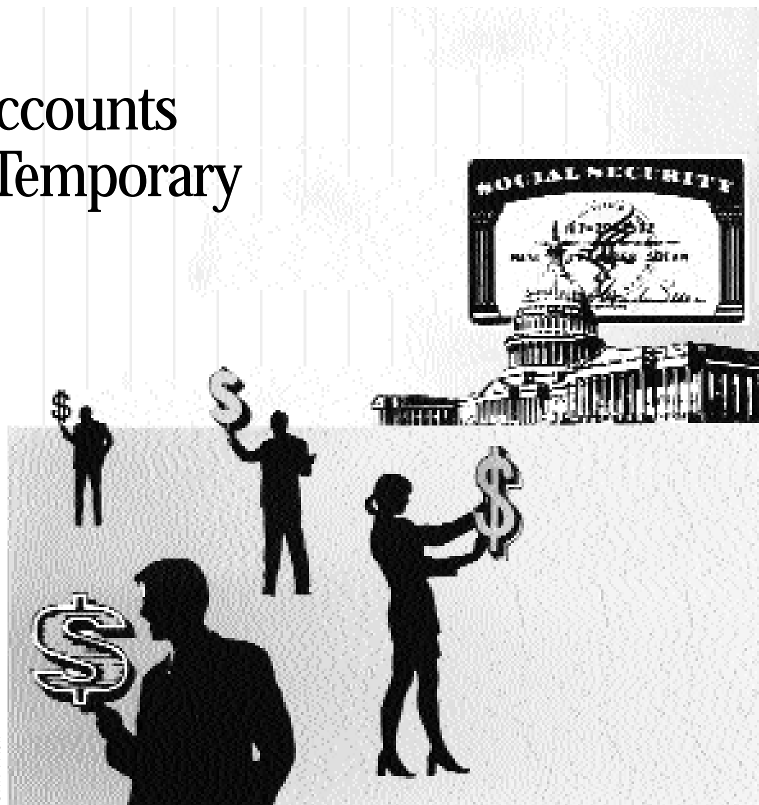
BY YUNG-PING CHEN

Social Security Private Accounts Should Be Mandatory and Temporary



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SINCE ALL MEMBERS OF THE PRESIDENT'S COMMISSION to Strengthen Social Security, in the words of White House Press Secretary Ari Fleischer, "share the president's view that personal retirement accounts are the way to save Social Security," many fear that the commission's sole purpose is to propose details to privatize Social Security.

My own view is that the commission will be recommending ways to restore long-range solvency as well as to create individual accounts. My hope is that the commission will at least discuss a method for adding individual accounts atop Social Security without cutting scheduled benefits.

Individual accounts have much to recommend them. Social Security was always intended to be supplemented by private pensions and personal savings. It's exactly how to create these individual accounts that's at issue here.

One method is to divert part of the payroll tax (called "carve-out"). The main problem with carve-outs is that they'll result in cutting benefits when an increase in payroll tax is ruled out. Moreover, all carve-out proposals to date would continue such diversion for all future years, thus giving rise to immense transition cost.

Another method is for people to contribute from their own income or for government to subsidize them (called "add-on"). One major problem with add-on is that people are either unable or unwilling to contribute, or that the account will become another entitlement if the government is subsidizing. Further, all add-on proposals to date would continue these accounts for all future years, thus aggravating these problems.

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If individual accounts are used to supplement Social Security, they should be mandatory, not voluntary. We already have a number of voluntary retirement savings arrangements, such as IRAs, 401(k)s, Keogh plans, and the Savings Incentive Match Plan for Employees (SIMPLE). In fact, recent legislation has liberalized tax-deductible amounts. It's unlikely that those who need to save the most would save if individual accounts were voluntary. I question if we need more voluntary accounts for those who would have saved anyway.

Whether individual accounts will work is a question that needs to be answered empirically rather than through endless hypothetical examples and ideological arguments. To gather empirical data, I propose that we divide the current Social Security program in two—a defined-benefit social insurance component, as we have now, and a defined-contribution individual account, which would be new—in a national demonstration program. This compromise reform plan would maintain social insurance features of Social Security and add individual accounts on top of it. In incorporating defined-contribution individual accounts into the traditional defined-benefit Social Security program, I have sought a middle ground between mandatory vs. voluntary accounts and between carve-out vs. add-on approaches.

The social insurance benefit would preserve the tra-

ditional old-age, survivors, and disability (OASDI) protections, to be funded on a pay-as-you-go (PAYGO) basis using 10.8 percentage points of the current FICA for the next 10 years. Funded by 1.6 percentage points of the current FICA, the individual account would be created without additional payroll taxes or contributions. Such financing is feasible because we don't need these funds to pay benefits during the next decade or so. The current FICA of 12.4 percent would remain.

Without committing the country to a policy change for all future years, the proposed individual accounts would be mandatory now but voluntary in the future. When the FICA needs to return to 12.4 percent, mandatory individual accounts will no longer be required. At that point, it's likely that workers who have had favorable experiences with individual accounts will continue to contribute to them. Induced by such good results, other people may be expected to follow suit. If experience has been unfavorable for most people, then why should the mandate continue? If experience turns out to be mixed, it would be sensible to allow individuals to choose whether or not to continue their accounts.

