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BRIEF ANALYSIS

Chile's Answer to Rising U.S. Disability Costs

by Pamela Villarreal and D. Sean Shurtleff

Americans are living longer and are healthier than previous generations, yet the number of workers receiving disability benefits is increasing. In fact, disability is the fastest-rising component of Social Security — growing at nearly twice the rate of spending on retirement benefits.

This phenomenon — improving health but increasing benefit claims — is occurring in many developed countries. Chile, however, has reversed this trend and curtailed its disability costs. In a new NCPA study, "Integrated Disability and Retirement Systems in Chile," former World Bank economist Estelle James concludes that the United States and other developed countries could reduce their disability costs and the number of disabled workers by adopting features of Chile's system.

The U.S. Disability System. Social Security pays disability benefits to individuals who are unable to work due to injury or illness. The disability program has been growing much faster than Social Security as a whole. According to the 2007 Social Security Trustees Report:

- From 1985 to 2006 the number of disabled beneficiaries more than doubled from 3.9 million to 8.4 million, whereas the number of people receiving old age benefits grew less than 25 percent.
- Over the same period, annual expenditures for disability benefits grew five-fold, while old age expenditures grew less than three-fold.
- Disability benefits previously constituted only 10 percent of total Social Security spending, but now they are 17 percent of the total.

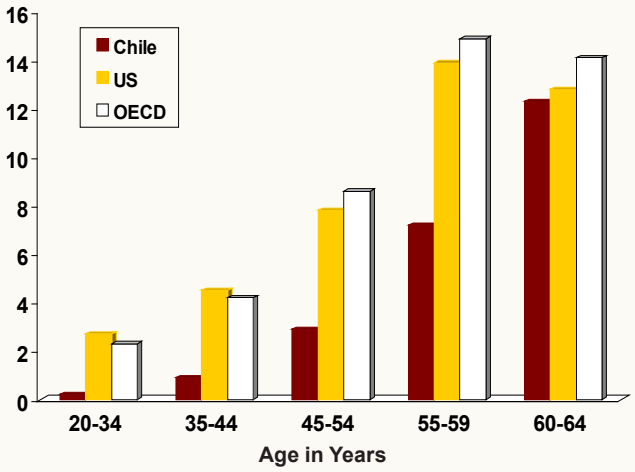
Why are U.S. disability claims rising? One reason is that older workers have an incentive to use disability as a form of early retirement. Currently, 72 percent of workers claim retirement benefits before reaching their normal retirement age and therefore receive a smaller monthly check. By contrast, a 62-year-old worker can claim disability and receive monthly benefits that are about 30 percent higher than his or her early retirement benefits.

The U.S. Disability Backlog. Disabled workers are required to apply for renewal of their benefits every two years. They must continue to submit medical evidence that they cannot work, and their disability status must be recertified by the Social Security Administration. Workers who are denied disability benefits can go through an appeals process. But the processing of applications and appeals has slowed to a crawl as the numbers have increased. According to the Social Security Administration:

- There was a backlog of 724,000 appeals pending as of June 2007, which the agency expects to grow to 1 million by 2010.
- This has led to an average waiting time of 17 months for a hearing, and up to 31 months in some states.

Almost two-thirds (65 percent) of disability applications are initially rejected. But of those that are appealed, about 60 percent are approved, although it can take many months to complete the process. In fact, an increasing number of disability applicants hire lawyers to help navigate the appeals process.

New Disability Beneficiaries in Chile, the United States and Developed Countries by Age
(per 1,000 persons, 1999)



Source: Estelle James and Augusto Iglesias, "Integrated Disability and Retirement Systems in Chile," National Center for Policy Analysis, Policy Report No. 302, September 2007, Table I.

Dallas Headquarters: 12770 Coit Rd., Suite 800 • Dallas, TX 75251• 972-386-6272 • Fax: 972-386-0924 • Web site: http://www.ncpa.org
Washington Office: 601 Pennsylvania Ave., N.W., Suite 900, South Building • Washington, D.C. 20004 • 202-220-3082• Fax: 202-220-3096
For more information, contact the NCPA Communications Department at 972/386-6272 or 800/859-1154.

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The Chilean Disability System. Twenty-five years ago, Chile replaced its traditional social security with a system of retirement accounts that are individually owned and privately invested. Workers put 10 percent of their wages into personal retirement accounts and pay an additional 2.4 percent for survivors' and disability insurance and account administrative fees. Upon retirement, Chilean workers get back their contributions plus investment earnings in the form of annuities that guarantee a steady lifetime income or through a choice of programmed withdrawals. In both cases, small accounts of eligible low-income workers are supplemented by government subsidies. Thus workers' savings fund their retirement benefits. This contrasts with the U.S. pay-as-you-go (PAYGO) system, where current workers finance today's retirees through payroll taxes.

Disabled workers in Chile, however, get a guaranteed benefit that does not depend on their own savings. Workers who have contributed regularly and become fully disabled are promised 70 percent of their average wage. Some of this benefit comes from the savings in their own retirement account. If the money in the account is insufficient to purchase an annuity that provides the promised benefit, the difference is covered by a group insurance policy that is purchased by the worker's pension fund and costs about 0.7 percent of payroll. On average, in the long run, workers' own savings will cover about 50 percent of the cost of their disability benefits; insurance will cover the rest.

How Chile Reduces Disability Costs. Several features of Chile's disability system reduce costs and provide workers with incentives to continue working and to forgo claiming disability.

First, part of the benefit is financed by the worker's retirement account and earnings on investment of the annuity premium, which reduces the payroll tax required to fund benefits.

Second, because all workers must finance at least part of the disability benefit out of their own accounts, they have less incentive to claim disability as a form of early retirement.

Third, the number of successful claims is reduced due to the participation of the private pension funds in the initial assessment procedure and the appeals process. In the United States and other countries with conventional systems, only the applicant has the right to appeal a disability determination. In Chile, by contrast, pension funds can challenge disability determinations made by independent medical boards. The funds have a financial incentive to reduce claims because it lowers their insurance costs. Statistical analysis indicates that this has reduced the number of successful claims.

Finally, once workers are approved for permanent disability, they are permitted to work. This encourages the disabled to remain in the labor force, which is good for the broader economy. (Having a disability does not mean a worker is unable to work; rather, it is a medically-determined physical or mental impairment that can reduce a worker's earning capacity.) In contrast, in the United States individuals cannot receive both wages and disability benefits, so most of the disabled face a strong disincentive to work.

Results: Chile versus United States. Prefunding benefits and allowing pension funds to participate in the appeals process has helped Chile curb disability claims and reduce costs relative to the traditional PAYGO system in the United States.

- In 1999, 2.9 per 1,000 insured 45-to-54-year-old Chilean workers were newly classified as disabled, less than half the rate in the United States (7.8 per 1,000) and less than one-third the rate in developed countries as a whole (8.6 per 1,000). [See the figure.]
- The U.S. disability system currently costs 1.8 percent of payroll and pays benefits only until normal retirement age — and this cost has been rising. The disability insurance fee in Chile is less than half of this and it pays lifetime benefits.

Conclusion. The success of Chile's reforms has led other Latin American countries to adopt personal accounts as part of their retirement and disability systems. Due to population aging and falling birth rates, the burden of elderly entitlements in the United States and other developed countries is growing precipitously. Incentives to encourage individuals to remain in the labor force are a necessary component of reforms designed to lower disability and retirement costs. The solutions Chile has found to these problems are worth considering.

Pamela Villarreal is a policy analyst and D. Sean Shurtleff is a student fellow with the National Center for Policy Analysis.