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FACING THE AGING WAVE:
PROPOSED SOCIAL SECURITY REFORM IN THE
PHILIPPINES

Les Coughran†

Abstract: The Philippines's Social Security System is eroding because of demographic changes. These changes have tipped the financial balance, which incremental design changes have failed to restore. The system contains weaknesses that are exacerbated by limited financial transparency and poor asset management. International social security systems, designed to include public defined benefit programs, public hypothetical account programs, publicly mandated defined contribution programs, and/or private sphere components, provide the Philippines with examples of alternate national systems. While each of these components alleviates certain risks, no single component is comprehensive in safeguarding against demographic, economic, or inflationary risks.

This Comment asserts that the Philippines should reform its public social security system and adopt a new diversified program. Consistent with the World Bank's recommendations, the Philippines should blend a hypothetical account-based public retirement benefit with a defined contribution retirement program. This diversified program will increase retirement income for a broader range of the population, while not materially increasing the national government's risk exposure. Most importantly, this program will secure the long-term viability of distributing social security benefits.

I. INTRODUCTION

Changes in demographics due to an aging population are undermining the Philippines's system for social security financing. This Comment identifies several causes of the Philippines's social security financial imbalance and suggests a specific model for reform. The retiree's financial security, society's macro-level economic stability, and the relative fairness of the available designs are balanced in formulating a new social security

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policy \(^1\) while recognizing that social security programs have both a substantial social and economic impact.\(^2\)

This Comment argues that the Philippines should modify its social security system by adopting a blended “hypothetical account”\(^3\) and “defined contribution”\(^4\) design. This proposed reform would involve changing the current social security benefit formula and adding tax-subsidized defined contribution savings accounts. This design recommendation is adapted from the World Bank’s preferred model of social security financing, and is tailored to meet the needs and capacity of the Philippines.\(^5\) The proposed reform is beneficial because it arguably reduces the economic, financial, and

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\(^1\) National social security programs can encompass a variety of economic protections, including access to health care, disability insurance, childcare, unemployment income and retirement income. This Comment, analyzing “social security policy,” is limited to post-employment income sources for the elderly from government-sponsored or subsidized programs. This includes public retirement income systems and private pensions or savings accounts. Pre-retirement life, disability, and health insurance, while important economic protections, are specifically excluded for purposes of this Comment.

\(^2\) The economic impact of social security programs is substantial. The annual cost of these programs, on average, in Eastern Europe and Central Asia, is at least eight percent of annual gross domestic product. David Lindeman et al., The Evolution of Pension Systems in Eastern Europe and Central Asia: Opportunities, Constraints, and Dilemmas 9 (2000), http://www.oecd.org/pdfIM00028000/M00028932.pdf (last visited Dec. 31, 2002). Reasonable baseline projections estimate that these costs will increase to over fourteen percent of annual gross domestic product within the next few decades. Id.

\(^3\) As used in this Comment, a “hypothetical account” retirement system uses personal contributions to determine retirement payments. Like a savings account, an individual would make “contributions,” which are social security tax payments. Also like a savings account, an individual would receive “interest,” which is a benefit credit for prior contribution periods. This “interest” adjustment makes the account balance accumulate as if it were a funded savings account. The “account” is a bookkeeping device to track implicit payment promises. The credits used to calculate retirement payments are pooled into a person’s “account,” but the account is fictional. Unlike a savings account, which is directly funded with assets, a hypothetical account has no corresponding investments and is not directly funded. There is no specific link between tax collections and benefit payments (i.e., benefit obligations do not correspond with any accumulated assets or tax collections, and the benefit obligations do not fluctuate based on the underlying assets). These “accounts” make up a tracking system that is effective to bring costs in line with each individual’s tax payments. While the terms used to describe this account give the appearance of a funded, contribution-based scheme, the hypothetical account program is not funded. It is simply a different way to communicate benefits under an unfunded social security program. This program is more effective in communicating value to the public and total costs to politicians than a regular defined benefit program. See infra Part IV.A for further discussion on the hypothetical account model that is proposed for the Philippines.

\(^4\) Defined contribution designs are individual savings accounts. Mukul Asher, Financial Crisis and its Implications for Pension Funds in Southeast Asia, http://www.worldbank.org.cn/english/content/pension1.html (on file with author) (last visited Dec. 4, 2001). The accounts are at all times fully funded. Id. The account’s value fluctuates with the value of the underlying assets being held. See infra Part IV.B for a further discussion of the defined contribution model proposed for the Philippines.

demographic risks associated with providing retirement benefits through
diversification.\footnote{6}{Id. (stating that changing the parameters of retirement programs, like retirement age, is politically unattractive and is a difficult way to implement social security reform).}

Part II reviews the current social security system in the Philippines,
examining the strengths, weaknesses and viability of the current program.\footnote{7}{The World Bank has several key areas of concern in social security system designs. Those key areas of concern are: "(1) short term financing; (2) long term viability; (3) effects on economic growth; (4) adequacy and distributional issues; and (5) political risk." \textsc{David Linde\-man}, \textsc{World Bank Group}, \textsc{Incentives and Design Issues in Pension Reform}, http://www.worldbank.org.cn/english/content/pension6.html (last visited Dec. 4, 2001).}

Part III surveys potential social security designs, including the World Bank’s recommended diversified “multi-pillar” approach.\footnote{8}{Under the terminology used by the World Bank in evaluating social security financing methods, each “pillar” is a distinct funding arrangement that provides retirement income. \textsc{Linde\-man et al.}, \textit{supra} note 2, at 6. “Pillar one” programs are systems in which the national government guarantees a stream of retirement payments based on a benefit formula. \textit{Id.} at 13. “Second pillar” systems are mandatory defined contribution systems, in which a national government requires savings, but the accumulated account balance determines benefit payments. \textit{Id.} “Third-pillar” arrangements are private sphere, either individual or employment-based, supplemental retirement income systems that are supported through tax subsidies. \textit{Id.}} Part IV recommends that the Philippines adopt a blended multi-pillar design, based on the World Bank model. This multi-pillar design involves redefining the current retirement benefit formula into a hypothetical account-based system. In addition, the proposed reform recommends adding a defined contribution program. Finally, Part V concludes that the suggested transition to the proposed blended design is both beneficial and feasible.

II. The Existing Philippine Social Security Program: Structure, Strengths, Weaknesses, and Coming Challenges

The Philippines currently maintains a partially funded “pay-as-you-go”\footnote{9}{A “pay-as-you-go” social security system does not have a funded link between taxes collected and benefits paid. \textit{See Holzmann, supra note 5, at 7.} Despite the appearance to the individual that they are paying social security taxes for their own benefit, the taxes collected are used to pay current retirees. \textit{Id.}} social security system. This system collects a portion of current employee wages through a social security tax,\footnote{10}{\textsc{Office of Policy and Research}, [\textsc{United States} \textsc{Social Security Administration}, \textsc{Social Security Programs Throughout the World - 1999}, at 283 (1999), http://www/ssa/gov/statistics/sspww/1999/English/index.html (last visited Dec. 31, 2002) [hereinafter \textsc{Office of Policy and Research}].} and with those funds pays current eligible retirees monthly retirement income.\footnote{11}{\textit{Id.}} The Social Security System (“SSS”), similar to the United States model, covers only private sector employees.\footnote{12}{Government employees are covered under a separate, but similar system. \textit{Id.}} The existing system is classified as a “defined benefit”\footnote{13}{\textit{Id.}}
system, because the "benefit formula"\textsuperscript{14} provides a specific monthly payment during retirement.

