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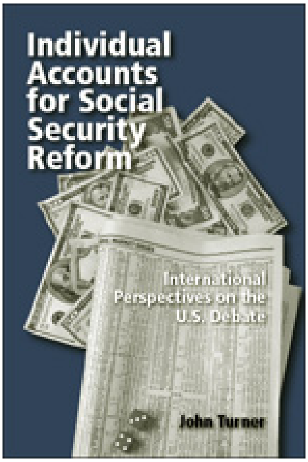
Individual Accounts and Social Security Reform



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Individual Accounts and Social Security Reform

Defined contribution pension plans providing workers with individual accounts dominate pension plan growth worldwide. Contributions are made into the accounts, usually by workers and sometimes by employers. The return on the investment of the funds is credited to the account. The participating worker usually has some choice over the investment of the account and bears the resulting financial risk. At retirement, the participant can convert the account balance to an annuity, receive it as a lump sum, or take benefits through phased withdrawals, depending on the rules governing the plan.

As recently as the early 1980s, defined contribution plans were an unimportant source of retirement income. In contrast, defined benefit plans have traditionally been the plan chosen by most countries for social security and by most employers who provide pensions for their employees. Such plans provide benefits determined by a formula that usually takes into account the worker's earnings and years of service. The risk associated with the financing that underlies defined benefit plans is not borne by the worker but by the plan sponsor or an insurance company. While there has been impressive growth in the number of countries that have adopted mandatory defined contribution plans, social security programs worldwide are still dominated by defined benefit plans.

As the popularity of mandatory defined contribution plans has spread, the names by which such plans are called have multiplied. Those names, which have political significance, differ in focus as to what element of the plan is stressed; some examples include personal retirement accounts, retirement savings accounts, private accounts, and individual accounts. This book follows the terminology used in publications of the National Academy of Social Insurance and refers to them as individual accounts.

Countries have adopted mandatory individual accounts primarily in Latin America and in Central and Eastern Europe, where the predecessor social security plans faced serious financial problems, but Hong

Kong, Sweden, and the United Kingdom are other notable examples. Twelve Latin American nations have adopted them, accounting for roughly half the population of Latin America, although only about half the labor force of these countries is covered (Gill, Packard, and Yermo 2005). Voluntary defined contribution plans have grown in importance in many high-income countries of the Organisation for Economic Co-operation and Development (OECD), particularly in the English-speaking countries of Australia, Canada, Ireland, the United Kingdom, and the United States. In the United States, 401(k) plans—an employer-provided individual account plan typically requiring employee contributions—have grown rapidly and are now the most common type of pension plan (USDOL 2005).

The structure of the book is as follows: after this general introduction, the second chapter introduces the topic of individual accounts, discusses the framework used to analyze them, and looks at the key issue of risk. The third chapter surveys the main issues in the social security reform debate and looks at social security reform involving individual accounts, as well as the use of individual accounts in social security systems around the world. The fourth and fifth chapters treat issues in the financial management of individual accounts: the fourth chapter looks at those issues that arise when agents (the officers of corporations and the managers of mutual funds) manage investments; the fifth chapter discusses problems that individuals encounter as a result of their own investment decisions. Chapter 6 examines labor market issues arising from individual accounts. Specifically, it looks at these accounts' effects on workers' behavior and on income distribution. The seventh chapter discusses the forms in which individual accounts pay benefits and the taxation of individual accounts. Chapter 8 provides a summary of the book.

Appendices A and B provide information relevant to the U.S. Social Security reform debate but treat topics that are of less general interest than those covered in the chapters. They present more technical subjects and are offered for readers who may have a more detailed interest in these areas. Rate-of-return guarantees, discussed in Appendix A, have been included in some proposals but have not been an aspect of the proposals associated with the Bush administration. Contribution evasion, discussed in Appendix B, has not been an issue in the reform debate, but it may be an important issue for self-employed workers and workers who are paid in cash.

IT BEGINS WITH A POLITICAL DECISION

Including individual accounts in social security is a political decision. However, that choice results from the interplay of a country's underlying cultural, economic, and demographic forces, as well as the financial status of its social security plan. As influenced by a country's culture, retirement income systems reflect differing political philosophies concerning individualism versus collective social responsibility and the roles of government, employers, the financial sector, families, individuals, and private charity.

In countries where social solidarity and communal responsibility for the less fortunate are important values, government plays a major role in retirement income through traditional defined benefit plans that provide social insurance. In countries placing a high value on individual responsibility and free choice, the private sector's role is larger, either through voluntary employer-provided plans or through individual accounts that are part of the social security system. Some countries favor individual accounts as a way of widening the range of personal choice and increasing reliance on the private sector. Even those countries, however, maintain a large mandatory element in their social security programs by requiring participation.

Ideology is a component of the political culture, but economic and demographic factors also affect the structure of retirement income systems. In upper-income countries, the development of domestic capital markets, containing the skilled personnel and the regulatory structure required to ensure their efficient functioning, plays a part in determining the possible role of individual accounts. In the United States, the development of 401(k) plans, providing workers with a familiarity with the functioning of individual accounts, has doubtlessly paved the way for the increased acceptability among American voters of individual accounts as a part of Social Security, although the replacement of defined benefit plans with 401(k) plans as the dominant plan type has also raised the level of financial risk borne by American workers.[1]

Population aging is a fundamental demographic force affecting retirement income systems. It occurs both through increased life expectancy and through reduced birth rates. It raises the ratio of retirees to workers, reducing social security's internal rate of return that workers receive as determined by the relationship between contributions and benefits for pay-as-you-go social security programs. "Pay as you go" means that the program has enough money to provide current benefits but that it does not have a reserve for future benefits. Population aging, by raising the old-age dependency ratio (the ratio of retirees to workers), favors the development of funded pensions, which can be either defined benefit or defined contribution. Funded pensions have a reserve for paying future benefits.

