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# ISSUE BRIEF
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# Social Security Reform: Voluntary or Mandatory Individual Accounts?

*The debate over Social Security reform has included discussion of numerous proposals to create individual accounts as part of Social Security. The current Social Security program is mandatory and has the same provisions for the vast majority of American workers; however, under many reform proposals, participation in the individual accounts would be voluntary. In other words, each participant would choose whether to establish and to contribute to such an account. In most such proposals seen to date, the choice would be one-time and irrevocable.*

*While allowing participants to make such a choice has obvious attraction, both in terms of participant satisfaction and as an economic matter, allowing participants to make this important decision also raises a number of concerns, including:*

- *Does offering a choice increase overall program costs?*
- *Would participants be sufficiently knowledgeable about both the existing ("traditional") and new plans to make informed decisions?*
- *What benefits should participants get if they choose to remain in the traditional plan, particularly if it is not financially sound?*
- *Could participants ever change their enrollment decisions?*
- *Should the government guarantee the greater of benefits under the traditional and new plans?*

*The purpose of this issue brief is to explore the issues that policy-makers should consider if they design Social Security reform proposals with individual accounts.*

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*Members of the Social Insurance Committee who participated in the design of this issue brief include: Bruce D. Schobel, FSA, FCA, MAAA, Chairperson; Eric J. Klieber, EA, FSA, MAAA, MSPA, Vice-Chairperson; Kenneth G. Buffin, EA, FSA, FCA, MAAA; Edward E. Burrows, EA, MAAA, MSPA; Ronald Gebhardtsbauer, EA, FSA, FCA, MAAA, MSPA; Robert J. Randall, Sr., FSA, MAAA; Richard G. Schreitmueller, FSA, FCA, MAAA; P.J. Eric Stallard, ASA, MAAA; Joan Weiss, EA, FSA, MAAA; James A. Wiseman, FSA, MAAA.*

AMERICAN ACADEMY *of* ACTUARIES

1100 Seventeenth Street NW Seventh Floor Washington, DC 20036
Tel 202 223 8196 Fax 202 872 1948
www.actuary.org

Richard C. Lawson, Executive Director
Noel Card, Director of Communications
M. Todd Tuten, Director of Public Policy
Heather Jerbi, Policy Analyst, Pension
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## I. Does Offering a Choice Increase Overall Program Costs?

Analysis of this question can begin with the proposition that benefits under the existing ("traditional") and new plans would not be identical for most participants. Some workers may expect to receive larger benefits under the traditional plan. Perhaps they have low earnings and will receive a high replacement rate under that program's weighted benefit formula. They may have young or disabled family members who would qualify for substantial ancillary benefits. Other workers — perhaps most — may expect to have larger benefits under the new plan. Virtually all reform proposals using individual accounts presume that a substantial part of the assets would be invested in equities and receive real rates of return assumed to average 6.5 percent annually — higher than is generally available from the existing program.

While these expectations may not be realized, policymakers and forecasters generally assume that most participants who are aware of the need to make a decision will act rationally in an economic sense — that is, each person will choose the plan that *appears* likely to produce higher lifetime benefits. Considering their knowledge of their own situations and the ability to consult various professional advisers, rational participants will *tend* to make the correct choices for themselves. Thus, people who would do better under the traditional program will tend to remain in it; similarly, those who would do better under the new program will tend to choose it. Because this type of self-selection is inherent in any system involving choice, such a system will have higher benefit costs than would an alternative system offering either the traditional or the new plan alone. Of course, the preceding statement does not take into account possible changes to the existing program.

Many participants will not be aware of the need to make a decision or will be aware but not take any action. These workers may remain in the traditional plan merely through inertia, assuming that the traditional plan is the default choice.

Simultaneously operating two Social Security arrangements — the traditional plan and the new one — in parallel would inevitably result in higher administrative costs than operating either plan alone. The traditional plan must continue to operate for many years in any case for the benefit of current beneficiaries, but if current young workers can choose — through an active or passive enrollment process — to remain in it, then the traditional plan will operate for many additional years. Also, informing workers about the need to make a choice and providing them with information on which to base that choice would have substantial additional costs.

## II. Would Participants Be Sufficiently Knowledgeable to Make Informed Decisions?

Many employee-benefit plans in the private sector require employees to choose among various options, some of which can be quite complicated. A common example is the choice of health-insurance plan: fee-for-service, HMO, PPO, etc., or none. In the pension context, most 401(k) plans offer numerous choices with respect to contribution rates, investment options, etc. Most of these decisions are reconsidered at least annually. One criticism of these arrangements is that employees often are not sufficiently informed to make these decisions in a rational way. Educating employees about the features of the various available options and the ramifications of making certain choices is a substantial employer burden — and, critics say, one that some employers fail to meet.

