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On the Issues

A New Approach to Personal Social Security Accounts

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Personal retirement accounts with a structure using inflation-indexed Treasury bonds would deliver the benefits of personal accounts without the risks or costs often cited by critics of such accounts and could transform Social Security.

The personal retirement account proposals for reforming Social Security, advanced by President George W. Bush and others, have profound attractions. As is well understood, given our aging population and increasing years of retirement, the current Social Security program is unsustainable for the future. Personal accounts would transform Social Security, at least in part, from a program of payments from the government to one of greater personal property for the average American. By beginning a shift to personal retirement assets financed by real savings, voluntary personal accounts would be a key structural reform.

But the current proposals also have serious disadvantages: they are complicated, to many people they are downright confusing and even frightening, and they require diverting a portion of payroll taxes away from the U.S. Treasury. Who will manage the new retirement accounts, and how can this be done effectively for millions of small accounts? Isn't the stock market too risky? Won't the transition cost billions or trillions of dollars, making the deficit problem even worse? Won't many people be confused by being forced to make choices they do not understand? Who can be sure the benefits are worth the costs and risks?

There is, however, a better way to launch Social Security reform using private accounts and Treasury Inflation Protected Securities (or TIPS), which will deliver all of the benefits of personal accounts with none of the costs or risks cited by their opponents.

This paper proposes how to create personal accounts with an extremely simple and clear financial structure, without diverting any payroll tax receipts away from the U.S. Treasury, and with low cost and efficient operations. The results will be greater ownership of risk-free assets throughout American households, ability for inheritance, clear links between one's own efforts and retirement savings, and complete clarity in the dealings between the government and the citizens. The transition could begin promptly.

The essential proposal is this: Social Security tax payments by individuals and employers and Social Security tax receipts by the government would remain the same as they are now. No cash would be diverted, and the Treasury would have the same cash receipts from Social Security taxes as it does now. But in exchange, Treasury would not issue bonds to the Social Security "trust fund." Instead it would issue bonds—specifically, TIPS—directly to the personal accounts of the individual citizens themselves. Thus these accounts would not receive cash but would

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automatically receive the safest possible investment for retirement savings.

This is proposed as a *voluntary* alternative covering the portion of Social Security taxes that represents mandatory savings. Everyone would be given the choice to participate in the proposed personal accounts or stay in the current Social Security program. It is very probable that a large majority would choose the personal accounts if they are designed as recommended, but this should be a purely voluntary option.

This financial structure transparently shows the real transaction that is taking place between the two real principals involved: the American citizen and the U.S. Treasury Department. It cuts out the unnecessary and confusing "middle man" role of the Social Security "trust fund," which in fact is simply a Treasury liability.

The government's total obligations would not increase. Some Treasury debt would shift from being owned by the "trust fund" on behalf of the citizens to being owned by the citizens themselves in their personal accounts. The bonds in the personal accounts would represent an increase in Treasury debt owned by the public but would be issued, like bonds now sent to the "trust fund," as automatic private placements.

Simplicity

The simplicity of the proposed approach would remove from the current political debates many distracting issues, such as whether we could afford the transition costs, whether personal accounts would be too risky, whether Wall Street would reap a bonanza, and whether operating costs would be too high. It would make unnecessary the proposed delay in implementation until 2009.

It would also remove a central objection made by the opponents of personal accounts: that Social Security must be a moral imperative, an inviolable promise, and part of the social contract. Nothing could make Social Security more imperative, inviolable, and a contract than to turn it into a U.S. Treasury bond. Indeed, the only advantage that might be argued for the current Social Security structure over the proposed personal accounts is that the current structure leaves open the possibility for the government to renege on its promises and reduce benefits. This is presumably not an argument that opponents of personal accounts will wish to emphasize.

How much of the current structure should be replaced by the proposed personal accounts? The answer reflects the fact that Social Security has two components: first, a mandatory savings program for retirement and old age, applicable to citizens of all levels of income; and second, a welfare or safety net program providing a minimum retirement income and disability insurance.

The second component by definition requires commingling of funds and should remain as it is. This would include the disability portion of Social Security and the provision of a minimum retirement income for low-income households.

The proposed personal accounts apply to the first or mandatory savings component, which is what most Americans think their Social Security payments should be. A meaningful portion, ideally the entirety, of Social Security taxes that represent mandatory savings should have available this personal account option.

The simplicity of the proposed change in the mandatory savings function is easy to see by reviewing the current structure of Social Security and contrasting it with the proposal.

Current Structure for Mandatory Savings

The current Social Security structure handles the mandatory savings function with the following process:

A. Cash from the citizen, both directly from wages and indirectly as employer contributions that could otherwise have been wages, is sent to the government as Social Security taxes.

B. Social Security cash goes to the U.S. Treasury.

C. The Treasury spends the cash.

D. The Treasury issues a Treasury debt obligation to the Social Security program. This debt is the "trust fund." It is part of the total Treasury debt outstanding.

