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ISSUE BRIEF

AMERICAN ACADEMY of ACTUARIES

Issues Regarding Social Security Individual Accounts

Some analysts are calling for changing the U.S. Social Security system by requiring (or allowing) individuals to accumulate a portion of their Social Security contribution in an individual account, which could be invested in the private markets. Advocates for this approach assert that it would provide substantially higher benefits for most workers than the existing Social Security program, and would provide workers with more control over their retirement security.

Before an individual account program can be crafted, several major questions must be addressed:

- *Should workers' participation in an individual account system be voluntary or mandatory?*
- *Will private-sector investments continue to yield higher rates of return than Social Security?*
- *Will individual investors take advantage of those higher rates?*
- *To what extent will higher administrative and investment costs erode rates of return?*
- *How will benefits be distributed?*
- *Will individuals be permitted to spend their accumulated funds before retirement?*
- *Will the cost of the transition to a new system create insurmountable financial and political obstacles?*
- *Do the American people want to change Social Security's fundamental philosophy by shifting to individuals the responsibility and risks for their own retirement income security? [See the Academy issue brief, Social Adequacy and Individual Equity in Social Security, for analysis of this question.]*

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States, providing clear actuarial analysis to elected officials, regulators and the news media. The Academy Committee on Social Insurance comprises leading actuaries with broad experience in the design and management of governmental social insurance programs. The committee has written a monograph, "Solutions to Social Security's and Medicare's Financial Problems," and several issue briefs on Social Security reform to bring the actuarial perspective on these important government programs into the public debate.

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Background

The existing Social Security program is funded primarily through payroll taxes on earnings. Contributions to the program that are not immediately paid out to meet benefit obligations are invested entirely in U.S. government securities. Accumulated assets are not allocated to individual worker accounts. Some analysts have advocated changing the basic structure of the program to allocate some or all of the program's contributions to accounts of individual workers, so that they could direct the investment of such assets. Their primary goals are to obtain a greater return on investment and provide workers with more personal responsibility for their retirement security. An additional goal is to increase net national savings and thereby increase net national productivity, so that the country could better afford to pay retirement benefits to the baby boomers and subsequent generations.

Individual Accounts

A range of legislative proposals currently exists that would require (or allow) workers to accumulate all or part of their Social Security retirement funds in

accounts similar to today's individual retirement accounts (IRAs). Although individually-owned, the funds typically would be administered by professional investment managers. The government could restrict investment choices to some extent to reduce administrative costs and to provide workers with additional protection. However, individual account owners would make the basic investment decisions and accept the accompanying risks.

Voluntary or Mandatory?

A fundamental question is whether individual worker participation in a privatized system would be voluntary or mandatory. If voluntary, the old system would have to continue indefinitely for those who choose not to participate. In this case, workers would choose the option most favorable to their specific circumstances, adding to program costs. In addition, running dual programs would be more complicated and more expensive administratively.

If participation in the individual account program is mandatory, and only a portion of the existing program were privatized, a two-tiered program would be necessary. For example, one tier would pay a government-guaranteed benefit, the other tier would contain an individual account component. Under some proposals, the government-guaranteed defined benefit would be flat, thereby not varying by income level, while the benefits derived from the individual accounts would vary both by income level and investment results. The flat benefit would be lower than current Social Security benefits, since part of the payroll tax would be used to fund individual accounts.

Investment of Funds

Under an individual account approach, investment risk shifts from the Social Security program to the individual. This transfer of risk could have significant impact on the success of an individual account program. Some individual investors do not take a long-term view, due to liquidity needs or limited personal resources. Some individuals also often lack access to investment information and the necessary sophistication to make effective investment decisions.

Additionally, individuals or even cohorts of workers cannot absorb the amount of risk that the Social Security program can, especially during periods when market values drop sharply. For both financial and psychological reasons, individuals are less able to ride out periods of poor market performance.

Individuals could become even more risk-averse if the Social Security safety net were reduced to a minimum benefit or eliminated altogether.

Absent a government guarantee, individuals are also more vulnerable to the loss of their principal. Principal can be lost due to an issuer's bankruptcy, inappropriate investment advice, or even securities fraud.

For these reasons, many individuals will steer a risk averse course in directing their investments. Based on historical experience, this is likely to be the route to lower returns and smaller benefits. Retirees and workers near retirement are especially likely to adopt conservative investment practices and receive lower returns. In addition, studies by a number of actuarial consulting firms have shown that investment returns for traditional pension plans where the employer assumes the investment risk are higher than returns on plans where individuals take the risk. Such differences can have a profound impact on benefits.

In summary, if enough consistently high-yielding investments exist, and individuals invest in them, net investment yields under an individual account approach may be greater on average than under the current Social Security program. However, it may not be reasonable to assume that individuals will earn the historically high returns of equity markets or the returns realized by traditional employer-provided pension plans. Workers will need investment education to ensure they recognize the opportunities as well as the risks of the private market. Lower paid workers, in particular, will need education since many of them will have no prior investment experience. It should be noted that individuals, regardless of their level of investment education or financial expertise, will still be vulnerable to fluctuations in the private market especially at the time that they expect to retire.

Distribution of Benefits

At retirement, individual accounts could be converted into annuities that pay a fixed monthly amount. (Mandatory conversion to annuities could be mandatory up to some income replacement level.) These annuities could be designed to pay increasing benefits, so that payments would approximately reflect changes in the cost of living. While Social Security benefits are indexed directly to the Consumer Price Index (CPI), such indexing of private annuity benefits is not generally available. One consideration is whether insurance companies would be able to offer CPI-indexed, or inflation-

indexed annuities.

