Session 4A: Public Pension Reform

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I was asked to focus my review on Beverly Orth's paper, *How to Survive Living to 100: Ways to Improve the U.S. Retirement System*, and also provide background to set her ideas in the context of Social Security reform proposals that are being discussed in the United States. It is worth noting that Orth's paper was about principles of change for the United States retirement system as opposed to being focused on reforming Social Security itself as an end-goal. However, it happens that given some of her ideas, she believes the most efficient and effective way to implement them are through making changes to Social Security. As an aside, I also note that many of the ideas she develops are very consistent with the Society of Actuaries' *Retirement 20/20* initiative, which is focused on creating better retirement systems for the future.

Orth laid out four basic problems or things that can go wrong in retirement from an individual's perspective, even someone who believes they've followed the rules and properly prepared. The four things that can go wrong for an individual are: 1) didn't save enough or picked the wrong investments, 2) end up living longer than planned for, 3) didn't annuitize enough assets or the insurer picked fails, 4) LTC needs exceed LTC coverage, or allocated too much savings to LTC premiums and too little to longevity insurance (or vice versa).

In focusing on the first two ideas: that individuals haven't saved enough or that they live longer expected, Orth proposes expanding Social Security coverage by increasing benefit levels and using default options in plan design to encourage annuitization from defined contribution (401(k)) plans. My non-expert view, sitting outside of Washington, D.C., is that any major policy changes when it comes to "entitlement programs," especially those that would raise costs are non-starters right now. Politicians don't want to make anything other than perhaps incremental, "around-the-edges" type changes, so that's one of the challenges with trying to develop meaningful reforms. The idea of using default distributions to encourage better decision making is a concept that I wholeheartedly endorse and one that is a consistent theme that we have been expounding and developing in our *Retirement 20/20* work.

Orth has an interesting comment on page three in her paper as follows, “The culture of U.S. retirement plans has evolved markedly from no choice four decades ago to individual choice about nearly every aspect of retirement income planning. The latest trend, however, is to reestablish some level of discipline through auto enrollment, default savings rates and default investment direction.” I believe that lessons we are learning from behavioral finance research are extremely valuable and using them in designing better retirement plans is extremely important. This is particularly true in the U.S. context where we tend to have an individual choice mindset dictating plan design that gives individuals maximum flexibility despite the knowledge that individuals may not always make optimal choices. In this context setting up these defaults is a very viable way to improve the effectiveness of retirement plans.

In focusing on Orth’s third problem, not having enough dollars being annuitized, she proposes providing a “longevity insurance” concept through Social Security that would provide an enhanced benefit at some later age (like age 85) to keep individuals’ Social Security incomes above some certain minimum baseline level. I really like this idea of “longevity insurance” although it’s one of those good ideas that is probably too ambitious for our politicians to actually consider right now. It has real merit as a way to protect older people. One of the key challenges with planning for retirement, which is illustrated in numerous surveys, is individuals don’t understand the planning time horizon for retirement. However, having a “longevity insurance” policy in place allows you to know your date of death in the sense that you can plan to use your remaining assets until the point that the “longevity insurance” policy starts paying. So if your “longevity insurance” kicks in at age 85, then effectively you are focused on a fixed planning period from your retirement age up to age 85.

A key challenge with putting this benefit into Social Security, is how you pay for it. Orth did suggest several ideas, but I question whether they are actually sufficient enough to provide a meaningful longevity-type of benefit and, in fact, the paper talks specifically about focusing the benefit on lower income individuals so it would not be a universal solution for all participants in the system.

Finally, in looking at Orth's fourth problem of things that can go wrong in retirement, the long-term care (LTC) problem is a very challenging issue. There have been considerable changes in the LTC market and it is very difficult, as Orth acknowledges, to get people to understand the importance of why they might actually need this type of coverage. As a solution, Orth proposes developing hybrid policies that combine LTC benefits with other products such as annuities, disability coverage or "longevity insurance." This concept makes a lot of sense, but there's a lot of work to be done there.

When discussing LTC needs in the U.S. context, the CLASS Act enacted in 2010 with the Health Care Reform legislation creates additional complexity. While this is not my area of expertise, I understand that the benefit provisions under the CLASS Act should be considered a supplement to any significant LTC needs and there are real questions about whether the program as designed is sustainable from an actuarial standpoint. The premium levels are considered by many to be inadequate and the fact that there's no mechanism for selection is a problem. A key criticism is the potentially huge anti-selection issue with respect to people coming into the program only when anticipation of care is needed. Nevertheless, this an area that will continue to evolve and further development of combo products as Orth suggests would be a step in the right direction.

