

Reducing The Downside Risk Of Not Receiving Anticipated Social Security Benefits By Using Personal Accounts

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Abstract

The government is not obligated to pay Social Security benefits and no one has the right to receive such benefits. This paper presents the argument that opting for a personal account in conjunction with traditional Social Security is less risky than opting to have all of ones Social Security taxes go into traditional Social Security. The overall downside risk of receiving lower than anticipated Social Security retirement income is reduced by diversifying to include personal accounts along with traditional Social Security.

INTRODUCTION

Partial privatization of Social Security including the use of optional personal accounts (also termed private accounts) has been proposed as a plan designed to help maintain Social Security retirement benefits for future retirees. The plan is controversial in nature. One particularly controversial aspect is the risk exposure for those workers who opt to participate in partial privatization by having their own personal accounts.

A number of papers in both the popular and academic press have examined the risks surrounding the proposed optional personal accounts. Many of the articles explicitly assume that traditional Social Security benefits are guaranteed. Marco (2005), for example, states, “The argument offered by private account advocates is that individual investors, with their investment skills, will exceed the return provided by the *Social Security guarantee* [emphasis added].” Likewise, another article challenging the viability of personal investment accounts suggests, a priori, that these accounts are not “an effective substitute for the *guaranteed life incomes* [emphasis added] provided by Social Security.” (Dreher 2005).

This paper argues that traditional Social Security retirement benefits are not and cannot be guaranteed. Although no argument is given for or against partial privatization of Social Security, per se, a meaningful evaluation of the risk surrounding personal accounts demands a consideration of the risk that future traditional Social Security benefits may be reduced or, in the extreme, not be available. That is, such risk analysis must be undertaken within the context that Social Security retirement benefits for existing and future retirees are likely to be reduced as a consequence of changing population demographics, and/or evolving economic and social conditions. Accordingly, traditional Social Security benefits are not guaranteed.

EXPLANATION AND RISKS OF OPTIONAL PARTIALPRIVATIZATION OF SOCIAL SECURITY AND THE USE OF PERSONAL ACCOUNTS

As proposed, the optional partial privatization of Social Security would afford workers born after 1950 the choice to 1) continue to have all of their Social Security contributions applied to the traditional Social Security program or 2) have a portion of their Social Security contributions (up to four percent of their wages with an initial limit of \$1,000) placed in a “personal account,” with the remainder applied to traditional Social Security. The latter choice could result in a maximum of about one-third of each worker’s combined employer-employee Social Security contribution going into a personal account and the remainder to traditional Social Security.

The funds placed in the personal accounts could be designated for investment in a restricted number of broad-based mutual funds modeled after the Thrift Savings Plan, the federal-employee retirement plan. The Thrift Savings Plan provides a limited choice of mutual funds including Treasury security, bond-index, and stock-index. Investment of personal account funds in individual corporate securities, for example, would be completely prohibited.

If partial privatization is implemented, it is proposed that the traditional Social Security program would be the default plan for all workers. That is, only those who specifically opt for personal accounts would participate in them.

Those workers who opt for partial privatization (and have a portion of their Social Security taxes placed in personal accounts) would receive smaller monthly traditional Social Security payments at retirement than those workers who opt to have all of their Social Security taxes placed in traditional Social Security. However, they would receive additional income from their personal accounts.

Those opting for partial privatization would select among the available mutual fund choices and then establish a personal account similar to an individual retirement account (IRA). If a worker died, the accumulation in her/his personal account would be passed on to her/his beneficiaries.

The primary financial issue that needs to be addressed by a worker considering participation in optional partial privatization is simple. What is the likelihood at retirement that she/he will receive higher total monthly benefits by 1) opting to participate entirely in traditional Social Security or 2) opting for a personal account and partial participation in traditional Social Security? Put another way, is it likely that the monthly retirement benefit paid by traditional Social Security will be greater than or less than the combined payment resulting from 1) the monthly income generated from the personal account plus 2) the reduced monthly payment from traditional Social Security?

The answers to these questions depend primarily on 1) the accumulation in each worker's personal account at the time of retirement and 2) the statutes governing the rates of payment for traditional Social Security benefits that the worker will receive at the time of retirement. Estimating the accumulation in a worker's personal account is briefly discussed below. Estimating a worker's traditional Social Security benefits necessitates an understanding that there is uncertainty surrounding those benefits; the laws defining traditional Social Security benefits have been and are likely to be changed periodically as a consequence of changing population demographics, and/or evolving economic and social conditions. As detailed in the Literature Review, traditional Social Security benefits are not and cannot be guaranteed.

The accumulation in each personal account at any given time depends on the following three factors – the same factors that affect accumulations in an IRA:

- The amount of each worker's contribution to the personal account (i.e., the amount of her/his Social Security taxes allocated to her/his personal account.)
- The length of time the worker participates in partial privatization and funds her/his personal account.
- The rate of return received on the worker's funds placed in her/his personal account.

