

Social Security in the United States and Chile

The United States is once again debating the future of the Social Security system, and several reform options have been advanced. Experiences in Chile over the last two decades provide insights for the U.S. debate.

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Social Security systems, world wide, are in financial trouble.¹ This stark reality has many causes, including increased life expectancy—meaning that retirees are collecting benefits for longer periods—and decreased fertility rates—meaning fewer workers are paying into the system compared to those receiving benefits.² In the United States, the ratio of employees to Social Security recipients was 42 to 1 in 1945. Today it is less than 4 to 1 and is projected to drop to 2 to 1 or less by the mid-21st century.³ Chile faced a similar fate in the late 1970s and chose a radical approach to reforming the system. This article discusses the Social Security dilemma in the United States and explores options for alleviating its problems. It also discusses the Chilean system and the relationship between Social Security programs and other sources of retirement income.

The Social Security debate

The current debate about the U.S. Social Security system comes at an un-

usual time in our Nation's history. After 30 years of Federal budget deficits, policy makers have recently been faced with the possibility of a budget surplus. According to the U.S. Office of Management and Budget, for the fiscal year ending September 30, 1998, the U.S. government will have its first surplus since 1969.⁴ This surplus, and projected future surpluses, results from a number of factors, including low inflation and interest rates, sustained growth, higher than expected tax revenues (due in part to low unemployment and stock market increases), and changes in national spending and tax priorities.⁵ Therefore, policy makers face a challenge they have not faced for many years: Deciding how to use these anticipated surpluses. While many spending increase and tax cut proposals have been offered, a great deal of attention has been given to use at least part of any fiscal surplus to strengthen the financial structure of Social Security.

Policy makers and others have offered many proposals to solve the So-

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cial Security dilemma, but three basic choices have been given the most attention. These choices, described in a 1997 Social Security Task Force report, range from traditional ideas such as revising tax and benefit schedules to more radical notions that would overhaul the basic doctrine of the system. One of the more radical proposals is to move away from social insurance (where a benefit is guaranteed for life) and toward a system of individual accounts (where contributions are placed in accounts specifically for an individual and benefits are drawn from those accounts), similar to what was done in Chile in 1981.

Social Security in the United States—1930s-70s

The U.S. Social Security system has been debated since its inception in the 1930s. The system was designed as income protection for older Americans.⁷ With the retirement age set at 65 and average life expectancy below 70, benefits were generally paid for a short period of time. The initial tax rate was 2 percent of earnings up to \$3,000 (1 percent paid by both the employer and employee). Through the 1950s and 1960s, debate centered on expanding benefits to include early retirement, disability, and a system of health care for older Americans—medicare. (Medicare is funded separately from Social Security and, while policy makers are also discussing its future, it is not a part of this discussion.) The era of expanded benefits ended in the 1970s, when the debate turned to the increased demands on the system by the expanded benefits and the accruing liabilities for the “baby boom” generation. This population group born from the late 1940s through the early 1960s will strain the system in the early years of the 21st century.⁸

Changes in the system—1980s-present

The concern for the financial health of the Social Security system was ad-

ressed in 1983, when reform recommendations from a bipartisan panel were enacted. The 1983 changes included: An acceleration in the timing of scheduled increases in taxes that support the system, limits on cost-of-living adjustments to beneficiaries, an increase in the retirement age for future recipients, and a tax on the benefits of wealthier beneficiaries. In addition, new employees working for the Federal Government were generally required to join the system, and currently covered State and local governments could no longer opt out of the system. These reforms were designed to spread the burden between retirees and working Americans. Although these reforms were intended to provide long-term financial solvency for Social Security, 15 years later there are new financial concerns.⁹

Each year, the Social Security Administration issues a report on the financial status of the system. According to the 1998 report, current projections have benefit payments exceeding revenues by 2013. At that time, the system will have to begin paying benefits out of trust fund interest and assets. By 2032, the assets will be depleted. The system will have to pay benefits out of current Social Security tax revenues, which would only provide enough funds to pay benefits at about three-fourths of the current levels.¹⁰

