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Social Security Reform: Lessons from Private Pensions

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SOCIAL SECURITY REFORM: 
LESSONS FROM PRIVATE PENSIONS

Karen C. Burke† & Grayson M.P. McCouch††

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INTRODUCTION

Widespread concerns about the long-term fiscal gap in Social Security have prompted various proposals for structural reform, with individual accounts as the centerpiece. In particular, the proposals issued by the President’s Commission to Strengthen Social Security in its 2001 final report would carve out a substantial portion of the existing defined benefit structure and replace it with voluntary individual accounts, resulting in a novel hybrid system.¹ The proposal to introduce individual accounts into the public system, while not fully specified, reflects a parallel shift from traditional defined benefit plans to defined contribution plans which has already unfolded in the private system of employer-provided pensions. In both public and private contexts, the debate over the structure of retirement savings programs exposes a deeper struggle over the goals of national retirement policy and the appropriate allocation of risks and responsibilities among government, employers, and workers.

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I
PRIVATE PENSIONS IN TRANSITION

The rapid expansion of employer-based pension plans during and after World War II was fueled not only by preferential tax treatment and wage pressures but also by the exceptionally generous benefits that the Social Security system conferred on early cohorts of workers. Social Security benefits were tilted in favor of low-income workers due to a progressive benefit formula which produced a declining ratio of benefits to pre-retirement income for higher-income workers. Private pension plans were also subject to nondiscrimination rules, which limited the employer's ability to skew plan benefits in favor of highly compensated employees. In testing for nondiscrimination, however, employers were allowed to claim full credit for Social Security benefits by "integrating" them with employer-provided pension benefits. As a result, while Social Security benefits were weighted in favor of low-income workers, private plans channeled benefits to high-income workers, who stood to gain the most from tax incentives.

Unlike the mandatory Social Security system, private pension plans are voluntary and largely tax-driven. The employer receives an immediate deduction for pension contributions, but the employee is not taxed until amounts are distributed from the plan, and the plan itself is tax-exempt so that earnings on plan assets accumulate tax-free. Qualified plans rank among the largest tax expenditures in the federal budget and have prompted persistent concerns about the efficiency and fairness of using tax incentives to encourage retirement saving. To qualify for favorable tax treatment, employer-based plans have long been required to provide coverage to a broad cross-section of workers, not merely to those at the top of the salary scale. Because high-income workers generally have the greatest ability and inclination to save for retirement, the tax treatment of qualified plans juxtaposes a "carrot" in the form of a tax subsidy with a "stick" in the form of government regulation. According to the "liberal" view traditionally associated with redistributive communitarian goals and tax expenditure analysis, preferential tax treatment is justified only to the extent

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that it induces employers to establish and maintain broad-based plans which provide significant pension benefits for rank-and-file workers.\footnote{See, e.g., Daniel I. Halperin & Alicia H. Munnell, Ensuring Retirement Income for All Workers, in THE EVOLVING PENSION SYSTEM 155 (William G. Gale et al. eds., 2005); Norman P. Stein & Patricia E. Dilley, Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Debate, 58 WASH. & LEE L. REV. 1369 (2001).}

In contrast, a "libertarian" view, emphasizing freedom of choice and individual opportunity, challenges the premise of tax expenditure analysis and questions the utility of government regulation.\footnote{See, e.g., Theodore R. Groom & John B. Shoven, Deregulating the Private Pension System, in THE EVOLVING PENSION SYSTEM, supra note 4, at 123; Sylvester J. Schieber, The Evolution and Implications of Federal Pension Regulation, in THE EVOLVING PENSION SYSTEM, supra note 4, at 11.} According to this view, the appropriate baseline for evaluating the tax treatment of private pensions is not an income tax, which implicitly favors consumption over saving, but rather a consumption tax, which would remove from the tax base all returns to saving. From a consumption tax perspective, the current treatment of pension plans is normatively correct and does not amount to a tax expenditure at all. Libertarians view current restrictions on private plans as costly, burdensome, and counterproductive, and they welcome 401(k) plans and individual retirement accounts (IRAs) as harbingers of a larger movement toward a consumption tax.\footnote{See, e.g., Edward A. Zelinsky, The Defined Contribution Paradigm, 114 YALE L.J. 451, 454 (2004) (describing the emergence of the "defined contribution society" as "a quiet, largely unheralded revolution" with fundamental consequences for tax and social policy).}

When the Employee Retirement Income Security Act (ERISA) was enacted in 1974, its regulatory provisions focused primarily on defined benefit plans, which at that time predominated over defined contribution plans. The situation has changed dramatically in the intervening years, as defined contribution plans have grown steadily and defined benefit plans have dwindled in relative importance.\footnote{By 2000, the value of assets held in defined contribution plans exceeded the value of assets held in defined benefit plans. See STAFF OF J. COMM. ON TAXATION, 107TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED CONTRIBUTION PLANS AND OTHER RETIREMENT ARRANGEMENTS 34 (Comm. Print 2002). Between 1992 and 2001, the share of households with pension coverage relying solely on defined contribution plans rose from 37% to 58%, while those relying solely on defined benefit plans fell from 40% to 19%, and 23% maintained dual coverage. See ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(k) PLANS 21 (2004).} In a traditional defined benefit plan, the employer promises to pay specified pension benefits to each covered employee upon retirement; the pension formula is typically based on the employee's years of service and final or average compensation. The employer sponsors the plan, funds it with contributions, directs the investment of plan assets, and bears the financial risk if those assets prove insufficient to pay promised benefits. Benefits are generally payable to the employee upon
retirement in the form of a single-life annuity (or a joint-and-survivor annuity, in the case of a married employee); before retirement, the employee typically has no access to pension funds. In contrast, 401(k) plans, which have become the dominant form of defined contribution plans, generally give employees control over crucial decisions concerning participation, contributions, investments, and distributions. The shift away from defined benefit plans has major implications for the allocation of risks and opportunities in the private pension system.

A. Tax Incentives for Coverage

The evolution of private plans since ERISA's enactment reflects a contest between the liberal objective of broadening pension coverage through targeted tax subsidies and the libertarian goal of reducing the burdens of taxation and regulation. In 1981, Congress slashed the top marginal tax rates but failed to restrain government spending, which led to mounting budget deficits. During the next several years, Congress scaled back the tax subsidy for private plans through new limits on contributions and slower funding rules, in an attempt to assert some degree of fiscal discipline without jeopardizing the tax-cutting agenda. At the same time, Congress also imposed new regulatory measures to ensure broader distribution of pension benefits and deter excessive accumulations. The strategy of reducing tax benefits and increasing regulatory requirements reached a high-water mark in 1986, but its political and practical limitations became increasingly apparent during the following decade. By the late 1990s, as the budget situation gradually improved, the pendulum began to swing back in the direction of relaxing regulatory restrictions and expanding opportunities for tax-preferred individual saving.

