PRIVATE ALTERNATIVES TO SOCIAL SECURITY IN OTHER COUNTRIES

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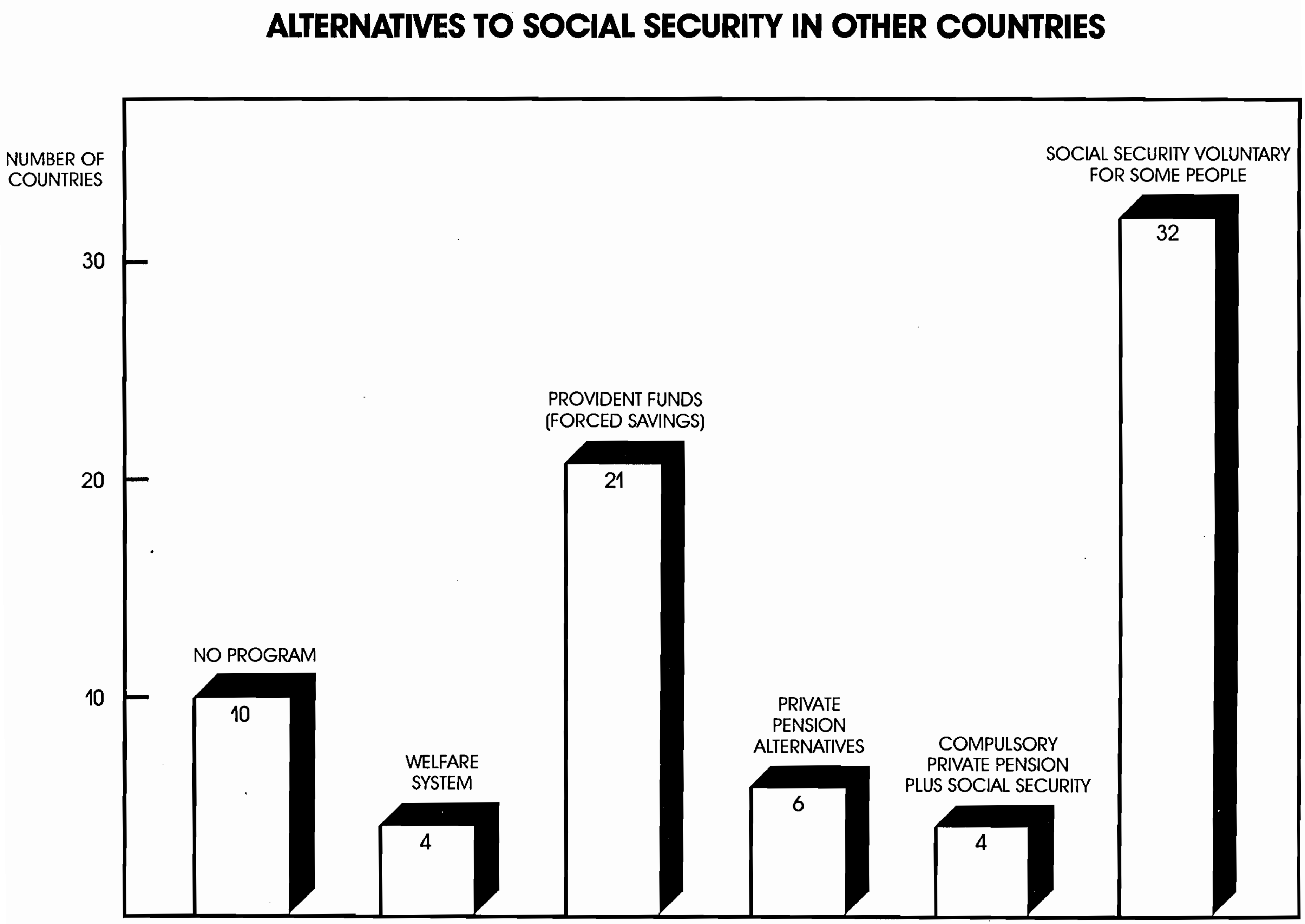
ALTERNATIVES TO SOCIAL SECURITY IN OTHER COUNTRIES
NUMBER OF COUNTRIES
30
20
10
NO PROGRAM
10
WELFARE SYSTEM
4
PROVIDENT FUNDS (FORCED SAVINGS)
21
PRIVATE PENSION ALTERNATIVES
6
COMPULSORY PRIVATE PENSION PLUS SOCIAL SECURITY
4
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32

EXECUTIVE SUMMARY

The social security systems of virtually all developed countries and many less developed countries face a severe financial crisis as we move into the 21st century. For example,

- At current fertility rates, the total population of the industrial democracies will be only 80 percent of its current size by the end of the next century.

- As a result, almost all developed countries will experience an indefinite aging of their populations and ever-increasing payroll tax burdens to fund their social security systems.

Many less developed countries face a social security financial crisis for a different reason. Despite young and growing populations, some of these countries have promised overly-lavish benefits to retirees and are facing increasing resistance to the higher payroll taxes needed to pay for these benefits.

A number of countries have avoided, or at least limited, the chain-letter approach to retirement income that characterizes pay-as-you-go social security:

- At least 21 countries have forced savings programs in which workers are required by law to save for their own retirement.

- At least six countries allow some private pensions to substitute for social security.

- At least four countries mandate private pensions to supplement a minimum income provided by social security.

This study contains three case studies of particularly innovative alternatives to traditional social security:

- In Singapore's provident fund system, all employees are forced to save for their own retirement and to save for hospitalization expenses through a Singapore version of medical IRA accounts.

- In Chile, 90 percent of all workers have opted out of public social security system by contributing to the Chilean equivalent of IRA accounts and by contracting with private companies for health, life and disability insurance.

- In Britain, employers have contracted about half of all British workers out of the second tier of British social security by providing equivalent private pensions, and Britain is now implementing an IRA alternative to social security.

INTRODUCTION [1]

In a recent survey of the social security systems of countries around the world, researchers at the U.S. Department of Health and Human Services found that,[2]

- Among 132 non-communist countries, 123 countries, or 93 percent have a government-mandated benefit program for the elderly.
- About 90 percent of these countries have some form of compulsory public or private retirement insurance system, primarily funded by payroll taxes.

Despite the fact that the vast majority of countries have adopted programs of retirement insurance financed by payroll taxes, there is considerable variety among the systems various countries have chosen. For example,

- About 20 percent of all non-communist countries -- one out of every five -- either have adopted a program of compulsory savings instead of social security or allow some private pensions to substitute for social security.
- About 30 percent of all countries either have no social security system or have adopted a system that significantly departs from the social security programs of the U.S. and most European countries.

As Table I shows, international experience furnishes us with a rich variety of approaches to retirement policy for the elderly. There is much to be learned by examining this experience.

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[1] The authors would like to thank Gerald Musgrave for contributing to the research for this report. Unless otherwise noted, the term "social security" is used in this study to refer to government pensions for the elderly.

[2] Office of Policy, Office of Research and Statistics, Social Security Administration, U.S. Department of Health and Human Services, <u>Social Security Programs Throughout the World -- 1985</u>, (Washington, D.C.: U.S. Government Printing Office, 1986). The interpretation of these statistics is our own.

TABLE 1

ALTERNATIVES TO SOCIAL SECURITY IN OTHER COUNTRIES

1.	No program of any kind	Afghanistan, Botswana, Burma, Ethiopia, South Korea, Malawi, Sierra Leone, Somalia, Thailand, Zimbabwe
2.	Welfare/entitlement benefits, unrelated to pre-retirement income and financed from general revenues	Australia, Hong Kong, New Zealand, South Africa
3.	Compulsory savings plans (Provident funds)	Fiji, Gambia, Ghana, India, Indonesia, Kenya, Kiribati (Gilbert Islands), Malaysia, Montserrat, Nepal, Nigeria, Papua New Guinea, Saint Vincent, Singapore, Solomon Islands, Sri Lanka, Swaziland, Tanzania, Uganda, Western Samoa, Zambia
4.	IRA alternative	Chile, United Kingdom
5.	Exclusions or options for participants in some private pension plans	Greece, Mauritius
6.	Optional contracting out to private pension plans	Japan, United Kingdom
7.	Compulsory private pensions to supplement social security	Finland, France, Ivory Coast, Switzerland
8.	Social Security optional for some people	At least 32 countries

THE INTERNATIONAL PROBLEM OF SOCIAL SECURITY

With few exceptions, public social security systems operate on a pay-as-you-go basis. Taxes collected today are used to finance current retirement pensions, government deficits and other current spending programs. Even those countries that go through the cosmetic exercise of creating social security "trust funds" usually are not investing social security taxes in real assets or adding to the nation's stock of capital. Instead, today's social security taxes pay for current spending, and tomorrow's promised benefits must be financed by taxes imposed on future workers.

As a result, social security tends to operate like a compulsory chain letter. Workers pay taxes today in return for promises tomorrow -- promises that can only be kept if future workers pay the taxes necessary to finance those promises. Moreover, like a private sector chain letter, in a young social security system those who qualify quickly for benefits receive benefits far in excess of any taxes they paid. As these systems begin to mature, however, the number of retirees grows relative to the number of taxpayers. What this usually means is that the "return" social security pays to each succeeding generation is less than the "return" paid to the previous generation.

A major question confronting all countries with traditional, pay-as-you-go social security systems is: Will governments be able to meet promises being made to today's young children or will the burden of those promises be so great that future taxpayers will be either unable or unwilling to pay for it?

For the developed countries, the answer to this question tends to hinge on three variables: (1) the fertility rate (the number of children produced by women of childbearing age), (2) the rate of economic growth, and (3) the rate of increase in life expectancy. Other things equal, a low fertility rate produces fewer future taxpayers per beneficiary and increases the tax burden for each individual worker. A low rate of economic growth produces less tax revenue for any given payroll tax rate and increases the need for hikes in payroll tax rates. A high rate of increase in life expectancy increases the size of the elderly population relative to the number of taxpayers. By contrast, high fertility rates, high rates of economic growth and low rates of increase in life expectancy tends to lessen the burdens for each individual taxpayer in the future.

