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SOCIAL SECURITY AND INHERITANCE: THE DUBIOUS PROMISE OF PRIVATE ACCOUNTS

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Executive Summary

Inheritance is one of the least understood issues in the Social Security debate. Supporters of private accounts often cite the ability to pass an account on to one's heirs as an especially attractive feature of private accounts, one that the traditional Social Security system cannot match. For example, in making the case that private accounts are "a better deal" than traditional Social Security, President Bush said in his 2005 State of the Union address that, with a private account, "you'll be able to pass along the money that accumulates . . . to your children and – or grandchildren."

KEY FINDINGS
• Social Security already contains a major inheritance provision in the form of survivors benefits, which can provide the equivalent of a $400,000 inheritance to a family with two young children if the breadwinner dies.
• Many private accounts plans include reductions in survivors benefits that would substantially exceed the amount that could be inherited through a private account. As a result, many surviving family members would receive smaller inheritances than under the current Social Security system.
• In addition, under the leading private-accounts plans, if a worker died before retiring, the spouse would inherit not only the deceased worker's account but also the *debt* that the worker owed to Social Security (for having elected to have funds diverted from Social Security to the account). For many spouses, the debt would exceed the size of the private account, leaving them with a negative inheritance.

Careful analysis shows, however, that this is a dubious and overblown promise, for several reasons.

First, Social Security already provides an inheritance benefit in the form of survivors benefits, which account for nearly one-fifth of all benefits that Social Security pays. When a worker dies, Social Security pays survivors benefits for a number of years to the worker's minor children as well as to the worker's spouse if the spouse is raising children who are under 16 or the spouse is 60 or older.[2] The Social Security actuaries have reported that for a typical family with two young

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[2] Social Security also pays survivors benefits to adult children with disabilities who become disabled before age 22 and to a spouse if she is raising a child of any age who has a disability, or if the spouse herself has a disability and is at least 50 years old.

children in which a worker dies before reaching retirement age, the survivors benefits can be the equivalent of inheriting $400,000, a much larger sum than most workers could accumulate in a private account.

Second, a number of the leading private-accounts plans include substantial *reductions* in Social Security survivors benefits or in other Social Security benefits that surviving spouses would receive. Because of the way in which Social Security benefits for many surviving family members generally are structured under private-account plans, many surviving family members would receive significantly smaller Social Security benefits than under the traditional Social Security system. These reductions in Social Security benefits for surviving family members often would *exceed* the size of the private accounts these survivors would inherit. That would leave surviving family members with a smaller inheritance overall than they would obtain under the current system.

Three principal groups (which are not mutually exclusive) of surviving family members could end up with net reductions in inheritances under the leading private-accounts plans:

- *Minor children and widows (or widowers) of deceased workers whose Social Security survivors benefits would be reduced by more than the private-account balances they could inherit.* Various private-accounts proposals, including the President's, contain substantial reductions in survivors benefits, as part of a broader set of benefit reductions designed to help close Social Security's long-term funding gap. These benefit reductions generally would be far larger than the private-account balances that many survivors could inherit. As a result, these survivors' overall inheritances would effectively be reduced, and many vulnerable survivors would be worse off than under the current system.

- *Widows who inherit not only the deceased worker's private account but also the <u>debt</u> that the worker owed to Social Security as a result of having elected an account.* Under most private-accounts plans, workers who opt for a private account must give up a portion of their traditional Social Security retirement benefits in exchange for a private account. This benefit reduction repays Social Security for the money deposited in these accounts (plus interest), reflecting the fact that this money would otherwise have remained in the Social Security Trust Fund. (This benefit reduction would be in addition to any benefit reductions made to help restore Social Security solvency.)

  If a worker died before retiring, the worker's spouse would inherit not only the worker's private account but also the debt that the worker owed to Social Security as a result of having elected an account. The spouse's own Social Security retirement benefits would be reduced by the amount necessary to repay that debt. (A surviving spouse also would be subject to these reductions in her own Social Security benefits if her husband died *after* retiring if her Social Security retirement benefits were based on his earnings record rather than her own.) Both the President's plan and the Social Security plans proposed by Senator DeMint and Congressman McCrery contain this provision.

  Under the President's plan, if the deceased worker's account earned less than about 5.5 percent a year on average (less than 2.7 percent above the inflation rate), the surviving spouse's Social Security retirement benefits would be reduced by an amount *larger* than the size of the worker's account, and the spouse would be worse off. The risks inherent in replacing guaranteed Social Security benefits with private accounts that rise and fall with financial markets would thus affect the well-being of large numbers of widows, including widows who had not elected a private account themselves.

- *Heirs of retirees who lived to a very old age.* Social Security pays benefits for as long as a retiree lives, and people who live to a very old age consequently receive considerably more in total benefits than people who die younger. Substituting a private account for a portion of an individual's Social Security benefits would undermine this aspect of Social Security and tend to have a negative result for people who live to a very old age.

