Summary and Conclusions

Individual accounts as part of social security are being debated in the United States and have been adopted in a number of countries. They can be structured so that they are simple. However, actual individual accounts are generally complex in their design and effects, a fact that is often not appreciated, in part because of their relatively short history in social security systems. Policy analysts, for example, often treat them as not affecting the behavior of workers, being similar to voluntary savings plans. Research on individual account proposals has often focused on stylized versions of these plans, without careful consideration of the effects of their specific features.

With the introduction of individual accounts, many nations around the world have radically changed the way participants accrue, and later receive, retirement income. International comparisons of mandatory individual accounts may be particularly useful for U.S. policymakers because U.S. experience is limited to voluntary plans.

This book analyzes public policy toward mandatory individual accounts. It examines them from numerous perspectives that include international experience and U.S. experience with voluntary accounts, and economic theory. Selective issues from each chapter are summarized in the following discussion.

Policy analysts and reformers in a number of countries have made great strides in developing ways of providing retirement income through individual accounts. Reformers desiring to add individual accounts to a traditional system of social security now have a wide range of options from which to choose, with large differences across countries in approaches that have been taken. Major distinctions depend on whether they are add-ons to or carve-outs from social security and whether they are mandatory or voluntary.
Individual accounts, used as part of social security, have grown considerably in importance in several regions of the world. Four pathways have been used to encourage the provision of individual accounts (Rein and Turner 2001). They are 1) voluntary with tax incentives, 2) voluntary carve-outs from social security, 3) collective bargaining, and 4) mandatory. This book focuses on voluntary carve-outs from social security and the mandatory approach. For policy analysts desiring to increase retirement savings, voluntary plans can be an alternative to mandatory ones and are generally tried first.

A second way of categorizing individual accounts is the relationship approach whereby individual accounts can be add-ons to or carve-outs from social security. Voluntary carve-out accounts reduce social security benefits and contributions, while mandatory add-on accounts do not affect the social security system but require more contributions.

Combining the pathways and the relationship approaches, individual accounts can be used as part of social security in five ways: 1) voluntary carve-outs that partially replace social security, 2) mandatory add-ons to social security, 3) mandatory carve-outs that partially replace social security, 4) voluntary carve-outs that fully replace social security, and 5) mandatory carve-outs that fully replace social security. Because of the focus on the U.S. debate, this book only considers voluntary carve-outs that partially replace social security and mandatory add-ons.

A third way of categorizing individual accounts is according to how they are managed. Individual accounts can be managed in at least three ways. First, they can be managed by pension fund management companies. In Chile and Mexico, individual workers choose a pension fund management company and direct their employer to send the individual’s contribution to that company each month. Second, individual accounts can be managed by employers, as in Australia and Switzerland. Third, the government can play a major role. In Sweden and Poland, the government serves as a clearinghouse, to which employers send their workers’ contributions. The government serves as a record keeper and disburses the appropriate amounts to each of the mutual funds in which each worker has elected to invest. In keeping with the U.S. debate, this
book focuses on the third approach, in which the government serves as a clearinghouse.

**RISK AND PRIVATIZATION**

An important criterion in judging social security reforms is the extent to which they meet the income needs of low- and middle-income workers. Social security should provide a stable and secure retirement income for these people. For this reason, the role of risk is important in assessing different retirement income options. It is not possible to conclude that one system is the best for all countries because the risk inherent in the traditional defined benefit social security system varies across nations, as does the risk in the financial markets in which the citizens of a country invest. Even in the high-income nations of the OECD, it is not possible to conclude that one system would be superior because the social security programs already in place in these countries vary considerably. In the international context, an important characteristic of the U.S. Social Security system is the low level of benefits it provides relative to preretirement income. This feature of the U.S. Social Security system is important to keep in mind when considering individual accounts.

Individual accounts are generally less secure for participants than are traditional defined benefit social security plans in high-income countries, such as the United States. Individual accounts are riskier in terms of investment risk, agency risk, individual management risk, the risk of adverse labor market outcomes, disability risk, the risk of premature death, replacement rate risk, annuitization (interest rate) risk, longevity risk, and inflation risk. Defined benefit plans are riskier in terms of dependency rate risk, and for younger workers they are riskier in terms of policy risk. Typically, for workers age 55 and older, there is little policy risk in defined benefit social security plans.

