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Commentary

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Lessons From Abroad

A recent international Social Security seminar provided some comparative commentary on the issues that have been the focus of debate in the United States. Expert speakers from Canada and Sweden presented thought-provoking descriptions of developments in those countries that provide important lessons for Social Security reform advocates in Washington.

One issue concerns the merits of investing the US Social Security Trust Fund in equity securities. At present the fund is invested in special issue treasury bonds. The Canada Pension Plan (CPP) now invests in equities. Following adoption of changes in the CPP investment policy, the amount of the buffer fund is to be increased from two to five years' benefit payments. The fund was formerly invested in provincial government bonds. It is now to be invested similarly to private sector pension plans and professionally managed with a target annual real rate of return of 3.8%. Securities have been essentially selected passively, generally reflecting broad market indices.

The CPP Investment Board was established in December 1997 and began investing in March 1999. Its mandate is to invest in the best interests of contributors and beneficiaries and to maximize long-term investment returns without undue risk of loss. The Investment Board is an independent entity operating at arm's length from the federal and provincial governments. Annual investment expenses are at the modest level of only nine basis points. The investment policy considers as eligible investments the securities of issuers engaged in a business that is lawful in Canada and those in any country with which Canada maintains normal financial, trade and investment relations. The board does not evaluate investments based on non-investment criteria. The target return on equities is set as the real return on bonds plus a risk premium of 1.6%. As of December 31, 2000 the CPP actuarial report included an assumed real rate of return for equities of 4.5%. The chief actuary for the CPP reported on the 1998 changes to benefits, contributions and investment policy concluding that a contribution rate of 9.9% together with investment income would be sufficient to meet the cash requirements for future benefits. Subsequent reports have confirmed the consistency of the 9.9% rate as adequate to maintain solvency of the CPP.

Another issue that has been widely debated in the United States is the potential introduction of individual accounts within the Social Security program. In Sweden, the National Pension System in operation from 1960 provided an inflation-indexed basic pension for all persons and a supplementary pension for wage earners. The defined-benefit system operated on a pay-as-you-go basis, maintaining a buffer fund of over five times annual benefit outgo. Reform of the system introduced a feature in 2000 whereby the whole system converted to defined contribution, with 2.5% of payroll being individually invested in mutual funds. The proponents of this change had claimed that the former system was unsustainable, that investment in stocks would generate higher returns for individuals than the implicit return under the former system, and that choice would empower the individual and permit a degree of influence over the means of providing for retirement.

The experience with the new system of individual accounts in Sweden has met with major criticism. The decision to change the pension system was made by an undemocratic process resulting in bad solutions providing generally lower pensions, with the changes being widely regarded as unfair compared to the previous system and many aspects of the new system incomprehensible to the general population. The changes were promoted using unrealistic rosy assumptions and resulted in administrative costs 250% higher, in addition to the expenses charged by the mutual funds. There are 71 independent institutions offering a total of 657 different fund choices and each individual participant may choose up to five funds. The difficulty of choosing among the funds is demonstrated by the extremely high rates of no choice being elected, resulting in default into a special government fund. Although free daily switches are permissible, ostensibly providing individuals the means to manage their retirement fund asset allocation, 89% have never made even a single switch and far less than 1% actively change funds.

The conclusion to be drawn from the Swedish experience with individual accounts is that society is best served if retirees have a decent standard of pension income that is not at risk in uncertain securities markets. Of particular significance is the fact that enormous administrative costs are incurred and lower pensions result when every person has to make investment decisions.

The Canadian and Swedish experiences may be regarded as important messages for policymakers in Washington. Some degree of direct equity investment by the Social Security Trust Funds should be considered as a means of enhancing the rate of investment return and strengthening the long-term solvency position. From Sweden the message is loud and clear that individual accounts have not been found to achieve their stated purposes.

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