Pensions internationally

American congressional considerations: Social security reforms and what can be learnt from abroad

Received: 12th July, 2000

David Harris

was recently transferred to the Insurance & Financial Services Practice of Watson Wyatt & Partners in Reigate, UK as a Consultant. He has extensive international research experience in the areas of life insurance and pension reforms. David continues to co-author a publication that examines pension reforms in leading developed and developing nations, begun while working for Watson Wyatt Worldwide in Washington, DC as a Research Associate. As the Australian 1996 AMP Churchill Fellow, David has travelled extensively in Asia, Africa, Europe and the Americas evaluating public confidence linked with the financial services industry. A graduate in Accounting and Bank Management from Charles Sturt University, David's experience in the mid-1990s centred on the regulation of pensions and life insurance in associated Australian government agencies.

Abstract This paper will broadly discuss the social security reform experiences in Australia, Chile and the United Kingdom. All three countries have shared since the beginning of the 1980s a political and economic will to 'grasp the thorny nettle of social security reform'. The successes and otherwise of these international social security models provide a useful 'blueprint' for the USA in its ongoing discussions over the future of social security reform. This paper largely concentrates on the experiences generated by Australia in moving towards a more fully funded approach to its retirement needs in the late 1980s and early 1990s. Additionally details are provided on the Chilean and British social security reform initiatives. While economic and demographic comparisons are not as strong as those with Australia, policy makers in the USA would be well served in looking at what lessons can be gained from these two models.

As a former International Research Manager for the Office of Fair Trading in the UK and a regulator of retirement products in Australia, the author considers it very important to comprehend the experiences of how Australia, Chile and the UK have fostered individual retirement accounts. Certainly it can be argued that the following international experiences, combined with the realities of an increasingly ageing 'baby boomer' population in the USA, will help solidify the need for individual retirement accounts.

Keywords: *social security reform; Australia; Chile; UK*

Australia

Developing and nurturing and individual retirement system

For Australia, a country that at the beginning of the 20th century had one

of the highest standards of living in the world, the Old Age Pension, introduced in 1909, appeared to be both a stable and viable approach to meeting an individual's retirement needs in the future. Under the system a flat-rate benefit is provided which equates to a

David O. Harris
(Watson Wyatt and
Partners, London Road,
Reigate RH2 9PR, UK
Tel: +44 (0)1737 241 144;
Fax: +44 (0)1737 241 496;
e-mail:
David_Harris@watsonwyatt.-
com)

maximum of 25 per cent of male average weekly earnings. Before the 1980s, a common mentality among retirees was that after paying taxes over their working lives, they were now entitled to an Old Age Pension from the Federal Government.

Yet as commodity prices slumped in the early 1980s and Australia encountered a deep recession, both politicians and bureaucrats alike realised that the current Old Age Pension could not be sustained with the rapid ageing of the population. Simply put, Australia could no longer afford a 'non-earmarked PAYG Old Age Pension' with its associated generous qualification requirements. The demographic concern towards Australia's ageing population was echoed by the then head of the Association of Superannuation Funds of Australia, Susan Ryan, who commented:

'For Australia the percentage of the population aged over 65 is expected to rise from 15% of the population, 2.9 million, to 23% by 2030, that is, 5 million people. The percentage aged over 85 is expected to more than double from around 2% to more than 5% amounting to 650,000 Australians over 85.'¹

Surprisingly for some in the USA, it was the Australian Labor Party, a social democratic political party who, with trade union (organised labour) support began to generate the momentum for change of Australia's retirement system. In the first instance, the newly elected Federal Government began the process of ensuring the long-term viability of the Old Age Pension at its current level. Maximum payments per fortnight by the mid-1980s were now determined through the interaction of a comparatively stringent income and asset test. A greater concern for the government of the day in the 1980s was

to the capping of pension expenditure.

Clearly to engineer or make such a significant shift in the overall retirement structure of any country requires a strong political resolve and vision for the future of a nation's citizens. In Australia's case, more through coincidence and luck a popular Federal Government, through trade union support, was able to convey to the nation the impending problems Australia would confront, if it did nothing about addressing its ageing population. This theme of the realisation and admittance of a future retirement hurdle was best summarised in the 'Better Incomes: Retirement into the Next Century' statement which expressed a commitment to:

'maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce.'²

For trade unions, which had strongly supported the election of a Federal Labor government in 1983, increasing superannuation coverage was seen as a major priority. Before the introduction of mandated, second-pillar, superannuation accounts, the extent of coverage of superannuation was limited to roughly 40 per cent of the workforce. Typically employees who were covered by superannuation were employed in middle-class, 'white collar' jobs where usually women and people from minority groups were under-represented. Brandishing this as a major bargaining tool, the trade union movement set about convincing the Federal Government that the level of superannuation coverage needed to be extended, via compulsory contributions into individual accounts.

