

## Social Security Super Bowl

**T**HE MAY/JUNE ISSUE OF *CONTINGENCIES* contained a high-level debate regarding private accounts. It raised a fundamental issue: safety net or ROI? As Canadian actuaries, we were enticed to compare how our two countries have tackled similar problems.

On our path to civilization, we Canadians have elevated the Lower Class to the Working Class. In many respects, the Working Class can also be referred to as the Middle Class. Now, members of the Working Class, after 40 years or so of dignified labor, can count on a decent retirement for their remaining lifetime. Officially, at least. How decent a retirement? That, of course, is a matter of opinion. The level of the Social Security benefit is determined, directly or indirectly, by the national definition of the poverty line, a manifestation of national conscience. Over time, the definition of the poverty line will change, as the economy grows and values evolve.

The base of the social pyramid, the Working Class, was meant to have a decent golden age. It was formally agreed that Social Security was to be the vehicle for providing a reasonably comfortable retirement. At this time, for one-third of all Americans over 65—about 11 million people—Social Security benefits constitute 90 percent of retirement income.

The discussion in the United States involves a potential tinkering with those benefits. The fact is, replacing wage indexing by price indexing would reduce Social Security benefits by about 25 percent for individuals retiring in 2041. Why do that? If it isn't broke, don't fix it. And the American Social Security plan definitely isn't broke, at least not yet.

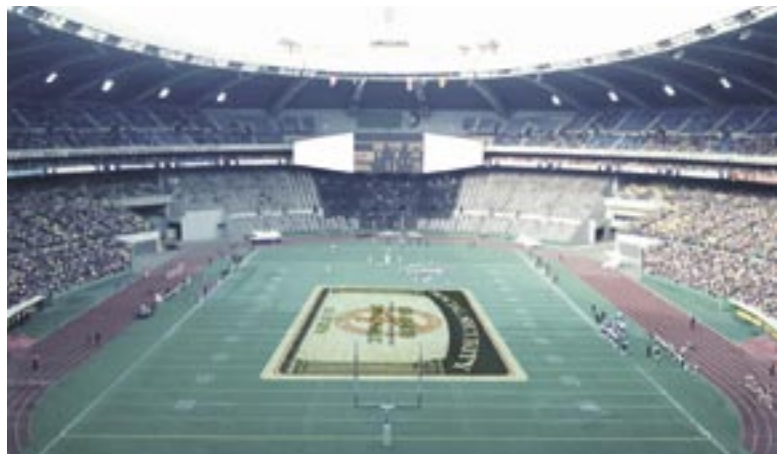
When will it be broke? When will doomsday be reached?

Back in 1994, the Social Security actuaries estimated doomsday in 35 years (year 2029). In 2005, their forecast is in 37 years (year 2041). Some changes to the plan were made, but there does appear to be some form of conservatism. While it's legitimate to include some

conservatism, it strikes us that politicians and journalists tend to claim the year of doomsday as carved in stone. This is ironic. Few economists can predict

the swings in the federal budget in the following year, but we deliberate with apparent precision on the next 75 years of Social Security. Shouldn't our role be to educate them about the stochastic nature of the results?

The United States chose not to make Social Security fully funded, unlike private and public pension plans—the same conclusion we reached in Canada. It seemed like the right thing to do then, and time has proved us



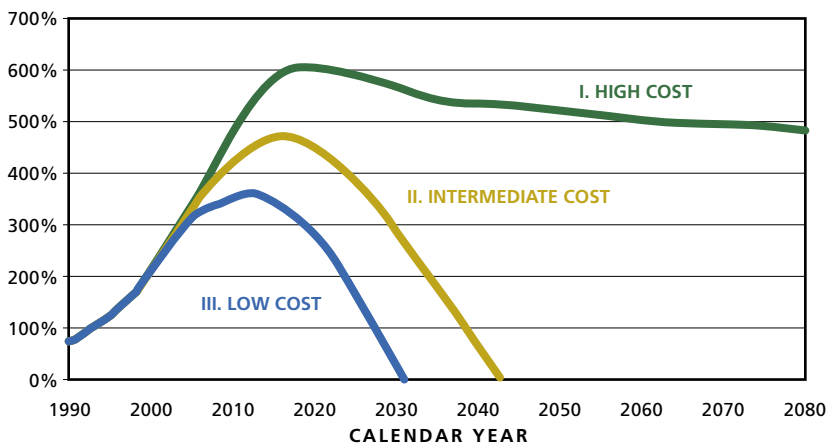
right. Doomsday has been postponed, primarily because of better-than-expected economic growth. Full funding is for closed groups, not for perpetually going concerns—as long as growth is perpetual, too. The funded status of Social Security can and should be postponed for now, but the Social Security trust fund is a different story.

