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## 12 Myths about Individual Accounts for Social Security Reform

*This article highlights research from John Turner's new book, Individual Accounts for Social Security Reform—International Perspectives on the U.S. Debate, which was published by the Upjohn Institute. See p. 7 for details.*

The recent federal budget proposal provides hundreds of billions of dollars to establish individual accounts as part of Social Security reform. The budget includes funding necessary to establish voluntary carve-out accounts, which are accounts that would partially replace Social Security. Workers who choose these accounts would receive reduced Social Security benefits, and in exchange would have part of their retirement income based on the investment performance of the account. The United Kingdom is the only high-income country that uses these accounts, but the number of British workers participating in them has declined by about 20 percent since its peak in 1993, despite growth in the labor force. The Pensions Commission, a national commission in the United Kingdom assigned to propose major reforms, has recommended abolishing those accounts.

This article examines 12 myths about individual accounts and how they would work if they were an option for Social Security participants. These myths persist because they contain elements of truth, though usually in a different context. For

example, some myths about voluntary carve-out accounts are true statements for mandatory add-on accounts that would be provided in addition to Social Security. Some myths are true in idealized situations but not in the actual implementation of individual accounts. Some contain elements of truth that are outweighed by other considerations in a more complete analysis.

### **Myth 1. Voluntary carve-out accounts are similar to 401(k) plans or the Thrift Savings Plan for federal government workers.**

All three are individual accounts, and some lessons can be learned from the experience with 401(k) plans and the Thrift Savings Plan. However, in this context the salient feature of 401(k) plans and the Thrift Savings Plan is that both are add-on account plans. They do not reduce workers' Social Security benefits, as would occur for voluntary carve-out accounts. In addition, the Thrift Savings Plan's reported administrative cost, often considered a benchmark, considerably understates the cost of a Social Security program of individual accounts because the government subsidizes the Thrift Savings Plan's administrative costs.

### **Myth 2. Voluntary carve-out accounts would foster an ownership society.**

Workers own outright their 401(k) plan accounts. However, with a voluntary carve-out account, while workers own the

balance in the account, the money used to fund the account is a loan that workers must pay back with interest through a cut in their future Social Security benefits. Thus, voluntary carve-out accounts could be characterized as fostering a debt society.

**Myth 3. Voluntary carve-out accounts would increase national savings.**

Whether add-on accounts increase national savings is controversial (Orszag and Stiglitz 2001). However, voluntary carve-out accounts are much less likely to do so. The worker finances them through the implicit borrowing from the Social Security program. Also, the government would likely borrow for at least part of the transition costs of paying current retirees' benefits.

**Myth 4. Workers would only choose a voluntary carve-out account if that choice made them better off.**

Well-informed workers making rational decisions who voluntarily choose an option are made better off. However, in the United Kingdom, many workers who have chosen voluntary carve-out accounts have been made worse off because they were wrongfully influenced in the "misselling" scandal. The magnitude of their errors is immense. These workers have been reimbursed \$26 billion by financial service providers in an economy a sixth as large as United States.

**Myth 5. A worker's survivors would be better off if the worker chose a voluntary carve-out account.**

Survivors could inherit the balance of the individual account if the account has not been annuitized. However, the worker with a voluntary carve-out account would give up some of the survivors insurance that Social Security provides. If that worker dies at a young age, the account balance would be small, and the survivors would generally be better off with the full survivor benefits that Social Security provides.

**Myth 6. Individual accounts would be free from political risk.**

Individual accounts, in principle, can be managed so that they are free from political risk. However, international

experience has shown that because they are created by legislators in a political environment, they frequently are subject to political risk. For example, in Sweden, the default fund, which most new participants invest in, does not invest in Coca Cola because of the Swedish government's objections to some of Coca Cola's policies.

**Myth 7. Individual accounts would reduce government involvement in the retirement income system.**

The government would probably provide a reduced percentage of retirement income if there were Social Security individual accounts. However, the Social Security Administration's bureaucracy could easily double due to the recordkeeping requirements for voluntary carve-out accounts (Hart et al. 2001). The government would also have an expanded role through its regulatory oversight of individual accounts.

