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THE NATURE OF SOCIAL INSURANCE PROGRAMS AND THEIR FUNDS (PART 2 OF 2)

By Sam Gutterman

Sam Gutterman, FSA, CERA, FCAS, HonFIA, MAAA, is director and consulting actuary for PricewaterhouseCoopers, LLP. He can be contacted at *sam.gutterman@us.pwc.com.*

EXECUTIVE SUMMARY

This article is the second in a two-part series that summarizes a longer paper that can be downloaded from the website of the Social Insurance and Public Finance Section at http://www.soa.org/professional-interests/social-ins/default.aspx. The first article appeared in the June 2013 publication of *In The Public Interest*.

Both articles take the form of a point-counterpoint dialogue addressing important aspects of social insurance programs. The first part discussed their nature, desirability and advantages, as well as whether they can form a framework to achieve sustainable inter-generational equity. The second part focuses on whether pre-funding of a social insurance program can occur and can contribute to the financial security of the participants. Fundamental differences of opinion exist regarding these programs, not only due to different personal and political values, but also as a result of the viewpoint taken (for example, assessment of the program in isolation, consideration of the sponsoring government's financial situation, or the overall national economy).

Note that the author does not agree with all the views described. In fact, a single best answer may not exist for each issue discussed.

BACKGROUND

A social insurance program provides protection for participants against adverse financial effects of demographic-based hazards (such as longer-than-expected longevity after retirement, disability, need for expensive medical treatment and unemployment) by sharing these costs across population segments and generations. Its benefits are payable when required criteria are met, regardless of the beneficiaries' income or assets, though contributions and benefits can be tilted to favor a population segment in need.

In many cases there is at least some pre-funding from contributions in excess of current benefits because of increasing costs with age for participants, particularly in the context of retirement or as the program matures. In other cases there is no pre-funding, operating on a pay-as-you-go (PAYGO) basis where current contributions pay for today's benefits.

Two views are presented here, expressing contrasting perspectives taken by various stakeholders and commentators on social insurance programs. One Supports (S) the long-term nature of these programs and a mechanism to provide pre-funding of their benefits, while the other presents an Alternative (A) view that argues that they are not necessary or, at most, should be provided only where those affected are in dire need and any funds generated are illusory. These views have often been taken by different political camps, with those supporting greater collective societal responsibility tending to support S, while those in camp A holding individual responsibility for personal financial planning as a principle.

POINT-COUNTERPOINT

Is there really a fund for social insurance programs?

S — Having a legally devoted fund, preferably independent of the rest of government, enhances trust in the long-term future of the program. Government debt is often purchased in arm's-length transactions by the social insurance program from the rest of government. This also provides a low-risk investment return that at the same time can reduce contributions or increase benefits. In addition to funding assistance for future benefits, it can also assist economic growth by reducing the crowding out of private debt and promoting consumer purchases and investment. Although it is impractical to provide full funding, contributions provide a systematic and explicit source of future fund balances that reduce financial uncertainty and insecurity. It also contributes to fiscal discipline by funding these programs in a sustainable manner over the long term.

A — But this so-called fund is an economic sham. It is simply a retrospective accumulation of moneys on a balance sheet, an historical record of past transactions. It is not directly related to either a value of the obligations of the program nor does it indicate the ability of the government to pay program benefits. The division of the government's financial balance sheet into little pieces simply makes it more likely that it is the other guy's responsibility for an overall surplus or deficit balance. In fact, the program's "investment policy" might indirectly encourage larger government debt because the so-called fund represents a ready buyer required to purchase them as assets, regardless of total government debt level. These bonds aren't really bonds after all, as all that is going on is that one part of government is borrowing from another—if the accounts were consolidated they would offset each other. Money received by all areas of government is just put into a large pot to be spent to fulfill total government needs. Governments have and will continue to spend all their tax receipts to meet their obligations, regardless of their source, and to borrow externally when they need to supplement their cash position. The better the economy operates over the short and long term, the more jobs will be created, productivity will be enhanced and contributions to social insurance programs will increase. If there is sufficient government and public support, the benefits of the program will be paid; if the program's revenues are not sufficient, its costs will be paid by the government, whether from general revenues, wage-related contributions or a designated sub-fund. Surely the only way to ensure financial security is for the government to effectively manage the economy and its overall budget.

What about its legal basis?

S — The U.S. Social Security program has lasted more than 75 years, prescribed by a body of laws. Its continuation has been the result of legal and political integrity, and, of course, the fact that it is wildly popular ensures its ultimate financial soundness! It is a social compact—certainly amoral, even if laws can be changed. Although there is certainly a small possibility that a social insurance program could be decreased or terminated by a future government, social insurance has demonstrated its staying power because of the efficient manner it addresses fundamental human needs. Politicians rarely vote in favor of adverse changes to such an important and widely accepted government program that so many citizens rely upon.