The current SSS follows a specific statutory structure, which defines the benefits payable, individual eligibility rules, and tax collection.\textsuperscript{15} These design features provide important protections for the aging. Despite these safeguards, the existing SSS is rife with problems. These problems are caused by the internal structure of the SSS as well as outside political and social factors. The SSS design also negatively affects the Philippine economy. These weaknesses undermine the program's viability, and create a need for reform.

\section*{A. Current Social Security System Design Features}

The specific attributes of the current Philippine SSS are delineated in this section, outlining the basic structure of the system and detailing various strengths and weakness that necessitate reform. The SSS requires participation for a broad class of individuals, and provides fixed monthly retirement payments.\textsuperscript{16} These payments begin at a relatively rigid retirement date. SSS benefit payments are funded through a labor tax, paid by both employer and employee, which are not directly linked with individual benefits.

\subsection*{1. The Benefit Structure of the Existing System}

The SSS is planned to provide specific benefits for a distinct portion of the Philippine population. The SSS is designed to be a broad-based, compulsory retirement program. Participation is required for private sector employees under age sixty, household employees earning at least 1,000.

\textsuperscript{13} As used in this Comment a "defined benefit" pension system refers to a particular type of benefit formula used in the retirement system. Under a defined benefit formula, individuals are promised a specific fixed retirement payment amount each period (i.e., monthly). Note that the benefit formula is distinct from the "pay-as-you-go" financing method. \textit{Compare} discussion \textit{supra} note 9. This distinction highlights an important feature of pension systems: promised benefits and the method of accumulating funds to pay those benefits are two distinct features and are not necessarily connected to one another. \textit{ASHER, supra} note 4.

\textsuperscript{14} As used in this Comment, the "benefit formula" is the statutory provision that determines how much income a retiree receives.

\textsuperscript{15} \textit{OFFICE OF POLICY AND RESEARCH, supra} note 10, at \textit{v} (social security programs reported by the Social Security Administration are only those established by statute).

\textsuperscript{16} Individuals receiving retirement benefits have their monthly amounts adjusted for inflation on an ad hoc basis. \textit{Id.} at 283.
pesos\textsuperscript{17} per month, and self-employed individuals with more than 1,000 pesos per month of income.\textsuperscript{18} Civil servants and military personnel are covered under a separate, but similar, system.\textsuperscript{19}

The SSS pays a fixed monthly amount to eligible retirees.\textsuperscript{20} While not a formal obligation to continue making payments, future retirees expect these payments to continue.\textsuperscript{21} An average worker in the Philippines, whose wages are subject to the social security tax, can expect to receive a monthly retirement benefit payment. The payment is determined under the statutory benefit formula and is equal to the greatest of the following amounts:

300 pesos, plus 20\% of the average monthly "credited earnings,"\textsuperscript{22} plus 2\% of the average monthly credited earnings for each year of service in excess of 10 years; or 40\% of average monthly credited earnings; or 1,200 pesos if the insured contributed for at least ten years but less than 20 years, or 2,400 pesos if the insured contributed for more than 20 years.\textsuperscript{23}

Eligible retirees receive these payments monthly from retirement until death.\textsuperscript{24}

Under current law, the formal retirement age is rigid.\textsuperscript{25} Individuals are eligible to retire at age 60 if they are not employed, and have 120 months of credited earnings.\textsuperscript{26} Payments must start by age 65, even if the individual remains employed, provided 120 months of credited earnings are recorded.\textsuperscript{27} If the retiree does not record the necessary 120 months of credited earnings, he or she is not eligible to receive monthly benefits as detailed in the benefit

\textsuperscript{17} The exchange rate was US$ 1.00 per 39.55 pesos when the Social Security Administration researched these formulas. \textit{Id.}
\textsuperscript{18} \textit{Id.}
\textsuperscript{19} \textit{Id.}
\textsuperscript{20} \textit{Id.}
\textsuperscript{21} LINDEMAN ET AL., \textit{supra} note 2, at 7.
\textsuperscript{22} "Credited earnings" describes the wages that are counted for calculating retirement payments. \textit{Id.}
\textsuperscript{23} The types of wages used in the formula are limited. OFFICE OF POLICY AND RESEARCH, \textit{supra} note 10, at 283. Certain earnings are not used, or "credited" under the formula. \textit{Id.} For example, monthly wages in excess of 12,000 pesos per month (the "social security wage base") or wages that were not reported to the social security system, which previously went untaxed, are not counted when determining retirement payments. \textit{Id.}
\textsuperscript{24} \textit{Id.}
\textsuperscript{25} This rigidity reduces the financial flexibility available to adjust the systems for demographic changes. See HOLZMANN, \textit{supra} note 5, at 7.
\textsuperscript{26} OFFICE OF POLICY AND RESEARCH, \textit{supra} note 10, at 283.
\textsuperscript{27} \textit{Id.}
These ineligible retirees receive a single "refund" payment as a lump-sum. The lump-sum payment equals the employee's and employer's contributions, plus 6% annual interest.

2. The SSS is Funded Primarily on a "Pay-as-You-Go" Basis Through Payroll Taxes

The benefits provided under the Philippine social security system are funded through a payroll tax. The government collects payroll taxes to pay benefits to current retirees. The contribution rate for retirement, death and disability programs under the SSS is 8.4% of the first 12,000 pesos of income per month. The employee pays 3.33% and the employer pays 5.07% of wages, up to the social security wage base, as taxes.

While tax collection serves as the means to pay for retirement benefits, there is no funding link between individual tax payments and retirement benefits disbursed to that person. Therefore, the system is financed on a pay-as-you-go basis. Even though workers pay social security taxes, no specific funds from those taxes are set aside for that particular worker's expected retirement payments.

B. The Current SSS Design Has Inherent Strengths

There are several inherent strengths to the current SSS design. The existing program protects against the three primary risks to retirees: poverty, inflation, and longevity. Besides these primary protections, the current SSS gives some lifestyle flexibility to those who are beginning retirement and protects certain dependants against the early death of the retiree. In addition, the SSS has accumulated an asset surplus, which provides financial security to the government and retirees beyond the current social security tax collection.

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28 Id.
29 Id.
30 Id. This credited interest rate is well below the market rate. ASHER, supra note 4.
31 OFFICE OF POLICY AND RESEARCH, supra note 10, at 283 (based on 1999 income levels).
32 Id.
33 Id.
34 ASHER, supra note 4.
35 OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.
36 ASHER, supra note 4.
The current SSS successfully reduces poverty among the elderly, meeting the primary social role of social security. The program replaces about 60% of pre-retirement income. These replacement levels are substantial when compared with the replacement levels of other pay-as-you-go defined benefit social security systems, which are substantially lower. Specific features of the benefit formula also aid the poverty-reducing effects. The monthly payments made under the benefit formula are mildly progressive and include a subsidy for low lifetime earners.

The risk that inflation will destroy the buying power of a fixed payment is addressed through an inflation adjustment. Payments to retirees are adjusted on an ad hoc basis for inflation. This readjustment for inflation helps maintain the system's poverty protection, and keeps the payments from being substantially reduced by inflation over time.

Longevity risk, the risk of outliving available financial resources, is substantially reduced by the primary "form of payment." The current program largely prevents eligible retirees from outliving their income by providing a monthly payment from retirement until death.

