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QUICK STUDY

Summary: *One of President Bush's most controversial campaign proposals was to let workers place a portion of their Social Security payroll tax into a personal account. Can such accounts avoid the risk associated with the stock market? Twenty years ago, three Texas counties opted out of Social Security and they have never lost a dime. These counties provide a real, working model for personal accounts that are as safe as a bank.*

No Risky Scheme:

Retirement Savings Accounts that are Personal and Safe

by Merril Matthews Jr., Ph.D.

One of President George W. Bush's most important and controversial campaign proposals was to let workers place a portion of their Social Security payroll tax into Personal Retirement Accounts (PRAs). However, recent market volatility — the market having lost, by some estimates, about $4 trillion in value — has raised questions about whether the stock market is safe enough for retirement savings.

Nevertheless, American workers want and need to make more than the roughly 2 percent or less interest they earn from their Social Security payroll tax contributions. And many are aware that Social Security is facing a financial day of reckoning — around the year 2016, according to the 2001 Social Security trustees' report. The Social Security trust fund may be in good financial shape today — but it won't be for long.

Problems with the Pay-As-You-Go System

Social Security is based on a pay-as-you-go system. Payroll taxes paid by workers today are sent out to cover current retirees' benefits. According to the Social Security trustees' "intermediate assumptions," both the Old Age Survivors Insurance (OASI) and the Disability Insurance (DI) programs will maintain a surplus until the year 2016. That means workers will be paying in more than is paid out to current retirees for approximately 15 more years. After 2016, however, the federal government will have to make up the deficit between trust-fund income and payout.

When the Social Security program was created in 1935, it was based on certain demographic facts that are no longer true.

- People lived shorter life spans, with the average life expectancy in 1940 being only 64 years; and there were only 9 million people over the age of 65.
- The rate of population growth, and therefore the number of workers, was rising, reaching 3.7 children per couple by 1957.
- The ratio of workers to retirees was high, about 42 to 1.

- Thus the payroll tax was low — 1 percent each from the employer and employee up to $3,000 in income, for a maximum of $60 per year per employee.

Today, things are very different. By 1999 there were 31 million retired workers and dependents drawing on Social Security, along with 6.5 million disabled workers and 7 million survivors of deceased workers. And the average life expectancy is currently more than 75 years and rising.

In 1998 there were three workers per retiree; by 2025 there will be only two workers per retiree. And workers currently pay 12.4 percent of their income — 6.2 percent each from the employer and employee — up to $80,400, and growing annually. That makes a maximum annual contribution in 2001 of just under $10,000, or about a 1,600 percent increase since the program's beginning.

However, not even a $10,000 per worker maximum contribution will save the program in the future. According to the trustees' report, the growing deficit will mean bringing Social Security into short-term actuarial balance could be achieved by either a 13 percent reduction in benefits or a 15 percent increase in the payroll tax, or some combination of the two. In order to ensure solvency for the next 75 years, a 50 percent increase would be necessary, to 18.5 percent of payroll.

An "IRA Model" vs. a "Banking Model"

One solution to the Social Security trust fund's financial troubles is to allow workers to "pre-fund" their retirement needs by making contributions to a Personal Retirement Account. Indeed, many countries already have taken a step in this direction, with positive results.

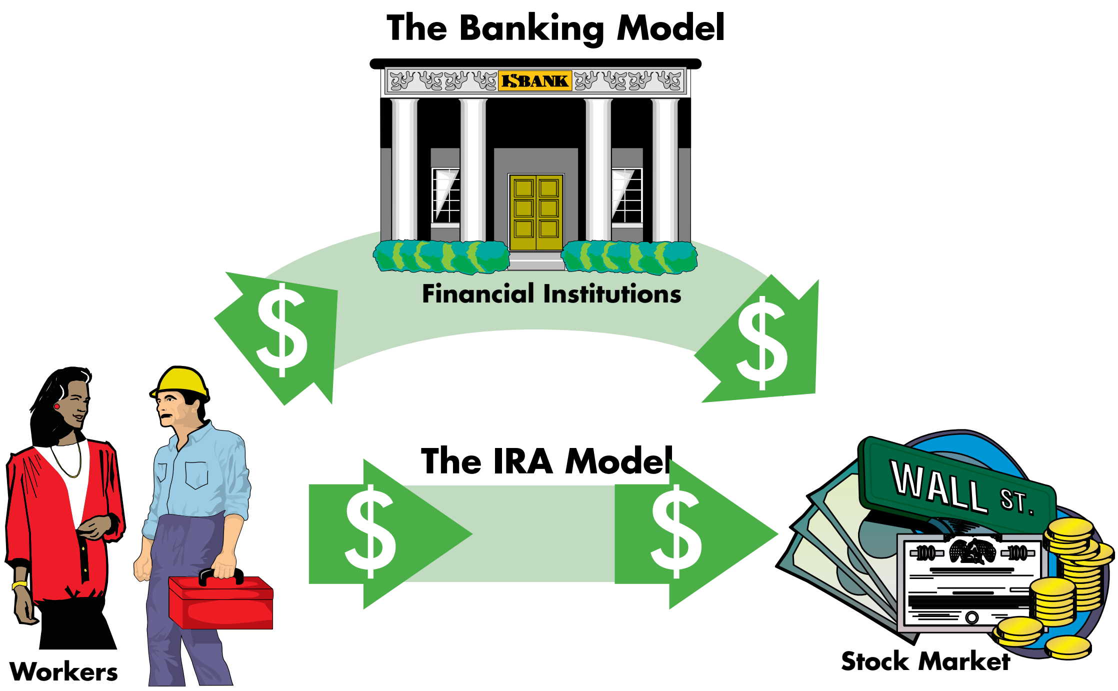
Currently, some 42 million Americans manage most or all of their personal retirement savings through an IRA, or Individual Retirement Account. The law gives accountholders wide discretion to invest their money in stocks, bonds, treasury notes, CDs or other financial instruments. While most Americans invest those funds fairly conservatively, such as in mutual or index funds that reduce their risk, even those funds took a financial beating over the past year.