Social Security Reform Proposals

Now I'd like to turn a corner and look at actual Social Security reform proposals in the United States. Rather than try to cover every proposal I am focusing on one of the latest reform proposals (as of January 2011) that was proposed through the Deficit Reduction Commission (sometimes referred to as the Simpson-Bowles Commission) that the Obama Administration commissioned. Their final report was released in December 2010 and one of their stated guiding principles and values was:

Keep America sound over the long run. *We need to implement policies today to ensure that future generations have retirement security, affordable health care, and financial freedom. To do that, we must make Social Security solvent and sound, reduce the long-term growth of health care spending, and tackle the nation's overwhelming debt burden.*

Thus they were focused on ensuring the solvency of the program over the 75-year time horizon, reducing poverty among seniors and reforming Social Security. They actually say in the proposal itself that they are reforming Social Security for its own sake and not purely for deficit reduction, which is a charge many critics made.

When talking about Social Security Reform in the U.S. context, it is a controversial topic and the proverbial "third rail" of politics. One of the questions raised is whether there even is a crisis and you get very different views expressed from some that argue the system is about to go bankrupt to others that say the system just needs some minor tweaks. So there's a debate of what the problem is, and one's views drive the proposed "reforms."

Simpson-Bowles proposed 10 steps for reforming Social Security, many of which have been floating around in various forms and other discussions. The full report, which includes many recommendations beyond just Social Security changes, can be found online at: http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf. However, focusing on just Social Security, there are a mix of benefit reductions, increases, coverage changes and revenue increases.

There are three ideas that are benefit reductions. The first is to make the benefit formula more progressive by adding an additional bend point which results in a lower percentage being provided for higher income earners. Second is increasing the Social Security Normal Retirement Age and tying further increases to life expectancy changes. This is a solution many have discussed that would seem to make "actuarial sense" and has been advocated within the actuarial profession but not without some controversy. The controversy in part is coming from the question of whether general increases in life expectancy are being experienced similarly across different socio-economic or ethnic groups. The argument is that those at the lowest income levels have experienced the smallest increases in life expectancy and so would be disproportionately impacted by an increase in the retirement age. Third, is a recommendation to improve the CPI measure; “improved” in this context apparently means a different measure that would actually result in a lower CPI over the long term, but would, according to some, be more in line with old age CPI.

In the spirit of “ensuring future generations have retirement security” there are also some increases in benefits that are part of the proposal. The first is to provide an enhanced benefit for low wage workers, which is consistent with what Orth proposes in her paper, but doesn’t appear to be nearly as significant a change. Orth proposes increasing the benefit levels for the whole population whereas this provision is focused solely on low-income workers. The second idea is to provide enhanced benefits for the “very old and long-time disabled. “ This idea is very similar to the “longevity insurance” concept that Orth raises. The key difference from what I understand is that it doesn’t appear to be quite as extensive of an increase as Orth proposes. Nevertheless the fact that it is raised as a proposal is significant in my mind and shows there is recognition that this is an idea that makes sense and is beneficial to implement. The specific proposal increases benefits 5 percent for individuals who have been eligible for (receiving) benefits for 20 years, effectively making the increases happen at ages in the late 80s. Third, the report recommends creating means for more flexibility in claiming benefits for those who cannot work past age 62. If successfully implemented, this could help offset some of the concerns about raising the normal retirement age.

There are also recommendations for increasing coverage and revenue to Social Security. First, including all future state and local employees in Social Security as approximately 25 percent of those who work for the public sector aren’t actually covered by Social Security. While this is viewed as a cost neutral provision, ultimately this would be a positive change as it would increase short-term revenue and could possibly decrease the dependency ratio slightly (at least for some period of time). Second, a key revenue proposal is to increase the taxable wage base. When first implemented, the concept was that taxable wages should be at 90 percent of all wages and it's currently in the mid-80 percent range. Gradually phasing back to the 90 percent target by 2050 is a key proposal to increase revenue for Social Security. Finally, there are two other ideas proposed which are in my view are not financial having to do with SSAs communications with beneficiaries and the recommendation of "beginning a broad dialogue on the importance of personal retirement savings."

The report states that if all changes are made, 100 percent of the current shortfall in the 75-year Social Security projections will be closed. However, the proposal is controversial. What has been interesting to me is that I have seen it being attacked from both sides of the political spectrum which may suggest that it represents a reasonable compromise between the different political viewpoints. The challenge is that it appears politicians don't want to tackle big reforms so changes will have to be done on an incremental basis. While it is tempting to label a recommendation of a "broad dialogue" as "cosmetic," an ongoing discussion about retirement issues is needed, both in Washington, DC, and in venues accessible to the general public. Ideas like those developed in Orth's paper and the SOA's *Retirement 20/20* initiative are important in keeping the discussion going and even if macro-level reforms are not possible, there are likely specific incremental ideas that can be pulled from this work to implement better retirement plans for the future.