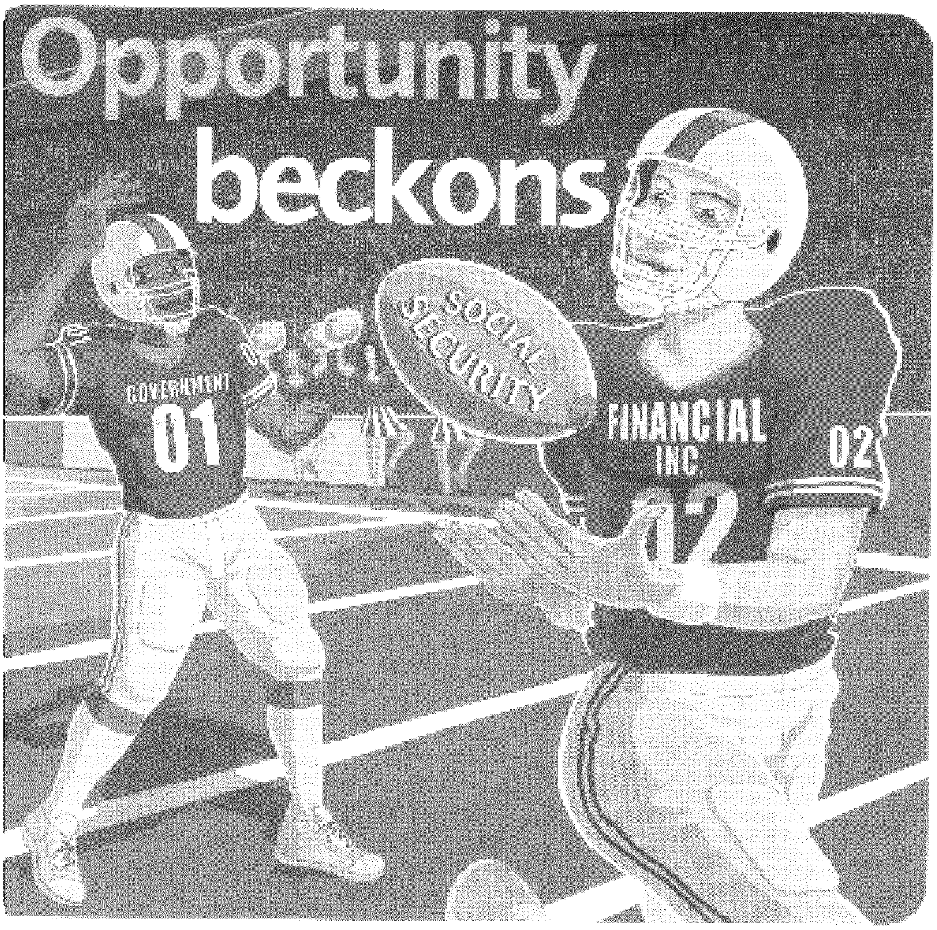
Opportunity beckons



Professor Krzysztof Ostaszewski, a board member of the Cato Institute body promoting the privatisation of social security, argues the issue ought to be of great interest to reinsurers.

The United States social security system is, effectively, the largest insurance system in the world. It encompasses Old Age Security, a retirement pension system, and Disability Income – a disability scheme. It is financed by payroll taxes at 12.4%, half of which is paid by the employer and half by the employee (the self-employed pay the full amount) Historically, the system has been a tremendous success and popular with voters. It has been said that talking about doing away with social security, or privatising it, was the "third rail of American politics" – meaning a deadly shock would await any politician who would dare venturing into such territory.

Yet during the 2000 presidential campaign, George Bush, did propose debate on privatisation of social security. Why? There are many perspectives on the issue.

One is that some form of privatisation reform has happened in many countries, including Great Britain, Chile, and recently Sweden and Poland. Secondly, Americans have grown accustomed to having private retirement accounts, through dramatic growth of private defined contribution pension schemes, such as group 401(k) plans, or personal individual retirement accounts.