E. The Social Security program has an obligation to pay the citizen benefits later.

Personal Accounts and Diversion of Cash

Under all proposals for personal Social Security accounts so far put forward, some portion of the citizen's cash would not be sent to the government, but deposited instead in an individually owned retirement account.

Numerous political and financial objections have been made to this idea, frequently with a good deal of heat, particularly focusing on lost Treasury receipts and on risk. Objections to current personal accounts proposals include:

1. The lost payroll taxes would take cash away from the Treasury and immediately cause very large transition costs.

2. Assuming that these increased costs would not be offset by increased taxes, the national debt must correspondingly increase.

3. This would require the bond market to absorb large increased sales of Treasury debt, perhaps pressuring domestic and foreign capital markets and resulting in upward pressure on interest rates and additional downward pressure on the dollar.

4. The individual accounts would impose difficult and intimidating decisions about how to invest the cash, which many people may not be equipped to make or indeed wish to make.

5. In trying to make these decisions, owners of their own retirement funds may be induced to take excessive risk—to "roll the dice" or "play the slots."

6. Personal accounts call into question the government's commitment to future Social Security benefits, which should be inviolable promises.

7. Supplying mutual funds to millions of small accounts would cause high operating costs.

8. The program would create large windfall profits for Wall Street firms.

9. Investments in personal accounts may not appropriately match the duration of investments with long-term retirement needs.

10. Transition costs mean that implementation needs to be delayed for several years.

The proposed new design for personal accounts addresses every one of these objections.

To achieve the social advantages of personal accounts, and to a significant extent replace the ideology of hoping for payments from the government with generating personally owned assets, is a major and highly desirable structural reform in and of itself. However, it also offers the possibility, as discussed below, to address the long-run excess of Social Security benefit expense versus income.

A New Structure for Personal Accounts

In the proposed structure, there would be no diversion of cash from the Treasury. Social Security payroll taxes paid to the government and cash received by the Treasury would stay the same as under the current structure. If voluntarily chosen by the citizen, the portion of these taxes representing mandatory savings would be earmarked for personal accounts. However, these accounts would not receive cash, but automatically receive an appropriate Treasury inflation-indexed security.

The mandatory savings function would thus work as follows:

A. Social Security taxes would be sent to the government, as they are now. Treasury's cash receipts would be the same as they are now. There would be no cash shortfall.

B. The Treasury would spend the cash, as it does now.

C. The Treasury would issue a Treasury debt obligation, *but to the citizen's personal account, not to the "trust fund."*

That is all. Thus the citizen would have a risk-free investment very well suited for retirement savings: an inflation-indexed Treasury security. Treasury debt in the hands of the public has increased, but debt owned by the "trust fund" has decreased. Treasury owes the citizen directly and clearly, rather than indirectly and confusingly through the trust fund "middle man."

Since the savings are now in the form of a directly owned, actual Treasury bond instead of future Social Security benefits, there must of necessity be an equivalent reduction in future benefits to offset the acquired Treasury security. The "trust fund" does not receive Treasury bonds but by the same taken has reduced future benefit obligations. For the citizen, the replacement of future benefits with actual assets of course applies only on a going-forward basis, as the personal accounts grow. All benefits earned by past Social Security taxes, before the private accounts transition, would remain unchanged.

The proposed structure is quite similar to a historically tried and true long-term savings program: payroll deduction for the purchase of U.S. savings bonds. It is also similar to a very popular option under the Thrift Savings Plan for federal government employees: the "G Fund," which invests solely in U.S. Treasury obligations.

Such analogies, as well as the basic simplicity of the structure, would make it easy for the public to understand. Would most people choose to create their own portfolio of Treasury inflation-indexed bonds rather than hoping for future payments from off–balance sheet political promises? I think they would.

Relation to Future Benefits

If the economic value of the bonds acquired in the personal accounts is exactly equal to the economic value of the reduction in future off–balance sheet benefit promises, we would have created the many advantages of ownership, but the aggregate Social Security fiscal deficit would remain unchanged. However, this trade-off could be given a progressive structure, analogous to recent proposals for progressive changes to Social Security indexation formulas for high-income households.

In other words, for the majority of households, the value of the benefits to TIPS exchange ratio would be 1 to 1, but for high-income households it could be greater than 1 to 1. Since many of these households believe that, in any case, their Social Security taxes will inevitably increase or their future benefits be reduced, or both, the trade in exchange for achieving personal accounts could be viewed as advantageous. The transition to personal accounts would then reduce the Social Security deficit in addition to its other attractions.

The Specific Treasury Bond

The perfect candidate for which Treasury obligations should be issued to the personal Social Security accounts is clear: Treasury Inflation Protected Securities (TIPS). TIPS by definition preserve purchasing power against inflation, the single greatest risk and an essential consideration for retirement savings.

The TIPS would be issued in automatic private placements for each personal account. Because all the TIPS involved will be book-entry securities in fully automated form, small accounts and small amounts could be easily handled, and operating costs will be low.

Suggestions for how the details of this would work follow. Details could obviously vary around the essential structure.

