CONFERENCIAS
It is a pleasure for me to be here and to speak to you on the subject of Social Security and the reform of Social Security. It is an enormously important question all over the world. In the recent election in the United States, one of the important differences between Governor Bush and Vice President Gore was their views on whether they wished to move toward some partial form of privatization of the Social Security system in our country. Unfortunately we do not know who was elected President, but they anticipate that before the year 2004 we will know the outcome.

Pay-as-you-go Social Security began in the 19th century in Germany. It actually began more as an individual account system, but it was after World War I that is transformed into a pay-as-you-go system. Other countries, following the German example, almost invariably approached providing for the retirement income of the elderly through a pay-as-you-go system. In this system, the current tax revenues placed on social security wages on individuals that are working are used to pay for the retirement benefits. That is what essentially is meant by a pay-as-you-go system.

I think it was in 1981, Chile was perhaps the first nation of the world that changed this system radically from a pay-as-you-go system to an individual account system. The Chilean system has been in existence for 18 or 19 years, and while there are still some people who retire under the pay-as-you-go system, most of the population now is under an individual account system. By that I mean that when they retire they will get benefits that depend not on the taxes on the current working population but on their accumulated savings, affected of course by the returns that they obtain on their assets. For the first 15 or 16 years of the Chilean system, the rates of return were very high, being the average about 11% in real terms. That is a remarkable rate, unlikely to be continued either there or in most countries. Really, a very high rate. They did remarkably well, and the system has been extremely popular, not only with the Government that introduced it. It was
introduced under the Pinochet government, but it has been supported by all the democratic governments that have succeeded the Pinochet government, and by all political parties.

Pay-as-you-go systems are under retreat now all over the world. Its retreat is not unique to developed or emerging market countries. It is under retreat everywhere. Why should that be? The reasons are, I think, several and very fundamental. The prospects in many systems for the future of pay-as-you-go is very poor, very pessimistic.

Why should that be? I will emphasize five factors. One, everybody recognizes it, is the low birth rates that have fallen in much of the world. Something like 40% of the world’s population now lives in nations which birth rates are below replacement. In some countries, like Italy, Spain, Portugal, Russia, Germany, Japan, Taiwan, Korea, and I could go on, the birth rates are very far below replacement.

Very low birth rates combined with increasing life expectancy, greater health and longer life of the retired people obviously means by simple arithmetical calculations that the number of workers who can provide for each retired person has gone drastically down. Before, fifty or so years ago, there were maybe four workers for every retired person. Now in some countries there will be significantly fewer than one worker for retired person. The arithmetic of that suggests that pay-as-you-go systems can only be continually financed in such an environment when you continue to raise the tax rate. By “the” tax rate, I mean the social security taxes on employers and employees, since we economists like to combine those and look at a total tax. Technically that is correct, politically it is not 100% correct, but the combined tax rate has risen in the US. It was very high in Chile when they made this reform and it is very high in most Western European countries today.

This takes us to the second reason why pay-as-you-go systems are in retreat. The social security tax is a tax on employment under a pay-as-you-go system. Therefore, it means a sizable increase in the cost of labor to companies. Naturally, when cost goes up, demand goes down. That is the fundamental economic principle. So the demand for workers has retreated in most countries, if not all countries, with very high tax rates under pay-as-you-go systems. That factor has also contributed to the difficulties of the system: when fewer workers get employed you get a reduction in the tax base, that is, the number of people to which the tax is applied. In other words, unemployed workers and workers who decide to work underground, in the untaxed sector of the economy, do not make any contributions to the pay-as-you-go system. That further drives down the potential solvency of the system.