  There are two factors at play. First, private accounts, unlike Social Security, would *not* provide more in total benefits to a retiree who lives for many years than to a retiree who lives for only a few years (unless the account has been converted to a life-long annuity). This is because a private account contains a fixed amount of money.[3] Second, under the leading private-account plans, retirees who elected a private account and then lived to a very old age would be subject to much greater total reductions in their Social Security benefits than retirees who died earlier. If a worker elected a private account, his or her Social Security retirement benefits would be reduced (to repay the worker's debt to Social Security) *every month for as long as he or she lived.* The longer such an individual lived, the larger the overall reductions in his or her Social Security benefits would be.

  Because of this, many retirees who elected a private account and then lived to a very old age would have significantly less total income over the course of their retirement than if they had not elected an account. To make up for these losses, they generally would need to consume more of their savings. That, in turn, would leave them with less money to pass on to their heirs. In some cases, they might be forced to ask relatives to help support them in their final years.

Heirs of many other retirees would not suffer net losses in inheritances under private-account plans but would not see large gains either. For retirees who lived to about an *average* life expectancy, private accounts would be likely neither to increase significantly nor to decrease significantly the amounts passed on to heirs.

The only groups of heirs who would consistently come out well ahead under private-accounts plans would be the heirs of workers who died at a younger than average age — either before or shortly after retiring — but only if they inherited the account *without* being required to repay the debt the deceased worker owed to Social Security.[4]

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[3] Private accounts would not have this problem if they required participants to fully annuitize their account balances at retirement. No private-account plan that has been proposed by the President or a Member of Congress, however, has included such a provision. To the contrary, all of those plans emphasize that full annuitization would *not* be required and that account-holders would have choices regarding the use of funds in the accounts.

[4] There are two situations in which this could occur. The first would take place when a worker died *before* or shortly after retiring and had *no* surviving spouse. Under private-accounts plans, only the surviving spouse, and not any other heirs, can be assigned the responsibility of repaying the debt to Social Security. The second situation in which an heir would come out well ahead would occur when a worker died shortly *after* retiring *and* his spouse's Social Security benefits were based on her own earnings record rather than the deceased worker's record. In both situations, little or nothing would have been withdrawn from the account before the worker died, and the amount that remained would be passed on to heirs without a companion obligation to repay Social Security.

Effect on Social Security Solvency

To the extent that adoption of a private-accounts system led to an increase in the total amount of inheritance benefits received by heirs *as a group,* this would signify that some of the money that had been diverted from Social Security to private accounts had not been repaid, leaving the Social Security system with a net loss. Some resources that otherwise would have remained in the Social Security Trust Fund would have been passed to heirs instead. To prevent Social Security's financing hole from expanding, these added inheritance benefits would have to be paid for — through deeper cuts in Social Security benefits or larger increases in taxes than otherwise would be needed. As elsewhere in public policy, there is no free lunch here.

These issues and findings are examined in more detail below.

I. How the Current System Provides Inheritance Benefits

The Social Security system provides benefits to the survivors of deceased workers. Social Security paid $88 billion in survivors benefits in 2004, which represented 18 percent of all Social Security payments.[5] These payments are currently made to 6.7 million survivors, including 1.9 million children.[6]

Survivors benefits serve as a life insurance system: they ensure that some of the most vulnerable survivors receive a basic level of income after a worker's death. Survivors benefits also are targeted, in that they provide more generous benefits to families that have more children and also provide benefits when the benefits are needed most — when children are young or disabled and when spouses are 60 or over and thus less likely to be able to work. Monthly survivors benefits are paid to a deceased worker's family if there are children who are under 18 or disabled (or children age 18 who are attending high school full time), to a deceased worker's spouse if the spouse is 60 or older or is caring for a child who is younger than 16 or disabled, and to other groups as well.[7] Survivors benefits are tantamount to an inheritance that is passed down, through the Social Security system, from the deceased worker to his or her dependent children and spouse.

Survivors benefits can be extremely valuable to families of deceased workers. In an analysis issued in 2001, the Social Security actuaries estimated that survivors benefits for a family with two young children are worth $403,000 if the deceased worker earned average wages.[8] The actuaries projected

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[5] Social Security Administration, *2005 Social Security Trustees Report,* March 2005, Table III.A5.

[6] This is the number of beneficiaries who received survivors insurance in November 2005. The 1.9 million children receiving survivors benefits included 1.3 million children under age 18, some 508,000 adult disabled children, and 54,000 children age 18 who are full-time high school students. Social Security Administration, *OASDI Monthly Statistics, November 2005*, Tables 4 and 6.

[7] Specifically, survivors benefits are paid to surviving children under age 18 (or under age 19, if the child is a full-time high school student); surviving adult children with disabilities (if the children become disabled before age 22); a widow at any age with a dependent child who is either under age 16 or disabled; disabled widows age 50 and over; elderly widows age 60 and over; and dependent parents age 62 and over.

[8] In this example, the actuaries assume that one child is a new-born, the second child is age two, and the widow is age 27 and does not work. The actuaries also assume that the deceased worker was a steady average earner. The total includes the value of benefits paid to both the children and the spouse. The value of the benefits is expressed in present-value terms. (The present-value measurement is the standard way of presenting financial transactions occurring over long

that for such a family, the Social Security survivors benefits that the family would receive over the years would be the equivalent of receiving an immediate inheritance of $403,000 when the worker died.