Three reform options

The Social Security Act states that an advisory council must be convened periodically to review various aspects of the Social Security system. The most recent council, which concentrated on long-term financial issues and submitted its report in 1997, identified financial concerns and offered three options for reform. One option mirrors the traditional approach taken in 1983—tax increases and benefit adjustments would distribute the burden to a wide range of Americans. The other two approaches are variations on the concept of moving away from a system of social insurance toward a

system of individual accounts.¹¹ These options are described below.¹²

Maintenance-of-benefit. Of the three options recommended by the Social Security Advisory Council, the maintenance-of-benefit option is the one that makes the fewest changes to the current system. Much like the 1983 reforms, this option keeps the Social Security tax and benefit structure intact. The main feature of this plan is to change the way benefits are taxed. In the beginning, Social Security benefit payments were not subject to income tax. This changed in 1983, when income taxes were imposed on benefits for higher income recipients.

Today, most retirement income benefits (excluding Social Security) are taxed in the same way as other sources of income, that is, all income in excess of already taxed contributions is subject to taxation.¹³ (This is the same principle as the taxation of a capital asset upon its sale, where all income in excess of the cost of the asset is taxable.) The maintenance-of-benefit option for reforming Social Security would apply this tax principle to Social Security benefits. This is a change from current procedures, whereby only recipients above a certain income level are taxed on their benefit. Another change advocated by the supporters of this option is to place all revenues from income taxes on Social Security benefits into the Social Security trust funds. Currently, some of this tax revenue is used to fund Medicare.

The maintenance-of-benefit option also includes the expansion of Social Security coverage to all new State and local government employees. According to the Bureau of Labor Statistics, about three-fourths of State and local government employees with employer sponsored retirement income coverage are also covered by Social Security.¹⁴ Other changes include slight adjustments to the benefit calculation formulas and a small increase in payroll taxes, but not until the 2040s.

Finally, this option supports a plan to study the investment of a portion of

Social Security assets in stocks of private companies, indexed to the broader stock market. Historically, all Social Security assets have been invested in government bonds. The Advisory Council acknowledged the higher long-run rate of return of stocks over government bonds, but also acknowledged the potential risk.

Individual account. This option combines a variety of traditional reform measures (such as increasing the age at which retirees are eligible for benefits) with the establishment of an individual account that would form a portion of an individual's retirement income. Proponents of individual accounts frequently cite the low savings rate among Americans and consider individual accounts as one way of increasing personal retirement savings.¹⁵ Under this option, workers would make a mandatory contribution of 1.6 percent of their Social Security covered earnings to their individual account.¹⁶

Accumulated funds in the individual account would be converted to an annuity at the defined Social Security retirement age. The annuity would include a minimum guaranteed payment, assuring that a minimum benefit would be paid even if a recipient died soon after retirement. The Advisory Council offered two alternatives for the taxation of benefits—either make contributions tax-deferred until withdrawn or taxable when deposited and not when withdrawn.¹⁷

This individual account is essentially separate from the existing Social Security system, and does not solve existing financial problems. Therefore, proponents of the individual account option would increase the age of eligibility for retirement benefits,¹⁸ reduce benefits gradually for middle- and high-wage workers, and vary the formulas used to compute spouse and survivor benefits.

Other changes are the same as those found in the maintenance-of-benefits option, including the changes for taxing and computing Social Security benefits and the coverage of all newly

hired State and local government employees.

Personal security account. The third option expands upon the notion of individual accounts. In this case, employer contributions and a small portion of employee contributions would be used to fund Social Security benefits. The Social Security benefits funded from these contributions would be the first tier of the system, providing minimum benefits. This minimum would be set at \$410 per month (indexed to wage growth).

Employee contributions equal to 5 percent of covered earnings would be deposited into a mandatory "personal security account" for each individual; proceeds from this account would supplement the first tier of this system (the Social Security benefit). Personal security accounts would be individually owned and managed, with a choice of investment options. Employee contributions would be made with after-tax funds, but all benefits received during retirement, including those resulting from account earnings, would not be subject to income tax.

Other changes include: An accelerated increase in the retirement age, changes to dependent and survivor benefit formulas, and the inclusion of all new State and local government employees.