The third reason why pay-as-you-go is under retreat is that the benefits and the taxes are largely politically determined under those systems. There is no natural link between the current taxes and the benefits, other than a necessity that somehow they be balanced. There is no fundamental economic foundation for the benefits or for the taxes. Therefore,
when you have a rising elderly population, governments have an incentive to promise larger and larger benefits to the elderly. The elderly are very active politically, and are more likely to vote than many other segments of the population. Since increases in benefits need to be financed in the pay-as-you-go system, you obtain a growth in taxes, which in turn helps destabilize the system. So, it is its political determination, one of the fundamentals of the pay-as-you-go system, that I consider one of the most fundamental weaknesses of these systems. Curiously enough, this weakness is often not mentioned by the critics of the system.

The fourth problem that I will mention is of a more technical nature, one of which has been studied by one of my students. Pay-as-you-go systems because of the way they tax workers and the way they provide benefits to the elderly, that is not entirely but largely independent of their contributions, tend to encourage families to have smaller families; parents have fewer children. I mentioned earlier that one of the difficulties of the pay-as-you-go systems is that we have low fertility, low birth rates. Most analysts take that as a given, coming somehow from economic and other forces, independent of the pay-as-you-go system. But that is false, as the pay-as-you-go system discourages parents from having large families, partly because of the tax imposed on their children, partly because the benefits come independently of their contribution. Economic analysis then predicts that you will get lower birth rates, other things being the same, under a pay-as-you-go system.

We have therefore shown that what holds in theory in this case also holds in practice. Pay-as-you-go systems tend to lower birth rates, the larger the benefits under a pay-as-you-go system the lower the birth rates. This is a vicious circle. Lower birth rates encourage higher taxes on social security taxes to finance the elderly, higher taxes and more generous social security systems encourage the lower birth rates. This is a downward spiral that has contributed, in a silent but very fundamental way, to some of the difficulties that pay-as-you-go systems are under.

The fifth and final reason I will analyze today is an equally or even more important implication of the political determination of the benefits. Just as the political incentives are to give more and more benefits, the incentives are such that generous benefits tend to provided in earlier and earlier ages. This is not a universal tendency, it is again confronted by the obligation to have a system where your taxes can, in the long run, pay for your benefits. But we have seen, country after country, provide benefits at earlier and earlier ages. In some countries of Western Europe, like Italy and Belgium, very healthy people retire in their fifties. This retirement is induced by the benefits provided under pay-as-you-go systems.

Typically in Europe, almost nobody works legally after age 60. Now, think of this. People are getting healthier, living longer and are more and more mentally active, due
to the way modern economies work. Still, pay-as-you-go system encourages people to retire at younger ages! The result is that some people retire at age 55, and will live another 30 years, without working. Some of these people might be happy they are not working. But we know, from experience, that when people have choice, they often want to continue working, maybe not full time, maybe part time, but they like to continue working. Many people do not know what to do with their time if they have no job to go to. Yet we have that the incentive structure of the pay-as-you-go system has induced healthy and mentally alert people to retire at early ages. This has happened all over the world.

These are some of the difficulties of pay-as-you-go systems that are not intrinsic, that are not a necessary part of every retirement system. Let me contrast that with individual account systems.

Uruguay has moved partially to an individual account system. An individual account system, by its very nature, allows individuals to save some of their earnings in their own accounts. They have their own name on it. In a well functioning system, people can choose among competing funds, and they can choose a mixture of portfolios that will be tailored to their individual needs and desires. For example, very risk-averse people will choose very conservative investments, government bonds or high-grade corporate bonds. More risk-taking individuals, or individuals who are continuing to work and can afford a riskier portfolio, will choose assets dominated more by equities, maybe even highly risky equities. But people have the choice, they are not required to hold the same portfolio of government bonds.

Those are the two basic features of an individual account system. First, each person has an account based on their own contributions, on their own investments. Second, they have the choice, and this is an important advantage, they have the choice in principle, of choosing a mix of assets which is better suited to their individual circumstances.

I will now address what are the main costs and benefits of an individual account system compared to social security. I mentioned already one important benefit, the flexibility in tailoring one’s account to one’s circumstances. And it is certainly a benefit.