37 See, e.g., [UNITED STATES] PRESIDENT'S COMMISSION ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 41-44 (1981) (stating that the current role of social security is to provide a minimum floor of protection for the aged), reprinted in JOHN H. LANGBEIN & BRUCE WOLK, PENSION AND EMPLOYEE BENEFIT LAW 41 (Robert C. Clark et al. eds., 3d ed. 2000).
38 ASHER, supra note 4.
39 For comparison, the "replacement rate" of a U.S. worker that has average career earnings of $30,000 per year is 30% under the United States social security program. LANGBEIN & WOLK, supra note 37, at 37.
40 "Progressive" is a normative term used to describe a program that benefits those who are poor more than the rich. See, e.g., BLACK'S LAW DICTIONARY 842 (6th ed. 1991) (defining progressive tax as a type of graduated tax which applies higher tax rates as the income of the taxpayer rises). Conversely, a "regressive" program benefits the wealthy more than the poor. See id. at 889 (defining a regressive tax as a tax for which rates decrease as the taxed base, such as income, increases).
41 The formula provides a guaranteed minimum payment for individuals with 120 credited earnings months, but whose average credited earnings are not large enough to produce 1,200 or 2,400 pesos of retirement income. See discussion supra Part II.A.1.
42 Economists describe the purchasing power of a dollar amount as the "real" value. See, e.g., FREDERICK MISHKIN & STANLEY EAKINS, FINANCIAL MARKETS AND INSTITUTIONS 61 (Denise Clinton et al. eds., 3d ed. 2000) (describing the real value of money in terms of actual goods and service that can be purchased). This is in contrast with the "nominal" value, which is the face value of money. Id. For example, if you were to give a retiree 100,000 pesos today in cash, with which he is able to buy a 100,000 peso car, the real and nominal value of the cash would both be 100,000. Now, assume instead it is twenty years in the future, and the cost of the same car has increased to 200,000 pesos. When the retiree is provided the same 100,000 pesos, he or she is only able to pay half of the price. While the nominal value of the cash remains $10,000, the "real" value has declined by half because of the increase in the cost of goods.
43 OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.
44 A "form of payment" as used in this Comment describes how the value of the benefit owed under the benefit formula is transferred to a retiree. Forms of payment encompass both the amount of payments and the period over which a retiree will receive these payments.
45 OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.
who has enough credits to earn retirement benefits receives poverty protection until his or her death.

In addition to the formula-based protections, the current SSS has several non-formula-based strengths. Certain beneficiaries are protected against the early death, including pre-retirement death, of a household earner. Individuals who have contributed for 120 months are eligible for either: i) a joint and survivor annuity for individuals with a spouse or dependants; or, ii) for those without eligible dependants, an annuity with sixty payments guaranteed. The determination of which death benefit protection a retiree receives is made at the time of death, rather than at the time of retirement. Consequently, a retiree gets the best available alternative. For example, if a retiree has children or a spouse at the time of retirement but not at death, the SSS will disburse the remaining payments, for up to sixty months, to the person’s parents or other descendants, rather than not paying any death benefits. These death benefit protections are paid in addition to the regular retirement benefit that a retired dependent may be receiving based on their own eligibility. Households that have sufficient contributions by both spouses receive double benefits under the survivor annuity provisions.

Another non-formula-based strength helps retirees with the transition into retirement. The retiree has the option to receive his first eighteen payments in a lump sum, discounted at a preferential rate of interest. This availability of additional funds at the start of retirement allows more lifestyle flexibility, by permitting retirees to have greater access to cash. This single-sum payment allows a person to purchase larger durable goods or relocate for retirement.

46 Id.
47 Id. Survivors of an old age pensioner receive 100% of the pension plus the dependant supplement. Id. A dependant supplement is the greater of 10% of the old age pension or 250 pesos per month. Id. Each child up to 5 under the age of 21 (including those conceived but not yet born) qualifies. Id. Children who are incapacitated and incapable of self-support from a congenital defect or disability acquired before age 21 continue to receive the supplement for their lifetime. Id. In the Philippines, if the participant dies within sixty months of the pension payment beginning, a lump sum equal to the remainder of the first sixty months is paid to dependent parents or other descendants. Id.
48 Id.
49 Id.
50 Id.
51 Id.
52 The payment of double benefits can be avoided by using imputed earnings to the surviving spouse, rather than a survivor annuity. See [United States] Social Security Administration, How your Retirement Benefit is Figured, S.S.A. Pub. No. 05-10070 (2000), http://www.ssa.gov/pubs/10070.html (last visited Dec. 31, 2002) [hereinafter How your Retirement Benefit is Figured]. Under an imputed earning design, the surviving spouse then gets the better of the two wage histories. Id.
53 OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.
The government of the Philippines has collected more in social security taxes than it has paid retirement benefits to date, and thus has accumulated a surplus.\textsuperscript{54} The total accumulated surplus for the SSS and civil service pension funds exceeds ten percent of annual GDP.\textsuperscript{55} This accumulated surplus provides a small buffer between the mismatch in tax collection and benefit payments.\textsuperscript{56}

\textbf{C. The Current Social Security System Has a Plethora of Weaknesses}

While the SSS provides several important safeguards, there are a variety of weaknesses in the current design. These problems stem from both the internal structure of the SSS and external social and political factors.

\textbf{1. Weaknesses in the SSS Stemming from Internal Structure of the SSS}

Although the structure of the SSS provides many benefits, there are a number of weaknesses in the internal structure. The financial consequences of five internal factors severely limit the longevity of the SSS.

The first weakness in the SSS is that the financial characteristics of the obligation to pay retirees and the means to collect and accumulate the funds with which to pay retirees are very different. For instance, the obligation to pay retirees will increase as the overall life expectancy increases,\textsuperscript{57} as non-formula benefits are available,\textsuperscript{58} or as payments are adjusted for inflation.\textsuperscript{59} The wage-based social security tax revenue used in the Philippines fluctuates with economic cycles and the number of employees in the workforce.\textsuperscript{60} Any accumulated assets (i.e. excess tax collections from prior periods) will fluctuate according to the investment choices.\textsuperscript{61} Typically, investments in financial assets decline in value during inflationary periods when the cost of the SSS would be rising.\textsuperscript{62} In order for

\textsuperscript{54} ASHER, supra note 4.
\textsuperscript{55} Id.
\textsuperscript{56} The relative costs of the SSS are in line with the average costs of other social security systems in Eastern Europe and Central Asia that exceed eight percent of gross domestic product. See LINDEMAN ET AL., supra note 2, at 9. The relative buffer provided by surplus assets is evaluated in relation to these overall costs.
\textsuperscript{57} The total number of payments made to an individual increase as they live longer. See discussion supra Part II.A.1 (detailing the current SSS benefit formula). The payments are not reduced for any longevity changes. See discussion supra Part II.A.1 (detailing the current SSS benefit formula). Id.
\textsuperscript{58} See discussion supra Part II.B (detailing the non-formula based benefit obligations).
\textsuperscript{59} See discussion supra Part II.B (describing the inflation adjustments to the SSS payments).
\textsuperscript{60} See discussion supra Part II.A.2 (discussing the employment based SSS tax).
\textsuperscript{61} See discussion infra Part II.C.2.c.
\textsuperscript{62} See THE VANGUARD GROUP, BULL AND BEAR MARKETS, at
payments to be made from the SSS trust funds to retirees, sufficient funds must be collected or accumulated. The government of the Philippines, by guaranteeing to pay a fixed monthly benefit, remains exposed to the risk that there are insufficient assets or funds to make such payments.