Because the current Social Security program is mandatory and has the same provisions for the vast majority of American workers, they have very few choices to make. Introducing choice presents concerns similar to those involving employee benefits, but they are more serious. First, the choice of Social Security plan would — under nearly all proposals seen to date — be one-time and irrevocable. Participants would live with their choices for the rest of their lives, even if they selected a plan that later turned out to be — or seemed to be — the wrong one. Second, the choices are much more difficult to

make. Participants would need to consider many variables, such as future wages and salaries, life expectancy (of both the worker and his or her spouse, if any), likelihood of disability, investment returns, etc. Even very well informed and sophisticated workers could quite reasonably make what later turns out to be the “wrong” choice.

Employers would be very unlikely to accept the burden of educating employees about the Social Security decision. The government would almost certainly need to do this directly, using mechanisms that do not exist currently. Even if the government undertook an extensive public-education effort to inform workers about the choice of Social Security plans, no one could ever be sure that all workers had gotten the message. Clearly, some workers would not make well-informed decisions. Some of these workers might present a political problem years later when they realize they made the wrong choice and want to change it. This problem does not arise under a single, mandatory plan.

## III. What Benefits Should Participants Get if They Remain in the Traditional Plan?

The existing Social Security program is projected to have financial problems that begin in about 15 years and become severe in about 40 years. (See the Academy’s issue brief, *An Actuarial Perspective on the 2002 Social Security Trustees Report*, April 2002.) Therefore, unless experience turns out to be considerably more favorable than the Trustees’ intermediate assumptions, the program cannot continue to operate indefinitely without changes in the law. This apparent need for change raises difficult questions regarding people who, under a Social Security reform proposal involving choice, choose to remain under the traditional program:

- Because the existing program is not considered to be sustainable under present law, should continued participation in this program be an option, or should participants be offered a modified traditional program that is financially sound?
- Can a modified traditional program be the default option for workers who do not make a choice?
- If the existing program cannot operate indefinitely with virtually the whole labor force covered, should the provisions of that program be offered to anyone?
- If the existing program must be changed at some point in the future to make it financially sound, should current participants be informed at that time as to the nature of those changes so they can make an informed choice between the two plans?
- Must policy-makers enact legislation making the necessary changes binding — although nothing can prevent the enactment of new legislation making further changes — before workers are asked to make this choice?
- How can policy-makers anticipate additional changes that may be required in the future, as economic and demographic experience emerge and society’s needs evolve?
- Should participants be told formally that all benefits, from either plan, are subject to change?

In addition to those questions involving current participants, a similar issue arises with respect to new entrants to the labor force. If both the traditional and new plans operate in parallel, then would new entrants get to choose which plan to join? Some proposals state (or assume) that assignment to the new plan would be mandatory for new entrants. In that case, participants in the traditional plan would be an ever-shrinking closed group with diminishing political clout. Some participants might not want to be part of such a group.

## IV. Could Participants Ever Change Their Enrollment Decisions?

With two Social Security arrangements operating simultaneously, as time goes by many participants will be able to determine that they would have done better under the plan they did not choose. This analysis will be easiest for workers who chose the new plan, because computing benefits under the traditional plan would be relatively straight-forward (assuming that the plan looks much like present law). Also, the traditional plan may be more generous for workers who become disabled or the families of workers who die prematurely, depending on how those types of benefits are affected by the establishment of individual accounts. Should participants be able to change their decisions if, with the benefit of hindsight, they appear to have been disadvantaged?

The most obvious consequence of allowing participants to reconsider their choices involves cost. Assuming that most participants who come to believe that their original choice was wrong are correct, allowing them to switch to the other choice would raise their benefits — and, of course, the cost of Social Security overall. The amount of additional cost would be difficult to determine. How would anyone compute the benefits for a worker who did not choose to establish an individual account originally but wishes to do so later? What investment decisions would that worker be assumed to have made? Who would fund the returns on "phantom" investments that were not actually made? Prohibiting retroactive changes could mitigate these problems, but even prospective-only changes would involve additional benefit cost and significant administrative complexity. A limited one-time-only "open season" could reduce these costs, but the government probably would still have to provide enough education so that participants could make informed choices.

Allowing participants to change their elections also introduces moral risk. Some workers could elect to establish individual accounts and then invest their funds as aggressively as the plan allows, hoping to achieve high rates of return. If they succeed, then they stay with that plan. However, if they fail — that is, if their investments do badly — then they could switch back to the old plan and get that level of benefits. They could argue, as happens not infrequently in the employee-benefit field today, that their original decision was based on a misunderstanding or incomplete information.

