

# **Social Security Reform in Lessons From Other Nations**

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Countries all around the world are reforming their social security systems. This is happening throughout Latin America, in several OECD (Organization for Economic Cooperation and Development) countries, and now a wave of reforms has begun in Eastern Europe and the former Soviet Union. This shows that pension reform, although it is politically difficult, is indeed possible even in democracies. And the basic reasons for reform are similar throughout the world.

First, countries see that populations are aging, and they are going to encounter major fiscal problems if they don't change their systems.

But second is a more positive reason, which is that a change from the old traditional pay-as-you-go, defined-benefit type of social security system to a system that includes more pre-funding, more individual accounts, and a closer link between benefits and contributions is good for the overall economy. It helps middle-income countries develop their financial markets. It helps all countries develop their long-term saving, which seems to be linked to capital formation and economic growth. It helps make labor markets more efficient and removes a deterrent to employment. It helps make labor markets more efficient and removes a deterrent to employment. And, beyond that, it is more equitable because, despite the mythology that has surrounded old traditional systems—that they are equitable, that they are redistributive toward low-income groups—people are beginning to realize that the facts show otherwise and that systems are available that are both more efficient and more equitable at the same time.

## **The Structure of Reform**

In the countries that are undergoing structural reforms, a multi-pillar structure is developing. This also happens to be the structure recommended by the World Bank, and we are glad that many countries are moving in that direction.

The new structure consists of two mandatory parts. One mandatory part—or pillar—handles people's retirement saving, the funded accounts that people are required to have. This pillar is usually defined contribution instead of defined benefit, thereby linking benefits closely with contributions. Benefits are funded rather than pay-as-you-go, and the funds are privately managed. That is really the centerpiece of the structural reforms.

This pillar is always buttressed by another mandatory pillar, which is a publicly managed tax-financed arrangement designed to provide a social safety net to protect low wage earners.

That's the basic system we find in countries that are instituting structural reforms.

In addition, there is always a third, voluntary pillar for people who want more consumption and income in old age. But this discussion will focus mainly on the mandatory part of the system. Despite the fact that this is the general model that reforming countries are following, they are implementing it in many different ways.

### **Defined Contribution vs. Defined Benefit**

This discussion starts with a brief explanation of the characteristics of the mandatory saving pillar, the pillar that handles people's individual savings accounts.

It is defined contribution rather than defined benefit. The rationale is that this links benefits closely to contributions. Therefore, it should reduce the incentive for evasion and the harmful effects of evasion on the system. Evasion is a big problem in many countries; sometimes 20-30% of the covered labor force evades. But the smaller the tax element, and the closer the link between benefits and contributions, the smaller the incentive for evasion. And under a defined contribution plan if people do evade this reduces their own pension, whereas in a defined benefit plan evaders often collect their benefits at the expense of others, thereby undermining the financial sustainability of the system.

Perhaps more important, a defined contribution plan discourages early retirement and makes the system less financially sensitive to early retirement decisions. Furthermore, it adjusts the retirement age upward or the benefit rate downward automatically, as longevity increases. When you retire in a defined-contribution plan in a competitive market, you turn your capital accumulation into an annuity on actuarially fair terms. So if you retire early or if longevity increases you get a lower benefit, because it is expected to continue for more years. This has two advantages. It makes the system financially sustainable and, since you're not passing the cost on to others, you are discouraged from retiring early.

In contrast, defined-benefit programs in most countries allow people to retire early at rates that are not actuarially fair. So if you retire early, over your lifetime you collect a larger total benefit than you do if you retire later. This produces a very high implicit tax on work and an incentive to retire early, because people are foregoing a large benefit if they continue working. In some countries, the implicit tax is as high as 70 or 80 percent of wages, and people respond to that high implicit tax by retiring. Jonathan Gruber and David Wise<sup>2</sup> have done an international study that shows this implicit tax is closely linked to peoples' decisions to retire early. This imposes a huge financial strain on the social security system. And it's bad for the economy because it reduces the experienced labor force.

