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Will it work?

Investing U.S. Social Security funds in common stocks

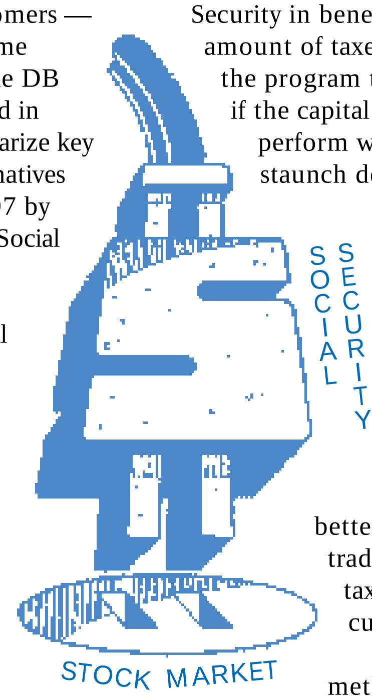
By Dick Schreitmueller

How should the United States reform Social Security benefits for baby boomers and young workers?

1. Adjust their retirement benefits and taxes, and invest part of the Social Security trust funds in the stock market (call this the "defined benefit," or DB, method).
2. Reduce their basic retirement benefits further, and have workers invest part of their future contributions in individual accounts (the "defined contributions," or DC, method).
3. There's no problem. Why reform the system at all?

Fewer and fewer Americans would choose answer 3, as surveys show that the public has a high level of concern about the future of Social Security. For example, a 1997 survey by the Employee Benefit Research Institute showed that only 58% of the American public — and only 44% of those younger than the baby boomers — believe they will receive some Social Security benefits. The DB and DC methods mentioned in points 1 and 2 above summarize key features of the leading alternatives for reform, proposed in 1997 by the government-appointed Social Security Advisory Council and refined in 1998 by the privately sponsored National Commission on Retirement Policy. All these proposals would preserve benefits for older Americans, with the changes affecting only workers below age 55.

Practically every major Social Security proposal today, from all across the political spectrum, would invest some funds in the stock market. Why is this happening? More important, would such proposals work in practice?



Why use stock market investments?

Social Security reform legislation in 1977 and 1983 relied heavily on tax increases and benefit cuts. Today, we could make similar changes, as no Social Security financing problem is too big to fix by revising taxes and benefits — in theory. The trouble is, such an approach would convince even more young workers that they'll never get their money's worth from Social Security in benefits relative to the amount of taxes they'll pay, causing the program to lose public support if the capital markets continue to perform well. Today, even some staunch defenders of the Social Security program no longer argue against investing some of the funds in equities. The expected higher returns could help restore the program's financial balance and give workers a better deal, though a few traditionalists assert that tax increases and benefit cuts will work again.

The DB and DC methods described earlier represent two very different ways to invest in stocks. The DB method maintains the current defined benefit structure and gradually invests about half the Social Security trust fund assets in equities. The DC approach creates a defined contribution tier — on top of a scaled-back defined benefit structure — in which workers choose how to invest their individual accounts. Depending on the

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whole and eliminate the greater risk / reward of investing in a single issue or market segment. They offer a simple way to focus on asset mix where so much of the risk can be managed.

Historic long-term rates serve as the basis of assumed future returns in the following analysis. The long government bond would yield a real rate of 2%. This is lower than the rates expected on the new 30-year inflation-indexed bonds. Corporate bonds would earn a real rate of 2.8% and equities a real rate of 6.5%-7%. Again, this is less than recent experience. In the long term, a balanced portfolio of index funds would earn a real rate of between 4 and 5%. Thus, unlike in many prior periods, the returns on personal accounts would be not only competitive with but superior to the rate of return on the pay-go system.

We are fortunate that there is a way to enlarge the returns for Social Security benefits. Even small accounts, for example based on a 1.6% contribution, under the above assumptions provide 30% of the benefits for lifetime participants.

Analysis of the rate of return requires more than this summary comparison. This analysis, however, is key to the policy decisions on structure. For a review of other investment issues in Social Security reform, see Dick Schreitmueller's article in this issue.

Finding a sensible route

As actuaries we are aware of how difficult it is for our models and assumptions to produce precise futures. Over the long term, a Social Security structure that adds a supplemental tier of modest investment accounts to a major program of defined benefits is preferable to a structure that relies too much on either defined benefits or investment accounts. It does not make any more sense for reform to exclude potentially high-return investment accounts than to abandon defined benefits that target needs.

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specific proposal, mandatory contributions to such individual accounts could range from about 2% to 5% of wages (some 20% to 50% of total Social Security retirement contributions), perhaps supplemented by voluntary contributions, and presumably workers would allocate much of this money to equities.

Investing trust funds in stocks

By law, the U.S. government has always invested trust fund assets for its large retirement programs (Social Security plus plans for military personnel and other federal employees) entirely in U.S. Treasury bonds. Policy makers knew that equity investments could earn a higher long-range return but would involve government interference in private businesses if Uncle Sam selected the securities, voted proxies, etc., based in part on political agendas instead of investment objectives. At best this would reduce investment returns, and at worst damage the economy.

