A Better Approach to Reforming Social Security

By Arun Muralidhar, PhD

Editor’s Note: This a response to an article in the November/December 2013 issue of Investments & Wealth Monitor, "Still a Better Deal: Private Investment vs. Social Security," by Michael Tanner.

Tanner (2013) makes a cogent and robust case for reforming U.S. Social Security. Sadly, like many of those keen to see the role of government limited in the provision of services, and possibly empowered by the calamitous roll-out of the Affordable Care Act, Tanner (2013) conflates two key issues in this debate and comes to the wrong conclusion. Unfortunately, the proposed approach is flawed, as global experiences with this experiment showed; in the late 1990s the World Bank pushed this same approach onto governments in Latin America and Eastern Europe, with disastrous consequences (Price and Rudolf 2013). Modigliani and Muralidhar (2004), hereafter referred to as MM, cautioned against such an approach and argued that it would lead to bad outcomes, which sadly were borne out, especially in 2008. MM argued that (1) privatization only privatizes risk; (2) these systems would lead to a transfer of wealth from the poor to rich asset managers (because of high fees and poor regulation); (3) market volatility would leave investors and governments worse off (because they would have to bail out citizens); and (4) using government debt to finance the transition from pay-as-you-go (PAYGO) government-administered pensions to privatized funded systems was effectively a poor, leveraged trade that would hurt in a secular bear market. Chastened by this experience, even the World Bank no longer argues for privatization, and many countries sensibly rolled back such systems.¹

So what issues does Tanner (2013) conflate? The paper conflates the funding issue and the type of system to adopt. Tanner (2013) is right to suggest that converting to a (partially) funded system and investing in the market can help with the Social Security crisis. However, that does not also immediately mean that we need to convert Social Security from a defined benefit (DB) scheme to a defined contribution (DC) scheme. This is the mistake that the World Bank made nearly 20 years ago. It decided to change social security from a government-sponsored, PAYGO DB scheme to a privatized, funded, DC scheme when only one aspect needed to be changed—the funding. Tanner (2013) demonstrates that the critical issue threatening social security systems globally, and specifically the United States, is a funding problem; namely, that PAYGO systems are likely to experience crises because their stability depends on sustainable population and productivity growth, and forecasts for both these parameters are meager. Further, small changes to these parameters lead to dramatic changes in contributions/taxes or benefits, as highlighted by Tanner (2013) and MM. Therefore, moving Social Security from a largely PAYGO system² to a partially funded system would only require moving the accumulated reserves from an arbitrary mechanism of recording reserves at the Treasury into a well-governed, properly invested portfolio of market assets with clear and transparent benchmarks as demonstrated in MM. The Canada Pension Plan Investment Board (CPPIB) provides a useful model of how good governance and good investing can be successfully implemented in a government entity.

How does the MM proposal compare with the privatized model suggested by Tanner (2013)? Consider the following:

Benefits. DC schemes can lead to wide variations in pensions for cohorts retiring a few years apart, all else equal. For a cohort that retired in 2008, pensions would have been scanty compared to a cohort that retired a few years before. A cohort that retired soon after 2008 also would have borne the brunt of the bad market. Further, many nonpractitioners of investments often do not realize that fixed-income assets also can decline and that moving more into fixed income closer to retirement is not a panacea. These capricious outcomes, driven largely by one’s date of conception, cannot be the basis of a mandatory social security system. A DB system, on the other hand, incorporates inter- and intra-generational risk sharing and allows for smoothing of outcomes.

Privatization of risk. DC schemes transfer risks to those least able to bear them—the poor. These individuals are financially unsophisticated and do not have access to good advice, further exacerbating the problem. Using life-cycle funds to address this problem is an equally troublesome approach. A growing population of poor retirees will lead governments to bail out the depleted accounts of investors setting the stage for excessive risk taking.³ Those with good outcomes will keep their gains;
those with bad outcomes will be bailed out by governments seeking re-election, and bailouts will lead to higher taxes.

**Costs.** The pure cost of running a funded (even partially) DB system will be far smaller than the cost of a privatized DC system, and plenty of evidence supports this. Every dollar saved leads to greater compounding over 40 years and to better pensions, as opposed to transferring this wealth to already wealthy asset managers. Further, MM showed that the cost of bailing out the entire system and ensuring a basic standard of living for all, should the markets enter a long-term secular decline, is far lower under a funded DB system than a privatized DC system. Even the volatility of contributions/taxes, a key pension risk-management parameter, is lowest under the funded DB system for reasonable changes in key parameters such as productivity growth, population growth, and investment volatility. Finally, the cost of providing annuities will be cheapest and most efficient under a DB scheme, especially when participation is mandatory.

**Financing the transition.** The proponents of privatized DC systems do not indicate clearly how the transition to this system will be financed. Financing the transition led to major problems in the developing world in the late 1990s. If individuals start to fund their individual accounts with monies previously destined for Social Security, then Social Security will be in even worse financial shape than Tanner (2013) predicts. MM showed that investing the existing reserves and future contributions in the market is a more sensible way to reform the system, but even under this approach additional contributions will be needed from all participants, because every delay in reforming Social Security since the Clinton-era surplus has led to a worsening of Social Security’s finances. The Obama administration worsened the problem with a 2-percent Social Security payroll-tax cut, transferring this funding burden to future generations. In short, there is no easy solution. Additional taxes will need to be borne by all citizens, the cost will rise with each delay, and the lowest-cost outcome is a conversion to a partially funded DB system. Debt-funded transitions are dangerous and increasingly impossible given the rising level of debt to gross domestic product.

I agree with Tanner (2013) that Social Security is flawed and on an unsustainable path. The benefit formula is complicated and difficult for even financially sophisticated individuals to fathom. However, changing every aspect of the system, as proposed by the World Bank in the 1990s and Tanner (2013), is not an acceptable solution. Using the accumulated reserves, along with funding from additional taxes, to start investing in a market portfolio, as Tanner (2013) suggests, is an acceptable and viable solution. With an appropriate governance structure and clear, transparent benchmarks, this change maintains Social Security’s DB structure and provides a simpler approach with potential for the best outcomes.

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**Endnotes**

1. The World Bank now recommends life-cycle funds, an approach that is equally flawed and will lead to equally bad outcomes because it requires enlightened regulators to set up appropriate life-cycle glide paths for each cohort in order to secure adequate retirements. Further, life-cycle funds have an inherent flaw in assuming that government bonds are the safe asset and that increasing the fixed-income allocation as one ages is a smart investment strategy. See Muralidhar (2011) for a critique of these approaches.

2. Social Security in the United States is not a pure PAYGO because excess contributions are maintained in the Social Security Trust Fund, discussed by Tanner (2013).

3. The government bailed out car companies and investment banks during the 2008 crisis, so it seems likely it will bail out large numbers of investors who will be retiring poor.

4. MM argue and show that rather than the current formula, which targets a replacement rate on the best 35 years of average lifetime salary, a simpler and easier approach would be offer a fixed (guaranteed) real return on contributions. MM show that this simplification provides the same outcome as the complex formula and also simplifies how much individuals accumulate in potential benefits, while making the DB system seem much like a DC system.

**References**


