1-1-2002

# Personal Retirement Accounts and Social Security Reform

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**Abstract**
Personal retirement accounts are attractive in the context of Social Security reform for several reasons. One is that such accounts would give workers ownership and a degree of responsibility over their own retirement saving. Another is that personal accounts would afford participants an opportunity to pass wealth to survivors in the event of premature death. Personal retirement accounts would also benefit divorced persons who receive Social Security spousal benefits unless they remain married ten years. Still another factor favoring personal accounts is that workers could chose how to allocate their retirement saving and diversify their investments over a range of capital market assets. Some also argue that personal accounts would provide all workers a higher rate of return than can be paid under the current Social Security system. In this note, I explore the limits of this last argument. I show that Social Security returns are projected to be low mainly because today's workers are committed to paying for the system's past debt. After clarifying several key terms, I discuss reform scenarios involving these concepts.

**Disciplines**
Economics

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**PRC WP 2002 -7**
January 2002

**Pension Research Council Working Paper**

**Pension Research Council**
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The U.S. Old-Age and Survivors' Insurance program, known as OASI, is financed today mainly by a 12.4 percent payroll tax on covered earnings of wage earners; some money is also received from the taxation of benefits.[1] Beginning in 2016, OASI is projected to collect less in tax revenues than it must pay out in benefits. As noted in the *Final Report* of the President's Commission to Strengthen Social Security (www.csss.gov), the Trust Fund would still show a positive balance at that time. Going forward, however, cash flow annual shortfalls will grow quickly, to $99 billion in 2020, $194 billion in 2025, $271 billion in 2030, and $318 billion in 2035 (in $2001). The system's future liability is estimated at around $10 trillion. The cost of paying scheduled benefits will rise from about 10 percent of taxable wages today to almost 18 percent in 2035. The fact that projected costs will balloon while program revenue lags behind means that as a nation, Americans face some unavoidable choices.

**Why Social Security Is In Debt**

Social Security was initially designed to be a prefunded program, meaning that retirees' benefits would be based on how much workers paid into the system. But after the program was launched, political pressure expanded benefit payments to encompass more people and richer benefits than initially envisaged, including to the already-elderly, early retirees, survivors, and dependents. Paying benefits to many people who had not contributed very much to the system meant that over time, Social Security ceased being prefunded and moved to a "pay-as-you-go"

[1] Here I abstract from the Disability Insurance plan under Social Security.

(PAYGO) program. That is, the system took on debt by paying more out benefits to retirees than these people had contributed during their worklives, and the burden was passed on to future generations.

As a result of coverage broadening and benefit increases, early participants got more back than they paid into the system. Knowing what we do about the system's historical evolution, it is not surprising to find that the several early generations of retirees received a high Social Security "rate of return" on their money. (The Social Security money's worth literature identifies this rate of return as the discount rate that equates a worker's lifetime payroll taxes and lifetime retirement benefits.) For instance, workers born in 1876 (the first generation to receive benefits) received a rate of return of more than 35 percent per year. Those born in 1900 received less than half this amount, around 12 percent. As the system matured, workers paid in more money over longer periods, and the rate of return continued to drop.

Future Social Security returns will fall further, under present law. As my research shows, substantial benefits were transferred through the Social Security system to generations born 1876 through 1976 (Geanakoplos, Mitchell, and Zeldes 1998, 1999). Indeed the first 60 birth cohorts of workers paying into the Social Security system received a positive transfer – they received much more back in benefits than they paid in taxes. Starting with the cohort born in 1937 and continuing thereafter, however, net transfers moved negative. In a PAYGO system, money flowing into and out of the system must sum to zero over time. Therefore, since past generations received more than they paid in, current and future generations must receive less.

How much less each generation of future workers receives depends on how the debt of about $10 trillion is spread out. If policymakers simply rolled the debt forward, paying interest but doing nothing else, one-quarter of every payroll tax dollar flowing into Social Security would be needed to paying interest on this obligation. That is, of the 12.4 percent of payroll currently paid to Social Security, 3.6 percent covers interest on this unfunded debt. As a result, as long as the debt is rolled forward, the long-run return on Social Security payroll taxes will be depressed due to the need to honor past debt. Research shows that workers in the future can expect projected Social Security returns to fall to 1.5 percent for people born in 1998, and even lower later. This pattern is often contrasted with an average real return on stocks of more than 9 percent over the post-WWII period.

**Social Security Prefunding, Diversification, and Personal Accounts**

When assessing measures to reform the system, it is important to emphasize that *prefunding, diversification*, and *personal accounts* are distinct concepts in the Social Security context (Mitchell and Zeldes, 1996). Prefunding requires reducing the debt held by the current system, which could be accomplished in a variety of ways. In essence, it would require curtailing system liabilities or boosting system revenue. Revenue could be increased by raising taxes on current workers, meaning that later cohorts would enjoy lower taxes, or by taxing future workers, thus leaving current workers less affected. Curtailing liabilities could be accomplished by cutting current retiree benefits, an option not generally perceived as a sensible option in most circles, or by lowering the rate of benefit growth for future retirees.