In 1986, as part of a comprehensive revision of the tax code, Congress imposed new limits on contributions and benefits for highly compensated employees as well as stricter coverage and nondiscrimination requirements. These changes were intended both to encourage broader pension coverage and benefits for low- and moderate-income workers and to limit revenue losses from the tax expenditure for qualified plans. The efficacy of the tax subsidy, however, was undermined by declining marginal tax rates, and the attraction of qualified plans was reduced by restrictions on contributions and benefits for highly compensated employees. Given the voluntary nature of qualified plans, it is hardly surprising that employers responded to the 1986 legislation not by expanding pension coverage

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8 See Schieber, supra note 5, at 30–32 (noting efforts in 1982 and 1984 to contain tax expenditure for pensions).

or broadening benefits among the rank and file but rather by searching for more valuable alternative forms of compensation.

As the attractiveness of qualified plans has diminished, many employers have resorted to nonqualified deferred compensation arrangements to remunerate highly paid employees. In general, a nonqualified plan consists of the employer’s unfunded, unsecured promise to pay pension benefits to the employee in the future. Both the employer’s deduction and the employee’s inclusion are deferred until the benefits are actually paid. Even if the employee and employer could earn the same pre-tax rate of return on an equivalent investment, deferral is advantageous to the employee whenever the employer’s marginal tax rate is lower than the employee’s. The principal attraction of nonqualified plans is that they are exempt from the regulatory requirements associated with qualified plans. As a result, private pension plans have evolved toward a two-tier system, with qualified plans for the rank and file and nonqualified plans for highly compensated employees.10

From a liberal perspective, the private pension system may be failing to accomplish its goals. While the nondiscrimination rules may have helped to limit tax expenditures for highly paid employees, they have done little to improve qualified plan coverage for the rank and file.11 Indeed, private pensions provide a negligible amount of retirement income for employees in the bottom 40% of the income scale.12 Moreover, the growth of 401(k) plans is unlikely to result in expanded coverage. Given a choice between immediate cash compensation and tax-preferred retirement saving, most low-income employees prefer cash, despite the tax benefits of qualified plans. Even as private pen-

10 See Groom & Shoven, supra note 5, at 134; Halperin, supra note 3, at 33–35, 50.
11 Less than half of workers in the private sector currently participate in pension plans. See Munnell & Sundén, supra note 7, at 6 (noting that pension coverage has remained "virtually stagnant" since the late 1970s); see also Robert L. Clark et al., Effects of Nondiscrimination Rules on Pension Participation, in PRIVATE PENSIONS AND PUBLIC POLICIES 259, 278–79 (William G. Gale et al. eds., 2004) (finding that nondiscrimination rules have not increased coverage of low-wage workers in absolute or relative terms); Peter R. Orszag, Comment, in PRIVATE PENSIONS AND PUBLIC POLICIES, supra, at 280, 285–86 (suggesting that even if nondiscrimination rules do not improve coverage, they may help to spread the tax expenditure more equally).
12 In 1998, pensions provided only 3% of income for retired workers over age sixty-five in the bottom quintile and 7% for those in the second-lowest quintile. See Halperin & Munnell, supra note 4, at 156. The distribution of retirement savings in defined contribution plans and IRAs is similarly skewed; in 2001, the median account balance for families in the lowest two quintiles was zero. See Nat’l Acad. of Soc. Ins., UNCHARTED WATERS: PAYING BENEFITS FROM INDIVIDUAL ACCOUNTS IN FEDERAL RETIREMENT POLICY 31–32 (Virginia P. Reno et al. eds., 2005), available at http://www.nasi.org/usr_doc/Uncharted_Waters_Report.pdf.
sion coverage falters, the tax expenditure for retirement saving has exceeded the net increase in total personal saving in recent years.\textsuperscript{13}

Libertarians assess the impact of the nondiscrimination rules quite differently. They view the nondiscrimination rules chiefly as a barrier to saving by high-income earners rather than as an inducement to saving by low-income earners. Since individuals differ widely in their taste for saving, the nondiscrimination rules represent an implicit tax to the extent that they require plans to cover employees who place a low value on pension coverage. As a result, some of the burden of subsidizing pension coverage for reluctant savers falls on employers and on employees who place a high value on retirement saving. In contrast, 401(k) plans permit employees to sort themselves according to their tastes for saving, resulting in more efficient channeling of the tax subsidy.\textsuperscript{14} For libertarians, the goal is not to curb excessive saving by highly paid employees, but rather to remove existing impediments to saving and to expand opportunities for individuals to save as they see fit for retirement and other purposes.\textsuperscript{15}

B. Decline of Defined Benefit Plans

Over the past thirty years, the decline of defined benefit plans has indisputably coincided with the rise of defined contribution plans, but the reasons for the shift remain controversial. The decline of traditional defined benefit plans can be traced in part to structural changes in labor markets and economic trends: intense competition from low-wage labor overseas, prompting employers to downsize workforces and demand significant concessions from the remaining employees; a decline in average job tenure; a dramatic erosion of labor union membership and bargaining power; the emergence of health care as the most important employer-provided fringe benefit for rank-and-file employees, displacing retirement benefits; and a widening gap in compensation between highly compensated and rank-and-file employees.\textsuperscript{16} In light of these trends, the assumption underpinning traditional defined benefit plans—a stable workforce with secure job tenure—has become largely obsolete.

Some observers believe that defined contribution plans have crowded out defined benefit plans that otherwise would have flour-

\begin{itemize}
  \item \textsuperscript{13} See Elizabeth Bell et al., \textit{Retirement Saving Incentives and Personal Saving}, 105 Tax Notes 1689, 1689 (2004).
  \item \textsuperscript{14} See Richard A. Ippolito, \textit{Disparate Savings Propensities and National Retirement Policy}, in \textit{Living With Defined Contribution Pensions} 247, 252–53 (Olivia S. Mitchell & Sylvester J. Schieber eds., 1998) (suggesting that "a 401(k) plan with matching encourages workers to align their pay and productivity without imposing monitoring costs on the firm").
  \item \textsuperscript{15} See Groom & Shoven, \textit{supra} note 5, at 140–41.
  \item \textsuperscript{16} See William G. Gale et al., \textit{The Shifting Structure of Private Pensions}, in \textit{The Evolving Pension System}, \textit{supra} note 4, at 51, 62–65; Schieber, \textit{supra} note 5, at 44–45.
\end{itemize}
ished. However, an alternative view suggests that defined benefit plans would have withered in any case, due in large part to the increasingly heavy burden of government regulation. ERISA's regulatory scheme bears more heavily on defined benefit plans and thus puts them at a comparative disadvantage relative to defined contribution plans. For example, ERISA requires that defined benefit plans pay annual premiums to the Pension Benefit Guaranty Corporation (PBGC), which monitors plan solvency and guarantees payment of a portion of promised benefits. ERISA also imposes minimum and maximum funding rules. For an employer, accelerated funding of a defined benefit plan offers a significant tax advantage because the plan's investment earnings accumulate tax-free, whereas the same return on assets held outside the plan would be taxable.

