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What's the best approach?

Defined benefit vs. defined contribution in social security

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The issues related to the appropriate approach to Social Security are being hotly debated in the United States. One of the SOA's many contributions to the public discussion was a panel session, "The Old-Age Crisis," at last year's annual meeting. As the 90-minute session proceeded, it evolved into a discussion on the value of a defined contribution approach versus that of the U.S. system's current defined benefit approach. These insights are important for public policy experts worldwide to consider.

Participants and panelists included a number of senior actuaries and economists who have worked with social security systems in North America and throughout the world. Serving on the panel were: Robert B. Friedland, director, National Academy of Aging; Robert M. Katz, principal actuary, the World Bank (moderator); Dimitri Vittas, advisor on pensions and insurance, the World Bank, and a consultant to many governments on social security issues; and myself. Among the session's active participants were Robert Myers, former chief actuary of the U.S. Social Security Administration, and Chris Daykin, government actuary, United Kingdom, and consultant to many governments on social security issues.

The discussion was triggered by the question of whether a crisis truly exists. Myers stated that population aging is predictable and that there is no crisis, especially considering that problems will occur over a period of many years hence. He points out that a crisis is something catastrophic that is likely to occur soon. At the session, he shared his perspective that the imbalance in the U.S. Social Security system can be corrected with modest changes and that radical ones are not required.

Which path?

Social security systems in several countries have been converted, at least in part, to privatized systems using individual accounts, privately managed and invested. The discussion focused on two different categories of reasons why defined contribution accounts might be used in social security systems: philosophy and environment including infrastructure.

The philosophical arguments are related to goals. A social insurance system is redistributive, balancing individual equity and social adequacy. Some citizens want a system to be primarily redistributive, whereas others want a personal savings medium managed on an individual basis. For those whose goals are focused on social adequacy and maintaining a certain level of retirement income for a large segment of the population, a traditional defined benefit plan seems best. Those who see the system as a means of forced individual savings, particularly if they are opposed to redistribution, prefer individual accounts. Under most of the proposed individual account plans, personal savings would be accompanied by a minimum benefit. The higher the minimum benefit, the less the incentive to save voluntarily.

The arguments related to environment and infrastructure are much more applicable in underdeveloped countries without long-term stability. Those situations may lack compliance with a tax system, record keeping capability, fiscal stability, and similar factors needed to maintain a defined benefit system. One difficulty with defined benefit systems is that money waiting to be distributed can be diverted for other purposes. Very early retirement ages is another common difficulty.

Defined contribution systems offer a more workable alternative in countries not ready to manage a defined benefit system, but they, too, are subject to problems including:

- Poor compliance with contribution requirements
- Inability to directly offer a floor of protection
- Significantly higher administrative costs, particularly for those participants who have small benefits
- Inability to provide an adequate income for lower earners and participants who move in and out of the labor force frequently

Perhaps the most crucial of those difficulties is the second. If the system's goal is to provide a floor of protection to most of the population, defined contribution systems generally will not fit that need.

Should we shift our focus? The alternatives presented by the last Social Security Advisory Council and now under discussion in the United States include moving to a mixed system with partial privatization, a defined benefit floor supplemented by defined contribution individual accounts invested in the private sector. In the SOA session, Myers, Daykin, and Vittas all agreed that such a change was not necessary in the United States and generally not desirable. None of the defined contribution systems have been in place long enough to show whether they will deliver adequate benefits, which is the ultimate test of a retirement benefit system.

The magnitude of the financial difficulties (i.e., imbalance of contributions and benefits) within the U.S. Social Security system is far less than in many other countries, but there are clearly problems of credibility with many

younger U.S. citizens. There also are much larger and more severe issues related to the aging society when one considers health care and Medicare, long-term care and other assistance required for the frail elderly, and Medicaid and other public assistance programs. Resources needed and the affordability of these programs in the aggregate will require major adjustments.

Many combinations of changes are possible. The changes will reflect a balancing of values, needs, and competing uses for resources. One of the challenges is to focus on the big picture. It is difficult enough to understand the Social Security and Medicare programs individually, much less comprehend the intricacies of the relationships between them and with

other organizations. However, it is the programs working together that will determine the well-being of the elderly population.

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161 new Fellows

The SOA welcomed 161 new FSAs at the two Fellowship Admissions Course (FAC) sessions offered March 1-3 in Atlanta and March 11-13 in Dallas. This brings the total of FAC "graduates" to 2,417 since the FAC sessions were instituted in 1990.

E&E on the Web

Developments in the redesign of the basic education and examination system are being posted on the SOA Web site (www.soa.org). An example is the final report of the Course 2 working group. The posted report describes the new course in detail, including the learning objectives and the topics to be covered; cites the relevant chapters of recommended texts; and offers sample questions of the type that candidates can expect on the Course 2 examination. Similar reports for other courses will be posted when they are available.

The Web site will include other important E&E information as well, such as clarifications of conversion rules and information about the new

education system that would help candidates and employers get a better sense of what to expect.

Also on the Web is general information, such as lists of passing candidates, new Associates, and new Fellows; the text of essay examination questions (Series 200-500) from the previous examination session; and the current examination catalog. Printed copies of material on the Web site are available from Pat Garrity at the SOA office. (phone: 847/706-3515; fax: 847/706-3599; e-mail: pgarrity@soa.org).

EA-1B restriction

U.S. pension candidates should be aware that credit for EA-1B is a partial requirement for the U.S. Retirement Benefits Course 8 in the new education system. When existing credit is converted to course and unassigned credit in the new system, credit for EA-1B will be reserved for use with the associated Course 8 unless the candidate demonstrates a firm intention to pass a different Course 8 to complete the Fellowship requirements. Evidence of intent is a request for conversion credit for another Course 8, substantial progress toward completion of the track requirements in an area other than U.S. pension, or a formal statement from the candidate that he or she plans to specialize in an

area other than U.S. pension. The conversion rules allow credit for each course examination to be used only once; candidates should note the EA-1B restriction so that they do not find themselves unable to complete the requirements for their specialty area of choice.

Professional

development update

Candidates planning professional development programs to satisfy that portion of the FSA educational requirements should note that a mechanism is not yet in place for filing or approval of their formal plans. The Professional Development Task Force hopes to complete most of its work in the 1998 calendar year. This would allow the framework and guidelines for both candidates and their mentors/advisors to be put in place in time for candidates to make some progress in the latter part of 1999.

A note on I440C

Syllabus material covering variable life, critical illness, and survivorship insurance has been added to the reading for the fall 1998 Course I440C examination (Advanced Design and Pricing — Canada). With the additional study material and the new topics covered, the course will now offer 20 credits.