In addition, as longevity increases, in a defined-benefit system politicians face the very difficult task of raising the retirement age continually to keep up with longevity increases. In a defined-contribution system, this process happens automatically as the accumulation is annuitized, without a difficult political decision. Either people voluntarily retire later, or they find

themselves faced with lower annual benefits, which in turn leads them to postpone their retirement.

These are some of the reasons why this partial shift to defined contribution is desirable.

### **The Shift to Funding**

Even more important is the shift to pre-funding, as compared with pay-as-you-go. This avoids unaffordable promises, which most developed countries have made by now. But the developing countries that we're dealing with haven't made them yet, or they cover only a small portion of the total labor force.

At the World Bank, we are urging them not to make those unaffordable promises. That avoids the large payroll tax increases that you get as populations age in a pay-as-you-go system. It avoids the intergenerational transfers that automatically take place—income transfers toward the early cohorts that retire, at the expense of their children and grandchildren. And it helps to build long-term saving.

Many countries, including the United States, feel that they have a shortage of long-term saving. It is true that we have global capital markets and to some extent we can import capital, but it is also true that domestic investment seems closely tied to the rate of domestic saving, and this in turn is a source of economic growth. So funding can be an important source of long-term national investment and growth if it is part of a set of policies designed to increase public and private saving. Of course, pension funding does not increase national saving if it crowds out other forms of household saving or leads to greater public deficits. As discussed below, the methods used to finance the transition strongly influence the net impact on long term national saving.

### **Higher Rates of Return Through Private Management**

Why should the funded mandatory saving pillar be privately and competitively managed? The important point here is that this maximizes the probability that investment decisions will be based on economic rather than political considerations. It therefore maximizes the real rate of return to society and the monetary rate of return to the pension fund.

A colleague of mine at the World Bank has assembled data on rates of return to publicly and privately managed pension funds, and he shows that publicly managed pension reserves around the world have fared poorly. In most countries, in fact, they have earned negative real rates of return.

The reason is that the investments have been politically dictated. Often they have to be invested exclusively in government bonds—we see that in the Social Security Trust Fund. But sometimes they are invested in special-issue government bonds that yield negative real rates of return. In addition, sometimes they have to be loaned to failing state enterprises that are going bankrupt. The pension funds are used to bail them out.

In any event, for a variety of reasons, if the funds are publicly managed, it is very difficult to avoid political objectives creeping in. And these can conflict with the economic objective of maximizing the economic rate of return. Decentralized competitive management is most likely to get you an efficient allocation of capital.

In addition, for the middle-income countries that the World Bank deals with, funded, privately managed pension plans can be a very important way of developing financial markets, and in fact this has been shown to have played a very important role. Econometric studies of Chile's rapid rate of economic growth during the past 15 years, for instance, indicate that the funded pension plans played a major role, in particular in developing financial markets. The development of financial markets is given credit for an increase in total factor productivity of about 1 percent per year.

### **The Latin American Model**

These pension reforms are taking somewhat different forms in different parts of the world. In particular, we see three major types of reforms.

The Latin American model more or less follows the model set by Chile in 1980. Chile was, as you know, a pioneer in social security reform. But that system has spread now throughout Latin America to Argentina, Mexico, Peru, Bolivia, and Uruguay. It is going to sweep South America and is moving to Central America.

Interestingly, it has just been adopted by Hungary and by Kazakhstan. I would expect that, in one form or another, in the next three to five years this kind of reform is going to be sweeping throughout Eastern and Central Europe and the former Soviet Union, always with variations dictated by country conditions.

The key features of the Latin American model are:

1. Workers choose the investment manager.
2. Workers have individual accounts and can move their individual accounts from one pension fund to another.
3. The pension funds are very much like mutual funds, but they operate subject to tight regulations that are set up by the governments.

Another key feature of the Latin American model is their transition costs. Pre-reform, a large contribution was being made to a pay-as-you-go system. When some of that contribution is diverted to the individual account, the system still has the obligations remaining from the old pay-as-you-go system. Somehow, these transition costs must be covered.