The magnitude of the mismatch between the potential revenue and the SSS obligations is greater than necessary because of the type of benefit formula used and non-formula-based benefits. Under the current formula, the total financial value of the series of SSS payments increases as people live longer. Thus, the actual total value of these payments varies by the individual’s life expectancy. The non-formula-based protections, like survivor benefits and the possibility for retirees to get the first eighteen payments as a lump sum, create additional uncertainty and make estimating the total value of retirement benefits more difficult. By making the best possible retirement death benefit available, the costs of these protections are not determined until the death of the retiree. Total SSS costs are affected when retirees chose to claim the first eighteen payments in a lump sum, at a preferential rate of interest. This subsidized initial payment supplies a benefit that is more valuable than the usual series of payments under the benefit formula. It is difficult to project with accuracy the costs of the SSS when the election of this more valuable disbursement remains a retiree choice.

The second internal weakness in the current SSS is that the individual remains exposed to substantial inflation risk. Close scrutiny of the benefit formula reveals only partial protection of retirement income against inflation risk, because of ad hoc inflation adjustments. The existing inflation protections are not consistently applied or routinely implemented.


Under the present benefit formula, individuals are promised the same (inflation adjusting) benefit for life. OFFICE OF POLICY AND RESEARCH, supra note 10, at 283. The present value of a monthly annuity over a longer period of time is more valuable than an annuity for a shorter period of time, where monthly benefits are the same. See STEPHEN ROSS ET AL., FUNDAMENTALS OF CORPORATE FINANCE 790-91 (Gina Huck ed., 4th ed. 1998) (comparing present value of a fixed annuity over various periods at different discount rates).

Financial analysis requires an estimate of cash-flow. ROSS ET AL., supra note 63, 265-327. If there are errors in the cash-flow estimates, such as those created by contingent payments, the financial analysis based on those factors can be misleading. Id. at 327.

See discussion supra Part II.B.

See discussion supra Part II.B.


See discussion supra Part II.A.1.

OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.

Id.
Furthermore, there is no pre-retirement inflation protection; under the current pure averaging formulas, inflation reduces the value of career earnings over time.\(^{71}\) Consequently, retirees who were exposed to pre-retirement inflation have the real value of their retirement payments reduced because the real value of their credited earnings, which are used to determine payments under the benefit formula, are reduced.\(^{72}\)

The third internal weakness is that the benefits paid from the program are regressive; greater benefits are paid to the wealthy, notwithstanding the fact that the individual monthly payments are slightly progressive.\(^{73}\) While a uniform benefit formula implies that each person receives an equal benefit, in reality each person receives only similar monthly payments. The value of the series of payments each retiree receives depends upon his or her life expectancy.\(^{74}\) Certain occupations, like mining, farming, and other manual labor professions, are higher risk and more physically grueling. Those employed in high-risk industries have decreased overall life expectancy.\(^{75}\) Under a benefit formula with a rigid retirement date and fixed payments thereafter, value is transferred away from riskier and more physically draining occupations to those in less risky occupations;\(^{76}\) slightly larger payments over a much shorter period of time are less valuable than slightly smaller payments over a much longer period of time.

The fourth internal weakness is that the individual costs are also regressive. The poor get less and pay more. The tax used to fund the program is regressive because it costs the poor a greater percentage of their income than the wealthy.\(^{77}\) The maximum wage base of 12,000 pesos per month\(^{78}\) makes the required employee contribution regressive,\(^{79}\) despite

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\(^{71}\) While not recommended in this Comment, because of the proposed “hypothetical account” design, there is a simple design solution to cure this pre-retirement inflation risk. Annual wage credits can be adjusted for inflation when converted into a benefit credit. See How Your Retirement Benefit is Figured, supra note 52.

\(^{72}\) See generally supra note 42 and accompanying text (explaining the economic concept of real value).

\(^{73}\) See generally supra note 40 and accompanying text (defining “progressive” and “regressive” tax structures).

\(^{74}\) See ROSS ET AL., supra note 63, 138-39, 790 (calculating the present value of an annuity; showing that value increases as more payments are expected).


\(^{77}\) OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.

\(^{78}\) Id.

\(^{79}\) See THE WORLD BANK, supra note 75.
uniform rates. As the individual’s income rises above 12,000 pesos per month, a higher paid worker pays a lower percentage of their wages to the system.

The tax collected under the 12,000 pesos per month wage ceiling is also regressive, despite a purported uniform rate. By defining tax payments as coming from the “employer” and the “employee,” the uniform tax becomes more regressive. The employer portion of the social security tax is economically a hidden tax on the employee, despite the different labels. While economically the “employer” and “employee” social security taxes are identical, the income tax treatment of these payments differs. The employer gets a deduction for all social security taxes paid as part of wages. Employees pay both social security tax and income tax on their 3.33% contribution. The “employers” 5.07% social security tax is not subject to income tax. Consequently, a portion of the employee’s economic wage is exempt from income tax. Since the income tax in the Philippines is progressive, rising income levels increase the employee tax savings from the SSS income exemption. The tax benefit of this exempt income is greater as incomes rise. As a result, the tax treatment of the SSS contribution is regressive.

A fifth internal weakness is achieving broad coverage in the SSS, despite the broad eligibility requirements. In 1993, the civil service and military pension scheme covered about 1.4 million employees, while the

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80 See generally JOSE PINERA, INTERNATIONAL CENTER FOR PENSION REFORM, EMPOWERING WORKERS: THE PRIVATIZATION OF SOCIAL SECURITY IN CHILE, http://www.pensionreform.org/cl10.html (last visited Dec. 31, 2002) (examining generally how the cost of labor taxes under defined benefit systems is really a tax on the employee regardless of who is labeled with the tax obligation).

81 See id. (indicating that “employer” labor taxes are economically taxes on the employee regardless of label).

82 PRICE WATERHOUSE, DOING BUSINESS IN THE PHILIPPINES 193 (1993). Where an employer pays employee wages, the full wage (including employee social security tax) and the employer social security tax are deductible as a business expense. Id. Thus the employer does not actually absorb any of the social security tax cost.

83 Id.

84 The economic wage as used here is the employer’s cost of hiring an employee. Since the employee absorbs both social security taxes, as used here, the economic wage is taxable wages (which includes the employee social security tax) plus the employer social security tax.

85 The Philippines has seven marginal tax brackets with the highest marginal tax bracket being 35%. PRICE WATERHOUSE, INDIVIDUAL TAXES, A WORLDWIDE SUMMARY 78 (1997).

86 Note that since the majority of the social security tax is “employer” paid, see discussion supra Part II.A.2, the social security tax is much more regressive than the national income tax.

87 ASHER, supra note 4.

88 See discussion supra Part II.A.1.

89 See discussion supra Part II.A.1.

90 See discussion supra Part II.A.1.
SSS had a membership of about 17.8 million. In 1995, the World Bank estimated that the Philippines had a work force of 28 million and a total population of 69 million. Thus under the current system, a substantial portion of the population is not covered by either the civil service or public SSS system.

Low coverage is likely the result of the labor market structure. Individuals who are not part of formal labor markets are not eligible for social security benefits because they fail to have 120 monthly contributions recorded to the SSS. In communities where the financial system or tax collection agency is not developed enough to facilitate payroll and income tax collection, or where wages are paid in non-reported cash or barter exchanges, populations are unable to accumulate sufficient credits with the SSS. With no minimum pension safeguards, these groups may be totally excluded from any elderly income security provided by the SSS.

