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### Key Points

- Social Security currently provides a defined benefit that is only indirectly related to contributions made by participants. Some have proposed turning part of Social Security into a defined contribution system where benefits would accumulate in individual accounts.
- Individual accounts could be an “add-on” or an “offset” to the current benefit structure. The add-on approach would leave the current structure in place, but allow for an additional 401(k)-like account, funded through additional payroll taxes. By contrast, an offset approach would reduce current structure benefits by the value of the offset account and shift a portion of future payroll taxes to individual accounts.
- Enacting offset approach individual accounts would require policymakers to work through a number of complex issues, including: how to transition to the new system; whether the individual accounts are voluntary or mandatory; how to preserve the balance between social adequacy and individual equity; and the investment options that are offered.
- Distributing benefits from individual accounts also raises several questions, including: Are loans or withdrawals permitted during the accumulation phase? Are annuities voluntary or mandatory? Who should provide the annuities and in what optional form of payment?

## Social Security Individual Accounts: Design Questions

Social Security is frequently cited, along with Medicare and Medicaid, as an entitlement whose increasing cost threatens to mire the federal government in unsustainable debt. According to recent Social Security Trustees reports, the system will not be able to continue paying promised benefits for more than a few decades unless the payroll tax that supports the system is raised. This has led some analysts and policymakers to call for major changes to the system. In particular, they have proposed replacing the current defined benefit system with a defined contribution system in which American workers would accumulate contributions in individual accounts to fund their retirement income. Proponents of this approach believe that, by investing their accounts in the stock market, workers can both stimulate the economy by increasing the availability of capital, and obtain retirement benefits comparable to those under the current system through higher long-term investment returns. If successful, this could lower future costs to Social Security and reduce or eliminate the need to raise additional revenues from higher taxes.

On the other hand, Social Security is among the most successful and popular programs of the federal government, so there is also stiff resistance to such change. Ninety percent of retirees currently receive at least 50 percent of their income

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from Social Security. Opponents of changing to a defined contribution system are concerned about workers losing what for many is their only source of guaranteed retirement income.

The American Academy of Actuaries' Social Security Committee does not take one side or the other in this policy debate. However, the committee believes the debate should be informed by a careful analysis of the practical issues that will arise in designing and implementing an individual account system. This issue brief addresses the following questions concerning Social Security individual accounts:

- Should individual accounts be mandatory or voluntary?
- Should individual accounts be added on to the current program, or should they replace all or part of the current program?
- How should the program grandfather the existing benefits for older workers and retirees?
- How should the program provide adequate benefits for lower-paid workers?
- How should the program provide adequate benefits for workers and their families in the event of disability or premature death?
- Should individual accounts be managed and invested centrally?
- How many investment alternatives should workers be offered and what should they be?
- How would workers be educated to make informed investment decisions?

- Would workers have access to funds in their accounts before retirement?
- Would payout of benefits by lifetime annuities be mandatory or voluntary? How would such annuities be designed and administered?

## Background and Scope

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Individual accounts would bring major changes to Social Security benefits and administration.

### Benefits

The current system is a defined benefit (DB) social insurance program in which a worker's benefits are only indirectly related to his or her total contributions. The contributions of all workers are pooled and available to pay benefits to any worker or dependent. In contrast, individual account balances are based directly on a worker's contributions plus investment earnings and are available only to pay benefits to that worker and his or her dependents. A pure individual account program cannot readily duplicate Social Security's additional benefits for lower-paid workers, disabled workers, and other family members, although it is possible to allocate funds for such purposes. Some proposals continue paying such benefits from a basic DB program patterned after traditional Social Security, as discussed below.

### Administration

The current Social Security program is relatively simple to administer, with little need to track each worker's earnings and contributions closely before benefit payments begin. In recent years Social Security has been providing workers with statements of their annual earnings and estimated benefits, and this process has highlighted errors, omissions, and delays in employers' reporting of earnings. Even so, many workers lack basic knowledge about Social Security, often waiting until near retirement to learn about their benefits. In contrast, individual accounts require accurate

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and timely record keeping so that funds can be invested and workers informed about their account balances. Workers would have an ongoing need to keep track of their individual accounts, learn how to make good investment choices, and actively participate in planning their retirement income.