One concern about moving toward a system of accounts, especially in this case where about half of all contributions would be diverted away from traditional Social Security payments, is the cost of moving to such a system. The current pay-as-you-go system requires current contribution revenue to pay for current beneficiaries. Those advocating the personal security accounts describe a system that is phased in over many years. Individuals under age 25 would be completely covered by the new system. Those between the ages of 25 and 54 would receive benefits based on their accrued work experience under the old system; for future years of service they would receive benefits under the new system and be required to invest in their per-

sonal security account. However, those age 55 and over when the new system begins would remain under the old system. A combination of increased taxes (other than the payroll tax) and Federal borrowing would help fund the costs associated with the transition.

The Chilean experience

Chile's social security system dates to the 1920s, when it was created as part of a series of labor reforms. Eventually over 150 separate systems existed. By the early 1970s, these systems covered more than 75 percent of the nation's workers and included, for certain occupations, such add-on benefits as health care and low-interest home purchase loans.¹⁹

Financial concerns and the lack of coordination among the systems led to reform efforts in the late 1970s. Options such as raising the retirement age or increasing taxes were considered but rejected. Instead, Chile chose to move toward a system of individual accounts. Under the leadership of Secretary of the Labor and Social Security, Jose Pinera, privately run pension companies and pension savings accounts (PSAs) were created.

The PSA system in Chile

This new system of individual accounts is intended to provide near universal coverage to the Chilean work force. All new workers are required to participate. They must contribute at least 10 percent of the first \$22,000 of annual wages, but they may make additional contributions. Funds are deposited into individual employee accounts and are tax-deferred.

About 20 competitive private companies, known as AFPs (Administradoras de Fondos de Pensiones, or pension fund administrators), manage the system. Each AFP operates like a mutual fund, investing in a variety of stocks, bonds, and other securities. Employees choose their AFP based on their investment objectives and are allowed to change their AFP. These fund administrators are regulated by the government and must abide by

TABLE 1. Percent of full-time employees participating in defined benefit pension plans who are required to contribute toward plan costs, United States, selected years, 1979-96

Selected years	Private establishments		State and local governments
	Medium and large	Small	
1979	11	-	-
1982	7	-	-
1985	10	-	-
1987	-	-	78
1988	6	-	-
1990	-	5	75
1991	5	-	-
1992	-	3	72
1994	-	-	72
1995	3	-	-
1996	-	3	-

NOTE: Medium and large private establishments are those with 100 or more employees. Small private establishments have fewer than 100 workers. Dash indicates no data for this category.

certain investment rules that emphasize diversification and reduced risk.

The “legal retirement age” under the PSA system is 65 for men and 60 for women. Employees have two payout choices at retirement: Purchase an annuity or set up a system of periodic withdrawals from the account. All benefits drawn at retirement are considered taxable income, although recipients do benefit from the lower tax rates applied to older individuals.

The PSA system is designed to provide a benefit equal to 70 percent of the employee’s final salary. This is based on a 10-percent savings rate and a 4-percent rate of return over a typical worklife. Workers who have made contributions for at least 20 years but whose fund is not sufficient to provide the 70 percent targeted benefit receive a benefit from the state once their account is depleted. Welfare-type pensions, at a lower rate, are available to those without 20 years of contributions. Accounts that exceed the targeted benefit threshold can be used to retire early, purchase additional benefits, provide spouse or survivor protection or both, or provide a lump sum to the retiree in addition to periodic pension payments.

When the PSA system began, those receiving pensions were not affected. Those already in the workforce were given the option of staying in the existing social insurance system (with the requirement to pay both the em-

ployee and employer contribution) or joining the new system. Individuals who chose the new system received a “recognition bond,” which acknowledged their contribution to the old system. This bond could be redeemed for a lump-sum benefit at retirement. Because no new contributions were coming into the government, the cost of these bonds, plus the cost of social insurance annuities for those who remained in the old system, was borne by the government.

As of 1995, the Chilean system is paying old-age pensions that are 40 to 50 percent higher than those paid under the old system. Resources administered by the private pension funds amounted to \$25 billion, or around 40 percent of gross national product. The PSA system is credited with bringing about lower unemployment, higher savings rates, and increased economic growth. The PSA is usually the main asset of a Chilean worker.

