Options Strengthen Social Security

MANY ALTERNATIVES FOR REFORMING SOCIAL SECURITY are under discussion. The choices include increases in payroll taxes, creating personal retirement accounts, reducing benefits, and investing the Social Security trust fund assets in equities. All of them come with pros and cons, suggesting there are no neat, easy solutions to the finance issues faced by the current system.

Clearly the issues faced by the Social Security system are complex. In fact, reasonable people would disagree on the extent of the funding problem. Despite arguments, many would agree that changes are needed to avoid "bankrupting" the trust fund at some point in the future. Some level of reform is no doubt needed, the sooner the better.

Many of the choices being considered have, by necessity, a negative impact for participants. As a result, individuals will lose (either through higher payroll taxes or smaller benefits) if these changes happen. They will feel the costs.

It's possible, however, to introduce benefit options (i.e., a menu of choices for participants) that offer the potential to boost monthly income and yet save money for the system. Indeed, participant options may be easier to adopt both economically and politically. In any event, they should be proposed and debated. One potential option is presented here.

Private Sector Annuity Option

In essence, the system would be modified to permit *new* retirees to replace their Social Security benefits with lifetime income provided by a variable payout annuity from the private sector. Under this proposal, future retirees would have the option (i.e., the right, but not the obligation) to "cash out" their monthly benefits and then have that amount invested inside a variable payout annuity contract.

Under this option, the retiree would be forced to use the lump sum to purchase an income annuity. The money could not be used for any other purpose. Then, in place of monthly lifetime benefits from the system, the retiree's income would derive directly from the annuity contract. Since it's a variable contract, it would offer the retiree the opportunity to grow income through various equity investment choices. (Also, the annuity contract could be designed to minimize insurance charges by having the trust fund participate in the contract's mortality experience. For example, gains from favorable mortality experience could revert to the government, as happens today.)

This cash-out option would be fully voluntary. Future retirees could continue to keep their Social Security benefits within the present system.

Those electing the private sector annuity would pay for the option by receiving a lump-sum amount that's below the economic value of their expected future Social Security benefits. However, participants electing the option would, of course, expect to more than fully recover the cost of the option by investing the lump sum in stocks (inside the variable annuity contract).

Calculation of Lump-Sum Value

For this proposal to be attractive to the Social Security trust fund, the lump sum paid by the system has to be less than the economic value of the future benefits the system expects to pay. Because retirees are offered an option, this is fair to the system and to the participants. Indeed, individuals can invest the lump sum in securities that are expected to offer a spread to treasuries (either corporate bonds or stocks). And participants who don't like the option can always stick with what they have today.

In calculating the lump-sum value, one possible approach is to assume that Social Security benefits will remain flat, i.e., zero credit for future Consumer Price Index (CPI) benefit increases. This clearly reduces liabilities for the Social Security program and should more than pay for the option. While the government's near-term cash flow needs would increase to accommodate those retirees electing lump sums (for reinvestment inside an annuity contract), the system's long-term liabilities would be reduced because of the CPI increases forfeited by the retirees electing the option.

The interest rate used to calculate the lump sum could be pegged to appropriate Treasury rates at the time the cash-out is paid. This assumption preserves cost neutrality for the government. And, if the annuity contract ultimately shifts all mortality risks back to the government, the lump-sum value could be calculated using any reasonable mortality table.

Note these assumptions are used for presentation purposes only. They shouldn't be interpreted as the "right" assumptions. Market testing is necessary to gauge how

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the price of the option impacts utilization. In fact, setting the right price for the option is critical if the program's goal is to maximize savings. Too high a price lowers utilization; too low a price increases it. In either case, however, total savings to the system are less than optimal.