Such a position adopted by the

ACTU was in line partially with its counterparts in the United Kingdom and Denmark but yet diametrically opposes the position adopted by the AFL-CIO in the USA with regard to social security reform. By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. Continuing wages pressure and demands by the union movement on the government for a comprehensive superannuation policy to be initiated saw the introduction of award superannuation, set at 3 per cent of an individual's yearly income. This amount was paid by the employer as part of a centralised wage increase of 6 per cent, with 3 per cent of this amount being deferred into individual retirement accounts.

By the actions of the Conciliation and Arbitration Commission in requiring compulsory contributions of 3 per cent to be made into individual superannuation accounts, award (employment conditions) superannuation was born. In the year that would precede its actual implementation in 1987, individual superannuation account balances would gradually increase. The trade union movement and the Federal Government would work together in refining and improving the delivery and regulation of superannuation products to employees. Moreover, trade unions would not simply just advocate a policy of increased superannuation coverage during the 1980s and early 1990s, but would rather become vigorous in the running and management of specific superannuation funds. Such specific involvement in the day-to-day operations of superannuation funds was directed principally towards industry funds. These funds generally gravitate around an occupation or industry and are sponsored by employer and employee organisations.³ Fundamentally, they were

established to receive the 3 per cent mandated award contribution. As at June 1996 there were 159 industry funds with 5.8m accounts (35 per cent of total accounts) and \$17.6bn in assets (6 per cent of total assets).

Most experts and politicians agreed that 3 per cent was not a sufficient level to generate adequate retirement income for employees once leaving the workforce, yet this was seen as the necessary first step. On this basis, the Federal Government would again intervene in 1992 to reposition Australia's long-term retirement income strategy.

Structure of the Australian superannuation industry — second pillar

With a delay to the 1990-1991 wage case occurring, where the ACTU and the Government supported a further 3 per cent round of award superannuation, the then government saw its opportunity to act in a decisive manner towards retirement saving. A major problem was seen to be slow and incomplete coverage.

In August 1991 the then Treasurer foreshadowed the Government's intention of introducing a Superannuation Guarantee Levy which commenced on 1st July, 1992. In issuing a paper on the levy the Treasurer indicated that such a scheme would facilitate:

- a major extension of superannuation coverage to employees not currently covered by award superannuation
- an efficient method of encouraging employers to comply with their obligation to provide superannuation to employees
- an orderly mechanism by which the level of employer superannuation support can be increased over time, consistent with retirement income

policy objectives and the economy's capacity to pay.⁴

Additionally in a statement 'Security in Retirement, Planning for Tomorrow Today' given on 30th June, 1992, the then Treasurer, the Hon. John Dawkins, MP, reaffirmed the government's position and direction on the ageing of Australia's population and the need for compulsory savings for retirement:

'Australia, unlike most other developed countries meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments.

'And, like most other people, Australians generally undervalue savings for their own future retirement. Private voluntary savings cannot be relied upon to provide an adequate retirement security for most Australians. This is so even with the very generous taxation concessions, which are available for private superannuation savings. ... In the face of these factors, changes are required to the current reliance on the pay-as-you-go approach to funding widely available retirement incomes. This means that we need now to start saving more for our future retirement. It also means that saving for retirement will have to be compulsory. It means that these savings will increasingly have to be 'preserved' for retirement purposes. Lastly, the rate of saving will have to ensure retirement incomes, which are higher than that provided today through the age pension system.

There seems to be a general awareness in the community that something has to be done now to meet our future retirement needs.'⁵

The Superannuation Guarantee Charge Act 1992 requires all employees to contribute to a complying superannuation fund at a level, which increased from 3 per cent p.a. in 1992

Table 1: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar

	Employer's prescribed rate of employee support (%)
1st July, 1997–30th June, 1998	6
1st July, 1998–30th June, 1999	7
1st July, 1999–30th June, 2000	7
1st July, 2000–30th June, 2001	8
1st July, 2001–30th June, 2002	8
1st July, 2002–03 and subsequent years	9

to 9 per cent p.a. It should be noted that some discrimination was made in the early years of implementation for small business in how the levy was introduced and increases, based on the size of the annual payroll. If the employer chooses not to pay the levy he or she will have a superannuation guarantee charge (SGC) imposed on their business operations by the Australian Taxation Office (ATO). By deciding to neglect their obligations under the Act the employer will not receive favourable taxation treatment in regard to contributions made by them on their employees' behalf.