There are concerns about the Chilean system, however. For example, there are reports of workers (those in the workforce before the new system began) being threatened by job loss by their employers unless they participate in the new system. In addition, not all Chileans under the new system have regular contributions made to their PSAs, because they cannot find work or because their employer does not deposit their contribution. Changes in oversight rules have been

enacted to attempt to eliminate these problems.²⁰

Social security reform efforts are not limited to Chile. Following the Chilean model, several South American countries moved toward systems of personal retirement accounts. In addition, Great Britain and Australia have also moved in that direction. For example, Great Britain moved to a two-tiered social security system: A flat-rate benefit, plus an earnings-related benefit. This system allows workers to invest a portion of their payroll taxes in private investments. The system gives workers the opportunity to own their retirement account, but also maintains a minimum safety net.²¹

Shifts in other retirement income plans

Changes in Social Security, toward plans that emphasize individual accounts, mirror changes taking place in employer-provided retirement plans. In many ways, the development of Social Security and employer-provided retirement plans in the United States have paralleled each other, and employer plans are often designed with Social Security in mind.²² Therefore, if there are changes in the Social Security system, it is possible that changes in employer plans will follow.

Traditionally, employer retirement plans have provided a guaranteed benefit for the retiree’s life, much like a traditional Social Security benefit. The risk associated with these plans, known as defined benefit plans, is borne entirely by the employer. In much the same way as Social Security, there is a guarantee of a benefit without regard to the employee’s contribution.²³ In fact, most of these plans are funded entirely by employers. Table 1 provides information on the percent of employees participating in a defined benefit pension plan that requires them to contribute toward the plan costs.

In 1980, about 6 out of 7 full-time workers in larger establishments were covered by an employer-provided retirement plan, nearly always a defined benefit plan.²⁴ A shift away from

TABLE 2. Percent of full-time employees participating in defined benefit pension plans with Social Security integration provisions, United States, selected years, 1980-96

Selected years	Private establishments		State and local governments
	Medium and large	Small	
1980	45	-	-
1982	45	-	-
1985	61	-	-
1987	-	-	18
1988	62	-	-
1990	-	49	8
1991	54	-	-
1992	-	46	10
1994	-	-	4
1995	51	-	-
1996	-	44	-

NOTE: Medium and larger private establishments are those with 100 or more employees. Small private establishments have fewer than 100 employees. Dash indicates no data for this category.

these traditional plans began in the early 1980s and continues today, as defined benefit plans have become less prevalent and, in their place, defined contribution plans have emerged. Similar to the individual account alternative mentioned in the Social Security debate, defined contribution plans emphasize individual savings, decision-making, and responsibility. The typical plan in the late 1990s gives the employee the option to contribute on a pre-tax basis, with some of those contributions matched by the employer. Employees may choose to invest funds in a variety of vehicles. Distributions at retirement are frequently in the form of a lump sum, although alternatives may be available. In cases where contributions were on a tax-deferred basis, all distributions from the plan are taxable.

The move away from defined benefit plans

This shift from defined benefit to defined contribution plans has been discussed extensively. Causes for this shift include: Changes in tax laws, strong financial markets, shifts in employment away from traditional manufacturing and goods-producing industries toward more service-oriented industries, and an increased awareness among workers of their retirement income needs.²⁵

While defined benefit plans have not been eliminated entirely, features found in some newer plans reflect the movement toward individual accounts. For example, the typical defined benefit pension plan has a formula for computing retirement benefits based on length of service and salary. There is no individual account and it is difficult for employees to place a "value" on their benefit while they are working.²⁶ A new defined pension plan known as a "cash account pension plan," uses a formula that allows employees to determine the current value of their plans at any time. Each year, an employee's account is "credited" with a percent of his or her earnings plus a fixed rate of return.

For example, an employee earning \$30,000 per year in a plan that credits 3 percent of earnings would see a credit of \$900 in his or her account. Each year, earnings on that \$900 would also be credited to the account. At retirement, the benefit received would be the annuity purchased from the cash value of the account. While these plans appear to resemble defined contribution plans, they are actually funded like other defined benefit plans. The employer is required to deposit sufficient funds to pay the expected future benefits. If investments do well, the employer may not have to make a contribution in a given year.