To prevent employers from using excess funds in qualified plans as a source of corporate financing, in 1986 Congress imposed a 10% excise tax (later increased to 50%) on asset reversions to employers from overfunded plans. One year later, Congress tightened the "full funding" provisions, which limit employers' ability to advance fund pension obligations on a tax-preferred basis. These restrictions sought to balance the goal of adequate funding of defined benefit plans against the need to limit the cost of the tax subsidy. During the stock market boom of the 1990s, rapidly increasing asset values allowed many employers to suspend contributions to defined benefit plans. The contribution holiday ended abruptly in 2000 and 2001, when falling stock prices and low interest rates produced a spike in required employer contributions. Critics argued that the funding limits would force employers who had been prohibited from advance-funding their plans during the boom years either to make massive catch-up contributions or to cut back promised future benefits.

Employers' attempts to slow the growth of funding obligations may help to explain the recent trend toward abandoning traditional defined benefit plans in favor of "cash balance" plans—hybrids which combine defined benefit and defined contribution features. A cash balance plan is formally classified as a defined benefit plan and is managed by the employer, who contributes funds to the common pool, controls investment decisions, bears financial risk, and pays insurance premiums to the PBGC. However, the defined benefit for each employee is equal to the balance in a notional individual account based on deemed contributions and deemed interest at a pre-

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17 See Munnell & Sundén, supra note 7, at 22; Schieber, supra note 5, at 43–46.
18 See Schieber, supra note 5, at 46–47.
19 By 2000, cash balance plans accounted for nearly one-fourth of all workers covered by defined benefit plans. See Gale et al., supra note 16, at 57. Conversion to a cash balance plan is also the only viable method of terminating an overfunded traditional defined benefit plan without incurring an excise tax on the plan reversion.
scribed rate. Thus, from the employee's perspective, a cash balance plan resembles a defined contribution plan: The employee receives periodic statements showing an account balance that the employee may withdraw in a lump sum upon termination of employment.

Conversions of traditional defined benefit plans to cash balance plans are controversial because they tend to favor younger workers at the expense of older workers, and it remains to be seen whether such conversions will withstand age discrimination challenges. Conversions of traditional defined benefit plans to cash balance plans are controversial because they tend to favor younger workers at the expense of older workers, and it remains to be seen whether such conversions will withstand age discrimination challenges.20 Pension conversions and "freezes" also raise concerns about the adequacy of total expected retirement benefits for the workers involved. Ironically, changes in the structure and funding of defined benefit plans may weaken retirement security for mid-career workers precisely when they must confront the prospect of Social Security reform.

C. Retirement Saving and Personal Wealth

According to the liberal view of tax-preferred retirement saving, pensions are intended to provide employees with income that, in conjunction with Social Security, will enable them to maintain an adequate standard of living during retirement. Under this view, it is appropriate to tailor the tax subsidy to encourage employees to preserve pension funds for consumption during retirement and to limit the amount and duration of tax-favored saving. For example, qualified plans have long been subject to minimum distribution rules, which require that participants begin receiving annual distributions based on their actuarial life expectancy once they reach a specified age. Additionally, in 1986 Congress enacted excise taxes on early withdrawals from qualified plans and on excess distributions and accumulations. These tax provisions limited the cost of the tax subsidy for qualified plans and reinforced the goal of retirement income security by discouraging the diversion of pension funds for other purposes.

As the budget outlook improved during the 1990s, however, the libertarian view, with its emphasis on the goal of removing tax burdens and regulatory restrictions on individual saving and wealth accumulation, began to gain ground. Libertarians saw no reason to restrict favorable tax treatment to qualified plans or to require that pension funds be consumed during retirement, and critics assailed the excise taxes on excess distributions and accumulations as "success

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20 One court has rejected such an age discrimination challenge. See Cooper v. IBM Pers. Pension Plan, 457 F.3d 636 (7th Cir. 2006). Due to the back-loaded accrual of benefits under a traditional defined benefit plan, mid-career employees typically stand to lose more than younger workers when a plan is converted. Conversions may in turn undermine the value of pension promises and indirectly increase the cost to employers of maintaining traditional defined benefit plans. See Halperin & Munnell, supra note 4, at 172; Richard A. Ippolito, Comment, in PRIVATE PENSIONS AND PUBLIC POLICIES, supra note 11, at 43, 54 (warning of a potential "lemons market" in pensions).
Barely a decade after enacting these excise taxes, Congress reversed course and repealed them.\textsuperscript{22} Most significantly, in 2001 Congress substantially increased pension benefits available to high-income earners by raising contribution and benefit limits. Liberal opponents pointed out that increasing the contribution limits for 401(k) plans would benefit only a small group—less than 10%—of participating employees, mostly highly paid, who already contributed the maximum allowable amount.\textsuperscript{23} These opponents also disputed the claim that increasing the tax advantage of retirement saving for highly paid employees would encourage employers to establish more plans and ultimately produce "trickle-down" benefits for rank-and-file employees.\textsuperscript{24} The 2001 changes marked a decisive retreat from the earlier strategy of targeted tax subsidies and regulation of qualified plans and reflected an emerging view of retirement savings as accumulations of bequeathable wealth.

II 
ASSESSING THE 401(k) MODEL

Defined contribution plans, particularly those of the 401(k) type, have decisively overtaken traditional defined benefit plans as the predominant form of private pension plan. The distinctive characteristic of 401(k) plans is that they give individual employees unprecedented control over decisions concerning contributions, investments, and withdrawals of funds in their own accounts. Thus, 401(k) plans represent a major shift of risk and responsibility from employers to employees. Although the nature of this shift is clear, its implications for retirement policy remain controversial. Liberals worry that employees, especially those at the lower end of the wage scale, are likely to make poor decisions and be left with inadequate retirement income. In contrast, libertarians believe that employees are in the best position to make choices concerning saving and investing for their own retirement. Moreover, libertarians welcome 401(k) plans as an evolutionary step on the road to unlimited tax-favored saving.