At the present time the levy is currently at 8 per cent which will increase progressively to 9 per cent by 2002 (see Table 1). The threshold for paying this levy was based initially on the individual earning a minimum of \$450 per month.

In March 1996, the then Labor Federal Government lost office and was replaced by a conservative, Liberal Coalition Government under Prime Minister John Howard. It had been the intention of the Australian Labor Party, with trade union blessing, further to expand the compulsory nature of superannuation by gathering a 3 per cent contribution from individual workers and providing an additional 3 per cent to

certain workers who met predefined income criteria. In total, this would have meant that many workers' individual superannuation contribution accounts would have been receiving total contributions of 15 per cent. Treasury estimates suggest that over a 40-year period these contributions would translate out to be approximately 60 per cent of one's salary on retirement.

With regard to the taxation of superannuation, Australia has pursued a course which is unique and which on the whole the author cannot agree with in terms of design and the overall rate of taxation applied. Based on Andrew Dilnot's model developed at the Institute of Fiscal Studies in London, Australia's taxation of superannuation can be described as TTT. Taxation of contributions at a rate of 15 per cent, along with possible additional taxation of 15 per cent for members' contributions who earn over \$73,220. A further tax of 15 per cent is levied on the investment income of superannuation fund and, finally, the benefits can be subjected to varying tax treatment of between 0-30 per cent, and depending on timing and source of the contributions.

The profile of the second pillar of Australia's retirement system depicts both a diversity and adequacy of return that reflects strong and vigorous competition among the financial services industry in Australia. Through a trustee structure, superannuation funds are managed in the most efficient and effective manner for members. Life insurance companies and fund managers, like in the United States, play an active role in the management and investment of superannuation fund assets. Additionally, specialised administration companies have developed services that allow superannuation fund trustees to outsource much of their investment and administrative functions. This intense competition has led to in

part returns being maximised and administrative fees being minimised.

Varying measurements exist for evaluating the success of how Australia has contained administrative costs, compared with other international models. In a recent paper presented at the National Bureau of Economic Research Conference, on the administrative costs of individual accounts, Sylvester J. Schieber, Vice-President, Watson Wyatt Worldwide, and John B. Shoven, Charles R. Schwab, Professor of Economics, Stanford University, made the following conclusions about Australia's cost structure:

'The Association of Superannuation Funds of Australia estimates that the average administration costs of their system equal A\$4.40—ie, US\$2.85 per member per week.⁶ In US currency terms, administrative costs at this rate for a system that held average balances of \$1,000 would be nearly 15 percent of assets per year. For a system that held average balances of \$5,000, it would drop to 3 percent per year. For one that held average balances of \$10,000, administrative costs would be 1.5 per cent per year. By the time average account balances got to be \$30,000, administrative costs would be under 0.5 percent per year. This pattern is important because it reflects the pattern of accumulating balances in a retirement system like Australia's as it is being phased in, as Australia's is now.⁷

Further evidence of the relatively low cost structure associated with superannuation accounts in Australia is highlighted in Table 2, prepared by the Financial Section of the Australian Bureau of Statistics, on behalf of Watson Wyatt Worldwide.

A further effort to define the average administration costs for accumulation funds was published in the June Quarter 1998 of the APRA Bulletin. In analysing superannuation

Table 2: Administrative costs as a per cent of assets under management in Australian individual account superannuation funds during 1996 and 1997^a

Number of members in the plan	1996 (%)	1997 (%)
1 to 99	0.689	0.619
100 to 499	0.849	0.673
500 to 2,499	0.803	0.797
2,500 to 9,999	0.854	0.837
10,000 or more	0.922	0.846
Total	0.900	0.835

Source: Australian Bureau of Statistics, Belconnen, Australia Capital Territory, tabulations of a joint quarterly survey done by the Australian Bureau of Statistics and the Australian Prudential Regulation Authority (APRA).

Table 3: Overview of the Australian superannuation industry — April 2000

Type of fund	Total assets (\$billion)	Number of funds (June 1999)	Number of accts (million)	Manner of investment	\$billion
Corporate	73.6	3,051	1.39	Directly invested	123.4
Industry	32.9	92	6.18	Placed with investment managers	171.5
Public sector	102.3	50	2.68	Invested in life office statutory funds	143.8
Retail (including RSA's)	126.0	225	9.88	Total assets	438.7
Small funds*	59.0	191,723	0.39		
Balance of statutory funds	47.7				
Total	438.7	195,141	20.53		

*Small funds refers to superannuation funds with fewer than five members.