These challenges reveal a basic structural solvency problem in the SSS. The costs of projected benefits is uncertain and do not correlate with sources of revenue. Individuals are not fully protected from inflation. There are substantial incentives for individuals to avoid participating in the program because of regressive features, and the tax collection agency has been unable to reach the informal labor markets. As a result of these challenges, current annual expenses exceed annual tax revenues. The SSS has operated an annual deficit since 1992, invading investment income to pay benefits.

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91 ASHER, supra note 4.
92 Id.
93 Id.
94 See discussion supra Part II.A.I (indicating that retirees must make 120 contributions in order to be eligible for monthly retirement payments).
95 Id.
96 SOCIAL PROTECTION, THE WORLD BANK, WORLD BANK PENSION REFORM PRIMER: COVERAGE, THE SCOPE OF PROTECTION IN RETIREMENT INCOME SYSTEMS 1 (2002), http://wbln0018.worldbank.org/HDNET/HDocs/asf2d5135ebf5351de6852566a90069b86b6/16b20a4531313bd085256ab00648164/$FILE/N%20Coverage%20v5.pdf (last visited Dec. 31, 2002) (stating that developing countries are “characterized by large scale subsistence agriculture that is essentially outside the government’s tax net. What drives the informal sector is likely to drive pension coverage.”).
97 See supra notes 57 - 67 and accompanying text.
98 See supra notes 68 - 72 and accompanying text.
99 See supra notes 73 - 96 and accompanying text.
100 ASHER, supra note 4.
101 Id.
2. **External Factors Causing Weakness in the SSS**

Aside from the above internal factors, there are several social and political factors in the Philippines causing further undermining of the SSS structure. Demographic changes, lack of financial disclosure, and poor investment returns exacerbate the system's existing internal weaknesses.

a. **Demographic changes will expose the weaknesses in the SSS design**

The demographic make-up of the Philippines is changing. Generally as nations develop and personal incomes rise, people live longer and birthrates decline. These trends are occurring in the Philippines.\(^{102}\) These demographic shifts will magnify many of the challenges identified within the current SSS design. Under the current benefit formula, as retirees live longer, the total value of the retirement payments provided to them increases.\(^{103}\) Also, as people live longer there are a greater number of retirees collecting benefits at any particular point in time. This resulting cost increase, both in total benefits and benefits received each month, will need to be covered by either accumulated assets or future tax collection. Based on the current revenue collection, which is below the cost of current retirement payments,\(^{104}\) additional retirees will accelerate the depletion of the trust fund, and continue the outflow of accumulated funds for the foreseeable future.

The total number of retirees can be compared with the tax-paying workers to create a "dependency ratio," providing a measure of how many retirees rely on each worker. Going forward under the current design, the Philippines will face a worsening dependency ratio as its demographics change.\(^{105}\) There will be more retirees supported by fewer workers and the capacity of these workers to pay social security taxes will be limited.

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\(^{102}\) The life expectancy of the general population has increased from 53.375 years in 1960 to 69.272 in 2000. THE WORLD BANK, 2002 WORLD BANK DEVELOPMENT INDICATORS (The 2002 World Bank Indicators CD-ROM, current through Jan. 1, 2002) [hereinafter DEVELOPMENT INDICATORS]. The crude birthrate per 1000 people dropped from 44.420 in 1960 to 26.780 in 2000. Id.

\(^{103}\) See discussion supra Part II.C.1.

\(^{104}\) ASHER, supra note 4.

\(^{105}\) See generally DEVELOPMENT INDICATORS, supra note 102.
b. Inadequate macro-level disclosure prevents the public from evaluating the financial position of the SSS

In the Philippines, there is inadequate information disclosed about the performance of the SSS. No information is available about accumulated assets or investment performance. Furthermore, there is no publicly disclosed estimate of the system's outstanding liabilities. This lack of publicly available data prevents the citizen inquiry into how the system functions financially. The lack of publicly available information is particularly alarming considering that current tax collections do not cover the current benefit payments and expenses. The investment income of the accumulated funds covers the current shortfall. While this does not create a risk to those currently receiving payments, the rate of using accumulated surpluses to pay current retirees and not accumulating assets for the future undermines the program's solvency for the future.

Defined benefit social security systems, such as the current SSS tend to suffer from political shortsightedness. Politicians often underestimate the long-term costs of providing benefits or avoid confronting the long-term costs altogether. Benefits are increased to unsustainable levels for current retirees to the detriment of future retirees. This cost shifting is preventable by disclosing the costs of the current system, both actual and projected, and educating the public about the financial health of the program.

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106 ASHER, supra note 4.
107 Id.
108 Id.
109 Social security annual reports are neither timely nor informative. Id. There is a general tendency to discourage public discussion of social security issues. Id
110 Id.
111 Id.
112 LAWRENCE H. THOMPSON, MANAGING PUBLIC PENSION PROGRAMS: ANALYSIS OF KEY ADMINISTRATIVE AND POLICY PROCESSES (2000), http://www.worldbank.org.cn/english/content/pension2.shtml (last visited Dec. 4, 2001) (“Experience shows ... [that the people who make pension promises] often underestimate how expensive these promises turn out to be.”).
113 Id.
114 Politicians have no incentive to implement changes to make social security systems solvent because the benefits would not be realized until long into the future after the responsible politician is out of office. HOLZMANN, supra note 5, at 7. Even marginal reform attempts may cause intense political backlash. Id.
115 Id.
116 THOMPSON, supra note 112.
c. Under-performing assets further reduce the financial solvency of the social security system

Poor asset management also plagues the SSS. By choosing to invest directly in private market instruments, the government's investment policies and performance play a crucial role in ensuring sustainable and adequate income security for the elderly.117 SSS asset performance and investment allocation is unclear, since the assets are carried on the SSS financial statement118 at purchase price,119 rather than the current market cost, thereby distorting the information that is disclosed. In addition, the financial disclosures are not audited,120 which reduces the credibility of the information disclosed. Thus far, SSS investment managers appear unable to successfully manage the SSS assets. Between 1976 and 1995, the estimated rate of return of the investment portfolio was below the rate of return on Philippine government bonds.121 Since the SSS reserves could have been invested in Philippine government bonds, in essence the Philippine government borrowed money only to lose part of it in the Philippine stock market.

The investment of SSS reserves in private assets makes the government a stockholder in the nation's private sphere enterprises. The national government is placed in the position of being both owner and regulator. The accumulated system assets are invested in public and private such changes are instituted; and (3) be made available to all interested parties, including workers and employers covered by the pension program.

Id.


118 Financial statements are reports created by accountants to disclose the financial performance of an entity. See ROSS ET AL., supra note 63, at 20-73 (showing the types and uses of financial statements for evaluating economic performance of an entity). Typically financial statements show an income statement, which shows the financial gain or loss for the year. Id. In addition, financial statements usually show a balance sheet, identifying the market value of assets and liabilities. Id.

119 ASHER, supra note 4.

120 Id.

121 Note that the rate of return is only estimated because the official government report does not include sufficient information to calculate the actual performance. Id. The World Bank estimates the real rate of return of the SSS trailed the performance of Philippine treasury bills by 0.59% annually. Id.
financial instruments, including government securities,\(^\text{122}\) home mortgages,\(^\text{123}\) private loans,\(^\text{124}\) and publicly traded equities.\(^\text{125}\) Government direct ownership of corporate stock is inherently subject to continued political manipulation and distorts the efficient use of capital.\(^\text{126}\) Structurally, this choice also causes asset underperformance because of political influence.\(^\text{127}\) Poor asset management creates an additional implicit cost for the taxpayer that is not reflected in SSS accounting.