\textsuperscript{21} Jay A. Soled \\
\textsuperscript{22} See id. In the late 1990s, Congress also relaxed the full funding limit for defined benefit plans and eased restrictions on early withdrawals in cases of "hardship" and other specified circumstances.
\textsuperscript{23} See Munnell \\
and Sundén, supra note 7, at 61–62; Halperin \\
and Munnell, supra note 4, at 187.
A. The Rise of 401(k)s

The growing popularity of 401(k) plans began in 1981, when the Treasury Department issued regulations approving "cash or deferred arrangements" in which employees elect to defer tax on a portion of their salary by directing the employer to contribute funds directly to a qualified defined contribution plan. The 401(k) model is attractive for both employers and employees. For employers, 401(k)s are less burdensome than defined benefit plans, both financially and administratively. In a 401(k), retirement benefits are based on the balance in each employee's individual account, which in turn depends on the employee's net contributions and investment performance; the employer is not responsible for providing any specified level of pension benefits.

For employees, the attraction of 401(k)s is that participation is voluntary: Each employee can choose either to contribute to his or her account (subject to deferred tax on withdrawal) or to receive compensation in cash (subject to immediate tax). Moreover, the entire account balance is fully vested and freely portable; changing jobs has no impact on account balances or future benefits. In addition, 401(k)s foster a sense of ownership which many employees find reassuring—employees receive periodic statements showing their account balances; plans typically allow employees to withdraw the entire balance in a lump sum upon retirement or termination of employment; and any balance remaining in an employee's account at death passes to his or her designated beneficiaries.25

In effect, 401(k)s function very much like IRAs, except that they are part of an employer-sponsored plan. Indeed, employers may have an important role to play in encouraging employees to participate in 401(k)s by setting up automatic payroll deductions to facilitate voluntary employee contributions and by providing an employer match for all or part of the employees' contributions. In addition, employers remain responsible as fiduciaries for maintaining the plans that they sponsor.

In recent years, many employers have taken steps to shift investment risks and responsibilities to employees, notably by ceding control to employees over the investment of funds in their individual accounts. Under a statutory safe harbor for self-directed accounts, employers are relieved of fiduciary liability for losses and breaches resulting from the exercise of control by employees. Nevertheless, employers retain residuary responsibility for maintaining a "broad range" of available investment options and ensuring that employees have ac-

25 Given a choice between a lump-sum distribution and an annuity, most people choose the lump-sum option. See MUNNELL & SUNDÉN, supra note 7, at 157–58.
cess to sufficient information to allow them to make informed decisions. Relieving employers of fiduciary responsibility for self-directed accounts, however, has the perverse effect of discouraging employers from providing specific investment advice that many employees desire. Indeed, self-directed plans offer an ever-expanding array of options, far beyond the minimum range required by the safe harbor.

The shift of risks and responsibilities to employees alarms some liberals, who see this trend as a sign of ERISA’s failure to respond to changes in the pension world. When ERISA was originally enacted, defined contribution plans were viewed mainly as supplements to a basic tier of retirement benefits provided by traditional defined benefit plans and Social Security. As defined benefit plans have given way to 401(k)s as the primary plan for many workers, the premise of ERISA’s lenient regulatory framework for self-directed plans appears increasingly at odds with the goal of ensuring that employees will end up with adequate income during retirement. Employers, however, would undoubtedly resist any attempt to impose greater fiduciary responsibility for guiding or monitoring investment decisions, just as many employees would object to new constraints on their ability to control the investments in their individual accounts. Accordingly, various reform proposals focus primarily on improving default rules to provide guidance for employees without impinging on their freedom of choice. It remains to be seen whether such “soft” paternalism will lead to greater retirement security across the board for 401(k) participants.

B. Assessing 401(k)s

While libertarians emphasize the success of 401(k) plans in opening opportunities for individual employees to make their own decisions about saving and investment, liberals see a much bleaker picture. Focusing on outcomes rather than opportunities, liberals point out that the rewards of 401(k)s are heavily skewed toward highly paid employees, who would accumulate savings even without a tax subsidy. Meanwhile, many rank-and-file employees fail to save adequately for retirement, even with the incentives of tax-favored treat-

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28 See Groom & Shoven, supra note 5, at 141 (advocating “maximum flexibility as to the type, form, and contents” of retirement saving and stressing the values of “[c]reativity of markets, self-reliance and individual responsibility”); id. at 151 (describing employer-sponsored pensions as “one of the big successes”).
ment and employer matching contributions—for them, 401(k)s are "coming up short." In making decisions about participation, investment, and use of assets, employees "make mistakes at every step along the way." Given the option to participate in a 401(k) plan, more than a quarter of all eligible employees do not do so at all, and less than 10% of participants contribute the maximum allowable amount. Moreover, whether through inexperience, bad advice, or poor judgment, 401(k) participants often make objectively bad investment decisions: most participants fail to diversify or rebalance their portfolios, more than half either hold no stocks at all or invest virtually their entire accounts in stocks, and many invest a substantial portion of their accounts in employer stock when they are allowed to do so. Finally, in deciding when and how to withdraw funds from their accounts, most participants take a lump sum distribution upon termination or retirement. Although large lump sums received at retirement are likely to be rolled over into IRAs, smaller amounts are likely to be spent rather than saved for retirement.

In making decisions about retirement and saving, employees frequently lack clearly defined, consistent preferences. Many employees are prone to inertia and procrastination; to avoid the laborious process of comparing alternative options and making affirmative choices, they simply follow default rules. Moreover, when faced with the need to choose—for example, in allocating funds among several investment options—they often take the path of least resistance or resort to a simplistic shortcut by spreading funds equally across all available options. Once employees make their initial choices, they are unlikely to reexamine or modify those choices.

Accordingly, it may be possible to influence decisions and achieve better outcomes simply by changing the default settings in 401(k)s and similar plans. For example, instead of requiring employees to

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29 See Munnell & Sundén, supra note 7, at 172.
30 Id. at 13; see id. at 80–92 (discussing investment decisions); id. at 150–59, 170–71 (discussing preference for lump sum distributions).
33 If the options are too numerous, the result may be confusion and paralysis. See Munnell & Sundén, supra note 7, at 71–73 (noting that a vast array of choices may be "demotivating" rather than welfare enhancing).
make an affirmative election to participate, the plan could provide for automatic enrollment while maintaining freedom of choice by permitting employees to opt out.\textsuperscript{35} Similarly, the plan could specify presumptive levels for contributions, with automatic increases geared to future salary raises to avoid the need for periodic review. Plans could encourage better investment practices by setting default allocations geared to the participant's age and income level. Default options could also be structured to encourage employees to preserve account balances until retirement (e.g., through an automatic rollover on termination before retirement), and to take distributions upon retirement in the form of a single-life annuity (or a joint-and-survivor annuity, in the case of a married employee).