As proposed, once a worker starts to fund a personal account, the accumulation in her/his account would belong to that worker; it would no longer fall under the purview of the government. Therefore, if Congress decided to change the laws regarding traditional Social Security retirement benefits, and decreased or eliminated traditional Social Security benefits for those retirees whose income exceeds a specified amount (as has been proposed), those retirees whose income exceeded that income limitation would still receive the income generated from their personal accounts. Personal accounts would represent personal nest eggs. This feature of personal accounts reduces their risk relative to the political risks inherent in traditional Social Security.

As noted earlier, the proposed mutual fund investment options available for personal accounts are expected to be very limited, as a risk-reducing measure, and likely will include only a small number “index mutual funds.” Index mutual funds mirror a broad bond index or a stock index such as the S&P 500. Since index mutual funds mirror a large portfolio of securities, each index fund offers a high level of portfolio diversification and thereby tends to minimize investment risk. In addition, index funds have very low operating costs. Limiting investments in personal accounts to index mutual funds (and not permitting investments in any individual securities) reduces personal account risk.

In addition to reducing risk through portfolio diversification, risk in personal accounts is reduced by the fact that workers who opt for personal accounts are likely to participate for many years – probably decades. A worker opting for a personal account at age 25, for example, is likely to be making contributions for some 40+ years before retiring. Very long time horizons such as 30 or more years tend to reduce risk since short-term market gyrations average out over time.

Even with the built-in safeguard of limiting investments to index mutual funds, some participants in personal accounts are likely to attempt to “time the market” and shift their contributions and accumulations from one available mutual fund to another. Timing the market is extraordinarily challenging and often results in investors buying high and selling low, thereby reducing their returns. Other participants in personal accounts might, for example, decide to place all of their personal account funds in only one category of investment such as equities (as opposed to diversifying to include bonds and other investments). This strategy of limiting portfolio diversification increases risk. Clearly, personal accounts encompass risk.

LITERATURE REVIEW

The widely held notion that Social Security is a guaranteed, inviolable provision of the federal government evidently fails a reality check on legal, actuarial, and political dimensions. The most fundamental challenge to this notion can be traced to the 1960 U.S. Supreme Court ruling in *Flemming v. Nestor*. Justice John Hanlan wrote that the “noncontractual interest of an employee covered by the [Social Security] Act cannot be soundly analogized to that of the holder of an annuity, whose right to benefits is bottomed on his contractual premium payments....” He further stated that Social Security “was designed to function into the indefinite future, and its specific provisions rest on predictions as to expected economic conditions, which must inevitably prove less than wholly accurate, and on judgments and preferences as to the proper allocation of the nation’s resources which evolving economic and social conditions will of necessity in some cases modify.” He also specified that viewing the Social Security System as a “concept of ‘accrued property rights’ would deprive it of the flexibility and boldness in adjustment to the ever-changing conditions it demands and which Congress probably had in mind when it expressly reserved the right to alter, amend or repeal any provision of the Act” (Supreme Court Case: *Flemming vs. Nestor* 2005).

Such “altering” of Social Security benefits clearly can be found in the 1983 Social Security amendments. They were based on recommendations of the Greenspan Commission. According to the National Center for Policy Analysis, these amendments authorized the following significant changes:

- Increasing Social Security payroll taxes.
- Increasing the “Full Retirement Age” (also called the “normal retirement age”) in steps from 65 to 67. This represented a reduction in benefits for future recipients.
- Subjecting a portion of Social Security benefits to taxation. This constituted a reduction of current benefits for many recipients.
- Reducing early retirement (age 62) benefits from 80 percent of Full Retirement Age benefits in 1983, to 75 percent in 2009, and 70 percent in 2027. Again, this represented a reduction in benefits for future recipients (National Center for Policy Analysis 2005).

It should be noted that the amendments’ primary impact was on future retirees; for the most part (aside from the taxation of some benefits for some recipients), the changes had little or no effect on the benefits received by the then current retirees or those approaching retirement age.

Earlier, the 1981 Congressional Reconciliation Act repealed the Social Security student benefit for students 18-21 years of age pursuing higher education (History of Social Security “Student” Benefits 2005). These two major benefit reductions enacted in 1981 and 1983 clearly indicate that one cannot depend on receiving those Social Security benefits defined under existing law at any point in time; the statutes may be changed in the future, decreasing the benefits. Furthermore, the pattern of changes appears to indicate that Congress is much more likely to change the future benefits of younger workers than to change existing recipient benefits or the expected benefits of those approaching retirement.

The foregoing examples underscore what Attarian calls the “mythmaking” of Social Security policymaking (Attarian 2003). These include misplaced public trust in the System as an insurance fund paying “guaranteed benefits ... as a matter of earned right.” Ultimately, Attarian argues, Social Security is “trapped between the imperatives of economics and the imperatives of politics.”

