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PROVIDING GUARANTEES IN SOCIAL SECURITY

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A number of recent proposals for Social Security reform contain guarantees. By its very nature, a guarantee raises the expected cost of a Social Security system. Moreover, a guarantee tends to lock in inequities, reduce flexibility, and make it much harder to enact future reforms of the system. Once guaranteed, Congress cannot easily change a benefit, even when the benefit is provided in a way that violates standards of equal justice (e.g., discriminates against single heads of household) or simply fails to meet society's assessment of effectiveness (e.g., at reducing poverty). When an option is provided to individuals, it also tends to be interpreted as a guarantee of the benefit provided under whatever option is chosen, since it is difficult to penalize a person by altering the very basis on which the decision was made.

One particular type of guarantee would provide that individuals not receive less under a reformed system than would be provided by the current law. Typically, this type of guarantee is provided along with an individual account. The logic often applied is that an account will earn a very high market return that will help cover the cost of the guarantee. However, the "current law" benefit formula provides that benefits will rise when wages rise. Any reform successfully adding to saving and economic growth, therefore, would affect the promised levels of benefits. Growth would also increase revenues and lower the interest rates that determine what could be earned and paid out of individual accounts.

One generic type of reform considered combines price indexing of future benefit amounts with a guarantee. Price indexing alone moves a long way toward restoring balance in Social Security in absence of a guarantee. However, the guarantee wipes out almost all of these gains under a variety of assumptions with regard to saving and size of deposits to individual accounts. In general, the greater the level of deposits to individual accounts, the less likely it is that individuals will need a guarantee, but then the greater the revenue loss. For a given deposit rate to individual accounts, the more that saving increases, the greater the amount of revenues, but then the greater the level of promised benefits and the more that beneficiaries make use of the guarantee to reach the guaranteed benefit level.

When individual accounts vary in value because of market fluctuations and different patterns of individual investment, the costs to government may rise yet further. The pattern, however, depends upon both how many people likely fall back on guarantees regardless of these fluctuations and on the extent to which individuals can play a lottery with the government in which they get to keep winnings but government bears much of the risk.

Actuaries must take into account all these potential effects on wages, benefits, interest rates, and taxes when estimating the budgetary effect of a reform containing a guarantee.