

INSURANCE NECESSITATES WINNERS AND LOSERS

For any insurance arrangement to work there must be winners and losers. Most of the time we are happy to be the loser. Who among us, other than a pyromaniac or a fraud, wants to “win” on their house insurance because it has burned down or been crushed by a meteorite? Which of us wants to “win” our life insurance bet by dying early--the earlier the more profitable? We don't buy auto insurance eagerly anticipating the day we can total our car and collect. We buy those insurances because we are willing to lose year after year in order to prevent a much larger loss should the insured event come to pass.

Take a look at the big picture for a moment to see why a focus on “winning” doesn't make sense when it discussing insurance. Any system that takes premiums, pays profits to an insurance company, commissions to a broker and distributes the rest of the money to policyholders can not be a “winner” for all, or even most, policyholders or the insurance arrangement would go bust. The insurance has value in part because it ameliorates risk.

BLIND MAN'S BLUFF AND SOCIAL SECURITY

However, when discussion turns to Social Security and traditional defined benefit pension plans, we ignore these same realities of winners and losers. In order for us to “win” in the game of Social Security, someone has to die. That is the undeniable truth about any annuity benefit. Those who die “early” forfeit benefits which are used to pay those who “live too long.”

Here is a simple example that illustrates the point. Four individuals know for certain that one of them will die at the end of the next four years. They each have \$100,000 saved for a total of \$400,000. There is no social insurance of any kind. If someone runs out of money they will starve. The four discuss alternatives.

To simply things, there is no inflation and investments are wealth storage devices, but pay no interest.

Actuary proposes they pool their money and pay each member \$40,000 annually. Individual payouts will total \$40,000 for the one who dies at the end of the first year, \$80,000, \$120,000 for deaths in years two and three and \$160,000 for the one who lives all four years. Actuary recognizes there will be winners and losers, but the losers shouldn't care much since they will be dead.

Banker points out it is patently unfair that one of them will get four times as much as another since they all started with the same amount. He conservatively suggests each of them spend \$25,000 per year so

none of them outlive their money.

Conniver thinks about Banker's plan and, since he figures he'll live the longest, suggests an amendment whereby any bank accounts left over are divided among the remaining members. He figures he'll get \$25,000 the first year, same as the banker's plan. Year two he's up to \$33,333; year three is \$50,000 and he clears \$100,000 in the fourth year for a total of \$208,333--much better than what Actuary proposed.

Dissembler incorrectly figures he will live on average two years since there's a 50/50 chance he'll live two years. He'll spend \$50,000 a year. Actuary is somehow cheating him of \$10,000. Banker is too conservative. Dissembler thinks to himself, but doesn't say out loud, that if he's still alive after two years, the other one won't really let him starve, so they'll just share.

Banker thinks that's irresponsible, but offers the following (using Dissembler's incorrect assumption about a two year expected life.) Start with \$50,000 but if you're still alive after the first year take the remaining amount and divide by half the remaining time so get \$33,333 the second year. If you're still alive you get the remaining \$16,666. Wait, he says this runs out of money after the third year. What happened?

Actuary corrects Banker and Dissembler and proves the average life expectancy is really 2.5 years $[(1+2+3+4)/4 = 2.5]$. So with your own account, you could start at \$40,000, but in year two it would reduce to \$30,000, and further reduce to \$20,000 and finally \$10,000 in the fourth year. Why, asks Actuary, do you think any of these are better than a guaranteed \$40,000 per year?

The other three dislike Actuary's plan because they know half of them will lose money and those are the ones who also lost the game of life by dying early. They "lost" their money by buying an annuity. What they didn't use could have been given to their children or favorite charity or at least buried with them.

In the real world, Conniver's method won't work unless a 100% estate tax is instituted and trends are heading the other way. Without annuities, holders of private accounts are left with the conservatism of Banker or implied (even if not acknowledge) deceit of Dissembler.

I do not want to suggest that everyone should take 100% of their assets at retirement and buy an annuity to maximize their retirement income. Investment earnings do apply in the real world and those with sufficient discretionary assets to withstand investment return variability have other choices to consider.

Right, I hear private account proponents say. It's the accumulation before retirement we're talking about.