A — The past is the past—legislation can be changed, as laws and regulations are modified every day by government or its politicians. Similarly, a social compact is only as solid as the political winds take it—social insurance laws can be tweaked, changed radically or even terminated tomorrow, as it depends on political will or the economic crisis of the moment. It is wishful thinking that society will always be willing to squirrel away adequate funds for the distant future, when other government programs compete so vigorously for funding, and may crowd out its promised benefits, reduce taxes or benefits. While beneficiaries may believe that they have a "right" or are "entitled" to their promised benefits, legally they do not. It is neither possible nor politically desirable to commit future governments to any such program, without affording them the flexibility to make changes as needed over time.

For argument's sake, let's assume a partial fund has been accumulated. What is the nature of such a fund and does it add value to the financial security being offered?

S — Changes in the fund consist of the net of (1) cash inflows, primarily contributions from participants and their employers and investment income, and in some cases general government funding and (2) cash outflows, including benefits to beneficiaries and administrative expenses. The net of these cash flows are invested in government securities or other investments. The purpose of such a fund is to help provide benefits over the long term so that contributions, benefits and taxes can be budgeted with limited financial distortion. Before any significant change is made, the government, the program's ultimate sponsor, has to provide its participants plenty of time to better plan for their individual financial futures, including retirement and for possible adverse financial events or conditions. Every dollar of government securities purchased by the fund means one dollar less otherwise borrowed from the public, reducing external public debt on a dollar-for-dollar basis. The need and cost of external financing is therefore reduced—an additional benefit of having

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such a fund. There is no way a government will default on such a program, even during a terrible economic meltdown, as the political and social ramifications of having retirees, the disabled and unemployed plummet into unplanned poverty are too horrific to contemplate. The calamitous implications of program termination by themselves demonstrate the government's commitment to the continuation of the program, enabling participants to plan for their future and enhance participants' trust in their long-term financial security of the benefits provided.

A — You still describe the fund using accounting terms, which is a meaningless historical construct, which does not affect the probability that the benefits will be paid, nor does not add value or security. Why isn't there a smoothing or pre-funding mechanism for every other wealth transfer or other social program? There is no reason that social insurance is unique in this way, while every other program uses general revenue to meet these problems. It is far better to focus on the finances of the government as a whole, as they ultimately determine the extent of the governmental and societal commitment regarding social insurance benefits. Investments in government bonds or even private assets are just IOUs to ourselves. And of course, taking the perspective of the government or the economy as a whole, every social insurance program is economically a PAYGO program anyway. The money to pay benefits and pay for all other government programs has to come from somewhere, including tax levels or tax sources, designated contributions, reduced spending or borrowing (although the government could just print more money, but that has other consequences). Almost any long-term pre-funding arrangement places huge pressure on government budgets over time, especially with our large debt burdens and less-than optimal overall economy. If government bonds are used as the fund's investment vehicle, we simply owe ourselves—an absurd concept. Any such interest payments might have been put to better long-term use for other purposes such as education, health or safety rather than to increase an internal account. If not effectively put to use, such resources contribute to less efficient government spending or higher interest rates for all.

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Does it matter whether the fund is ring-fenced or is a part of general government accounts?

S — If a fund for a social insurance program is held in a segregated trust account, its assets can be legally protected from being raided by other parts of the government. In most cases they are held in conservative long-term investments. Legal control lies in the fund's trustees, although it is unimportant whether it is called a "trust fund." Transparent information regarding the fund facilitates monitoring for sound governance practice and planning. Objectively determined actuarial projections along with sensitivity analysis provide information needed for policymakers to tweak the program's financing and benefit design to enable it to continue to achieve its objectives. It also facilitates better financial planning by its participants and reduces political temptation to expand benefits beyond those that can be afforded. Fortunately for its beneficiaries, government consists of laws and not just annual budgets—thus, segregated funds cannot be diverted to other purposes without what would be an explicit wildly unpopular policy shift.

A — To understand its economic effects, the legal form of the fund has to be considered. Governments operate as a holistic venture, with the effects of flows of moneys between their sub-funds of limited economic consequence. Future benefits must be met from future revenue or from future borrowings of the government as a whole. Clarity in accounting will not prevent government from reneging on promises when it is short of resources. In government budgets, social insurance contributions and benefits are usually treated as just other income or outgo on a PAYGO basis and do little to protect against program changes. The existence of a ring-fenced fund and pre-funding does not affect the amount or timing of benefits, as future governmental decisions can supersede and disregard accounting values.

Does it matter if the funds are invested in vehicles other than government bonds, such as those found in capital markets or in real estate?

S — Receiving yields greater than governmental bonds on nongovernment securities can provide additional funding for a social insurance program. This type of investment can achieve multiple objectives if it can simultaneously help provide products and services that enhance the overall economy. Examples of such projects to enhance future productivity or economic well-being include public infrastructure and education. In some countries, such as Canada, such invested funds are expected to earn more investment income for the fund while also providing asset diversification. If these objectives are met, contributions (and/or taxes) will be able to be reduced, benefits increased, or funding adequacy enhanced. A fund containing such assets can thus help stabilize the cost between generations and better provide for personal life cycle needs. Some believe that social insurance programs should invest their funds in equities, both to promote economic growth and increase returns for the fund over the long term. Foreign investments can provide additional benefits in terms of increased trade and exports.