Source: APRA Bulletin issued April 2000.

fund administration, the regulatory authority indicated that average weekly administration charges were A\$1.35 per member or US\$0.86. It should be mentioned briefly that investment decisions and strategies are developed solely between the investment managers and associated trustees of each superannuation fund. The Australian Government plays no role in shaping directly or indirectly the investment decisions of the individual superannuation fund, but rather through regulation stresses the need for a sensible and sustainable investment strategy. Regulations refer to this approach as the prudent man test. Further, the April issue of the APRA Bulletin highlights that 40.2 per cent and 19.3 per cent of the total superannuation assets of A\$438.7bn or

US\$256.88 are invested in equities and units in trust and overseas assets respectively. Clearly this level is deemed appropriate by government, trustees and superannuation fund members alike. It should be noted that the government does not generally intervene except to outlaw borrowing and loans to members. A concise overview of the Australian superannuation industry, as at April 2000, is provided in Table 3.

Unlike some other international retirement models, the third pillar of Australia's retirement income system is characterised by individual retirement accounts being generated on a voluntary basis through the private annuity, retail funds management and life insurance markets. With regard to final benefits, Australia allows these to

be taken in the form of a lump sum or annuity. Past experience has seen a lump sum favoured by many retirees but, with changes in recent tax laws, annuity and allocated pension vehicles are increasing in popularity.

The paper will now turn briefly to the mechanics associated with selling, distribution and withdrawal of benefits from the superannuation account. One of the reasons why Australia has been so successful in keeping administrative costs low and also avoiding the problems associated with mis-selling is through effective and cost-efficient regulation. Strict rules govern how superannuation policies are sold and switched. Moreover, consumers are required to receive minimum levels of information about the superannuation products at the time of sale and also on a regular basis. Clearly it is felt that, as this is the largest financial transaction that a consumer will enter into in their life, effective disclosure should be provided to encourage transparency in the transaction. Increasingly, superannuation account holders are being provided with greater investment choices. Some retail funds for example offer between five and seven investment choices and proposed legislation by the Federal Government will force employers to offer choice of funds. Consequently, effective consumer protection strategies will provide an important deterrent for any forms mis-selling from occurring.

As already mentioned, effective consumer protection strategies are crucial in offsetting the transitional risks linked with nurturing a more fully funded retirement system. In a recently published chapter of the book 'Consumer Protection of Financial Services' (edited by Mr Peter Cartwright and published by Kluwer Law International), Sue Jones and the

author argued that public education was crucial for the success of any associated social security reforms. Australia's experience of public education campaigns associated with social security reform took place in 1994 and was delivered between 1995 and 1996 by Federal Government agencies. To build a better understanding and stress the value of superannuation, the Federal Government through the Australian Taxation Office, Department of Social Security and the Insurance & Superannuation Commission initiated a comprehensive public campaign. This campaign harnessed both electronic and print media to convey several main themes including the future benefits of superannuation for the nation and the individual, information on how the new mandated system functioned and how a regulatory body was active in safeguarding superannuation assets. The estimated cost of this campaign was approximately A\$11m in 1995 or the equivalent US\$159m on a per capita basis. When devising the elaborate and integral public education campaign, the Federal Government was committed to directing part of the campaign towards women and ethnic minorities.

The United Kingdom

Underlying the overall national retirement programme of the UK is the basic state pension. To receive the benefit you must be aged over 65 for men and 60 for women, with the benefit calculated on a flat-rate, contributory basis. As of April 1999, the first pillar has been worth £66.75 a week for a single pensioner, which equates to 15 per cent of average earnings. An additional dependant addition of £39.95 a week is also provided where one partner does not meet the necessary contribution

Table 4: Projected future state spending on pensions as a percentage of GDP

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
United Kingdom	4.5	4.5	5.2	5.1	5.5	4.0	4.1
United States	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: OECD, cited in Johnson (1999).

criteria. The second tier, compulsory for all employees above a certain floor, consists of the State Earnings-Related Pension Scheme and a largely vibrant and evolving private pension market.

In 1948 the Beveridge Report had developed a compulsory pension system which consisted only of the first tier. In effect, this was the basic state pension and means-tested National Assistance. Yet increasingly, pressure on the government to provide a more substantial second-tier approach for all workers developed, partly as a result of the strong growth in occupational schemes. Between 1953 and its peak in 1967, occupational pension coverage expanded from 28 to 53 per cent of employees. This coverage in recent years has declined, which partly can be attributed to an overall trend in changing employment patterns.