Although changing the default rules might seem to be an easy and obvious way to address the shortcomings of 401(k) plans, this approach is likely to encounter resistance from employers because it implies a more active role on the part of plan sponsors. A significant obstacle to any provision for automatic enrollment stems from the design-based safe harbor for 401(k)s, which allows an employer to satisfy the nondiscrimination rules by offering to match a portion of employee contributions, even if no employee actually accepts the offer. Since any increase in employee contributions drives up the cost of the employer match, employers have little incentive to encourage broad-based employee participation or investor education, and they would undoubtedly oppose any attempt to limit the design-based safe harbor (e.g., by making it available only for plans that offer automatic enrollment). Problems also arise in formulating prudent investment rules for participants who fail to make affirmative choices. Under the safe harbor for self-directed accounts, employers are not liable for losses resulting from employee investment decisions, and they are unlikely to embrace an expanded role of providing investment advice with its additional fiduciary responsibilities.\textsuperscript{36}

The principal goal of changing the default rules would be to help individual employees to make better decisions concerning participation and investment throughout their working lives. For liberals, this mildly paternalistic approach promises to improve participation rates.

\textsuperscript{35} This approach is now authorized by statute. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 902(a), 120 Stat. 780, 1033-34.

\textsuperscript{36} Employers that sponsor 401(k) plans with automatic enrollment often establish low-risk, low-return money market funds as the default investment option. To encourage them to adopt a default setting with higher risks and returns, it might be necessary to provide additional protection from potential fiduciary liability. See MUNNELL & SUNDÉN, supra note 7, at 175.
and investment outcomes among rank-and-file employees who are not well served by the existing system. Even libertarians, who generally oppose regulatory constraints on individual choice, should be willing to accept welfare-enhancing changes in the default rules as long as individual employees can freely opt out. Given the limited efficacy of previous efforts to turn rank-and-file employees—who stand most in need of assistance—into sophisticated investors, the only practicable alternative may be to streamline the decisions they are expected to make in saving for retirement.

C. Tax Reform Proposals

As part of its tax-cutting agenda, the Bush Administration has advanced proposals to reduce tax rates on capital income and expand opportunities for tax-sheltered individual savings accounts. These proposals would move the existing hybrid system in the direction of a consumption tax, and they raise questions about the continued viability of 401(k)s in a consumption-tax world. Under a pure consumption tax, all savings would be exempt from tax, and retirement savings would thus lose their relative tax advantage. As a result, the regulatory restrictions, which are linked to the tax subsidy for qualified plans under current law, would become increasingly difficult to maintain. Since most individuals save very little on their own initiative, a decline in employer-based plans might well leave increasing numbers of employees without adequate retirement savings.

Expanding access to tax-sheltered individual savings accounts would blur the distinction between special-purpose retirement saving and all-purpose general saving. To the extent that the new accounts allow free access to tax-preferred savings, they would create pressure to allow employees to withdraw funds from their 401(k) balances before retirement. For example, the proposed Lifetime Savings Account (LSA) would allow penalty-free withdrawals at any time and for

37 See Sunstein & Thaler, supra note 32, at 1161–62; id. at 1182 (noting the "inevitability of paternalism").
39 Lower tax rates might stimulate some additional all-purpose general saving, but it seems implausible that such saving would be undertaken by individuals who fail to respond to existing tax incentives or that it would be used for retirement purposes. See Karen C. Burke & Grayson M.P. McCouch, Lipstick, Light Beer, and Back-Loaded Savings Accounts, 25 VA. TAX REV. 1101, 1139–44 (2006).
any purpose; it might better be described as a lifetime *spending* account.\(^{40}\) For most low- and moderate-income individuals, the LSA would probably emerge as the primary savings vehicle.\(^{41}\)

The Bush Administration’s proposals highlight the tension between liberal and libertarian views concerning tax and retirement policies. From a liberal perspective, the proposed new savings accounts would weaken the existing tax incentives for employer-based retirement plans and might amount to little more than costly tax shelters for highly compensated employees. The new accounts would appeal primarily to high-income individuals who are constrained by the contribution limits for 401(k)s and IRAs under current law. Those individuals would likely not increase their net saving but rather simply shift existing funds from taxable vehicles to the new tax-sheltered accounts.\(^{42}\) The new accounts would also give rise to substantial long-term revenue losses due to their back-loaded structure—unlike traditional IRAs, contributions would not be deductible, but the entire yield would be tax-exempt. As with Roth IRAs, this structure apparently reflects the exigencies of budget politics rather than any coherent tax policy.\(^{43}\)

From a libertarian perspective, proposals to expand tax-sheltered individual savings accounts provide a welcome opportunity to reassess the role of employers in facilitating retirement saving. If individual accounts compete successfully with employer-based plans, they may herald a decisive shift away from the traditional system of tax-subsidized, heavily regulated employer-based plans toward a deregulated system of individual accounts administered by private financial intermediaries. In the evolving system, employers would be relieved of their remaining fiduciary responsibilities and their role would be limited to coordinating voluntary employee enrollment and participation through payroll deductions.\(^{44}\) In short, existing 401(k) plans and IRAs might be viewed as evolutionary steps on a path toward a model

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\(^{40}\) See id. at 1144.

\(^{41}\) See id. at 1139–40.

\(^{42}\) See id. at 1133–36.

\(^{43}\) See id. at 1116–19, 1121–24.

\(^{44}\) Indeed, such a shift in the role of employers may already be occurring. See Pamela Perun & C. Eugene Steuerle, From Fiduciary to Facilitator: Employers and Defined Contribution Plans, in THE EVOLVING PENSION SYSTEM, supra note 4, at 191–92 (discussing the movement toward “a system of individual accounts held, managed, and administered by the financial services industry”).
of unlimited private savings with minimal restrictions on contributions, investments, and distributions.

III

INDIVIDUAL ACCOUNTS AND SOCIAL SECURITY

Since its inception over sixty years ago, Social Security has reflected a tension between the liberal goal of ensuring minimally adequate retirement income for all covered workers and the libertarian goal of promoting individual choice and responsibility for retirement saving. The existing system is essentially a mandatory, broad-based defined benefit plan which is financed on a pay-as-you-go basis through a flat payroll tax on covered wages. In addition to the implicit transfers from younger workers to older retirees, the system also redistributes benefits within generations due to its bottom-weighted benefit formula and its subsidized benefits for spouses and dependent family members. Given the imbalance between projected revenues and promised benefits, some changes will clearly be necessary, but there is no consensus on the scope of the problem or the direction of future reform.

