Privatizing Social Security Via the Macabre

by John Cobin, Ph.D. for *The Times Examiner*
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A couple of years ago I was invited to speak as a member of a four-person panel at the Cato Institute in Washington, DC. The topic was the privatization of Social Security, with special emphasis on how the Hispanic community would be impacted. A key reason that I was invited involved, no doubt, that I had lived in Chile for nearly five years—a nation which completely privatized its public pension system two decades ago. Another reason must have been that I made the Cato Institute look moderate. How so? Well, besides Cato's lightly-seasoned Libertarian representative, two Hispanic liberals were invited as panelists. Not surprisingly, the liberal folks were opposed to privatizing Social Security. The Cato guy was more of a gradualist for the sake of political expediency. He would rather—and I proposed—completely do away with government-coerced pension plans entirely. Yet, since that solution is hardly attainable, he was open to other, "halfway house" alternatives on account of pragmatism.

My position was more straightforward, and certainly not moderate. If the state will not abolish Social Security, then the next best alternative would be to completely privatize it akin to what occurred in Chile. Moreover, if the state is going to force people to save for retirement, then the state should do so via those products that have the best rates of return and with the strongest guarantees. (Actually, I think that people should be able to save in any way they desire, even if it is risky, but since my liberal panelists were holding up riskiness as a reason for having a state-run Social Security plan, I thought I would recommend a market-based, private alternative that would provide better guarantees and a higher rate of return than the state-run system could provide.)

What could possibly offer a better rate of return with more security than the state? After all, the "risk-free" rate in financial theory is always defined a the return that can be obtained on short term U.S. Government securities like Treasury Bills. The U.S. has never defaulted on its debt and has a lot of power and resources by which to make good on its obligations. So the audience and panelists waited with anticipation for my answer about how the market could provide a better rate of return with a *better* guarantee than the U.S. Government gives. Here is where the macabre enters into the mix.

There is a chance, no matter how slim one considers it to be, that the U.S. Government will default on its obligations. There is something else, however, that will never default, and that is absolutely guaranteed to occur: *death*. At this point, the audience and panelists were perplexed. What does death have to do with guaranteeing a rate of return or privatizing Social Security? As they soon found out, it has everything to do with both things. Death is the one thing that you can count on, and actuaries can predict its frequency with a great deal of accuracy. Actuaries are so good at their craft that a whole industry in life insurance has developed which is both profitable for them and efficient as a means of transferring the risk of loss from those who cannot bear it to a larger pool of insureds.

Whole life insurance provides returns that are not subject to stock market volatility. And I am not merely referring to the cash value of a policy—I am referring to the death benefit. Life insurance is one kind of insurance policy that is sure to be used if kept in force. The insured *will* die. He may never use his medical, automobile, or disability insurance, but there will be a claim filed against his life insurance. Death is a better guarantee than any state guarantee. But how is this fact relevant to the issue at hand?

Suppose that instead of "paying into" Social Security a person is required to pay the premiums on a participating (mutual company's) whole life policy on one of his parents, or another rela-

tive or acquaintance from his parent's generation. Suppose he has a choice to pick the person that poses the least amount of insurance risk and thus has the lowest cost of insurance. Suppose that he is also able to purchase a rider on the policy that guarantees that the premiums will be paid for him in case he becomes disabled and can no longer pay the premiums. Suppose that he can choose between a competitive pool of over 50 companies who are wiling to provide such a policy, so that he can get the highest quality at the lowest cost. Also suppose that an annuity that guarantees monthly income of $2,000 per month for life costs $300,000 (starting at age 55). This income is roughly double what a typical person might expect to earn from (shaky) Social Security benefits today.

If a "typical" 35 year-old worker earns $60,000 per year, he will pay about $7,440 per year in FICA taxes. If he has a healthy parent in their mid-50s, the cost of insurance for a $300,000 policy on that parent would be substantially less than the amount he will pay in FICA tax. When the parent dies, the worker will receive a fully tax-free payment of $300,000 from the insurance company that can fund his retirement annuity. It makes no difference how the stock market has performed. It makes no difference if the parent dies young or lives too long. The death benefit is paid no matter what age the parent lives to. And, in the case of premature death, the worker will not have to "pay in" as much as others do for this market-based pension program. If the parent lives longer than 20 years, the whole life policy eventually will build up a cash value that is equal to (or greater than) the original death benefit. This cash value can be used to fund an annuity payment instead of the death benefit, although some prudent financial planning will have to be done to make the distributions tax-free. If the worker becomes disabled, his premiums will be paid for him by the insurance company. Over the long run, the use of the "paid up additions" dividend option in the policy allows the death benefit to keep up with inflation more or less. In addition, the annuity payment, if chosen as the best means to fund the worker's retirement, can be reduced (as set up) so that the worker's spouse or heirs can continue to receive benefits.

What's more, a policy like this can usually be paid for after 15 years. At that point, the dividends (although not guaranteed) will be large enough to pay the premiums. By the way, while dividends are not guaranteed, mutual insurance companies have a record of paying dividends that extends well over 100 years without fault. And the death benefit does not depend on dividends anyway, only the cash values do, and even they have a minimum rate of return (e.g., 4%) that is guaranteed. So there is hardly any reason to worry about the payout being made. Each state also provides a guarantee fund that backs up the insurance policy or annuity (typically up to $300,000) in case an insurance company goes bankrupt.

In other words, a worker can pay much less into his private pension system—likely for only 15 years—and be guaranteed to have twice as much income when he retires. Of course, the actual amount paid for a $300,000 policy depends on many factors including the age and health of the parent or acquaintance. So one worker might pay a greater or lesser amount than his counterparts. Of course, that fact must be balanced with issues like expected retirement age. For instance, a 55 year old worker might pay twice as much as a 35 year old work for the same $300,000 policy because the parent is older. But the 55 year-olds parent has a much shorter life expectancy, typically. Overall, therefore, nearly every worker will benefit and have a huge windfall by exchanging present social security for such a life insurance plan. So why not do it? Well, the only real and sustainable objection is that not everyone can do it. Disabled youth or retarded people who do not work will not be able to get insurance on parents, unless someone gives them the money to do so. Also, the elderly at the time of transition to the new system would be left out since they have no way to feasibly buy insurance on the generation prior to them. Nevertheless, these problems can be resolved by (1) providing a public fund for the permanently unemployed and (2) by allowing a transitional public policy granting people over a certain age to have benefits for up to 15 years under the current program. While this proposal is not perfect, it is still vastly better and stronger than our current policy.