

The Financial Costs of Individual Accounts

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Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. Social Security is an exceptionally efficient administrative system for collecting payments and distributing retirement benefits. The Social Security Administration (SSA) is consistently ranked by the Office of Management and Budget (OMB), Congressional Committees, and outside observers as one of the best-managed government agencies. Administrative costs account for only 0.6 percent of total retirement and survivors benefit payments.² If Social Security's retirement program were operated like a mutual fund, that would be equivalent to an annual charge of about 0.03 percent of assets under management. In contrast, the average annual charge for a mutual fund is 1.09 percent.³

Establishing over 100 million voluntary individual accounts for Social Security would complicate the system and be substantially less efficient than the current system. Individual accounts would require a wide-range of tasks that go well beyond the scope of what SSA does today, including tracking contributions, allocating them to different investments, managing the assets, answering questions about the accounts, providing general financial education, handling assets in the case of premature death or divorce, distributing benefits at retirement, and monitoring and enforcing all the new regulations. Many of these tasks would require a substantial number of new personnel who would likely be organized in a new government agency. In my testimony I will make four points:

- First, administrative costs in a private accounts system would be at least ten times as large as the costs under the current system. In some proposals, administrative costs could eat up more than one-third of the final account balance.
- Second, establishing accounts would require a substantial increase in government staffing, likely in the form of a new government agency that could be about half the size of the Internal Revenue Service (IRS) or SSA.

¹ The views expressed in this testimony are mine alone.

² In 2004, administrative expenses for OASI were \$2.4 billion and total benefits were \$415 billion. See Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds*, ("2005 Trustees Report").

³ Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.

- Third, when administrative costs are considered, returns for many participants under a private accounts system would be lower than in a reformed system without accounts.
- Fourth, private accounts generally result in a large increase in debt held by the public and would increase the risks facing financial markets and fiscal policy.

First, administrative costs in a private accounts system would be at least ten times as large as the costs under the current system. In some proposals, administrative costs could eat up more than one-third of the final account balance.

Establishing over 100 million individual accounts for Social Security contributors would entail substantial new complexities and a wide range of new tasks. All of these new tasks would be *in addition* to everything Social Security does today.⁴ Replacing portions of the extremely efficient Social Security benefit with a considerably less efficient private account would make little economic sense.

Policymakers would face a tradeoff between encouraging choice and high-quality service and holding down administrative costs. If accounts are established for Social Security, policymakers will have to decide:

- Whether to organize record keeping and account management through a central agency or privately, on a decentralized basis like 401(k)s and IRAs.
- How much choice to give participants about their investments. Are they limited to just a few government-selected funds or allowed to invest in a wider-range of privately managed funds or even individual stocks and bonds?
- How long participants must wait between making a tax payment and allocating their contribution to a chosen investment.
- How often participants can change allocation between funds.
- If accounts are voluntary and how often, if ever, individuals can opt in and out of accounts?
- How many options there are for withdrawal from the funds at retirement. Is there one mandated payout option or a range of choices that include lump-sums and annuities?
- What level of service to provide for account holders. Is there a website? Or an 800 number? How long are the hold times and how high-quality is the information? How often are account values updated?
- How to educate participants so they can understand the different investment choices and withdrawal options at retirement.

Based on these choices, the ultimate cost of accounts could range greatly as shown in Table 1.⁵

⁴ Large benefit reductions that nevertheless keep the existing Social Security structure intact would not reduce the costs of administering Social Security.

⁵ A substantial portion of the cost is a “fixed cost” that depends on the account size. These estimates are generally applicable to accounts in the 2 to 4 percent of payroll range.

Table 1

Costs of Alternative Account Options		
Investment Option	Annual Cost (% of assets)	Total Cost (% of account at retirement)
Social Security	0.03%	0.6%
Government organized (limited choice, SSA actuaries)	0.30%	7%
Government organized (more choice, Swedish experience)	0.73%	15%
Privately organized (limited choice, SSA actuaries)	1.00%	20%
Privately organized (more choice, UK experience)	2.05%	36%

Note: Costs do not include the charges for annuities at retirement.

