

A Way Out of Europe's Pension Crisis

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On the wall of my office in Santiago, Chile, I have a map of the Americas with South America's sharp southern tip pointing toward the top and the United States and Canada at the bottom. Visitors often look puzzled, then exclaim, "*Oh, they've hung your map upside down.*"

"No," I say, "*it's just a different way of looking at the world.*" I often think of that map when I'm asked how Europe's crisis-riddled pension systems can be fixed.

Reform is possible, I reply, if people are willing to look at the world in a different way. Most importantly individuals will need more power to provide for their own retirement - and the government's role must be scaled back. We've accomplished this in Chile, and reform on the Chilean model is being seriously considered in the United States. In the meantime, the system has already spread to several other nations around the globe.

Beneath its veneer of egalitarianism, Europe's present pension systems are hideously unfair to tens of millions. Most young workers can look only to paying more and more to support those on retirement today - and then to receiving less and less when they themselves retire. Many under-40 members of today's working population may end up on income support to make ends meet in the next few decades, even though they pay up to 20% or more of their income in social security taxes.

Part of the problem is demographics. Europe's state pension systems are based on the so-called *pay-as-you-go* (Paygo) principle, meaning that the pension payroll taxes of today's working populations are passed through immediately to today's retirees. This system worked half-a-century ago in a world where there were seven or more workers for each retiree, who typically lived only a few years after he left the work force.

That world is gone. Thanks to a sharply declining birth rate and longer life expectancy, there are now an average of only four people of working age to support each pensioner in the 15 member states of the European Union. By 2040 there will be only two, and in some countries like Germany the ratio of workers to pensioners will

be closer to one to one.

As a result, the financial burdens will become enormous. Pension contributions in Germany, for example, are now 20.3% of earnings, and the government has just increased VAT to finance the cost of pensions. And that is just the beginning. In France, pension contributions may have to double to 40% of earnings. But higher payroll taxes lead to even higher unemployment and thus fewer contributors to the pension system.

At the same time, the payouts will be trimmed. European governments have already begun doing so, for example, by increasing the retirement age. Meanwhile, every pressure group wants to cut the best deal for its members. Thus we see that Italian civil servants retire in their early 50s and that French truck drivers can end their working lives at 55. Does anyone seriously believe that such a system can survive in the 21st century?

Twenty years ago my country faced a similar crisis. Chile had created a state pension system in 1925 and by the 1970s it was on the brink of bankruptcy, rife with special privileges and burdened by high payroll taxes.

When I was appointed minister of labor and social security, my team and I hit upon a simple, yet radical way to keep the idea of a national retirement system, but change the way it is structured. Every worker's payroll taxes, we proposed, could go into a private, individual pension account that would be his own property. His money would be invested in professionally managed funds of stocks and bonds. If he changed his job, his retirement accounts would move with him. These would fuel - and keep up with - a growing economy, yielding a far better pension income than if the same sums went to the government.

Here's how the Pension Savings Account (PSA) system works. To start with, every working man and woman gets a PSA passbook to keep track of how much has accumulated and how well the investment fund has performed.

To manage these growing assets, individuals choose freely among a number of private companies that invest in a diversified, low-risk portfolio of stocks and bonds. Since workers can change freely from one company to another, they compete to provide

better customer service and lower commissions. Many have user-friendly computer terminals where individuals can calculate the value of their pensions or find out how much to deposit in order to retire at a given age. The companies are regulated by the government and there's also a safety net: the state guarantees a minimum pension if the worker's savings fall short.

The PSA system changes the very notion of what a pension is. For example, Chile no longer has a rigid legal retirement age. People can retire whenever they want, as long as they have sufficient savings in their accounts for a "reasonable pension" (50% of average salary of the previous 10 years, as long as it is higher than the minimum pension). If they want to, they can continue working without contributing to the plan after their pension begins. No longer is anyone forced to leave the labor force - or work on the black market - because he draws a pension.

The result?

Today Chile's private pension system has accumulated an investment fund of some \$30 billion, in a country of only 14 million people and a gross domestic product of only \$70 billion. As University of California economist Sebastian Edwards noted, the system "*has contributed to the phenomenal increase in the country's savings rate, from less than 10% in 1986 to almost 29% in 1996.*" Chilean people have reaped a rich harvest. The average worker has earned 12% annually after inflation, and pensions today are much higher than under the old system, nearly 80% of annual income over the last 10 years of working life.

Can this system work in Europe? Some economists assert that it can't. Let's examine their objections.

- "*The transition to an investment-based system is too costly.*" If today's worker's taxes get redirected into individual retirement funds, critics wonder, who will pay the pensions of today's retired workers? In Chile, we covered the guarantees to already retired workers in several ways. The government issued new bonds, which spread some of the cost over the generations. Privatization of state-owned business, and a reduction in government spending elsewhere, were also important. We levied a small temporary transition tax; and the economic growth unleashed by the PSA system brought in greater overall tax revenues.

In the meantime, during the transition, everyone contributing to the old system

could remain in it, but those who moved had their rights to partially accrued pension income guaranteed by the government. All new entrants to the work force were required to go into the PSA system.

- "*Operating costs of an investment-based system are higher.*" True, professional pension fund managers do have advertising and investment costs that tax-and-spend government programs run by civil servants do not incur. But the costs are low - and are dwarfed by the higher returns the PSA system generates.
- "*Private pensions are less reliable and safe.*" In fact, it's hard to consider the present setup reliable, with governments increasing taxes and decreasing payouts. The investment results of private funds cannot be guaranteed. But all studies of past performance show that the long-term gains of a well-chosen portfolio of bonds and equities have been far greater than that of Paygo systems. The government supervises the investment companies, and of course the fund managers themselves keep a constant watchful eye on the accounts.

The PSA system has other benefits. For example, if this system were adopted Europe-wide, workers would not risk losing their pension rights if they left a job in one country for a job in another. Interestingly, the EU Commission is considering a change from *Paygo* to an investment-based retirement system for its own workers.

Harvard University economist Martin Feldstein has estimated that the value of future benefits to the American economy of privatizing Social Security pensions could reach an astounding \$20 trillion. "*It is difficult to think of any other policy,*" he recently wrote, "*that could produce such a substantial permanent rise in the standard of living of the vast majority of the population.*" Europe could also derive a similarly huge benefit.

I cannot emphasize enough that the PSA is not a solution of the political right or left; it empowers all workers. It allows them ownership of financial capital that many have never had, giving them a greater stake in the economy than ever before. It may seem revolutionary to suggest that Europeans give up their dependence on the state for their old-age livelihood in favor of taking their pension provision into their own hands. Nevertheless, millions of people in countries such as Peru, Argentina, Colombia, Bolivia, El Salvador, and Mexico have already done so, with excellent results for

themselves, their economies and their societies.

To all who say it cannot be done, my reply is twofold: it has been done, and - considering the ruinous state of Europe's pensions financing - it must be done.

José Piñera is president of the International Center for Pension Reform (www.pensionreform.org). As Chile's minister of labour and social security from 1978 to 1980, and of mining in 1981, he was responsible for three key structural reforms: the privatization of the pension system, the labour law, and the restoration of private property rights in mining. He holds an M.A. and a Ph.D. in economics from Harvard University (U.S.A.).

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