"Voluntary Individual Accounts: The Lessons from the U.K. Experience"

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Mr. Chairman and Members of the Subcommittee, my name is Peter Orszag. I am currently the president of an economic consulting firm, and will join the Brookings Institution next week as a Senior Fellow in Economic Studies. It is an honor to appear before the Subcommittee to discuss Social Security reform and the lessons that we may be able to draw from experiences in countries that have adopted personal retirement accounts.

My testimony this morning will focus on the United Kingdom, which has had a system of voluntary individual accounts for more than a decade. The U.K. offers two important advantages in providing lessons for the Social Security debate in the United States.

First, although cross-country comparisons are fraught with difficulties, the U.K. is similar in many ways to the United States. In addition to our shared language and traditions, both the U.K. and the U.S. are advanced industrialized economies. Many of the other countries cited in the debate over individual accounts are developing economies, which face substantially different challenges than we do. Drawing lessons for the United States from the experiences of these developing economies is particularly difficult.

Second, the U.K. is the only industrialized nation of which I am aware that allows individuals to opt out of its state-run Social Security system and into an individual account. Other industrialized countries have adopted individual accounts, but have made them mandatory. The U.K. thus provides an important case study on the operation of *voluntary* individual accounts.

As you know, the Bush Administration has endorsed such voluntary accounts. One of its guiding principles for Social Security reform is that "Modernization must include individually

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controlled, voluntary personal retirement accounts, which will augment Social Security."[2] I hope that the experience with voluntary accounts in the U.K. will prove helpful to you in evaluating the potential costs and benefits of such accounts here.

Voluntary individual accounts likely seem innocuous at worst, and quite promising at best, to many who first hear about them. After all, how can anyone be opposed to such accounts if participation is voluntary? Unfortunately, as I hope to illustrate through the experience in the U.K., the reality is more complicated.

I. Background on the U.K. pension system

The pension system in the United Kingdom is complicated.[3] It consists of two tiers: a flat-rate basic state pension, and an earnings-related pension. The government provides the first tier, which is not related to earnings. The second tier, which can be managed by an individual, his or her employer, or the government, depends on an individual's earnings history.

Basic State Pension

The first tier of the U.K. pension program is called the basic state retirement pension (BSP). The BSP is a pay-as-you-go system. Under the BSP, a portion of the National Insurance Contribution (NIC) payroll tax finances a flat-rate benefit for retirees. In other words, once a worker qualifies by working for a sufficient number of years, this basic benefit does not vary with the worker's earnings level. The full benefit payments amount to about £70 (or about $100) per week per person. Currently, about 11 million pensioners, or virtually the entire population of retirees, receive a basic state pension. Such pensions currently provide about one-third of total income for retirees.

The State Earnings-Related Pension Scheme and Opting Out

The second tier of the U.K. system offers three different alternatives to workers. Roughly one-quarter of full-time British workers currently choose the most basic option, the State Earnings-Related Pension Scheme (SERPS). SERPS is similar in some senses to our Social Security system: It is run by the government and provides an earnings-related defined benefit pension. When it was first introduced in 1978, SERPS was relatively generous. Over time, a series of reforms made the

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[2] President Bush has also recently appointed a commission to examine how to design and implement voluntary individual accounts (see http://www.commtostrengthensocsec.gov). Former Senator Daniel Patrick Moynihan is one of the co-chairs of that commission. Senator Moynihan previously sponsored legislation in 1998 (S. 1792) that included voluntary individual accounts.

[3] For more detailed discussion on the features of the U.K. pension system, see Lillian Liu, "Retirement Income Security in the United Kingdom." ORES Working Paper 79, Social Security Administration, 1998; and Mamta 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* (The World Bank, 2001).

program less attractive to middle- and upper-income workers.[4] Beginning in April 2002, SERPS will be replaced by the State Second Pension, which will provide substantially improved benefits for lower- and moderate-earners.