\section*{D. The Current Form of the SSS Has Negative Collateral Effects on Economic Growth in the Philippines}

In addition to their social role, social security programs substantially affect national economies.\(^\text{128}\) The development of retirement savings programs has the potential to make labor markets more efficient and mobile, accumulate domestic capital,\(^\text{129}\) stabilize national financial systems,\(^\text{130}\) and promote economic development. As a national economy grows, the economic strength and position of its poor tend to improve.\(^\text{131}\) Therefore, a

\begin{footnotesize}
\begin{enumerate}
\item[\text{122}]
Forty-five percent of the portfolio is held in government securities. \textit{Id.} This particular figure also includes bank held time deposits, assets not usually categorized as a government debt obligation. \textit{Id.}
\item[\text{123}]
Forty percent of the assets are held in mortgages. \textit{Id.}
\item[\text{124}]
\textit{Id.}
\item[\text{125}]
Approximately ten percent of the assets are held in private sphere assets. \textit{Id.}
\item[\text{126}]
\item[\text{127}]
\item[\text{128}]
The cost of social security systems in Eastern Europe and Central Asia averages at least eight percent of annual gross domestic product. \textit{Lindeman et al., supra} note 2, at 9. Reasonable baseline projections estimate that these costs will increase to over fourteen percent of annual gross domestic product within the next few decades. \textit{Id.}
\item[\text{129}]
\item[\text{130}]
\textit{Id.} at 4 (concluding that pension funds can act as catalysts for the development of efficient trading and settlement systems, the adoption of modern accounting and auditing standards, and the promotion of meaningful disclosure).
\item[\text{131}]
\end{enumerate}
\end{footnotesize}
properly designed pension system can both stimulate economic growth and reduce poverty. 132

Unfortunately, the Philippines is not reaping these benefits. Instead, its poorly designed social security systems have a distorting impact on work decisions. 133 In the Philippines, because social security benefits are not directly linked with contributions, younger workers treat the contribution as a labor tax. 134 This conception often leads to tax evasion. 135 Under the current design, both the employer and the employee gain financially by not reporting wage income, encouraging the use of informal unreported labor. 136 The use of informal labor limits a nation's future economic growth through higher transaction costs. 137 In addition, the SSS encourages use of inferior production technology, 138 because the cost of labor to the employer is cheaper, lessening the incentive to be efficient.

Social security programs that do not use private savings affect a country’s aggregate savings and its capital market development. Capital accumulation is reduced because private savings institutions and instruments are not developed, slowing the maturation of financial markets. 139

E. Future Projections: The Philippines SSS as Currently Designed Is Not Viable for the Long-Term and a New Design Is Needed

The design weaknesses of the SSS will erode system assets until the system is no longer viable. Low investment returns have depleted the asset base of the SSS. 140 Existing retirees have adequate benefits, but the system is operating on a long-term deficit, 141 despite the short-term accumulated surplus. 142 Annual expenses exceed current tax revenue and SSS trust fund income has been invaded to pay current benefits since 1992. 143 Over time, as the population structure ages, there will be insufficient accumulated assets, absent extraordinary investment returns, to maintain benefits at

132 HOLZMANN, supra note 5, at 2.
133 Id. at 5.
134 Id.
135 Id.
136 The adverse effect of high contribution rates of traditional defined benefit pension systems, especially the detrimental effects on labor demands in the formal sector, should be a matter of serious concern to policy makers. LINDEMANN ET AL., supra note 2, at 9.
137 HOLZMANN, supra note 5, at 5.
138 LINDEMANN, supra note 7.
139 Id.
140 ASHER, supra note 4.
141 Id.
142 Id.
143 Id.
current tax levels. To keep the SSS self-contained it will need to pay decreased benefits,\(^4\) have an increased tax rate or alternate source of revenue, or cover a lower percentage of the population.\(^4\) While these solutions are relatively well understood, they are politically unpopular,\(^4\) regressive,\(^4\) or create additional political risks.\(^4\) Without some design modification, however, the program will become bankrupt.

There are two potential alternatives for change, that make the SSS solvent, while keeping the program self-contained financially: incremental adjustments to the existing design or a new design. The Philippines has already attempted incremental change to offset the growing liabilities,\(^4\) but those changes have not made the system solvent for the long-term. Based on the government's inability to successfully operate the existing design, the remaining alternative is to redesign the SSS. Pension reform could bring the system into long-term financial balance without substantially increasing costs, or moving the program onto the general government budget. Once reform is undertaken, there would also be an opportunity to correct many of the other existing defects.

III. WORLD BANK DESIGN RECOMMENDATIONS ARE AN APPROPRIATE MODEL

The circumstances driving the financial imbalance of the SSS in the Philippines are not wholly unique. In analyzing the shortcomings of similar, traditional defined benefit social security systems, the World Bank has identified three potential models, aside from family or local community arrangements, to finance social security systems.\(^5\) These social security

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\(^4\) Benefit reduction can be accomplished through decreasing monthly payments, inflation adjustments, or increasing the retirement age. Holzmann, supra note 5, at 7. These incremental adjustments are either regressive or cut into the financial security that the program provides. Id.

\(^5\) Certain nations may have organic law impediments to modification of their benefit formulas for either the public or civil servants. LindeMan et al., supra note 2, at 17; see, e.g., Alaska Const. art. XII, §7 (constitutionally protecting accrued pension benefits of public employees).

\(^6\) Smith, supra note 76; see also The World Bank, supra note 75 (indicating longevity differences between rich and poor are predictable).

\(^7\) A redesign of the SSS can be achieved by paying any cost overruns from the general budget. Asher, supra note 4. This approach also lowers aggregate savings. LindeMan, supra note 7. Moving expenses into the general government budget also creates additional political risk. Id. Because of the magnitude of social security costs, the availability of excess funds fluctuates with the national budget. Holzmann, supra note 5, at 10. Consequently, payments under social security programs funded through the general budget tend to excessively respond to changes in the national government's budget. Id.

\(^8\) The maximum wage base was increased 20% between 1997 and 1999. Asher, supra note 4.

\(^9\) Holzmann, supra note 5, at 6-11; Asher, supra note 4.
design strategies can be adopted individually or combined to meet the specific needs of a particular country.  


The World Bank calls each of its potential components “pillars.” A “first-pillar” program is a defined benefit system, though there is some flexibility in how the benefits are defined. A “second-pillar” system is a mandatory defined contribution program. “Third-pillar” is used to describe a tax-subsidized private retirement program. The same shorthand labels to describe these systems are used throughout the remainder of this Comment.

The World Bank’s “first-pillar” is a “pay-as-you-go” defined benefit system. The Philippine’s current system is an example of a first-pillar program. Under this system a worker pays taxes, then receives retirement benefits. These systems are publicly managed, mandate participation, and are non-discretionary entitlements regardless of income. The government serves as the financial guarantor, with payments made according to a specific formula. Payment formulas are usually earnings-based and can be a fixed monthly benefit or of a hypothetical account nature. The first-pillar system can be unfunded, under-funded or theoretically fully-funded by equating the benefit formula exactly with payments. If the system is pre-funded to any degree, choices may exist for how the funds are invested and supervised.