### **Add-ons and offsets**

Social Security individual accounts come in two varieties, add-on and offset. Add-on accounts leave the existing system intact, but add a new tier of benefits financed by additional payroll taxes. Add-on accounts work much like a 401(k) plan, except scaled up to encompass all workers rather than only the workers of a single employer. The accounts may be mandatory or voluntary; in the case of voluntary accounts, proposals often include incentives to participate such as matching contributions, particularly for lower paid workers. Proposals such as this have been introduced in Congress from time to time over the past several decades, but none has garnered significant support either in Congress itself or among the public. A pure add-on plan would give participating workers greater benefits, but by itself would not address the system's long-term financial issues.

Offset accounts are funded by a portion of the current payroll tax. Benefits funded by the accounts reduce, or offset, the benefits provided under current benefit formula. For example, the Bush administration and Republicans in Congress have supported proposals that would shift 2 percent of earnings from participating workers' pooled taxes to individual accounts, reducing the combined Social Security payroll-tax rate from 12.4 percent of pay to 10.4 percent. Traditional benefits supported by the remaining pooled taxes would be reduced, often with proportionately greater reductions for higher paid workers. The traditional benefits would be supplemented at retirement by benefits provided from the individual accounts, which would be higher for higher paid workers. Advocates of this approach expect that the combined benefits would be at least comparable to benefits under the current system.

### **Allocation of risk**

Under the current system, the benefits workers earn in covered employment are guaranteed for life. The principal risk is political: that Congress will fail to enact changes in time to bring the system into actuarial

balance, and benefits will need to be cut across the board once the trust funds run out of money. Individual accounts would shift additional risk onto workers, since a portion of their benefits would be based on the returns realized on the securities held in their accounts. Many workers are already assuming a greater portion of retirement risk as employers move away from defined benefit pension plans toward defined contribution plans like 401(k) plans.

## **Existing Program Models**

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Since individual accounts would raise many new administrative and investment issues for Social Security, analysts sometimes cite similar existing programs as models.

### **Individual retirement accounts (IRAs)**

Created as part of ERISA in 1974, IRAs fill an important role as retirement savings vehicles. Individual workers may choose among a wide range of private-sector alternatives to invest and manage their IRA funds.

### **401(k) plans**

Employers' 401(k) plans have spread rapidly since they were first offered in the late 1970s. Employees may be given only a few investment options or a great many options, with one administrator usually handling a plan's record keeping. These plans often give workers access to their money before retirement in the form of loans or hardship withdrawals.

### **Thrift Savings Plan**

The federal employees' Thrift Savings Plan (TSP), enacted in 1986 after Congress considered several alternative designs, is often considered a model for Social Security reform.

- **Investments:** Policymakers across the political spectrum have applauded the TSP's use of index funds to invest in stocks and bonds because this keeps politics out of investing, gives satisfactory investment results, and holds down investment costs. The TSP now offers five funds, including three stock index funds investing in larger U.S. companies, smaller U.S. companies, and overseas companies, plus a bond index fund and a fund holding Treasury securities.
- **Centralization:** Some proponents of individual accounts also would copy the TSP's centralized ad-