Klein appropriately observes that the historical ideological legacy of the American public-private welfare state – that of the basic welfare state, contained and limited, with all other needs met by private sources – continues to dominate policy proposals and legislation up to the present day” (Klein 2004). In this context, the state functions within a network of relationships involving business, service, and labor sectors. From a similar perspective, Peters calls attention to a “new welfare regime – one that is no longer focused on the rights of the citizen, but that is based on the model of the citizen-consumer who makes investments in the self at critical points in the life cycle” (Peters, 2005). Hacker, reflecting these sentiments, notes the “deep interconnections” between public and private pension plans, citing the Employee Retirement Income Security Act (ERISA) as emblematic of the public and private nature of the American welfare state (Hacker 2002).

Accordingly, proposals for privatizing some aspects of Social Security evidently are in accord with the realities of the modern political state, which embrace the marketplace and the public sector. Bartlett points out that one advantage of personal accounts for some part of Social Security would be to provide older workers an incentive for staying in the labor force (Bartlett 2005). He also says that an especially attractive feature of these accounts would be their inheritability. Moreover, Bartlett remarks that workers would no longer feel any compulsion to use benefits early in fear of losing them. Such are the perceived benefits of a “culture of ownership and personal responsibility” (Bernstein 2005).

Implicit in these observations is a question of risk, whether associated with private accounts or possible Social Security System benefit reductions, as a worst-case situation. Varian notes that the Social Security Administration’s Office of the Actuary has used a seven-percent figure in projecting returns under proposed privatization plans (Varian 2001). But, he says, that figure might be wrong. Viewed in this light, Social Security projections entail a risk, which Varian believes could be mitigated by using “sophisticated risk-analysis tools like ‘value at risk,’ ‘real options,’ and ‘Monte Carlo simulation.’”

Engaging the public sector in such risk assessment puts the matter of risk assessment in a relative framework. Risk associated with projections of Social Security income appears to do some violence to the “safety net” myth, to borrow Attarian’s phrase. On the other hand, the marketplace obviously entails risk, as well.

In a heuristic framework, economists and financial analysts have embraced modern portfolio theory (MPT) and “its rich set of tools” as a way to help investors carry out strategic asset allocation (Ambachsteer 2005). These analytical approaches, used in the private sector for portfolio management, may give comfort to the “citizen-consumer,” to borrow Peter’s phrase, functioning in the reality of a public-private mix that includes not only Social Security, but also Medicare and long-term health care. In addition to sophisticated tools available to investors, modern investment theory also holds firm to the well-established principle of diversification to reduce investment risk (Peake 1996).

ANALYSIS

The Literature Review clearly details that the government is not obligated to pay Social Security benefits and that no one has the right to such benefits. Social Security benefits are not and cannot be guaranteed. Furthermore, there has been a history of Social Security benefit reductions. With ever-changing population demographics (in particular the decreasing ratio of workers to retirees), the rates of economic and productivity growth varying from period to period, as well as a large and growing national debt, there is every reason to assume that Social Security benefits will be further reduced for future recipients. For purposes of personal account risk analysis, it is therefore erroneous to use as a baseline the existing Social Security benefit structure and consider that structure as “guaranteed.” The rapid decline in the ratio of workers to retirees as well as the ongoing increases in longevity point to the inevitability of further benefit reductions, especially for younger workers.

Furthermore, when comparing the risk associated with personal accounts and the risk associated with traditional Social Security, it must be noted that for many years Congress has spent hundreds of billions of dollars of excess Social Security taxes (over benefits paid and administrative costs) for other government programs. The excess has not been saved. In light of this record, workers considering opting for personal accounts need to ask a very basic question: Is it less risky for a worker to have *all* of her/his Social Security taxes go into the traditional Social Security program, *or* is it less risky for the worker to opt to have *a portion* of those taxes invested in a personal account that is owned by the worker? Put simply, is it less risky to place all of one’s Social Security taxes in the hands of the politicians, or is it less risky to place a portion in a personal account that is owned by the worker?

Clearly, both personal accounts and traditional Social Security involve significant risks; neither is guaranteed. Portfolio theory suggests that risk may be minimized through diversification. Based on the significant downside risk resulting from the likely future benefit reductions in traditional Social Security, combined with the lack of any legal right on the part of Social Security participants to collect benefits, portfolio theory suggests that to minimize the overall downside risk of receiving reduced total Social Security retirement benefits, it pays to diversify. Opting for a personal account in conjunction with traditional Social Security is *less risky* than opting to have all of one’s Social Security taxes go into traditional Social Security. The overall risk of minimizing the loss of all or a part of one’s Social Security retirement income is reduced by diversifying to include personal accounts along with traditional Social Security.

Although this paper argues that worker risk can be reduced with the use of personal accounts in conjunction with traditional Social Security, other issues surrounding partial privatization also need to be addressed. One significant economic issue, for example, is how to replace those Social Security tax revenues that would be siphoned off to fund personal accounts if partial privatization of Social Security is enacted.

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