Estimates that show low administrative costs for accounts are based on limited choice and an unprecedented degree of government administration that could prove to be politically untenable over time. This section focuses on the most important choice: the choice between centralized government organization of the investment accounts and private, decentralized management.

Administrative costs of government-organized accounts

The President has proposed government-organized accounts with very restricted investment options. The President's proposal would establish a central administrative authority modeled on the government's Thrift Savings Plan (TSP). According to the White House description of the proposal,

A centralized administrative structure would be created to collect personal retirement account contributions, manage investments, maintain records, and facilitate withdrawals at retirement... The central administrator would answer questions from account participants and distribute periodic account statements.⁶

The TSP is one of the best administrated funds in the world, with a cost of only 0.06 percent of assets in 2004.⁷ The administrative burdens associated with individual accounts would be far greater. As former TSP Executive Director Francis X. Cavanaugh has stressed, the TSP only covers one employer with a sophisticated electronic payments system and a relatively stable workforce.⁸ Expanding the system to millions of employers – including small business, part-time employers, and high-turnover workers – would greatly increase costs. Furthermore, TSP accountholder's employer agency serves as the principal point of contact for the TSP plan and is responsible for any associated financial education or other information. As a result, these substantial costs are borne by the agencies and are not reflected in the TSP administrative costs. Replicating TSP services would require far larger administrative costs or a costly employer mandate.

⁶ White House, "Strengthening Social Security," February 2005.

⁷ Thrift Savings Fund, "Statement of Assets Available for Benefits As of December 31, 2004 and 2003," March 4, 2005.

⁸ Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP 2002-14, September 2002.

In the case of the President's proposal for government-organized accounts with limited choice, the Social Security's Office of the Chief Actuary "assumed that the ultimate administrative expenses would be about 0.30 percent of IA assets."⁹ At this expense rate, on average, administrative costs would eat up about 7 percent of the ultimate retirement benefit. *That is more than ten times as much as the administrative costs in the current Social Security system.*

The ultimate administrative costs are sometimes called the "charge ratio" – the difference between the total assets in the account at retirement with administrative costs and without administrative costs. The charge ratio substantially exceeds the annual expenses because it reflects the accumulation over a number of years. For example, suppose a person puts \$1,000 in an account for 40 years at a 0.30 percent annual cost. The person would pay \$3 annually to manage the contribution – or \$120 (or 12 percent) over 40 years. In contrast, if the contribution were just made for one year it would only cost \$3 (or 0.3 percent). The total charge ratio of 7 percent is close to the average of these two extreme cases.

The Social Security actuaries' estimates are likely to understate the administrative costs of the accounts for several reasons. First, the actuaries estimate is only for the "ultimate" administrative expenses. The initial costs of setting up an account are orders of magnitude higher than the ultimate management of the account. Factoring these in would raise the total cost. Second, as discussed in more detail below, these estimates do not include the cost of partially annuitizing accounts at retirement.

More fundamentally, expanded investment choices would lead to higher costs. Under the President's proposed accounts, participants would have a choice of only about five diversified mutual funds modeled on the TSP. The President's Social Security Commission, however, concluded that, "The centralized approach is sensible to implement in the short term but is probably not the best approach in the long run" and recommended that participants be allowed to invest balances above \$5,000 in a potentially unlimited roster of certified private-sector funds.¹⁰ This approach has been followed in a follow by several other plans. If these private-sector funds were managed, their fees could be comparable to the 1.09 percent average fees on mutual funds today, or 21 percent of the account balance at retirement.¹¹

Even if an individual account plan initially offered only a few funds, it is likely that political pressure would expand the options over time. Some have raised concerns that government investment in equities could result in political interference in equity markets. Exactly the same set of concerns would apply in a centralized system with limited choices. Although workers could choose the allocation between stocks and bonds, they would not have any choice about the allocation within equities. Furthermore, under many accounts proposals, accounts would hold a substantially larger share of the total equity market than has ever been proposed in the case of government investment of the trust fund.

⁹ Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005.

¹⁰ President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth For All Americans*, December, 2001.

¹¹ Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.

