

## BRIEF ANALYSIS

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## Social Security Reform: Other Countries Are Leading the Way

From the inception of Social Security in 1935, politicians have encouraged people to think of the system as similar to private pensions. Private pension plans that invest a person's contributions in secure, interest-bearing instruments do not go broke.

But according to the latest report from the Board of Trustees of the Social Security Trust Funds:

- Social Security tax revenues alone will be insufficient to pay current benefits as early as the year 2012.
- Tax revenues *plus interest on the trust funds* will be inadequate to pay the promised benefits by the year 2019.

**Dollars In, Dollars Out.** Social Security is a pay-as-you-go system under which taxes collected from current workers are used to pay current retirees. Every dollar collected in payroll taxes is spent immediately. No investment is made in real assets.

What about the Social Security Trust Funds? These are trust funds in name only, consisting of IOUs the government has written to itself. In the future, we will need to impose more and higher taxes in order to pay promised benefits. And that's the problem.

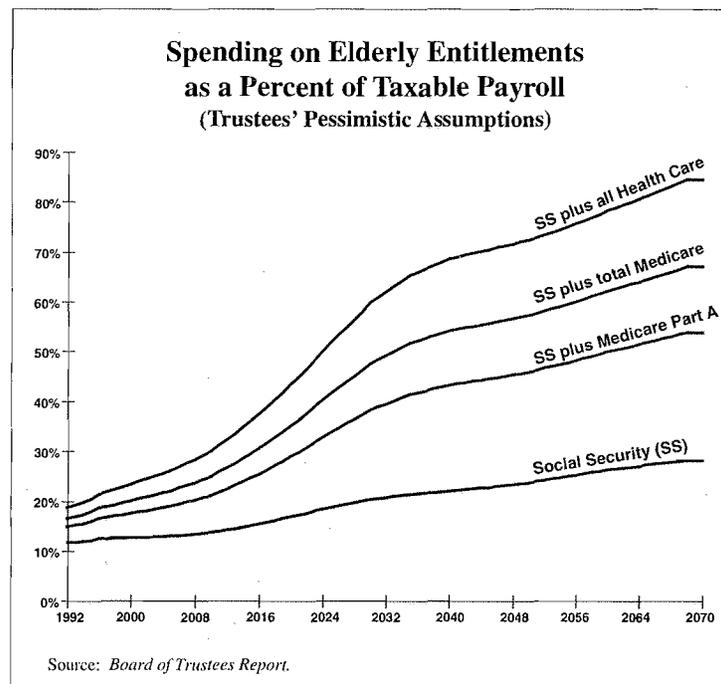
Everyone who will be 65 years of age or older in the year 2060 is already alive today. Social Security actuaries forecast that in that year Social Security and both parts of Medicare will consume from 35 percent (intermediate assumption) to 61 percent (pessimistic assumption) of the total taxable U. S. payroll. [See the figure.] When other spending on elderly medical bills (Medicaid, VA system, mandates on private employers, etc.) is

included, the National Center for Policy Analysis estimates that the figure will reach 43 to 77 percent.

**Support for Privatization.** In response to Social Security's gloomy financial future, there is growing bipartisan support for reform through partial or complete privatization of the system. Fortunately, Congress need not search for solutions unguided. Several countries already have private social security systems, and we can learn from them.

**Case Study: Chile.** Chile was the first nation in the Western Hemisphere to adopt a social security system

(1929) and the first nation in the world to completely privatize one (1981). Currently, employees must pay 10 percent of their wages to the Chilean equivalent of Individual Retirement Accounts. Individuals cannot direct their own investments. However, they can choose among 21 competing private investment companies, which are similar to U.S. mutual funds. These funds are required to invest conservatively in a diversified portfolio of stocks and bonds. An employee dissatisfied with his or her fund can easily switch to another.



Workers must also contribute to buy private life and disability insurance, bringing the total required contribution to about 13 percent. The benefits of this approach are compelling. Retirement benefits, which depend on the rate of return earned by private accounts, have generally been anywhere from 50 to 70 percent higher under the new system.

**Case Study: Singapore.** Like Chile, Singapore has a private retirement system; unlike Chile's, Singapore's system was private from its inception in 1955. Residents are required to save for all manner of needs: retirement, medical expenses, education, even the purchase of a home. The rate of contribution for both employers and

employees is 20 percent. In effect, residents of Singapore are forced to save 40 percent of their incomes. At retirement—generally age 55—workers must purchase an annuity with a portion of their funds. The annuity pays a fixed sum for the rest of the individual's life, thus ensuring a steady stream of income.

The country's pragmatic commitment to economic growth has assured a steady source of capital for investment and undoubtedly is responsible for the country's high economic growth rate. As a result of these high rates of contribution, Singapore has the *highest savings rate in the world*. It also has the highest home ownership rate, with about 85 percent of the population living in homes they own.

**Case Study: England.** European countries are also searching for private alternatives, and Britain is leading the way. Britain's two-tiered system consists of a bottom tier (a minimum income paid to all retirees) and a second earnings-based tier that is comparable to a private pension.

In 1978 the British government began to permit employers to contract their employees out of the second tier by providing them with a private pension at least as generous as the government pension they would have received. Since 1988, all British workers have been allowed to individually opt out of the second tier by setting up personal pension accounts, similar to American IRAs. Through these private options, more than 70 percent of British workers have moved out of the second tier.

Individuals who contract out give up the right to draw a second-tier pension from the state. In return, they receive a tax reduction of 4.8 percentage points. In general, the tax reduction is calculated so that employees will, on average, gain financially from contracting out.

**Principles for U.S. Reform.** Whatever approach Congress takes to reform the Social Security system, it needs to adopt three basic principles.

*Choice.* At least initially, people should have the option of staying in traditional Social Security or opting for a private plan.

*Tax differential.* Those who opt out of Social Security should pay lower taxes than those who stay in. This differential should be large enough to encourage most people to choose a private plan.

*Secure benefits for current retirees.* The federal government should guarantee that those currently on Social Security can retain their benefits.

**Options for U.S. Reform.** While the United States faces different problems in privatizing than do the countries profiled here, it nevertheless should consider features of their reforms.

*Mandatory minimum contribution.* A privatized system should require a mandatory contribution to ensure that those opting out of Social Security are actually saving money for their retirement.

*Voluntary contributions.* Workers could be allowed to add extra tax-free funds, similar to current IRA plans, as they can in England and Chile.

*Other financial contingencies.* Social Security provides for disability income and survivors' benefits. Part of the required contribution could go to the purchase of private-sector life and disability policies to provide for those contingencies.

*Investment options.* Restricting the investment options to choices among several diversified, conservative portfolios may be the best way of addressing the political necessity of ensuring the safety of the investments.

*Mandatory annuity at retirement.* Social Security works like an annuity, making monthly payments to the retiree for life. A privatized Social Security system could require the retiree to use part of the funds to purchase a private-sector annuity at retirement, as is the practice in Singapore and Chile. This would ensure a steady stream of cash for the rest of the person's life, regardless of what he did with the remaining funds.

**Conclusion.** As Congress considers Social Security reform, it has the opportunity to analyze the system of other countries. We may not want to copy any one of them, but by studying them we can learn valuable lessons and avoid serious mistakes.

*This Brief Analysis was prepared by NCPA President John C. Goodman.*