The Social Security trustees' report includes three alternatives. (See graph on page 16.) The intermediate economic and demographic assumptions, designated as alternative II, reflects the trustees' best guess. For example, the interest rate is assumed to be 5.8 percent, while it's 6 percent for alternative I (high cost), and 5.5 percent for alternative III (low cost).

The Congressional Budget Office estimates doomsday in 2052 by using more aggressive assumptions than alternative II and because it's using a more sophisticated modeling technique. For decision-makers, we feel the 2052 doomsday is appropriate, as long they're aware that the actual date will likely be between years 2038 and

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## Alternative Economic Assumptions



2076. Yes to acting sooner rather than later, no to panicking.

The trust fund has \$1.7 trillion of pure Treasury bond Social Security gravy. This is Working-Class money, accumulating from the surpluses every year because the payroll taxes collected exceeded the benefits paid out. Even today, Social Security has taxes exceeding payouts.

But not for long. Current estimates call for benefits to start exceeding taxes in 2017, and that's fine. That's why the trust fund was created in the first place, to postpone doomsday for a very long time, even forever.

But where is the money?

Uncle Sam has it. Uncle Sam borrowed it. Uncle Sam pays interest on it, on paper at least, acting as the banker for the Social Security Administration (SSA). And this isn't right. Uncle Sam should cough it up, the whole trillion-and-a-half bucks, and now.

Will Uncle Sam have to borrow the money in the global markets to pay SSA? Of course not! Uncle Sam has already borrowed the money, a private placement from the SSA, spent it, and now owes it. Congress can have the Treasury Department issue \$1.7 trillion worth of T-bills to the SSA.

This money was intended to be repaid anyway, and will cost the same amount of interest. This money is too important to leave in the hands of politicians. Let the legislature and the executive branch choose who manages the money, but they

should then be cut out of the loop.

Canada separated the fund from the state, first in Quebec in 1965, followed by the rest of the country in 1999. Our Working-Class money is now in the hands of independent entities that are totally public, transparent, and watched very closely. But what is America to do?

Transferring Social Security money into private accounts would be tantamount to lowering benefit levels and raising the level of risk. Private accounts should be in addition to, not instead of, Social Security. Relatively unsophisticated Working-Class people should not be expected to gamble with their guarantees; structural poverty could be a very real danger and should be avoided.

Private accounts are a wonderful addition to Social Security, as we've proven in Canada with our Registered Retirement Savings Plans, where one can salt away 18 percent of one's income every year to enrich retirement above and beyond Social Security benefits. But there's a warm, fuzzy feeling that even if all else fails, there's always the safety net.

The question remains: What to do with the \$1.7 trillion? Well, it would help, first, to talk objectives.

Remember that doomsday arrives in 2041. Doomsday can be postponed. The Social Security trust fund can accomplish that. Historically, the return on Treasury bonds has been low. The return on stocks has been significantly higher. Under scenario II, for every 1 percent improvement

in the annual investment income of the trust fund, doomsday will be postponed by four years. Doomsday will be postponed longer if experience is better than alternative II.

The solution in Canada, namely the use of stolid government agencies, won't appeal to the Americans. Thus, we offer an American-style solution to the Social Security conundrum. We call it the National Trust Fund League (NTFL).

America loves its sports, its leagues—competition, championships, grand prizes! No other nation organizes leagues better than the Americans. The NTFL will be a league of competing fund managers.

Here's how it'll work. We have an initial portfolio of \$1.7 trillion, all in Treasury bonds. Our objective is an asset allocation model that achieves a much better rate of return than Treasury bonds. Let's say we take \$500 billion of the portfolio and earmark that sum for equities. The money will have to be given to fund managers of some kind. If it's divvied up amongst the Big Houses, which would be the normal inclination, it'll cost the fund up to 1 percent in management fees annually, plus 20 percent of gain as back end. It's the industry norm.

We can do better.

Imagine 100 teams of money managers, each with \$5 billion to manage, engaged in a five-year championship. There will be no or minimal management fees. Compensation can come in the form of 10 percent of the investment return in excess of 3 percent, payable annually. Managers with inferior "losing" returns can be eliminated from the league at intervals and their share of the portfolio turned over to the better "winning" performers.

Don't forget fair rules of entry and selection, and a level playing field. You need to get the brightest and best fund managers to postpone doomsday and keep postponing it. Failure will result in an increase in payroll taxes, a cut in benefit levels, or both.

It seems as if fund managers have had their share of shame and ignominy; now it's time to give them a chance at fame and glory.