In 1975 the Social Security Act introduced the State Earnings Related Pensions Scheme (SERPS). Its design allowed occupational schemes to contract out of SERPS to avoid the scheme substituting for private sector provision. Effectively, the design of the second-tier pension was for those people not in occupational schemes.

During the initial period of this second-tier pension scheme benefits were comparatively generous with today's levels. SERPS guaranteed contributors to

the scheme an additional pension of 25 per cent of their earnings between lower and upper earnings limits. The scheme was compulsory. As indicated, employers and contributors could contract out of SERPS only into a salary-related occupational scheme if it offered benefits at least equal to those provided by SERPS.

Earnings in the best 20 years counted towards the pension at a rate of 1.25 per cent of earnings between lower and upper limits. These limits were revalued in line with average earnings. Once payments commenced, the additional pension was uprated annually in line with consumer prices. The cost of uprating the basic pension (first tier) and SERPS was met by the National Insurance Fund.

Pensions under SERPS matured in 20 years and, as a result of the 20 best earning years formula, were especially advantageous to some groups. Employees earning more than the Lower Earnings Limit (LEL) for National Insurance Contributions (NICs) £57 per week for 1994–95 pay Class 1 NICs earn entitlement to SERPS as well as the basic pension, unless they are contracted out. The Upper Earnings Limit (UEL) must by law lie between 6.5 and 7.5 times the basic state pension, and stood at £430 per week in 1994–95 — around 120 per cent of average male earnings.

In June 1985 the Conservative Government published a Green Paper, 'Reform of Social Security'. This document highlighted the implications of the basic state pension and SERPS over the following 50 years. The concerns raised by this paper in regard to these two forms of pensions provisions can be summarised by Budd and Campbell:

'The Green Paper pointed out that the increased cost of the basic pension would benefit all pensioners equally. However, the case was different for recipients of SERPS. Its earnings-related nature meant that the newly retired would benefit more than older pensioners. Also half the extra cost would result from payments to members of contracted-out schemes (to provide indexation top-up to the Guaranteed Minimum Pension). The cost of SERPS (in 1985 prices) was expected to be about £24 billion in 2035, compared with a basic pension cost in 1985 of about £15 billion.'

A significant change to SERPS took place in the second half of the 1980s when the Social Security Act 1986 provided that from 1999 onwards, SERPS additions to the basic state pension would be calculated not on the basis of the best 20 years rule, but instead on lifetime average earnings. Now SERPS would provide 20 per cent of average earnings over the whole working life of the individual. The current cost of SERPS is only around £2bn per annum, due to relatively few retired people having significant entitlements. By 2030 in contrast, these entitlements will have grown to its maturity point.

In summary SERPS payments in the future will progressively diminish as a percentage of a person's final retirement income through changes in the 1980s which saw these payments linked to prices rather than earnings.

The UEL has fallen from 140 per cent

of average earnings to 120 per cent and will continue to fall. With price indexation, and 2 per cent real earnings growth per annum, the UEL will be less than 60 per cent of average male earnings by 2030, implying a maximum SERPS pension of only 10 per cent of average male earnings.

Contracting out of SERPS

As indicated previously, when SERPS was introduced members and employers of occupational schemes had the ability to generate a contracting-out rebate if the scheme agreed to provide a guaranteed minimum pension, related to individual average lifetime earnings. This rebate was initially set at 7 per cent of earnings (between LEL and UEL for National Insurance contributions). The current rate, applying from 1993–94 onwards, is 4.8 per cent.

In 1988, the contracting-out option was extended to a further range of products, principally personal pension products. The reason for this decision is subject to some conjecture. Some elements say it had an ideological basis spawned by the then Prime Minister, Margaret Thatcher, who felt that Government should not be involved in pensions provisions for the second tier. More likely was that advice provided by the Treasury and Government Actuary's Department indicated that through the effects of an ageing population, the United Kingdom's economy would be crippled by overly generous welfare payments. The condition for leaving SERPS is not that a guaranteed minimum pension should be paid, but that a guaranteed minimum contribution should be made. This minimum level is the contracted-out rebate. Levels of rebate offered to people newly contracted out into personal pensions (or group-defined contribution schemes) was set above the

rebate for those in occupational pensions. Initially, an extra 2 per cent 'incentive' rebate was offered with the aim of 'kick-starting' the personal pensions sector. In 1993–94, this declined to an incentive rebate of 1 per cent restricted to the over-30s. The rationale for this policy was that a large number have already taken out personal pensions, and so a kick-start is no longer required.

