NATIONAL CENTER FOR POLICY ANALYSIS

Social Security by Choice: The Experience of Three Texas Counties

Brief Analysis No. 765 by Merrill Matthews April 12, 2012

Stock market volatility remains one of the primary objections to switching from the current pay-as-you-go method of funding Social Security benefits to a system of prefunded personal retirement accounts. However, three Texas counties that opted out of Social Security 30 years ago have solved the risk problem.

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Galveston County opted out of Social Security in 1981, and Matagorda and Brazoria counties followed suit in 1982. County employees have since seen their retirement savings grow every year, including during the recent recession. Today, county workers retire with more money, and have better supplemental benefits in case of disability or an early death. Moreover, the counties face no long-term unfunded pension liabilities.

If state and local governments — and Congress — are really looking for a path to long-term sustainable entitlement reform, they might consider what is known as the "Alternate Plan."

The Alternate Plan. The Alternate Plan does not follow the traditional defined-benefit or defined-contribution model. Rather, employee and employer retirement contributions are actively managed by a financial planner — in this case, First Financial Benefits, Inc., of Houston, which both originated the plan and has managed it since inception.

Like Social Security, employees contribute 6.2 percent of their income, with the county matching the contribution (Galveston has chosen to provide a slightly larger share). Once the county makes its contribution, its financial obligation is done. As a result, there are no long-term unfunded liabilities.

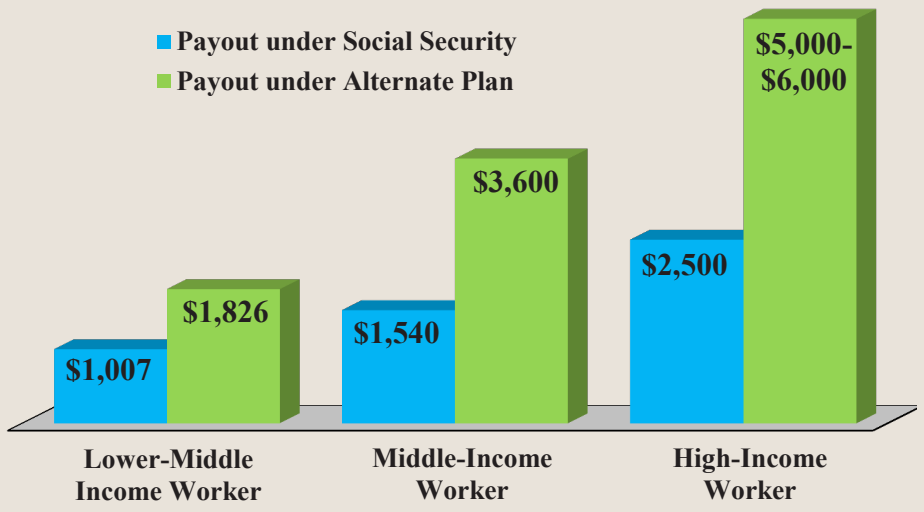
The Banking Model. Unlike a traditional IRA or 401(k) plan, where account holders can actively manage their investments, the contributions are pooled, like bank deposits to a savings account, and top-rated financial institutions bid on the money.

Those institutions guarantee a base interest rate — usually about 3.75 percent — which can increase if the market does well. Over the last decade, the accounts have earned between 3.75 percent and 5.75 percent every year, with an average of around 5 percent. The 1990s often saw even higher interest rates, 6.5 percent to 7 percent. Thus, when the market goes up, employees make more; but when the market goes down, employees still make something, virtually eliminating the problem of workers deciding not to retire because of major drop in the market.

A Real Alternative to Social Security. Social Security is not just a retirement fund. It is social insurance that provides a death benefit, survivors' insurance and a disability benefit. When financial planner Rick Gornto devised the Alternate Plan for Galveston County, he wanted it to be a complete substitute for Social Security. Thus, part of the employer contribution provides a term life insurance policy, which pays four times the employee's salary tax free,

up to a maximum of $215,000. That's nearly 850 times Social Security's death benefit of $255.

If a worker participating in Social Security dies before retirement, he loses his contribution (though part of that money might go to surviving minor children or a spouse who never worked). A worker in the Alternate Plan owns his or her account, so the entire account belongs to the estate. The Plan also provides a disability benefit that pays immediately upon injury, rather than Social Security's six-month wait, plus other restrictions.



Source: First Financial.

More Retirement Income. Alternate Plan retirees do much better than those who retire under Social Security. According to First Financial's calculations, based on 40 years of contributions [see the figure]:

- A lower-middle income worker making about $26,000 at retirement would get about $1,007 a month under Social Security, but $1,826 under the Alternate Plan.
- A middle-income worker making $51,200 would get about $1,540 monthly from Social Security, but $3,600 from the Alternate Plan.
- And a high-income worker who maxed out on his Social Security contribution every year would receive about $2,500 a month from Social Security compared to $5,000 to $6,000 a month from the Alternate Plan.

It is evident that higher-income workers fare better, relative to lower-income workers. The reason is that Social Security's payout formula adjusts higher-income workers' benefits down so that low-income workers' benefits can be adjusted up. The Alternate Plan makes no such transfer payments. Even so, lower-income workers still do significantly better than they do under Social Security's social insurance model.

It Is Safe and It Works. What the Alternate Plan has demonstrated over 30 years is that personal retirement accounts work, with many retirees making more than twice what they would under Social Security. New county employees who have worked long enough in other jobs to qualify for Social Security keep those benefits, but they must join the Alternate Plan. However, the reduced employment time will mean lower returns than if they had put in a full 30 or 40 years for the county.

A Model for Reform? Roughly 25 percent of public employees — about 6 million people — are part of state and local government retirement plans outside of Social Security. Many of those plans are facing serious unfunded liability problems, just like Social Security. Those state and local plans do not have to wait for Congress to act — they can switch to the Alternate Plan immediately. However, state and local plans currently participating in Social Security are stuck. The Greenspan Commission, led by soon-to-be Federal Reserve Chairman Alan Greenspan, closed that opt-out window in 1983.

The Alternate Plan could also serve as a model for reforming Social Security. It provides all of the benefits of Social Security while avoiding the unfunded liabilities that are crippling the program — and the economy.

A retirement system that is prefunded and safe is not a dream. Three Texas counties have proven it can work. If states or Congress really want to address entitlement reform, the Alternate Plan is a good place to start.

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