That's the important issue. It's the young people getting short shrift and they provide numerous examples to prove it. There are two issues to consider here. The first brings us back to the issue of "losing" on insurance.

THE "OTHER" SOCIAL SECURITY BENEFITS

Social Security does not provide only retirement benefits. It provides benefits for those permanently disabled and it provides benefits to widows and widowers and their dependent children. These are paid by the same payroll tax used to support the retirement benefits. I managed to avoid receiving permanent disability benefits and am very thankful. My children are now old enough that they won't benefit if I die before starting my Social Security benefits. An ex-wife might be enriched with "widow" benefits, but I'm hoping to outlive her!

These ancillary benefits make up over 30% of current benefit payments from Social Security. Why are they neglected by the private account proponents? Because these are "winners" under the insurance lottery.

Even if private accounts grow sufficiently to provide adequate retirement benefits, they will be inadequate to cover disability and death benefits. This is particularly true for Disability benefits. Currently of the total employee and employer 12.4% payroll tax that supports OASDI (Old Age, Survivor and Disability Insurance benefits) the Disability portion is 1.8%. The chart below shows the accumulated fund available for an individual based on the following assumptions:

- All dollars are real (i.e. reflect current purchasing power)
- Contributions to the account equal \$1,000 per year (i.e. wages start at \$55,556)
- Real investment return is 2.5% per annum i.e. investment return is 2.5% over inflation)

Year	Account Value	Year	Account Value
5	5,256	25	34,158
10	11,203	30	43,903
15	17,932	35	54,928
20	25,525	40	67,403

The current average monthly benefit for a disabled worker is about \$1,000. After 10 years of working the disability account would be depleted in less than a year's time. Even after 30 years of working, the account will be depleted in under four years. Clearly this portion of the benefit can't be handled by

individual accounts.

THE ACCUMULATION PHASE

Proponents of private accounts whether in Social Security or 401(k) plans refer to the following benefits:

- The individual or his heir(s) receives 100% of the account value, regardless of early death, disability or late retirement.
- The account will earn “market” rates. The investor can determine an acceptable level of risk.
- Historical returns show larger retirement benefits could be provided than have been under a “traditional” plan.

Focusing on retaining 100% of the value of the account misses the point. Setting aside my house insurance premium or automobile insurance premium in a separate account will allow me to capture its whole value. The price is steep, however. It leaves me at risk for a catastrophic event. If I relied on the accumulated value of a “home insurance” account, after thirty years of home ownership, I might have \$30,000 or \$40,000 saved, which wouldn't go far toward replacing my house its contents.

The same holds true for life insurance or disability coverage. The private account proponents ignore the insurance aspect of current plans, which clearly had great value for early death or disability. What about the insurance aspect of the retirement accumulation?

For an individual or family, it depends on their total assets. Warren Buffet, the billionaire investor, probably does not need a portion of his assets invested in an annuity to assure a minimum of guaranteed life income. He can afford the risks inherent in investing in the market.

What about the 22% of elderly for whom Social Security is their sole source of retirement income? What level of risk can they assume? Very little. They are barely scraping by.

Will there be volatility? Absolutely, unless investments are locked into savings accounts, CDs, GICs and the like, in which case they won't earn a sufficiently high rate of return to be “better” than the current systems. When illustrating the benefits of individual accounts, often proponents use a long-term historical rate of return is used and applied it to future years to illustrate the power of “compound interest”.

To illustrate the effect of volatility let's look at three scenarios all with an "average" return of 6% per year. For this illustration we'll assume the first year contribution is \$1,000 and that contributions increase 3% per year to reflect inflation.

The three scenarios are:

- 6% each and every year (the one most often used)
- 12% for the first 10 years, 6% for the middle 10 years, and 0% for the last 10 years.
- 0% for the first 10 years, 6% for the middle 10 years and 12% for the last 10 years.

Scenario	Value after 30 Years
6% each year	\$111,000
12%/6%/0%	\$76,000
0%/6%/12%	\$161,000

The timing of investment returns matters! While the three scenarios are all extremely unlikely, significantly different returns during three successive decades is not, especially after reflecting the effects of inflation.