Interestingly, small differences in these three rates today lead to huge differences in taxpayer burdens 60 or 70 years from now. For example, in the United States, the Social Security Administration's "intermediate" projections assume a fertility rate of 2.0, a rate of growth of real wages of 1.5 percent and a modest slowing in the rate of increase in life expectancy. The "pessimistic" projections assume a fertility rate of 1.65, a rate of growth of real wages of 1.0 percent and a continuation of the current rate of increase in life expectancy.

These small differences in assumptions today lead to substantial differences in tax burdens tomorrow -- differences which become increasingly magnified the further we look into the future. For example,[3]

- According to the "intermediate" projection, the payroll tax needed to pay benefits currently promised by law will be 23 percent of the nation's taxable payroll by the year 2050.

- According to the "pessimistic" projection, the payroll tax rate needed will be 38 percent of the nation's taxable payroll by the year 2050.

There is no economic model that can accurately predict the rate of economic growth for any country for the next 60 to 70 years, and any speculation about what medical science will be able to accomplish over that time period probably should be classified as science fiction. Fertility rates are a different matter. Quite apart from other uncertainties, recent trends in fertility rates have created critical concern about the future of social security in all developed countries.

Demographic Trends in Developed Countries

Roughly speaking, a nation's fertility rate is the average number of children that women of childbearing age will have over their lifetimes. In developed countries, a fertility rate of 2.1 is the replacement rate -- the rate necessary to maintain the size of the current population. In other words, each adult man and woman must be replaced by approximately two children in order to keep the total population at its current size. Countries that have fertility rates in excess of 2.1 will have growing populations. Countries that have fertility rates below 2.1 will have shrinking populations.

In 1960, virtually all developed countries had fertility rates in excess of 2.1, and most had rates substantially higher than 2.1. Yet one of the most striking sociological changes that has occurred throughout the developed world is the dramatic drop in fertility rates over the last few decades. As Table II shows,

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3The payroll tax rates cited are the rates necessary to pay Social Security retirement benefits, Medicare, and survivors and disability benefits. The "intermediate" projection is based on Social Security Financing Alternative II B assumptions. The "pessimistic" projection is based on Social Security Financing Alternative III assumptions. The rates given in the text are long-term rates, assumed to prevail over a 75-year period. These rates are assumed to differ somewhat in the short run. For a more detailed explanation, see the 1987 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds, March 30, 1987, Table E3.

TABLE II

DROP IN FERTILITY RATES SINCE 1960

Country	Change
Australia	- 43 %
Austria	- 42 %
Belgium	- 40 %
Canada	- 55 %
Denmark	- 44 %
Finland	- 37 %
France	- 33 %
Germany	- 44 %
Iceland	- 56 %
Ireland	- 34 %
Israel (Jewish Population)	- 23 %
Italy	- 39 %
Japan	- 10 %
Luxembourg	- 39 %
Netherlands	- 52 %
New Zealand	- 44 %
Norway	- 39 %
Spain	- 39 %
Sweden	- 23 %
Switzerland	- 35 %
United Kingdom	- 33 %
United States	- 51 %

Source: Ben J. Wattenberg, The Birth Dearth, (New York: Pharos Books, 1987), Chart 2A, p. 173.

- Since 1960, every developed country has experienced a substantial drop in its fertility rate.

- The U.S., Canada, Iceland and the Netherlands have experienced more than a 50 percent drop in fertility rates in the last 25 years.

- In Belgium, Austria, Denmark, Australia, Germany, and New Zealand the decrease has been 40 percent or greater.

As a result of this dramatic change, the vast majority of developed countries today have fertility rates which are substantially below the replacement rate. Specifically,[4]

- The fertility rate in Germany is currently 1.3, and in Italy, Luxembourg, and Denmark the fertility rate is only 1.4.

- Overall, out of 22 western industrial democracies, only three (New Zealand, Ireland, and the Jewish population of Israel) have fertility rates that currently are above the replacement level.

The implications of this development are devastating for the social security systems of all developed countries. Unless there are major lifestyle changes in these countries, most will experience an indefinite aging of the population and all will experience growing payroll tax burdens in order to pay for social security benefits currently being promised to future generations of workers.[5]

TABLE III

MEDIAN AGE OF THE POPULATION

Country	1970	1980	1990	2000	2025
U.S.	28	30	33	37	42
France	32	33	35	37	42
Germany	34	37	39	42	50
Japan	29	33	37	40	44

Source: Ben J. Wattenberg, The Birth Dearth, p. 67.

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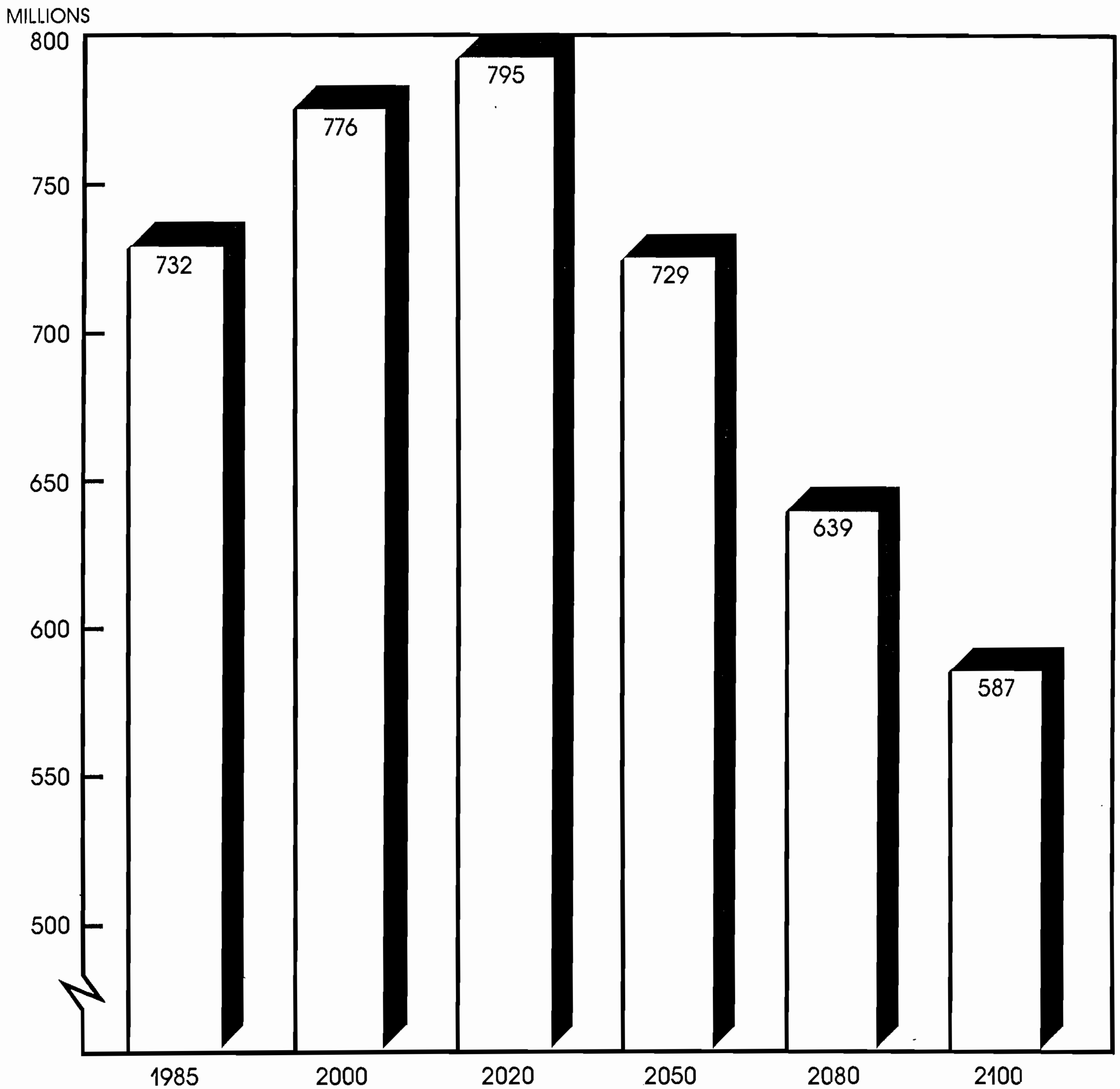
[4]Ben J. Wattenberg, The Birth Dearth, (New York: Pharos Books, 1987), Chart 2A, p. 173.

[5]In principle, these countries could attempt to increase their populations through immigration. However, almost all developed countries have very restrictive immigration policies and the trend is toward even more restrictions.

PROJECTED POPULATION: WESTERN INDUSTRIAL DEMOCRACIES*



*Based on 1984 fertility rates

SOURCE: BEN J. WATTENBERG, THE BIRTH DEARTH, (NEW YORK: PHAROS BOOKS, 1987), CHART 4B, P. 174.

Social Security in Less-Developed Countries

In contrast to the bleak future faced by the social security systems of developed countries, less-developed countries, in general, have very young populations, very high fertility rates and relatively low life expectancies. As a consequence, the ratio of the number of workers to the number of persons age 65 and older in these countries is quite high, and, in principle, these countries could provide retirees with very generous benefits financed with relatively low payroll taxes for many years into the future.[6]

Despite these favorable conditions, the social security systems in some less-developed countries already face a serious financial crisis. This crisis primarily is due to the inability of many countries to collect payroll taxes from workers and the failure to show restraint in promising benefits. For example,[7]

- In about half the countries in Latin America, less than 25 percent of the economically active population is paying payroll taxes.

- In some countries, retirees are promised a pension that exceeds 100 percent of pre-retirement earnings, and some workers can begin drawing retirement pension benefits at the age of 45.

As a result, some less-developed countries face a financial crisis of a magnitude that is not expected in the United States until well into the next century. Specifically, in some Latin American countries,[8]

- The total payroll tax already exceeds 26 percent of earnings;

- There are fewer than two taxpayers for every beneficiary; and

- Social insurance expenditures exceed ten percent of gross domestic product and are more than one-third of current government expenditures.