Through allowing people to contract out of their SERPS entitlements and transfer from occupational schemes personal pensions in 1988 received a significant boost in sales growth and long-term product development. The popularity of these products was quickly established and thus by 1992 23 per cent of male and 19 per cent of female employees had contracted out and were in personal pensions.

Concern in Treasury and other areas government was that these new retirement vehicles were being used only to receive the rebate, provided through transferring out of SERPS. In 1991, 24 per cent of employees had contracted out into personal pensions yet about three-fifths of these personal pensions had been established simply to receive the associated rebate and incentives provided by the Government. Such a situation led or induced the mis-selling of pensions, which has continued to erode a recovery in the public confidence, within the industry.

Overall personal pensions today are 'manufactured' by a number of providers. These companies are mainly life insurance companies, although building societies, unit trusts and other financial organisations are permitted to administer pensions (at least up to retirement). Restrictions on investments are relatively few and it is important to note that even supermarkets in the UK are offering such financial services products on an execution basis.

In general, the deposits from personal pension funds must be used to purchase annuity. Recent legislative amendments have increased the individual's freedom of choice between annuity suppliers. The Government has ensured that the same tax privileges extend to personal pensions, as which exist for occupational schemes.

A concise summary or assessment of personal pensions and the future role that they are likely to play in the British market is provided by Mr C. D. Daykin, the United Kingdom's Government Actuary, in his report to the European Commission.

'Personal pensions at the minimum level for contracting-out are unlikely to provide a very inadequate income in retirement. A major challenge for education (and marketing) is, therefore, to persuade people that they must make additional voluntary contributions and that the responsibility for ensuring an adequate retirement is theirs. The State will not provide more than the basic flat-rate pension. Of course, there will still be the possibility of means-tested income support, but the whole thrust of encouraging private provision for pensions is to lessen the dependence on State Benefits.

'Views differ as to the likely success of these objectives. Trade unions and staff associations in general remain very suspicious of personal pensions, which they see as putting too much of the risk (particularly of investment performance relative to inflation) on the individual and too much money (commission, profit, etc) into the hands of financial intermediaries, insurance companies and other financial institutions. The preferred option of organized labour is the final salary occupational pension scheme, if possible with full price indexation of pensions, both in payment and in deferment.'¹⁰

Chile

Chile was the first South American country to move towards adopting a

mandatory, funded, privately managed defined contribution retirement system in 1981. In 1980, Chile passed Decree Law 3500 and 3501, which partially replaced the state-run pay-as-you-go (PAYG), unfunded social security system. This system had functioned in Chile since 1924 and by the mid-1970s symptoms of its long-term weakness in providing benefits for recipients was increasingly becoming pronounced.

In effect, the reforms meant that from 1st May, 1981, new workers were eliminated from having the option of becoming a member of the complex unfunded national defined benefit scheme, or in this paper referred to as the first pillar. Workers were also given the option up to 1985 of remaining with the old system or joining the new scheme. By 1985, 98 per cent of workers had already joined the new scheme. Like any PAYG system, the first pillar failed to establish a strict linkage between the amount of benefits and contributions to the system. This flaw can often lead to irresponsibility and unaccountability, a trend complicated by the fact that the impact of inappropriate economic decisions will be passed on to other generations.

Chile quite obviously displayed these characteristics with a progressive decline in the numbers of workers matched against existing retirees:

'To illustrate the long-term effects of this trend, let us examine the active workers/retirees ratio of the old system. While the system's ratio was 8.6 in 1960, it declined sharply to 2.5 in 1979. At first glance, the drop could be attributable to the aging of the population. However, in 1960, the number of people over 60 years of age was 15.6% of those between the ages of 20 and 60; in 1980 the ratio was 16.7 percent, indicating that there were no significant changes in the average age of the population. This data shows that the old

system was structured to provide benefits that surpassed its ability to pay.'¹¹

To assist workers in making contributions to the new defined contribution accounts, the dictatorship mandated that employers raise wages by 18 per cent for existing workers and new labour force entrants. Clearly, the advantage of introducing such reforms under a military dictatorship was highlighted in this aspect or transition of the Chilean social security system. Today the first pillar of the Chilean social security system can be described as a minimum benefit funded from consolidated revenues. Such a benefit guarantees retirement benefits worth the higher of 75 per cent of poverty or 25 per cent of a worker's average pay over the ten years prior to retirement. This benefit will be generated only 'if his or her defined contribution account is too small to generate equivalent income (ie, to provide annual benefits greater than 75 per cent of poverty or 25 per cent of the worker's average pay). In such cases, the worker's defined contribution account is taxed 100 per cent to help pay for the first-tier benefit. In other words, no Chilean receives payouts from both of the system's tiers. If workers do not accumulate enough in their defined contribution accounts, they must forfeit their balance and receive the minimum benefit.'¹²

As a basic safety net the State provides a minimum pension to employees only when the second pillar is unable to generate a sufficient pension, in retirement for the employee. A minimum will occur where their pension produces a monthly income which is less than Ch\$51,014. Employees are required to have at least 20 years' coverage to be eligible for the minimum pension. This minimum pension is not indexed, but

adjusted by the government from time to time.