Most government equity investment plans are limited to 15 percent of the total equity market (including the plan proposed by President Clinton and the more recent plan from former Social Security Commission Bob Ball). In contrast, 4 percent private accounts would hold more than 40 percent of the equity market. Some plans have even larger account sizes and would hold equity portfolios equivalent to the *entire* current valuation of the market.

In the case of government investment, many of these political concerns could be allayed by having an independent board modeled on the Federal Reserve Board or the Federal Retirement Thrift Investment Board that oversees the TSP. The political economy of individual accounts would make this solution less sustainable.

Advocates of accounts tout the benefits of choice, ownership and control. This could lead to momentum for expanded choice in investment options based on the contention that it would give participants a shot at higher returns than participants would have with a limited choice of TSP funds.

In addition, many participants may not want to invest in companies they consider socially problematic – whether it is because the company makes cigarettes, produces pornography, supports gay rights, or invests in countries that violate human rights. Today a range of mutual funds from Christian mutual funds to environmental mutual funds cater to a variety of tastes in ownership. If individual accounts are instituted the political pressure to include these types of funds would be difficult for legislators and policymakers to resist.

The closest parallel to the President’s plan for government-organized accounts with a range of investment choices is the Swedish system. In Sweden, workers can invest in up to five certified funds chosen from more than 500 funds offered by private managers. Under the Swedish system, a government agency like the President’s proposed central administrative authority, collects all the contributions, communicates with participants, conveys the investments collectively to the fund managers, and distributes benefits. The Swedish system allocates contributions to specific investments up to two years after they are earned and only allows participants to change the allocation once a year. The default fund established by the Swedish government costs 0.3 percent of assets and private fund fees range from 0.2 percent to 3.97 percent.¹² Most Swedish participants choose lower-cost funds, and the average participant pays 0.73 percent of assets in administrative fees, or 15 percent of the account balance at retirement.¹³ Furthermore, additional administrative costs may be covered by the Swedish government.

Another study conducted for the World Bank found costs for government-organized accounts in other countries have ranged from 0.15 percent to 0.8 percent annually.¹⁴

¹² John Turner, “Individual Accounts: Lessons from Sweden,” AARP Issue Brief No. 60, May 2003.

¹³ Mårten Palme, Annika Sundén, and Paul Söderlind, “Investment Choice in the Swedish Premium Pension Plan,” Center for Retirement Research at Boston College, April 2005.

¹⁴ Estelle James, James Smalhout, and Dimitri Vittas, “Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective,” in Robert Holzmann and Joseph E. Stiglitz (eds), *New Ideas About Old-age Security*, World Bank, 2001.

Administrative costs of privately-organized accounts

An alternative to the President's government-organized approach would be privately-organized accounts like existing IRAs and 401(k)s. Under a privately-organized plan, individuals would set up an account at a financial institution and make choices about how to allocate assets. The financial institution would keep track of each individual's account and would be responsible for communicating with accountholders. A decentralized system would also entail choices about whether to limit investment options and trading frequency (as Chile has done) or permit a broader range of choices (as the United Kingdom has done).

Towards the low end of cost estimates, the *Report of the 1994-96 Advisory Council on Social Security* projected that privately-organized accounts could be established for 1.0 percent of annual assets, or about 20 percent of the ultimate account. This is similar to estimates by MIT economist Peter Diamond.¹⁵

The experience of 401(k)s and other countries shows that the costs could be considerably higher, especially if participants are given more choices. A survey by the Department of Labor's Pension and Welfare Benefits Administration (PWBA) found 401(k) costs ranging from 0.3 percent to 3 percent.¹⁶ The Congressional Budget Office (CBO) estimates tend towards the middle of this range.¹⁷

Chile and the United Kingdom both have very high administrative costs. According to testimony by James B. Lockhart III, the Deputy Commissioner of Social Security, "[s]ome countries, such as the United Kingdom and Chile, have experienced relatively high costs in administering accounts."¹⁸ In the Chilean system, administrative costs have been estimated to cost 1.36 percent annually,¹⁹ reducing the final account balance by 26 percent. Other estimates have found even higher fees in Chile.²⁰ Administrative costs were even higher in the UK system: before reforms that limited fees they were running at a level that would have reduced ultimate account balances by 36 percent or 43 percent including the cost of annuitizing balances at retirement.²¹ That is equivalent to an annual charge of about 2.0 percent of assets.