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[6] See Wattenberg, The Birth Dearth, pp. 170 - 171, and Chart 41, p. 176.

[7] Carmelo Mesa-Lago, "Comparative Study of the Development of Social Security in Latin America," International Social Security Review, February, 1986, pp. 127-152.

[8] Ibid., p. 132. Note: About half of social insurance spending in these countries is for retirement benefits.

ALTERNATIVES TO SOCIAL SECURITY AROUND THE WORLD[9]

Almost all developed countries and many less-developed countries face an immediate crisis in social security. The crisis is immediate in the sense that unless something is done to revise social security today, an unavoidable payroll tax nightmare awaits them during the 21st century. Some countries have avoided this crisis by avoiding pay-as-you-go social insurance altogether. Other countries have attempted to contain the problem by encouraging private savings as a substitute for participation in social security. What follows is a brief summary of policies in other countries that substantially depart from traditional social security.

Purely Private Retirement Systems

Although the vast majority of all countries have legislated compulsory public or private retirement insurance programs, a significant proportion of workers in non-communist countries are not participating in any compulsory program. In at least ten countries, there is no retirement policy of any kind, and many countries that have mandatory programs exclude large segments of the population. This is especially true in the less developed countries.

The social security systems of most less-developed countries tend to focus on employees of large companies in urban areas. These systems frequently exclude agricultural workers, low-income workers, employees of small firms, and self-employed workers. For example, despite the fact that agriculture is the predominant occupation in most less-developed countries,

- All agricultural workers are excluded from participation in social security in Colombia, El Salvador, Jordan, Iraq and Saudi Arabia.
- In Honduras, agricultural employees participate only if they work for a firm that employs ten or more workers.

In general, self-employment and employment by small firms is far more common in less developed countries than in the developed world. Indeed, the vast majority of workers in less developed countries probably are either self-employed or work for small firms.[10] Yet,

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[9]Unless otherwise noted, the statistics in this section are taken from Social Security Programs Throughout the World -- 1985.

[10]For example, from 48 to 70 percent of the labor force in Bolivia, Guatemala, Haiti, Honduras, Paraguay and Peru is either self-employed or works as an "unpaid family member" of a business. See Mesa-Lago, "Comparative Study of the Development of Social Security in Latin America," p. 139.

- In Bahrain and Pakistan, social security covers only workers employed by firms with ten or more employees.

- Social security is limited to firms with at least 20 employees in Saudi Arabia, 25 employees in Liberia and 30 employees in Sudan.

- In general, self-employed workers are not required to participate in social security in a majority of less developed countries.

Less-developed countries that have adopted a compulsory savings approach to retirement (discussed below) show similar patterns of restricting coverage to employees of large firms that typically operate in urban areas. For example,

- India restricts its provident fund system to firms at least three years old with at least 50 employees or to five-year-old firms with at least 20 employees.

- Indonesia restricts its system to firms with at least 100 employees.

- Papua New Guinea's system is restricted to firms with at least 25 employees and exempts most of New Guinea's major industries.

Even if less-developed countries were to extend their formal programs to the self employed and to employees of small firms, it is doubtful that they could force compliance. This is because large segments of the populations of these countries work in the "informal" or "underground" economy, outside the formal legal system. For example,[11]

- In Peru, 48 percent of the population is engaged in the underground economy.

- This accounts for more than 61 percent of all man-hours worked and 32 percent of Peru's gross domestic product.

Peru is not unique. The existence of huge and thriving underground economies has been documented throughout Latin America and appears to be characteristic of almost all less-developed countries.[12]

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[11]Robert Litan, Luis Morales-Bayro, and Jorge Fernandez-Baca, "International Structural Reforms in Peru: A Promising Road Out of the Debt Crisis," Journal of Economic Growth, Vol. 1, No. 2, 1986, pp. 28-36.

[12]See, for example, Hernando de Soto, El Otro Sendero, (Lima, Peru: Instituto Libertad Y Democracia, 1986), and John Goodman and Ramona Moritz-Baden, eds, Fighting the War of Ideas in Latin America, (Dallas, Texas: National Center for Policy Analysis, 1988), forthcoming.

It appears reasonable to conclude that a large percentage of workers in less-developed countries (possibly the majority) are not part of any compulsory retirement system and rely instead on traditional devices -- private savings, support from other family members, and in a few cases welfare benefits from government.[13]

Welfare Systems

The idea of social insurance is that people pay taxes during their working years and receive benefits during their retirement years. Usually, there is a relationship between the taxes paid and the benefits received, although most governments skew the benefit payments so that low-income workers get a better "return" on their "contributions" than high-income workers.

A number of countries have avoided even the pretense of social insurance of this type, however. In these countries, payments to the elderly are treated like any other entitlement or welfare program and are funded from current general revenue rather than from payroll taxes. For example,

- South Africa has a pure welfare program for the elderly in which monthly payments are based solely on need.
- Hong Kong has a mixed system -- part entitlement, part welfare -- in which all elderly citizens receive a small, minimum income from government and the low-income elderly receive twice the minimum provided they can demonstrate financial need.
- Australia and New Zealand also have mixed welfare-entitlement systems financed from general revenues. These programs are structurally similar to welfare-entitlement payments made to the non-elderly.

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[13]According to the official estimates of the governments of Latin American countries, about 61 percent of all Latin American workers are participating in social security. If Brazil is excluded, that figure drops to 43 percent. See Mesa-Lago, "Comparative Study of the Development of Social Security in Latin America," Table 3, p. 137. Note, however, that most Latin American governments underestimate the size of their informal, or underground, economies.

Compulsory Savings Through Provident Funds[14]

Unlike pay-as-you-go social security, the idea behind a provident fund is that contributions are accumulated and invested in assets. Although governments often exert control over such funds, managing boards typically are composed of representatives of management and labor; all funds are contributed by employees and their employers; and employees have a property right to their share of the fund. At least 21 countries have mandated participation in such plans for certain classes of workers -- usually employees of large firms in urban areas.[15]

A policy of mandatory provident fund participation is, in effect, a policy which forces workers to save for their own retirement. Typically, governments insist that the funds pay a minimum rate of return, and upon reaching retirement workers usually receive their accumulation in form of a lump sum payment. In some countries, workers have the option of taking an annuity in lieu of a lump sum amount, and, in any event, workers can use their lump sum distributions to purchase private annuities.

Because provident funds are comparable to private savings plans or private pension plans, countries that mandate participation often allow exclusions for workers and companies that have equivalent private plans, and often make participation voluntary for other workers. For example,

- In Fiji, Gambia, Malaysia, Saint Vincent and Sri Lanka, workers are excluded from provident funds if they have equivalent private plans.

- India allows for contracting out of provident funds to other private sector pension plans.

- In Ghana, Indonesia, Nigeria and Uganda certain excluded workers are given the opportunity to voluntarily participate in the provident funds.

Although the primary purpose of provident funds is to provide savings for retirement (or benefits to survivors in the case of an early death), many of these funds also allow withdrawals for other purposes for which people voluntarily save. For example,

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[14]The following discussion of provident funds is based primarily on John Dixon, "Provident Funds in the Third World: A Cross-National Review," Public Administration and Development, 1982, Vol. 2, pp. 325-344; and John Dixon, "Provident Funds: Their Nature and Performance," unpublished manuscript prepared for the International Labor Office, 1984.

[15]A list of these countries, along with special exclusions and voluntary options, are contained in Appendix A. Singapore's provident fund system is discussed in greater detail below.

- Almost all provident funds allow members to withdraw their share of the fund in the case of permanent disability.

- In Ghana and Montserrat, limited withdrawals are allowed in the case of sickness.

- In Kenya, withdrawals are allowed in the case of hospitalization; and withdrawals are allowed in order to pay for medical expenses in India and for hospitalization expenses in Singapore.

- In Ghana, Nigeria, Tanzania and Uganda, partial withdrawals are allowed in the case of unemployment.

- Withdrawals also are allowed to finance the marriage of a child in India; the purchase of a house in Singapore, Malaysia, Papua New Guinea, Fiji and Zambia; for other types of personal savings in Zambia; and for investments in the capital market in Singapore.

A number of provident funds also allow members to borrow from their accumulated deposits for certain purposes. For example,

- In Nepal, provident fund members are entitled to "medicare loans," "contingency loans," "real estate loans," and "social obligation loans" (e.g., to meet the cost of a funeral or marriage).

- In Fiji, Singapore and Zambia, provident fund members may obtain loans for the purchase of a house.

- In Ghana, members may even borrow for the purpose of purchasing consumer durables.

Finally, a number of provident funds combine forced savings with insurance for certain types of contingencies. In general, these arrangements provide members and their families with benefits unrelated to the member's individual contributions. Specifically,

- In India, Indonesia, Fiji, Kiribati, Nepal, Malaysia, Western Samoa, the Solomon Islands, Uganda and Zambia, provident funds make special death grants or funeral grants to the surviving family.

- Life insurance is automatically provided by provident funds in India.

- Maternity grants are provided in Zambia.

- Means-tested allowances are paid to the elderly and to widows in Fiji.

Private Pension Alternatives to Social Security[16]

At least six countries with traditional, pay-as-you-go social security systems also have provisions that exclude workers in certain private pensions or give workers and their employers private alternatives to participation. For example,

- Greece excludes workers in certain private pension plans from participation in the Greek social security system.

- In Guyana and Lebanon, participation in social security is voluntary for workers who were in preexisting private plans when the current social security system was started.

Contracting out to private firms is becoming an increasingly popular idea as governments around the world join the international privatization revolution. At least two countries have applied the concept to social security:

- Both Britain and Japan have social security systems that pay a basic benefit (unrelated to pre-retirement income) and an earnings-related benefit.

- Both countries allow companies to contract out of the earnings-related portion of social security by providing private pensions with equivalent benefits.

No country has gone further in the attempt to privatize a preexisting social security system than Chile. As a result of the 1980-81 reforms, Chile has created the Chilean equivalent of an IRA as an alternative to participation in social security, and Chilean workers are given substantial tax incentives to choose the private alternative.