In Appendix A, rate-of-return guarantees for individual account investments are discussed. The argument for rate-of-return guarantees is stronger for carve-out than for add-on accounts because carve-out accounts are replacing part of the traditional social security program. (However, rate-of-return guarantees may be difficult to maintain during prolonged market downturns.) Rate-of-return guarantees are also more
important for carve-out accounts than for add-on accounts if the accounts provide a relatively substantial part of retirement income.

Privatization of social security by incorporating individual accounts appeals to some people on both economic and ideological grounds. From the economic standpoint, it is argued that privatizing social security would increase national savings and economic growth. With a declining internal rate of return to pay-as-you-go social security due to slowing population and productivity growth, there is political support for reducing the role of traditional social security programs. Ideologically, privatizing social security is favored by some because it would lessen the role of the government and give people greater responsibility and choice. However, individual accounts that are voluntary carve-outs reduce the secure base provided by traditional social security programs, which in the case of U.S. Social Security is already rather low. It is difficult to construct voluntary carve-out accounts so that they are age- and gender-neutral and are neutral in their effects on the financing of the traditional social security program. Further, individual accounts are subject to some of the same criticisms of traditional social security systems. The level of annuitized benefits they provide is subject to longevity risk, and annuitized benefits tend to redistribute income to higher income people.

The extent to which individual accounts have supplanted social security programs has varied, with a few countries fully replacing their social security systems but a larger number partially changing them. Until the reform in Chile in 1981, however, no country had private administration of a social security individual accounts program. After observing the Chilean social security reform for more than a decade, other Latin American countries introduced individual accounts as part of their social security systems.

Following the 1991 breakup of the Soviet Union, the benefits provided by existing and recently created social protection systems of the new countries were not sufficient to handle the economic problems facing the region’s retirees. Many of these countries are rethinking their social security programs, with some adopting mandatory individual accounts. Comprehensive social security reforms have been implemented in Croatia, the Czech Republic, Hungary, Latvia, and Poland. Russia has introduced mandatory individual accounts, based in part on the system in Sweden.
PROBLEMS RELATED TO FINANCIAL MANAGEMENT

While the term “tiers” is often used to describe different parts of a retirement income system, it is used in this book to refer to three levels of management of participants’ investments in individual accounts. These are financial management by corporations, by mutual funds, and by individual participants. Problems for individual account participants occur at all three levels.

In considering financial management by corporations, the question arises of whether participants in individual accounts, and other investors, have sufficient safeguards. The collapse of Enron Corporation exposed weaknesses in financial protections for U.S. investors. For mutual funds, the level of fees participants pay and the transparency of those fees need to be evaluated. Although individual accounts are sometimes considered to be transparent, the fees participants pay are generally far from transparent.

In addition, individual accounts place a burden of financial market expertise on all workers. Many people are uninformed about investments and financial theory, do not have any interest in pursuing these topics, and are perplexed when required to do so. Such issues can be complex, and even experts do not all agree on some basic strategies, such as how investment portfolios should change as workers age. Many low-income and poorly educated workers have no background in finance and do not even have checking accounts. Financial education may need to be an aspect of an individual account system.

Experience with individual accounts as part of social security in Sweden indicates that frequently workers do not make an investment choice. Many people end up with the default fund for their pension investments (Sweden, Argentina). While some people may not make a choice, others may choose the default fund, thinking that it is the recommended alternative. Consequently, the portfolio held by the default fund is a critical aspect of system design. The default fund in Sweden is heavily invested in equities, and there is no provision to reduce exposure to equity market risk as people approach retirement age. By comparison, in Chile the default funds vary by the age of the worker, with older workers being placed in default funds with less risk.
Compared to professional money managers, individual workers tend to be more conservative and less sophisticated. Various factors may explain why women tend to be more cautious investors of pension funds than men, including the generally lower earnings of women. Investment mistakes made by unsophisticated (and sophisticated) pension participants include insufficient diversification, excessive trading, market timing (trying to anticipate the swings of the market), trading following market changes, and holding what would appear to be too much or too little risk when compared to the investment portfolios of professional investors. Inertia may keep workers from making needed adjustments to their portfolios.