Cost estimates for setting up privately-organized accounts in the United States are comparably high. For example, a study by the Kelly Olsen and Dallas Salisbury of the

¹⁵ Peter Diamond, "Administrative Costs and Equilibrium Charges with Individual Accounts," in John B. Shoven (ed.) *Administrative Aspects of Investment-Based Social Security Reform*, University of Chicago Press, 2000.

¹⁶ Cited in GAO, "Administrative Costs for Individual Accounts Depend on System Design," GAO/HEHS-00-131, June 1999.

¹⁷ Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.

¹⁸ James B. Lockhart III, "Testimony for the Hearing Before the Senate Committee on Ageing, Strengthening Social Security: What Can We Learn From Other Nations?" May 18, 2004.

¹⁹ Estelle James, James Smalhout, and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph E. Stiglitz (eds), *New Ideas About Old-age Security*, World Bank, 2001.

²⁰ Indermit S. Gill, Truman Packard, and Juan Yermo. *Keeping the Promise of Social Security in Latin America*. Washington, DC: World Bank, 2005.

²¹ Mamata Murthi, J. Michael Orszag, and Peter R. Orszag, "Administrative Costs Under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom," in Robert Holzmann and Joseph E. Stiglitz (eds), *New Ideas About Old-age Security*, World Bank, 2001.

Employee Benefit Research Institute (EBRI) found that workers “would receive 40 percent to 42 percent lower IA benefits under high administrative cost assumptions than under low-cost assumptions.”²²

The costs of privately-organized accounts would represent windfall revenues to financial institutions. This is also true of some of the costs under government-organized accounts with private fund managers. Estimates by Austan Goolsbee of the University of Chicago Business School found that under some account designs, “the [financial managers’] fees would be the largest financial windfall in American history.”²³

Additional costs for annuitizing accounts and other complications

In addition to the administrative costs associated with managing worker’s account balances, there could be substantial costs associated with annuitizing the accounts at retirement. Currently, annuities purchased in the private market generally cost about 15 percent of total assets relative to a fair price for the average person. About 10 percentage points of the 15 percent cost of annuities is due to adverse selection, healthier people sign up for annuities because they expect to live longer and collect more money. The other 5 percentage points are due to other factors like administrative expenses and imperfect competition in a small market.²⁴ If individual accounts led to more annuitization, the market could become thicker and these costs could come down somewhat. Nevertheless, the cost of purchasing a private annuity would substantially add to the administrative costs shown in Table 1 – more than doubling the costs in a government-organized system.

Alternatively, the government could provide the annuity, as proposed by the President.²⁵ This would reduce many of the costs faced by purchasers of annuities because it would create a much larger market with economies of scale and the government would not make a profit on the transaction. But, unless the individual accounts plan required full annuitization, the government would face the same adverse selection problems that private annuity providers do because healthier seniors would annuitize more of their accounts. These seniors would live longer than average and collect more money from their accounts. If the annuities were not subsidized, the government would need to reduce annuity payouts to reflect the longer-living populations which purchase them. And if the government offered an actuarially fair annuity, it would have to subsidize the adverse selection costs out of general revenue. As a result, these costs would be borne by accountholders through their income taxes rather than out of their accounts directly.

Individual accounts could result in complications that add to administrative costs and reduce account accumulations. A voluntary account system such as the one that the President

²² Kelly A. Olsen and Dallas L. Salisbury, “Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs,” EBRI Issues Brief 203, November 1998.

²³ Austan Goolsbee, “The Fees of Private Accounts and the Impact of Social Security Privatization on Financial Managers,” September 2004.

²⁴ Olivia S. Mitchell, James M. Poterba, Mark J. Warshawsky, and Jeffrey R. Brown, “New Evidence on Money’s Worth of Individual Annuities,” *American Economic Review* 89(5), December 1999.

²⁵ According to a background briefing by a senior administration official on February 2, 2005, “the federal government would do the purchasing of the annuity contracts... People wouldn’t be out there shopping on their own for a private-sector annuity.”

has proposed requires more education and administrative tasks than a mandatory system. Very few countries have voluntary accounts systems. In one of the few that does, the United Kingdom, the administrative costs are very high.