The case for allowing participants to reconsider their enrollment decisions is more compelling if either or both of the plans change after the decision was made. Such changes are almost inevitable, as evidenced by numerous significant changes to Social Security since it was first enacted into law in 1935. If the plans change, should participants be permitted to make new decisions? How significant must changes be to trigger this right?

When participants request to change their enrollment decisions, policy-makers will have three possible responses:

1. Refuse to allow changes. The consequence of this position is that some participants and their families would receive smaller benefits than they would have received if they had made a different choice. Some might require government assistance.
2. Allow changes, either retrospectively or prospectively, as described above. This would result in additional benefits and administrative costs that presumably would be borne by the government — who else could bear them? — and ultimately passed on to taxpayers. Note that change might be allowed only in the direction of the new plan.
3. Allow changes only if the participant can demonstrate that he or she was misled or misinformed when making the original decision. Obviously, some evidentiary standard would need to be met. While this option would greatly reduce the number of participants switching back and forth, the additional benefits and administrative cost would still need to be met, presumably by the government.

## V. Should the Government Guarantee the Greater of Benefits Under the Old and New Plans?

This avoids the problem of participants wanting to reconsider their enrollment decisions. In fact, under this type of proposal, participants would not have to choose at all! Every worker would be effectively enrolled in both plans at the same time, and their benefits would be paid from whichever plan produces the higher amount at retirement. While this may seem overly generous to some, similar guarantee features have been included in several Social Security reform proposals.

This type of guarantee provision has at least two serious problems. The first involves cost. Obviously, paying the greater of two possible benefits to every participant must cost substantially more than an alternative system under which each participant has to live with the consequences of a one-time, irrevocable choice. Moreover, under an individual-account plan, the assets are supposed to be invested. These assets cannot be in two places at once: in the individual accounts and funding the traditional plan. If they are invested through the individual accounts, then the traditional plan would be underfunded. If the traditional plan gets its intended level of funding, then the money cannot be invested in the individual accounts.

Finally, minimum guarantees introduce moral risk. For example, if participants in the individual-account plan know that they will get *at least* the traditional system's benefits no matter how well or poorly they invest, then they should invest as aggressively as possible. Other people will pay for their mistakes. For that reason, many proposals allow investment in only certain stock and bond indexes and specify the allocation rates. However, keeping these restrictions forever will be difficult for the government to do. Eventually, some people would be able to put increasing percentages of their funds in risky options, effectively taking advantage of other taxpayers. If the government responded by charging a risk-related premium, it would need to investigate all possible investments (and companies) in order to set the correct premium. This would require too much involvement in corporate transactions, so the government would probably want to avoid these guarantees.

## Case Study

The Federal Employees' Retirement System (FERS) provides an interesting example of what can occur when participants are given the opportunity to choose a retirement plan. Before the enactment of FERS, most full-time federal civilian employees were in the Civil Service Retirement System (CSRS) and not covered by Social Security. When the Social Security Amendments of 1983 imposed mandatory Social Security coverage for newly hired federal workers, a new retirement system had to be designed for those workers. That system, FERS, was enacted into law in 1986.

Federal employees newly hired after 1983 were automatically in FERS. Other employees, who were in CSRS, were given a one-time opportunity, during 1987, to switch irrevocably to FERS (and Social Security). If they did nothing, they would remain in CSRS. The government gave these employees a great deal of information about both plans, so that they could make informed decisions.

This choice was much easier than the ones envisioned under many Social Security reform proposals. Both plans were simpler, and the better choice — to remain in CSRS — was obvious for most older, long-service employees who planned to remain with the government. Still, a significant number of younger employees — particularly those not expecting to stay in government until retirement — could anticipate receiving higher benefits under FERS and should have chosen to switch.

Few did. Of 2.15 million employees who were eligible to switch to FERS, only 70,000 — about 3 percent — did. This was way below expectations and disappointing to the plans' administrators. In response to employee requests, another "one-time" opportunity to switch was provided late in the 1990s. Again, very few workers switched.

The FERS experience shows that many employees, given a choice of retirement plans, did not choose well. The reason was probably not lack of information in this case, although many employees claimed that they were not given enough. At least one more likely cause is inertia. Many employees simply failed to take any action, which left them in CSRS by default. If this experience is repeated with Social Security reform, proponents may be disappointed when large numbers of workers remain in the old plan.

## CONCLUSION

While choice may be generally desirable from both the political and economic perspectives, it raises serious questions in the context of Social Security reform and government in general. Just as having multiple Internal Revenue Services would be inefficient and confusing, so would having multiple Social Security systems. Choice may be so desirable that it justifies the associated cost and confusion, but policy-makers need to be aware of these consequences.

American Academy of Actuaries

1100 Seventeenth Street NW
Seventh Floor
Washington, DC 20036
www.actuary.org