The second important advantage of individual account systems is that there is a natural force determining the amount of pensions: benefits are determined by one’s savings. I mentioned there were no natural forces under a pay-as-you-go system; it is all a question of politics. And when you leave things to politics, I am afraid you often get not very good results. That is unfortunate, but that is why I am a free-market economist and not a central planner. Now the government can mess around with the natural forces determining benefits in an individual account system too, of course. But its power to mess that up is more limited, because there is a fundamental basis for setting benefits. I have saved a certain amount over my lifetime, I receive a certain rate of return on it, at
some age, say 60-65, I have a certain amount of assets, that is my assets. Of course, governments can add or subtract, but I have an asset there, under my name.

In addition, that is a great feeling for people. People do not realize how happy people are to see every month a statement of the account that says: Gary Becker, you have so and so much in assets that you have accumulated, and when you reach 65 this is the assets you will have to spend during your retirement age.

As I said before, every activity is vulnerable to political interference, there is no question about that. But some forms of institutions, some forms of systems are less vulnerable than others. And an individual account system has the great protection that there is a way of calculating what people's benefits should be.

Moreover, the fact that you have a certain amount of assets under an individual account system, creates the potential to separate the age at which people collect benefits from the age at which they stop working. Under a pay-as-you-go system, at least the ones I know of, these two ages are always tied together.

In the United States even now at age 65, you cannot begin to collect benefits unless you retire. So, if you retire at age 60 in the United States, you would be unable to collect benefits. In Europe that is virtually uniform, if you want to collect your social security benefits, you must retire. Now again, that is a strange system. We are discouraging from work an increasingly large fraction of the population, an increasingly healthy population, and a population that will live longer and longer.

Under an individual account system, it is easy to separate the age at which you collect your benefits from the age at which you retire. In particular in Chile, there is a complete separation between these two. In Chile you can begin to collect the benefits from your individual account, I think it is at age 60 or 65, but this is entirely independent of the age at which you retire. If, say, I reach 65 and I want to continue to work, I can still collect my benefits.

That is the appropriate way for a system to operate, because in principle there is no connection between the age at which I want to collect my benefits for old age, and the age at which I decide to stop working. Some people will want to continue to work until they drop dead. For example my father was a businessman, and he kept working basically until a few days before he died. He preferred working than sitting at home. Other people may want to retire earlier. That is a matter of choice. A well functioning system, of any type, respects individual choices and differences. The advantage of going to an individual account system, if it is done in the ideal way, is that you can completely separate the retirement age from the age at which you collect your benefits.

This is a very important point. If we allowed people in Europe, the United States and elsewhere, to continue to make the choice whether they wanted to work or not and
would not be conditioned on what they receive from their social security system, you would have a sizable increase in the labor force. In a reasonably well functioning labor market this would create a sizable increase in employment.

This increase in the number of people who want to work should not create an increase in unemployment. If you have a badly run labor market, where jobs are scarce, and unemployment is high, as currently in Uruguay, many of these elderly people would not be able to take jobs. But one’s hope is that in most of these economies, politicians will see the light that has led to the flexibility of the labor force. Then, there would be no reason why elderly people in general would have difficulty finding employment.

In the United States we have many elder people now who reached the retirement age and still work. Some of them continue to work at the jobs they worked at all their lives. An experienced worker, who has built up a large knowledge of a particular activity can be a great asset to a company. It would be a shame to take the choice of retirement largely out of their hands, and link it to the social-security system.

A third major disadvantage of a pay-as-you-go system compared to an individual account system, is that under pay-as-you-go systems your social security payments are mostly taxes. There is a very weak link in most pay-as-you-go systems between the taxes that people pay in the so-called social security taxes and the benefits they receive. Generally speaking, for each dollar, in the United States, that a person pays into Social Security, they get about 30 cents back in benefits. Therefore, most of it is a pure tax, and it is even worse in Europe, it is mostly a tax.

Naturally, as any tax, there are consequences. It raises the cost of labor to companies, and it discourages and lowers the wages that workers earn net of taxes. So it discourages workers from formal employment and encourages them to get an underground employment.