In addition, the distribution of individual accounts raises a number of other costly administrative issues in cases of divorce, pre-retirement death, and alternative options for distribution at retirement. Many of these issues were addressed by a National Academy of Social Insurance (NASI) study *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy* (January 2005).

Second, establishing accounts would require a substantial increase in government staffing, likely in the form of a new government agency that could be about half the size of the Internal Revenue Service (IRS) or SSA.

Establishing private accounts would require substantial new government employment and could require a new government agency to handle account administration. Cavanaugh has extrapolated from the TSP's experience to estimate that "there would be a potential need for more than 10,000 highly trained telephone counselors" just to answer account inquiries.²⁶ A detailed study by the Clinton administration's Department of the Treasury found that,

"[B]are-bones accounts... could be run at an annual cost of \$20 to \$30 per account, while accounts with service similar to that in current 401(k)s (though not including loans) would be two or three times as expensive. With roughly 180 million accounts, total annual costs could exceed \$5 billion a year in today's dollars (more than half as large as the current budget of the IRS and therefore more than half the cost of administering the entire federal tax code) and tens of thousands of new government workers would be needed to answer phone inquiries and process worker choices of fund managers."²⁷

An SSA study found that accounts would require between 8,000 and 34,000 new employees just at SSA. The study did not attempt to estimate increased employment at other agencies.²⁸

If 4 percent accounts are phased-in as proposed by the President, then at the end of 10 years they will hold nearly \$1.5 trillion in assets. At the 0.30 percent cost assumed by the actuaries, that would be \$4.4 billion expended on individual account administration and asset management fees.

²⁶ Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP 2002-14, September 2002. This could understate the number of personnel needed for Social Security since much of the TSP information is provided by agencies, not the TSP itself.

²⁷ Douglas W. Elmendorf, Jeffrey B. Liebman, and David W. Wilcox, "Fiscal Policy and Social Security Policy During the 1990s," in Jeffrey A. Frankel and Peter R. Orszag (eds.) *American Economic Policy in the 1990s*, Cambridge, MA, MIT Press, 2002.

²⁸ Lawrence E. Hart, Mark Kearney, Carol Musil, and Kelly Olsen, "SSA's Estimates of Administrative Costs Under a Centralized Program of Individual Accounts," January 9, 2001.

According to the White House, “Most of these administrative costs are for recordkeeping which would be done by the government, not investment management done by Wall Street.”²⁹ That would represent enough for about 30,000 new government employees, assuming two-thirds of this total cost is for personnel. Additional government employees to provide financial education and other services could end up being paid for by general revenue, meaning that workers would pay the administrative costs out of their taxes rather than account balances. If participants were provided even a slightly greater range of choices (like the choice of investing in certified mutual funds) and greater services, the required government employment could easily exceed 100,000 annually.

By comparison, currently SSA has a total staff of about 65,000 (of which 20,000 administer the retirement and survivor’s program) and the IRS has a staff of about 100,000.

Third, when administrative costs are considered, returns for many participants under a private accounts system would be lower than in a reformed system without accounts.

Additional administrative costs associated with individual accounts are certain. Any potential gains from accounts, however, are uncertain. In recognition of this uncertainty, CBO uses what is known as “risk adjustment” in estimating the returns on private accounts established under Social Security plans. This means that CBO adjusts stock returns to reflect the higher risk that stock investments carry. The result is that, on a comparable basis to Social Security, accounts are assumed to earn the same return as Treasury bonds minus administrative costs. This is the same assumption used by the Office of Management and Budget in accounting for equity investment by the Railroad Retirement system.³⁰

For a worker that has a portfolio of stocks and bonds, the option of an individual account does not offer any additional benefits. The President’s proposal would allow the worker to effectively borrow money at what is intended to be the Treasury bond rate and invest it in a portfolio that includes equities.³¹ In the process, the worker would incur the additional administrative costs on the private accounts established with, in effect, borrowed funds. If there are truly additional benefits to investing in stocks, workers who own bonds could capture them by not participating in the accounts and instead selling some bonds and using the proceeds to invest in stocks. This latter course would not entail any additional administrative costs.