- Chilean workers who were participating in Social Security in 1980 had the choice to opt out of the system and choose the private IRA alternative.

- All new entrants into the labor market are required to take the IRA alternative.

- Currently, about 90 percent of all Chilean workers are covered by IRA plans rather than by social security.

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[16]The British and Chilean social security systems are discussed in greater detail below.

Mandatory Private Pensions Combined With Social Security[17]

At least five countries with traditional, pay-as-you-go social security programs have mandated private pension coverage as a supplement to social security. In effect, these countries are combining social security with "forced savings." An apparent motivation for these policies is to force the private sector to provide more of the earnings-related portion of retirement income, leaving government free to manage that portion of retirement income that involves redistribution of income.

Take Finland, for example. Like Britain and Japan, Finland has a basic benefit (which is unrelated to pre-retirement income) and an earnings-related benefit (which is directly related to contributions). However, whereas Britain and Japan give workers and their employers the option of contracting out the earnings-related pension to the private sector, Finland has taken a more aggressive approach. In Finland, employers are required to provide private pensions with certain minimum earnings-related benefits.

Since Finnish social security is financed by a payroll tax, the basic benefit involves redistribution of income -- with low-income workers getting a better "deal" than high-income workers. This part of the program probably could only be managed by government. The earnings-related component, however, is comparable in structure to a private pension plan and can therefore be furnished by the private sector.

Other countries with mandatory private pensions are France, Switzerland and the Ivory Coast. In Sweden, private pensions are not mandated by the government. However, about 90 percent of Swedish workers are covered by private pensions negotiated under country-wide collective bargaining agreements, and the public social security program is integrated with the provisions of private pensions.

Voluntary Participation in Social Security

Although the notion of voluntary participation in U.S. Social Security generated considerable political consternation in the 1960s and 1970s, as recently

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[17] For a discussion of mandatory pensions in Europe, see Max Horlick and Alfred M. Skolnik, Mandating Private Pensions: A Study of European Experience, (Washington, D.C.: U. S. Department of Health and Human Services, Social Security Administration: Office of Policy, Office of Research and Statistics, Research Report No. 51, 1978); and Max Horlick, Private Pension Plans in West Germany and France, (Washington, D.C.: U.S. Department of Health and Human Services, Social Security Administration: Office of Policy, Office of Research and Statistics, Research Report No. 55, 1980).

as 1983 one in every five U.S. workers had the option of participation.[18] This was not an option that could be exercised by the individuals themselves. But it was an option that could be exercised by employers -- primarily state and local governments and nonprofit organizations.

The U.S. experience is not unique. Voluntary participation in social security is a worldwide phenomenon, and is especially prevalent in less-developed countries. For example,[19]

- In general, workers who leave covered employment have the option of continued participation in the Bahamas, Bermuda, Bolivia, Cyprus, Morocco, Peru and Zaire.

- Participation in social security is voluntary for the self-employed in Belize, Bolivia, Costa Rica, Luxembourg, and Mali.

- In general, workers who otherwise are not covered have the option of participation in Cameroon, Ecuador, Germany, Liberia, Mexico, Saint Christopher and Nevis, and Trinidad and Tobago.

- Participation in social security also is voluntary for non-working wives in Japan and France, for low-income workers and non-employed persons in the United Kingdom and for all non-working individuals in Argentina.

CASE STUDY: FORCED SAVINGS THROUGH A PROVIDENT FUND IN SINGAPORE[20]

In 1955, Singapore introduced a compulsory savings program that covers virtually all employed people in the country. Employer and employee contributions are made to the Central Provident Fund (CPF), which is controlled by the government and has a monopoly status. In the early years, the CPF invested its funds entirely in government securities and withdrawals were essentially limited to lump sum retirement benefits or survivors benefits. Over the years, however, the program has gained increased flexibility -- giving workers more control over the investment of their funds and expanding the withdrawal options to include the use of funds to purchase houses and to pay for hospital care.

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[18]See A. Haeworth Robertson, <u>The Coming Revolution in Social Security</u>, (McLean, Virginia: Security Press, 1981), Ch. 16, 17 and 18.

[19]A more detailed account of provisions for optional participation in various countries is contained in Appendix B.

[20]This section is based largely on Alan Street, "Benefits in Singapore," <u>Benefits and Compensation International</u>, January, 1988, pp. 19-23. See also Adrian Waddingham, "Retirement Benefits in Malaysia and Singapore," <u>Benefits International</u>, June, 1983.

Contributions

Singapore is one of the Pacific Rim countries that has demonstrated a very pragmatic commitment to economic growth. Its program of forced savings has insured a steady source of capital for investment and undoubtedly is responsible for the country's high economic growth rate, which averages between five and six percent per year.

Rates of Contributions. When the provident fund system was introduced in 1955, the required rates of contributions were 5.0 percent of payroll for both employees and employers. Over time, those rates were steadily increased until they reached a total of 50 percent of salary (25 percent each for the employee and the employer) up to $30,000 of annual salary in 1984.[21] What this effectively meant was that residents of Singapore were being forced to save one-half of their incomes![22]

In April, 1986 the government temporarily lowered the employers' contribution from 25 percent to ten percent in order to combat an anticipated recession. Current plans are to move toward rates of 20 percent each for employers and employees over the next three years.

Ordinary and Special Accounts. Prior to 1978, individuals had no control over the investment of the funds accumulating in their accounts. Beginning that year, however, the government allowed individuals to transfer funds from an ordinary account to a special account in which investment decisions are made by the account holder. The range of permitted investments was gradually expanded, and employees now can use funds in their special accounts to purchase stocks on the Singapore stock exchange, bonds, gold or gold certificates, and shares of mutual funds. The amount of contributions placed in special accounts tends to vary between ten and 20 percent of total contributions. Since April, 1986, however, the government has temporarily suspended new contributions to special accounts.

Medisave Accounts. Beginning in 1984, the government of Singapore extended its program of forced savings to require that a certain portion of CPF contributions be put into "medisave accounts" to provide a source of funds for hospitalization expenses.[23] Currently, six percent of an employee's salary is placed in a medisave account until the balance reaches approximately $7,500. Once that total is reached and maintained, any additional contributions are automatically placed in an individual's ordinary account.

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[21]Calculated at a rate of S $100 = U.S. $50.

[22]Throughout this study, we make the normal economic assumption that any payroll taxes or fringe benefit payments paid by employers are amounts that otherwise would have been paid to employees in the form of wages.

[23]These funds may not be used for outpatient care. Funds used for hospitalization may be used for treatment at a government hospital or at an approved private hospital.

TABLE IV

SINGAPORE CENTRAL PROVIDENT FUND:
CONTRIBUTIONS AS A PERCENT OF SALARY

Date	Ordinary Accounts	Special Individual Investment Accounts	Medisave Accounts	Total
1977/78	30.0 %	1.0 %	---	31.0 %
1978/79	30.0 %	3.0 %	---	33.0 %
1979/80	30.0 %	7.0 %	---	37.0 %
1980/81	32.0 %	6.5 %	---	38.5 %
1981/82	38.5 %	4.0 %	---	42.5 %
1982/83	40.0 %	5.0 %	---	45.0 %
1983/84	40.0 %	6.0 %	---	46.0 %
1984/85	40.0 %	4.0 %	6.0 %	50.0 %
1985/86	40.0 %	4.0	6.0 %	50.0 %
April, 1986 [1]	29.0 %	---	6.0 %	35.0 %

[1] In April, 1986 the employer's contribution was temporarily lowered from 25 percent to 10 percent and contributions to special investment accounts were temporarily suspended.

Source: Alan Street, "Benefits in Singapore," Benefits and Compensation Review, January, 1988, Table 3, p. 21.

Performance of the Provident Fund. At the end of 1986, the accumulated funds in the CPF equaled about $5,500 for every man, woman and child in Singapore. Moreover, the rates of return earned by the CPF invariably exceed the rate of inflation, providing for real earnings growth. As Table V shows,

- Over the last decade, the CPF has generated a real rate of return of three percent.

- Over the 1980s, the real rate of return has been almost five percent.

TABLE V

REAL RATES OF RETURN ON PROVIDENT FUND CONTRIBUTIONS

Period	Inflation Rate	Nominal Rate of Return	Real Rate of Return
1977-1987	3.3 %	6.3 %	3.0 %
1981-1987	1.3 %	6.2 %	4.9 %
1985-1987	- 0.2 %	5.6 %	5.8 %

Source: Alan Street, "Benefits in Singapore," Benefits and Compensation International, January, 1988, Table 6, p. 23.

Benefits

All employees in Singapore have a private property right to the funds which accumulate in their individual CPF accounts. These funds may be withdrawn at retirement, in the event of permanent disability, or if the individual emigrates from Singapore or Malaysia. In the case of death, the funds are payable to the individual's heirs. These funds also may be used to purchase a house or pay for medical expenses.

Retirement Benefits. In general, all employees are entitled to a lump sum withdrawal of their CPF account upon reaching the normal retirement age of 55. However, beginning in January, 1986, the government imposed a requirement that anyone who does not own real estate with a value of at least $15,000 must leave $15,000 in a CPF account and draw a $115 monthly income from the account beginning at age 60. The purpose of this requirement is to insure that no elderly person is left without a minimum income. It is expected that this requirement will affect only 10 percent of the population.

Medical Care Benefits. As noted above, employees must make monthly contributions to an individual "medisave account" until a balance of $7,500 is attained. In Singapore, this sum of money would be sufficient to cover hospitalization expenses except in very rare catastrophic cases.[24] In 1986, for example, 145,000 members of the CPF (out of a total Singapore population of 2.6 million) made Medisave withdrawals averaging about $300 per person.

