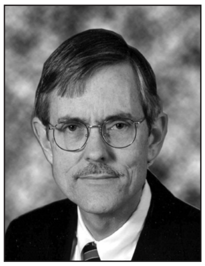
Social Security Private Account Reform: Retaining the Defined-Benefit Model with Indexed Benefit Offsets

by Stephen J. Hoeffner



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President Bush is to be commended for making Social Security private account reform a top legislative priority, but the mixed defined-benefit / defined-contribution model that he has in mind has been criticized for transferring too much investment and longevity risk to accountholders. In response, President Bush should consider an alternative approach to private account design— indexed benefit offsets —that would retain the existing defined-benefit model and eliminate this risk transfer.

In the private pension system, most large companies are way ahead of President Bush, having already transitioned to a mixed defined-benefit/defined-contribution model. This trend is an ominous one for rank and file employees, who are ill-equipped to take on the investment and longevity risks inherent in defined-contribution plans, and I agree with reform opponents who argue that it would be still worse for Social Security.

The Bush plan is expected to have two key elements: private accounts funded through a dedicated portion of current payroll taxes, and new, reduced Social Security benefit formulas that will take into account the lifetime payments that these private accounts may be able to provide (leaving total benefits theoretically unchanged). Since individual experience will differ from the life expectancy and investment earnings assumptions reflected in the benefit formula reductions, critics see only increased risk for accountholders.

President Bush should not be deterred by this criticism, because equity-related investment returns on private accounts would give Social Security a huge new source of financing, making it stronger and more secure for everyone—but especially for lower income Americans who rely so heavily upon it. Advance funding has been an enormous boon for all private pension plan participants and would be equally advantageous for Social Security. But there ought to be a better way to do it—and there is.

Here's how private account reform could retain the existing defined benefit model. Instead of reducing the existing benefit formulas today based on some *assumed* earning rate, Congress should leave the formulas completely alone. Then, at retirement, a unique benefit offset would be calculated for each accountholder based on what he or she could have *really* accumulated by investing in a stipulated performance index, such as the S&P 500.

Under this indexed benefit offset approach, when John Doe retires, the Social Security computers would calculate a notional (i.e., hypothetical) offset account balance for him based on his own private account contribution history and the performance of the index. Based on this hypothetical offset account balance, his benefit under the existing formulas would be reduced for a fixed offset period—say five or 10 years. After the offset period, Social Security would pay his full benefits.

Here's John Doe's net monthly payment, assuming a benefit under the existing formulas of $3,000, a 10-year (120-month) offset period and a *hypothetical* offset account of $50,000. (Social Security would calculate this amount—without using, or even knowing, his *actual* private account balance.)

Monthly Benefit by Formula	$3,000
Indexed Offset [$50,000 / 120 months]	(417)
Net Social Security Payment	$2,583

At the end of the first year, his hypothetical offset account would be updated for assumed payments ($417 per month) and changes in the index, and then his offset would be recalculated, reflecting the 108 months remaining in the offset period. (Social Security still wouldn't know his actual private account balance, or if he had actually taken any payments from it.) Annual offset calculations would continue, ceasing after 10 years.

Let's say that John Doe had always fully invested his *actual* private account in the index. He'd have accumulated about $50,000—the same as the *hypothetical* account balance Social Security was using in his offset calculation. To make himself "whole," he would just draw down the offset amounts ($417 per month in the first year, etc.) His actual private account would keep pace with his hypothetical offset account until they were both exhausted at the end of 10 years.

If his actual private account had outperformed the index, his monthly drawdowns could be larger than the offsets, and he would receive increased total benefits—but "windfalls" should be rare. If he wanted to take no risk, he would just always stay 100 percent invested in the index.

Even without potential windfalls, there are still good reasons to expect that workers would want to invest in private accounts. The accounts would be passed on to one's heirs at death, and retirees would have flexibility to draw down their accounts as slowly as they wished—or not at all. (Workers would also know that, no matter what happened to Social Security, their own private accounts would always be there for them.)

With indexed benefit offsets, there would be only one almost surefire windfall—to the Social Security system itself. The system would keep almost all investment gains, just as it would if the existing "trust fund" were invested in common stocks, instead of government bonds, but with none of the practical concerns associated with actual government ownership. (This is why it's a defined-benefit reform model.)

In closing, here's one more suggestion. Turn private account administration over to the existing private system (employer plans and IRA providers). With carefully drafted guidelines/restrictions, there should be no need for a big new government bureaucracy, and, with indexed benefit offsets and few windfalls, no insurmountable concerns over fair treatment of workers who may initially lack access to the private system.

Private system administration and indexed benefit offsets would offer most of the economic and political advantages of real, broad-based account ownership, while retaining all of the benefit guarantees and progressivity of the current Social Security benefit structure. No other approach can do all this, helping to reestablish the efficient, fair and secure Social Security system that we all want. ◆

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