In a private accounts system the government is essentially borrowing money at the Treasury rate and lending out to investors who only get the Treasury rate minus administrative costs. As a result, on a comparable risk-adjusted basis, a Social Security system with private accounts would have a lower rate for return for a large fraction of workers than a system without

²⁹ White House, “Strengthening Social Security,” February 2005.

³⁰ For more details see Jason Furman, “Would Private Accounts Provide a Higher Rate of Return than Social Security,” Center on Budget and Policy Priorities, June 2, 2005.

³¹ Specifically, in the President’s plan, contributions to accounts are accumulated at a 3 percent interest rate above inflation and subtracted from the traditional defined Social Security benefit at retirement. This is the “benefit offset.”

accounts. Table 2 shows a range of estimates of this loss for workers retiring in 2055, with annual losses ranging from \$706 to \$3,792.

Table 2

Effect of Alternative Administrative Cost Assumptions on Participants (inflation-adjusted 2005 dollars, annual values)				
	Annual Admin. Costs	Account Value at Retirement (annuity)	Social Security Benefit Offset for IAs	Net Change
Centralized system (limited choice)	0.30%	\$10,057	-\$10,763	-\$706
Centralized system (more choice)	0.73%	9,140	-10,763	-1,623
Decentralized system (limited choice)	1.00%	8,616	-10,763	-2,147
Decentralized system (more choice)	2.00%	6,971	-10,763	-3,792

For lower-income workers who are not fully diversified, accounts are one way to increase their exposure to equities. Without adjusting for risk, the benefit of investing in equities is measured by the equity premium: the difference between the average rate of return on stocks and the average rate of return on bonds. Financial experts project that the equity premium will be anywhere from 1 to 4.5 percent going forward.³² After adjusting for risk, however, the benefits of diversification for lower-income workers are considerably smaller than the equity premium and could be more than outweighed by the additional administrative costs. In addition, there are other ways to increase equity exposure for undiversified workers without increasing overall retirement risk by reducing Social Security benefits. For example by making it easier and more automatic to save through IRAs and 401(k)s.³³

The costs shown in Table 2 are solely those associated with the accounts. In addition, workers would see their annual benefits reduced by thousands of dollars in any plan that, like the President's, relies principally on benefit reductions to restore solvency.

Fourth, establishing private accounts generally result in a large increase in debt held by the public and would increase the risks facing financial markets and fiscal policy.

Carveout private accounts take payroll taxes that are currently used to pay benefits (or augment the trust fund) and divert them into accounts. The government is forced to borrow money to make up for the diverted funds resulting in a substantial increase in debt held by the public. Many add-on accounts also require substantial borrowing to fund the account contributions directly or to fund tax incentives for contributors to accounts. These large, and in

³² The 4.6 percent estimate is from the Social Security actuaries. The 1 percent is the bottom of the range in a survey of 10 leading financial economists by the *Wall Street Journal*. The median equity premium in that survey was 1.8 percent. See Mark Whitehouse, "Social Security Reform Plan Leans on Bullish Market," *Wall Street Journal*, February 28, 2005.

³³ See the work of the Retirement Security Project at www.retirementsecurityproject.org.

some cases permanent, increases in the debt augment the risks facing financial markets and fiscal policy.

As Harvard economist Martin Feldstein explained in a paper he wrote in 2001, he had advised against President Reagan establishing individual accounts in part because “the overall budget was in substantial deficit, starting to fund investment-based accounts would have required a tax increase or an even larger overall budget deficit.”³⁴

According to the Social Security actuaries, the President’s accounts would cost \$743 billion over the first seven fiscal years (from 2009 to 2015). Even this estimate is not fully reflective of the fully phased-in cost because the accounts would only be available to all workers for the last four of these seven years.³⁵

Over longer periods, the effect on the debt would be far greater. The President’s accounts would add \$1.5 trillion to the debt over the first ten years that the plan is in effect (from 2009 to 2018). The accounts would cause the debt to increase by another \$3.8 trillion in the decade after that, for a total of \$5.3 trillion over the first twenty years.