II. How Private Accounts Plans Would Reduce Inheritances for Many Surviving Family Members

For many surviving family members, private-account plans would reduce inheritance benefits rather than increase them. Private-account plans would tend to reduce inheritances for three groups of survivors.

- Under private-account plans that include substantial reductions in Social Security survivors benefits, many minor children and widows (or widowers) of deceased workers would be worse off, because the reductions in their survivors benefits would far surpass the account balances that they could inherit.

- A second group of surviving family members whose inheritances could be reduced consists of widows (or widowers) who would inherit a private account that had not performed well in the stock market and who would have to repay Social Security for the debt associated with that account. To repay the debt, these widows' own Social Security retirement benefits could be reduced by *more* than the amount they would receive by inheriting the account.[9]

- The third group consists of the heirs of retirees who live to a very old age and, as a result, have their Social Security benefits reduced by more than the amounts they receive from their private accounts. These retirees often would have to dig deeper into their own savings to support themselves in very old age, leaving them with less to pass to heirs.

The following sections of the analysis examine each of these three groups.

1. Surviving Family Members Who Would Face Large Reductions in Survivors Benefits

Many private-account plans contain large reductions in Social Security benefits, including survivors benefits, to help restore solvency. For example, the President's plan includes "sliding-scale benefit reductions" (also referred to as "progressive price indexing"). These reductions would affect

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periods of time. A dollar in the future is worth less than a dollar today. The present-value calculation takes this "time value" of money into account.) Office of the Social Security Chief Actuary, "Present Values of Expected Survivor and Disability Benefits for an Illustrative Case," 2001.

[9] Most widows in this group are widows whose husbands have died before starting to collect Social Security retirement benefits and who themselves live to an average life expectancy or longer. (Note: If a worker dies *after* starting to collect Social Security retirement benefits, and the widow's Social Security retirement benefits are based on her own earnings record rather than her husband's, she would inherit what remained in his account without having to repay what remained of his debt. However, if the worker died after retiring but the spouse's Social Security benefits were based on her deceased husband's earnings record rather than her own, she *would* be responsible for repaying his debt.) These complexities, and the potentially large differences in the inheritance benefits that would go to the heirs of otherwise similar workers who died only a few weeks or months apart, represent an additional problem associated with private-account plans.

TABLE 1

Proposed Sliding Scale Benefit Reductions

(Reduction for Surviving Family with Two Young Children)*

Average Earnings of Deceased Worker and Year of Death**	*Annual* Dollar Reduction (in 2005 dollars)	*Total* Dollar Reduction (net present value)	Percentage Reduction***
Earnings of $36,600			
Worker dying in 2045	-$7,950	-$124,800	-18%
Worker dying in 2075	-$17,820	-$270,100	-29%
Earnings of $58,560			
Worker dying in 2045	-$15,010	-$236,900	-26%
Worker dying in 2075	-$33,700	-$513,500	-43%
Earnings of $90,000 or more			
Worker dying in 2045	-$23,730	-$374,700	-31%
Worker dying in 2075	-$53,160	-$809,800	-51%

Notes: * Includes the value of reduced benefits for the surviving widow and two dependent children, consistent with the Social Security actuaries' example (see footnote 6). As in the actuaries' example, the estimates assume that the workers are steady earners.

** The earnings levels in the table are given in today's terms. Over time, workers' earnings are assumed to grow at the same rate as average wages.

*** The percentage reductions in survivors benefits shown here are slightly higher than the percentage reductions in retirement benefits (as reported in other CBPP papers) for people who retired at age 65 in the same year. Under the proposed sliding-scale benefit reductions, the percentage reduction in benefits is based on the year that a beneficiary becomes eligible for Social Security. Retirees are first eligible to receive benefits at age 62. Thus, the percentage reduction in newly awarded survivors benefits in any year would be the same as the percentage reduction in retirement benefits for people who began to draw those benefits at age 62 in the same year. This percentage reduction would be slightly larger than the percentage reduction in benefits for people who began drawing retirement benefits at age 65 in that year.

Sources: Authors' calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005 and Social Security Trustees, *2004 Annual Report*, March 2005.

survivors benefits along with retirement benefits. These reductions ultimately would result in rather sharp benefit cuts for the majority of people who qualify for survivors benefits.

- Under the President's plan, benefits would be reduced for survivors of all deceased workers who earned an average of at least $20,000 a year (in today's terms).[10]

- The reductions in benefits for the survivors of middle-class workers would eventually become quite large. Consider a deceased worker with two young children who earned the average wage (which is $36,600 today). Under the President's plan, the surviving family members of such a worker would face a reduction in their Social Security survivors benefits of $7,950 a year (in

[10] The benefit reductions would escalate sharply in size as the deceased worker's average earnings rose above $20,000, until the worker's average earnings reached $90,000. The benefit reductions would be the same for the survivors of people who earned an average of $90,000 as for the survivors of people who earned larger amounts.

today's dollars) if the worker died in 2045, and a reduction of $17,820 a year if the worker died in 2075. The families would lose a total of *$124,800* and *$270,100,* respectively, in survivors benefits over the years they received these benefits.[11] These would represent reductions in their Social Security survivors benefits of 18 percent and 29 percent, respectively. (See Table 1.)