Another recent shift in defined benefit plans has been the movement away from integration of these plans with Social Security. As mentioned earlier, defined benefit plans often work in tandem with a retiree's Social Security pension. Integration features are intended to eliminate the employer's obligation to pay for both Social Security and pension benefits at lower income levels.²⁷ This is done by reducing the employees' pension benefits for that portion of their earnings that are subject to Social Security taxes. Changes in tax law and the move toward defined contribution plans have lessened the overall incidence of integrated plans in recent years.²⁸ (See table 2 for the percent of employees participating in integrated pension plans.)

Shifts in Social Security could further change the complexion of integrated employer retirement plans. For example, if Social Security contributions are diverted to individual accounts, and basic Social Security benefits are proportionately reduced, the amount offset from an employer pension plan due to Social Security may likewise be reduced. Alternatively, if Social Security contributions are increased or if the retirement age is increased, meaning employers will have to pay greater contributions for longer periods, there may be a move toward greater Social Security offsets from employer pension plans. At this time, it is impossible to speculate just how changes in Social Security will effect employer pensions.

The future of Social Security

The move toward individual accounts and increased responsibility for one's own retirement income has changed the face of employer pensions over the last 2 decades. While it is not yet known in what direction changes in Social Security will go, the knowledge gained from existing systems here and elsewhere in the world will be important to policy makers as they debate the future of Social Security. ■

¹ For a detailed discussion of financial problems among Social Security programs, see Zvi Bodie, Olivia S. Mitchell, and John A. Turner, *Securing Employer-Based Pensions: An International Perspective*, Philadelphia: The Pension Research Council, 1996.

² For example, life expectancy in the United States has risen from 68.2 years in 1950 to slightly over 75 years in the early 1990s. For more information, see U.S. Department of Health and Human Services, Public Health Service, *Health United States*, 1994. Fertility rates, the average number of children born to American women, declined steadily through the first half of the 20th century. This trend was reversed during the “baby boom” period (roughly 1946 through 1964) when fertility rates reached 3.7 children per woman. Since that time, fertility rates have once again dropped, to a current rate of 1.98 children per woman—below the “replacement rate” of 2.1 children per woman needed to keep one generation as large as the previous. For a thorough discussion of fertility rates, see Ben Wattenberg, “The Grandchild Gap,” *Think Tank*, Public Broadcasting Service, 1997.

³ Social Security Administration, *1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, 1996.

⁴ See John F. Harris, “Higher Surplus Data Renew Budget Spat,” *The Washington Post*, May 27, 1998, p. A4.

⁵ For a detailed discussion of the Federal budget, see “The Economic and Budget Outlook: Fiscal Years 1999-2008,” Congressional Budget Office, January 1998.

⁶ “State of the Union Address by the President,” White House Press Release, January 27, 1998.

⁷ More information on the history of Social Security is available in Robert J. Myers, *Social Security*, Homewood, Illinois: McCahan Foundation, 1985.

⁸ There are currently about 33 million Americans age 65 and older, 12.7 percent of the population. That population cohort is projected to increase to 53 million, or 16.5 percent of the population, in 2020, when those born in 1955 reach age 65. For more information, see U.S. Department of Commerce, Bureau of the Census, *Current Population Reports*, 1996.

⁹ Details of the 1983 Social Security reforms may be found in Myers, *Social Security*.

¹⁰ “Social Security Board of Trustees Announce Social Security Solvent Until 2032,” News Release, Social Security Administration, April 28, 1998.

¹¹ Information on the options for Social Security reform is from *Social Security Administration Advisory Council: Findings, Recommendations and Statements*, Social Security Admin-

istration, January 1997.

¹² Other options have been proposed as well. For example, Senator Daniel P. Moynihan of New York offered an approach that would reduce both the employer and employee payroll tax and allow, but not require, workers to invest those reduced taxes in a tax-deferred account. To offset the reduced tax revenue, the Moynihan plan would reduce cost-of-living increases, raise the retirement age, and tax all benefits once an employee re-coups payroll taxes paid. This final provision would make the taxation of Social Security benefits similar to that of other forms of retirement income, that is, all monies received beyond the amount of contributions paid by the recipient would be taxable. See James K. Glassman, “Moynihan’s Social Security Plan,” *The Washington Post*, March 24, 1998, p. A19. For a slightly different approach, see Albert B. Crenshaw, “Panel Proposes Fixes for Social Security System,” *The Washington Post*, May 20, 1998, p. A9.