Under the system all benefits are provided through the AFP (pension fund administration companies). These are privately owned and managed companies who are regulated by the Superintendency of Pensions and are required to meet a variety of solvency and consumer protection issues. Although some pressure is mounting to lift the current retirement age in Chile, the existing level remains at 65 for men and 60 for women. Due to its defined contribution characteristics, the new system relies on the merits of the AFP generating a sufficient rate of return on its investments. The assessment of the likely benefits to be provided by the annuity that is purchased from a life insurance company, via accrued contributions, was estimated by the Instituto Libertad y Desarrollo:

'Actuarial calculations indicated that retirement for men at age 65 and for women at age 60, with a pension of approximately 75% of their last active year's income, required a system that could deliver an average annual rate of return of 4 percent. This seemed perfectly compatible with the potential of Chile's economy.'¹³

All covered or 'dependent' workers must lodge 10 per cent of their monthly earnings in a savings account with an approved, high-regulated intermediary called the AFP. Each AFP manages a single fund, with the complete return on the fund being allocated to the individual accounts. An additional function of the AFP is also to provide survivors and disability insurance, according to rules prescribed by the government. Once the worker becomes eligible to receive pension benefits he or she has one of two options. They can choose a sequence of phased withdrawals provided

by the AFP or purchase a real annuity. This latter option will require the affiliate to purchase the annuity from a life insurance company.

With Chile's long history of using indexed debt during periods of high inflation, this has allowed the regulator to restrict quite easily the annuity option to indexed annuities. Unlike other privatised models such as that in the United Kingdom and Australia, it is very rare to find any employer-sponsored pension plans. With strong competition among multi-nationals to retain good-quality staff, some are evaluating the possibilities for developing supplementary retirement benefits.

The major drawbacks associated with the Chilean model are the overall costs associated with administration, distribution and regulatory restrictions. In response to these concerns the regulators tightened the transfer rules, requiring account holders to produce ID cards and the most recent statement of their account. The net effect has been that transfers have dropped dramatically. In five years they have decreased from 220,000 a month to 22,000 with the sales force being consequently halved.

For example, the administrators face extensive restrictions on investments. They must guarantee a return within a certain band of the average return of the industry, if needed, through their personal resources. The administrators can offer only one fund, the affiliate can invest with only one AFP. Existing banks, mutual funds, or insurance companies cannot manage mandated savings. Also transfer between different pension funds is restricted based on minimum stay periods and transfer fees. The fund administrators can charge fees as a percentage of salary (which is typical) and of the assets managed, as well as flat transaction fees for deposit, withdrawal, account statements.

Table 5: Chilean pensions fund system — major historical statistics, 1981–1996

	Total assets (MM US\$)	Annual return	Number of affiliates	Number of contributors
1981	291.82	12.7	1,400,000	N/A
1982	919.50	26.5	1,440,000	1,060,000
1983	1,670.24	22.7	1,620,000	1,230,000
1984	2,177.54	2.9	1,930,353	1,360,000
1985	3,042.00	13.4	2,283,830	1,558,194
1986	3,986.09	12.0	2,591,484	1,774,057
1987	4,883.07	6.4	2,890,680	2,023,739
1988	5,954.12	4.8	3,183,002	2,167,568
1989	7,358.64	6.7	3,470,845	2,267,622
1990	9,758.30	17.7	3,739,542	2,642,757
1991	13,810.67	28.6	4,109,184	2,486,813
1992	15,399.57	4.0	4,434,795	2,695,580
1993	19,788.07	16.7	4,708,840	2,792,118
1994	23,925.72	17.8	5,014,444	2,879,637
1995	25,433.17	(2.5)	5,320,913	2,961,928
1996	27,523.17	3.5	5,571,482	3,121,139

Source: Superintendency of Private Pension Fund Administrators.

The major historical statistics of the system are noted in Table 5.

On the issue of market efficiency and competition a similar argument can be mounted that seemingly excessive or ineffective regulation puts an undue cost on AFPs and the market for private annuities. Associated regulations, which relate to the requirements for capital to enter the system, investment limitations, annual return requirements, and management fee limitations place an indirect cost on the associated affiliate and impact on associated competition among industry affiliates.