- Many *low-income* survivors would be among those subject to these cuts. As long as a deceased worker had average annual earnings of at least $20,000 in today's terms, the survivors benefits that would be paid to the worker's children and spouse would be reduced, regardless of how low the incomes of the children and spouse had fallen after the worker's death. It is common for many spouses and children who are not poor while the family's breadwinner is alive to suffer sharp drops in income, and to fall into or close to poverty, after the breadwinner dies.[12]

For many surviving spouses and children, private accounts would not come close to making up for these large reductions in Social Security survivors benefits. Table 2 shows the value of a private account for a deceased worker who has been employed for ten years before dying and who leaves behind a spouse and two young children. It compares the value of the private account that would be passed on to the worker's family with the reduction in survivors benefits to which the family would be subject under the President's plan.

- If the worker earned an average of $36,600 in today's terms (the current average wage) for ten years and died in 2045, the worker's private account would be worth about $25,100.[13] If the worker were employed for five years before dying, the account would be worth a little less than half that amount. In either case, the account balance would be dwarfed by the $124,800 in lifetime reductions in Social Security survivors benefits to which the surviving family members

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[11] The $124,800 and $270,100 figures are expressed in net present value. They represent the amount of money that a family would have to set aside in the year that it started collecting benefits in order to make up, with interest, for the benefit reductions to which it would be subject. (These estimates assume that the deceased workers were steady average earners. This is the same assumption as is used by the Social Security actuaries in making a similar calculation.)

[12] For more details, see Jason Furman, "New White House Document Shows That Many Low-Income Beneficiaries Would Face Benefit Cuts," Center on Budget and Policy Priorities, May 10, 2005, available at http://www.cbpp.org/5-10-05socsec2.htm.

[13] The value of the private account is calculated assuming a "risk-adjusted" rate of return on the private account of 3.0 percent above inflation. Over time, Treasury bonds are expected to earn a 3.0 percent real rate of return. Although equities would be expected to earn a higher average rate of return, that is because equities are more volatile and involve higher risk. Investors demand to be compensated for this additional risk. In other words, since investments in stocks are riskier and can lose more money, *average* returns on stocks have to be higher over time or else few would be willing to invest in them.

The difference between the average rate of return on stocks and the average rate of return on bonds is known as the "risk premium." Most policy analysts — including the Congressional Budget Office — subtract the risk premium when projecting the returns on a portfolio. That produces what is known as a "risk-adjusted" rate of return. The rate of return assumed here uses the same risk-adjusted methodology that CBO uses in its analyses of Social Security plans.

Assuming a higher rate of return on private accounts would not substantially affect the results in this example. The worker in this example dies at an early age, so the account would have accrued interest for only a few years at that point. Under the intermediate assumptions of the Social Security actuaries, private accounts would earn an average rate of return of 4.6 percent above inflation, without adjusting for risk. At that rate of return, the account of a worker with average earnings who dies in 2045 after contributing to the account for ten years would be worth $2,100 more than if the account had earned a 3.0 percent real rate of return, as assumed above. At the higher rate of return, a reduction in survivors benefits from the sliding-scale benefit reductions would still far surpass the size of the private account. The surviving family members would be worse off by $97,600, as compared to how they would do under the current system.

TABLE 2

Sliding Scale Benefit Reductions and Private Accounts: Net Effect on Survivors' Inheritances
(For surviving family with two young children in which the worker dies after contributing to a private account for ten years)*

Average Earnings of Deceased Worker and Year of Death**	Cut in Survivors Benefits (Reduction Over Lifetime)	Value of Private Account at Worker's Death	Net Financial Effect on Survivors (Over Lifetime)***	Percentage Reduction in Inherited Benefits
Earnings of $36,600				
Worker dying in 2045	-$124,800	$25,100	-$99,700	-13%
Worker dying in 2075	-$270,100	$34,700	-$235,400	-25%
Earnings of $58,560				
Worker dying in 2045	-$236,900	$40,200	-$196,700	-22%
Worker dying in 2075	-$513,500	$55,400	-$458,000	-39%
Earnings of $90,000 or more				
Worker dying in 2045	-$374,700	$58,100	-$316,500	-26%
Worker dying in 2075	-$809,800	$84,800	-$725,000	-46%

Notes: * Includes the value of reductions in benefits for the surviving widow and two dependent children, consistent with how the Social Security actuaries calculated the current value of survivors benefits for such a family (see footnote 6). Following the actuaries' methodology, the estimates assume that the workers are steady earners. All figures are in 2005 dollars and are expressed in present value as of the worker's death.

** The earnings levels in the table are given in today's terms. Over time, workers' earnings are assumed to grow at the same rate as average wages.