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151 The World Bank favors a multi-pillar approach, but in a pragmatic and country specific manner. HOLZMANN, supra note 5, at 2. This cautious approach recognizes that the exact mix of policy choices depends on a nation’s starting conditions, expectations, and financing constraints. Id. at 7.
152 Id. supra note 4.
153 Id.
154 Id.
155 Id.
156 Id.
157 Taxation can serve as a hidden way to reduce benefits for those with higher incomes, often called a “means test,” in nations that maintain these entitlement benefits. See I.R.C. § 86 (2002). In the United States, portions of social security benefit payments are taxed. Id. As taxable incomes rise, a greater portion of the benefit is recaptured in the form of income tax. Id. § 1 (stating that marginal tax rates rise as taxable income rises); Id. § 61 (defining taxable income to include a portion of social security benefits).
158 ASHER, supra note 4.
159 LINDEMANN ETAL., supra note 2, at 14.
160 This distinction is based on the nature of the benefit formula, and the type of assets used to fund benefits. ASHER, supra note 4.
161 See THE WORLD BANK, PENSION PRIMER, supra note 127 (examining institutional choices for asset management of accumulated social security funds).
The benefits of a first-pillar system are numerous. As currently provided in the Philippines, the forms of payment provide protection against both inflation and longevity risks. Moreover, combining household participation credits or making them transferable to the surviving spouse upon death can overcome gender inequities in labor force participation. Under this model, society serves as the risk-pooling agent and finances the risk under general government revenue or a separately earmarked trust fund. A "second-pillar" arrangement is a mandatory defined contribution system. Under this model, a worker receives retirement income from a funded savings account that they have been required to contribute to during their working career. The amount of retirement income is equal to contributions made during the retiree's working life, plus accrued interest and investment earnings, less any fees. Since benefits and contributions are directly linked, absent any additional government guarantees, the system is fully funded at all times from contributions, leaving no possibility of a funding shortfall. Since each worker receives his or her own contributions during retirement, there is no redistribution of funds before taxation is used. Unlike a first-pillar system, where the benefit formula can contain additional subsidized benefits for the poor, second-pillar systems do not permit subsidized benefits, absent preferential tax-treatment.

Under second-pillar arrangements, the individual's benefit is linked with the financial performance of their personal account. The worker benefits from investment gains, but also absorbs investment losses. These systems usually involve uniform contribution rates, and offer a variety of withdrawal options. Under second-pillar systems each person receives only what is in their account. Thus, explicit provisions need to be made for both longevity and inflation risk since individuals can outlive their income stream and inflation erodes the real value of the account. Also, since each individual bears the risk of loss, sufficient legal protections need

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162 ASHER, supra note 4.
164 ASHER, supra note 4.
165 Id.
166 Id.
167 See discussion supra note 41 and accompanying text.
168 ASHER, supra note 4.
169 See id.
170 Id.
171 Id.
172 Id.
to be in place to ensure that investment managers act prudently and do not embezzle or misuse the assets.\footnote{See ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, FINANCIAL GOVERNANCE: OECD GUIDELINES FOR PENSION FUND GOVERNANCE (2002), at http://www.oecd.org/EN/document/0,EN-document-0-nodirectorate-no-12-35842-0,00.html (last visited Mar. 1, 2003) (offering guidelines for the administration of private pension funds that are designed to protect individuals’ retirement benefit from mismanagement and fraud; including legal and governance structures to ensure that funds are managed in the best interests of plan members and beneficiaries).}

“Third-pillar” schemes can be introduced as a developing nation’s financial systems and government tax policy mature. As defined by the World Bank and used in this Comment, “third-pillar” systems involve public subsidization of private pension schemes, including occupational-based systems or contractual savings devices through the country’s financial system.\footnote{See id.} These non-mandatory systems can provide defined benefits or require defined contributions; yet both types of pillar-three benefits are privately managed and operated.\footnote{LINDEMAN, supra note 7, at 3.} The primary role of these systems is to provide supplemental retirement income.\footnote{For example, in the United States, individuals can defer taxation on retirement assets if the assets remain in the account until age 70.5. I.R.C. §§ 402(a), 401(a)(9). Substantially more assets are accumulated because of the larger initial amount through the use of pre-tax funds, and the faster compounding because of the tax-exempt status. See BERGER FINANCIAL GROUP, LLC, THE POWER OF TAX-ADVANTAGE COMPOUNDING at http://www.bergerfunds.com/planning/education/compunding.html (last visited Dec. 31, 2002) (providing graphical display of the differences in asset accumulation with pre-tax contributions and tax free compounding compared with assets in accounts without those benefits). However, if the assets are not used for retirement there is a tax penalty that is assessed on the distribution in addition to income tax. I.R.C. § 72(i). Hence, there is a substantial economic incentive to earmark assets for retirement, but once the assets are set aside the availability for other uses is substantially diminished.} These systems exchange tax advantages for preferred benefit features to workers.\footnote{Dimitri Vittas, Designing Mandatory Pension Schemes, 72 PUB. POL’Y FOR THE PRIVATE SECTOR 1, 4 (1996) [hereinafter Vittas, Designing Mandatory Pension Schemes].} A common subsidy is a deferment of income taxes.\footnote{See id.} Government regulation and tax policy are used to ensure distributive goals, fund security, and encourage prudent investment.\footnote{HOLZMANN, supra note 5, at 2.}

B. Diversification Among the Alternatives Reduces the Overall Risk Exposure and Protects Against Greater Risk Alternatives

The World Bank evaluated the various financial components of social security programs and recommends a program that blends the use of each of the three pillars described above.\footnote{See id.} Diversification among these three
pills is designed to shelter retirement income sources from various political, economic, and social risks.\(^{181}\)

Risk reduction from diversification occurs for both the individual and society as a whole. Individuals in a diversified program have a variety of income sources. They receive publicly guaranteed retirement income from a pillar-one program, an income stream from market assets that they have been forced to save over their entire working lives through a second pillar system, and, finally, third-pillar programs offer additional supplemental savings that participants have elected to save to avoid any lifestyle decline during retirement.

A society's risk reduction in a diversified program comes from a reduction in the national government’s guarantor role and the use of broader tools to subsidize retirement income. The government only serves to guarantee the income from first-pillar programs.\(^{182}\) Second and third pillars are fully funded and subsidized annually when contributions are deposited into the savings accounts. Second and third pillars are flexible tools that allow the overall design of the retirement income institutions to be modified according to social need.

C. Remaining Problems with the World Bank Model

While this Comment adopts the World Bank's terminology and agrees with the concepts of diversification, problems remain with the World Bank Model. First, the various pension system designs promoted by the World Bank implicitly assume that formal labor markets exist.\(^{183}\) Government programs can alter the timing or amount of wage payments through a social security scheme only after formal wages are paid. Since more than eighty percent of individuals in low-income countries and forty percent of those in middle-income countries are informal non-wage workers,\(^{184}\) few social security benefits are provided to those individuals because they operate beyond the reach of retirement contribution programs. A specific limitation in the social security system of less developed countries is the lack of consistency in income payment and reporting. Only if the government can capture the informal labor market will these design alternatives increase the coverage of the social security program. The model suggested in the

\(^{181}\) Id. at 9-10.

\(^{182}\) See generally ASHER, supra note 4.

\(^{183}\) See HOLZMANN, supra note 5, at 2.

Comment attempts to address this problem by reducing the incentives for avoidance. In addition, the proposed reform model advocated here would provide coverage to those who intermittently work in formal and informal labor markets.