If the target was approximately \$111,000, no one is going to complain about a \$161,000 balance, over 45% greater than expected. Not so with a \$76,000 balance, a loss of almost one third from the anticipated funds. Cutting benefits by one third for someone living solely on Social Security is a disaster.

There is a key message the proponents of individual accounts do not want understood.

WHAT HAPPENS IN THE LAST TEN YEARS MATTERS THE MOST

If we agree, for the moment, the target is \$111,000, let's see what happens with different results in the last ten years.

Yrs. 1-10	Yrs. 11-20	Yrs. 21-30	Balance at End
6%	6%	6%	\$111,000
6%	6%	8%	\$131,000
6%	6%	4%	\$94,000
8%	8%	4%	\$110,000
12%	12%	0%	\$109,000

The second and third rows of the chart above illustrate the difference +/- 2% can make in the final account balance. Earning an extra 2% provides an increase of 18% over expected. Earning 2% less than expected for the last ten years delivers a 15% deficiency. The difference between the two results is almost 40%.

The fourth and fifty rows illustrate that to make up for deficient earnings of x% in the last ten years, it takes *twenty* prior years with excess earnings of x% to end up with roughly the same account balance.

And so?

Who can foresee the last ten years? If they go against us, we have no time as individuals to recover from their ill effects. Our only choices are to retire less well off than expected or work longer.

This result says nothing of individual merit, nothing of the person's forward planning, nothing of their other resources. It is all a luck of the draw, foreordained at the moment of birth, but unknown until the actual event.

As individuals we can only oversave like Banker or rely on an unplanned for safety net like Dissembler or starve.

THE UNPLANNED SAFETY NET

In the end, proponents of individual private account plans as a panacea rely on an implicit American understanding that we won't let people starve. While we quibble over what "starvation" means (what kind of housing is acceptable, what level of food consumption, what medical care should indigent have), no one assumes they or anyone they know will starve and so we have guarantees.

The government is terrible at determining the cost of its guarantees. They invariably understate the costs of guarantees, what economists call "put options." Three examples will illustrate my point:

Farm subsidies. To prop up farm prices, the government takes two approaches. One, pay a minimum price or two, pay farmers to NOT plant in order to reduce the crop and allow the market price to rise. Farmers by and large plant crops to make money. The first approach introduces a put option. The farmer can either sell his crop on the open market or "put it to" the government at the agreed minimum price.

Once a minimum price is introduced, some farmers who could not make money at a lower price can farm that crop at a profit. More is produced than the government anticipated, which drives down the market price. The government pays a larger difference between market price and the guarantee than it expected AND on more bushels of whatever.

Hence the no planting subsidy, which is intended to avoid the problem described above. However, it too comes with a hidden cost. In some cases a farmer can make more money not planting Crop A than he can planting Crop B--and that is what he does and the government pays more than expected.

Old enough to remember the Savings and Loan Crisis? With governmental guarantees for depositors, S&Ls attracted money from savers with high rates and in turn invested in risky assets. When they went bust the government picked up the tab to the tune of billions of dollars.

Today it's the Pension Benefit Guarantee Corporation (PBGC). For years steel companies, airlines and others negotiated increased pension benefits in lieu of immediate wages and funded their plans at the minimum level required by law. Why? Employees were told their benefits were "guaranteed" by the PBGC (which was only partly true). Employers were at risk for up to 30% of their net worth if they terminated the plans with insufficient assets.

Everyone's protected -- except they aren't. Steel, airlines and others now routinely go "bankrupt," settle their obligations for pennies on the dollar and are resurrected without their debt load. Who suffers? Their investors, for sure, but the answer is we the taxpayers by way of the PBGC who is left holding the billions of dollars of pension liabilities.

Airline A cashes its put option and the PBGC shoulders the burden. Airline A now has a lower cost structure than airline B and can undercut it on price. Airline B is forced into bankruptcy and shortly the entire industry has shed its pension obligations and the PBGC (read you and me) are picking it up.

To make up its deficit, the PBGC can either tax the remaining pension plans or tax us. Could this problem have been avoided when the PBGC first came into existence as much needed safety net? Of course and in retrospect we could devise a number of approaches.

But politicians solve today's problem, not tomorrow's or the next generation's.