|   | IRA  | 401(k) plan   | TSP  |
|---|--|---|--|
| <b>What investment choices do participants have?</b>                | Individual account owner has almost unlimited choice.  | Each plan sponsor decides which choices to offer. Range of available choices varies widely. Target date mutual funds, which shift from more to less risky investments as workers near retirement, have become increasingly popular. | As specified by law, five funds are available for participants to invest in equities or fixed-income. Four use index funds to invest in the private sector and the fifth uses Treasury securities. |
| <b>Who holds and manages investments?</b>                           | A trustee or custodian is responsible under the participant's direction.   | Plan sponsor is ultimately responsible, but task is typically outsourced to one or more investment companies and advisors   | Thrift Board is responsible. Treasury securities are managed internally. The four index funds are run by one or two fund managers in the private sector.   |
| <b>Who does the recordkeeping?</b>                                  | Each individual is responsible, with financial institutions offering considerable help.  | Plan sponsor is responsible, but outsourcing to third party administrator is common.  | An agency within the U.S. Office of Personnel Management   |
| <b>What is the level of expense charges?</b>                        | Varies, but often high because services are provided in a retail environment.  | Usually lower than IRAs because the cost of services is spread over all plan participants.  | Very low because the TSP operates as a very large 401(k)-type plan that offers only a few choices.   |
| <b>How do participants learn about investing and other choices?</b> | Individuals are on their own to learn about choices available and use them wisely. Not many Americans understand investments, and the advice they get varies widely. | Employers usually try to help workers understand plan features and make good choices, sometimes using third-party advisors. Recent changes to federal regulations make it easier for employers to provide such advice.              | The Thrift Board makes available a website and printed materials. Each federal agency employs full-time retirement planning specialists to advise its workers.                                     |

ministration, which simplifies record keeping and communications. In creating the TSP, Congress explicitly rejected the “retail” approach used by IRAs as too costly and cumbersome for a single plan covering millions of workers, preferring a structure more like the one used by large 401(k) plans.

- **Independence:** A federal agency (the “Thrift Board”) administers the TSP. Wanting to keep politics out of TSP investment management, Congress gave the Thrift Board great independence, somewhat like the Federal Reserve Board.

Successful experience with IRAs, 401(k) plans, and the TSP has made each of these arrangements a possible model for an individual account plan under Social Security. The above outline briefly compares certain features of these three approaches that might be useful in Social Security reform.

## Mechanics of Offset Individual Accounts

While add-on individual accounts are fairly straightforward and resemble 401(k) and other types of defined contribution plans, offset individual accounts are more complex and involve strategies not in common use in retirement plans in the United States. Converting even a portion of the existing Social Security system to individual accounts would be a formidable task administratively, financially, and politically. While the following sections of this issue brief, on managing individual accounts and paying out funds from the accounts, apply equally to add-on and offset accounts, this section deals with issues unique to offset accounts. This issue brief assumes that a primary objective of any offset individual account proposal is to make Social Security financially sustainable, so that the individual accounts would use a portion of

the payroll tax now dedicated exclusively to funding workers' traditional Social Security benefits, and workers' traditional benefits would be reduced to take into account the diversion of a portion of the payroll tax to the individual accounts.

### Transition

Social Security reform proposals almost always continue the current system for workers receiving benefits as well as active workers above a cutoff age such as 55.

To finance Social Security without raising payroll taxes, an offset individual account plan usually needs substantial new income from general revenue beyond what would be needed to restore the current system to actuarial balance without reducing benefits. This is because some of the current payroll-tax revenue, which would otherwise be available to pay benefits to current retired workers and dependents, would be shifted to provide individual accounts for younger workers who will not retire until well into the future. As a result, the basic defined benefit part of Social Security would soon need an alternate source of income to pay ongoing benefits and expenses.

There is another way to explain this transition. Under the current system, each generation largely pays for the benefits of the preceding generation. Under an individual account system, each generation pays for its own benefits. During the transition from defined benefit to individual account, there will inevitably be a transition generation that must pay for both the preceding generation's benefits and its own. This additional burden is called the "transition cost." While the amount varies among proposals, estimated liabilities in the range of \$10 trillion are not atypical. Proponents of individual accounts often say this liability already exists and is not created by the transition to individual accounts. However, the issue here is not the existence of the liability, but the timing of when it comes due. The transition to individual accounts places the burden of the Social Security liabilities of two generations on one.

