Social Security Reform: Solutions Outside the Box
Proposals Including Individual Accounts

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Overview
Possible Advantages of Individual Accounts

• Give workers ownership and control
• Potentially greater return on contributions
• Address Social Security’s long-term deficit
• Help economy raise investment capital
• More individual equity
Possible Disadvantages of Individual Accounts

- High “transition costs”
- Increase risks to workers and families
- Increase administrative costs
- Cut benefits for lower-paid workers
- Burden on other social programs if workers make poor decisions
Individual Accounts would bring major changes

- **Investments:** Choices, communication, management, politics
- **Administration:** Record-keeping, education, payouts
- **Program would have two tiers**
  - Proposals usually shift about 2 percent of taxable wages to IAs
  - Traditional defined benefits would continue, with reductions for people with IAs
- **Transition:** Need to close financing gap and keep paying existing benefits
Possible models: IRA, federal TSP, 401(k)

- Investment choices – Few vs. many? Use index funds?
- Recordkeeping – Centralized vs. decentralized?
- Payouts – Allow access to funds before retirement?
- Level of expense charges – Retail vs. wholesale?
- Investment education – Teaching workers how to invest
Designing Individual Accounts: 10 Key Issues

• Should IAs be mandatory or voluntary?
• How to keep benefits adequate for low-paid workers?
• How to grandfather older workers and retirees?
• How to preserve disability benefits?
• Should all individual accounts be managed centrally?
• What investment choices should workers have?
• How can workers make informed investment decisions?
• Should workers have access to funds before retirement?
• Should payout annuities be mandatory or voluntary?
• How to design and administer payout annuities?
Basic Design
Should Individual Accounts be voluntary or mandatory?

• Issues to be addressed in a voluntary system
• Open seasons – extra handling, extra costs
• Inertia – many would stay in current program
• Second thoughts – workers may want to change their elections if investments perform poorly or current program modified
  – Should workers with IAs get benefit guarantees?
  – Would current benefits be protected against cuts?
Adequacy Issues

• Current benefits favor workers with low pay, employment gaps, dependents
  – Benefit formula is weighted to help lower-paid workers
  – Benefit formula also helps workers with gaps in employment

• IA plan will either make up these subsidies or create winners and losers
  – To help small accounts, charge investment expenses as a % of assets
  – Could also subsidize accounts of low-paid workers
Likely design of basic benefits

- Existing beneficiaries – maintain benefits in pay status, including survivors & COLAs
- Older workers, e.g., 55 & up – also maintain current program
- Younger workers – they pay the current S.S. contribution minus amount going to IAs. They get current program’s benefits, offset by benefits derived from IAs
- Future workers – get scaled-back defined benefits
- Disability and survivors’ benefits – to be restructured, reflecting benefits from IAs
Offset for benefits derived from individual account

• Worker’s basic benefit is usually offset by an estimated benefit derived from IA
• Formula might assume all IA contributions earn a 3% real rate of return
  – For workers earning over 3% real, IA benefits will exceed offset
  – For workers earning less, offset will exceed IA benefits
• Actual benefits and costs are very sensitive to this assumed rate of return
• Proponents of IAs often tout high potential returns on stocks, but workers may invest more conservatively
• In practice, offset formula may hurt public acceptance
Earnings sharing, in case of divorce

- Should each spouse get half of benefits during the marriage
- With traditional Social Security, difficult to administer
- With individual accounts, much more workable
Administration & Investing
Administrative issues & challenges

- Keeping politics out of investing
- Holding down costs to manage & invest accounts
- Educating workers about investing
- Payout of funds for retirement income
- These issues are critical to success of IA plan
Keeping politics out of investing

• If government agency handles investment, security selection could be seen as government endorsement

• Alternatives include:
  – Government approved private investment funds
  – Index funds

• Should “socially responsible investment” be permitted?
  – If so, who decides “good” from “bad”?
  – Can weapon makers be excluded while the government wages war?
Holding down costs to manage & invest accounts

- Such costs add up over time, reduce retirement funds
- IRA approach
  - Individual chooses from many providers & funds
  - Investment advice may not be objective
  - High “retail” costs to handle & invest
- TSP approach
  - Few investment choices, central administration
  - Government controls investment advice
  - Lower “wholesale” costs to handle
  - Index funds have low costs to invest
Educating workers about investing

- Not many workers understand investments
  - Must explain choices clearly, answer questions
  - Small employers can’t help much
- Simple plan with few choices would simplify worker education
- Sophisticated investors may clamor for greater flexibility
  - They can also better afford costs of “retail” investing
  - Equity issues if wealthy enjoy more choices
Payout of Funds
Before retirement: loans & withdrawals

- Before retirement, many workers will want to tap funds.
- Some of these individuals will be in dire financial need.
- Policy makers must decide up front whether to allow access to funds in hardship cases.
  - Any exceptions weaken the program as a retirement vehicle.
  - Better for individuals to use other programs & resources.
- At worker’s death, beneficiary can be paid the account balance.
After retirement: should annuity be mandatory?

**Disadvantages**
- Worker may want to keep control
- Annuities favor people with longer life expectancies
- Annuities favor married people and especially those with young spouses unless benefits actuarially reduced for survivor benefits

**Advantages**
- Retirees can’t outlive resources
- Avoids tough problems of self-managed retirement fund, particularly among the very aged or infirm
- Cuts annuity costs – broad spread of risk, low expenses
- Makes unisex pricing feasible – attractive to women
What form of annuity?

• Specifying a standard form has advantages
  – Suggest lifetime annuity in fixed amount with automatic COLAs
  – After death of married worker, continue 2/3rds to surviving spouse
  – After death of worker and spouse, pay account balance at retirement minus all annuity payments

• This guarantees that benefits will at least equal the account balance at retirement
• Death benefit doesn’t change abruptly at retirement
• No tough decisions or complex comparisons
Who should provide the annuities?

• Why not let the government run the annuity program, working through private firms?
  – Annuities would be cheaper, covering a cross-section of risks with low handling costs
  – Can avoid any risk of loss due to insurer insolvency if government assumes risk
  – Accommodates inflation-indexed annuities and unisex rates
  – Can cut costs by coordinating payments with basic Social Security benefits
Timing of annuity purchases at retirement

• Cashing out stocks to buy an annuity can be risky
• Worst case is when stocks are down and annuity yields are also down
  – Can spread sale of stock funds over a few years
  – Can either buy annuities gradually or lock in favorable annuity rates
  – In UK, full annuitization mandatory by age 70
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