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Social Security and the Stock Market: Lessons from Around the World

Alicia Haydock Munnell
Boston College

Steven A. Sass
Boston College

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W.E. Upjohn Institute
for Employment Research
300 S. Westnedge Avenue
Kalamazoo, MI 49007-4686
(269) 343-5541
www.upjohninstitute.org

Randall W. Eberts
Executive Director

Alicia H. Munnell and Steven A. Sass

Social Security and the Stock Market

Lessons from Around the World

This article is based on the authors' book Social Security and the Stock Market: How the Pursuit of Market Magic Shapes the System, *which is available now from the Upjohn Institute.*

The U.S. retirement income system faces major challenges as the transition to a much older society begins. The ratio of the elderly population (age 65 or over) to working-age adults (ages 20–64) will rise from 20 percent today to about 35 percent by 2030 (Figure 1). Social Security, the backbone of the nation's retirement income system, faces a long-term shortfall equal to 2.02 percent of taxable payrolls when measured over the traditional 75-year planning horizon (Table 1). That deficit is significantly larger if we also consider the years beyond that horizon.

Our book focuses on a surprising point of consensus in the contentious debate on Social Security: a portion of the funds that pass through the program ought to be invested in equities.

Compounding the challenge is the fact that fewer employers sponsor traditional defined-benefit pension plans. This removes employer investment management, risk-bearing, and a significant amount of employer contributions from the retirement income system. In the now dominant 401(k) plans, workers assume the investment and mortality risks formerly borne by their employers; so far they have not accumulated the assets needed for a secure retirement.

Our new book, *Social Security and the Stock Market: How the Pursuit of Market Magic Shapes the System*, is a contribution to the debate over how to restore financial balance to the Social Security program. It focuses on a surprising point of consensus in that contentious debate: a portion of the funds that pass through the program ought to be invested in equities. Policymakers from all political camps see investment in equities, with the higher expected returns they offer, as a way to minimize tax increases or retirement income cuts—the only other options for closing the financing shortfall.

The 1994–1996 Social Security Advisory Council proposed three main approaches for using equities in the U.S. Social Security program: 1) invest a portion of trust fund assets in equities; 2) use add-on individual accounts, which would top up the reduced benefits that could be financed by the payroll tax; and 3) use carve-out individual accounts, funded by redirecting a portion of current payroll taxes in exchange for a further reduction of guaranteed social

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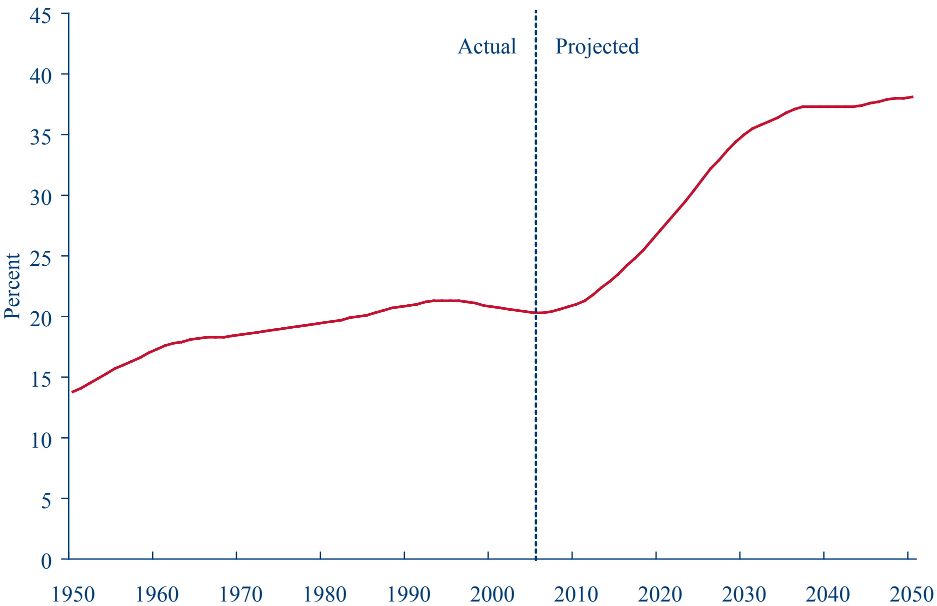
Figure 1 U.S. Population Age 65+ as a Percentage of Population 20–64, 1950–2050



SOURCE: U.S. Social Security Administration (2006).

insurance benefits. But the council failed to reach a consensus on which method to recommend, and no action has since been taken.

To help evaluate the nation's options going forward, our book explores the experiences of three countries—the United Kingdom, Australia, and Canada—with retirement systems much like that of the United States that have introduced equities into their public pension system in each of the three ways proposed by the Advisory Council.

Lessons from the U.K. Experience

The United Kingdom reformed its system along the lines of the Advisory Council carve-out approach. It sharply cut its two social insurance pension programs, the Basic State Pension and the State Earnings Related Pension Scheme (SERPS), rather than schedule a sharp increase in taxes. The Basic State Pension fell from 25 percent of the average earnings in 1980 to 15 percent today, and is projected to be just 7 percent by the middle of the twenty-first century. The government even encouraged workers to "contract out" of SERPS by redirecting their payroll tax contributions to individual retirement savings accounts.

One lesson from the British experience is that individual accounts can result in high administrative and regulatory costs, along with significant mismanagement and scandal. Most U.S. carve-out proposals would improve on the British design by using the government to collect and administer accounts with small balances. But the cost of selling, administering, and regulating individual accounts, even well above the "small balance" threshold, is nevertheless high.