### Voluntary or mandatory

A voluntary individual account program would have obvious appeal for many workers. Still, a voluntary program has formidable issues that do not arise under a single, mandatory plan. In virtually all proposals to date where offset individual accounts are voluntary, a

worker's decision about whether to participate in individual accounts is one-time and irrevocable. In practice, it seems inevitable that over time workers would insist on having open seasons in which to change their elections. Workers could say, for example, that they were not properly informed or that circumstances had changed, especially if either Social Security or the individual account plan had been modified in any way.

Making offset individual accounts voluntary would raise system cost. Sources of additional cost include:

- Tracking workers' choices and maintaining parallel systems for workers opting in vs. opting out.
- Handling initial and ongoing communications with workers about their alternatives.
- Anti-selection, that is, workers' choosing the option they believe most favorable to themselves and, hence, most costly to the system.

Most employers could not do an adequate job of educating employees, so the government would have to take on this task itself. Even so, some workers who found they made the wrong choice would seek to undo it. Experience during the transition from the old Civil Service Retirement System to the current Federal Employees Retirement System in the 1980s suggests that many people who stand to benefit from electing the new plan are likely to stay in the old plan because of inertia. In that event, workers might not make take the best advantage of the new program.

Unless Congress takes action to raise payroll taxes or reduce benefits, Social Security is expected to be unable to pay benefits in full within a few decades, and this raises difficult questions if offset individual accounts are voluntary. Should workers who stay in the traditional system get a scaled-back version of Social Security? Should workers be told that the program they choose is subject to unspecified changes?

In some proposals the government guarantees the greater of the benefits under the old and new programs. This provision adds further to benefit costs and complicates program administration. It also could encourage workers to invest as aggressively as possible, knowing that they can't lose if the investments turn out badly, unless investment options were severely limited.

### Adequacy vs. equity

Social Security has always tried to balance social adequacy with individual equity. In this context, ad-

equacy means that the program gives all workers and their families a basic level of protection against loss of income because of old age, death, or disability. Equity means that each worker gets what he or she paid for, with expected benefits being proportional to the worker's contributions plus investment earnings. Under current law, all covered workers have the same payroll tax rate, but benefits as a percentage of earnings vary widely based on where the worker's earnings fall on the spectrum from low-paid to high-paid, as well as the worker's age, sex, marital status, and number of dependents at benefit commencement. Nevertheless, higher income workers, who pay more in taxes, receive higher benefits.

Social Security benefits are only loosely related to a worker's contributions. Certain provisions now clearly favor workers who have low income, gaps in employment, or dependent family members.

- The Primary Insurance Amount (PIA) formula helps lower-paid workers by providing proportionately higher benefits to workers with lower average earnings over their careers.
- The PIA formula helps workers who have short gaps in employment, for education, child-rearing, layoff, early retirement, or other purposes, by counting only the highest 35 years of earnings. Workers with longer absences from the work force also benefit from the formula itself in the same manner described above for lower-paid workers.
- In addition, spouses, former spouses, children, and other family members get benefits under certain conditions without any additional worker contributions.

Cutting back some of the traditional benefits, and replacing them with individual accounts that are proportional to earnings, without other compensating changes, would cut back some of these "adequacy" features. Without careful benefit design that ensures adequate benefits for workers in all circumstances, the public might not be satisfied. Examples of adequacy provisions include:

- The government might provide matching contributions for lower paid workers.
- Workers might be required or permitted to use money from their accounts to purchase life and/or disability insurance. Rates for such insurance could be subsidized for the low-paid to enable them to af-

ford adequate insurance without unduly depleting their accounts. Alternatively, the current system of death and disability benefits could be maintained, while using individual accounts only for old age benefits.

- Administrative expense charges based on actual handling costs may be unreasonably high for small accounts. It may be deemed preferable to charge expenses as a flat percentage of assets, thus letting large accounts subsidize small ones to some extent.