Administrative costs vary significantly among countries with individual accounts. Fees can reduce workers’ investments substantially. In most individual account systems, fees paid are not clearly disclosed, and participants have little understanding of how much they have paid in fees.

**BEHAVIORAL EFFECTS**

Voluntary individual accounts can be designed so as not to have labor market effects. Mandated individual accounts, however, generally may influence aspects of labor supply, and they usually contain regressive features, due in part to the shorter life expectancies of low-wage workers.

Individual accounts may affect hours worked and retirement age. They may have behavioral impacts because of the structure of their administrative expenses, the effects of worker myopia, capital market risks on account balances, and interest rate risks on monthly benefits when benefits are annuitized, with participants possibly timing retirement based on their expectations as to interest rates. If people delay retirement because of declines in the values of their individual accounts, there will be greater difficulties for other workers who are trying to find jobs during an economic downturn.

Furthermore, individual accounts may change worker behavior through their relationship to minimum benefit and poverty programs, which may provide incentives to low-wage employees to evade par-
Participation in individual accounts or to spend down those accounts so as to qualify for social assistance benefits. Thus, the impact of individual accounts may depend on the structure of the system as a whole rather than on just the accounts themselves. Further empirical and theoretical research is needed to assess the magnitudes of the effects discussed.

Issues related to contribution evasion and avoidance have implications for the labor market, particularly for lower-wage workers in the informal sector. Contribution evasion and avoidance, reflecting attitudes toward taxation in general, is a problem for employees as well as for the social security system.

**BENEFIT PAYOUT**

When a worker reaches retirement, the question arises as to how that worker’s individual account should be converted into a retirement benefit. Difficult issues need to be addressed concerning the payout options that are provided and whether, for example, all participants should be made to fully annuitize their individual account balances. Alternatively, only annuitization of a minimum amount sufficient to guarantee income above poverty could be required, or phased payments could be an option. The mandatory individual accounts in Sweden give participants flexibility as to when they can start receiving benefits and also allow for partial receipt of benefits, facilitating partial or phased retirement.

Annuitization of benefits provides insurance against outliving one’s benefits, but it also tends to be relatively unfavorable to lower-income workers. Lower-income participants (within gender groups) tend to have shorter life expectancy, but women tend to have lower income and higher life expectancy. While traditional social security defined benefit plans typically provide price-indexed benefits, this is uncommon for individual accounts. Social Security in the United States is a bigger percentage of retirement income for low-income workers, and thus any changes in Social Security, including introducing individual accounts, have a bigger effect on them.

Generally, participants in individual accounts wishing to annuitize their balance are affected by interest rate risk because the calculation of their benefit depends on the interest rates prevailing at the time of con-
version. A higher interest rate means a higher annuitized benefit. Annu-
ity conversion rate risk in individual accounts can be reduced through
rate-of-return guarantees at the point of annuitization. While such guar-
antees have been fairly common during the accumulation phase, they
are not nearly as common for annuity conversions.

Taxation issues need to be considered for individual accounts. Diff-
icult issues arise in attempting to make the tax treatment of individual
accounts neutral with respect to both social security benefits and private
pension benefits.

TWELVE MYTHS ABOUT INDIVIDUAL ACCOUNTS

A number of myths have been part of the Social Security reform
debate. These myths persist because they contain an element of truth.
This section discusses myths about voluntary carve-out individual ac-
counts. Some of these myths are true for mandatory or voluntary add-on
individual accounts but not for voluntary carve-out accounts. Some of
them are true for 401(k) plans or for the Thrift Savings Plan for federal
government workers. Some of these myths arise from abstract analysis
of idealized situations rather than from an examination of the actual ex-
perience of countries that have enacted the types of policies the United
States is considering. Some of the myths contain an element of truth
that is outweighed by considerations in a more complete analysis.