Funds that accumulate in a Medisave account provide a source of self-insurance for hospitalization throughout the employee's working life, and also during retirement. For example, retirees are required to leave about $3,250 in the Medisave account to cover medical expenses after reaching the age of 65. Singapore's Medisave program, therefore, is an interesting application of the more general concept of the medical IRA, which has been proposed in various forms in the U.S.[25]

The Purchase of Housing. In 1968, the government began allowing CPF members to use a portion of their account money to purchase housing. If the amount withdrawn is insufficient to pay for the house, a commercial loan may be negotiated and mortgage payments may be met from future CPF contributions. More than 600,000 CPF members (probably the vast majority of Singapore households) have purchased homes by using their CPF account money in this way.

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[24]The Singapore government currently is engaged in negotiations with private health insurance companies, and it is possible that in the future some portion of the Medisave account funds will be allocated to catastrophic health insurance coverage.

[25]See Peter Ferrara, John Goodman, Gerald Musgrave and Richard Rahn, "Solving the Problem of Medicare," NCPA Policy Report No. 109, National Center for Policy Analysis, January, 1984.

An Evaluation

Like most other provident fund systems around the world, the Singapore system forces people to save, but allows them to make withdrawals for many of the purposes for which people ordinarily engage in private, voluntary savings--including retirement, disability, death, medical expenses and the purchase of a home.

Singapore differs from other provident funds in that there is very little insurance (and therefore no pooling of risks) for adverse contingencies such as hospitalization, disability or death. What individuals receive in the event of these contingencies is based solely on their own contributions.[26] However, the mandatory contribution rates are so high that most people are effectively self-insured for these events.

In many ways, the Singapore system is an interesting variation on the Super IRA concept -- a proposal to replace Social Security, Medicare, and survivors and disability insurance in the U.S. with private IRA alternatives.[27] The Singapore system accomplishes this goal but expands it and allows for uses of private savings for other purposes prior to the age of retirement.

The most obvious defect in the Singapore system is that it does not allow competition among funds for the employees' contributions, since Singapore's CPF has a virtual monopoly on fund management. In addition, individual investment choice has been unduly restricted.

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[26]An exception is compulsory mortgage insurance, for which the premium is paid from the CPF account of people who purchase low-cost housing. In the event of death or permanent disability, the policy pays the balance of the mortgage.

[27]See Peter J. Ferrara, Social Security: Averting the Crisis, (Washington, D.C.: Cato Institute, 1982); and Peter J. Ferrara, "The Social Security System," in Mandate for Leadership II, (Washington, D.C.: Heritage Foundation, November, 1984), Ch. 18.

CASE STUDY: PRIVATIZATION THROUGH IRA ACCOUNTS IN CHILE[28]

Chile was the first nation in the Western Hemisphere to adopt a social security system, establishing its program in 1924. Chile also is the first nation in the world to dismantle a public social security system through sweeping privatization. To the extent that the Chilean system involves forced savings for retirement and adverse contingencies, it has much in common with the provident fund systems of Singapore and other former British colonies. Yet because Chile allows competition among private companies who manage the individual savings accounts and because workers are free to choose among portfolio managers, the Chilean system in many ways resembles a U.S.-type IRA system.[29]

The Old Social Security System in Chile

The old Chilean social security program was patterned after the traditional social insurance programs of Europe. The system paid retirement benefits, survivors benefits, disability benefits and health benefits, and was financed by a payroll tax that eventually exceeded 26 percent of wages. The employer usually paid more than half of this tax, and employees paid the remainder. At times, the system accumulated some reserve funds which were invested, but it was far from fully funded. Instead, it tended to operate on a pay-as-you-go basis. In the years prior to its dismantlement, revenues were routinely insufficient to pay promised benefits. In 1980, general tax revenues financed 28 percent of the system's benefits, and the annual social security deficit was projected to grow in future years.

The old system actually consisted of many separate social security systems: a general one for manual workers, a general one for salaried employees, a general one for government workers and about 50 additional programs for workers in different occupations and in different locations. One unfortunate consequence of this diversity was that the groups with the greatest political clout and influence got the most favorable programs. For example,

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[28]This section is based on Sergio Baeza, ed. Analysis de la Prevision en Chile (Santiago, Chile: Centre de Estudios Publicos, 1986); Jose Pinera, "Chilean Trade Union and Social Security Reform and Its Effect on Employment," (mimeograph, 1985); Peter J. Ferrara, "Successful Strategies for Integrating Employment Policies and Practices," (mimeograph, 1986); Jose Pinera "Chileans Unravel Social Security Tangle," The Wall Street Journal, January 3, 1986, p. 11; and Robert J. Myers, "Privatization of Chile's Social Security Program," Benefits Quarterly, Vol. 1, No. 3, Third Quarter, 1985, pp. 26-35.

[29]Although the term "IRA" is not commonly used in Chile, it is used here for the convenience of the U.S. reader.

- Some workers paid lower payroll taxes than other workers for similar benefits.

- Some salaried workers received retirement benefits equal to 100 percent of average wages for their last five years of employment, while manual workers received only 75 percent.

- Some workers were allowed to collect benefits after only 35 years of employment, while the general system for manual workers had a retirement age of 65.

- Under the general system for salaried workers, pensions in payment were indexed for at least two years, whereas the general system for manual workers had no automatic inflation indexing.

These special benefits and tax breaks almost always favored higher-income workers who had the political muscle to win the special concessions. Low-income and middle-income workers usually had to pay higher taxes to finance these special benefits.

Widespread evasion of the payroll taxes added to the system's problems. Those workers who knew they would not qualify for more than the minimum benefit (unrelated to contributions) often would collude with their employers to underreport wages so both could pay less in payroll taxes. Workers also would collude with their employers to underreport earnings prior to their last five years of work, because earnings in earlier years were not counted in calculating benefits.

The social security funds that accumulated were poorly managed. Administrators of the funds were subject to political influence in making investment decisions, and sometimes invested funds in projects managed by friends and business associates. As a result, the funds often earned a low rate of return and capital was not allocated to its most productive uses. These practices made the Chilean economy less efficient and slowed its rate of economic growth.

Finally, since pensions in payment were either not indexed for inflation or had only limited indexing, many retirees saw the real value of their benefits decimated during the 1970s when annual inflation rates under the Allende regime exceeded 1000 percent.

The New Social Security System

In 1981, the government of Chile adopted sweeping reforms to address these problems. The reforms created a new system relying on private, fully funded retirement investment programs rather than a public social security system. Under the reform, workers who had participated in the old system were given the option to switch to the private system prior to 1986. All new entrants into the labor market are required to participate in the private system.

Retirement Pensions. Under the new system, each worker who opted for private coverage is required to make a monthly tax deductible contribution equal to ten percent of wages to an individual pension savings account. The worker can voluntarily make additional tax deductible contributions to the account up to another ten percent of wages. These funds are invested, and the investment income accumulates tax free.

The government has authorized 12 private investment companies, known as Administradoras de Fondas de Pensiones, or AFPs, to administer and invest the individual account funds. These companies were specially created for this purpose and are not allowed to engage in other business or financial activities.[30] Workers are required to place their account with one of these 12 investment companies, although they can switch their accounts to another company on short notice.

The companies can invest in government and corporate bonds, mortgages, stocks, bank certificates of deposit and other financial instruments, but they are regulated to require that they invest pension account funds in a diversified portfolio with limited risk.[31] Each company is required to provide a minimum rate of return on pension account funds, set as a percentage of the average return earned by all 12 companies. The government guarantees this minimum return, which effectively means that the government is an insurer of last resort.

The new system has a uniform retirement age of 65 for men and 60 for women. At this age, workers can use the funds accumulated in their accounts to finance their retirement benefits. Retirees can choose to use all of their funds to buy an annuity from an insurance company that pays a specified annual income for life plus survivors benefits for their dependents, backed by a government guarantee. Retirees also can choose to keep their account with the investment company and rely on periodic withdrawals, leaving the remaining funds in their estate to be passed on to their children or other heirs. Such withdrawals are subject to limits based on the life expectancy of retirees and their surviving dependents, so the funds cannot be completely depleted before their death. If retirees have more than enough funds in their accounts to pay normal expected benefits, they can withdraw the excess as they choose.

The ultimate amount of retirement benefits paid depends on the rate of return earned by the private account investments. But the reform was designed with the expectation that workers contributing the required amounts into the new system over their entire working lives would, with normal investment returns,

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[30] There is no legal limit on the number of investment companies which can be formed and authorized. New ones may enter the system in future years. Workers can join together and form authorized investment companies on their own or through their unions, and two authorized companies have been formed by worker groups.

[31] For example, no more than 30 percent of an AFP's portfolio may consist of common stocks and no more than five percent may be invested in the stock of any one company.

receive retirement benefits equal to 70 percent of their final salary, plus survivors benefits. These survivors benefits are to equal 50 percent of the worker's retirement benefits for a surviving spouse or dependent parent, and an additional 15 percent for each dependent child.

This is a high benefit level, since 70 percent of final salary generally is considered sufficient by itself to enable retirees to maintain the same standard of living they enjoyed during working years. The new system allows workers to retire at any time before the minimum retirement age if the accumulated funds in their accounts are sufficient to pay the targeted benefit level of 70 percent of final salary plus commensurate survivors' benefits.

The government guarantees a minimum pension benefit to all workers under the new system, supplementing the worker's private benefits to the extent necessary to achieve the minimum. The amount of this minimum benefit is 85 percent of the minimum wage, increased to 90 percent for retirees age 70 and over. The minimum wage in Chile is about half the average wage in the country. Consequently, the minimum pension benefit under the new system guarantees all workers a pension equal to about 40 percent of average wages, which is about what the U.S. Social Security system pays to workers on the average.

Survivors and Disability Insurance. Workers under the new system also are required to contribute another 3.5 percent of wages for the purchase of private life and disability insurance from approved private insurance companies of their choice. These private insurance policies replace the survivors and disability benefits paid by the old system for disability or death occurring during the pre-retirement years of the worker. The disability policy, along with funds accumulated in the worker's retirement account, pays a monthly benefit for the rest of the worker's life equal to 70 percent of average earned wages during the 12 months prior to disability. The life insurance policy, along with the worker's retirement funds, pays the same benefit (as a percentage of income) to a surviving spouse, dependent parents and dependent children as paid to the survivors of retirees (described above). The disability benefits under the new system amount to more than twice the disability benefits payable under the old system, and the new system's survivors benefits are almost double those paid under the old system. In addition, the government guarantees the same minimum benefit for disability as for retirement, and guarantees minimum survivors benefits as well.