This is a big problem, and it has stymied a lot of countries. It really slowed down the

reform process in Eastern and Central Europe. But, in fact, it turns out that the transition cost problem can be solved, as will be discussed below., and I will talk for a minute or two at the end about how it has been solved in these countries.

A major criticism of the Latin American model—and I mention it because it is sure to surface in the United States as an important factor—is the issue of administrative cost. Chile has been criticized for having high administrative costs, stemming in large part from high marketing costs. I just want to Three important points should be made about this issue.

**First**, The administrative costs in Chile have been overstated, because in the early years temporary start-up costs were high. They always are when you're instituting a new system.

**Second**, in Chile all the fees are front-loaded. That is, you pay when you make your contribution, but you don't pay further annual expenses based on your accumulated assets. Naturally, in the first few years of the plan, when contributions are high relative to assets, this looks like a big subtraction from your rate of return. But as time moves on and your assets grow relative to your annual contributions, it will be a much smaller subtraction from net return. These costs have been coming down over time as a percentage of assets. Simulations show that for a worker who contributes for 40 years, the fee structure in Chile will be equivalent to less than 1 percent of assets annually, which is less than what the average mutual fund charges in the U.S. So this is in part a red herring.

Nevertheless, my **third** point is that even 1 percent is pretty high for a mandatory system. It is something we have to think that has to be thought about seriously, and we have to develop ways ways have to be developed to bring it down.

## The OECD Model

The second main model that we find is developing is what I call the OECD model. Australia is a key example of this model. You also find it It is also found in Switzerland, Denmark, and the United Kingdom.

A key feature of the OECD model is that rather than having individual accounts with individual choice, group choice determines the investment manager. That is, the employer and/or union trustees choose the investment manager for the company or occupational group as a whole.

This course was taken in these countries for historical reasons. They had a large number of collectively bargained plans; and when they added a mandatory savings tier, it was easier and more politically acceptable to build on these plans and simply say "We are going to have group choice."

The advantage of group choice is the possibility of economies of scale and expertise, which may keep costs down. But the possible disadvantage is the principal agent problem. The investment manager your employer chooses for you may not be the investment manager you would have chosen for yourself. This manager may not use the investment strategy that you

want; he may accept too little or too much risk, for example.

As a result, we see in these countries some choice for workers is beginning to emerge—although more limited than U.S. workers have in 401(k) plans. The employer may say, “You can choose any fund you want from among this family of funds.” Furthermore, in the United Kingdom workers are allowed to opt out of the employer’s plan into their own personal account.

I believe that pure group choice is not really a viable political equilibrium in a defined contribution plan where workers bear the investment risk. Pressures develop to give people some individual choice. But these OECD countries started with group choice, and still have predominantly group choice.

The other really important feature of the OECD countries is that these countries typically had very modest first pillars. Australia just had a means and asset-tested publicly financed safety net, and Switzerland had a modest pay-as-you-go system. So when they decided they needed a second funded tier, they just added it on. They said, “Well, we had this small tax-financed public pillar. It’s clearly not going to be enough as the population ages, so we’re going to add on a mandatory saving component. Since we already have many employer-sponsored plans, we will make it compulsory for all employers to provide this.” Since they did not divert contributions away from the old system, there was no transition costs problem in these countries.

### **The institutional model for the funded pillar and the notional DC plan for the first pillar**

The third model for the mandatory savings pillar uses the institutional market. Bolivia has used this model and Sweden has adapted it. In the institutional market, workers’ small contributions are aggregated and moved in large blocs to a limited number of pension funds, according to worker choice. In Bolivia a competitive bidding process resulted in the selection of two funds, between which workers will soon be allowed to choose. The basic idea here is to use the bargaining power of large money blocs to keep administrative fees and marketing expenses low, rather than turning workers over to the retail market that deals with small accounts and incurs high marketing expenses that are passed on to its members. This approach does seem to have the potential to keep costs and fees low, but it also introduces inflexibility and limited choice of investment managers into the system. Given this trade-off, some countries will favor this approach while others will be skeptical, but at least it should be carefully considered because it holds the potential of increasing workers’ accumulations and pensions.