Virtually all proposals for shifting Social Security to a system of pre-funded accounts have assumed some form of direct market investment. While numerous economists have clearly demonstrated that over time stock market loses are offset by much larger gains, PRA opponents are saying that any type of direct investment is a "risky scheme."

How then are we to create a Personal Retirement Account option that will ensure a better return on workers' savings than Social Security — thereby providing a better and more financially secure retirement — while avoiding the risk associated with the stock market? The answer is to move from an "IRA model" to a "banking model," or, to put it another way, from an "investing model" to a "savings model" — what we might call a Retirement Savings Account (RSA).
[See the illustration.]

The Galveston Model

Currently, about 5 million municipal employees (including those working for state, county and city governments and public school teachers) have their own retirement systems separate from Social Security. However, virtually all of them are defined-benefit plans similar to Social Security — although



most of them are in much better financial shape — that pay retirees based on a promised benefit rather than on how much the employee contributed.

Twenty years ago, officials in Galveston County, Texas, wanted to explore the possibility of leaving the Social Security system (Congress ended that option in 1983). However, they didn't want simply to copy the defined-benefit plans available to so many other public employees. County officials contacted Rick Gornto, a financial planner, who devised a retirement savings plan that included disability income and survivors' benefits — in other words, a real alternative to Social Security.

In 1981 Galveston County employees voted by a margin of 72 percent to 28 percent to adopt the "Alternate Plan." In 1982 Matagorda and Brazoria Counties followed suit.

Currently, there are about 2,740 full-time employees participating (plus many who have already retired). But while their payroll tax is about the same as those in traditional Social Security (12.4 percent), the benefits are very different.

Workers in Galveston contribute 9.7 percentage points of their payroll tax to retirement savings. The company that manages the Alternate Plan, First Financial Benefits of Houston, pools the money from all of the employees and loans it to a top-rated financial institution for a guaranteed interest rate. Those rates have varied from about 5 percent up to 15.5 percent, but average in the 7.5 percent to 8 percent range.

No Risk *and* Better Benefits

Thus, employees bear virtually no risk; *they get their interest whether the stock market goes up or down — and they have done so for 20 years.* Nor or employees making investment decisions. Professional money managers do that for them. This process works much more like a bank than an investment brokerage. And, for all intents and purposes, the money is as safe as if it were in a bank.

Even without the risk, the Alternate Plan has proven to be very rewarding financially. Galveston employees contribute 6.13 percent of their income while the county pays 7.785 percent (though it only has to pay 6.2 percent). The combined 13.915 percent is dispersed as follows:

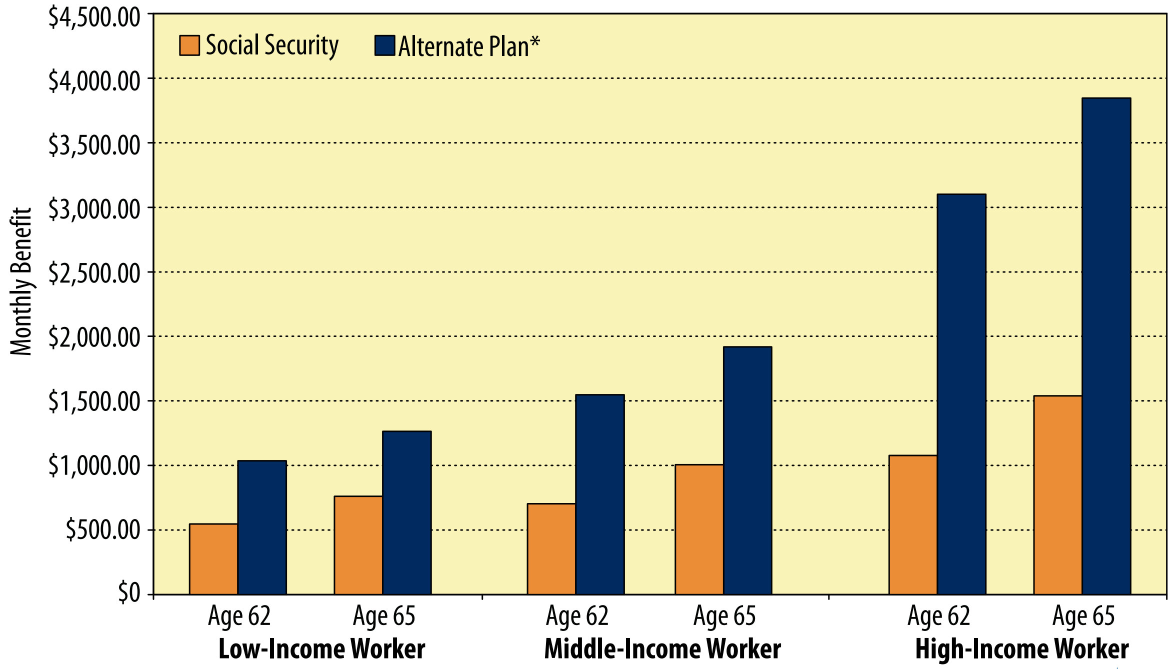
- Retirement Annuity 9.737%
- Survivorship Benefit 2.85%
- Long-term Disability 1.18%
- Waiver of Premium .148%