Myth 1: Voluntary carve-out accounts are like 401(k) plans or
like the Thrift Savings Plan for federal government workers.

The element of truth in this myth is that there is a similarity among
these types of plans in that all three are examples of individual account
plans. However, the popular 401(k) plan and the Thrift Savings Plan are
both add-on accounts. Workers participating in those plans participate
fully in Social Security—those plans do not reduce the Social Security
benefits of workers participating in them.
Myth 2: Voluntary carve-out accounts foster an ownership society.

This myth also contains an element of truth. You own outright an add-on individual account, such as a 401(k) plan or the Thrift Savings Plan. However, a voluntary carve-out plan is a loan. While workers own the amount in the account, the money used to establish the account is a loan. The money contributed to the account is a loan because at retirement workers are required to pay back that amount, with interest, through a reduction in their Social Security benefits.

Myth 3: Voluntary carve-out accounts will increase national savings.

The element of truth in this myth is that add-on accounts may increase national savings. However, voluntary carve-out accounts are much less likely to increase national savings. The worker finances them by debt, which is the implicit borrowing from the Social Security program. On a national basis, the government likely will need to borrow to finance the payment of the benefits of current retirees that would have been financed by the payroll tax payments that no longer are going into Social Security but instead are going into individual accounts.

Myth 4: An individual account will be free from political interference or political risk that arises from changes in government policies.

The element of truth in this myth is that it is possible to construct individual accounts so that they are free from political interference. However, experience in other countries has shown that to not always be the case. For example, in Sweden, the default fund, which is the fund that most new participants invest in, does not invest in Coca-Cola because of the Swedish government’s objections to some of its policies. As for political risk, in the United Kingdom the terms of the tradeoff between the reduction in social security benefits and the contribution to the individual account are reset by the government every five years to adjust to changing economic and demographic conditions. This adjustment is subject to error and has added an element of risk to the U.K. system.
Myth 5: People who choose a voluntary carve-out account will be better off because that option expands the range of choice. Since the choice is voluntary, people will only take a voluntary carve-out account if that makes them better off.

Abstract analysis of an idealized situation indicates that people who voluntarily choose an option are by definition made better off by having the option to choose and by their having viewed it to be in their interest to voluntarily choose it. In the United Kingdom, however, many people who have chosen voluntary carve-out accounts have been made worse off by their choice because they were influenced to make a particular choice in what is known as the “mis-selling” scandal. But in the United Kingdom, the negative effects of this problem are limited by the ability of people to return fully to the social security system if they feel that their choice has made them worse off. Proposals in the United States have generally not provided the option of later returning to full participation in Social Security.

Myth 6: Voluntary carve-out accounts will reduce government involvement in the retirement income system.

The element of truth in this myth is that the government would provide a reduced percentage of retirement income. However, the government bureaucracy overseeing the retirement income system would expand substantially. The staffing of the Social Security Administration could easily double because of the record-keeping requirements for voluntary carve-out individual accounts (Hart et al. 2001).

Myth 7: Poor and low-income people would find individual accounts to be a desirable option.

The element of truth in this myth is that poor and low-income people tend not to have investments in the stock market, and having an individual account would diversify their sources of retirement income. However, people that rely entirely on Social Security for their retirement income are not well situated to bear the risk that is inherent in investments in the stock market. The rate of return they receive from Social Security tends to be higher than for higher-income workers because of the progressivity of the Social Security benefit formula. Also,
the level of financial literacy in these groups tends to be low, so they would be more prone to errors in managing their accounts.

Myth 8: Individuals will be good financial managers of their individual accounts.

The element of truth is that some individuals will be good financial managers. However, experience with 401(k) plans and with the mandatory individual accounts in Sweden indicates that many individuals make errors in choosing their investments and in the timing of changes in their investments.

Myth 9: Survivors will be better off if workers choose an individual account.

The element of truth is that survivors will be able to inherit the balance of the individual account when workers die, assuming that the individual account has not been annuitized. However, the cost in doing so is that the worker gives up the survivors insurance provided by Social Security. If a person dies young, the balance of his or her individual account would be small, and the survivors clearly would be better off in many situations with the survivors benefits that Social Security provides.

