Editorial – Saving social security

All over the world, public pension funds — like Social Security — are heading for bankruptcy under the impact of three trends: ageing population, slowing productivity growth and increases in longevity. Unless these systems are promptly reformed, they face an unsavoury choice of raising contributions and/or cutting benefits. The basic reason why so many public pension plans are, at present, suffering from the negative impact of the three trends above is that they are not funded (ie not financed from reserves accumulated through lifetime contributions, as in traditional private systems). They are financed instead, thanks to an ingenious piece of financial engineering called Pay-As-You-Go (PAYGO), by the current contributions of the younger working generations. It is readily understandable that the three developments will all have the effect of reducing the income and contributions of the younger workers relative to the pension claims of those retired, pushing a PAYGO system toward insolvency. But the remarkable thing is that these same trends would tend not to affect a funded system, because the pensions of the retired are paid by their own accumulation and not by the contributions of the young. The problems of insolvency facing PAYGO are not immediate, and therefore procrastinating is possible without immediate consequences; but it must be recognised that the longer we wait, the harsher will be the costs borne by future generations.

Faced with the problem, many well-meaning reformers have come out in favour of moving towards a type of radical restructuring of the current PAYGO system, which goes under the name of ‘Privatisation of Social Security’. This is a (highly misleading) name, ably picked by its inventor and propagandist, namely Chile, at a time when ‘privatisation’ was a holy word. The aim of its 1981 pension reform was that of eventually eliminating Social Security by redirecting the individual contributions to individual accounts, whose accumulation would serve to fund the pension, replacing the Social Security PAYGO pensions.

The Chilean example has had a remarkable appeal, despite its deleterious shortcomings detailed below. It was promptly imitated by many large and small countries in South America and Eastern Europe, partly at the urging/coercion of agencies such as the World Bank. It has also been proposed for other developed countries including the USA, where President Bush’s Commission to Strengthen Social Security has recommended offering an option to shift contributions to private accounts. There are a number of reasons why this approach seems appealing.

In the first place, the name ‘privatisation’ and the notion of eliminating a public pension agency (like Social Security) appealed to the many (especially the fans of the market) who were easily persuaded that the malady affecting all PAYGO systems was due to the usual presumed shortcomings of

publicly managed agencies (stupidity, wastefulness, dishonesty, personal interests, etc). Hence, returning to the private investor the right to decide how to invest his retirement reserves was bound to appear a great improvement. But this view of the cause of Social Security's problems is largely fallacious. The current difficulties arise from the interaction of the structure of PAYGO and the trends discussed earlier. These difficulties were compounded when the system was poorly designed, eg failing to provide adequate inflation protection or investing surpluses poorly, as was variously the case in Chile and other Latin American countries. But Social Security in the USA and numerous other countries with PAYGO is running into difficulties without any evidence of suffering from any of the above public failures.

The conclusion is that the troubles are not due to public mismanagement, but to poor design, which can be eliminated without recourse to individual accounts.

The second source of appeal is the replacement of PAYGO with funding, a system less accident prone, and possibly more cost effective. But the proponents forget that a funded system is superior because it is already funded, ie it has accumulated the capital necessary to pay pensions. But with PAYGO, there is no accumulated capital, hence, in order to move to funding, that capital has to be accumulated. It cannot be accumulated by simply redirecting contributions from Social Security to individual accounts, because Social Security needs those contributions to pay the current pensions — something the Bush Commission does not address clearly. To accumulate the capital requires large supplementary forced saving, eg requiring current participants to pay double contributions: one to finance the old pensions and one to fund the new system. This poses a

very difficult problem, known as the 'transition problem', involving some highly delicate intergenerational equity issues. These issues have been poorly handled in the South American reforms, generally worse than in Chile, which could ease the transition thanks to a unique pre-existing budget surplus. Fundamentally, the transition is being financed through government deficits, which impoverish the country through less capital and more taxes.

Finally, those who have pushed for the imitation of the Chilean privatisation have failed to realise some very fundamental flaws. The crucial one is that it eliminates the 'progressive' pensions guaranteed by the government under the current defined benefit structure to replace it with 'defined contributions', a structure under which the contributions remain government mandated, but benefits become highly erratic, depending on luck in choosing one's portfolio (and date of retirement, if not date of conception!). Indeed, on close reflection, one must conclude that privatisation leaves to the government all major decisions: the only thing that is truly 'privatised' is risk! This results in an arbitrary and capricious redistribution of pension income. To be sure, some will end up above average, as is frequently emphasised by the supporters, but they conveniently forget about the rest who will do worse. The inequalities generated by privatisation are especially repellent because they are artificial and serve no useful (eg incentive) functions.