In an individual account system payments are not a tax, they are savings. Payments do not raise the cost of labor to companies, nor is there any incentive to move underground simply because what you pay into the social security system is a form of saving. An issue that I will discuss later is that if you have too high a rate of compulsory saving, it is partially a tax, but basically it is not a tax, it is savings. Therefore you break that link between taxation and employment. Moreover, an individual account system may be a way of increasing people’s incentives to save because they use a portfolio of assets that are well tailored to meet their own needs.

A fourth advantage of individual account systems is that under pay-as-you-go social security, the future liabilities are never explicitly accounted for by governments, they are un-funded liabilities. If we ask people, if we ask even government officials, what are the obligations under pay-as-you-go for future generations, most people will not be able
to give you the answer. In the government’s accounting systems those future liabilities are never shown. It is only experts in the field, economists basically, who make those calculations and know those numbers. They tell us, for example, that by the year 2020 or so, maybe earlier, the U.S. system will be in great financial trouble.

Under an individual account system, well functioning of course, there is no such unfunded liability, it is all funded; it is funded by the assets the people are saving. Companies and Governments do not have unfunded liabilities: they borrow individual’s assets and invest them, so that liabilities are backed by assets. Therefore everything is accounted above-board and one can see which companies have bad portfolios or are in trouble and which are not.

Under pay-as-you-go systems you have to estimate that, you cannot see that directly, you cannot know. The typical American does not know the difficulty we will get into, and some politicians say: Oh, that’s good! We hide the cost.

In 1996 I was an advisor to a President of Canada who lost the election, so I am not so proud of my role in that, although I think we gave a reasonably good advice. We had proposed to him that we tried to move toward an individual account system and reform social security. The answer we got is that social security was untouchable, they would not contemplate any changes in social security, and they did not. In the current election, to Governor Bush’s credit—I have not been an advisor to Governor Bush—he has come up for a partial movement toward an individual account system. He was heavily criticized, I think in a demagogic fashion, by many on the other side, who claimed that that would destroy social security. Reform of social security systems is often a very difficult issue politically. I praise, and I commend those countries, including Uruguay, that have been able to make progress toward an individual account system.

Let me give you a criticism that has been advanced of individual account systems, and I will advance some of my own criticisms. Mine I think can be solved.

One criticism has been made that individual account systems have very high administrative cost. This is true if you look at Chile, particularly during the early days. The cost of running the system, of running the private investment funds, per dollar of funds they collected was quite sizable. Despite all this, the rates of return on these funds was enormously high. I think the participants do not have much reasons to complain, they are getting 11% real rate of return, net of all cost, on their investments, which is a remarkable return. But that is unlikely to be the situation in other countries, and the question is whether this is a legitimate criticism. I think it is not: in a pay-as-you-go system we have a government monopoly, in which they do not have to convince anybody to participate. Governments do not have to give people any information on where savings are. We know nothing about it. When I decided to start collecting my benefits, I said Well, I’ll call the Social Security to find out. Unfortunately, I could not get through
anybody. Nobody ever answered the phone. This is a true experience, and I tried many times. There are no services provided. It is a monopoly, so of course it can be done very cheaply. They give you nothing much in return for your payments.

Under a competitive system, of course, competitors spend money trying to get people to invest with them. But these costs serve a useful function. That is what people do not understand. Under the pressure of competition, there are selling costs, but you provide information to your potential customers. Companies are forced to tell about their investments and about people’s portfolios. Moreover, some studies in the United States have shown, not in social security but in other industries, that when we allow competition and allow companies to advertise, selling costs go up but the prices charged go down. That seems paradoxical. How can you raise cost and lower price? The answer is very simple and it has two parts. By opening to competition, you allow the more efficient providers to enter the industry. But to enter an industry you have to advertise, you have to sell your product. So that explains why selling costs go up, but prices charged go down. Often non-economists and even some economists fail to understand this process, and think that when you have more selling cost you must have higher prices or lower returns than in a pay-as-you-go system.