**Myth 8. Low-income workers would be better off with individual accounts.**

Low-income workers tend to not own stock; thus, having an individual account could diversify their sources of retirement income. However, workers with low income are poorly situated to bear stock market risk because of their limited ability to absorb downside risk. Also, the rate of return that low-income workers receive from Social Security tends to be higher than for higher-income workers because of the progressivity of Social Security's benefit formula. The taxation of the Social Security benefits of higher earners further reduces their rate of return from Social Security. Thus, high-income workers have more to gain from individual accounts that substitute for Social Security than do low-income workers. In addition, the level of financial literacy among low-income workers tends to be low, so they would be more prone to costly investment errors. Relatively few low-income workers in the United Kingdom participate in the voluntary carve-out individual accounts.

**Myth 9. Workers would be good financial managers of their individual accounts.**

Some workers would be good financial managers. However, experience

with 401(k) plans and the mandatory individual accounts in Sweden indicates that many workers make errors in choosing their investments and in the timing of changes in their investments. Some workers follow trends, buying high and selling low. Many workers who are financially vulnerable have a low level of financial literacy, and lack of financial literacy appears to be a cause of workers making investment errors. Demographic literacy is also important. Surveys have found that many workers underestimate their life expectancy, and do not understand the probability of living longer than their life expectancy, which would cause them to plan for a shorter retirement period than they likely will experience.

**Myth 10. The rate of return workers receive from individual accounts would be higher than what they receive from Social Security.**

Stocks on average earn a higher gross rate of return than the implicit rate of return workers receive on their contributions to Social Security. However, if appropriate adjustments are made, on average the two rates of return would be equivalent (Brown, Hassett, and Smetters 2005). Those adjustments include taking into account the higher risk in stocks, the higher administrative costs of individual accounts, the value of the various forms of insurance Social Security provides, the cost of annuitization of account balances, and the higher taxes ultimately needed to pay transition costs to an individual account system. The comparison also assumes that workers do not make serious errors in financial management.

**Myth 11. Individual accounts would not redistribute income.**

Individual accounts can be disbursed as lump sum benefits, which do not redistribute income. However, when they are annuitized, they perversely (regressively) redistribute income from low- to high-wage workers who tend to have longer life expectancy and thus receive benefits for more years. If lower-income workers receive lower rates of return than higher-income workers, that would also cause an adverse change in the distribution of retirement income.

**Myth 12. Individual accounts would not affect labor supply and retirement age because they closely link contributions and benefits.**

There is a close link between contributions and the amount invested in an individual account. Also, individual accounts would not be financed by an explicit tax, which would distort labor supply. However, the volatility in stock and bond markets causes there to be a weak link between contributions and benefits. Further, a mandatory contribution, whatever its link to benefits, can be an implicit tax because it is mandatory. If the mandatory contributions act like an implicit tax, that would discourage workers from working and encourage them to retire. The low participation rates of workers in Latin American mandatory accounts may result from such an effect on their labor supply. In addition, a sharp downturn in equity markets can cause workers with individual accounts to delay retirement, with that effect occurring at a time when the demand for labor is reduced.

*John Turner is a senior policy advisor at the AARP Public Policy Institute in Washington, D.C.*

**Suggestions for Further Reading**

Brown, Jeffrey, Kevin Hassett, and Kent Smetters. 2005. "The Top Ten Myths of Social Security Reform." CRR WP 2005-11, October. Boston: Center for Retirement Research at Boston College.

Hart, Larence E., Mark Kearney, Carol Musil, and Kelly Olsen. 2001. "SSA's Estimates of Administrative Costs under a Centralized Program of Individual Accounts." Social Security Administration, January 9.

Orszag, Peter R., and Joseph E. Stiglitz. 2001. "Rethinking Pension Reform: Ten Myths about Social Security Systems." In *New Ideas about Old Age Security: Toward Sustainable Pension Systems in the Twenty-First Century*, Robert Holzmann and Joseph E. Stiglitz, eds. Washington, DC: World Bank, pp. 17–56.

Read the first chapter of Dr. Turner's book at <http://www.upjohninstitute.org/publications/ch1/iassr.pdf>.