Health Insurance. Workers under the new system also are required to contribute six percent of wages for health insurance coverage. Workers can choose to have this coverage provided by special private health insurance companies or by the government health service.

Inflation Indexing. All benefits under the new system are indexed for inflation. The contracts for retirement annuities are written to leave the insurer responsible for maintaining the real value of promised benefits each year. Similarly, the contracts for disability and life insurance protection require the insurer to maintain promised benefits in real terms. The government-guaranteed minimum benefit also is indexed for inflation. .This inflation protection is possible

TABLE VI

INCENTIVES TO OPT OUT OF CHILEAN SOCIAL SECURITY (1985)

<u>Total Payroll Tax Rates for Workers Who Opt In</u> *	
Old Age, Survivors, and Disability Insurance	18.89 % - 19.94 %
Health Insurance	5.74 % - 6.55 %
Total Payroll Tax	24.63 % - 26.49 %
<u>Required Contribution Rates for Workers Who Opt Out</u>	
Retirement Account	10.0 %
Health Insurance	6.0 %
Disability and Life Insurance	3.5 %
Total Contribution Rate	19.5 %
<u>Financial Incentive to Opt Out</u> * (Expressed as a Percent of Income)	5.13 % - 6.99 %

*The first rate given is the rate paid by workers participating in the general system for manual workers. The second rate is for workers participating in the general system for salaried workers. See <u>Social Security Programs Throughout the World - 1985</u>, p. 52.

because the private capital market regularly pays a rate of return in excess of the rate of inflation. Indeed, many investments are made in real terms, with the borrower obligated to pay back the real value of the loan plus a fixed amount of real interest.

The new system is in fact entirely denominated in terms of a separate currency (la Unidad de Fomento or UF) whose value is adjusted for inflation each month by the government so each unit of the currency maintains a constant value in real terms. All benefit amounts, individual investment account totals, and investment returns under the new system are expressed in this currency so that real values adjusted for inflation can be easily determined.

Making the Transition

Under the reform, employers no longer pay payroll taxes. But they were required to pay all workers an across-the-board 18 percent wage increase at the time the reform was adopted.[32] For workers under the new system, this meant a net increase of about ten percent in take-home pay, after making the required contributions for retirement, survivors and disability insurance, and health insurance. Since employers no longer pay payroll taxes, workers continuing under the old system now are required to bear the full burden of the payroll tax for that system. With the mandated 18 percent wage increase, this left workers remaining in the public system with about the same net take-home pay as before the reform.

Workers who were participating in the old system at the time of the reform had the option of remaining in the public system or switching to the new private system. For those who made the switch, the government issued special non-transferable bonds -- called recognition bonds -- to compensate them for their past contributions to the old government system. These bonds represented a sum roughly equal to the proportion of benefits already earned under the old system by past contributions. This sum is indexed to increase with inflation and earns interest until retirement. At that time, this accumulated sum, along with the funds in the worker's individual retirement account, will be used to finance the worker's retirement benefits. Workers who switched to the private system also are eligible for the government-guaranteed minimum benefit. Between these minimum benefits and the recognition bonds, all workers who switched to the private system are assured of receiving benefits at least as high as promised under the old system, and probably higher.

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[32]This was done to insure that the reduction in social security taxes paid by employers was immediately passed on to workers in the form of higher wages. Although normal market forces would have accomplished this result in any event, the Chilean government wanted to build political support for its program quickly and was unwilling to wait for labor market wage adjustments.

The government finances the recognition bonds, minimum benefits and benefits currently being paid under the old system out of general revenues. The reform also abolished an additional payroll tax of more than ten percent, which financed unemployment insurance, workmen's compensation and family assistance benefits. These benefits are now paid out of general revenues, and a value-added tax was adopted to help finance these expenditures.

Benefits of Privatization

The reform has been both highly popular and highly successful. More than 90 percent of the workers in the old state-run social security system have now opted for the new private system. Workers who did not do so were mainly those close to retirement without enough working years left to qualify for minimum benefits under the new system.

Moving to a Fully Funded System. The new system completely avoids the chronic, long-term financing problems of the old system because benefits are based strictly on the accumulated savings of the worker. Consequently, general revenue contributions to cover chronic deficits and payroll tax increases to close long-term financial gaps will no longer be needed.

Freedom of Choice for Employees. The new system increases workers' freedom of choice and gives them control over their own resources:

- Workers are free to choose which investment company will handle their funds, and consequently can pick the institution that offers the investment strategy they prefer.

- The private retirement investment accounts are completely portable, following the worker from job to job, so the system does not restrain choice in employment.

- Workers can choose to contribute additional funds to their accounts, up to double the required ten percent of wage income; with these additional contributions, workers can choose an earlier retirement age or higher benefits at the normal retirement age.

- Workers can choose to delay their retirement without penalty, increasing the benefits they will receive at a later retirement age.

- At retirement, workers can choose to purchase an annuity, providing them with a fixed monthly income, or they can choose to make periodic withdrawals from their accounts and leave the remainder for their heirs.

The Performance of Private Funds. In contrast to the public bureaucracies that administered whatever funds accumulated under the old system, under the new system the retirement account funds are administered by private companies subject to intense competition. Workers have the legal right to shift account funds from one company to another company. They also have access to instant information regarding their funds, and receive regular quarterly reports.

The investment companies are strictly regulated to avoid political influence or personal favoritism in making investment decisions -- a common practice under the old system. To remain competitive, each investment company must rule out any extraneous influences on investment decisions. As a result, the new system tends to produce high returns on investments and to allocate funds to the most urgent and productive uses indicated by the market. The more efficient allocation of capital in turn means higher overall national productivity, output, income and economic growth.

The investment returns on funds in the private retirement accounts have been quite high. The latest available data show that the funds have earned an average <u>real</u> rate of return of ten percent. This performance has greatly exceeded expectations and would result in substantially higher than projected benefits, even if returns fall substantially in future years. As a result of the heavy participation in the new system and the high returns earned on retirement investments, the retirement funds have grown quite rapidly:

- From December, 1981 to December, 1985, funds in the private retirement accounts grew tenfold; and in 1986, the funds were growing by 36 percent per year.

- Over the first four years, the individual accounts grew to a combined total equivalent to ten percent of GNP, or about 50 percent of the nation's total time deposits in banks and other financial institutions.

- The private account funds are projected to double from 1986 to 1990, and to double again by 1995.

Equity and Fairness. Former Labor Minister Pinera, the principal architect of the new system, argues that the lack of a direct link between payments and contributions under the old system is what caused it to deteriorate into a morass of special and arbitrary privileges. Benefits under the new system are based entirely on past contributions and returns (apart from minimum benefits), so there is no real opportunity for special interest groups to demand special benefits. The direct link between contributions and benefits under the new system should eliminate the widespread tax evasion that prevailed under the old system. If workers contribute less than is required, they will receive less in benefits. Since employers no longer pay payroll taxes, they no longer have an incentive to underreport wages.

Effects on Savings. Because the new system operates on a fully funded basis rather than on pay-as-you-go financing, the shift to the new system could potentially increase national savings sharply.[33] Savings may be further increased because workers can make additional voluntary tax-deductible contributions to their retirement accounts and earn tax-free investment income.

- In recent years, the growth in the funds has equaled almost 50 percent of the growth in total private internal savings in the country.

- By 1995, the private retirement system is projected to hold 21 percent of all accumulated private internal savings.

Increased savings means additional capital investment and faster economic growth. Chilean officials believe that the savings of the new system are contributing substantially to the economic development of the nation. They suggest that the private retirement accounts are particularly helpful for projects that require stable long-term financing, such as infrastructure development and housing.

Effects on Employment. The new system also is helping to increase employment and job opportunities in Chile. Increased savings and capital investment from the new system ultimately results in the creation of new jobs and higher real wages. Another crucial factor is the sharp reduction in payroll taxes under the reform. The payroll tax discourages employers from hiring and discourages workers from working. The reduction in this tax should lead to further creation of new jobs and increased employment.

Former Labor Minister Pinera suggests that the 19.5 percent contribution is perceived less as a tax and more as personal savings that enhance the workers' personal wealth and are part of their employment compensation. To this extent this is so, the depressing effect of the old system's heavy payroll tax burden has been reduced even further, and the new system will result in still more jobs and increased employment.

Political Change

Under the new system, workers are developing substantial direct ownership in the nation's private business sector through investments in their private retirement accounts. This means more widespread ownership of private companies, which is appealing to many in its own right. This new ownership also has the effect of changing public opinion toward private enterprise. Workers are now more willing to support public policies that create and maintain free markets and enhance the long-term growth and prosperity of Chilean enterprises.

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[33]For further discussion of this savings issue, see Peter J. Ferrara, "Intergenerational Transfers and Super IRAs," Cato Journal, Vol. 6, No. 1, Spring/Summer 1986, pp. 195-220.

Trade Union Reforms. Former Labor Minister Pinera argues that the change in public opinion attitudes resulting from social security reform helped make fundamental trade union reforms possible. With more of a direct personal stake in private enterprises, workers became much less supportive of militant union demands that threatened to damage those enterprises, and began to favor efforts to increase cooperation with management and enhance the ultimate success of firms. The ten percent take-home pay increase for workers under the new private retirement system also helped ease the transition to the new trade union system.

Other Privatization. Social security reform also helped to make possible other privatization policies of the Chilean government. The Chilean government had owned numerous inefficient, heavily subsidized enterprises that it sought to sell to the private sector. The new funds pouring into the private investment accounts have expanded the capital markets and their ability to absorb shares in these state enterprises as they were sold to the public.

