Voice

Individual Accounts, Yes; Privatization, No
A Social Security investment alternative

Since his State of the Union address, President Bush has been campaigning to let younger workers invest a portion of their Social Security payroll taxes in the stock market. Under his proposal, younger workers would be allowed to divert some of their payroll taxes into private accounts that would operate a lot like today’s Individual Retirement Accounts (IRAs) and employer-sponsored 401(k) plans. Creating a system of individual accounts would help encourage millions of elderly Americans to work longer and accumulate more retirement wealth before eventually retiring. On the other hand, having millions of individual workers decide which stock market investments to make is ludicrous. Instead, we should incorporate “hypothetical” individual accounts into the current Social Security system and let the Social Security Administration manage investments in the stock market. These hypothetical accounts would operate like those found in so-called “cash balance” pension plans in the private sector and in the so-called “notional account” Social Security systems now used in Italy, Poland, Sweden, and several other countries. As those countries have done, we should replace our underfunded Social Security system with a hypothetical individual account system. (According to the 2005 Report of the Social Security Trustees, the Social Security system currently has an unfunded liability of $4.0 trillion. That is, to pay benefits for the next 75 years, the government needs $4.0 trillion more than it will collect in payroll taxes and interest over that period.)

In a hypothetical account system, the government would establish a hypothetical account for each participant in the Social Security system. From then on, all (or a portion) of each worker’s annual payroll tax “contributions” would be added to that account and, each year, the starting balance would be credited with investment interest. For example, a simple plan could allocate 4% of payroll from each worker into her account each year and credit her account with 7% interest on its beginning-of-the-year balance. Under such a plan, a worker who earned $50,000 in a given year would get a hypothetical account credit of $2,000 (4% of $50,000), plus 7% on the starting balance.

Like the current system, a hypothetical account system would be a defined benefit plan. However, instead of defining the worker’s benefit as a monthly annuity payable at retirement age, a hypothetical account system would define the worker’s accrued benefit as the balance in a hypothetical individual account. Each worker would receive quarterly reports showing the growing balance in her account.

At retirement, the balance in a worker’s hypothetical account typically would be used to purchase a lifetime annuity. A worker with a large enough balance also could be allowed to take a partial lump-sum distribution, and any worker who died before withdrawing all of her funds could pass on the balance in her account to her spouse or other heirs.

Setting the rate of return is, perhaps, the hardest issue that would need to be decided for a hypothetical account system. The government could, for example, simply set the rate of return equal to the Treasury-bond interest rate (currently about 4.5% on a 10-year bond). Alternatively, the rate of return could be tied to some measure of wage growth. For example, Sweden chose to tie the rate of return on its notional accounts to per capita wage growth.

Another approach would be to let individuals choose how to “invest” their hypothetical individual accounts. Individuals might be given choices that include government bonds, separate stock market index funds, and widely diversified mutual funds. Alternatively, individuals might be given even greater freedom to choose their “investments.”

By far the best approach would be to let the Social Security Administration pool the assets and invest them in the stock market. The Social Security Administration then would credit the hypothetical individual accounts with the actual rate of return.
that it earns (less its negligible administrative costs). Study after study has shown that the investment returns of large pension plans far outstrip the meager returns earned by the average individual investor taking a “random walk” down Wall Street. I know because I sit on the board of trustees of the Oklahoma Public Employees Retirement System (OPERS). Large plans like ours routinely earn a higher rate of return—and pay less in fees and hidden costs—than do individual investors. So, too, the Social Security Administration should be able to achieve a significantly higher rate of return than could ever be achieved under a system of millions of individually directed accounts.

Creating hypothetical individual accounts in the current Social Security system also would dramatically reduce the current Social Security system’s perverse work disincentives. The current system’s high payroll tax rates—15.3% of the first $90,000 of earnings in 2005—discourage people from working. Worse still, the way that benefits are paid out virtually pushes older workers into retirement, even if they want to keep working. For example, because Social Security benefits are based on just 35 years of earnings, those who work more than 35 years get no return on the payroll taxes they paid for their extra years of work. In addition, if you are single and you work until you drop, you will get no retirement benefits whatsoever. It’s no wonder that 56% of new Social Security beneficiaries claim their benefits as soon as they can—at age 62—and nearly 80% claim them by age 65.

Shifting to a system of hypothetical individual accounts would give older workers much greater incentive to keep working and saving for a more comfortable retirement. Their payroll taxes would be credited to their individual accounts and eventually would lead to larger retirement benefits or larger bequests to their loved ones. Older Americans would have every incentive to stay on the job.

In short, individual accounts make sense, but letting millions of workers speculate with the money in those accounts does not. All in all, replacing a portion of the current Social Security system with a system of hypothetical individual accounts would help make Social Security work. —Jon Forman

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