Myth 10: The rate of return a worker receives from the individual account would be higher than what would be received from Social Security.

The element of truth is that stocks earn a higher rate of return than what workers can receive through participation in Social Security. However, if that rate of return is adjusted for the higher risk in stocks, and is adjusted for the higher taxes that ultimately would be needed to pay the transition costs to an individual account system, the rate of return would be essentially the same.

Myth 11: Individual accounts do not redistribute income.

Individual accounts can be constructed as lump sum benefits so that they do not redistribute income. However, when they are annuitized, as they nearly always are, they redistribute income from low-
high-wage workers because high-wage workers tend to have longer life expectancy than do low-wage workers. Because high-wage workers receive the annuitized benefits for more years, the accounts are more valuable to them.

**Myth 12: Individual accounts do not affect labor supply and retirement age.**

The element of truth in this myth is that individual accounts are not financed by an explicit tax, and thus do not affect labor supply or retirement age through the distorting effect of an explicit tax. However, a high mandatory contribution can function as an implicit tax. Further, for any individual account plan, a sharp downturn in equity markets can cause workers on the verge of retirement to delay retirement. Their change in plans comes at a time when a weak economy has reduced the demand for labor. Thus, older workers are induced to work longer just when firms tend to be laying off workers. Their hanging onto their jobs only increases the number of layoffs that occur in such times.

**CONCLUSIONS**

An important criterion in judging social security reforms is the extent to which the reforms meet the needs of low- and middle-income workers. Social security should provide these workers a stable, low-risk retirement income. For this reason, the role of risk is important in assessing different retirement income options. And, for the same reason, the risk of add-on individual accounts is less significant in Sweden, with its generous base system, than it would be for voluntary carve-out accounts that would reduce an already modest level of Social Security benefits in the United States.

Individual accounts should not be viewed generically. Policy discussion should delineate whether those accounts are add-ons or carve-outs and whether they are voluntary or mandatory. While voluntary carve-out accounts have appeal in that they preserve an element of choice, in actual functioning—notably in the United Kingdom—serious problems
have been encountered in structuring the selection and in participants choosing wisely.

Social security systems must adjust to changing economic and demographic realities. It is safe to conclude that no social security system is without problems—a point, however, that is sometimes overlooked when new systems are being proposed.

The U.S. Social Security program needs to be reformed to restore the balance of contributions and benefits. That problem rightfully ranks high on the national agenda, and it requires changes in traditional benefits and contributions. Individual accounts do not help restore Social Security to solvency, and voluntary carve-out accounts worsen the financing problem over a transition period lasting decades. The arguments advanced for adding individual accounts to Social Security relate to issues of national savings, economic efficiency, and private ownership—areas where there is not a national consensus as to the analysis of the issues, nor as to their significance.

When considering new programs, it is important that their strengths and weaknesses be evaluated, rather than focusing solely on the weaknesses of existing programs. Sufficient time has now passed that the functioning of individual accounts can be evaluated based on lessons learned from the experiences of the United Kingdom and Chile. The Swedish reform is relatively new, so its innovative features have not stood the test of time, though its approach appears to have desirable features with respect to limiting administrative costs and providing flexibility in the receipt of benefits. In both the voluntary carve-out accounts in the United Kingdom and the mandatory carve-out accounts in Chile, the individual account reforms have decreased in popularity: workers have “voted with their feet,” and participation in those accounts has declined. In the United Kingdom in 2005, a national pension commission recommended abolishing voluntary carve-out individual accounts.

Mandatory add-on accounts provided on top of a secure base Social Security benefit would not have the problems of carve-out accounts of worsening Social Security financing during the transition and reducing Social Security benefits, nor the problem of how to structure the tradeoff between Social Security benefits and contributions to an individual account. They have some of the desirable features of individual accounts in that they could increase the amount of funded pension sav-
ings and raise retirement income, but they would also raise the Social Security payments made by workers, including low-wage workers who may have more pressing financial needs. It can be hoped that the continuing national debate on these issues will benefit from clear thinking as to the strengths and weaknesses of alternative approaches.