*** The reduction in survivors benefits, in present value terms, can be compared to the value of the private account at the time of the worker's death.

Numbers may not add due to rounding.

Source: Authors' calculations.

would be subject under the President's proposal. The survivor's family would be worse off by $99,700, even before taking into account the additional Social Security benefit reductions (described below) to which the surviving spouse could be subject in order to repay her deceased husband's debt to Social Security.

- In subsequent decades, the reduction in survivors benefits would grow still larger and leave such families further behind. The President's proposal would reduce survivors benefits by $270,100, or 29 percent, for a family with two young children in which the worker earned average wages and died in 2075. If such a worker were employed ten years, his or her private account would be worth about $34,700 when the worker died. In this case, the family would be worse off by $235,400. (As Table 2 indicates, the reductions in survivors benefits would be still larger for survivors of workers with higher earnings levels.)

- Other types of survivors also would be subject to these losses, including elderly widows and adult children with disabilities. (If children become disabled before age 22, they receive Social Security survivors benefits throughout their lives.) For many of these survivors as well, the value of a private account would be heavily outweighed by the reductions in survivors benefits under plans such as the President's.

It should be noted that these examples *understate* the reduction in well-being for many surviving families under private accounts, because the examples do not reflect another key feature of leading private-account plans. Under the President's plan, the DeMint and McCrery plans, and various other plans, if a worker dies before retiring, the surviving spouse, in many cases, would inherit not only the worker's private account but also the reduction in Social Security retirement benefits to which the worker would have been subject in order to repay Social Security for the diversion of revenues to his account. This aspect of private-account plans and its effect on inheritance benefits is discussed next.

2. Surviving Spouses Who Would Inherit the Deceased Worker's "Debt" to Social Security, As Well as the Worker's Account

A second group of surviving family members who could be made worse off under a number of the leading private-account plans — i.e., whose inheritances could essentially be reduced by these plans — are survivors who would inherit the deceased worker's debt as well as his account. Under most private-accounts plans, the widows (or widowers) of workers who died before retiring would inherit not only the deceased spouse's account but also the *debt* associated with that account.

If the investments made with the private account performed poorly in the market, the widow could be left with a debt that was larger than the value of the account she inherited. For this reason, private accounts could represent a risky gamble for many widows.

To understand this point, some background on how many private-accounts plans would work is in order. The leading private-account plans all impose a "benefit offset" on workers who elect private accounts. A worker who elects an account would essentially take out a *loan* from the Social Security Trust Fund; a portion of the worker's payroll taxes would essentially be loaned from the Social Security Trust Fund to the worker's private account. The worker would then owe this money back to Social Security, with interest. Under the President's proposal, the worker would owe back the amount of the worker's payroll taxes that had been deposited in a private account plus an interest charge set at 2.7 percent per year above the inflation rate (or about 5.5 percent per year overall).[14] A "benefit offset" would be used to collect these loan repayments — the worker would repay Social Security by having his or her Social Security benefits reduced each month in retirement for as long as the worker lived. The amount of the monthly benefit reduction would be set equal to the amount that the worker would have to pay Social Security each month to pay off his or her debt if the worker lived to an average life expectancy.

As a result, if the investments a worker made with the funds in his or her account, on average, earned *less* than 2.7 percent a year above the inflation rate (i.e., less than about 5.5 percent per year overall), the worker would come out behind. The amount that the worker would lose in Social Security benefit reductions (assuming the worker lived to an average life expectancy) would exceed the value of the account.

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[14] The DeMint and McCrery plans are very similar.. Under these plans, the Social Security benefits of a worker who elected a private account would be reduced by the amount that the worker had contributed to the account, plus an interest charge set 0.3 percent below the Treasury bill rate. Under the long-term economic assumptions of the Social Security actuaries, this interest charge would be equivalent to a fixed interest charge of 2.7 percent, which is the same as in the President's plan.

On the other hand, if the investments that a worker made with his or her private account earned *more* than 5.5 percent per year on average, the worker would come out ahead. The worker's net gain would be the portion of the return that exceeded 5.5 percent.

Research by noted financial market expert Robert Shiller, the author of *Irrational Exuberance*, indicates that a substantial percentage of workers would likely come out behind under this arrangement and lose money as a result of having elected a private account. Shiller's research suggests that a significant portion of workers would be expected to earn less than an average of 5.5 percent per year on their accounts. Their accounts consequently would not make up for the Social Security benefit reductions to which the workers would be subject as a result of having elected an account.[15]

With this background, we now turn back to the issue of how private-account plans would affect inheritances. Under most private-account plans, including the President's plan and the DeMint and McCrery plans, the "benefit offset" would be applied not only to the Social Security retirement benefits of workers who had elected an account *but also to the Social Security retirement benefits of spouses who inherited an account* if the worker to whom they were married died before retiring. (Children or other heirs of a worker who died *without* a surviving spouse would inherit the account without being required to pay the "benefit offset.")