The third point is that performance of private capital markets over the 20-year period ending just before the election of 2000 had been nothing short of spectacular – while social security benefit level is set low in comparison to national income averages, aiming at a 25% wage replacement ratio. The long-term actuarial balance of social security has been in doubt since the early 1990s, without any attempt to address the problem. In 1989, social security was in long-term actuarial surplus (while delivering surplus cash flows to the unified federal government budget). By 1994, the picture deteriorated dramatically and long-term actuarial deficit was estimated to be near 3% of payroll. This was in excess of the level judged dramatic enough to implement changes suggested by the Greenspan Commission in 1983 (when tax increases and benefit cuts were put in place in response to long-term financing shortfall).

Through the second half of the 1990s, long-term actuarial balance of social security improved gradually as the economy boomed, but never reached long-term solvency. In fact, even at the end of the boom, the system was still projected to have to cut as much as 25% of benefits when the trust fund runs out of money.

The current economic downturn may increase the long-term problems of the system, but it is too early to tell how serious this will become. Nevertheless, many voters have become disillusioned with social security and proposing its partial privatisation did not do any damage to Mr Bush's campaign, in fact it probably gained him support. The president has now appointed a commission to propose changes to the system, widely expected to include allowing workers to redirect a portion of their 12.4% payroll tax, most likely in at least 2% range, to individual accounts. Of course it is extremely difficult to predict the outcome of the political process, especially in view of the recent terrorist attack on America and the accompanying decline in the stock market.

Privatisation of social insurance is commonly promoted politically as a mechanism for increasing the capital base and savings rate. This is inaccurate. The surest way to increase the savings rate is to have a quick painful recession or even war, so people will be scared and stop shopping. This may have been delivered, whether we like it or not. Proponents of privatisation tell voters they will make more money by investing on their own. Again, one must note it is also possible to make less. What is crucially different in a privatised system is the overall relationship of benefits to contributions. The pension received is no longer determined by legislation, but by the markets.

A private market-based system has two dramatic advantages: freedom and freedom. Freedom in pricing of capital assets – the price of one's pension is set by markets, not by legislative fiat. And freedom from lobbying – if one's pension comes from working and investing, there will be more of it and less lobbying politicians. If the savings rate and productivity increase, all the better, but that is most likely to come from more working and less lobbying, not directly from private retirement accounts. In other words: freedom is the capital base that will increase, any capital deepening is a nice dividend.

Opponents of privatisation have raised many strong arguments against it. Some make sense, some are pure politics. The main argument is commonly called transition cost. It claims if government were to give up payroll tax, it would have a shortfall of cash needed to pay benefits. It does not mention that when payroll taxes are diverted to private accounts, the social insurance system is relieved of future liabilities created by the same payroll taxes. It concentrates only on current cash flows. Cash is diverted to private accounts, but still needed to pay benefits. Alas, cash placed in private accounts will not remain cash. It must be invested somewhere and the government is free to bid for it. If the private sector submits a more attractive bid, cash will be diverted to there. In other words, the funds will be more productively invested. In the long run, we will end up with more productive investments and a more productive economy. The argument against privatisation therefore is as follows: "We can't afford the transition to a more productive economy with a larger private sector." The fact is, we can't afford not to move in that direction – the existing system is, in the long run, insolvent. We can seek to save it with a government bailout, or we can seek to save it by growing our economy.

But those opponents also raise some interesting points, outside the bogus argument of transition costs. The existing social security system was created in the midst of the Great Depression. It allowed people, unable to accumulate capital assets during the Depression and World War II, to enjoy steady retirement income. Generations hurt economically because of cataclysmic economic and political events, were able to share in the prosperity of subsequent generations. This is commonly termed intergenerational risk redistribution. The problem with social security has been that in a market risk-sharing mechanism subsequent generations should give up some of their prosperity because of the contribution they made to the Greatest Generation. They did not have to, they could lobby the government to keep pushing the burden into the future. Social Security system also allows for perfect annuitisation of benefits and removes the risk of annuitisation timing. Any time the stock market tanks and interest rates decline, a person with stock market exposure faces decline in assets available for purchase of retirement annuity, while the price of such an annuity increases.

