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Commentary

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Social Security Debate Resumes

The Harvard Business Review published an article in its November 2002 edition entitled "Arm Yourself for the Coming Battle over Social Security" by Robert C. Pozen, a Visiting Professor at Harvard Law School. Professor Pozen was a member of President Bush's Commission to Strengthen Social Security and was formerly head of mutual funds at Fidelity Investments, in which capacity he was regarded as the principal spokesperson of the mutual fund industry for privatizing Social Security. Professor Pozen is to be complimented for his stated objective of encouraging participation in the Social Security debate. The essence of the Pozen article is contained in the following selected quotes.

"The system is in deep trouble. Unless reformed, the system will become insolvent around 2041. Essentially, we are trying to balance the U.S. budget on the basis of an accounting scheme that makes the Enron debacle look like a minor bookkeeping error. President Bush's recent tax cuts will confront the political pressures of Social Security financing as Social Security contributes less to annual budget surpluses, and from 2017 onward will contribute deficits to the overall budget. The budget gauntlet will have to be run to get the federal government to build more highways, continue a beleaguered defense program, or install high-speed internet lines in schools. After 2017, the U.S.Treasury will have to sell more public debt to finance the Social Security deficit. In turn, corporate borrowers are likely to experience higher long-term interest rates as they become crowded out by U.S Treasury debt. Workers, especially younger ones, have become increasingly concerned about whether they will receive their promised level of benefits. Of limited help in solving Social Security's financing challenges is the projected rise in worker productivity. Reliance on general revenues will undermine Social Security as a contributory retirement system and deplete federal resources for programs such as defense, education, and healthcare. Thus the focus should be not on whether but on how to improve Social Security's long-term financing problems by obtaining a higher return on assets through personal retirement accounts."

Professor Pozen opens his article with the statement that unless the Social Security system is reformed, it will become insolvent by 2041. He concludes by saying that the solution to the problem is to obtain higher returns on assets through personal retirement accounts. He attributes his opening statement to "the best estimates of the non-partisan experts at the Social Security Administration." A qualifying footnote defines these as the intermediate estimates in the 2002 report of the trustees of the Social Security trust fund. He makes no reference to the existence in the trustees' reports of alternative high-cost and low-cost estimates and makes no reference to the important qualifying language in the trustees' reports that warns readers about the validity and reliability of long-term estimates, viz: "although, in general, a greater degree of certainty can be presumed for projections encompassing the next few years than for a period as long as 75 years, any estimation of future experience is uncertain, therefore three alternative sets of demographic, economic, and program-specific assumptions are used to show a range of possible outcomes for all projections. The intermediate set of assumptions reflects the trustees' best estimates of future experience, the low-cost is more optimistic, and the high-cost alternative more pessimistic for the trust funds' future financial outlook." Professor Pozen makes the fundamental error of interpreting the 75-year projections as a precise prediction of the financial condition of the system over the entire 75-year period and then proceeds to base his analysis and conclusions on this false premise. He also ignores the excellent section of the trustees' report that discusses in great detail the significance of the sensitivity to changes in each of the actuarial, economic and demographic assumptions underlying the 75-year projections. Our own independent research has quantified the reliability or credibility of the nature of the long-term Social Security projections and, based on the actual numbers reported by the trustees in their 2002 annual report, we derived an index of relative credibility for the intermediate projections with a base of 100 for the 25-year projection. This index of credibility was computed as 67 for the 50-year projection and only 52 for the 75-year projection. This index measures the "increasing funnel of doubt" that is evident from studying the extent of the divergence of the trustees' three official projections.

Professor Pozen may well be an excellent professor of law, but he does not do justice to the complex actuarial and statistical concepts underlying the trustees' reports in his rush to reach his pre-conceived conclusion that the best interests of Social Security participants will be served by investing in individual accounts. We appeal to all interested parties to regard Social Security reform as a topic that deserves serious objective debate and not as a "battle" in which to take up arms as Professor Pozen urges.

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