The Bush Administration has consistently pressed for individual accounts as an essential component of Social Security reform. In keeping with President Bush's insistence that "[m]odernization must include individually controlled, voluntary personal retirement accounts," the President's Commission to Strengthen Social Security outlined three alternative proposals featuring individual accounts as part of its final report issued in December 2001.45 Although the proposals vary in detail and are not fully specified, they signal a fundamental change in the structure of the existing Social Security system by shifting significant risk from the public system to individual participants.46

A. The Structure of Individual Accounts

Under the Commission's proposals, each worker would have the option to divert a portion of his or her payroll taxes from the traditional Social Security system to an individual account in the worker's own name.47 Workers exercising the option would receive fully vested ownership of the balance in their individual accounts, but they would also pay a price in the form of reduced regular Social Security bene-

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45 PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., supra note 1, at 14-16.
46 The discussion here focuses primarily on the Commission's Reform Model 2. See id. at 15, 119-30.
47 Under the Commission's proposals, a worker could divert a specified portion of covered wages each year: 2% under Reform Model 1; 4% (up to $1,000) under Reform Model 2; or 2.5% (up to $1,000) under Reform Model 3. See id. at 14-16.
fits. The reduced benefit would be calculated by taking the amounts contributed to a worker's individual account, compounding them to the worker's retirement date at a specified interest rate (the "offset rate"), and converting the result to a hypothetical single-life annuity, which would then be offset dollar-for-dollar against the worker's regular Social Security benefit.\textsuperscript{48} The arrangement is functionally equivalent to a margin transaction in which the worker borrows funds to acquire the investments in the individual account and agrees to repay the loan, with interest, solely from his or her regular Social Security benefit. Thus, the worker stands to gain if the investments in the individual account outperform the offset rate, and stands to lose if they do not.

The Commission contemplates a two-tiered system of individual accounts, comprising a basic, low-cost tier with a limited choice of index funds and a supplemental tier with a broader range of investment options and correspondingly higher administrative costs.\textsuperscript{49} All contributions would initially be invested in the basic tier, which would offer nine investment options, including diversified stock and bond index funds, balanced index funds, and federal government bond funds. Once the balance in a worker's individual account reached a specified threshold (e.g., $5,000), additional investment options in the supplemental tier would become available, including a range of diversified, no-load mutual funds. A "standard" fund would be designated as the default investment for workers who failed to make an affirmative allocation. No withdrawals from individual accounts would be allowed before retirement. Upon retirement, workers would be required to annuitize a portion of their individual accounts before they could withdraw the remaining balance. The annuity requirement, which might be satisfied either by purchasing a commercial annuity or by taking phased withdrawals over time, is intended to ensure that workers and their spouses will have sufficient income from their individual accounts, in combination with their regular Social Security benefits, to keep them out of poverty during retirement. Any balance remaining in an individual account at the owner's death would be fully inheritable.

\textsuperscript{48} The Commission appears to contemplate an offset rate corresponding to a real rate of return (i.e., the rate in excess of inflation) ranging from 2% to 3.5%. See id. at 99 (3.5% under Reform Model 1; 2% under Reform Model 2; 2.5% under Reform Model 3). For further discussion of the offset mechanism, see Peter A. Diamond & Peter R. Orszag, Assessing the Plans Proposed by the President's Commission to Strengthen Social Security, 96 TAX NOTES 703 (2002); Alan L. Gustman & Thomas L. Steinmeier, Offsetting the Principal in the New Social Security Accounts, 107 TAX NOTES 109 (2005).

\textsuperscript{49} The structure of the proposed individual account system is described in President's Comm'n to Strengthen Soc. Sec., supra note 1, at 41-62.
The Commission's proposals are designed to give workers an opportunity to accumulate sufficient individual account balances to replace the regular Social Security benefits lost as a result of the offset. The structure of the standard fund would be especially important, since experience with 401(k) plans indicates that many workers are likely to have their individual account balances invested in that fund by default. Moreover, some workers may view the standard fund as a benchmark for their own investments, or as implicitly endorsed by the government. Recognizing that the appropriate level of risk may depend on a worker's age, the Commission appears to contemplate a "life cycle" allocation weighted toward stocks for younger workers and bonds for older workers.\textsuperscript{50} To the extent that the standard fund reflects a safe investment strategy, however, it may reinforce the risk-averse preferences of many low-income workers and generate low returns that cancel out much of the progressive tilt in the formula for regular Social Security benefits. Indeed, without a government guarantee of a minimum rate of return, low-income workers may be sufficiently concerned about the loss of regular Social Security benefits that they will hesitate to opt for individual accounts in the first place.

Even small administrative costs could significantly erode the value of individual accounts over time. In both tiers of the individual account system, mutual fund providers would be prohibited from charging front-end or back-end sales loads, and would further be required to combine all administrative charges in a single annual fee expressed as a percentage of asset values. The Commission relies primarily on competition among mutual fund providers and standardized disclosure of fees to contain administrative costs, without proposing any caps on permissible fees.\textsuperscript{51} Since mutual funds routinely charge reduced fees for large account balances, a disproportionate share of the burden would likely fall on workers with small individual account balances, and the number of small accounts would be enormous.\textsuperscript{52} Although the Commission apparently intends to provide a measure of

\textsuperscript{50} See id. at 52. There is no assurance that a life-cycle approach would yield any specified rate of return. See Robert J. Shiller, The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation 8–10 (Nat'l Bureau of Econ. Research, Working Paper No. 11300, 2005), available at http://www.nber.org/papers/w11300 (projecting a substantial probability of negative investment returns, net of the offset, for various hypothetical life-cycle portfolios); see also id. at 6 (describing the life-cycle portfolio as the "centerpiece" of the Bush Administration's plan).

\textsuperscript{51} The Commission assumes an annual administrative charge of 0.3% of the individual account balance which, when deducted from the assumed 4.9% real rate of return (in excess of inflation) on a balanced portfolio, leaves a net annual real rate of return of 4.6%. See President's Comm'n to Strengthen Soc. Sec., supra note 1, at 97. These assumptions may be unduly optimistic.

\textsuperscript{52} In 2001, half of all workers earned less than $21,600; their annual contributions to individual accounts at a 2% rate would amount to no more than $432 per account. See Nat'l Acad. of Soc. Ins., supra note 12, at 37.
protection for low-income workers while allowing greater freedom of choice for moderate- and high-income workers, the two-tiered approach seems inherently fragile. Workers with a taste for riskier investments and mutual fund providers would undoubtedly press for more flexibility and less regulation in the supplemental tier, and it would become politically awkward to accede to their demands while denying similar treatment for workers with accounts invested in the basic tier.\(^5\) Consequently, the basic tier might ultimately serve as little more than a default setting for workers who failed to choose a different investment option. There would be no assurance, however, that workers who opted out of the basic tier would be better off as a result.