An Evaluation

Over the long run, social security reform in Chile will shift the provision of fundamental retirement and insurance protection for workers from bureaucratic, monopolistic, public sector programs to competitive free markets. The reform creates a new system fundamentally based on individual economic liberty, freedom of choice and workers' control over their own resources. The new system does retain substantial continued government involvement through supervision, regulations, guarantees and the payment of minimum benefits. But the reform probably involves the single most massive dismantlement of public sector social insurance in modern history.

CASE STUDY: CONTRACTING OUT OF SOCIAL SECURITY IN THE UNITED KINGDOM [34]

British social security is a two-tier system. The first tier promises a basic benefit (or minimum income) that is unrelated to pre-retirement income. The

[34]For a description of contracting out under the 1978 pension reforms, see John Goodman, Social Security in the United Kingdom: Contracting Out of the System, (Washington, D.C.: American Enterprise Institute, 1981); and John Goodman, "Private Alternatives to Social Security: The Experience of Other Countries," Cato Journal, Vol. 3, No. 2, Fall, 1983, pp. 563-573, -- reprinted in Peter J. Ferrara, ed., Social Security: Prospects for Real Reform, (Washington, D.C.: Cato Institute, 1985), pp. 103-112. For a description of more recent social security reforms, see Janet Walford, Personal Pensions, (London: Financial Times Business Information, 1987).

second tier promises an earnings-related benefit that is directly proportional to pre-retirement earnings. Since 1978, Britain has allowed employers to contract their employees out of the earnings-related tier of British social security by providing workers with a private pension plan that promises benefits at least as high as the benefits promised by second tier social security. Beginning in 1988, workers will have the option to individually opt out of the earnings-related tier by making minimum contributions to the British equivalent of IRA accounts.[35]

Contracting Out Under the 1978 Pension Reform

Britain has experienced intermittent periods of contracting out of social security since 1960. In many ways, the issue of contracting out had a history similar to the history of privatization of the steel industry. The Conservative Party favored it. The Labour Party opposed it. When either party assumed power, it reversed the policy of the previous government. In 1975, however, a political compromise was reached, and in 1978 Britain launched the most comprehensive contracting-out program in its history, with the endorsement of both the Conservative and Labour parties.

Social Security Benefits for Workers Who Are Not Contracted Out. Beginning in 1978, all employees who fully participated in social security began paying higher payroll taxes and, in return, began to qualify for an earnings-related pension under the State Earnings-Related Pension Scheme (SERPS). Under the original terms of the 1978 program,

- For each year of employment under the system, an employee was entitled to a second-tier retirement pension equal to 1.25 percent of earnings between a lower and upper earnings limit.

- A worker who was employed for 20 years under the new system was entitled to a retirement pension equal to 25 percent (1.25 % x 20) of pre-retirement earnings between the two earnings limits.

- Workers who were employed for more than 20 years under the new system were entitled to a pension equal to 25 percent of the average of their highest 20 years of pre-retirement earnings.

- In calculating the pension, past wages were wage-indexed -- increased in line with the increase in average wages paid in Britain.

- Pensions were payable at the official retirement age of 65 for men and 60 for women and were inflation indexed.

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[35]As in the case of Chile, the term "IRA" is not commonly used in Britain. The term is used here for the convenience of the U.S. reader.

Under the new system, a male worker earning the average wage paid to blue-collar workers could expect to receive a total retirement pension (the basic pension plus the earnings-related pension) equal to about 41 percent of pre-retirement income if he participated for at least 20 years. If the worker had a dependent spouse, the total pension would be equal to about 55 percent of pre-retirement earnings.[36] These percentages are roughly equal to benefits paid under U.S. Social Security.

Pension Benefits for Workers Who Are Contracted Out. Since 1978, employers have been able to contract their employees out of SERPS by providing them with private pensions with certain minimum benefits.[37] In general, employees must receive a private, earnings-related pension at least as high as the pension they would have received had they fully participated in social security. Although employers are financially obligated to meet these commitments, they may transfer the obligation back to the government with the payment of certain penalties. As a result, the government remains insurer of last resort for the minimum guaranteed private pension for contracted-out employees.[38]

Payroll Tax Incentives to Contract Out. Employees who are contracted out give up the right to draw an earnings-related pension from the state. In return, these employees and their employers receive payroll tax reductions to compensate them. In general, the tax reduction has been calculated so that employees, on the average, will realize a financial gain from being contracted out. Between 1978 and 1983, for example, the tax reduction was equal to 7.0 percentage points of income between the lower and upper earnings limits.[39] As Table VII shows, this tax reduction was 7.0 percentage points in 1978, falling to 6.25 percentage points in 1983, and to 5.80 percentage points in 1988.

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[36] A dependent spouse is entitled to 60 percent of her husband's basic pension.

[37] The choice to contract out can only be exercised by employers. Prior to 1988, employees could not individually contract out.

[38] Note: During their careers, employees may work for several employers who are contracted out and several employers who are contracted in. As a result, retirees may receive part of their earnings-related pension income from the government as well as separate pensions from each of the contracted-out employers for whom they worked.

[39] The tax reduction for employees was 2.5 percentage points. The reduction for employers was 4.5 percentage points.

The Success of Contracting Out. The new British system of contracting out has been popular and successful among workers who were already members of employer-provided pension plans at the time the system was started. For example,[40]

- Among full-time male and female employees, about 60 percent belong to employer-sponsored pension plans.

- Among male workers over the age of 25, more than 75 percent belong to employer-sponsored pension plans.

- About 90 percent of members of employer-sponsored pension plans currently are contracted out.

Among all British workers, however, only about half are contracted out, and it is doubtful that any significant progress toward further privatization could be made without the creation of IRA alternatives to SERPS.

TABLE VII

INCENTIVES TO CONTRACT OUT OF BRITISH SOCIAL SECURITY TAX[1]

Employee Payroll Tax Rates

	1978/1983	1983/1988	1988/1993[2]
Employees Fully Participating	**18.5 %**	**20.95 %**	**19.45 %**
Employees Contracted Out	**11.5 %**	**14.70 %**	**13.65 %**
Difference	**7.0 %**	**6.25 %**	**5.80 %**

[1]All rates apply to income between a lower earnings limit and an upper earnings limit.

[2]Rates shown are for middle and upper-income employees as of April 6, 1988. Lower-income employees now face lower payroll taxes, but the differential for contracting out is 5.8 percentage points for all income levels between the two earnings limits.

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[40]See Leslie Hannah, Inventing Retirement: The Development of Occupational Pensions in Britain, (Cambridge: Cambridge University Press, 1986), p. 138; and Harold Rose, "Occupational Pension Schemes: Economic Background and Issues," in The Economics of Pension Arrangements, Panel Paper No. 20, Bank of England, March, 1983, p. 5; and Report of the Government Actuary, Occupational Pension Schemes, (London: Her Majesty's Stationery Office, 1987), p. 3.

<u>Personal and Portable Pensions</u>

The retirement programs of both Singapore and Chile are "defined contribution" arrangements. Under these systems, a worker's retirement annuity depends solely on the amount contributed and the rate of return earned on the investments. By contrast, both the public social security system and the minimum benefit component of private, contracted-out pensions in Britain are "defined benefit" arrangements. Under this system, workers are promised a retirement pension equal to a fixed percentage of final salary or average salary. Either the state, or the private pension plan, is obligated to pay a fixed retirement benefit, independent of the amount of contributions and independent of the investment return on those contributions.

At one time, defined-contribution pensions (called "money purchase" plans) were quite popular in Britain. Today, however, about 92 percent of all employer provided pensions are "final salary" pensions in which the worker's pension is a fixed percentage of salary in the last year of employment or of the average salary earned in the last three years of employment.[41]

The principal defect of private-sector, defined-benefit pensions (as they are usually structured) is that they involve redistribution of income -- from younger workers to older workers and from workers who change jobs frequently to workers who stay with the same employer throughout their career. Workers who leave employment before they are vested receive no private pension. But even workers who are fully vested lose substantial pension benefits when they switch jobs. Prior to 1985, for example,[42]

- High-income workers in a representative private pension plan could lose as much as one-half of their pension benefits by a single job change in mid-career and could lose almost two-thirds of their pension benefits by switching jobs every ten years.

- Median-income workers could lose almost one-third of their pension benefits by one job change in mid-career and could lose more than half of their pension benefits by switching jobs every ten years.

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[41] Hannah, <u>Inventing Retirement</u>, p. 105.

[42] See David Campbell, "Social Security Act 1985: The Implications," <u>Pensions Management</u>, December, 1985, pp. 11-15. Similar results occur for defined-benefit pensions in the U.S. See Dennis Logue, <u>Pension Plans at Risk: A Potential Hazard of Deficit Reduction and Tax Reform</u>, National Center for Policy Analysis, NCPA Policy Report No. 119, October, 1985.

Because defined-benefit pensions with these features involve substantial redistribution of income among workers, it is doubtful that they could survive in a truly competitive labor market.[43] Both in the U.S. and in Britain, however, these pensions have been encouraged by tax law and by labor law. In Britain they have been further encouraged by the contracting-out requirements under British social security.

In the mid-1980s, the Thatcher government, aided by the research efforts of a number of influential British think tanks, launched a campaign to encourage personal and portable pensions as an alternative to final salary private pension plans and as an alternative to SERPS.[44] As part of private pension reform,

- The required vesting period for employer-sponsored pensions was reduced from five years to two years;
- Employers were considerably restricted in their ability to penalize "early leavers;" and
- Employees were given increased rights to substitute personal IRA-type pensions for participation in traditional defined-benefit plans.

These reforms were supplemented by additional reforms aimed at allowing (and encouraging) employees to individually opt out of SERPS.

Creating an IRA Alternative to Social Security

The initial goal of the Thatcher government was to abolish the earnings-related tier of British social security altogether and replace it with private pension alternatives. When this proposal met with resistance, the Thatcher government did the next best thing: It substantially reduced the benefits promised under the earnings-related component of social security, and it made it possible for all employees to opt out of SERPS. Specifically,

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[43] See Edward J. Harpham, Private Pensions in Crisis: The Case for Radical Reform, National Center for Policy Analysis, NCPA Policy Report No. 115, January, 1984.