The most important lesson from the U.K experience is that a broad take-up of the individual account option, with a resulting reduction in guaranteed benefits below the socially acceptable level of adequacy, could quickly lead to a major expansion of means-testing. The British elderly, on the whole, are now on the road to becoming a welfare-dependent population. To avoid this outcome, the British government is considering major reform of its retirement income system that would abandon the carve-out design.

The goal of the U.K.'s carve-out approach was to reduce dependence on the state and increase reliance on individual initiative and private financial markets. However, retirement income systems emerged throughout the industrial world because people generally

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proved themselves incapable of preparing for their own old age. The British experience suggests that this original incapacity has not been overcome. Thus the outcome of sharp social insurance cutbacks and expanded privatization—in the United States as in Britain—is likely to be just the opposite of what its proponents desire.

Lessons from the Australian Experience

Australia reformed its retirement income system along the lines of the add-on individual account approach. Like the add-on proposal of the Social Security Advisory Council, the Australian Superannuation Guarantee program brought additional resources

Table 1 U.S. Social Security's Financing Shortfall

		As a percent of	
Period	Present discounted value (trillion $)	Taxable payrolls	GDP
2006–2080	4.9[a]	2.02	0.7
2006–Infinity	13.4	3.7	1.3

[a] The $4.9 trillion includes $4.6 trillion, the difference between scheduled benefits and projected revenues, and $343 billion required to bring the trust fund to 100 percent of annual cost by the end of the period.

SOURCE: U.S. Social Security Administration (2006).

to the retirement income system. Superannuation Guarantee contributions, at 9 percent of earnings, are far larger than add-on proposals in the United States. But the preexisting Australian public system was limited to the means-tested Age Pension and had no earnings-related component.

Many Australians hoped that workers would accumulate enough assets in their Superannuation Guarantee accounts to return the Age Pension to its original safety net function. But Treasury projects that 75 percent of the elderly will collect Age Pension benefits even after the Superannuation Guarantee program matures, with even more collecting benefits at some point in their lives, and benefits for the average beneficiary only slightly reduced. For this reason, the Age Pension will remain the central component of the Australian retirement income system.

A key lesson for the United States arises from the interaction between Australia's Superannuation Guarantee individual account and its means-tested Age Pension programs. The retirement income generated by Superannuation Guarantee accounts, invested in equities, carries a good deal of risk. The risks are essentially identical to those in individual account employer plans, which are becoming as dominant in Australia as in the United States. The means-tested Age Pension plays an important role in offsetting a significant portion of this risk. Age Pension benefits rise for those who outlive their assets, invest poorly, or are in unlucky cohorts when it comes to investment returns. And it effectively funds those higher benefits by reducing benefits to those who do well or die young.

But using the Age Pension means test to dampen the risks of holding equities in individual accounts has two dysfunctional effects. The first is the overinvestment in privileged assets, such as housing and consumer durables, that yield higher returns than alternative investments, such as stocks and bonds, only after netting out Age Pension reductions. Potentially far more serious is the incentive, created by the means test, for workers to retire early, cut back on savings, and spend down their assets prior to reaching old age to collect a higher Age Pension benefit.

Lessons from the Canadian Experience

Canada reformed its system along the lines of the trust fund approach. It set up the quasi-independent Canada Pension Plan Investment Board to oversee the investment of social insurance trust fund assets in equities. It also introduced a default mechanism that adjusts contribution and benefit levels to restore solvency over a 100-year period should market fluctuations, or other causes, push the plan out of balance.

The Canadian experience shows that the cost of administering and regulating equity investments through a centrally managed trust fund is dramatically lower than through a myriad of individual accounts. Investment and mortality risks are also pooled far more effectively, in that the effect of market fluctuations and "excess" longevity on individual workers and retirees is dramatically less. This is especially important as workers in Canada, just as in the United States, are increasingly dependent on individual account employer retirement plans. The trust fund approach to pooling risk also avoids the moral hazard inherent in Australia's means-tested approach.

The major concern about investing social insurance trust fund assets in equities is the power it potentially puts in the hands of government.

The major concern about investing social insurance trust fund assets in equities is the power it potentially puts in the hands of government. The Investment Board is free to invest trust fund assets in the full gamut of opportunities available to managers of employer defined-benefit pension plans. The Board could use this freedom to advance "socially desirable" purposes, which could undermine retirement income security and open the door to government interference in the economy. To guard against such threats, Canada adopted an elaborate process to minimize political influence in selecting the members of the Investment Board. It also mandated an extensive reporting process to make the workings of the Investment Board as transparent and open to public scrutiny as possible. Canadian observers generally agree that the Investment Board has thus far performed its duties in a professional manner, free of political influence.

Summary

The experience from these three countries seems to clearly indicate that a trust fund approach similar to the Canadian system would be the least problematic for the United States. The political stakes in placing such a large amount of wealth and corporate shares in government hands would be high. But the task of overseeing equity investments in Social Security would be simplified, and the likelihood of success significantly enhanced, if equities were added to the system through the trust fund approach. The task of governing the investment of the trust fund in a passive equity index is clearly less complex than the daunting challenge of overseeing and regulating equity investments in a great number of individual accounts.

Reference

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Alicia H. Munnell is the director of the Center for Retirement Research at Boston College and the Peter F. Drucker Professor in Management Sciences at Boston College's Carrol School of Management. Steven A. Sass is associate director for research at the Center for Retirement Research at Boston College.