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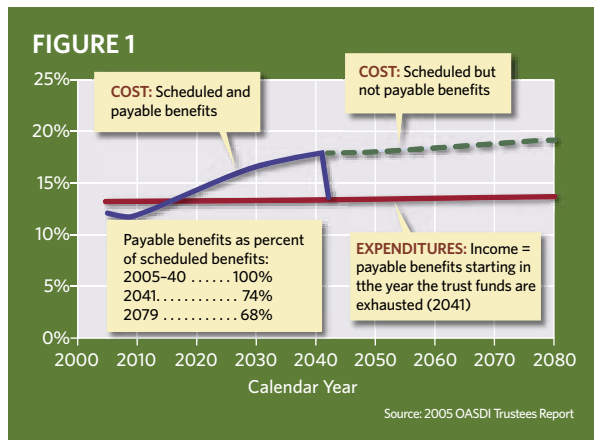
Social Security, the nation's paternalistic retirement program, has a two-part financing problem. The first component is the imbalance, which can be summarized as follows: In the short term, the system will take in more money than it will spend, but in only 12 years, the reverse will be true, with significant and ever-growing shortfalls in the out-years. Projected revenues and expenditures are not in balance (See Fig. 1).

The second component is the surplus. Today, the government takes in more Social Security tax revenue than it spends, which creates surpluses. The government invests the current surpluses in special-issue government bonds and spends rather than invests them. Instead of potentially increasing national savings, which could fund the benefits for future retirees, our current financing arrangement lowers savings and raises the national debt.

If we continue investing surplus as-

sets in government bonds, traditional solutions to the projected shortfall, such as raising payroll taxes or reducing near-term benefits, won't do us much good. These remedies would simply build up larger near-term surpluses for the government to spend, thus aggravating the surplus problem. So, what's the best way to ensure long-term solvency, provide adequate benefits, and ensure that the government keeps its hands off money that could be used to prefund a portion of future benefits?

This article briefly discusses some key advantages and disadvantages of the three basic alternatives: adjust our current system to eliminate surpluses, invest the trust fund in private securities, and establish individual accounts. The first two options, which maintain the defined-benefit nature of the system, are simpler and more efficient than introducing individual accounts into the system, as proposed by the Bush administration.



The best way to fix Social Security may be a combination of adjusting it back into balance and investing the surplus where Congress can't get at it.

By Kenneth A. Steiner

Best Fix?

SOLUTION #1:

Maintain Pay-as-You-Go Financing with Adjustments

The simplest solution to the financing shortfalls ahead would be to bring tax rates and benefits into balance within Social Security's current structure while avoiding significant surpluses. Some analysts have suggested implementing some combination of lower current tax rates, higher future tax rates, and lower future benefit payments to more accurately match revenue and payment streams, thereby avoiding surpluses altogether.

This approach has the advantage of simplicity, but it could come at the cost of relatively steep increases in taxes or significant reductions in benefits or both. On the other hand, holding Social Security payroll-tax rates relatively flat (or even decreasing them somewhat in the short term) and scaling down future benefits to match the expected revenue stream should give younger workers sufficient time to save enough to make up for reductions in future benefits. The president's proposal to progressively price-index future benefits or proposals to index the normal retirement age are consistent with this approach.

Whether workers would actually save more to make up for future benefit reductions is a good question, given the persistently low U.S. personal savings rates. It's reasonable to assume that some workers either could not or would not save enough under this less paternalistic approach, thereby increasing welfare costs in the future. Further, this approach would likely leave future retirees on the losing end of money's-worth comparisons with current retirees.

SOLUTION #2:

Invest the Trust Fund in Private Securities

One way to keep the government from spending Social Security surpluses would be to invest them in private securities rather than government bonds. This would effectively remove

trust fund assets from the unified budget and force Congress to get along without them.

This approach would preserve Social Security's current defined-benefit structure. Although investing in stocks rather than government bonds would not solve the imbalance problem by itself, we could implement traditional combinations of tax increases and benefit reductions without aggravating the surplus problem. Congress would have to look elsewhere for additional revenue to fund its other programs.

Investing the trust fund in private securities has many advantages. First, it would increase expected returns on trust fund assets, potentially increasing national savings. The higher investment risk associated with private securities would be spread over all program participants. Benefits would be payable to participants as intended, rather than leaking out of the program to serve other purposes (such as payments to heirs).

As in the individual-account approach described ahead, investment amounts could be varied by adjusting future patterns of expected revenues and expenditures. Proponents claim that the same advantages touted for individual accounts could be achieved more efficiently by investing the trust fund in private securities.

The primary disadvantage of this approach is that the government would select the private securities. Defenders maintain that we could mitigate the government's involvement by investing the trust fund in indexed mutual funds selected by an independent board of trustees charged with representing the interests of program participants.