Suppose a worker died at age 55 and the total contributions that he had made to his account, compounded at a rate set 2.7 percent above inflation (about 5.5 percent overall), equaled $100,000. Under the President's plan, he would owe $100,000 back to Social Security. If he had lived, this amount would have been collected by reducing his Social Security retirement benefits each month. Now that he has died, his spouse would inherit *both* his private account *and* his *$100,000* debt to Social Security. The debt would be collected by reducing the *spouse's* Social Security retirement benefits when she retired, regardless of whether she had signed up for a private account herself.

As a consequence, the spouse would come out ahead as a result of inheriting her deceased husband's account only if the investments in his account performed well enough for the account to have more than $100,000 in it.

- If there was $120,000 in his account, the spouse would come out ahead by $20,000. But if the deceased worker's investments did not do well and earned an average rate of return below about 5.5 percent, the spouse would come out behind.

- Suppose the account earned less than 5.5 percent on average and had $80,000 in it. The spouse would still owe $100,000 back to Social Security; she would be subject to reductions of $100,000 in her monthly Social Security benefits over the course of her retirement, assuming she lived to an average life expectancy. She would come out $20,000 behind. Stated another way, her inheritance from her deceased husband's private account would effectively be a *negative $20,000*.

Even if she came out ahead, her "inheritance benefit" would be much smaller than many private-account proponents imply. In the case in which the account performed well and had $120,000 in it,

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[15] Robert Shiller, "Life Cycle Portfolios as Government Policy," *Economist's Voice* Volume 2:1, http://www.bepress.com/ev/vol2/iss1/art14.

many private-account advocates would portray the spouse's inheritance benefit as being $120,000. In fact, it would be $20,000.

The inheritance benefits thus would be based on risk. They would depend on how a deceased worker's private-account investments fared in the stock and bond markets. This would reflect a major shift, from Social Security benefits that are free of market risk to a private account that is subject to market risk.

A final important point is that private-account plans that would operate in this manner would produce inheritances from private accounts that the public would likely regard as extremely unfair. A widow whose husband died just *before* he began collecting Social Security retirement benefits would inherit both her deceased husband's account and the debt that he owed to Social Security. She might end up behind. But another widow whose husband died just *after* he began collecting retirement benefits might inherit her husband's account *without* inheriting any of his debt to Social Security. If her Social Security retirement benefit was based on her own work history, she would get his account without being subject to the "benefit offset." Even though the deaths of the two husbands in this example could occur just a few months apart, the differences for the widows would be very substantial. For example, assuming the deceased workers were average earners scheduled to retire in 2045, there would be a difference of about $100,000 in the value of the private accounts passed on to their widows. This makes little sense as public policy and would likely be perceived by the public as inequitable and unacceptable.

3. Heirs of Retirees Who Live to a Very Old Age

A third group of surviving family members whose inheritances could be reduced under private-accounts plans are relatives of retirees who elect a private account and then live to a very old age. Retirees in those circumstances could lose money as a result of a private account and be left with less money on which to live. As a result, they may deplete other savings to a greater degree and have less to pass on to their heirs, or they may need younger family members to contribute more to help support them in old age.

A fundamental principle of Social Security is that it helps to insure retirees against the possibility of outliving their assets. It does this by providing an inflation-adjusted retirement benefit that lasts as long as a retiree lives. The current system consequently provides more in total benefits to people who live to a very old age, since it pays benefits to these people for more years.

A private account, by contrast, would *not* provide more in total benefits to a retiree who lives for many years than to a retiree who lives only a few years, unless the account has been converted to a life-long annuity. A private account contains a fixed amount of money. Unlike Social Security, it can run out for someone who lives to a very old age. (Most private-account plans would require their participants to annuitize a *portion* of their account, usually enough to provide income in old age equal to the poverty line or slightly more than the poverty line. No major private accounts plan proposed by the President or a member of Congress would require participants to annuitize most or all of their accounts.[16])

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[16] An exception is a recent plan proposed by Jeffrey Liebman, Maya MacGuineas and Andrew Samwick.

Annuities, Private Accounts, and Inheritances

A retiree could elect to convert his or her private account to a life-long annuity when he or she retired and thereby avoid a penalty for living too long. However, if an individual fully annuitized his or her accounts, there would be *no* inheritance benefit from the account. For this reason, private-account advocates who tout the supposed inheritance benefits of such accounts typically emphasize scenarios in which retirees do *not* annuitize their accounts.

Moreover, most private-account proposals would not require full (as distinguished from partial) annuitization of accounts. Given the limited degree to which retirees currently purchase annuities with their retirement savings, it is likely that most retirees would not annuitize much of their private accounts. If so, they and their heirs could suffer the consequences if they lived well beyond the average life expectancy.

Retirees who had a *shorter*-than-average life expectancy would benefit from not annuitizing their accounts. Even so, failing to annuitize often represents a risky tradeoff. Without annuitization, people who end up living for a very long time, and consequently need more total resources over the course of their old age, can find themselves in difficult financial straits in the final years of their lives.

