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OPINION

Some questions on Social Security

by Michael Sze

Social Security has been the subject of numerous recent debates. Many experts believe in the short-term health of the system while recognizing its long-term problem. The experts, however, cannot agree on a solution. Even members of the Social Security Administration Advisory Council, which issued its long-awaited report in January, failed to reach a unanimous recommendation. They proposed three alternative solutions.

Session 8-8 of the March 19, 1997, Enrolled Actuaries meeting will focus on the proposals and seek to answer these questions:

- What impact do the proposed changes have on private pension plans?
- How will the cost to plan sponsors and the benefits to employees be affected?

The 3 approaches: an overview

Here is a very brief summary of the proposals in the Advisory Council report.

1. *Maintenance of benefits:* Under this approach, current benefits would be maintained. Social Security tax would be increased, and some HI taxes (Hospital Insurance, Part A) would be redirected to the Old-Age and Survivors Insurance and Disability Insurance fund. Furthermore, a portion of the Social Security Trust Fund may be invested in equity.

2. *Individual accounts:* This approach calls for a reduction in benefits provided by the current Social Security system. The reduction would be achieved by increasing the income tax on benefits, raising the normal retirement age, and reducing the formula for individual benefits. Each employee would have to contribute a new 1.6% of pay into his or her individual account. Such funds would be publicly managed, and a part might be invested in equities. The combined benefit under this approach is expected to be comparable to that under the current system.

3. *Personal security accounts:* This approach requires a severe cutback of benefits provided by the current system, leading to a monthly benefit of about $410 in 1996 dollars. Also, the normal and early retirement ages would be increased. Five percentage points of the present 12.4% tax would be diverted into the worker's individual account, which would be privately managed. On average, the combined benefit under this approach is expected to exceed that of the current system. The expected 1.52% transitional cost increase would be financed as a payroll tax or from general revenue, and from additional public debt.

Questions for the road ahead

It is not my intention to enter into another round of debate over these proposed solutions. Instead of arguing over the virtues of each approach, I will raise some questions related to them. The questions are deliberately phrased in a controversial manner to stimulate discussions. Comments, criticisms, and, of course, answers to these questions from readers are welcome.

Is 'privatization' a misnomer?

Proponents of Social Security privatization are promoting a universal system with mandatory participation and a defined contribution formula. The only private elements are the individual accounts, allowing full or partial individual control of investment. As such, the individual bears the investment risk and gets the rewards of favorable investment returns. Can such a system be termed "private"?

Must a 'privatized' system require a defined contribution?

Proponents of privatization usually assume that such a system would be based on defined contributions (a DC system). However, individual accounting also can be achieved through a system that provides defined benefits (a DB system). The only difference is that a DC system has predictable contributions each year and undetermined benefits on retirement, while a DB system provides more predictable benefits on retirement with varying contributions to reflect plan experience. A DB system can still be universal with a set formula. Both DC and DB accounts are portable, moving with the employee as he or she changes jobs. So, must a private system provide defined contribution benefits?

Must a 'privatized' system be fully funded?

It has been argued that for a universal system such as Social Security, whether the system is fully funded or not, the burden of benefit payments for the elderly always lies on the shoulders of the working population. If that is true for the current system, would the situation be different for a privatized system just because every covered person has a private account? How would a "pay-as-you-go" privatized system work? Would it behave like the current system?

Can any proposed change end Social Security's ills?

Is the Social Security system a wealth-distribution device or a goods-production tool? If it is a production tool, what goods does it produce? If it is only a distribution device, how can a change in that system solve any consumption shortage problem? After all, isn't it true that at any time, the production of the workers is shared by the young, the workers, and the old? If the cure for Social Security problems lies in increasing future productivity, doesn't raising productivity become a nationwide concern? How can we expect the Social Security system to remedy a national economic problem? Are we asking a blacksmith to build a car (even if the blacksmith is exceptionally skilled)?

Is there really a long-term production problem?

Most people attribute Social Security problems to a shift in the population's demography. As the baby boomers retire, the ratio of the number of Social Security beneficiaries to the number of workers (called the dependency ratio) increases. It is feared that the rate of production will lag behind the rate of consumption, causing a struggle over limited resources. However, such an analysis presupposes that the quantity of production depends mainly on the number of workers. This may be true if the industrial economy continues into the next millennium. However, if the information revolution succeeds, won't future production depend more on information than manpower? In the agrarian economy, a vast number of farmers was required to feed the nation. The industrial economy drastically reduced that number. Would the information-economy paradigm bring similar changes in the next century?

What's the ultimate guarantee for future productivity?

If the future economy is based on information, what is our best guarantee? Research and education? If so, is the Social Security system the best vehicle to promote research and education activities? How does each of the current proposals address such issues? What can be done through a Social Security system? Would new government policy be a better solution?

If we don't have production problems in the future, do we still have a Social Security problem?

Even with enough production, will future generations think it fair to share a third of their production with retirees? Isn't this an intergenerational equity issue? Doesn't this boil down to an entitlement issue? In this context, don't we still have a distribution problem? Is that what everyone is trying to solve?

What will be considered a fair share of Social Security benefits for any generation? To receive as much as the generation contributes? In this context, should we ask the current generation to contribute a bit more today and expect to receive a bit less in the future?

What is the best way to establish entitlement to future production: by capital accumulation or political clout? In this context, will different investments of the Trust Fund create a different sense of entitlement?

Intriguing questions

As an actuary, I find these questions intriguing. I pose them only to raise discussion. They do not reflect the position of any committee or organization I belong to. *The Actuary* welcomes your comments.

Canada's solution

Incidently, the Canada Pension Plan (CPP) faces funding problems similar to those of the OASDI. The solution, agreed to by the federal government and eight out of 10 provinces, was published recently under the title "Securing the Canada Pension Plan." The solution involves increasing CPP contributions in steps from the current rate of 5.85% of contributory earnings to 9.9% of earnings in six years, coupled with a decrease in retirement, disability, and death benefits. The reserve fund build-up will be prudently invested in a diversified portfolio that may include equity and foreign investments. (A copy of the document may be obtained from the Distribution Centre, Department of Finance, 300 Laurier Avenue West, Ottawa K1A 0G5, Canada; phone: 800/343-8282.)

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Derivatives for risk management to be conference topic

A conference focusing on the use of derivatives in managing financial risks and enhancing profits for insurers will be held May 15-16 at Georgia State University, Atlanta.

"Managing Risks With Financial Derivatives in the Insurance Industry" will include discussions of innovative financial risk management strategies, the regulation of derivatives, both statutory and GAAP financial reporting issues, and new research into the effects of derivatives on insurer risk and return.

The featured speakers will be Andrew M. Alper, partner, Goldman Sachs & Company, and J. David Cummins, Ph.D., the Harry J. Loman Professor of Insurance, The Wharton School. A half-day tutorial on the basics of derivatives will be offered by Prakash Shimpi, FSA, president and chief executive officer of Swiss RE Financial Products, and Stephen D. Smith, holder of the H. Talmage Dobbs Jr. Chair of Finance, Georgia State.

The conference is being co-sponsored by the SOA, the Casualty Actuarial Society, and Georgia State. Additional support is being provided by the Federal Reserve Bank of Atlanta and the American Academy of Actuaries.

Details are available from Richard D. Phillips at the Center for Risk Management and Insurance Research, Georgia State (phone: 404/651-4250; e-mail: rphillips@gsu.edu).