I am not sufficiently familiar with the Uruguayan system, but I know that in Chile and in Argentina, people get a monthly accounting, on what the benefits are, on how they are doing. Customers there know something, they have this piece of paper in which they are told how they are doing. Under most pay-as-you-go systems you are treated with the arrogance that any monopoly tends to treat its customers with: “Why on earth would I have to give you any services? You have to be with me whether you like it or not.”

So I think that the administrative cost argument is wrong, that people do not look at it appropriately.

There are two other criticisms that could be made of individual account systems. One is compulsion. Do we want an individual account system where you require people to save a certain percentage of their wages? In Chile and Argentina I think people are required to save 10% of their wages up to a certain point. Do you want to require them to save or you want to give them the choice as to how much they save?

The argument for compulsion has been that if you leave people free to choose, some people would not save and then when they retire they will have no income and the government will be forced to take care of them. There is some truth to that argument. The question is how much truth there is to that argument and how much compulsion do you want. The problem is that once you have a law requiring compulsion, you automatically give the government a significant role in overseeing and controlling the investment funds. I believe government deserves to have some role in this, the question is how big a role, how much restriction should there be.
I believe that the tendency to have a very large rate of compulsion is a mistake, I believe the problem is exaggerated. I would be willing to accept that people are required to save, say, 2% of a wage income. I believe that with this amount people would have a minimum level of income when they retire. Then, I would allow the other amounts they want to invest to be a choice. Some people might want to invest 20%, other people 8%. I do not think there is any difference from a thousand of other choices that individuals make.

A second criticism that could be made of individual account systems is that funds are not free to invest in whatever they see fit. In Chile and in Argentina, and in most countries that have individual account systems, the assets are largely restricted to domestic securities, bonds mainly, and to some extent domestic equities. That also, in my judgment, is a serious mistake, specially for small nations. A small nation wants to diversify their assets, otherwise, the funds will be subject to more risk than necessary. Economists have always preached about the virtues of diversification, and this is exactly the same. A company should be allowed to diversify internationally. For example, Chilean companies should be allowed to put a large fraction of their assets into international companies, into U.S. securities, into European securities, into securities in Mexico, into Japanese securities, and the like. I think now they are only allowed to put 15% of their assets in foreign markets.

A mistake in most of these systems is to excessively emphasize the country assets at the expense of diversification. I also believe there is usually too much emphasis placed upon fixed income securities as opposed to a broader portfolio. We know equities are riskier, but they also in a long run yield much higher rates of return than bonds. Studies that have been made for the United States and Europe show that if you look over a hundred-year period, on the average equities have yielded 5% higher real rate of return than bonds. That is enormous. In fact, equities have also been less risky because of the inflationary risk of bonds, that are less well protected against it. That may just be an accident of the past history, but the higher rates of return I think will continue with us for a long time. Moreover, you want more than one equity in your portfolio, because some equities can hedge each other. Countries like Uruguay or Argentina have an insufficient number of equities, so companies should be allowed to invest internationally.

Another related issue, is that savings should be tax free. Of course, that is like saying “I prefer a consumption tax”, which I do, but they should be tax-free. Then, people will have a big incentive to save on their own. People are not stupid. You do not want a system based on the assumption that 95% of people are stupid, when really you have only a small percentage of people who are stupid. You want a system based on what the average person needs. The average person, after gaining experience, would be able to save enough and would take great pride in that.

I was recently speaking with the father of the Chilean social-security system, and I said: “Pepe, you have too much compulsion in the Chilean system. You should not have it. I
am not criticizing you, you were pioneers but now you can make this change”. He agreed with me, and he said they are trying to make some changes. Uruguay has moved to a partially individual account system, and I want to congratulate Uruguayans for being one of the early countries to move in that direction. The U.S. has not yet moved to an individual account system, so we are behind Uruguay and other countries. However, I think the level of compulsion in the Uruguayan system is excessive. Moreover, the degree of contribution to the individual account as opposed to the public social security system is skewed toward the public system and against the individual account system. I believe there should be a greater role for the individual account system, and less compulsion.