The TIPS should have maturities based on the individual's expected retirement date. For example, a twenty-five-year-old with an expected retirement age of sixty-five might in the first instance receive forty-year TIPS. Note that it is proposed to consider creating long-term TIPS to match the needs of retirement savings. All interest and inflation adjustments should simply accrue, as with typical savings bonds, so there is no problem of investing small amounts of cash. Laddering maturities as discussed below would result in a sensible pattern of cash flow during retirement.

The average real return of government bonds (i.e. the yield net of inflation) in the long term is approximately 3 percent. The long-term TIPS to be privately placed in the personal accounts with a restricted period could have a real yield of about this same 3 percent. In an average inflation of 2 or 3 percent, for example, this would result in a compound annual return of 5 or 6 percent, respectively. A 3-percent real yield would match the real 3-percent discount rate often used in calculations of the value of future Social Security benefits.

For ownership to be effective, the TIPS received in the personal accounts must be negotiable securities. However, it would make sense to have a period after each private placement during which sale would be restricted. After that, the citizen would be entirely free to sell in order to make other eligible investments, if desired, provided of course that all proceeds and investments must stay in the retirement account until qualified for withdrawal.

The appropriate length of the restricted period before the privately placed TIPS would become negotiable must be defined. A starting suggestion would be five years, to insure a smooth transition, while also allowing the future addition of private asset categories.

The maturities of the TIPS should be based on expected retirement age but should not all mature at that date, which would cause a difficult decision point and large reinvestment risk. The idea of buying an annuity upon retirement does not address this problem, since if at that time interest rates are low, annuities will be unattractive to purchase—not to mention the need to address the credit risk of the annuity writer. A preferable approach would be to automatically ladder the maturities of the TIPS in the personal accounts to spread cash receipts from maturing bonds over the retirement years. Recall in this context that the safety net component of Social Security would also continue to function.

Individuals who choose to continue working past retirement age would continue to accumulate assets in their personal accounts. This would provide an incentive to reduce the extended period of retirement, which is a central cause of Social Security's fiscal deficit, without having to mandate changes in retirement age that would naturally be inappropriate in many individual cases.

In sum, the personal accounts would represent a voluntary way to hold mandatory savings. Continuing to hold the TIPS past their restricted period would also be voluntary.

But no investment decisions or risks would be forced upon the citizen. Especially considering those who might feel confused or intimidated, no action would be required to have a very sensible and safe investment, with zero credit risk and guaranteed inflation protection, very suitable for retirement savings, automatically provided. This means that there is a robust "default case," an important element in a system of choices.

A safe prediction is that a significant proportion of these securities would never be sold, but would be held to maturity. There would be no rush and no pressure on the individual to have to do anything, unlike the case of having to invest cash. In addition, the restricted period should comfort any observers who might fear the possibility of a large initial outflow of TIPS into the market.

Results for an Ordinary Couple

Suppose an ordinary couple signed up for the personal account option when they were both twenty-five years old, with a household income of $50,000 per year. What might their personal account retirement assets look like at age sixty-five, assuming the "default case" of simply holding their TIPS?

As an example, assume the real yield on TIPS is 3 percent, average inflation 2.5 percent, real wage increases 1.5 percent, and half the Social Security tax represents mandatory savings devoted to personal accounts. At age sixty-five they would own investments totaling over $800,000. If they worked to age seventy in line with their greater expected longevity and health, the personal account investments would total $1.15 million.

Now suppose two-thirds of the Social Security tax represents mandatory savings that generate TIPS for the personal account. At sixty-five, the investments would be more than $1 million, and at age seventy, more than $1.5 million.

These would be real assets, really owned by ordinary Americans.

Conclusion

The proposed approach would lead to personal Social Security accounts as a key transition and structural reform. It addresses all of the objections to private accounts, as follows:

1. There would be no cash shortfall to the Treasury.

2. There would be no increase in the total national obligations. Treasury debt owned by the public would increase, but Treasury debt owned by the "trust fund" would decrease. Off–balance sheet future benefit liabilities would also decrease. If the suggested progressive structure were adopted, future liabilities would decrease by more than the value of the TIPS issued, thus reducing the Social Security deficit.

3. There would be no need to market more Treasury debt—the bonds involved would automatically be privately placed in the personal accounts.

4. No difficult choices would be imposed on individuals—if they do nothing, a very safe and appropriate retirement investment is automatically provided. The default case is robust.

5. There is no pressure to take risk or "roll the dice." *TIPS are the exact opposite of rolling the dice*. In particular, they directly address the biggest risk to retirement savings, namely inflation.

6. The best way to make the promises of the government truly inviolable is to make them into an explicit Treasury bond.

7. The use of TIPS would allow a low-cost, efficient book entry system.

8. With investments automatically provided, there is no windfall for Wall Street, and small accounts can be handled efficiently.

9. Appropriate long-term investments matched to retirement needs are automatically provided.

10. The proposal would allow prompt implementation of personal accounts.

Moreover, the idea is simple and easy to understand. As a voluntary alternative to build personal ownership of long-term savings, I believe it would be readily chosen by a majority of Americans.

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