Under the 10-year national demonstration proposal, every person will have an individual account for a trial period of 10 years. Thus, those who are covered in 2002 will have their mandatory accounts until 2011, and those covered in 2011 will have theirs until 2020. If the experiment starts in 2002, this demonstration program will have accumulated empirical data for 19 years.

The experiment would yield such data as people's investment behavior and investment performance by key demographic and economic characteristics (e.g., age, sex, family status, and wage/salary), administrative costs, and other relevant variables. Such data would be valuable in guiding future policy development.

Administration of individual accounts should be patterned after the federal Thrift Savings Plan, with accounts held and managed by a central authority and a limited number of investment options for account holders. Smaller accounts may be pooled for greater earning potential, then individual investing would be permitted when the account reaches a certain size.

The large number of accounts and the limited number of investment options may help drive down administrative costs. Such a model would have the added advantage of avoiding fraudulent sales practices some individuals often encounter when investing on their own, faced as they are with a bewildering array of choices and sales pitches.

Meant to supplement Social Security, the proposed accounts are an add-on. Even though these accounts are created from payroll tax revenue, they're not a carve-out because this revenue is currently unneeded and will be replenished in the

future from general revenue. The rationale for using general revenue is that this experiment serves a major national purpose. Using general revenue would eliminate the need for a payroll tax increase or benefit cut.

The general revenue needed to replace the payroll tax revenue may not be as much as that used for creating these accounts, however, if payroll tax revenue grows faster than presently projected, as some have strenuously argued.

This approach to individual accounts would move national retirement income policy toward a better balance between Social Security and private pension. Now, only about half the workforce is covered by private pensions. Far too many retirees rely solely on Social Security. Mandatory individual accounts, therefore, would be a pension supplement akin to the universal private pension system recommended in 1981 by another presidential commission, the President's Commission on Pension Policy.

That commission recommended a universal private pension program that would be funded by employers alone, over and above the taxes they pay into Social Security, except those employers who are already meeting the requirement. What I suggest here would be funded by both the employer and the worker — by the payroll taxes that they are already paying, not by new taxes on either employer or worker. As an add-on to Social Security, these individual accounts would benefit all workers, and they would benefit most those who are not currently covered by private pensions, many of whom are minorities and women.

In spirit, the suggested experiment is not unlike what is contained in two recent pieces of legislation. The 1996 Health Insurance Portability and Accountability Act created a pilot program of "medical savings accounts," and welfare reform in1996 authorized a demonstration program of "individual development accounts." Interestingly, the much-heralded and much-maligned Economic Growth and Taxpayer Relief Reconciliation Act of 2001 is itself an experiment. Under it, the across-the-board, overall reductions in tax rates, begun in 2001 and fully phased in by 2006, will terminate by Jan. 1, 2011.

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The basic rationale for proposing a national experiment on individual accounts is that using them to replace part or all of Social Security raises many questions:

- Would investing in stocks and bonds really offer beneficiaries a higher rate of return than the current system, inclusive of retirement, disability, and survivor benefits?
- Do women, who spend less time in the workforce than men, get a bad deal from the existing program?
- Are blacks, who tend to die relatively young, shortchanged by present law?
- What about workers whose unemployment or disability cuts short the period of contribution to these accounts?
- How are these accounts divided at divorce?
- What about survivors of deceased workers?
- Will women, who now appear to be conservative investors, remain so in the future, thereby earning lower returns than men of comparable levels of income and investment?
- Do people in general possess the knowledge and inclination to invest their funds?
- What about the consequences of unwise or unlucky investments? And what about a bear market that lasts for years?
- Are people allowed to withdraw from their accounts before retirement (in hardship cases)?
- Are administrative costs so high that they would severely reduce the rate of return, especially for small account holders?

Because of the many uncertainties surrounding them, individual accounts are an unreliable method to restore long-range solvency to Social Security. We need to contemplate some changes, such as the following. The deficit of 1.86 percent of payroll could be removed by:

- Improving the accuracy of the COLA by using the new "superlative" CPI as computed by the Bureau of Labor Statistics starting in 2002, which would reduce the deficit by 0.23 percent of payroll.
- Covering newly hired state and local government employees beginning in 2002, which would reduce the deficit by 0.21 percent of payroll.
- Taxing Social Security benefits in a manner similar to private pension income and phasing out the lower income thresholds during 2002-2011. This would reduce the deficit by 0.44 percent of payroll.
- Increasing the taxable maximum (contribution and benefit base) so it will gradually reach 90 percent of earnings—the level that was once taxable. This would reduce the deficit by 0.69 percent of payroll.
- Phasing in the currently scheduled increase in normal retirement age to 67 by 2016 rather than 2027, and then indexing the normal retirement age (by one month every two years) up to age 68. This would reduce the deficit by 0.43 percent of payroll.

These changes may be made in a manner consistent with the social insurance model of Social Security we currently have. Many who oppose funding Social Security as social insurance on a pay-as-you-go (PAYGO) basis assume that PAYGO will impose a heavy tax burden on future workers. However, PAYGO need not entail high tax rates if the growth in benefits is moderated by these or similar changes.

I'm under no illusion that the ideas suggested in this article will be easy to enact. However, these and other possible modifications will be taken more seriously, I trust, once everyone is convinced that there are only hard choices ahead and that the sooner we make them, the better. If anyone can come up with a fiscally responsible solution that is less painful, I'll be the first to defer.