Workers who opt out of SERPS receive a NIC tax rebate and, as a result, do not accrue SERPS benefits. Since their subsequent pensions are in effect not financed out of NIC taxes, the government provides a payroll tax rebate to reflect reduced future SERPS payments. The tax rebate then finances an employer-provided pension or an individual account. The two opt-out options are:

- *Individual Accounts*. Since 1988, one way to opt out of SERPS has been through an individual account. About 25 percent of workers in the United Kingdom are currently enrolled in individual accounts. The government's payroll tax rebate finances contributions into individual accounts that are roughly equivalent to three percent of average annual earnings for American workers covered by the U.S. Social Security system. Roughly half of those who have these accounts contribute an additional amount on top of the government rebate.

- *Employer-Based Pensions.* About half of all workers participate in an employer-sponsored pension plan (often referred to as an "occupational pension"). Occupational pensions can be either defined benefit or defined contribution plans.

To summarize, roughly one-quarter of workers belong to the state-run program (SERPS). One-quarter opt out of SERPS and into individual accounts, and one-half opt out of SERPS and into employer-based pensions.

II. Design of Voluntary Individual Accounts

The individual accounts adopted in the U.K. illustrate many of the difficult implementation issues that any system of voluntary accounts in the United States would face:

<u>Consumer protection and financial advice</u>

One crucial challenge in a voluntary system is how to ensure that workers make good decisions about whether to opt into the individual accounts. This concern is particularly relevant to the U.K. experience.

In the United Kingdom, in what has become known as the "mis-selling" scandal, individuals were deceived as to the benefits of individual accounts. High-pressure sales tactics were used to persuade workers to switch into unsuitable individual account plans. Sales agents had often sought

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[4] For a description of the reforms, many of which were designed to encourage movement to either employer- or individual-based pension systems, see Lillian Liu, "Retirement Income Security in the United Kingdom," ORES Working Paper 79, Social Security Administration, 1998.

too little information from potential clients to provide proper advice.

The U.K. regulatory authorities began an investigation of this mis-selling phenomenon after the problem became apparent in the early- to mid-1990s. As a result of this investigation, financial firms are being forced to repay amounts estimated at more than $15 billion to the individuals who were given misleading advice. In addition, regulators have adopted a more aggressive enforcement stance for the advice offered to individuals.

If voluntary individual accounts were adopted in the United States, careful attention would have to be given to ensuring that individuals were given responsible advice regarding whether they should opt for such accounts. Two issues arise with regard to such advice and financial education. First, an important question involves who should provide the advice: independent analysts, the government, the financial firms offering the accounts, or some combination thereof. The U.K. experience suggests that allowing advice to be provided by the financial firms themselves may cause significant problems, even in the presence of comprehensive and good-faith regulation. Second, the costs of providing the advice should not be under-estimated. Even in the United States, financial literacy levels are surprisingly low. For example, according to the Securities and Exchange Commission, more than half of all Americans do not know the difference between a stock and a bond; only 12 percent know the difference between a load and no-load mutual fund; only 16 percent say they have a clear understanding of what an Individual Retirement Account is; and only 8 percent say they completely understand the expenses that their mutual funds charge.[5]

Temporary or permanent opt-out choices

If workers are allowed to partially opt out of Social Security, is the choice a permanent one? Or would an individual be allowed to opt out in some years and opt back in others? Either approach has potential problems. Making the choice irrevocable could strand some workers who realize they made a mistake in opting out. But allowing workers to move back and forth between the two systems could increase the opportunities for gaming both systems, as well as increase the administrative burdens and costs for the Social Security Administration, which would have to track the choices that workers made each year regarding whether to divert payroll contributions to individual accounts or to remain within the pure Social Security system.

The U.K. has chosen to allow workers to switch back and forth between the state-run system and individual accounts. This policy decision means that workers must decide on an ongoing basis whether to opt into individual accounts, and has raised the costs associated with providing advice to workers on the best option available to them. The data on switching are unfortunately limited because of the complexity of the system, but it appears that switching among the options is more likely when workers change jobs.

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[5] Arthur Levitt, Speech at the John F. Kennedy School of Government, Harvard University, October 19, 1998.