Although population aging is often cited as a reason for switching from a traditional social security plan to a defined contribution individual account, defined contribution plans are not immune to the effects of demographic change. Increased life expectancy at retirement age raises the number of years in retirement and thus the costs of providing a given level of annual benefits in both defined benefit and defined contribution systems.

SOCIAL SECURITY REFORM WITH INDIVIDUAL ACCOUNTS

Should social security benefits be provided through individual accounts? The answer depends in part on whether those plans are add-ons to social security or carve-outs that reduce the value of social security benefits. This book considers public policy issues concerning individual accounts as part of a national social security system. It analyzes policies several countries have adopted. International experience provides insights as to the range of policy options and the effects of different approaches.

This book has several themes. First, the desirability of individual accounts in social security reform depends on their role in retirement income and whether they reduce or supplement social security. Thus, the plans cannot be judged in isolation, but must be evaluated according to their role in the retirement income system.

Second, while individual accounts as part of social security can be designed so that they are simple and benign, having little or no effect on the behavior of workers, generally they are complicated in their structure and effects. The complexity of individual accounts is often not appreciated in policy debates, in part because of the comparatively short history of experience with them in social security systems. Policy analysts, for example, generally have treated them as not affecting the behavior of workers, believing that they are similar to voluntary savings plans. Because the actual details of plan structure are important, this book provides descriptive detail about the operations of the major types of mandatory individual accounts.

Third, risk in individual accounts occurs in many different forms, not solely because of the financial market. This topic is raised in various sections of the book. From most perspectives, individual accounts are riskier than are defined benefit plans in high-income countries that have well-managed social security systems. The aspects of risk affect the role of individual accounts in providing retirement income.

This book relies primarily on economic analysis and foreign experience for assessing mandatory individual accounts, but it also discusses 401(k) plans and the Thrift Savings Plan for federal government workers. The focus is on issues relevant to including individual accounts in social security in the United States and in other high-income countries.

International comparisons of individual accounts may be particularly useful for U.S. policymakers. While the U.S. experience is limited to voluntary plans, a number of countries have experience with individual accounts that are part of social security. The relevance for the United States of the policy experience in other countries is assessed, taking into consideration, for example, additional sources of retirement income that may affect the structure and functioning of individual accounts. International experience, when properly applied, can provide insights for the United States into both the successes and the failures of other countries' policies. In some cases, the lessons from policy failures are that the problems are fixable; in other cases, the failures indicate problems inherent in the particular structure of an individual account system.

THE BIG PICTURE: THE ROLES OF TRADITIONAL SOCIAL SECURITY PLANS AND INDIVIDUAL ACCOUNTS

Much of this book focuses on the microeconomics of how mandatory individual accounts function. The big picture, by contrast, concerns how these plans fit into a retirement income system (World Bank 1994; Gillion et al. 2000). To conclude this chapter, I will comment on issues affecting the big picture.

Most recent reforms of social security have been driven in part by the need to restore solvency to traditional systems in the face of population aging. In this context, add-on individual accounts generally have no effect on solvency because their financing is independent of that of the traditional social security program. Carve-out individual accounts generally worsen solvency issues over a transition period lasting decades because of the need to continue financing the benefits in the traditional social security program. Thus, in social security reform debates, it is important to separate the issues of individual accounts and social security solvency.

Some analysts have focused on social insurance issues and the prevention of old-age poverty (Gill, Packard, and Yermo 2005). Within this framework, the roles of different types of pension plans are compared, based on their ability to provide insurance by transferring income across people and to shift income from the individual's working period to retirement. One view is that the need for social insurance is diminishing as the risk of old-age poverty declines. The contention is that the function of mandatory savings for retirement should occur through individual accounts, but that poverty prevention should occur though mandatory defined benefit plans.

Other analysts, however, have focused on the ability of different types of pension plans to spur national savings and economic growth (World Bank 1994). They argue that mandatory individual accounts should be used to encourage savings and growth. In this context, it is important to distinguish between carve-out and add-on accounts. Carve-out accounts are less likely to add to national savings, in part because they replace benefits that were already provided and in part because they reduce the financing for the traditional social security program.

Another perspective places relatively more emphasis on risk-bearing by workers and the risks of different types of pension plans (Gillion et al. 2000). Analysis indicates that in countries where policy risk is relatively small, mandatory individual accounts generally are considerably more risky than are traditional social security plans.

THE GOAL OF THE BOOK

The primary goal of this book is to provide a better understanding of how individual accounts would work if they were adopted in the United States as part of Social Security reform. It is important when new approaches are being considered to carefully think about how they might work, evaluating both their positive and their negative aspects. That is done by using the tools of economics and learning from the experiences of other countries. The next chapter will acquaint the reader with different types of defined contribution plans and the financial structure and management of individual accounts. It will also detail the many risks inherent in mandatory individual accounts.

Note

1. The term "social security" is capitalized when referring to the U.S. Old Age and Survivors Insurance (OASI) program. The term "workers" is generally taken to include the self-employed in the U.S. context.