The Actuary

September 1999 – volume 33 - Issue 7

What's the impact? (continued from page 1)

allocation decisions are preordained by the actions of past voters and legislators, citing a decrease in the entitlement budget's discretionary portion from two-thirds in 1962 to one-third in 1996. As "ownership" becomes more removed from the current public, the younger generations become increasingly skeptical of entitlement programs such as Social Security.

Turning to old age programs, Steuerle cited four primary factors affecting their growth:

1. Continuous real growth in annual pension benefits for each cohort of retirees (because the pension benefits replace the same percentage of preretirement income over time)
2. Longer retirement span (due to early retirement and longer lifespan)
3. Increasing aged dependency ratio (the ratio of elderly to working-age people)
4. Open-ended subsidies for healthcare benefits

Steuerle's perspective is that the solution to Social Security's funding problems hinges on budgeting future resources to meet all future needs, not just pension needs. One of the major controversies in the debate is whether privatization creates growth in the economy and improved rates of return. Steuerle argued that it does not.

Goss, in his presentation, explained that recent proposals, starting with those of the 1994-96 Advisory Council on Social Security, have tended toward more advance funding and investment in higher yielding, but riskier, private securities, especially stocks. More recently, proposals have suggested meeting a portion of advance funding's transition cost by using General Fund transfers, facilitated by the expected federal government budget surplus. Goss provided detailed actuarial estimates on several of the proposals.

Gebhardtsbauer began his presentation by noting that all social security reform proposals must cut benefits or increase income through higher taxes or investment returns. Options for decreasing benefits include raising the retirement age, reducing cost of living adjustments, reducing the benefit accrual rate, subjecting retirement income to means testing, and increasing the number of years during which a worker must contribute to receive full benefits. Increasing tax options include raising the tax rate, raising the taxable wage base, taxing social security benefits, and expanding the coverage of social security to state and local

Paygo vs. individual accounts: two views

A good overview of the pros and cons of individual accounts and the paygo system was offered by two speakers at the symposium, "Impact of Social Security Privatization on Retirement Income."

Advocating privatization was Peter Ferrara, general counsel and chief economist of Americans for Tax Reform and senior fellow at the Cato Institute. Speaking for paygo was Robert L. Brown, professor of actuarial science and director of the Institute of Insurance and Pension Research at the University of Waterloo.

For private accounts and investment

Ferrara argued that a revolution in opinion and policy regarding social security is sweeping the world. Eight Latin American countries have adopted reforms letting workers choose personal investment and insurance accounts as an alternative to traditional, government-run social security systems. Similar reforms have been adopted by five European and Eastern European countries, and even Communist China is implementing personal accounts rather than a traditional system.

Ferrara noted several reasons behind this shift. First is the financial crisis faced by traditional social security systems worldwide, which, he said, was inevitable in a mature paygo system. But a far bigger reason is that private investments through personal accounts will earn far higher returns and benefits than a mature paygo system. Such investments help produce new income and wealth, which finances a return on investment that averages the full, real, before-tax return to capital. Even if tax revenues grew over time with growth in real wages and the number of workers, a mature paygo system, which is a tax and redistribution scheme, would never pay a return even remotely approaching the pre-tax, real rate of return to capital earned through private accounts.

He also argued that national economic growth would increase because of the savings and investment through personal accounts. Ferrara quoted Harvard Professor Martin Feldstein, president of the National Bureau of Economic Research, as estimating the present value of the net economic benefits from such reform to be between $10 and $20 trillion. Such expected benefits have led the World Bank to promote the shift to personal accounts around the world, Ferrara said.

government workers. Options for increasing investment returns include investing social security assets in the private sector and introducing private accounts.

Privatization's pros, cons

A spirited debate spotlighted two very different views of the effects of privatized defined-contribution (DC) accounts on the Social Security system. One view was presented by a luminary from Americans for Tax Reform and the Cato Institute, the other by a professor of actuarial science. (See sidebar, "Paygo vs. individual accounts: two views," page 4.)

Impact of privatization

Three presenters discussed the impact of various reform proposals from different perspectives.

- Sylvester J. Schieber, vice president, Watson Wyatt, and a member of the Social Security Advisory Board, discussed the risks involved in different approaches. (He also compared the current social insurance programs in various countries and various reform proposals for the U.S. Social Security system along two dimensions — paygo vs. full funding and DB vs. DC. (See story, page 8.)
- Anna Rappaport, principal, William M. Mercer, considered the potential impact on women.
- Chris Bone, chief actuary, Actuarial Sciences Associates, Inc., summarized the potential impact on private pension plans.

Schieber identified the obvious Social Security reform risks to participants as being forced either to receive lower benefits than promised or contribute more dollars than anticipated. Major risks to the U.S. Social Security system include financial market risk, risks associated with changing the system's redistributive nature, and the risk of possible reductions in disability benefits. Some of the major risks in the current system, he observed, are those associated with undiversified investments. Schieber noted the reasons for funding any retirement plan, including Social Security, as lower contribution costs over time, enhancing the ability of workers to meet consumption needs after retirement, and the importance of increasing national savings. He summarized reasons for moving to a DC approach as allowing a more dynamic adjustment of the system, the perception by workers that benefits are more secure, allowing more flexibility in raising contribution rates, and the possibility that it may be the only road to reform.

Schieber's conclusions were: there is tremendous risk in the current system, the current risks to retirement income security are not randomly distributed, using budget surplus will not eliminate current benefit risks, and diversification and plan design can reduce many of the risks.

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Social equity would be enhanced as well, he argued, as poor and moderate-income workers are able to participate in private markets for the first time, producing better benefits for them. This is far preferable to reforms that would cut benefits or increase taxes, Ferrara stated.

Applauding the paygo system

Brown, in his presentation, focused on establishing criteria that would ultimately provide "security for social security."

Brown began by comparing privatization with the advantages of a paygo defined benefit system, citing paygo advantages such as universality, vesting, and portability; indexing of benefit amounts; and low administrative costs.

Brown summarized research showing that prefunded systems have natural cost advantages over paygo financing under some economic assumptions but not others. He cited a study by the Canadian Institute of Actuaries on the financing of Canadian social security systems. Using 1960s assumptions about demographic and economic events (including a 2% real rate of return on assets and a 2% real wage increase), the study found a significant advantage to the paygo method — finding that paygo would be less expensive than prefunding by 5.5% of payroll. However, based on 1990s assumptions (including a 4% rate of return on assets and only a 1% increase in real wages), paygo has a cost disadvantage of more than 7% of payroll. Brown questioned whether changes should be based primarily on different views of the future economy, particularly views that expect high rates of return and relatively low wage growth. Brown stressed the importance of using consistent assumptions when comparing systems, saying the recent U.S. debate has seen advocates of private accounts assuming higher rates of return on investments than used by the government, placing the individual account concept in an apparently favorable light.

The historical effects of prefunding do not necessarily support a conclusion that prefunding social security benefits will increase gross national savings, Brown argued. He cited one study that found a decrease in the Chilean gross national savings rate from 21% when the Chilean system was adopted to under 19% in 1991. Another study found higher gross Chilean savings but attributed the result to factors other than prefunding of social security.

Finally, Brown questioned whether the additional funds generated by greater savings would lead to higher productivity or would instead be used in less-than-optimally productive pursuits.

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