Age-related incentives to opt into individual accounts

If participation in a system of individual accounts is voluntary, and if workers can switch back and forth between the individual account and the state-run system, workers will typically find it more attractive to opt into the individual account when young and then into the state-run system when old.

For example, consider two workers earning $25,000 a year. One worker is aged 60 and intends to retire in five years. The other worker is aged 25 and intends to retire in 40 years. Both are given the option to put two percent of their wages into an individual account. If the older worker puts two percent ($500) of her wages into an individual account and earns five percent per year (after inflation) on the balance in the account, her account will accumulate to $638 (in inflation-adjusted dollars) upon retirement. However, if the younger worker puts two percent ($500) into an individual account and earns the same rate of return per year as the older worker, the $500 will accumulate to more than $3,500 upon retirement because interest will compound for a much longer number of years. If both workers would receive $750 more in lifetime Social Security benefits if they did *not* opt to contribute the $500 to the individual account, the older worker should choose not to contribute to the account (since $638 is less than $750) while the younger worker should choose to do so (since $3,500 is more than $750). If switching back and forth between the two systems is allowed, a worker would likely find it advantageous to opt into individual accounts when young and then back into the state-run system when old.

To offset the incentive of younger workers to disproportionately opt into individual accounts, the U.K. has adopted an age-related tax rebate scheme. Workers who opt into an individual account obtain a rebate on their payroll taxes, which is used to fund the individual account contribution. But the rebate rate is larger for older workers and smaller for younger workers. The purpose of these age-related rebates is to offset the impact of age on the incentives to opt into individual accounts. The age-related rebates, however, further complicate the administration of the system and are confusing to many workers.

Disproportionate incentives for higher earners to opt into individual accounts

In designing a system of voluntary accounts, one must also consider how the incentives to opt into individual accounts vary by earnings level. For example, the existing Social Security system in the United States is progressive: higher-income workers receive lower rates of return than lower-income workers, even after taking into account the longer life expectancies of higher earners. Higher-income taxpayers would therefore generally have a stronger incentive to partially opt out of the Social Security system than lower-income taxpayers, since Social Security represents a less attractive deal for higher earners than lower earners.

The tendency of higher earners to find individual accounts more attractive is precisely what has occurred in the U.K.: Higher earners have disproportionately opted out of the state-run system.

Indeed, the majority of Britons who remain enrolled in SERPS today earn less than £10,000 annually. It may be possible to design voluntary individual accounts that would provide stronger incentives for lower earners to opt into them, but the challenges in doing so are substantial. In any case, the U.K. has not pursued that path.

The partial withdrawal of higher-income workers under a voluntary system of individual accounts leaves behind a pool of disproportionately lower-income workers. The partial withdrawal of higher-income workers from Social Security consequently would weaken the system's ability to accomplish redistribution toward such lower-income workers. As Harvard economist David Cutler has emphasized:

> "We typically think that giving people choice is optimal since people can decide what is best for them. Thus, the economic bias is to believe that, if people want to opt out of social security, they should be allowed to do so. In the context of social security privatization, however, this analysis is *not* right. Allowing people to opt out of social security to avoid adverse redistribution is not efficient; it just destroys what society was trying to accomplish....An analogy may be helpful. Suppose that contributions to national defense are made voluntary. Probably, few people would choose to contribute; why pay when you can get the public good for free? Realizing this, we make payments for national defense mandatory. The same is true of redistribution. Redistribution is a public good just as much as national defense; no one wants to do it, but everyone benefits from it. As a result, making contributions to redistribution voluntary will be just as bad as making contributions to national defense voluntary. We need to make redistribution mandatory, or no one will pay for it."[6]

Such factors suggest that *voluntary* individual accounts pose unique challenges, which is why most proponents of individual accounts would make them mandatory. But other features of the U.K. system highlight some of the issues that must be addressed in any system of individual accounts, including mandatory ones. Such issues include:

Choice of providers and investments

The U.K. has a decentralized system of individual accounts, somewhat similar to the rules governing Individual Retirement Accounts in the United States. The individual accounts in the U.K. can be held at a wide number of financial institutions. The assets in the individual accounts can be held in a variety of different forms, and are not restricted to broad market index funds. An alternative would mimic the more centralized approach of the Thrift Savings Plan, by restricting where the accounts could be held and the types of assets they could hold.