‘The new system imposes minimum and maximum restrictions over the funds’ rate of return on pension investments, such that no AFP is permitted to earn 2% more or less than the all AFP average. In addition, AFP commissions are subject to regulatory restrictions, including the requirement that commissions be levied only on new contributions (and not on assets or returns). New entrants to the AFP fund group are permitted, with minimum capital requirements for reserves set at approximately US\$120,000–\$480,000 (in 1991\$). Finally, the Chilean government

tightly limits AFP investments by specific asset class: the maximum allowable domestic (Chilean) equity holding was 30% of the fund’s portfolio, while the foreign equities cap was 10% (later lifted to 20%), and government bonds can constitute no more than 45% of the AFP portfolio.’¹⁴

It should be noted that Chile has made great strides in addressing some of the problems highlighted in respect of system design and regulation. More in-tune regulation concerning distribution has contained both marketing and administrative costs. Additionally, modifications to the overall retirement system have seen it more attractive for AFPs to hold overseas assets. Yet today the number of AFPs, through mergers, has declined to around eight participants. The challenge for the Chilean system will remain in generating high returns for AFP members and containing significant compliance, regulatory and administrative costs in the long term.

Conclusions

For the USA, one particular international model cannot be used as a template for

social security reform. Yet clearly the experiences of Australia, Chile and the United Kingdom lend weight to the argument that social security reform, through the use of individual retirement accounts, can be successful, based on returns generated on individual retirement accounts but moreover through the harnessing of the individual rather than the state, in providing for one's standard of living in retirement.

Today and also in the future individuals in Australia, Chile and the United Kingdom will be exposed less and less to the vagaries of political risk associated with their long-term retirement 'nest egg'. Through providing the necessary infrastructure, all three countries are benefiting from empowering their citizens to be proactive with regard to their retirement savings and also minimising the long-term liabilities linked with the retirement of the baby boomer generation in the next century.

References

- 1 Ryan, Susan (1997) 'Quality of Life as It Relates to Australia's Aging Population or Living to 100 in a Civilized Society', Association of Superannuation Funds of Australia, Speech.
- 2 Senate Select Committee on Superannuation: 'Safeguarding Super', June 1992, p. 7, Canberra, Australia.
- 3 Employers can satisfy their award/SG obligations to make contributions for employees in company funds — even defined benefit funds (the actuary certifies equivalence with 1 per cent of salary required to be contributed). Many employers using these company funds have 'absorbed' the rising SG rates. As the SG has risen, so has the vesting rate lifted in funds that had poor vesting. This is important for acceptance and implementation of the national scheme.
- 4 Senate Select Committee on Superannuation (1992) 'Safeguarding Super', June, p. 13, Canberra, Australia.
- 5 The Hon. John Dawkins, MP, Treasurer (1992) 'Security in Retirement, Planning for Tomorrow Today', 30th June, pp. 1–2, Canberra, Australia.
- 6 In 1999 the Association of Superannuation Funds of Australia (ASFA) estimated figure was \$1.64 on average.
- 7 Schieber, S. J. and Shoven, J. B. (1998) 'Administering a Cost-Effective National Program of Personal Security Accounts' (Draft), NBER, Cambridge, MA, December 4th, p. 16.
- 8 Ibid, p. 17.
- 9 Budd, A. and Campbell, N. (1996) 'The roles of the Public and Private Sectors in the UK Pension System', HMSO, London, United Kingdom, p. 7.
- 10 Daykin, C. D. (1994) 'Pension Provision in Britain — Report on Supplementary Pension Provision in the United Kingdom', HMSO, London, United Kingdom.
- 11 Larrain, L. A. (1993) 'A Bold Step in Chile's Reforms: Privatization of the Pension System', Instituto Libertad y Desarrollo, Center for International Private Enterprise, Santiago, Chile, p. 2.
- 12 EBRI Notes (1997) 'Chilean Social Security Reform as a Prototype for Other Nations', EBRI, Vol. 18, Number 8, August, Washington, United States, p. 2.
- 13 Larrain, L. A. (1993) 'A Bold Step in Chile's Reforms: Privatization of the Pension System', Instituto Libertad y Desarrollo, Center for International Private Enterprise, Santiago, Chile, p. 6.
- 14 Mitchell, O. S. and Barreto, F. A. (1997) 'After Chile, What? Second-Round Pension Reforms in Latin America', NBER, Cambridge, United States, pp. 4–5.

The views in this paper are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.