A breakthrough came in 1985-86 when Congress created and enacted the federal employee thrift savings plan (TSP), giving employees the option to invest in common stocks through an index fund administered by a new government agency under tight statutory control. Congress decided not to let employees invest TSP accounts in the open market, as if they were IRAs, because of administrative difficulties and costs. Since its inception in 1987, the TSP stock index fund has been very successful in earning high returns, keeping expenses low, and steering clear of politics. Today, advocates for investing Social Security trust funds in equities point to the TSP as proof that an index fund can avoid the classic dangers of government control. (See my 1988 paper in the *Transactions*, vol. 40, pp. 562-573, for more background on political-social investing, index funds, and operation of the TSP.)

But Social Security is a much bigger program — covering 145 million workers versus some 2 million eligible for the TSP — involving vast sums and reaching into the lives of all Americans. Before enacting Social Security reforms, policy makers need to make a diligent search for basic weaknesses and ask whether any fundamental flaw is fixable or fatal. Although I was present at the creation of the TSP index fund and am one of its biggest fans, I believe investing Social Security trust funds in an index fund raises questions that are troubling or unresolved.

Political temptation: Even with the best of intentions at the outset, can politicians resist the temptation to use the growing funds for political or social objectives? Under our current Constitution, Congress cannot be prevented from writing new laws that override an index fund's statutory controls. (The Canada Pension Plan's newly enacted reforms imply optimism about such issues, relying on fiduciary standards plus some indexing to make a politically appointed board manage equity funds at arm's length.)

Proxy voting: Is it feasible for Social Security to follow the TSP practice of delegating proxy voting to an outside fund manager who serves participants as a fiduciary? What are the dangers of concentrating so much government control over specific companies in one place? Is it better for nobody to exercise voting power with respect to stocks held centrally by Social Security?

Impact of the index: Mindful that including a given stock in the Social Security index fund will boost the price of that stock, how can Uncle Sam define the index to minimize market distortions or abuses? Could index funds held by Social Security and others become so dominant that stock prices no longer

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reflect business reality or provide incentive for management to perform?

Risk and volatility: How would Social Security policy makers and the public react to unexpected gains or losses in equities? Is a politician's short-term horizon compatible with long-term investment success?

Baby boomers' withdrawals: As retired baby boomers draw down their savings to cover living costs, tending to depress the stock market, would a shrinking Social Security stock fund make matters worse by selling stocks at the same time?

Finally, why go to all this trouble? If the Social Security funds buy stocks, the government must sell more of its bonds to outside investors — a zero-sum game with no appreciable effect on national savings, at least in the short term. This tends to raise both the investment return that Social Security earns on its trust funds and the interest that Treasury pays on its bonds. Thus, some people consider the current arrangement a subsidy of Treasury by Social Security taxpayers. Would it make more sense for the Treasury Department just to repay such a subsidy directly to Social Security without going through the stock market, such as by paying higher interest rates on the special bonds that Treasury sells to the trust funds?

Investing contributions in individual accounts

The defined contribution (DC) alternative would let workers decide how their accounts are invested, avoiding most or all problems with government control of the economy as discussed above, but creating an enormous number of small transactions that need accurate, efficient handling. The DC proposals entail administrative challenges that go well beyond the existing Social Security program, combining the universal scope of Social Security with the complex record keeping of a 401(k) plan — and administration of these simpler programs is hardly free from error. If the DC system is to have any chance of working, its design must emphasize the "KISS" principle ("keep it simple, stupid"), cutting out frills and limiting choices. After the DC launch got off the ground, we would have plenty of time to add new features — just as we did with the original Social Security program.

Under the DC approach, a critical issue is whether to let workers choose among many investment alternatives available on the open market (the IRA model) or among a few investment funds designed specifically for Social Security (the "KISS" model). The TSP uses the latter method because it simplifies administration, holds down costs, and avoids confusing employees; these would also be major advantages for Social Security. Moreover, the British are reporting bad experience with their version of the IRA model for personal Social Security accounts, as aggressive sales practices have led workers to make poor choices.

Allowing voluntary contributions is not a good idea if it requires offering loans or withdrawals — features that are complex to administer and may dilute retirement savings. Requiring the purchase of CPI-indexed annuities at retirement makes sense, at least up to a level that covers basic retirement living expenses, provided the annuities are attractively priced and have no risk of insurer insolvency. The potential market for such annuities warrants creative design efforts by the government and the insurance industry.

Benefit experts must speak

Many organizations advocate the DC approach to Social Security reform, recognizing that the private sector may play roles in investment management, communications, record keeping, and annuity underwriting, perhaps using syndicates or alliances. Large employers may want the option to administer their own DC plans as an alternative to the DC tier of Social Security. Although some find the DC approach impractical and risky, the DB approach presents bigger problems. We need to move steadily toward a consensus, avoiding misguided design efforts that incite fervent opposition, such as the "Harry and Louise" ads that helped bury the Clinton health care plan. Benefit experts in the private sector should express their views and work closely with lawmakers to reform Social Security in ways that will stand the test of time.

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Share your views on U.S. Social Security reform

In the U.S. Congress, public forums, and the pages of the news media, many actuaries have offered ideas on how the U.S. Social Security system should be reformed. Now, *The Actuary* asks for your views on some of these ideas in a special survey.

A form accompanying this month's issue asks SOA members and students to "vote" for their preference on a few of the most discussed reform topics. The form also asks for some demographic information so that results can be correlated across categories.

Completed forms should arrive in the SOA office by Oct. 30. They should be sent by fax or regular mail (not e-mail) to: Social Security Survey, *The Actuary*, Society of Actuaries, 475 N. Martingale Road, Suite 800, Schaumburg, IL 60173, fax 847/706-3599. Results will be announced in a future issue of *The Actuary*.