This choice involves a difficult tradeoff: Decentralized systems, such as the one in the U.K.,

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[6] David Cutler, "Comment on Gustman and Steinmeier, 'Privatizing Social Security: Effects of a Voluntary System,'" in Martin Feldstein, editor, *Privatizing Social Security* (University of Chicago Press: Chicago, 1998), page 358.

typically involve substantially higher administrative costs than more centralized systems.[7] They also expose individuals to the possibility of making particularly poor investment choices, and therefore require even more aggressive financial education efforts than centralized plans.

Although centralized systems of individual accounts are preferable to decentralized systems because they reduce administrative costs and ensure diversified portfolios, such centralized systems tend to generate less political enthusiasm. They also raise many of the same political issues (such as the choice of which firms are included in the index funds) that would be involved in allowing the government to invest directly in private assets.

Fee regulations

As explained below, administrative costs on individual accounts in the U.K. have proven to be extremely high. The government has recently adopted a series of reforms to cap the fees that financial providers can impose on a new type of individual accounts, called Stakeholder Pensions. The previous experience with individual accounts in the absence of fee regulations suggests that competition alone is insufficient to reduce fees to reasonable levels (see below).

Annuitization

The SERPS program in the United Kingdom automatically provides an inflation-adjusted annuity to beneficiaries. Systems of individual accounts often mandate that accounts be converted into an annuity upon retirement (in other words, the account value is exchanged for a monthly or annual payment that is made as long as the retiree or the retiree's spouse is alive) to ensure that individuals avoid outliving their savings. The regulations governing when an annuity must be purchased in the United Kingdom are complicated. They require that the portion of an individual account funded by tax rebates (as opposed to any additional contributions) must be fully annuitized. The annuity must be purchased at some point between age 60 and age 75. The portion of an individual account funded by additional contributions (beyond the tax rebate) does not have to be entirely annuitized. In particular, up to 25 percent of the accumulated balance from this component of the individual account can be withdrawn tax-free in a lump sum. If workers die before annuitizing their account, the balance of the account enters their estate.

Many supporters of individual accounts highlight the potential of such accounts to provide payments to heirs. It is crucial to realize, however, that providing a payment to heirs requires that a retiree receive a lower monthly annuity payment and have less to live on in old age. The iron laws of finance demand such an outcome, since the same dollars can be used for only one purpose. Thus, each dollar that a pensioner can bequeath to heirs means a dollar less to support retirement income, because the pool of funds available to finance retirement benefits is reduced. This iron law holds for

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[7] 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* (The World Bank, 2001).

all pensions — Social Security, private pensions, and individual accounts.

Annuities in the U.K. illustrate this tradeoff. To ensure adequate retirement income, individual accounts accumulated from tax rebates must be annuitized using a basic annuity, under which the payments end with the death of the annuitant. In other words, following annuitization, heirs receive *nothing* from the individual accounts that had been accumulated from tax rebates.

For those who made additional contributions to their accounts (beyond the tax rebates), other options are available. For example, more complicated annuities offer a guaranteed payment period. Under these annuities, the heirs receive some payment if the annuitant dies before the end of the guaranteed period. In the U.K. market, for example, a 65-year-old single man who had accumulated a £100,000 account could turn that balance into an annuity payment of about £9,000 per year for as long as he lived.[8] That would, however, leave nothing for his heirs. To obtain a 10-year guaranteed payment period, he would have to accept a lower annuity payment per year. In the U.K. market, the cost involved would reduce his annuity per year by about £550, or roughly 6 percent.[9] And that would provide a payment to his heirs only if he died before age 75. If he died after age 75, the annuity payments would end with his death and the heirs would receive nothing. The U.K. market data highlight the unavoidable tradeoff between the provision of retirement income and the provision of a bequest to heirs.

