National Center for Policy Analysis

BRIEF ANALYSIS
No. 362
For immediate release:
Friday, May 18, 2001

Questions and Answers About Personal Social Security Retirement Accounts

By Matt Moore

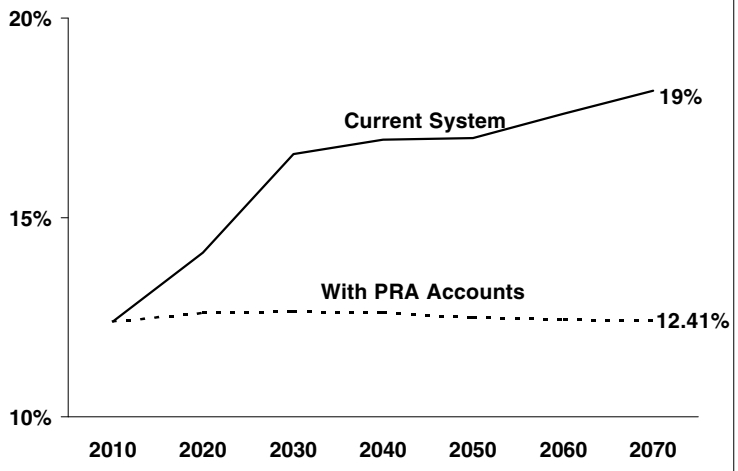
Between now and 2015 Social Security will accumulate large surpluses. Social Security reform proposals before Congress would utilize these surpluses by allowing workers to invest 2 percentage points of their payroll taxes in personal retirement accounts (PRAs). The PRA balances, with their accumulated interest and dividends, would replace an increasing portion of retirees' Social Security benefits and reduce the government's obligation to pay retirement benefits.

Why Is Private Investment Needed? Private equities markets consistently provide a higher return on contributed dollars than Social Security:

- According to the U.S. General Accounting Office, inflation-adjusted annual returns on stocks in the Standard & Poor's composite index have averaged 7 percent to 8 percent per year, despite the Great Depression, World War II and the stock market crash of 1987.
- By contrast, Social Security's expected rate of return on payroll taxes contributed is a meager 2 percent or less for baby boomers, less than 1 percent for Generation Xers and close to zero for today's newborns.

The higher long-run rates of return offered by the capital market would allow individual workers to earn more on their investment than Social Security pays. Over time, PRA balances would pay an increasing portion of workers' retirement benefits. As the figure shows, PRAs would enable the government to hold down expenses (and therefore taxes), while enabling retirees to reap higher benefits.

Social Security Payroll Tax Need to Pay Benefits



Source: *2001 Social Security Trustees Report* and Liqun Liu, Andrew J. Rettenmaier and Thomas R. Saving, "Saving the Surplus," NCPA Policy Report No. 241, January 2001, p. 13.

Why Invest Through Individual Accounts? An alternative to individual accounts is to allow government to invest in the stock market. But this option gives government too much control over private enterprise. The temptation would exist to manipulate investments to encourage or discourage certain industries, achieve social goals, reward friends or punish enemies. Studies show that such manipulations of state and local government pension funds reduce investment returns by as much as 2 percentage points.

The government would also be tempted to use Social Security's investment earnings for other programs. After all, that is what the government has been doing with payroll tax surpluses since the beginning of the program. Currently, the Treasury borrows Social Security surpluses and replaces them with IOUs — which are the only assets the trust funds actually hold. By contrast, personal retirement accounts that were the private property of individuals would be much more difficult for the government to seize and spend elsewhere.

Will Inexperienced Investors Make Good Investment Decisions? Under most reform proposals workers would not select individual stocks but would choose among mutual fund portfolios directed by professional management firms. These firms would be strictly regulated and a supervisory board would certify companies as qualified to handle the accounts.

An example of this arrangement is the Federal Thrift Savings Plan, in which federal workers choose from three investment options: a U.S. Treasury securities fund, a fund that tracks the Standard & Poor's 500 stock

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index and a U.S. government and corporate bond fund. Many labor unions — including some that oppose PRAs — already operate retirement plans that allow members to invest in a limited number of stock portfolios. According to a report from Citizens for a Sound Economy:

- The California Public Employees' Retirement System has 43.9 percent of its $155.8 billion in assets invested in domestic stocks and 19.7 percent in foreign stocks.
- The New York State Common Retirement Fund has 50.2 percent of its $111.4 billion in assets invested in domestic stocks and 11.8 percent in foreign stocks.
- The United Mine Workers Retirement Fund has more than 44 percent of its $7.5 billion in assets invested in domestic stocks and 8 percent in foreign stocks.

Millions of federal and state government employees and nonunion private sector employees also make choices and invest in the stock market every day. All told, more than half of Americans own stock today — compared with just 13 percent in 1980 — and they are gaining experience in the market.

Is Private Investment Risky? PRA opponents point to two types of risk. First, critics claim PRAs would subject workers' retirement savings to a volatile stock market. However, while the market fluctuates from day to day, over a typical 35- to 45-year working life, the market is fairly stable and steadily increases in value. A forthcoming NCPA study shows that portfolios with at least 60 percent stock holdings outperform Social Security's long-run rate of return 98 percent of the time.

Second, PRA critics ask what happens to people who retire in the year of a stock market crash. In a study for the Cato Institute, Bill Shipman of State Street Global Advisors answered that question. Shipman calculated how workers born between 1930 and 1976 would fare if they invested all of their Social Security payroll taxes in the U.S. stock market and purchased a retirement annuity with whatever is available at age 65. He determined that even if just before their retirement the market were to fall as dramatically as its worst day, month or quarter in history, in every case but one workers of all income levels and dates of birth would receive substantially higher retirement benefits than are promised by Social Security.

To counteract even these negligible risks, most Social Security reform proposals would protect retirees with a guaranteed minimum benefit. Under many plans, no one could do worse than under the current system. If PRA account balances fall short, taxpayers would be the insurers of last resort. Thus individuals who participate face no downside risk, only the opportunity to earn more money.

Will Administrative Fees Wipe Out Expected Gains? Critics claim management fees and administrative costs will wipe out the potential gains from PRA investments — at least for ordinary workers with small account balances. But structuring the system so this doesn't happen is relatively easy.

"Government could guarantee no one would be worse off."

The Federal Thrift Savings Plan has an average administrative cost of only 0.09 percent, and the administrative costs for privately managed index funds average 0.19 percent. State Street Global Advisors estimates administrative costs of a properly designed private system would range from 0.18 percent to 0.34 percent of assets over the first five years.

The General Accounting Office agrees that administrative costs can be low, depending on how the plan is devised. For instance, the problem of high investor fees, which occurs when investors have many options and switch investments frequently, can be solved by depositing everyone's initial investments into large, generic funds until individual accounts grow large enough to allow more investment choices.

Conclusion. The debate over Social Security reform has coalesced around the idea of personal retirement accounts. PRAs are not risky and they will require no previous investment experience. For more information about Social Security and PRAs, visit the NCPA's Social Security website at www.mysocialsecurity.org.

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