There are two key factors here. First, as just noted, private accounts could not provide more in benefits to long-lived retirees than to other retirees unless the accounts had been annuitized. Second, most private-account proposals would require longer-lived retirees *to undergo larger Social Security benefit reductions*. This would occur because the Social Security benefits of workers who elected private accounts would be reduced every month for *as long as the workers lived*. The monthly Social Security benefits of retirees who lived to an older age thus would be reduced for more years than would the benefits of retirees who died sooner, and the long-lived retirees consequently would be subject to greater overall benefit reductions. (Note: the amount that a worker's monthly Social Security benefits would be reduced each month to pay back Social Security would be based on the assumption that the worker would live to an average life expectancy for a retiree. If the worker lived to an older age than that, the worker's Social Security benefits would be reduced for more months than it would take to pay Social Security back.)

Long-lived retirees consequently would be at greater risk than other retirees of seeing their Social Security benefits reduced by *more* than the amounts they had accumulated in their private accounts. To the extent that long-lived retirees were made worse off by private accounts, they would have less money to support themselves in old age.

Some retirees who found themselves in this situation would respond to the loss of income in old age by going more deeply into their savings. That, in turn, would reduce the size of the inheritances they could pass on to their heirs.

Other very long-lived retirees — particularly those with less money, who might not have been able to leave much, if any, inheritance anyway — might have to rely more heavily on family members for financial support in old age in order to make up for the loss in income they would have suffered by electing a private account and then living to a very old age. These individuals would essentially leave a larger *negative inheritance* to their relatives as a result of the private accounts. In both types of cases, private accounts would have left heirs worse off.

Heirs of individuals who died soon after retiring, and well before reaching the average life expectancies for a retiree, would face the reverse situation. In these cases, the deceased worker would not have lived long enough to pay back Social Security for the private account, and surviving family members generally would be able to inherit the account without having to pay back the remainder of the deceased worker's debt to the Social Security system. If the deceased worker had neither fully annuitized the account nor spent most of the funds in the account before dying, the surviving members would generally receive larger inheritances as a result of the private accounts.

III. A Retiree's Consumption Versus an Heir's Inheritance

Previous sections of this paper have examined situations in which heirs would end up worse off under private-account plans. For many other retirees, private accounts would make little difference in how much their heirs inherited.

For retirees who live to about an average life expectancy, private accounts would offer essentially the same tradeoff as retirees face today in the absence of private accounts: retirees could leave a nest egg for their heirs, but to do so, they would have to sacrifice some of their own consumption in old age.

Retirees can use their resources either to consume for themselves or to save for heirs. If private-account plans provide retirees with the same overall level of resources as a system without private accounts (as would generally be the case for people who live to about an average life expectancy for retirees), then the choice will remain essentially the same for retirees, irrespective of the form in which the money comes. A monthly Social Security check can either be spent or saved for an inheritance. The same goes for a lump-sum payment or monthly income from a private account.

Accordingly, retirees with private accounts would face similar decisions to those that retirees face under the current system. Under both systems, retirees would have to decide to what degree to spend to meet current needs and to what degree to save for heirs.

IV. Negative Effects on Social Security Solvency

Under most private-account plans, including the President's plan and the DeMint and McCrery plans, private accounts would essentially be treated as a loan from the government that would be repaid by reducing the account-owner's Social Security benefits in retirement. As long as the loans are paid back in full, long-term Social Security solvency would not be affected. If, however, the loans are *not* paid back fully, the Social Security shortfall would be enlarged, necessitating deeper Social Security benefit cuts or greater payroll tax increases to bring the system into long-term financial balance.

As this analysis explains, the reduction in Social Security benefits to which workers who elect private accounts would be subject under most private-account plans would be calculated so that a worker's debt would be fully repaid if the worker lived to an average life expectancy. Retirees who lived to a very old age would pay back *more than* their debt, while those who died shortly after retiring would pay back only a portion of their debt. From the standpoint of Social Security solvency, the effects from these two groups of retirees (those who lived to a very old age and those who died soon after retiring) would largely offset each other, leaving long-term solvency essentially unaffected.

There would, however, be another group of workers — those who died *before* and who did not have a surviving spouse. Under the Bush, DeMint, McCrery, and other private-account plans, the

Social Security Could be Changed to Provide Comparable Inheritance Benefits to Private Accounts

If a worker dies only a few years into retirement, he or she will receive relatively few retirement benefits from Social Security. The worker will not be able to save and then pass to heirs the Social Security benefits that he or she would have received if the worker had lived longer.

If policyworkers wished to do so, they could modify the current Social Security system to provide the same "inheritance benefit" in such circumstances that private-account proponents trumpet, *without* converting part of Social Security to private accounts. As with private accounts, however, doing so would come at the expense of people who live longer in retirement and would represent dubious policy.

The Trade-off: A Guaranteed Life-Long Benefit Versus A Lump-Sum Payment at Retirement

Specifically, Social Security could be changed so retirees could collect a portion of their benefits as a lump sum at retirement, in exchange for receiving a reduced annual benefit for the rest of their lives. If this exchange were designed so it was actuarially neutral, it would not affect Social Security's long-run solvency.