Individual portfolios will tend to increase the gap between the rich and the poor in two ways:

- (a) The rich will be in a position to gain more from the option, as they have access to better investment strategies and can better afford the risks inherent in equities and other more

remunerative instruments (recent studies show that less than 25 per cent of 401,000 participants use retirement advice tools to help them plan for retirement, suggesting negligence or fear based on lack of knowledge on their part).

- (b) The pension based on an individual account would eliminate the progressive aspect of the current system under which the rich are credited with a somewhat lower return than the poor are. This provides a further inducement for the rich to exit Social Security if they get the option, and invest in their own portfolio.

The result is that the poor will receive smaller pensions while the pensions of the rich will be enhanced.

The management costs, combined with the additional costs of administration and regulation, are prohibitive, often causing a reduction in pensions of as much as 15–20 per cent.

When all these flaws are taken into account, one must conclude that privatisation must be rejected unconditionally in favour of some of the existing alternatives that avoid individual accounts. A number of countries are in a position to make the transition from systems on the verge of bankruptcy to a more robust system, staying away from privatisation.

We propose here to give an outline of a 'permanent' solution to the problem of maintaining current benefits levels and stable contribution rates, which is discussed more fully in a forthcoming book (*Rethinking Pension Reform*, Cambridge University Press). Focusing on the USA, our approach, which we label 'risk diversification through a common portfolio', achieves lasting reform by gradually shifting from PAYGO towards a system more like a

traditionally funded one — common in the corporate world — under which pensions are funded by the capital accumulated through lifetime contributions, while maintaining the attractive defined benefit structure.

To cover the growing funding gap in Social Security, reserves must be gradually increased above the level projected with the current system. We agree with President Bush's Social Security Commission that one way to secure these additional resources is to invest reserves in the securities market, rather than in low-yielding loans to the government. But we hold that the cost- and risk-effective way to do so is not through individual accounts managed by some manager from a government-approved list, but by continuing to direct all contributions to the existing Trust Funds which will invest all reserves in a common portfolio. We require that portfolio to be a highly diversified portfolio, under the supervision of a Blue Ribbon Board. Ireland and Canada have successfully created such boards. The common portfolio, together with some imaginative financial arrangements (eg a swap between the Treasury and the Social Security Administration), ensures that all participants enjoy the same, safe return, thereby providing the foundation for the continuation of defined benefits. Pooling also dramatically lowers management and administrative costs. In addition, the book demonstrates how innovative arrangements such as flexible contributions — practices that are commonplace to the corporate fund world — can lower asset-liability risk. It also demonstrates that retaining a defined benefit as the first pillar, combined with voluntary savings, is critical to the achievement of diverse retirement objectives.

Any proposal to invest reserves in the market, however, even in the more

efficient form of the common portfolio, is no longer sufficient to solve the Social Security funding problem in many countries including the USA. Such a step alone might have been sufficient if supplemented by the kind of government contribution that had been promised by former President Clinton out of the huge surplus that he bequeathed to President Bush. Unfortunately, the Bush tax cuts, plus declining revenues from an economy cooling even before September 11th, and rising spending have eaten up the entire surplus.

Given that the budget deficits are projected to grow dramatically into the future, the only feasible alternative is to increase, once and for all, individual contributions. By how much depends upon how promptly such an increase is implemented: the longer the wait, the greater the cost. We calculate that, if it were done immediately, the contribution increase necessary to cure the problem for the indefinite future could be very modest (1 percentage point or raising contributions from 12.5 to 13.5 per cent) assuming very prudently that the portfolio in the Trust Fund would have a long-run real return of approximately 5.25 per cent. And that increase could be reduced or even eliminated with a higher return and/or by introducing some reasonable modifications, such as indexing the standard retirement age to life expectancy. The contingency of an appreciably different long-term return

can be readily handled by allowing some flexibility in the rate of contribution.

If we procrastinate until the Trust Funds are exhausted, individual contributions needed to maintain benefits would have to rise by approximately 50 per cent to a tax of 20 per cent of wages. But if we act now, Social Security can be saved for the indefinite future, in substantially its present form with a few simple, affordable reforms, namely:

- (i) Continue to direct all contributions to Social Security with instructions to invest any surplus in an indexed market portfolio under the supervision of a Blue Ribbon Board.
- (ii) Authorise Social Security and the Treasury to implement a swap to guarantee a real rate of return, thereby ensuring the continuation of defined benefits.
- (iii) Decree a small, permanent increase in the contribution rate.
- (iv) Allow for some long-run flexibility in contributions.

Acknowledgments

Special thanks to Thomas Philips (Paradigm Asset Management), Ronald van der Wouden (The World Bank) and Maria Luisa Ceprini.

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