A new model that has some of the features we have been recommending also exists for the first pillar—the notional defined contribution system. This originated in Sweden, and has been adopted also in Italy, Latvia and Poland. China would like to have a funded individual account system, but can’t figure out how to finance the transition; therefore at this point China has a notional individual account system.

The basic idea of the notional individual account system is that, ostensibly, it is defined-contribution instead of defined-benefit but it remains pay-as-you-go. People have individual accounts. They have bankbooks that show their accumulations and the interest that they are

earning on the accumulations. But there is actually no money in those accounts. There are no assets. It's virtual; it's notional.

The theory behind this is that you get the advantage of defined contribution and the closer link between benefits and contributions. Yet the system basically remains pay-as-you-go. This means the countries don't face transition cost problems. In fact, the countries that have adopted this system have done so precisely to *avoid* facing the transition cost problem. The money keeps flowing into the pay-as-you-go system.

However, it also means that these countries don't get the benefits of pre-funding. They don't get the buildup of long-term national saving or financial market development. They don't avoid payroll tax increases in the future, or intergenerational transfers. And the notional interest rate, as well as the rate of conversion to an annuity upon retirement, are both subject to political manipulation.

Typically, countries that have adopted the notional defined contribution system for their first pillar have augmented it with a second funded pillar. In Sweden the contribution to the funded pillar is only 2.5%, all collection and record-keeping is centralized, workers choose the investment manager from among a long list of mutual funds, and the money will be moved in large blocs, subject to complex price controls. Poland has a larger funded component, with the fund managers chosen according to the Latin American model.

### **Covering Transition Costs**

When part of the contribution is carved out or diverted to a funded account, countries must find ways to cover the obligations they already owe to pensioners and workers, as a legacy of the old system. This is known as "the transition cost problem." The Latin American countries, and now Hungary and Poland, have used four main methods to cover their transition costs. They are:

**1) Downsizing.** The most universal is to downsize the old system. Usually, the old system is too generous to begin with. It is unsustainable, and it has to be downsized. You Governments cut the benefit rate; raise the retirement rate; change the indexation method, often from wage indexation to price indexation; and eliminate the abuse of disability.

This is almost universal. We find thisIt is found in practically every country that has reformed. And I would say that it's essential. Of course, it's also essential that these changes be phased in gradually. Current pensioners and older workers have been exempt from cuts in practically every case. For younger workers, much of the cuts in their PAYG benefits are replaced by the accumulation in their new funded accounts.

**2) Other sources of revenue or assets.** You can use otherOther revenue sources can be used to help pay the existing pensioners—such as a surplus in the treasury or the social security system. Chile accumulated a budget surplus for this purpose. The U.S. happens to be in the fortunate position that we may have a budgetary surplus that we can usecan be used for this purpose.

Some countries have just privatized or will privatize state enterprises, and they are allocating some of those revenues for pension reform. Kazakhstan is using oil revenues for this purpose. So special revenue sources or assets can be used to offset these outstanding pension liabilities. Because of the fungibility of money, the choice of which revenue source will be used to finance the transition is largely a political public relations issue, rather than an economic issue.

**3) Partial pay-as-you-go.** You can It is common to keep part of the new system as pay-as-you-go. Some countries, such as Uruguay and Hungary, that started with a large implicit pension debt and high transition costs, have kept a big pay-as-you-go pillar in their new systems. No country has made a total switch away from pay-as-you-go or tax-financing. Some people say Chile made a total switch, but I consider that this is a misnomer because workers did have a choice. Some workers, particularly older workers, stayed in the old system. Furthermore, Chile still provides a social safety net, the minimum pension guarantee,, that is financed out of current taxes.

The typical reform keeps older workers in the old system but lets younger workers choose. Some countries even allow new workers to choose, although I think that is a big mistake. It is not sustainable and ends up with the administrative costs of two systems instead of one.

When you keep part of your system pay-as-you-go, this means you keep some revenues flowing into the pay-as-you-go system. That helps to pay your current obligations. That is the plus. The minus is that, at the same time, you are building future obligations to the people who are making those contributions.