Another concern is that annuities payable to women would be smaller than those to men since women have a longer life expectancy. One option is to mandate gender-neutral, or unisex, annuities. Mandatory unisex annuities would be feasible in a system that required retirement benefits to be paid only as life or joint and survivor annuities. If annuitization of individual accounts were mandatory, an important concern would be whether these would be offered by the government, by individual insurance companies or through some type of consortium arrangement. It might be difficult for insurance companies to offer unisex annuities on their own since men would be less willing to pay for the higher unisex rates.

Another basic question is whether benefits derived from individual accounts could be paid in forms other than life annuities, and under what circumstances exceptions would be permitted. Preservation of capital during the working years is a serious issue, as many workers with legitimate needs—health-care emergencies, unemployment, natural disasters, etc.—would seek to withdraw (or borrow) funds from their individual accounts for nonretirement purposes. The evolution of loan provisions in current 401(k) and IRA plans illustrates the issues involved. Initially, these funds were off-limits until retirement. If funds were withdrawn, a stiff tax penalty was imposed. Then, as workers clamored for access to meet important preretirement financial needs, loan provisions were enacted into law.

If retirement funds cannot be preserved and used for retirement, workers could actually be worse off in retirement under a privatization arrangement than under the existing program, even with an increased level of funding and higher rates of return in the private equity markets. However, it might prove politically impossible to seal account funds off from workers who face financial needs before retirement.

Preserving funds *after* retirement poses yet another problem. Individuals who do not convert their accounts into annuities at retirement risk the possibility of outliving their resources, especially if the individual account is their primary source of income. Without the restraint provided by a lifetime Social Security annuity or pension payment, some retirees may consume their individual account balances too rapidly. A large group of people with a sharply reduced standard of living could place heavy burdens on governmental safety nets.

Administrative Issues

One of the pivotal questions regarding individual accounts is whether private-sector investment returns will be high enough that workers could pay for higher administrative costs and still receive greater benefits than under the current program.

Administrative costs of the existing Social Security program are very low, less than 1 percent of outgo. Critics of privatization question whether private-sector investment managers could match this. In addition, there would be new costs associated with privatization including marketing expenses and possible commissions, collection, enforcement, allocation, educating the public on investing, new record keeping requirements, etc. These higher costs would partially offset the expected higher investment returns and affect the level of benefits available from the individual accounts. For example, if an investment manager charged 100 basis points each year over a 40-year working career, it could reduce benefits at age 65 by 20 percent. Expense loadings of annuities could add another 2 percent–3percent. Further-more, if annuitization is optional, adverse selection will inevitably occur, which will significantly increase costs.

Another concern is that administrative costs could offset potentially higher investment returns for small accounts. For example, if the mandated contribution rate were 2 percent, someone earning minimum wages of \$10,000 a year would have to contribute \$200 per year or about \$4 per week.

Privatization advocates counter that Social Security's administrative costs are low partly because employers provide much of the program's administrative work. Individual Account proposals could also reduce administrative costs by taking advantage of the current infrastructure for tax collection. For example, employers could send their employee's Individual Account contributions to the government with other taxes they are required to file in a bulk check. The government would hold the contributions (plus interest) until they identified in the following year through income tax returns how much each worker contributed. The government would then forward the appropriate contribution to an investment manager chosen by the individual. Under this procedure, though, there could be a period of time (up to one year in some instances) that workers may not have investment control over a portion of their accounts. This could be important during times of market volatility.

Transition

Under Social Security's current system, which is financed on close to a pay-as-you-go basis, the program's continued existence depends on receiving future tax income to meet obligations to current and near term beneficiaries. If payroll taxes are diverted into private accounts, benefits would need to be reduced, or taxes would have to be increased to meet the program's benefit obligations. Moreover, to the extent that Social Security's trust fund build-up masks the government's deficit, any reduction in the trust fund build-up hurts the unified budget.

For these reasons, most individual account proposals would be phased in over several decades, thus providing enough income to pay benefits to current retirees, while simultaneously building up substantial private accounts for younger workers. Under some proposals, individuals who already had benefits accrued under the existing program would be treated differently depending on age. The youngest workers—perhaps those under 30—might forfeit all accrued benefits under the existing program. Middle-aged workers might get some past-service credit but not accrue additional benefits. The oldest workers, those closest to retirement, might not see a decrease in their initial benefit, but their cost of living increases could be reduced, or they might have to

pay higher payroll or income taxes. To pay benefits to these workers and to current retirees, additional revenue would be needed for several decades. In effect, several future generations would have to finance their own retirement and maintain the existing program for their elders.

How would these additional costs be financed? One concern is that employers and employees might reduce contributions to their pension and 401(k) plans. If that is the case, the government might consider allowing employer plans to satisfy the individual account mandate, as in Great Britain, at least for their full time employees.

While the transition would be lengthy and expensive, a privatization plan based on individual accounts could be implemented depending on the length of the transition period, and to what degree the program is privatized.

Conclusions

The details of implementing an individual account system are complex and beyond the scope of this issue brief. We encourage policy makers to address the questions posed by this issue brief as a first step in identifying some of the major issues that must be addressed before the Social Security system is significantly changed.