The government also acts to dampen moral hazard inherent in retirement systems. People can refuse to save to fund their own retirement, hoping if they arrive penniless at old age, the government will take care of them. Because government makes participation in social insurance mandatory and sets the tax rate, it has tools to make such behavior less likely. Finally, government tends to have low administrative and marketing expenses for its retirement system, because it provides identical, uniform product to all its customers and it does not face competition.

But do we want our retirement provider not to face competition? Arguably, retirement provision is almost a sacred duty. It requires long-term commitment and honesty on the part of the provider, because when the time comes to pay the pension and there is not enough money to purchase an annuity meeting the needs of the client, there is no second chance. This has been one of the arguments for government provision of pensions. But if we do have a choice of providers, even the government is likely to become a better and more honest provider.

These arguments in favour of government-run social insurance – intergenerational risk redistribution, risk of annuitisation, moral hazard, and administrative and marketing expenses – have a common thread. They make the government the ultimate reinsurer. Many aspects of the government-run system have been retained in privatised systems, precisely because government is wanted as such an ultimate reinsurer.

Why has privatisation of social insurance become increasingly popular and accepted? It is because of the proposition that private markets can deliver higher, more equitable benefits to retirees and strengthen the national economy. They can teach people to work more and lobby less. They can teach character, honesty, hard work and integrity. Why then are there fears of privatisation? Because the issues raised against it are legitimate – a privatised system will require wide-scale reinsurance.

It is important that while the general level of retirement benefits should be set by the market process, we should seek a private system which provides a degree of minimal income replacement ratio. We should seek a system which rides out long-term cycles of economic and political struggle. We should price the moral hazard risk. We should seek low administrative expenses. We have accepted too easily that such wide-scale reinsurance can only be provided by the government. We do not have to assume that. It is better if such wide-scale risks are priced by the market, instead of by legislative fiat and the lobbying process.

The insurance industry has been shockingly silent in the privatisation debate. It seems as if it were not interested in managing the nation's retirement savings. No wonder the industry is continuously losing market share to other financial intermediaries. But insurance products can and should be a vital part of private accounts. Reinsurance firms can take on the role played by the government in the following ways:

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- Long-term economic cycles can be dampened because they can be reinsured. Generations living in times of boom should pay a premium for having an assurance that if there is a bust before they retire, they will still be able to retire. There is a temptation to shift this responsibility to the government and make it free. Let us argue at least that those who have private accounts with reinsurance coverage against long-term cycles should not be required to pay tax to bail out those who do not.
- Annuitisation risk can be reinsured by insuring annuity purchase rates in advance and by having standardised annuitisation rates offered by reinsurers.
- Moral hazard can be handled by requiring a small private premium to be paid by the individual account provider to a reinsurer, with level of such premium dependent on one's savings pattern.
- Reinsurance companies can provide low-cost, uniform index fund participation for individual account providers. While individual accounts may have varying asset allocations, for wide scale investments, passive index fund investing may be the most economic choice. It does not make sense for those index funds to be created separately by each provider. Such funds enjoy tremendous economies of scale and it is best if individual accounts providers could shop for them from other providers.

Individual account providers can behave just as badly as individual customers and can go bankrupt. They can take too much investment risk and can spend too much on marketing. We know from the experience of other countries which have privatised. This is commonly handled by government bailing them out. The nation may be better off with such providers having to face market rates of insurance for their own solvency, provided by the reinsurance industry.

As I like to point out, the great advantage of privatisation lies in freedom and market incentives. People need to feel their own pain. So do the companies providing their retirement benefits. The government works best if it does not have to play the role of someone else, but acts as a catalyst for private sector and economic growth. ®

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