So there is a trade-off between meeting immediate cash flow needs on the one hand, and meeting longer-term obligations on the other hand. It is a danger to go too far in the pay-as-you-go direction, since that may defeat the object of the reform, but this is a method that all countries have used to some extent.

**4) Debt finance.** Finally, if all these other methods still leave a financing gap, you countries can use a combination of debt finance and a temporary tax that is used to retire that debt. In fact, some debt finance is almost inevitable. It spreads the transition costs over many cohorts rather than just making the first few cohorts bear the entire burden.

You People often hear people say, “Oh, you can’t make a transition because one generation will be paying for its own retirement and for the current pensioners’ retirement at the same time, and it’s too heavy a burden.” Debt finance is a way of spreading out this burden and gaining control over its intergenerational distribution. However, most countries would want to pay off that debt pretty quickly to get the advantages of long-term saving. (If additional private saving is simply offset by additional public dissaving, this does not leave any net increase for productive investment. Thus, debt finance can be useful in the short and medium term, but in the long term the debt must be repaid and the transition financed by cuts in benefits or other government expenditures relative to what would have occurred otherwise, or by tax or contribution increases, in order to augment national saving).

When considering debt finance to finance the transition, you political leaders might say, “This is bad; the financial markets won’t react well to this.” Indeed, the IMF used to discourage pension reform on the grounds that it would increase the explicit debt. But the IMF has changed its position on this because they now recognize that temporary debt finance is just a way of transforming an implicit debt into an explicit debt. It is really not increasing the debt. In fact, if it is part of a comprehensive pension reform program, it is decreasing the debt in the long term. Hungary even got an improved credit rating from Moody’s when it did its pension reform partly financed by debt, because Moody’s saw this as a signal of long-term fiscal prudence.

### **Relevance for the United States**

Let me comment on What is the relevance of this for the United States. States? Which of these models is more appropriate? Basically, the U.S. could really go either way—that is, with the Latin American model and some transition costs or the OECD add-on model and no transition costs—because we have a relatively modest pay-as-you-go system by international standards.

I think we do face some important trade-offs, however. While interest in individual accounts is strong, the numbers that people are talking about are very small—such as a 2 percentage point carve-out or add-on to payroll taxes that would go into an individual account. This contrasts with most reforming countries where the individual accounts have contribution rates varying from 6 to 10 percentage points.

If we don’t have an add-on, because people equate this with a tax increase, and if we are reluctant to have a large carve-out because of the transition cost problem, then we are the United States is stuck with very small individual accounts. A 2 percentage point individual account means, for the average worker, about \$500-600 a year going into the individual accounts. Even for high-income workers, it means only \$1,300-1500 a year.

This is a small amount, in the face of large scale economies associated with individual accounts. If accounts are small, Americans may not benefit from scale economies. Small accounts require very careful thought about how to run the system on a cost-effective basis. Probably investment choices for workers as well as other services supplied would have to be very limited choice in order to reap those scale economies and avoid high costs per account. Using the institutional market might be considered, especially in the early years of the new system.

In contrast, a larger account would probably require an add-on combined with a carve-out. This would allow workers the possibility of greater choice among investment options while still reaping scale economies and permitting more generous retirement benefits as well.

I think we’re the United States is going to end up with some individual accounts, but important issues will be what should the size be, of them be; what kind of safety net should be provided; should we make the defined benefit pillar more progressive to offset the neutrality of

the defined contribution pillar; what will the impact be on administrative costs, costs; how much investment choice can be allowed; and what should be the restrictions on annuities and other forms of withdrawals upon retirement? The devil is in the details, and we can learn a lot about the many options and their consequences by examining the experience of other countries.

<sup>1</sup> This article is based on a speech delivered at The Heritage Foundation on April 9, 1998. Estelle James is the principal author of *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*. She was formerly Lead Economist at and is now consultant to the World Bank.

<sup>2</sup> Gruber, Jonathan and David Wise. 1998. *Social Security and Retirement Around the World*. Chicago: University of Chicago Press.