If employees' deposits only grow at 5 percent (most years they have had higher interest rates), they can expect to get about twice as much in retirement as they could expect from Social Security. According to First Financial Benefits: [See Figure 1.]

- A low-income worker ($17,124) retiring at age 65 would get $782 per month from Social Security, but $1,285 from the Alternate Plan.
- And the high-income worker ($51,263) at 65 will get $1,540 from Social Security versus $3,846 from the Texas counties.

Upon retirement, workers can take their money in a lump sum or purchase an annuity that will pay them a guaranteed income for life. It's their money, so it's their choice. Since the account and the funds therein actually belong to the employees, it becomes part of their estate regardless of when they die.

Figure 1 Monthly Retirement Benefit: Social Security vs. Alternate Plan



*Begins work at age 25, earns same salary throughout life, growing at 5% compounded daily.
Source: First Financial Benefits, Houston, Texas.

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In addition, the Galveston Model includes a life insurance policy that pays three times a worker's salary, between a minimum of $50,000 and a maximum of $150,000 — and the policy pays double if the worker dies accidentally. In the vast majority of cases, the insurance payout will greatly exceed Social Security's survivors' benefits.

And according to the U.S. General Accounting Office (GAO), workers in the Alternate Plan can expect to draw significantly more money than those who must rely on Social Security disability benefits. For example:

- A 36-year-old low-income disabled worker would get $788 from Social Security versus $1,346 under the Alternate Plan, according to the GAO. And a 61-year-old could expect $1,013 a month from Social Security as opposed to $2,106 from the Alternate Plan.
- A 36-year-old high-income disabled worker would get $1,459 from Social Security versus $4,030 under the Alternate Plan. And a 61-year-old could expect $1,869 a month from Social Security as opposed to $5,000, the maximum payout.

A Model for a National Plan?

There is nothing new about Americans giving their savings to financial institutions that guarantee them a fixed return. That is, in essence, all the three Texas counties do. Banks and other financial institutions themselves could create a retirement package that included life and disability insurance along with a guaranteed interest rate.

Consider the competition that would ensue from the banking model. RSAs would be large, ill-liquid pools of money — several hundreds of thousands of dollars for older workers — that would be extremely attractive to financial institutions, which would offer the highest possible interest rate to attract accounts.

Administrative costs imposed on RSAs would likely be very low. Indeed, most banks are willing to waive administrative fees for depositors who maintain a minimum balance in order to attract customers and their money.

Banks, insurers and other types of financial institutions operate under a government regulatory framework meant to protect consumers and their money. A system of RSAs would likely operate under a similar framework. That role should include setting basic minimums on insurance coverage. It might also set certain institutional minimums such as reserve requirements, and it might require certain accounting standards and other process-oriented minimums. Finally, the government would likely have to guarantee deposits, just as it does for banks through the Federal Deposit Insurance Corporation (FDIC) program.

Safety First

For several years the debate over reforming Social Security has centered on an IRA Model, in which people's contributions rise or fall with the stock market — or even individual stocks. That model works in other countries and it can work here. However, stock market volatility and political posturing may make that option politically impossible.

In addition, there is a growing concern that many Americans managing their own 401(k) retirement funds may be getting sub-optimal returns not because they are too aggressive, but because they allocate their assets too conservatively. One solution is to make sure that PRA funds go into broad-based index funds that grow — and occasionally shrink — with the economy. Another way is to set aside the "investment model" that envisions direct market investment and shift to a banking model that functions more like a savings account — hence, a Retirement Savings Account rather than a Personal Retirement Account.

Unless proponents of a personal account option find a plan that addresses the "risky scheme" demagoguery that will be hurled at them, they will never get to a serious debate over those accounts. Only a model that is as safe as a bank is a viable political option.

This study is a summary of IPI Policy Report # 163, *No Risky Scheme: Retirement Savings Accounts that are Personal and Safe,* by IPI Visiting Scholar Merrill Matthews Jr., Ph.D.

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Editor & Publisher . . . . Tom Giovanetti

IPI *Quick Study* is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.

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