Annuity Contract Design

So long as the annuity contract operates like a typical variable payout annuity contract but uses assumptions consistent with the cash-out rates (e.g., an annual interest rate equal to the cash-out interest rate, annuity mortality equal to cash-out mortality rates), the retiree would begin to receive monthly payments equal to those from the Social Security system. In other words, the initial payment from the annuity contract would equal that paid by the system. Future benefits to the retiree, however, would then be recomputed based on the underlying contract assumptions and the actual investment performance of the funds selected by the retiree (instead of CPI increases).

Implications for the System

This proposal is conceptually related to the individual account proposals. Both approaches produce negative short-term cash flows for the system. The initial impact of the private sector annuity option is likely to be modest compared with the impact of introducing individual accounts, in part because of lower expected utilization.

In reality, many retirees would opt for the status quo and stay with the present program in order to keep the inflation feature they now enjoy. Unlike the individual account proposals, the cash flow impact of the annuity proposal would decrease over time, as the system makes no further payments to individuals who elect the option.

Despite a near-term negative cash flow hit for the system, Social Security's long-term liabilities would, in fact, be reduced. Assuming the lump-sum calculation is based on a zero-CPI indexed benefit, and a 10 percent election rate among future retirees, the system could save as much as $100 billion in today's dollars. These savings assume that future CPI increases will average just over 3 percent and would be forfeited by those who elect the proposal. These savings aren't enough to protect the system's long-term solvency, but they can help.

Equally important, the success of the private sector annuity option can be monitored to see if further changes are needed. These changes are readily controllable because the proposal is incremental; it impacts only future retirees, not every participant. For this reason, it would be relatively simple to conduct an experiment and evaluate results by offering the option to individuals retiring, say, from 2004 to 2008.

Implications for Participants

Again, the proposed change is incremental. No retiree would be forced to take the annuity. Only those electing the private sector annuity would experience a change.

The option may not be attractive to many future retirees. Some, however, will find it very attractive. Those opting for the lump sum would understand that all future benefit payments from the system (including CPI adjustments) are forfeited. And they'd be obligated to invest the commuted value in a variable payout annuity from the private sector. This would, in turn, provide them with monthly income payments for life as well as the opportunity to maximize that income by investing in a mix of bonds and equities (as is done with today's variable income annuities).

Much like the individual account proposals, those opting for the annuity would take on the investment risk. However, the annuity contract could (for a fee, of course) provide for some minimum level of lifetime income.

A Numerical Example

Figure 1 shows some numbers that help illustrate how the proposal would work for a new retiree. All figures are approximations for a hypothetical male retiring at age 65.

FIGURE 1 Approximations for a male retiring at age 75

	CURRENT SYSTEM	PRIVATE SECTOR ANNUITY OPTION
Monthly benefits	$1,000 + CPI	$1,000 +/– investment return relative to AIR
Expected PV cost to trust fund (if CPI = 3%)	$190,000	$140,000
Lump sum to annuity contract (use CPI = 0%)	$140,000	NA
Cash-out interest rate (at assumed Treasury yield)	5%	NA
Annuity contract (AIR)	NA	5%
Cash-out mortality table	Annuity 2000 table	NA
Annuity mortality table	NA	Annuity 2000 table

Conclusions

Reforms based on offering options to participants may not solve the Social Security's finance problems, but they can help. Indeed, the system is in a unique position. It can take advantage of the arbitrage opportunity created by offering options that, in effect, swap the government's credit for corporate credits.

The private sector annuity option benefits those participants now closest to retirement (a group that has contributed substantial amounts to the system). Unlike other individual account proposals, the option provides significant amounts of money for investment in an individual account (inside an annuity contract).

Because only new retirees are eligible for the annuity option, running an experiment may be relatively simple. And adjustments could be made as necessary.

Given the stock market's recent results, now may not be the best time to tout equity investments. But, assuming history is an indication of the future, equity markets will rebound, and some retirees will want to stay fully invested, especially as mortality improvements continue. Arguably, with many retirements expected to last more than 20 years, this may be a good time to tout equities for retirees. ●