### **Traditional defined benefits**

As noted above, the current system will be unable to pay promised benefits in a few decades without an increase in the payroll tax or subsidies from general revenues. This reality exerts pressure to reduce traditional benefits even before considering offsets based on the diversion of tax revenue to individual accounts, which is discussed further below. A number of formulas have been proposed that have the effect of preserving current benefit levels for the lower-paid while reducing benefits for the higher-paid. Proponents of individual accounts assert that higher account balances together with the long-term superior performance of equity investments will enable the higher-paid to recover their lost traditional benefits. However, equity investments are not guaranteed, and there is a risk that an equity portfolio could decline in value at the moment when it is most needed.

### **Offsets**

In most proposals, a worker's traditional formula benefit, after any reduction described in the preceding paragraph is further reduced by the benefit expected to be provided by the worker's individual account. This offset is typically computed by assuming the worker's individual account earns a specified baseline investment return every year and then converting the resulting account balance to a retirement annuity based on that same rate of return. A worker whose account earns higher than the baseline rate, on average, would get a higher benefit. Conversely, a worker who earns a lower rate would get a lower benefit, although some proposals include a guarantee to protect workers against any reduction in total benefits.

How the baseline rate is set can have a major effect on both costs and benefits. Traditional benefits will cost less if offsets are calculated using a higher baseline rate, but this will make it less likely workers will

be able to make up the lost portion of their traditional benefits from their individual accounts. In practice, many workers will not be willing or able to take on the investment risk necessary to meet or exceed a high baseline rate. This would be particularly true of the lower-paid, who are less likely to have investment knowledge and experience, and to have employer-provided or personal retirement savings to supplement Social Security.

### Earnings sharing

Some observers have long advocated that Social Security split married couples' earnings records evenly between spouses. In the event of divorce, each spouse would automatically get half of the benefits earned during the marriage, more or less, depending on how the weighted benefit formulas operate for the couple. Historically, such a proposal has appeared difficult to implement under Social Security's defined benefit system, but it would be more workable for individual accounts.

### Managing the Individual Accounts

Designing an individual account plan for Social Security presents several administrative challenges. Such a plan should help workers choose among attractive investment options, with an administrative structure that handles their accounts efficiently and economically. The plan should operate solely in the interests of participants and not allow elected officials to help choose the appropriate stocks to buy or sell. A basic question is whether an individual account plan for Social Security could better satisfy these objectives by decentralization, as in the IRA model, or by centralization along the lines of the TSP model.

### Ethical and political investment considerations

Investors sometimes want to make a statement that transcends financial considerations, choosing to invest in company A, whose products and practices embody values they want to support, rather than company B, whose values they dislike. Accordingly, many "ethical" or "socially responsible" mutual funds will not invest in certain kinds of companies – e.g., those whose products include alcohol, tobacco, or firearms – or who are considered to have poor records on safety, the environment, or employee relations.

Some elected officials may likewise be strongly tempted to inject their own values into an investment

process managed by the government. But opinions differ widely about what companies are "good" or "bad," and focusing on ethical values instead of profits may detract from investment performance. In creating and enacting the TSP, Congress overwhelmingly supported the principle of keeping politics out of governmental investing. Would the same "hands-off" attitude prevail in adopting Social Security individual accounts? Resolving this issue effectively would be a critical step in designing a viable program.

### Centralized vs. decentralized investments

Compared to the IRA model, a centralized investment structure for the individual accounts has both advantages and disadvantages:

- A centralized plan would limit workers' options. Such a plan could start out offering only a few investment choices and offer more later. Opinions differ on whether providing more choices would represent an advantage or a disadvantage. Offering more options gives workers greater flexibility, but may confuse unsophisticated investors. A smaller number of highly diversified funds may give workers meaningful choices while limiting the number of funds to explain and administer.
- Simplicity and low costs are major advantages of centralization. Private sector specialty firms might play a smaller role than in a decentralized system, acting as outsourcing providers rather than full-service investment brokers or money managers.
- Keeping politics out of investments would be an ongoing problem for a centralized plan. Investment authority could reside in an independent board with broad power to set investment policy and choose investments, although such a board might be difficult to insulate from politics. Alternatively, the TSP has addressed this issue by using index funds to make such decisions more or less automatically under the direction of an independent board with little investment authority. However, index funds may not be a practical alternative if Social Security individual accounts grow to comprise a large portion of invested assets. If too large a portion of securities is invested according to a mechanical formula, supply and demand signals that enable markets to function properly could become distorted.
- Workers may expect to be able to change their in-

vestments at least once a year if not more frequently. Such choices would require creating suitable communications vehicles and tools, contacting all workers, explaining options, and updating records. Communications and employee education would be extremely important. Centralizing the management of these functions and offering only a limited number of choices may be more cost-effective and reduce the problem of independent vendors overselling investment products.

### Independent agency

The TSP experience to date shows that an independent agency can be difficult to manage. Soon after creating the TSP, Congress had to tweak the law several times to keep the Thrift Board members from resigning because of concerns about fiduciary liability. Other startup problems involving the Thrift Board include: insisting that Treasury issue debt securities with interest yields of long-term bonds but with durations of only one day; submitting its annual budget to Congress without White House review; and deciding how to handle proxy voting for its individual stock holdings.

The Thrift Board's independence is an ongoing policy experiment that can always be changed by lawmakers who wish to impose their own values. In view of Social Security's much greater political prominence, it would seem that Congress should give careful thought to any statutory rules about independent government administration of individual accounts, recognizing that a future Congress can rewrite such rules.

## Payout of Funds

### Loans and withdrawals

During the accumulation phase, some workers would want loans or withdrawals from their individual accounts. Some of these individuals or their families will have suffered great personal and financial misfortune. Policymakers need to decide at the outset whether to offer access to funds, or instead to make workers rely on other programs and resources. Making exceptions in cases of extreme hardship is likely to open the door to other cases and weaken the plan's ability to fulfill its objectives.

### Should annuities be voluntary or mandatory?

That is, should lump sum payments be made available at retirement, or should all workers instead be required to convert their account balances to annuities?

- Mandatory annuities could be unpopular. Such a restriction on the use of their funds could be unpopular among workers with large account balances, other sources of retirement income, great confidence in their own ability to invest profitably, or poor health that limits their life expectancy.
- Mandatory annuities favor people with a longer life expectancy, generally including people in good health, women, high earners, and members of long-lived racial or ethnic groups. People with the opposite characteristics would tend to have shorter lives and collect less from annuities.
- Mandatory annuities ensure that retirees do not outlive their resources. Nobody knows how long his or her retirement savings will last, and an annuity removes the guesswork. An annuity also avoids the problem of people depleting their accounts too soon, and then living in poverty for the rest of their lives.
- Mandatory annuities address the widespread lack of investment skills needed to manage a large sum of money and produce a steady rate of income, even at an advanced age.
- Mandatory annuities reduce the cost of annuities. Under the voluntary system that now exists in the individual annuity market, only people in excellent health are willing to buy an annuity. This above-average life expectancy drives up the cost of annuities and makes them impractical for someone whose health is impaired. In contrast, mandatory annuities would cover a cross-section of workers with average longevity, making annuities less costly. Mandatory annuities with standard features also reduce administrative costs that would be reflected in annuity pricing.
- Mandatory annuities make unisex pricing feasible. If annuities were voluntary as they are now, a free and competitive annuity market would give women less attractive rates than men; that is, in the absence of legal constraints to the contrary, women pay more for an annuity because they tend to live



longer. Higher annuity prices for women could be a major barrier to public acceptance of individual accounts, since currently the Social Security system treats both sexes alike.

### Form of annuity

An annuity could have a great many forms, including payments for a specified number of years, payments over the life of one or more persons, and so on. Variable annuities are an option, with the amount of income varying with the performance of an underlying investment portfolio, but many workers may not have an appropriate understanding of the accompanying risks. Whatever standard form of annuity is adopted, optional forms could also be offered to allow workers flexibility to tailor benefits to their individual circumstances.