Opponents argue that investing Social Security trust funds in the stock market could negatively affect the economy or the financial markets. But assuming that the private assets committed to the program would be comparable under both this and the individual-account proposal, the effects on the economy should be comparable as well. We need look no further than to our neighbor to the north, Canada, for a successful model of how this approach could work.

The simplest and most efficient way to preserve the basic safety-net char

SOLUTION #3:

Establish Individual Accounts

Under the simplest version of an individual-account approach, the portion of payroll taxes representing the surplus of current revenue over current outgo would be diverted into workers' individual accounts. The worker would invest the money himself and, upon retirement, the worker's defined-benefit promise would be reduced by the annuity value of the accumulated account (or the value of a hypothetical account).

This approach could solve the surplus problem. However, because the surpluses projected under current law are relatively small and the administration says it won't increase current taxes or decrease current benefits, President Bush's more complicated individual-account proposal would seed workers' accounts with contributions of 4 percent of taxable earnings (initially up to a maximum of \$1,000) per year. General-revenue financing (in the form of increased borrowing or larger deficits) would pay for the resulting revenue shortfalls.

Since adopting individual accounts would not, by itself, resolve the shortfalls ahead, the administration's proposal would also decrease future benefit payments. This would bring them more in line with expected revenue, in a manner similar to that

discussed under the pay-as-you-go alternative discussed above. Workers could then choose either to accept a lower retirement benefit than projected under current law or to opt for an individual account with the potential for either higher or lower benefits than those promised under the reduced defined-benefit program. Similarly situated workers, whose accounts earned annual returns equal to inflation plus 3 percent, would receive roughly the same level of benefits as those who chose not to participate in the individual account program. As structured, the president's individual-account proposal would provide the nation's workers with an opportunity to gamble with some of their basic retirement income.

Similar to investing the Social Security trust funds in private securities, investing individual-account assets in private securities would be expected to earn higher long-term returns than yields on government bonds, but the higher investment risk would be borne individually rather than spread across generations of workers. Workers whose accounts earned returns well over inflation plus 3 percent could become big winners. Other workers could become big losers. To the extent that benefits fell short of providing adequate retirement income, welfare programs would have to supplement the benefits of the affected retirees.

The president has indicated that workers who opted for individual accounts would "own" those accounts, and, in the event of a worker's premature death, the accounts could pay benefits to heirs. However, the administration's proposals would require many people to convert most or all of their accumulated account balances at retirement into cost-of-living-adjusted lifetime annuities, and people couldn't tap their assets for other purposes. This paternalistic provision would be necessary to ensure that retirees wouldn't outlive their retirement income.

At retirement, the money (or most of the money) "owned" by the worker would essentially be returned to the government (or to private insurance companies selected by the government) so the program could provide lifetime income—the same promise made under the current defined-benefit program. In this sense, workers would temporarily manage the investments but would never really own the accounts.

The individual-account approach is less efficient at providing retirement income than the other two approaches. As noted above, each dollar that "leaks" out of the system (e.g., to pay heirs) is a dollar that can't be used to pay widows who live longer-than-average lives.

While individual accounts may appeal to those who expect to die relatively early, this approach would provide the same level of retirement benefit protection as the other options but at a higher cost. Establishing millions of individual accounts would involve significantly more record keeping and participant communication, which would be expensive. Allowing workers to choose from among different benefit approaches would make it more difficult to change the program later, as many people would claim they have an implied contract with the government.



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acteristics of Social Security would be to retain its defined-benefit nature.

Finally, it would be considerably more efficient for professional asset managers to manage one big pot of accumulated assets than for millions of workers to manage their own small portions.

Proponents of individual accounts claim an advantage over investing the trust fund in private securities because individual-account holders—rather than the government—would make the investment decisions. However, the administration is proposing that the government select four or five investment alternatives for workers to choose from, so this advantage would be more illusory than real.

Individual-account advocates also argue that the experience of managing citizens' own accounts would raise their awareness of the importance of saving and increase their investment know-how. These advocates believe that participants in tomorrow's "ownership society" will become better savers and investors.

The Best Solution

Many analysts argue that Social Security benefits cannot be prefunded. They say that since the benefits for future retirees must

be financed out of the nation's productivity at the time they're paid, we can't "save" current output to provide for future retirees. Under the current program, however, the government is spending surplus Social Security assets and increasing the national debt, thus lowering national savings.

To avoid exorbitant increases to payroll taxes in the future and resolve both the imbalance and surplus problems, it may make sense to invest Social Security assets in private investments (either directly or through the use of individual accounts) or reduce future benefits and encourage individuals to save more themselves.

While all three approaches have advantages and disadvantages, the simplest and most efficient way to preserve the basic safety-net characteristics of Social Security would be to retain its defined-benefit nature. If we want a more paternalistic prefunded approach, the better alternative is working within the proven defined-benefit plan structure rather than trying to force a defined-contribution plan to behave like a defined-benefit plan.

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