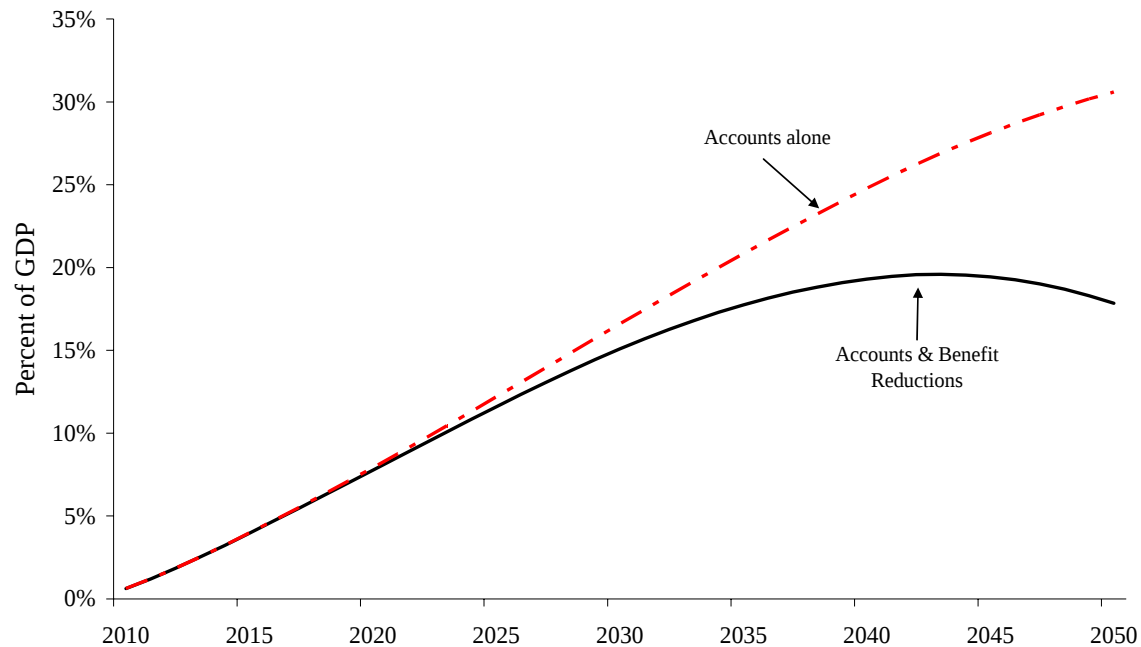
The sliding-scale benefit reductions that the President is proposing would reduce the debt by relatively modest amounts in coming decades. Over the first twenty years, those benefit reductions would reduce the debt by \$400 billion. The combined effect of the accounts and the sliding-scale benefit reductions the White House is proposing would add \$4.9 trillion to the debt over the first twenty years.

The debt would continue to rise after twenty years, both in dollar terms and as a share of GDP, as shown in Figure 1. The accounts, by themselves, would lead to *permanently* elevated debt. Although the sliding-scale benefit reductions would eventually start to bring that debt down, the debt would remain elevated through 2067. This would lead to higher interest payments on the debt, increasing the burden for future taxpayers.

³⁴ Martin Feldstein, “Comments on Fiscal Policy and Social Security Policy During the 1990s,” in Jeffrey A. Frankel and Peter R. Orszag (eds.) *American Economic Policy in the 1990s*, Cambridge, MA, MIT Press, 2002.

³⁵ The accounts would not be available to all workers until 2011 and they would not be phased fully in until 2041. That is the year in which the cap on the maximum amount that could be diverted to a private account each year would rise to a high enough level so that all workers could contribute a full 4 percent of their taxable earnings to the accounts.

Figure 1. Additional Debt Held by the Public



Source: Author's calculations.