[44] See, for example, the interview with Norman Fowler, Secretary of State for Social Services, in Pensions Management, November, 1985, pp. 11-14; E. Victor Morgan, Choice in Pensions: The Political Economy of Saving for Retirement, (London: The Institute of Economic Affairs, 1984); Nigel Vinson and Phillips Chappel, Personal and Portable Pensions For All, (London: Center for Policy Studies, 1983); and Social Security, (London: Adam Smith Institute, 1984).

- Beginning in 1988, the earnings-related social security pension is reduced from 25 percent of pre-retirement earnings to 20 percent, and pre-retirement earnings now are calculated on the basis of the average of all years worked, rather than the 20 years of highest earnings.

- For many young workers, these changes reduce promised, earnings-related benefits by 20 to 50 percent.

In order to further encourage a private pension alternative to SERPS, the new reforms allow all previously contracted-out employees to opt out of their employer-sponsored pension plans into personal pension accounts. The reforms provide an additional subsidy to the personal pension accounts of those employees who opt out of SERPS and who were not previously contracted out.

Tax Incentives to Opt Out. Starting July 1, 1988, all British workers may individually opt out of SERPS by setting up personal pension accounts.[45] As Table VIII shows, those who do so will receive a tax rebate equal to the difference in payroll tax rates for contracted-out and fully-participating employees, plus a small income tax rebate. Employees who choose this system (and their employers) will pay the same payroll taxes paid by fully-participating workers, and the government will periodically deposit the tax rebate in the employee's personal pension account. For workers who were not previously contracted out, an additional government subsidy is paid equal to 2.0 percent of income between the earnings limits.

For all employees who choose to opt out of SERPS, the government's deposit to the individual's personal pension account is the <u>minimum</u> contribution that must be made. However, individuals also may make additional tax deductible contributions to their personal pension accounts. For example, employees under 51 years of age may contribute an additional 17.5 percent of their <u>total</u> income. Employees 61 years of age or older may make contributions as high as 27.5 percent of their income.

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[45]The timing may be backdated to April, 1988.

TABLE VIII

TAX INCENTIVES TO CHOOSE AN IRA ALTERNATIVE
TO BRITISH SOCIAL SECURITY

(April, 1988 - April, 1993)

Type of Tax Rebate	Tax Reduction as a Percent of Income[1]
Payroll Tax Reduction for Employers of Contracted-Out Workers	3.80 %
Payroll Tax Reduction for Contracted-Out Employees	2.00 %
Income Tax Rebate on the Employee's Payroll Tax Reduction[2]	0.74 %
Incentive Bonus for Employees Who Were Not Previously Contracted Out	2.00 %
Total Tax Rebate[3]	8.54 %

[1]Rates are expressed as a percentage of earnings between the lower and upper earnings limit.

[2]This is the income tax that employees, on the average, can expect to pay on 2.0 percent of their earnings.

[3]Employees and their employers pay the full payroll tax rates (rates charged to fully participating workers). The total tax rebate is the amount paid by government to the employee's private pension account.

Management of Personal Pension Accounts. In a manner similar to IRA accounts in the U.S., only qualified institutions in Britain may accept and manage deposits made to personal pension accounts. However, at present there are at least 1,700 mutual funds and investment funds that can accept deposits. Unlike the U.S. system, however, there are restrictions on the riskiness of investments. For example, qualified funds may not invest more than 15 percent of their assets in commodities, futures, or options.[46]

Drawing Retirement Benefits. Individuals who make only the minimum contribution to their personal pension accounts are required to withdraw their retirement benefits according to strict rules. Among the requirements,[47]

- At the retirement age, individuals must purchase a compulsory annuity to provide an annual income for the remainder of their lives.
- The annuity must provide for a 50 percent continuing payment to a surviving spouse.
- The annuity must be increased each year by the increase in the consumer price index or by 3.0 percent -- whichever is lower.

Individuals who make more than the minimum contribution to their personal pension accounts have discretion over how they withdraw the excess funds and the investment income earned by these funds.

The Purchase of Housing. Subject to certain limitations, employees may use part of their personal pension accounts as collateral for the purchase of a home. Under the arrangement, home buyers take out an interest-only mortgage during their working years. At the time of their retirement, they may use part of the funds in their personal pension account to repay the principal.

Built-in Protection. Two objections are sometimes leveled against defined-contribution pensions. First, it is argued that a sudden downturn in the value of an investment portfolio immediately prior to retirement (such as the October 19, 1987 stock market plunge) could greatly diminish the value of the retiree's pension annuity. Put another way, although contributions and benefit payments occur over long periods of time, short-term changes in portfolio values can substantially alter the relationship between the contributions and the benefits. However, in Britain (and in most countries with provident fund systems) investment funds typically base their distributions on the average return earned over a period of time, rather than on day-to-day fluctuations in the market.[48]

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[46] See the discussion in Walford, Personal Pensions, pp. 14-19.

[47] Ibid., pp. 33-39.

[48] See Morgan, Choice in Pensions, p. 43.

Second, it is sometimes argued that pensions in payment cannot be properly indexed for inflation by the private sector. In Britain, however, the government now issues inflation-indexed securities. As a result, investors can purchase securities that promise a real rate of return, with automatic adjustments for inflation.[49]

An Evaluation

In some ways, Britain provides a more interesting case study than Singapore or Chile. Britain has proved that an advanced industrial democracy can create private pension alternatives to pay-as-you-go social security. In doing so, Britain has set an example that other developed countries may emulate.

FORCED SAVINGS VS. SOCIAL SECURITY: A PROPOSAL FOR THE U.S.

If the United States is to follow the example of other countries and move from a pay-as-you-go Social Security system to a fully funded private system, a way must be found to make the transition. To date, all serious proposals for making such a transition involve giving individuals tax deductions or tax credits for deposits to IRA accounts. In return for the right to make such deposits, individuals (roughly speaking) would give up the right to draw a dollar in Social Security benefits for each dollar deposited in their private accounts. After a number of years, the special IRA account balances would grow to a point where the account holders' claims against Social Security are reduced to zero. Through a similar mechanism, individuals also could opt out of Medicare, and out of the survivors and disability system as well.

In this way, the U.S. could move quickly toward a private savings alternative to pay-as-you-go social insurance and avoid the financial crisis that looms in our future. The experience of other countries demonstrates that this is an option well worth considering.

Note: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

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[49] Ibid., p. 37. The real rate of return on inflation-indexed securities has been averaging 3 1/2 to 4.0 percent. See Occupational Pension Schemes, p. 5.

APPENDIX A

COUNTRIES WITH PROVIDENT FUNDS

Country	Exclusions and Voluntary Options
1. Fiji	Excludes employees with equivalent private pension plans.
2. Gambia	Excludes employees with private pension plans.
3. Ghana	Voluntary for employees of small firms and for the self employed.
4. India	Employees covered by equivalent private plans may be contracted out.
5. Indonesia	Compulsory for employees of large firms; voluntary coverage available for others.
6. Kenya	
7. Kiribati (Gilbert Islands)	
8. Malaysia	Excludes members of equivalent private plans.
9. Montserrat	
10. Nepal	
11. Nigeria	Voluntary for some categories of workers.
12. Papua New Guinea	
13. Saint Vincent	Excludes members of equivalent private pension plans.
14. Singapore	Allows personally-managed investment options.
15. Solomon Islands	
16. Sri Lanka	Excludes employees with approved private pension plans.

17. Swaziland	
18. Tanzania	
19. Uganda	**Voluntary for excluded workers.**
20. Western Samoa	
21. Zambia	**Voluntary for some workers.**

Source: Office of Policy, Office of Research and Statistics, Social Security Administration, U.S. Department of Health and Human Services, Social Security Programs Throughout the World -- 1985, (Washington, D.C.: U.S. Government Printing Office, 1986); and John Dixon, "Provident Funds in Third World Countries: A Cross National View," Public Administration and Development, 1982, Vol. 2, pp. 325-344.

APPENDIX B

COUNTRIES IN WHICH PARTICIPATION IN SOCIAL SECURITY IS OPTIONAL FOR CERTAIN CATEGORIES OF PEOPLE

	Country	Categories
1.	Argentina	Nonworking persons under age 55.
2.	Bahamas	Formerly employed.
3.	Belize	Self-employed.
4.	Benin	Voluntary provident fund for citizens residing abroad.
5.	Bermuda	Formerly covered.
6.	Bolivia	Formerly covered and the self employed.
7.	Brazil	Clergy.
8.	Cameroon	Everyone not otherwise covered.
9.	Costa Rica	Self-employed.
10.	Cyprus	The formerly covered, etc.
11.	Ecuador	Anyone not otherwise covered with 18 months of employment.
12.	France	Housewives, etc.
13.	Germany	Anyone not otherwise covered.
14.	Greece	Citizens living abroad, etc.
15.	Israel	Some non-employed women.
16.	Jamaica	Certain persons not otherwise covered.
17.	Japan	Nonworking wives, etc.
18.	Liberia	Anyone not otherwise covered.
19.	Luxembourg	The self-employed.

20.	Mali	The self-employed.
21.	Malta	Optional for non-employed married women prior to April 1, 1978.
22.	Mauritius	Anyone not otherwise covered.
23.	Mexico	Anyone not otherwise covered.
24.	Morocco	Persons leaving covered employment.
25.	Peru	Self-employed and persons leaving covered employment.
26.	Portugal	A separate system is available for certain persons not otherwise covered.
27.	Saint Christopher and Nevis	Anyone not otherwise covered.
28.	Switzerland	Citizens living abroad.
29.	Taiwan	Employees of private schools.
30.	Trinidad and Tobago	Anyone not otherwise covered.
31.	United Kingdom	Low-income employees and non-employed persons.
32.	Zaire	Certain previously covered employees.

Source: Office of Policy, Office of Research and Statistics, Social Security Administration, U.S. Department of Health and Human Services, Social Security Programs Throughout the World -- 1985, (Washington, D.C.: U.S. Government Printing Office, 1986).

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