Diversification means investing Social Security payroll taxes in capital market assets such as stocks and bonds. Setting up personal accounts would entail changing the Social Security system to include accounts held and managed by individual workers.

My research shows that reform plans can include any or all of these three concepts. For example, Latvia has "virtual" but unfunded personal accounts, which are therefore undiversified.

Switzerland invests its national retirement money in stocks as well as bonds, so that the system is both diversified and prefunded but does not include personal accounts. Mexico provides its workers with prefunded mandatory personal accounts, but until recently, the government required these to be invested solely in government bonds (diversification is planned for this year). Chile, leading several of her sister nations in Latin America, established mandatory, prefunded, diversified, personal accounts. These and other models are under active debate in the United States at present.

**Individual Retirement Accounts without Diversification or Prefunding**

What if the US Social Security system were to transition to a personal retirement account system without drawing down past debt accumulated under the old program? This is not an approach that most mainstream analysts recommend, since it would entail shutting down the current system and depositing all new Social Security payroll taxes only in personal accounts. In this case, honoring past promises might involve issuing so-called "recognition bonds" equal to the system's current unfunded promises. On the assumption that the nation would not default on Social Security debt, new taxes would have to be raised to cover the interest as well as eventually to redeem the bonds. Under this scenario, the net result would be that workers would reap higher returns in their personal accounts, but new taxes would offset some of these gains when viewed as a whole. Those who critique low returns now promised by OASI today generally ignore the cost of honoring past Social Security debt.

**Is Diversification the Key?**

Many policymakers favor personal accounts because these afford workers a chance to hold a diversified asset portfolio, particularly with stocks included as part of the mix. Since stocks pay a higher expected rate of return, proponents argue that workers would benefit from taking advantage of the equity premium. Of course, higher expected returns must be balanced in each case against exposure to more risk. Some people would welcome this, while others might not.

On balance, it is likely that people who currently have no retirement saving might benefit the most from access to the capital market through a diversified personal account under Social Security. This set of workers is also most vulnerable to the uncertainty associated with today's insolvent Social Security system, since their future benefit promises cannot be counted on in light of the troubled finances outlined above. People who already have a diversified personal savings portfolio would perceive less relative gain from personal accounts, since for them, the risk-adjusted rate of return on stocks is identical to that on bonds.

One unknown, going forward, is whether personal accounts might influence market values of stocks and bonds. Some speculate that if the demand for equities rises during the saving phase, this might boost stock prices early but when baby boomers retire, prices might fall. Potential market reactions have not yet received much research attention, but experts believe that personal accounts under Social Security would track the positive experience of 401(k) plans in the American financial scene.

**Do Personal Retirement Accounts Raise Social Security Costs?**

Some have argued that instituting funded personal accounts within the Social Security context might mean increased costs for Social Security. The claim is that a dollar sent to a personal account would be a dollar less to keep the Social Security system's cash flow positive.

An understanding of the system's financing, however, confirms that unfunded past Social Security debt exists independent of personal accounts. Arguing otherwise ignores the nature of the underfunded PAYGO system. One way to see this is that a personal account model could be established without any impact on Social Security's net liabilities, as outlined in the *Final Report* of the President's Commission to Strengthen Social Security. This could be done, for example, by adding-on voluntary contributions on top of existing payroll taxes so system finances would be unaffected. Another approach would be to allow workers to voluntarily divert some of their payroll taxes to a personal account, in exchange for a proportional offset to traditional Social Security benefits. This could be done in such a way as to leave the financial gap under the PAYGO system untouched. In other words, other reforms are still required to rectify the fundamental system shortfalls, such as raising new revenue or reducing the rate of growth of benefits below current unsustainable levels.

Another concern sometimes expressed is that the fees and charges associated with managing personal accounts might be steep. But international as well as domestic evidence show that these costs can be kept quite low with sensible plan design (Mitchell, 1998). For instance, collecting the personal account contributions centrally is a much lower-cost approach than is a decentralized collection model. Investment charges can be minimized as illustrated by the Thrift Saving Plan, the personal accounts program covering US federal civil servants and the military. Standardized investment education and recordkeeping would greatly improve workers' financial literacy and understanding of their retirement saving options. With careful thought to plan design, cost concerns need not be an obstacle.

**Conclusions**

Personal retirement accounts would not "solve" all of Social Security's financing problems, a point recently made by the President's Commission to Strengthen Social Security. However they have many positive aspects. They would provide workers with ownership of wealth, they allow people to invest according to their own risk preferences, and they are available in the event of divorce or premature death. Some workers will be better off by having the chance to invest in stocks and earn higher expected returns; others who believe that risk-adjusted expected stock returns equal risk-adjusted bond returns would be neutral.  On net, it is likely that a majority of workers would chose to invest in personal accounts given a choice, since they know that Social Security promises are highly uncertain in view of system financing shortfalls. Yet irrespective of whether personal retirement accounts are adopted, Social Security reforms are needed that reduce system debt if future generations are to do better than the dismal returns projected from our troubled system.

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