A — Although this approach to investment strategy might theoretically increase yield, it doesn't always succeed. It can't really benefit from diversification, as the objective of diversification is usually a reduction in asset risk or volatility, not to increase yield; you can't realize less risk than in national government securities. Non-governmental investing could be viewed as nationalizing part of the economy, which may not be desirable. Alternative (external to the government) investing can also be more costly and risky, with more volatile returns and credit risk. In addition, markets in most countries aren't large enough to handle the amounts of investment involved, while at the same time most private entities do not want the government as a part owner (even if through a passive government agency).

What is the real economic impact of these funds?

A — If the assets in these funds are government bonds, the pass-through transactions involving these bonds have been used for current expenditures, seeming to reduce the need for greater revenue. In effect, these funds simply transfer the financing of current deficits to a future date. Any funding approach is economically equivalent in all ways that matter (other than perception) to a pure PAYGO approach. In addition, the availability of cash transfers to general revenues can obfuscate the true extent of government deficit spending. So, clarity in overall governmental accounts is not enhanced by attempting to have more transparency in the accounts of a social insurance program. It is clear which is more important; information about performance of the social insurance program can always be obtained from separate actuarial projections, without providing a separate historical accounting with no economic reality. The bonds simply represent inter-entity transfers that, in general purpose financial reporting standards, would not be reported separately in a consolidated set of accounts. Any sub-funds should not be considered separately as a part of unified government accounts and budget. The legal and political nature of a social insurance fund has encouraged many participants to over-rely on the current commitment of the government to continue what is often referred to as an entitlement program, thus creating moral hazard (i.e., the existence of social insurance reduces the incentive to personally save for adverse financial conditions). As a result, many workers have come to depend on its continued existence, saving very little outside of it. What is surprising is that this overreliance occurs even though many of these same people, especially the young, indicate in surveys that they are convinced that the social insurance programs will not exist when they themselves will need them.

S — These are real securities, whose principal and interest are solely available to provide for social insurance benefits, either now or in the future. A social insurance fund can provide a sound base for providing for retirement and disability financial

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needs—otherwise, future levels of contributions/taxation may become less affordable if on a true PAYGO basis, particularly if supplemented with fully funded personal and employer-sponsored plans. Most participants don't mind contributing to a program in which multiple generations participate, setting aside money in a cost-effective and convenient manner, with minimal operating and marketing costs. Although moral hazard is possible, given the financial strain and squeeze felt by the middle class, it cannot exert a significant effect. What is in essence forced savings through public retirement and disability programs is an important contribution to the general welfare of the population and fully within the public interest. One can forget that the same moral hazard also exists with employer-sponsored benefit programs.

What are your key takeaways from this discussion?

S — Social insurance shares key attributes of insurance and retirement/disability plans, protecting against the financial effects of participants' adverse life cycle events, supported by what has and continues to be the long-term commitment of governments to maintain and adapt them to changing circumstances. They have, for the most part, been managed on a sound financial basis, for example, to reflect the effect of inflation and longer lifetimes. They provide a soundly based social safety net, protecting participants from the worst financial hazards encountered during their life cycle. They promote equity, hard work, fairness, financial security and the public good, contributing over a long period to a better economy and society.

A segregated fund can be used to partially prefund future benefits as the population ages and universally has proven to be immune to most populist pressure; few want to be remembered as the killer of what are the most popular and needed government programs that equitably reduce unnecessary poverty of those who cannot or are unable to help themselves within the context of a social contract. The debate over the nature of a trust fund is a distraction from important long-term fiscal issues.

A — A delusion has been perpetrated on the public, as some are both convinced and have relied on the fact these benefits are guaranteed, in part because funds have been set aside. That's far from the truth—the economy responds to a country's entire financial and economic structure, not to the status of a single fund. Needed protection against financially adverse events can only be provided through operationally effective and efficient programs. Our long-term economic and personal financial futures have been jeopardized by unaffordable and out-of-control entitlement programs. Current and future generations are not guaranteed benefits and only promote unnecessary spending and reduce the incentive to take personal responsibility for individual and family financial future, regardless of whether a fund invests in government debt or outside investments that drain the private sector of needed funds, which can only lead to more government debt that may lead to reduced economic growth.

Although some social safety net is needed, at the same time its design should not result in dependency or a sense of entitlement. Social insurance may not be the most cost-efficient and fair way to satisfy these needs. Rather, a combination of private insurance, employee benefits unencumbered by excessive regulation, and welfare where needed meets the needs addressed in a more affordable manner. Goods and services that retired people use, like golf, health care and restaurant meals, must be produced at the time consumed—it is not practical to save those goods and services for future use. As a result, retirement programs invest in financial assets, representing claims on future goods and services. Whether those claims will be honored does not depend on the existence of a fund, which may be decimated by long-term demographic forces or political decisions. In any event future workers bear the ultimate risks. Inevitably there is only 100 percent of GDP to allocate—pre-funding is not the only factor to consider in ensuring needed benefits. Without economic growth or an ever-growing contribution rate, no social insurance program can fulfill its promises over the long run.

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