists demonstrates.[19] The papers show that when analytically valid comparisons are undertaken, the supposedly higher rates of return from individual accounts as compared to Social Security essentially disappear. Other economists, including quite conservative ones, have reached essentially the same analytic conclusions. For example, Kevin Murphy and Finis Welch conclude that "many of the touted gains to privatization are more apparent than real, and any gains have more to do with the details of what is done (whether private or public) than with

[19] John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, "Would a Privatized Social Security System Really Pay a Higher Rate of Return?" in R. Douglas Arnold, Michael J. Graetz, and Alicia H. Munnell, eds., *Framing the Social Security Debate: Values, Politics, and Economics* (Brookings Institution Press: Washington, 1998), and John Geanakoplos, Olivia Mitchell, and Stephen P. Zeldes, "Social Security Money's Worth," in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of Pennsylvania Press: Philadelphia, 1999). A summary of these arguments can be found in Peter R. Orszag, "Individual Accounts and Social Security: Does Social Security Really Provide a Lower Rate of Return?" Center on Budget and Policy Priorities, March 1999.

privatization per se."[20] A similar point is emphasized in a working paper published by the National Bureau of Economic Research.[21] (See the appendix for an explanation of why simple comparisons of rates of return are misleading.)

Conclusion

Voluntary individual accounts could attenuate the social compact behind Social Security by allowing higher-income and younger 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 very 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 particularly 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 is also 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. Individual account contributions equal to two percent of taxable payroll could accelerate the year in which Social Security's tax revenue would no longer be sufficient to pay current-law benefits from 2016 to 2007, and could increase the actuarial imbalance within Social Security from about 1.9 percent of taxable payroll to about 3.9 percent of taxable payroll.

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.

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[20] Kevin Murphy and Finis Welch, "Perspectives on the Social Security Crisis and Proposed Solutions," *American Economic Review*, May 1998, page 142.

[21] Hans-Werner Sinn, "Why a Funded Pension System is Useful and Why It is Not Useful," NBER Working Paper 7592, March 2000.

Appendix

Rate of return comparisons

This appendix explains why the type of rate-of-return comparisons that some proponents of individual accounts make are not valid. Imagine a simple pay-as-you-go Social Security system, under which one generation pays $1 while it is young and receives $1 while old. Generation A, which is old in period 1 when the system is implemented, receives $1 in period 1 without having made any contributions itself. That $1 is paid for by Generation B, which is young in period 1. In period 2, Generation B is old and receives $1, paid for by Generation C, which is young in period 2, and so on. The table below presents the operation of the system.

Table 1
The Simplified Pay-as-you-go System

	Generation			
Period	**A**	**B**	**C**	**D**
1	+$1	-$1		
2		+$1	-$1	
3			+$1	-$1
4				+$1

Assume further that the interest rate the market pays is 10 percent per period. Now consider the system from the perspective of Generation C:

- Under the pay-as-you-go system, Generation C pays $1 during period 2 and receives $1 back during period 3. The pay-as-you-go system's rate of return is zero. (Note that the actual Social Security system pays a positive rate of return. The zero rate-of-return in this example is a result of the simplified assumptions — no productivity growth and no labor force growth — applied here.)

- Under an individual accounts system, Generation C would invest the $1 contribution and receive $1.10 in period 3.

- Generation C thus receives a below-market rate of return from the pay-as-you-go system.

After allowing Generation A to earn an extremely high rate of return, all subsequent generations must earn a rate of return on the pay-as-you-go system that is below the market interest rate. Allowing some members of Generation C to opt out of the pay-as-you-go system would appear to produce a higher rate of return, since such members would earn the 10 percent market rate of interest, rather than the zero percent real rate of return on the pay-as-you-go system. But would Generation C really receive a higher rate of return?

If all members of Generation C put $1 into individual accounts during period 2, that $1 could *not* be used to finance the benefits for Generation B. Yet Generation B’s benefits still would have to be paid unless society is willing to allow Generation B to go without benefits. Assume that Generation B’s benefits are financed through government borrowing (or reduced debt reduction) and that the higher interest costs that result are paid for in each period by the older generation. With an interest rate of 10 percent, the interest payments on each $1 in extra debt (relative to a baseline without individual accounts) would amount to 10 cents per period. Thus, Generation C would get $1.10 back from its individual accounts, but it would have to pay 10 cents in interest costs on the extra debt that would result, so it would receive a net benefit of only $1 after paying the interest costs. As a result, the rate of return for Generation C would be zero: this generation would pay $1 and receive a net benefit of $1. Once the interest costs are accounted for, Generation C would earn the same rate of return as the rate of return the pay-as-you-go system provided (e.g., a zero rate of return).

For Generation C and each generation thereafter, the extra benefit from the individual-account system thus is more apparent than real: the extra benefit is exactly offset by the cost of the interest payments on the debt that financed Generation B's benefits. A simple comparison of rates of return of Social Security and individual accounts that ignores this aspect of Social Security financing is misleading.

Now consider a situation in which the individual accounts are voluntary, and not all members of society choose to contribute to them. For example, assume that half of Generation C decides to opt out of the system and the other half decides to stay in the current system. Half of Generation B’s benefits could then be financed by the contributions from the half of Generation C that remains in the Social Security system. The other half would be financed by borrowing. But if the additional borrowing costs were paid by *all* members of a generation, including those that did *not* opt out of the Social Security system, those who did opt out would gain at the expense of those who did not. In particular, those who opt out would put $1 into their individual accounts and receive $1.10 in the next period. They would have to pay some interest on the borrowing to pay for Generation B’s benefits, but that interest would amount to only 5 cents, rather than 10 cents, because the borrowing would need to cover only half the cost of Generation B’s benefits. Those who opted out would thus receive, after interest, $1.05 ($1.10 minus the five cents they would pay in interest) and earn a rate of return of 5 percent. Those who did not opt out, however, would receive a *negative* rate of return: They would pay in $1 in period 2 and receive $1 from the Social Security system in period 3. But they also would have to pay 5 cents in interest costs. Those remaining in the Social Security system thus would receive only 95 cents (after interest) in exchange for the $1 they contributed. The likely consequence of this dynamic is that either everyone would opt out of the system or those who were least informed about the system’s true implications would be left bearing a disproportionate burden.