

Social Security: Foreign Lessons

By Gary S. Becker and Isaac Ehrlich

Social security -- once widely regarded as the diadem of the modern welfare state -- has lost much of its glitter in recent years. This is largely because the systems in the U.S. and many other Western countries are facing major financial problems -- not this year or in the next few, but sometime early in the next century.

The difficulties are not an inevitable outcome of the basic concept, but rather of the way it has been implemented. Western countries have by and large adopted a defined-benefits pay-as-you-go system in which the benefits to retirees are paid from concurrent contributions by active workers. Asian countries, by contrast, have relied much less on such systems.

Hong Kong and Taiwan so far have had no mandatory pension schemes; South Korea has only recently introduced a modest one; while Singapore, Malaysia, and 20 other Asian countries have relied mainly on a central provident fund. This is a fully funded forced-savings plan that ties retirees' benefits to their own contributions. These contributions are accumulated in individualized accounts managed by the government.

Chile and a few other countries have also adopted systems that mandate contributions to individual accounts. In these retirement protection systems, private funds compete for the right to manage individual accounts. Since these systems have the advantage of competition among private companies, they are superior to government-managed central provident fund systems, which are in turn much better than pay-as-you-go systems.

Substantial Nest Egg

If workers contribute 10% of their earnings during their working lives, they can build up a substantial nest egg in a retirement protection system. For example, a 3% real rate of return on savings for a period of 40 years will ensure a pension after retirement of almost two-thirds of annual real earnings for the subsequent 15 years. This 10% contribution is only two-thirds of the current combined contribution by employers and employees to Social Security in the U.S.

The government should have the obligation to add to the retirement incomes of people who have not built up a sufficient fund over their working lives to stay

above the poverty level in retirement. This obligation to provide a safety net for older people explains why it may be desirable to mandate worker contributions. A mandate prevents young people from neglecting to provide for their old age when they can count on the government to help them out if they lack sufficient savings when they are old.

Pay-as-you-go systems, unlike fully funded plans, provide benefits to the elderly that are tied not strictly to their own lifetime contributions, but mainly to taxes on younger generations of active workers. These systems depend critically on the support ratio -- the number of people in the prime labor-force-participation age groups of 20 to 64 available to support the pensions of those age 65 and over. These support ratios have been falling throughout the developed world.

In the U.S. the ratio has declined from 7.1 in 1950 to 4.7 in 1990, and it is expected to drop to 3.3 in the year 2020. In West Germany the rate is expected to fall to under 3 in 2020, and in Japan it may reach as low as 2.

The support ratio has declined partly because adult mortality has fallen, and partly because birth rates are now very low. The average couple in most rich countries produces fewer than two children; in Germany, Japan and some others, it produces only about 1.5 children.

The aging of the population implies that growing government spending would be required to finance the cost of any given level of per-capita benefits to retired people. As a result, higher taxes will have to be imposed on relatively fewer workers. All the projections suggest that unless benefit levels are reduced significantly, by the year 2025 government spending on social security will increase greatly as a fraction of national output in the U.S. and other rich countries. In the early 1970s it was estimated that a tax rate of 65% on earnings would be needed in Chile to produce the full menu of mandated benefits to the elderly. No wonder Chile went on to pioneer the privatization of a pay-as-you-go system into a retirement protection system.

Quite apart from their financial difficulties, pay-as-you-go systems also hurt the real economy. The underlying philosophy of these systems is that society

can behave like an extended family in which parents, children and grandchildren engage in mutually beneficial transfers. But in a family setting, different generations share in the industriousness and productivity of one another. Parents' old-age pleasure and material comfort are directly linked to the productivity and success of themselves and their children and grandchildren, while children are also helped by the parents. A pay-as-you-go system does not have this linkage.

Parents' social security entitlements are largely independent of their own contributions to the social fund, and they are entirely independent of their children's contributions. This encourages families to decrease the support they provide each other, and rely instead on government aid. It also encourages reductions in birth rates, since parents become less dependent on their own children for old-age support. But this decline in family size puts further strains on the financial health of a pay-as-you-go system.

Neither the adverse financial consequences nor the harmful real effects of the pay-as-you-go system need occur under fully funded schemes. Since retirement payments are proportional to the worker's accumulated contributions, and the accumulated reserves are invested in financial instruments that tend to yield a competitive rate of return, these systems do not have the same effect on birth rates and aggregate economic performance. Trends in fertility and longevity may still affect market interest rates earned on deposits, but they do not have other direct effects on fully funded schemes.

To ensure the success of a private system, it is desirable to leave the business of management to private annuity companies that compete for customers with their pension products. Governments should monitor the behavior of these funds and require minimum levels of capital. The main deficiency of a Singapore-style central provident fund is that the government becomes a major investor and owner of private equity, since it manages huge accumulating balances.

The evolution of the Singaporean central provident fund provides an instructive lesson. The mandated combined contributions of employees and employers rose to a peak of 50% of earnings in 1984, and are currently set at the still exorbitant level of 40%. This government-monopolized system has yielded a real return to workers of only 2% a year from 1961 to 1992 -- much less than what private equity markets yielded in Singapore or elsewhere in Asia.

With the government running out of profitable investment options, a partial privatization has already taken place in Singapore. Workers are allowed to withdraw increasing amounts of their accumulated balances prior to retirement for housing, education and health outlays, and more recently also for investment in stocks, bonds and even gold.

A privately managed retirement system may seem wholly impractical and out of touch with political reality. But this is precisely what Chile has been doing for 13 years, since people there became fed up with the public system. Several private funds actively compete in Chile for the right to manage the savings that workers are required to put aside for their old age. Government regulations require private management funds to have minimum capitalization, and they limit investments to particular categories of securities.

Although expenses were high during the early years in Chile, they have fallen sharply over time as experience with the system has grown. The inflation-adjusted annual rate of return on investments from 1981 to 1990 was more than 12%. And the pensions awarded so far under this system have been generous compared with those offered by the old system.

Gradual Integration

Hong Kong's 1992 draft proposal to establish a community-wide retirement protection system is similar in spirit to the Chilean system, but the government recently turned away from this promising idea by proposing instead a pay-as-you-go system. Fortunately, mounting public criticism may still revive the earlier plan. A few other countries have either introduced a Chilean-style system or are considering doing so.

Of course, older workers in the U.S. who have been contributing to the traditional Social Security system for many years will have to be gradually integrated into a privatized system. Chile offered older workers the option of either remaining in the pay-as-you-go system or transferring into the privatized system and receiving a bond valued in proportion to their accumulated past contributions. The transition there went smoothly -- perhaps because the bond values were rather generous -- and practically all older workers opted out of the traditional system.

The U.S. has done little to privatize its state enterprises. Its privatization movement should begin with one of America's most significant industries: provision of security for elderly people.

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