The additional debt associated with accounts would have a significant impact on financial markets, lowering stock returns and increasing bond rates.³⁶ According to Princeton economist Harvey Rosen, who recently stepped down as the Chairman of the Council of Economic Advisers, “In order to induce private investors to accept government bonds that would have been bought by the Trust Fund, their yield has to go up (increasing the debt burden on taxpayers), or the yield on stocks must fall, or both.”³⁷

Some have argued that the additional debt associated with the accounts would not harm financial markets or the economy more broadly. They argue that, over an infinite horizon, this debt diminishes or disappears and that as a result even the initially high levels of debt should be considered neutral from an overall fiscal position. Accounts causing no fiscal harm is the best case scenario. No one has argued that the debt associated with the accounts has any direct fiscal benefits.

There is a significant probability that the debt associated with the accounts would harm the economy.³⁸ The borrowing to pay for the accounts would take the form of “explicit debt,” that is government bonds. These bonds cannot be defaulted on and must be rolled over or serviced on an annual basis. This explicit debt would replace “implicit debt” in the form of

³⁶ Note, accounts could initially drive up stock prices conferring a windfall on existing equity holders. But with stocks more expensive, the future returns would be lower.

³⁷ Harvey S. Rosen, *Public Finance*, Seventh Edition, 2005, p. 208.

³⁸ For an extended discussion of these issues see Jason Furman, William G. Gale and Peter R. Orszag, “Should the Budget Rules Be Changed To Exclude the Cost of Individual Accounts,” *Tax Notes* January 24, 2005.

reduced future Social Security obligations. Implicit debt, however, is very different from explicit debt. It does not need to be rolled over or serviced on an annual basis. The total amount of implicit debt is based on projections and is not legally binding, unlike the tangible debt issued in the form of Treasury bonds.

Financial markets, both in the United States and abroad, are likely to be more troubled by the explicit debt than they currently are by the implicit obligations of the U.S. government. Federal Reserve Chairman Alan Greenspan testified that if financial markets did not distinguish between implicit and explicit debt, then the borrowing associated with accounts would have no impact on the market. But he went on to say, “But we don’t know that. And if we were to go forward in a large way and we were wrong, it would be creating more difficulties than I would imagine.”³⁹

The record is replete with nations undergoing fiscal crises because of explicit debt. No nation has undergone a fiscal crisis because of implicit debt.

Furthermore, rational financial markets would understand that the eventual repayment of the debt associated with the President’s accounts would be decades in the future and would depend on large and potentially politically unsustainable benefit reductions. To the degree that financial markets partially discounted these benefit reductions or factored in the possibility of a government bailout in the event of a major stock market crash, this added debt would have a significant impact.

In summary, the accounts portion of the President’s plan would result in *permanently* higher debt than the same plan without accounts. Even when combined with sliding-scale benefit reductions, the debt would be elevated for more than sixty years. It is important to remember that even from the vantage point of 2067, when the debt would be the same as under current law, the proposal would be judged a failure. The goal of Social Security reform is not to leave the debt the same as under current law, it is to significantly reduce the debt in order to help relieve future fiscal pressures. The debt associated with the President’s accounts proposal would have no upside benefits and substantial downside risks.

In conclusion,

I have outlined the financial ramifications of private accounts, in particular the substantial “hidden costs” associated with administration and new government staffing. These costs would lower the rate of return in a reformed system. At the same time, the debt associated with accounts poses new risks for financial markets and the economy.

These are only some considerations in establishing individual accounts, elsewhere I have gone into more detail about other issues.⁴⁰ Accounts do not help restore solvency and even hurt solvency over a finite horizon or even over an infinite horizon if the accounts are subsidized.

³⁹ Alan Greenspan Testimony, February 16, 2005.

⁴⁰ For a summary, see Jason Furman, “Evaluating Alternative Social Security Reforms,” Testimony Before the Full Committee of the House Committee on Ways and Means, May 12, 2005.

Accounts, by themselves, do not raise national savings and might even reduce national savings. Finally, if accounts are combined with deep benefit reductions to help restore solvency, the result is a radically transformed Social Security system, a large increase in risk in the secure tier of retirement income, and a reduction in the overall retirement benefit.

A better Social Security reform would modify the current system to make it sustainably solvent. In addition, there is substantial scope for encouraging genuinely new savings and financial investment *without* the need for any new government staff or large new fixed costs associated with establishing additional accounts. Specifically, this could be done through making it easier and potentially more rewarding to save through existing vehicles like 401(k)s and IRAs.