Restrictions on access to individual accounts before and during retirement are also likely to prove unpopular. Experience with 401(k) plans illustrates the political difficulty of maintaining a strict prohibition on early withdrawals, especially in cases of hardship. Likewise, a requirement of partial annuitization during retirement will collide with the marked preference of most employees for lump sum distributions. Requiring a threshold level of annuitization to keep retired workers above the poverty level is fully consistent with the goal of social adequacy, but that goal could be realized much more readily by adjusting the defined benefit formula in the traditional Social Security system than by restricting access to individual accounts. In effect, a partial annuitization requirement will produce a bifurcated system that forces low-income workers to annuitize most or all of their individual account balances, while allowing higher-income workers greater choice in the timing of withdrawals.\(^5\)

Such differential treatment may be challenged as unfair. It also runs counter to the Commission's claim that individual accounts would enhance opportunities for low-income workers to accumulate personal wealth. Indeed, the notion of individual accounts as a source of bequeathable wealth is fundamentally inconsistent with a social insurance model designed to provide retirement income as a replacement for lost wages. Allowing workers to bequeath their remaining individual account balances at death represents a form of leakage which drains resources from the defined benefit component of Social Security and implicitly drives up the cost of regular retirement benefits for the remaining workers.

\(^{53}\) The expanded role of financial intermediaries might elicit demands to protect participants from fraud or overreaching, which would presumably require a new layer of government regulation. See Karen C. Burke & Grayson M.P. McCouch, Privatizing Social Security: Administration and Implementation, 58 Wash. & Lee L. Rev. 1325, 1336–39 (2001).

B. Impact on Social Security

Workers who establish individual accounts would incur new market risks and lose a portion of their regular Social Security benefits. In assessing the impact of the proposals on the Social Security system, the central question is whether the advantages of individual accounts outweigh the risks. It is thus important to note that individual accounts by themselves will not restore Social Security to fiscal solvency. Under the Commission’s proposals, solvency can be achieved only through a combination of reductions in promised benefits and infusions of additional revenue from unspecified sources. Diverting payroll taxes to fund individual accounts would reduce the revenue available to pay promised benefits, and the loss would be offset only to the extent that the interest rate charged on individual account contributions matched the rate of return on Treasury obligations held in the Social Security trust fund. In theory, assuming an actuarially neutral offset rate, the reduction in regular Social Security benefits would compensate for the reduced revenue, resulting in a wash.

Although individual accounts would not directly improve Social Security’s fiscal outlook, they are sometimes portrayed as a necessary “sweetener” to facilitate other changes—in particular, scaled-back regular benefits for moderate- and high-income workers. According to this argument, such workers will accept reductions in their regular Social Security benefits more readily if they have the opportunity to earn a return on their individual accounts in excess of the offset rate on funds diverted from the rest of the system. For individuals who already hold diversified portfolios of stocks and bonds, however, an unsubsidized loan from the government, with interest equal to the rate of return on Treasury obligations, holds no special appeal. If such individuals wish to increase their exposure to stock market returns, they can already do so by exchanging bonds for stocks; the higher yield on stocks merely compensates for the increased market risk of the portfolio. Low-income individuals who lack adequate exposure to stocks might benefit from greater diversification, but as illustrated by experience with 401(k) plans, such individuals are likely to be strongly risk-averse and to encounter difficulties in making appropriate investment choices.

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To induce workers to contribute to individual accounts, it may be necessary to provide a subsidy by reducing the offset rate below an actuarially neutral level. Such a subsidy might be attractive, especially to high earners, but it would drive up the cost of individual accounts and exacerbate the long-term fiscal imbalance of the rest of the Social Security system. In the absence of additional revenue from increased payroll taxes or general revenues, a subsidy for individual accounts would require further reductions in regular Social Security benefits for workers in the rest of the system. Thus, if individual accounts are subsidized to the extent necessary to make them attractive, they threaten to undermine the defined benefit component of the Social Security system.

The most significant cost savings come from proposals to scale back regular Social Security benefits for moderate- and high-income workers through progressive price indexing. These proposals would leave the traditional wage-indexed benefit formula unchanged for the 30% of covered workers who earn less than $20,000. For workers further up the salary scale, however, wage indexing would be phased out and replaced with price indexing. Thus, workers with maximum covered wages would receive benefits based solely on price indexing. Under price indexing, real benefit levels would rise with price increases but would no longer keep pace with real wage growth. In effect, price indexing is equivalent to a substantial reduction in promised benefits for future retirees. Low-income workers would be exempted from price indexing in order to spare them from shoulder-ing the burden of restoring solvency to the existing system. Over time, however, the progressive price indexing proposals would ultimately replace traditional earnings-based benefits with a flat benefit for most workers. Replacement rates for moderate- and high-in-
come workers would fall, and workers at the top of the wage scale would receive the same dollar amount of benefits as workers earning much less. Ironically, the implicit benefit cuts from full price indexing would be more than sufficient to restore Social Security to solvency, without injecting individual accounts into the system. Indeed, solvency could have been achieved with less drastic benefit cuts had the Commission not been barred from considering any increase in the payroll tax.

By cutting regular Social Security benefits to make room for individual accounts while purportedly preserving benefits for low-income workers, the Commission’s proposals accentuate the redistributive features of the benefit formula. To the extent that low-income workers receive a disproportionately high ratio of benefits to wages, the defined benefit component of the proposed system is likely to be identified as a welfare program. Moreover, under the Commission’s proposals, moderate- and high-income workers would have a diminishing stake in that part of the system, even as it becomes more important for low-income workers. As a result, the defined benefit component might lose political support and become vulnerable to additional cuts in the future. Indeed, if asset values in individual accounts were to drop sharply during an economic downturn, political pressure to grant relief to individual account holders by reducing the offset rate might well prove irresistible, even though such relief would leave the rest of the system in an even more precarious condition. Thus, from a liberal perspective, any proposal to carve out individual accounts with diverted payroll taxes threatens to jeopardize the fiscal and political viability of the defined benefit component of the system.

In contrast, from a libertarian perspective, the Commission’s proposals do not go far enough. In a fully privatized system, benefits would depend entirely on the accumulated value of the holder’s individual account, and there would be no redistribution within or across generations. The hybrid system proposed by the Commission, com-


(“[S]omewhat paradoxically, if real wages rise faster than projected, price indexing would result in deeper benefit cuts, even as Social Security’s unfunded 75-year liability would be shrinking.”).

60 See id. at 6 (“According to the [Social Security Administration], fully price-indexing initial benefits would more than restore solvency to Social Security.”).