The third criticism I would make of the way the individual account system is organized in Uruguay is that there should be no link between the age which somebody decides to collect their benefits, and the age at which they stop working. There is no natural link between these two. I strongly recommend the discussion of breaking the existing link. As I have said, Chile has no link, so it is not that there is not precedent for that. I think elderly people would greatly appreciate the increase in their available choices.

Many people pointed out, and rightly so, that there in a transition to an individual account system a cost must be paid. Some of the advocates of individual account systems have been less than truthful in trying to ignore the fact that there are significant transition costs. But they can be financed, you need some extra taxes for a while. The reason is that working people will have to pay two things. On one hand, they will have to accumulate some money in their individual accounts. But on the other, they must pay for the obligations that the government has with older generations, the obligation to give retired people a certain income. You have to meet those commitments if you are a government with any degree of ethics or morality.

Therefore, there is a transitional problem, and you need an extra tax, and you have something of that nature in Uruguay. Chile did it during a period of great surpluses, Argentina has a tax too. Because of that, some of the critics of individual account systems say: “Well, since you have a transition system, what is the advantage of an individual account system? They both have to do the same thing, provide for the retirement of the elderly.”

In order to answer to those critics, let me draw a parallelism. What they say is like saying: “Why privatize your telecommunication system?” If you have a monopoly in telecommunications, “Why privatize it? Any system has to be able to provide people with telephones, and the correct market structure is a privatized system under competitive conditions. I do not mean privatized monopolies. Privatized systems under competitive conditions are much more efficient. Competition forces people to be efficient. I do not care if they are public enterprises or private enterprises. My advice is: just allow competitive entry into the system to compete against the public system. I think if you do
that without biasing the legislation in favor of the public system, you will make the
public system better, but more fundamentally you will make consumers better off. That
is exactly true in privatized social security. Yes, there is a transition system, a private
system has to provide for retirement, just like private companies have to produce phone
messages or steel. But they do it better because competition forces improvements
overtime, improvements that are often difficult to anticipate beforehand.

You cannot always understand ahead of time. We do not have the imagination to know
what are the new changes that are going to occur. I often answer people, and say: “I do
not know what they will be, but the market will tell us what they will be”. You want to
allow people with good ideas and annuity funds with new types of portfolios to develop.
You want annuity funds with options, and derivatives, and various mixtures, and so on.
We have had enormous innovations in the financial world in the last twenty years,
driven by competition, not by government monopolies. Driven by competition. I am
happy to say the Chicago Board of Trade in the American Teller Exchange is one of the
leaders in some of the new instruments, because they are involved in a tough competition
against the New York and London stock exchanges.

Therefore, a privatized system has transition cost, because if you allow competition,
you have to have extra taxes. But you give the consumer a greater product.

So far, I have emphasized some of the different forces that are often stressed in
talking about the advantages of an individual account system. However, I think that
the real advantage is that the world as a whole will be forced country after country
to move to this, and most new countries adopting social security systems will not
adopt pay-as-you-go. Hong Kong adopted a system which is not pay-as-you-go
system, it is an individual account system, they had no system before. China has
been discussing that, and I believe they will adopt a version of an individual account
system, that is where all the signs point to. Pay-as-you-go was adopted by many
countries in the past because other countries had it. Now we know we can do things
more effectively. Individual account systems will allow people to work longer; will
break the link between retirement age and the age which you collect benefits; will
enable people to diversify their portfolios; will enable people to tailor the portfolio
that best meets their needs; will enable to replace a tax on earnings with a higher
savings rate; and will lead to innovations, that if we have a competitive investment
structure it is very hard to anticipate at present.

These are enormous benefits. Country after country are beginning to appreciate these
benefits. I applaud Uruguay for being one of the leaders, and I only hope my own country,
the United States, will not be the last country to adopt individual account systems.
Thank you very much.