- Policymakers may want to consider a standard form of annuity, which may include the following provisions:
- Payments are made for a worker's life.
- Payments are adjusted annually to keep pace with increases in the cost of living, as under the current system.
- After death of a married worker, payments continue at a two-thirds rate to a surviving spouse for life.
- After death of a worker and any surviving spouse, a cash refund is paid equal to the account balance at retirement, less annuity payments already made.

This type of annuity is consistent with the current Social Security program, paying benefits for life to the worker, with 2/3 of the couple's benefit paid to a surviving spouse, and with annual cost-of-living adjustments. The cash refund death benefit is consistent with a pre-retirement lump-sum death benefit equal to the account balance, providing similar death benefits if an unmarried worker dies shortly before retirement or shortly after. Low-income individuals make up a disproportionate share of those with shorter life expectancies, and the lump-sum death benefit ensures that each worker's family will get back at least the amount the worker paid in.

### Who should provide the annuity?

This question has at least three reasonable answers: the private annuity market; the federal government by itself, working through an agency such as the Social

Security Administration; and the federal government working through private firms.

The TSP now contracts with one insurer to issue annuities to the few retirees who want them, using rates that are the same for men and women. For Social Security individual accounts, some kind of centralized annuity program operated or sponsored by the federal government could have major advantages over the traditional private annuity market:

- **Gaining economies of scale.** Compared to the existing "retail" annuity market, a centralized "wholesale" system would have substantial expense savings and could cover a cross-section of the population instead of just the healthiest people, which could lead to annuity rates that are more attractive. Some administrative and financial tasks could be contracted out to private firms or consortia.

- **Avoiding risks of insurer insolvency.** The existing annuity market entails some risk of insurer insolvency that could reduce or stop payment of annuities, although all states sponsor guaranty funds that provide substantial backup. For annuities derived from a Social Security individual account program, any such risk may be politically unacceptable. A federal guarantee of private annuities would require a new framework of federal regulation, controls, and occasional bailouts. A simpler and more direct approach is for the federal government to take full responsibility for paying the annuity benefits, similar to the government's role in the current Medicare program, which uses private insurers to pay claims using government funds.

- **Accommodating inflation-indexed annuities.** Few if any annuity providers in the private sector now issue annuities with full protection against inflation. Meanwhile, the federal government provides "annuities" fully indexed to the CPI under Social Security, the Civil Service Retirement System, and the Military Retirement System. This experience strongly suggests that the government can readily extend such inflation protection to annuities paid from an individual account program.

- **Permitting unisex rates.** As noted above, unisex rates and options are politically desirable, but are not consistent with a free and competitive private market for individual annuities. The TSP experi-

ence shows that the government can contract with private firms for annuities at unisex rates, and perhaps could do so under a much larger program such as Social Security.

- **Administration of annuities.** Annuities would be more economical to administer if their payments were combined with payments of other Social Security benefits. Combining the payments would make it feasible to administer annuities derived from small account balances.

A separate issue is timing of annuity purchases. For example, spreading the conversion of the account balance into an annuity over several years could smooth out fluctuations in investment performance and interest rates. This would protect a worker getting ready to retire from sudden changes in investment markets that could sharply reduce the amount of annuity income available. An alternative is to convert any stocks to long-term, fixed-income securities over several years before retirement. Target date funds could be used for this purpose.

## Conclusion

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This issue brief presents an actuarial viewpoint on design concepts similar to those in recent proposals to divert a portion of Social Security payroll taxes to individual accounts. Revising the Social Security system to include individual accounts would be a difficult and complex undertaking. Convincing Congress and the country at large of the wisdom of such an approach is only part of the task facing its proponents. They must also design an individual account system that is practical and inexpensive to administer, and one that continues to provide workers and their dependents with adequate retirement benefits.