Why personal accounts and why now?

By Estelle James and Deborah James[1]

Why should we fix the social security system when it won't go bust until 2042? Because this enables us to make the right choice while we still have the chance. The choice we can make now, but not later, is to build personal retirement savings accounts. Total social security benefits would then come from two sources: income from funds accumulated in the retiree's own account plus a defined benefit financed by current workers. We're better off with funds and we're better off if individuals, rather than the government, invest those funds.

Using today's cash surplus to jump-start the accounts

Social security's "crisis" is not here yet. The social security trust fund still runs a surplus each year, as total revenues from payroll taxes exceed total benefits paid. This is projected to continue until 2018. If we start now, for 13 years the trust fund will have money with which to jump-start the personal accounts.

Avoiding the build-up of a hidden government debt to the trust fund

Right now the OASDI trust fund is required to lend the surplus to the treasury and receives iou's in exchange. The surplus cancels out some of the treasury's deficit in the government's unified budget--which may encourage the treasury to incur larger deficits than it would have otherwise. These accumulated iou's currently add almost 40% ($1.6 trillion) to the publicly held debt number that is usually reported. Eventually taxes will have to rise (or government spending fall) to enable the treasury to repay its debt to the trust fund. In contrast, if the money is put into personal accounts it won't automatically be lent to the treasury and won't offset the treasury's deficit. This is more likely to impose some fiscal discipline, reduce the growth in hidden government debt, and cut down on the extra taxes we will have to pay later for iou redemptions to fulfill the commitment to retirees.

Trust fund investments in the stock market create new problems

If control of the government debt is our objective, why don't we limit the ability of the treasury to borrow from social security and instruct the trust fund to invest in the stock market instead? The problem is--this would concentrate substantial stock market power in the trust fund and would create a conflict of interest with other government agencies (the SEC, FCC, FDA, etc.) that regulate companies in which it invested. Can effective informational firewalls be set up within the government? Would the regulators impose penalties on companies in which the trust fund has invested? Would the trust fund's portfolio include small companies—it might end up as their major stockholder? How would the government deter lobbying to include or exclude certain industries in the trust fund's portfolio?

Personal accounts can do better

Private individuals can invest their accounts in the stock market and earn the equity premium without these conflicts and political pressures that are inevitable when the government invests for us. Investment does involve risk—but this risk can be reduced by broad diversification, investment in government bonds, or public or private guarantees. The account makes the benefit more secure—because workers in the future may not be willing to pay the high payroll tax rate we will need to maintain scheduled benefits under the current system.

But it takes a long time for savings accounts to grow. They won't be there in time for the baby-boomers and post-baby-boomers unless we start building them now.

Individual accounts promote economic growth

Most importantly, individual accounts are good for the economy. Putting money into the accounts increases national saving and therefore productivity. With higher productivity, more goods and services will be available for workers and retirees. As global capital become increasingly scarce relative to labor, due to the entry into global labor markets of a billion workers from China and India, retirees will benefit from diversifying their income sources and holding some of that capital. Very few workers in the bottom half of the income distribution do so now.

Tinkering with the system to increase the trust fund—not a good idea

Some people suggest that tinkering with the current system--reducing benefits or raising contributions a bit here and there—will make it unnecessary for us to make more radical changes, such as personal accounts. But these small changes are designed to stretch out the periods of annual cash surpluses, without addressing the issue of how the surpluses will be invested. If government increases its borrowing and we miss the opportunity to save and invest productively, we will have only an illusion of progress and a larger bill at the end.

These are the reasons why over 30 countries (for example, Switzerland, Australia, the UK, Sweden, Hong Kong, Poland, Hungary, Chile and most Eastern European and Latin American countries) now include privately managed personal accounts in their mandatory social security systems.

How to do it right

Of course, for personal accounts to help they must be done right. Extra money is needed, beyond the current payroll tax, and the safety net has to be strengthened:

- The accounts should be financed, in part, with an additional contribution (an "add-on"), to help maintain total benefits.
- The add-on should be matched by money "carved out" from the payroll tax or trust fund. The match should be progressive—higher for low earners.
- A minimum pension should be added, to offset labor and financial market risk. (Practically every country with personal accounts has a minimum pension).
- Transition costs (the financing gap created by the carve-out after the trust fund surplus runs out) should not be debt-financed, which would defeat the object of increased national saving. Instead, the limit could be raised on earnings subject to the payroll tax. (Most wage increases in recent years have gone to earnings above the current taxable ceiling of $90,000). Or, better still, a surtax on all incomes (not simply wages) could be imposed.
- Wage indexation of the traditional benefit should continue. If we switch to price indexation, the benefit would fall drastically relative to wages and contributions that rise over time. Many seniors would end up way below the average standard of living.
- Retirement age should be automatically linked to increases in life expectancy, which are expected to accelerate. There is no way that the same contribution rate can pay the same benefit for more and more years.
- Workers should be given a choice among a limited number of investment options, indexed to broad diversified market benchmarks, with asset managers chosen in a competitive bidding process, to keep administrative costs and risk low. This is similar to the Thrift Saving Plan, currently used by federal civil servants.
- Most payouts should take the form of annuities or gradual payouts designed to last the individual's full life, with joint pensions required for married couples.

This plan would put social security on a more sustainable financial footing, maintain total benefits and promote economic growth. It would be a win-win solution for politicians of both parties and for all Americans—if we adopt it soon.

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