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Social Security Reform: Reducing the Risk of Poverty

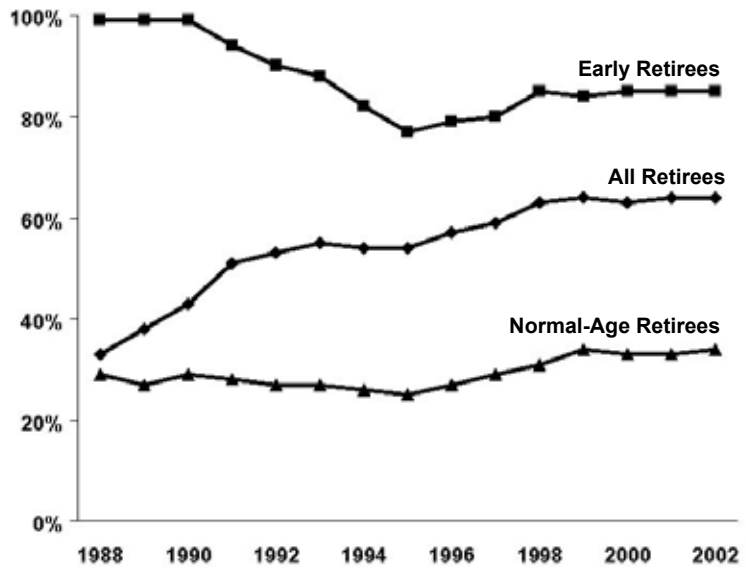
by Estelle James, Ph.D.

President Bush wants to add a personal investment component to the U.S. Social Security system. Under a Bush-style reform plan, workers would be able to contribute a portion of their payroll taxes into personal retirement accounts, which would pay a gradually increasing part of their retirement benefits.

Critics of personal accounts often cite the risk of poverty for retirees who outlive their retirement savings and for vulnerable populations like low-wage workers and women as reasons to reject this approach. But international examples demonstrate how individual account systems can successfully protect participants against these risks. Specifically, the risks are:

- Low-wage workers and those with shorter work histories and low investment returns may retire with account balances too small to keep them from poverty.
- Retirees may spend all their account funds before they die or their pensions may not keep pace with inflation, leaving them in poverty or dependent on welfare.
- Women generally live longer than men, thus, their pensions must last more years; yet women with children often work fewer years and make smaller contributions than men. These factors increase the risk of poverty in very old age.

Percentage of Policies Annuitized in Chile, 1988-2002



Source: Estelle James, "Private Pension Annuities in Chile," National Center for Policy Analysis, NCPA Policy Report No. 271, December 2004.

Protecting Workers from Outliving Assets and Inflation. The Chilean individual account system started more than 20 years ago and many workers have retired under the reformed system. Two-thirds of them have purchased an annuity at retirement. [See the figure.] An annuity is a contract with an insurance company that provides the purchaser with a monthly income. The prices of lifetime annuities reflect the predicted life expectancy at retirement for individuals born in a particular year.

These annuities are offered by insurance companies that compete for retirees' business. Because of the highly competitive annuities market, retirees get the same rate of return they would get on government bonds, plus longevity and inflation insurance. The insurance companies cover their costs by investing in higher-yielding financial instruments such as corporate bonds or mortgage-backed securities. The annuity industry in Chile has grown by leaps and bounds over the past 20 years.

Annuities are popular in large part because regulations encourage workers to annuitize. For example:

- Chile requires workers to purchase an annuity or take their money out of the system in very gradual installments. Lump-sum withdrawals are not permitted unless very stringent conditions are met.
- Insurers offer annuities that are required to adjust for inflation, protecting workers against a rise in the price level.
- The government guarantees three-fourths of an annuity's value in case the insurance company becomes insolvent; however, insurance companies are heavily regulated to make sure that doesn't happen.
- A worker can withdraw money from his account before the normal retirement age of 65 only if his account balance is adequate to purchase a pension that replaces

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at least 70 percent of his preretirement wage and 150 percent of the minimum guaranteed pension.

After adjusting for inflation, accounts in Chile earned an average annual rate of return of more than 10 percent from 1982 to 2002. Because of these high returns — and the favorable terms of annuities — many workers are able to purchase an annuity or start gradually withdrawing their personal account funds in their 50s. If they continue working after retirement, they are exempt from the pension payroll tax. This reduction in payroll taxes has led to a dramatic rise in the labor supply of older workers — which is good for the economy.

Protecting Low-Wage Earners and Those with Low Investment Returns. The size of the annuity purchased in an individual account system is determined by the amount contributed to the account and its accumulated investment returns. But how do these systems protect low-wage workers or those with low investment returns, whose account balances are too small to purchase an annuity that will keep them above the poverty level in old age?

Every country with an individual account system provides a social safety net designed to keep older people above the poverty line. It is often financed out of general government revenues and indexed to prices and/or wages:

- Chile (and many other Latin American countries) provides a minimum pension guarantee — equal to 25 percent of the country's average wage — to every worker with 20 years of contributions, and a smaller means-tested welfare benefit for noncontributors.
- Sweden, Poland, Hungary and most other Eastern and Central European countries also offer a minimum pension — usually 15 percent to 35 percent of the average wage — plus a public benefit that increases with work and contributions.
- Australia, the Netherlands and the United Kingdom supplement the pension from the individual account with a flat or means-tested public benefit that most older people receive, whether or not they have worked.
- In addition to a minimum pension guarantee, Mexico tries to encourage work and prevent poverty by paying a flat public contribution into the account of every worker for every day worked.
- Switzerland's safety net is a very progressive defined benefit. The benefit has a floor and a ceiling — but there is no ceiling on taxable earnings. Benefits grow when the average wage in the economy grows, but at a somewhat slower pace.

Increasing Benefits for Women. On average, women spend less time in the workplace. They generally earn less and contribute less, but live longer. And married women are typically younger than their husbands, so they are prone to becoming widows with low incomes. Older women form pockets of poverty in many countries. Research has shown that Latin American women will be the biggest gainers from their countries' individual account reforms:

- The minimum pension or flat benefit helps low earners, many of whom are women.
- Husbands are required to purchase a joint pension from their individual account, so widows get a survivor's benefit — but it is financed by their husbands rather than by taxpayers. (Thus single women are not taxed to subsidize married women).
- Widows get to keep their own pension plus the joint pension.

In contrast, in the United States, widows must choose between their own Social Security benefit and the widow's benefit (which is equal to the individual benefit based on her husband's earnings, or two-thirds of the benefit they receive as a couple). Thus, many women who work in the marketplace receive no additional benefit from years of contributions.

Conclusion. A personal account system can be good or bad depending on its design. The experience of other countries provides a guide for constructing a system that avoids poverty and mitigates labor and financial market risks.

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