III. Administrative costs

A final and crucial lesson to be learned from the U.K. experience with voluntary accounts involves administrative costs. Operating individual accounts entails various costs that reduce the account balances. The level of administrative costs in a system of individual accounts would depend on a number of factors, including: how centralized the system of accounts was and how limited the investment choices were; the level of service provided (e.g., whether individuals enjoyed unlimited telephone calls to account representatives, frequent account balance statements, and other services); the size of the accounts; and the rules and regulations governing the accounts. The higher the administrative cost, the lower the ultimate benefit a worker would receive (all else being equal), since more of the funds in the accounts would be consumed by administrative costs and less would be left to pay retirement benefits.

Administrative costs for voluntary accounts are likely to be substantially higher than for mandatory accounts, since voluntary accounts involve administrative complexities not present in a mandatory system. For example, voluntary systems require tracking which workers have opted into the individual account system; a mandatory system can instead rely on comprehensive worker records. Voluntary systems also require the provision of more advice to beneficiaries, since beneficiaries need to decide whether to opt into individual accounts (and to opt partially out of Social Security).

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[8] See http://www.annuity-bureau.co.uk/rates.html.

[9] See http://www.annuity-bureau.co.uk/annuity-optional.html

Evidence from the United Kingdom shows that the voluntary individual account system there has produced significantly higher administrative costs than under mandatory individual account systems in other countries.

Along with two colleagues, I recently completed a World Bank study of administrative costs in the United Kingdom.[10] We focused on the system of individual accounts before the new type of individual accounts, with capped fees, were introduced.

We concluded that over a working career, the historical fees in the U.K. would have reduced account balances for the typical worker by *43 percent* relative to the balances that would accrue in the absence of administrative costs. Other studies by actuaries and financial analysts in the United Kingdom have reached similar conclusions.[11] (The 43 percent estimate includes the cost of converting the account balance to an annuity upon retirement. Without such annuitization costs, the historical administrative costs in the U.K. system would have reduced account balances for the typical worker by 36 percent.) These high administrative costs dramatically reduce the retirement income from individual accounts.

These charges indicate that competition alone is not sufficient, or at least was not sufficient in the U.K., to reduce fees to reasonable levels. Indeed, in response to the high charges imposed on individual account holders, the U.K. government has recently adopted reforms to cap the fees that can be charged by individual account providers. The political viability of such regulations in the United States is unclear.

Conclusion

Although they may sound attractive, voluntary individual accounts involve a variety of very difficult administrative issues. The experience in the United Kingdom should serve as a particularly forceful indicator of the potential problems associated with voluntary individual accounts. The United Kingdom has witnessed a scandal in which vulnerable members of society were given misleading advice regarding the benefits of individual accounts and also has suffered from high administrative costs under its voluntary individual account system that sharply reduce the retirement benefits those with such accounts eventually receive. The government has recently been forced to impose a cap on the fees that can be charged on individual accounts by financial firms.

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[10] Mamta 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* (The World Bank, 2001). For a summary, see Peter Orszag, "Administrative Costs in Individual Accounts In The United Kingdom," Center on Budget and Policy Priorities, March 1999, available at http://www.cbpp.org.

[11] See John L. Shuttleworth,, "Operating costs of different forms of pension provision in the U.K.," Coopers & Lybrand, June 27, 1997, and John Chapman, "Pension plans made easy," *Money Management*, November 1998.

Finally, it is important to remember that voluntary individual accounts do nothing in and of themselves to improve Social Security's financial condition. To the extent that they divert current revenue away from Social Security, they could exacerbate the Social Security shortfall. Individual account contributions equal to two percent of taxable payroll, in and of themselves, would increase the 75-year long-term deficit within Social Security from 1.9 percent of taxable payroll to 3.9 percent of taxable payroll. Policy-makers considering a system of voluntary individual accounts in the United States should carefully examine the potential costs involved. The fact that the accounts are voluntary does not mean they are not harmful.