¹³ While there are several variations on the tax treatment of employer retirement plans, the basic concept is that any income that has not already been taxed is subject to income taxes when received. Thus, if an employee contributes \$20,000 to an employer retirement plan over his or her work life, and those contributions were subject to income taxes when they were earned, only retirement benefits above \$20,000 would be subject to taxation. In some plans, employee contributions are considered “pre-tax” and are not subject to income taxes when the contributions are made. In such a case, all retirement income, whether attributable to employee or employer funds, is subject to income taxes when received.

¹⁴ See *Employee Benefits in State and Local Governments, 1994*, Bureau of Labor Statistics, Bulletin 2477, May 1996, p. 119.

¹⁵ Personal savings, as a percentage of disposable income, has ranged from 3.8 to 5.9 percent per year throughout the 1990s, compared with rates generally between 7 and 10 percent from the 1950s until the mid-1980s. See U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, 1997. For a discussion of reasons behind this decline in savings, see “Assessing the Decline in the National Saving Rate,” Congressional Budget Office, April 1993.

¹⁶ Covered payroll is the amount of earnings upon which Social Security taxes are paid. In 1998, maximum covered payroll is \$68,400. Maximum covered payroll is indexed to inflation each year.

¹⁷ Both of these methods are currently used in the taxation of employer retirement plans. Where contributions are made with taxable income, benefits attributable to those contributions are not subject to taxation when received. Alternatively,

all benefits attributable to pre-tax contributions are subject to taxation when received.

¹⁸ Social Security provides benefits at the “normal retirement age” and reduced benefits at the “early retirement age.” Under current law, the normal retirement age is age 65 for those born in or before 1938. For those born after 1938, the normal retirement age increases gradually to age 67 for those born in 1960 or later. Early retirement benefits are available at age 62, with reductions in benefits for those years before the normal retirement age that benefits are received.

¹⁹ For more details on the Chilean Social Security system and its history, see Jose Pinera, “Empowering Workers: The Privatization of Social Security in Chile,” *The Cato Journal*, Volume 15, Fall/Winter, 1996. See also Barbara E. Kritzer, “Privatizing Social Security: The Chilean Experience,” *Social Security Bulletin*, Volume 59, Fall 1996, pp. 45-55.

²⁰ See Carmelo Mesa-Lago, *Changing Social Security in Latin America*, Boulder City, Colorado: Lynne Rienner Publishing, Inc., 1994.

²¹ For a discussion of foreign Social Security reform efforts, see Bodie, Mitchell, and Turner, *Securing Employer-Based Pensions: An International Perspective*.

²² See “Effect of Social Security Act on Company Pensions,” *Monthly Labor Review*, March 1940, pp. 642-47.

²³ Total employee contributions to Social Security and, where required, to employer-provided defined benefit plans, have no effect on the lifetime guarantee of benefits. However, Social Security and many defined benefit pension plans base initial benefits on employee earnings, so some relationship between earnings and benefits does exist.

²⁴ *Employee Benefits in Industry, 1980*, Bureau of Labor Statistics, Bulletin 2107, September 1981.

²⁵ For a discussion of reasons for the switch from defined benefit to defined contribution plans, see Michael S. Gordon, Olivia S. Mitchell, and Marc M. Twinner, *Positioning Pensions for the Twenty-First Century*, Pension Research Council, 1997.

²⁶ For a discussion of the “value” of employee benefits, see Melissa Famulari and Marilyn E. Manser, “Employer-Provided Benefits: Employer Cost Versus Employee Value,” *Monthly Labor Review*, December 1989, pp. 24-32.

²⁷ For a comprehensive analysis of pension benefit formulas integrated with Social Security, see Avy D. Graham, “Coordinating Private Pension Benefits with Social Security,” *Monthly Labor Review*, March 1994, pp. 35-38.

²⁸ For information on the 1986 tax law changes, and their effect on employer-provided retirement plans, see Graham, “Coordinating Private Pension Benefits with Social Security.”