

Why personal accounts—and how to do them right?

By Estelle James ^[1]

Personal accounts are part of the solution to social security's ills, but only part and only if done right. We'll get more for our money if benefits are backed with funds and if individuals, rather than government, invest these funds, but we also need new revenues to keep the "security" in social security.

Why are personal accounts part of the solution? They can increase the size of the pie, keep payroll taxes low, and put social security on a fiscally sustainable path. Putting money into retirement accounts can increase national saving (currently near zero), capital and therefore productivity. With higher productivity, more goods and services will be available for everyone. Workers will get access to that higher productivity through higher wages and retirees through investment returns. This includes many low earners who don't have 401k's and don't get any investment returns now.

These investment returns enable retirees to get larger benefits than they could get for the same contribution, in the current system. Thus, lower payroll taxes will be needed to cover future benefits. Social security will be less dependent on current contributions and won't be in financial trouble when the ratio of workers to retirees falls.

Some have proposed that we accumulate funds to back social security, but the funds should be invested by government. We tried this with the trust fund—which lends its entire surplus to the government. This "off the books" borrowing encourages the treasury to incur a larger debt than it would have otherwise—which defeats the purpose of the funds and passes the larger debt on to our children to repay. And stock market investments by government open the door to political pressures and conflicts of interest.

These potential gains in terms of higher saving, benefits and sustainability are the reasons why over 30 countries (for example, Switzerland, Australia, the UK, Sweden, Hong Kong, Poland, Hungary, Chile and most Eastern European and Latin American countries) now include personal accounts in their social security systems—and why we should include them too.

Why are personal account only part of the solution? Current system revenues are simply not enough. The numbers tell us that, even with the added push from personal accounts, solvency for social security still comes at the expense of lower benefits than currently planned. How can we achieve solvency and acceptable benefits simultaneously? How can benefits continue to keep pace with wages so that many seniors don't end up way below the average standard of living? Personal accounts are part of the answer, but new revenues are also needed.

New revenues are also needed to reduce the financial market risk that account holders will face and to help cover transition costs.

How to do

them right—and where can we get new revenues? The most logical new revenue is to finance the accounts, in part, with an additional contribution (an "add-on"). The add-on should be matched by money "carved out" from the payroll tax—a progressive match that is higher for low earners who need a larger financial cushion. This keeps benefits up and transition costs down.

A personal account system means that some workers may make bad investment choices or have bad luck, and will be destitute in retirement. This risk is reduced by mandating diversified portfolios, but more needs to be done. We should set a floor on retirement income by guaranteeing a minimum pension. This minimum could be higher for people who work longer. Practically every country with personal accounts has a minimum pension, usually around 25% of the average wage.

If government debt balloons to finance the transition, this will offset the hike in personal saving and we won't get increased productivity and growth. We can help finance the transition as well as the minimum pension by raising the limit on earnings subject to the payroll tax. This would reflect the fact that the bulk of wage increases in recent years have gone to earnings above the current taxable ceiling of \$90,000. (Or we could broaden the base and postpone the elimination of the estate tax or the income tax on wealthiest individuals).

A large part of social security's financial trouble stems from the fact that people are living longer. That's great, but realistically there is no way that the same contribution rate can pay the same benefit for more and more years. We should automatically link the normal retirement age to increases in life expectancy. This will raise revenues while reducing expenditures. People who want a longer retirement period can still have it, by saving more.

A middle ground. This plan would put social security on a financially sustainable path, maintain total benefits and promote economic growth. It would be a middle-ground, a win-win solution for politicians of both parties and for all Americans—if only our policy-makers can get us there.

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