62 In 2004, Social Security benefits accounted for more than 90% of income for the bottom quintile and less than 20% of income for the top quintile; pensions and annuities accounted for less than 2% of income for the bottom quintile and more than 25% for the top quintile. Ken McDonnell, Income of the Elderly Population, Age 65 and Over, 2004, Emp. Benefit Res. Inst. Notes, Jan. 2006, at 9, 9.
prising individual accounts as well as defined benefits, would perpetu-
ate the redistributive features of the traditional Social Security system,
including derivative benefits for spouses and dependent family mem-
bers. It seems unrealistic, however, to expect that the existing sys-
tem of elaborate cross-subsidies would survive intact in the new hybrid
system. Thus, libertarians may find a system with carved-out individ-
ual accounts acceptable on tactical grounds as an incremental step
away from social adequacy and toward individual equity. In sum, lib-
ertarians may view the Commission's proposals as an opportunity to
change the nature of the existing Social Security system and move to-
ward full privatization.64

C. Alternative Approaches

The existing Social Security system provides a basic tier of infla-
tion-protected retirement income which lasts throughout each
worker's lifetime. The public system of defined benefits has become
increasingly important for many workers, especially as traditional de-
fining benefit plans have given way to 401(k) plans in the private pen-
sion sector. Due to its mandatory, nearly universal coverage, Social
Security also facilitates the pooling of risks within and across genera-
tions in ways that would be difficult or impossible to achieve in a de-
fining contribution system. While individual accounts might make
sense as a supplement to Social Security's defined benefit system, di-
verting payroll taxes to fund voluntary carved-out individual accounts
is likely to impose new costs and burdens with potentially destabilizing
effects on the entire system. Although some workers might reap sub-
stantial rewards from individual accounts, others would certainly lose.
Unlike the defined benefit component, individual accounts would of-
er no guarantee of even minimally adequate benefits, and workers
seeking higher returns from stock market investments would be ex-
posed to correspondingly higher risks and market fluctuations. Expe-
rience with 401(k)s suggests that many workers, especially those with
low lifetime earnings, would make inappropriate choices and end up
with inadequate retirement savings.

Although individual accounts are often touted as vehicles for fos-
tering broad-based wealth accumulation and individual financial re-
responsibility, such claims signal a radical rejection of fundamental

63 For example, in the case of a one-earner married couple, the offset based on the
worker's individual account contributions would apply to the couple's total benefits, result-
ing in a smaller percentage benefit reduction than for an unmarried worker. See Nat'l
Acad. of Soc. Ins., supra note 12, at 175–76. The Commission also recommends increas-
ing benefits for "widows of below-average wage earners." President's Comm'n to
Strengthen Soc. Sec., supra note 1, at 107.
64 See Daniel Shaviro, Social Security Privatization and the Fiscal Gap, 65 Ohio St. L.J. 95,
principles of social insurance. Moreover, the argument that individual accounts are needed as a sweetener to compensate highly paid workers for steep cuts in regular Social Security benefits appears to be little more than a tautology intended to justify the Bush Administration’s insistence that individual accounts form an integral part of any reform proposal. Under the Commission’s proposals, individual accounts would be attractive only if they were subsidized by an artificially low offset rate, which in turn would increase fiscal pressure on the rest of the system and might eventually lead to even deeper cuts in the defined benefit component.

Social Security has traditionally been the basic source of retirement security for most workers, with employer-based plans and personal savings providing supplementary income. Since few individuals currently contribute the maximum allowable amount to 401(k) plans and even fewer accumulate substantial personal savings, the reasons for carving out voluntary individual accounts within Social Security remain unclear. If the goal is to encourage broad-based saving for retirement, it might be worth considering alternative approaches. For example, expanding tax-favored saving opportunities for low-income earners through a federal matching program would ameliorate the inadequacy of existing Social Security benefits for low-income earners while channeling benefits to those most in need of increased retirement savings.65 Such a matching program would be more likely to increase overall savings than tax subsidies to high-income earners, who may simply shift savings from taxable to tax-preferred vehicles. Given the skewing of private pension benefits toward high-income earners against a backdrop of rising inequality of income and wealth and a regressive payroll tax structure, it may be appropriate for high-income earners to bear a larger share of the burden for restoring Social Security to solvency.

CONCLUSION

In the debate over Social Security reform, attention has focused on recent proposals to restructure Social Security as a hybrid system with voluntary individual accounts and a residual defined benefit component. Carving out individual accounts from the existing system would shift significant risks and responsibilities to individual workers. A parallel development has already occurred in the area of private pensions, where 401(k) plans have overtaken defined benefit plans as the dominant employer-based vehicle for retirement saving. Experience with 401(k)s indicates that many workers will have difficulty mak-

ing prudent decisions concerning investment and withdrawal of funds in their individual accounts. Moreover, in implementing any system of voluntary individual accounts, it will be important to design default settings that provide appropriate guidance for workers with heterogeneous levels of financial sophistication and risk tolerance. In contrast to private pensions, Social Security provides mandatory, nearly universal coverage without relying on tax incentives to induce participation by reluctant savers. Although a two-tiered structure of individual accounts could provide basic safeguards by constraining investment and withdrawal options for workers with small account balances, the pressure to weaken those safeguards might prove irresistible over time.

It is not immediately clear why individual accounts occupy such a central role in the Social Security debate. Individual accounts do not ameliorate the long-term fiscal gap which is the catalyst for reform. Moreover, voluntary individual accounts are already available through 401(k) plans and IRAs, and those vehicles could readily be expanded without restructuring Social Security. The most plausible explanation appears to lie in the realm of values and politics rather than economics.66 By carving out individual accounts and funding them with payroll taxes diverted from the existing defined benefit system, the reform proposals would change the very nature of Social Security. The existing system is based on the concept of social insurance, which balances social adequacy and individual equity and commands broad political support while providing a reliable source of retirement income to workers at all income levels. In contrast, a bifurcated system with individual accounts would isolate the defined benefit component and accentuate its redistributive function. If, as seems likely, the individual accounts were subsidized to the extent necessary to make them attractive, they could easily exacerbate the fiscal gap and gradually undermine political support for the defined benefit component. Notwithstanding the ostensible goal of saving Social Security, the ultimate outcome might be the dismantling of the existing social insurance program.

From the perspective of national retirement policy, proposals for Social Security reform cannot realistically be evaluated in isolation from private pensions. Employer-based plans provide an important source of retirement income for many workers, but they are generally understood as ancillary to the basic coverage provided by Social Security. Indeed, with the rise of 401(k) plans, it has become increasingly clear that tax-driven private pensions have a limited capacity to ex-

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66 See Peter A. Diamond, The Economics of Social Security Reform, in FRAMING THE SOCIAL SECURITY DEBATE 38, 63 (R. Douglas Arnold et al. eds., 1998) ("[T]he heart of the reform debate is based on different values and different prognoses of politics, not substantial economic disagreements.").
pand coverage or increase voluntary retirement saving among workers who stand most in need. As a result, the central goal of Social Security reform should be to close the fiscal gap in a way that preserves rather than undermines the existing system of mandatory defined benefits for all workers.