Lessons from Pension Reform in the Americas

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Chapter 16

Epilogue: The Future of Retirement Systems in the Americas

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Financing retirement is actually a very simple concept—at least in theory. That is, people are supposed to set aside money during their work lives, and then draw down the interest and principal during the retirement period. The problem, of course, is in moving from theory to practice. Workers are not particularly well informed about their lifetime earnings paths; they are often financially illiterate about capital market investments; and most do not know when they will die, so are unable to formulate the necessary optimal asset buildup and drawdown paths. Most people also lack the remarkable self-control and predictable lives that saving for retirement takes, and instead are often tempted or forced to draw down their savings for consumption needs, housing, or other emergencies (Mitchell and Utkus 2004).

These realities are typically the rationale for government-provided, or government-mandated, old-age retirement programs. From this perspective, having an old-age system is seen as a necessary self-control device, one that operates on the 'if you don’t see it you won’t spend it’ principle. Old-age programs are therefore a way to get workers to pay today so that funds will be there in the future to support their old-age consumption. In most of the Americas, the first pillar of old-age support is often called ‘the Social Security system’.

Precision in Speaking and Thinking Matters
But what exactly is social security? One of the lessons I have learned from many years of working on pension reforms in Mexico, Uruguay, Bermuda, Brazil, Japan, and the USA is that precision in speaking and thinking about social security is essential but too often ignored. In fact, sometimes we are the six blind men of myth who confronted the elephant. When each man felt a different anatomical feature of the beast, he concluded that the
ear, the trunk, or the tail defined the animal in its entirety. If we fail to understand and appreciate key aspects of a country’s old-age system, we also run the risk of standing in the way of, or even subverting, ways to engage in successful retirement system reform.

As one example, there are wide differences of opinion about what social security is and what it should be. When I was working on administrative costs and expenses of social security programs in Latin America, I found enormous cross-country differences in costs—which only made sense when I noticed the wide variation in tasks that these systems are asked to carry out (Mitchell 1998). As an example, most countries have old-age benefits included, but after that, there is huge diversity. Sometimes social security goes on to include disability as well as survivor and dependent benefits. Often in the Americas other risks are also included—for example, unemployment and severance pay, health care and maternity leave, poverty-alleviation measures, and, in some cases, even housing and educational subsidies. As a result, being clear about vocabulary matters, since how people talk about their system reveals what they expect from a reform—and this might be very different from how others conceive of the system and its objectives. Until we fully understand what the system is asked to do in a given country, it is impossible to figure out if it is doing it efficiently, cost effectively, and equitably.

Another example of when precision in speaking and thinking has been inadequately precise is in the discussion around ‘replacement rates’. All the literature on the topic uses the term, but just a moment of thought confirms that it means very different things to different people. For instance, the current US Social Security system links workers’ old-age benefit accruals to their own lifetime earnings. This is justified as a means to maintain a given ‘own lifetime earnings replacement rate’, by which is meant that a retiree’s benefits replace a fixed percent of his own lifetime pay; after retirement, benefits are indexed to prices, not wages, so they fall relative to active workers. Whether this is affordable is, of course, a debate in the USA, but it is by no means a unique definition of the replacement rate concept. In contrast, in Europe and some Latin-American countries, retiree benefits are set up so they are tied to payroll rather than prices after retirement, either formally or informally. For instance, the pension of a public-sector retiree in Brazil rises every time the person now holding the retiree’s job gets a raise. This is an entirely different concept of replacement rate, yet nobody pays attention to the vastly different and more expensive financing implications.

When I served on the President’s Commission to Strengthen Social Security (see www.csss.gov), we proposed bringing the national DB system into balance rather than wage-indexing the benefit accrual path (Cogan and Mitchell 2003). This would lead to lower ‘own lifetime earnings
replacement rates’ for many, but it would enhance the system’s solvency and ensure that no benefits would fall in purchasing power, compared to today. It also permitted us to identify money to raise benefits for low-wage workers and poor widows. Hence our proposal would have brought about a solvent, sustainable, and more equitable result, with higher lifetime replacement rates for low-wage workers. Over the long haul, this would mean that eventually everyone would get a flat benefit amount, producing high lifetime earnings replacement rates for the poor and lower ones for the highly paid.

A third arena where clearer thinking would be invaluable has to do with the use of the term ‘transition costs’. Many critics of reform have argued, incorrectly, that reforming retirement systems always means new and expensive ‘transition financing’. In fact, those who complain about ‘transition costs’ due to reforms are usually wrong. The sensible way to think about it when a country has an insolvent social security or pension program follows.

First, figure out how much promised benefits are worth, ideally computed using an open-ended horizon and sensible economic and demographic assumptions. Then, figure out how much future system revenues can be expected to be, and difference the benefits and the revenue. What remains is the unfunded liability of the system; this is the hole to be filled.

Next, determine projected revenue and benefit streams given a specific reform plan. To the extent that this reform reduces the system’s unfunded liability, the reform generates a saving, not a cost.

In practice, many reform critics focus exclusively on the financing needs of the reform, but remain oblivious to (or at least silent on) the size of the hole to be filled if there were no reform. In the US case, many charged our commission’s proposals as having high transition costs; the reality is that our plan generated transition savings, by moving to a new system. Much more clarity along these lines is required in the future.

**Retirement Reform Is a Process, Not an End in Itself**

A second lesson I have learned after many years of pension reform in the Americas is that reforming retirement systems takes patience and, in fact, the process is never over. So if you are a young, eager, and energetic reformer, the good news is that you have steady employment prospects. The bad news is that there will be political and economic risk, and your job is never done.