For example, under current law, an average earner who retires in 2005 at age 65 would receive an annual Social Security benefit of $14,830. Under this change to Social Security, such a worker could take a portion of his or her annual benefit as a lump sum; for example, the worker could collect a poverty-level annual benefit of $9,250 per year, plus a $72,060 lump sum, instead of a $14,830 annual Social Security benefit. The worker would accept a reduction of $5,580 a year in benefits for as long as he or she lived in return for the lump-sum payment.

The retiree could spend the lump sum as he or she chose. The worker could spend the amount quickly on a new house or an around-the-world cruise, spend it down slowly as a supplement to his or her monthly Social Security check, or leave it to his or her heirs.

Why This Would Not Be a Sound Idea

If the worker died soon after retirement, he or she would come out ahead under this option, because the worker would have gotten either to spend the lump sum amount or to leave it to heirs. If the worker lived for 30 years in retirement, however, the worker would be much worse off as a result of having received the lump-sum payment. The total value of the worker's Social Security benefits would be substantially less than under current law, because the worker would lose $5,580 in Social Security benefit every year for 30 years. In addition, there would be serious risk that the worker would eventually exhaust all of his or her other assets and be left in very old age with nothing more than a Social Security benefit that had been reduced to the poverty line.

In short, the lump-sum payment that could be passed on to heirs would be financed by eroding one of the major forms of insurance that Social Security provides — insurance against living a very long life.

Private accounts entail the same tradeoff. They would provide expanded choices to retirees but would do so in return for substantial reductions in annual Social Security benefits — and less insurance against a retiree having to reduce his or her living standards and facing difficult straits in very old age.

entire account would be passed to heirs in these cases, with *none* of the debt to Social Security being repaid.

Heirs would receive significant inheritances in these circumstances. The Social Security Trust Fund, however, would never recoup the loan it had made to the worker whose account was passed on to heirs. The increased inheritance these heirs would receive would not come for free. It would come at the expense of Social Security solvency.

Because of such situations, the Social Security Trust Fund would likely incur a net long-term loss as a result of most private account plans, with the net loss enlarging the Social Security shortfall. That, in turn, would necessitate deeper Social Security benefit cuts or larger tax increases to restore long-term solvency.

As economists like to say, "there is no such thing as a free lunch." If the net effect of private accounts is to increase inheritances overall, then private accounts will enlarge the Social Security shortfall in so doing. (The money to pay for the increased inheritances must come from somewhere, and under most private account plans, these funds would come directly from the Social Security Trust Fund.) Moreover, even if the total amount passed on to heirs increased, many *individuals'* inheritances would shrink, as this analysis explains, and many of the people who ended up with smaller inheritances would be the people who most need adequate resources to make ends meet.

V. Conclusion

Private-account advocates frequently promote accounts as a way to allow workers and retirees to pass Social Security benefits on to heirs. As this analysis demonstrates, however, private accounts offer a false promise to many heirs.

Many private-account plans, including the President's, feature proposals to scale back Social Security benefits substantially, including survivors benefits. Such proposals would harm some of the most vulnerable survivors, including minor children, adult children with disabilities, and elderly widows. For many of these survivors, the additional money, if any, that they would receive by inheriting a private account would make up for only a modest fraction of the survivors benefits they would lose.

In addition, spouses of workers who died before retirement would inherit not only the deceased worker's account but also the debt that the worker owed to Social Security for having set up the account. If the deceased worker's account did not produce earnings averaging about 5.5 percent per year (under the President's plan), the debt would exceed the value of the account, and the net inheritance the spouse would receive would be *negative*.

Private-account plans also would be detrimental to the heirs of many retirees who lived to a very old age. Such retirees often would lose more, through the offsetting Social Security benefit reductions to which they would be subject, than they would gain from the accounts. To the extent that such retirees depleted more of their savings in old age because they had less income as a result of having elected an account, they would have fewer assets left to pass on to heirs. For other heirs, such as the heirs of retirees who fully annuitized their accounts and the heirs of retirees who lived to about an average life expectancy, there generally would be little or no change in the amounts that they inherited.

To be sure, some heirs would come out ahead. In many cases, however, their additional inheritance benefits would come at the expense of the Social Security Trust Fund — and ultimately would have to be financed primarily through deeper Social Security benefit reductions or larger tax increases. Furthermore, unlike Social Security survivors benefits, any increased "inheritance benefits" that resulted from private accounts would not be targeted effectively on people who were most in need of financial support after the death of a spouse or a parent.

Lastly, this analysis suggests that seeking to expand inheritance benefits by making changes in the Social Security system — whether by replacing part of Social Security with private accounts or by altering Social Security to offer lump-sum payments at retirement — would be ill-advised. Expanding inheritance benefits in either of these ways would make the Social Security shortfall larger, result in substantial numbers of seniors being poorer in very old age, or both. Other mechanisms to strengthen retirement security and inheritances — such as improvements in the private pension system so that more workers can participate in it and save more for their retirement — would constitute much sounder and less risky ways to pursue this goal.