This is a frustrating message to many economists, particularly because we often see wasted opportunities and little problems turn into big ones, for lack of action and attention. As my mother used to say, ‘Time is money’,
and so, too, is it here. Each day reform is postponed, the workforce ages, the number of retirees grows, and the more insolvent become many of the systems on which so many people rely for survival. In the case of the USA, everyday Congress does nothing means that pensions and social security will be that much more difficult to fix in the future.

This observation also applies to the individual accounts programs that so many Latin-American nations have developed over the past two decades, in variants of Chile’s personal accounts approach. The political and implementation process has tended to focus too often on getting the ‘front-end’ of the reform going—the accumulation phase, having the money flow into the accounts. However, often there is too little attention paid to common elements needed to support the new system, such as tax reform, health-care reform, and capital market reform. Without these, the new pension system may fail to inspire trust, for example, when it forces people to hold government bonds in their accounts, or unduly encourages mortgages rather than diversifying participants’ holdings (Bodie, Mitchell, and Turner 1996). In most of the Americas, governments have devoted too little attention to the regulatory, supervisory, and payout mechanisms—for instance, overlooking the need to restructure the insurance and annuity markets so that workers gain the confidence that they will not run out of money in retirement (Brown et al. 2001).

The inevitable constraints of time, money, and political energy may imply that retirement reforms will often be gradual and sequential in nature, particularly in poor countries where there are urgent claims on resources. However, in the retirement system arena, it is important to underscore that the challenge is to announce a reform and keep on a steady path. After all, we are asking participants to make decisions about working, saving, and investing that will affect their financial wellbeing 60 or 80 years into the future. Even the most coldly rational consumer is unlikely to believe that today’s retirement system will be identical to that in place one to two decades from now. As Carranza and Morón (2008) note, ‘policymaking in Peru is characterized by constant policy reversal…new governments have been prone to redo entire reforms without caring how costly it was to implement them’. This has been a more general problem with pension reform in the Americas. While stability is a virtue, at the same time it is essentially impossible to tie the hands of future policymakers. In fact, it could even be a bad idea to force people to continue under a legacy system designed for a different era but which now falls far short for the evolving economy. As an example, the fact that many retirement systems in the Americas induce early retirement, particularly for women, is a good example of a shortsighted and outdated practice that must be changed in order to better target retirement security in old age.
Suggestions for the Future

One of the most critical consequences of the aging revolution in the Americas is that all of us must think more creatively if we are to find new ways to ensure that our older citizens have a decent standard of living. As more of us survive to older ages, it will become more and more difficult to tax increasing fractions of the younger population’s earnings. At the end of the day, then, the real question is: ‘What needs to be done to make retirement systems more resilient?’

First, making accumulation easier and more automatic will help. To boost saving, employers and governments must get young people ‘in the habit’ of saving at a very tender age. Habit-formation effects are substantial, and will help loosen constraints later.

Second, a serious and country-specific debate is required to explore how much can be afforded for minimum benefits: what can be financed and how it is an essential exercise that should not be delayed. This includes all groups in society—and yet a major challenge for the next decade throughout the Americas is to figure out ways to fold in public-sector workers—such as federal or state employees, the military and police, and other ‘special’ groups who have enjoyed above-average benefits that are now unaffordable.

Third, more research is needed on the capital market so we have better ideas about how to configure the environment for more cost-effective and efficient pension offerings, disability and survivor offerings, health insurance, and even retirement guarantees. Much remains to be learned about these key issues.

Fourth, policymakers and analysts desperately need more microeconomic individual-based household data to make sensible retirement policy. The Encuesta de Previdencia Social (EPS) in Chile, the HRS in the USA, and Mexico’s Mexican Health and Aging Study (MHAS) are some shining examples. Such micropanel data help illuminate people’s financial knowledge and expectations, along with their assets and debts; these illustrate where governments, employers, unions, and educators should concentrate their efforts in designing their plans, and then on executing them. As Peter Drucker said, ‘Plans are only good intentions unless they immediately degenerate into hard work.’

Conclusions

In serving on the President’s Bipartisan Commission to Strengthen Social Security, I was pleased to share with the commission the lessons of Latin-American pension reform for the USA. Though the USA has not yet taken steps to reform its system, we still stand to learn much from the numerous
alternative reforms undertaken by our Latin neighbors, and to follow their useful examples.

The commission devoted enormous energy and collegiality to clarifying concepts, identifying future spending burdens, and developing solutions. Since the commission submitted its report, I have continued to spread the message that the US system is running short of funds to pay promised benefits, and this will happen soon. I was proud to be able to develop and support reform proposals that would enhance the safety net for old age in the USA, while permitting some diversification out of the traditional PAYGO system.

President Franklin D. Roosevelt once remarked: ‘Old age is like everything else. To make a success of it, you’ve got to start young.’ This leaves a substantial task for those of us in the policy and planning business. The goal in the retirement security arena is to help people ‘do what they know they should’—save more, invest wisely, work longer, and avoid outliving their assets. Education is critical, though sometimes a hard sell—a lesson I learned from personal experience, when I tried to convince my teenage daughter to save part of her summer earnings in a retirement account. Financial institutions must help more as well, by developing more attractive, sensible, and low-cost ways to meet retirement objectives. Last but not the least, our elected officials must take up the challenge to make retirement security a national goal and to structure a more coherent environment for workers and retirees of the future.

References