Second, the World Bank multi-pillar model does not provide a specific policy recommendation. This cautious, but indeterminate approach recognizes that the exact mix of policy choices depends on the nation’s starting conditions, expectations, and financing constraints. The World Bank leaves the design of a social security program relatively open. The multi-pillar model requires examination of the existing system, and an application of the World Bank’s tools to meet the projected needs. This Comment attempts to overcome the model’s generality by applying the model to the Philippines’ current situation.

IV. APPLYING THE WORLD BANK MODEL TO THE PHILIPPINES AND CUSTOMIZING THE MODEL TO MEET EXPECTED NEEDS

The World Bank model does not offer guidance on the relative size of each of its pillars. The World Bank instead encourages these pillars to be adopted in a country-specific manner, leaving substantial discretion in the final design. The World Bank’s pillars are modular pieces that can be shaped and combined to meet the needs of a particular nation. Based on a survey of the challenges associated with the SSS, this Comment argues that the Philippines should adopt a blended “hypothetical account” first-pillar system, and add a pillar two and pillar three defined contribution program to the SSS. This proposed reform model continues to provide the strong protections associated with the SSS, but does so at reduced risk and with increased flexibility.

A. Redefining the SSS Benefit Formula from Defined Benefit to a “Hypothetical Account” First-Pillar is Advantageous

Under the World Bank model, there are two alternate first-pillar designs. The Philippines should modify its current defined benefit first-pillar and replace it with a hypothetical account first-pillar. A hypothetical account system does not alter the national government’s role in providing income security via a first-pillar, but it represents a paradigm shift in the

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185 Holzmann, supra note 5, at 7.
186 Id. at 2.
way the benefit is characterized. Adopting a hypothetical account benefit formula has specific advantages. Benefit obligations under this type of formula are more definite. Consequently, a hypothetical account formula reduces the national government’s overall risk exposure.

1. Proposed Attributes of a Hypothetical Account Pillar-One Program for the Philippines

The Philippines should modify the existing benefit structure of the SSS to be a hypothetical account benefit formula. Under a hypothetical account system, each retiree’s benefit is more definite. Under this proposed system, an individual’s account balance would be accumulated over time with contributions credited to the worker’s personal account. Periodically, the value of the account is increased according to a hypothetical rate of return, much like a bond receiving interest. Over time, new contributions are added and in effect accumulated account balances will earn compound interest.

The available series of retirement payments, including any survivor benefits or lump-sum payments under the redesigned program should also be readjusted to make the value more definite. If such a change is adopted, the total value payable is determined under the individual’s hypothetical account. All distributions from such account will reduce the value of the hypothetical account. At retirement, the account is converted into an annuity that is exactly equal to the individual’s life expectancy. Over time, the annuity factors are readjusted to compensate for current life expectancies.

187 A cash balance plan uses the terminology of defined contribution systems for building a defined benefit pension. LINDEMAN, supra note 7, at 4. Participants get an annual contribution from wages credited to their “account.” Id. at 6. Each subsequent year, the account is credited with “interest,” set by referencing an external indicator. Id. Over time, the balance accumulates, with reference to principal and accumulated earnings. HOLZMANN, supra note 5, at 7 n.1; LINDEMAN ET AL., supra note 2, at 7 n.6.

188 LINDEMAN, supra note 7, at 6.

189 While similar to investment earnings, the growth factor can be linked to a variety of factors like GDP growth, average wage growth, or aggregate wage growth. HOLZMANN, supra note 5, at 7 n.1. Each return design has different fiscal implications under different economic, demographic and employment conditions. This choice of a return index is an integral part of the total retirement system design. Id. at 7. See also LINDEMAN, supra note 7 (noting that the choice of the indexing factor has implications for the system’s long-term stability).

190 Note that because the account is hypothetical, there are no assets earning compound interest that are being held by the account. See supra note 13. The funding assets and the liabilities as expressed by the benefit formula can be specifically disconnected. Id. Financial risk management techniques in asset selection can be used in order to hedge the liabilities to reduce the risk of financing the system. ROSS ET AL., supra note 63, at 641-703.

191 HOLZMANN, supra note 5, at 7 n.1.
and interest rates. This readjustment serves to manage the demographic risks within the existing market conditions. An inflation-adjusted annuity, with related actuarial factors, can be constructed by using the debt market’s assets characteristics, which helps eliminate inflation risks from retirement income payments. Similarly, any lump sum payment or adjustments for survivor annuity payments would reduce the monthly amount payable to the retiree.

In adopting this new design, contributions should be redefined so that the full contribution is included for income tax purposes, with the employee making the entire contribution. This would capture both the “employer” and “employee” contributions. In addition, the 12,000 pesos per month wage limit would be eliminated. Thus, this change would make the social security tax progressive instead of regressive. Employers would continue to be responsible for collecting and transmitting the payment to the Social Security Commission as part of their payroll practices.

2. There Are Advantages to Redefining the Benefit Obligations in the Current System

Changing the SSS to the pillar-one benefit formula described above would better manage demographic risks in the Philippines and reduce the national government’s overall financial risk by turning the social security obligations into a liability that mimics debt instruments in the financial markets. The underlying economic performance of a hypothetical account is similar to a U.S. Savings Bond (Series EE), in that the principal is always secure, but interest is periodically capitalized. The Philippines already

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192 Id. This constant readjustment helps maintain a more sustainable benefit level. Id. Actuarial tables can encompass a variety of risk factors, and single factor tables actuarially shift costs to higher risk populations. See Smith, supra note 76.

193 HOLZMANN, supra note 5.

194 The presence of both fixed interest and inflation-adjusted securities allows policy makers to directly measure the real interest rate. MISHKIN & EAKINS, supra note 42, at 61. Without inflation adjusting securities, the process of estimating real interest rates is more complex, but can be achieved. See id. (discussing how to empirically estimate the real rate of return in the absence of inflation indexed bonds). Once a real rate of return is established, discount rates for inflation-protected forms of payment can be deduced. See PINERA, supra note 80.

195 Shifting more of the contribution to workers would increase the individual awareness of the cost of providing state social security pensions. LINDEMAN ET AL., supra note 2, at 14.

196 Pension systems almost invariably make the employer responsible for withholding the employee contributions from the employee’s pay and depositing the contributions with the tax collection agency. THOMPSON, supra note 112.

issues and manages government bond liabilities, and this reform model creates social security liabilities with very similar characteristics. 198

Having bonds as investments would be the most appropriate financial hedge because the liabilities would behave like a bond. 199 Thus, moving to this type of benefit formula would justify the divestiture of the stocks in the Philippines' current investment portfolio, which would also reduce the manipulation of the market associated with the government's holding of substantial private stock investments. 200 The process of selling the stocks would need to be appropriately managed to avoid any major stock market crash in the transition.

The current tax rate in the Philippines would be sufficient to cover a hypothetical account system without undermining the existing social safety net. 201 Because the employee would be responsible for the entire contribution under the proposed reform, the tax rate would be progressive because of the income tax treatment, 202 and the system costs would be fully disclosed to the employee. 203 There would be no implicit costs, because all forms of payments would reduce the account balance. In addition, there would be no government investment discretion; instead, all asset accumulation would correlate with liabilities. Combining all the cash-account balances could identify the total system liabilities. The forms of payment would be unaltered, leaving the life insurance protections in place. 204 In addition, the modified benefit formula would protect against inflationary risk during both the accrual and payment periods.

Moving to a hypothetical account design would not require any modification to the current institutional framework employed in the

198 ASHER, supra note 4.
199 See ROSS ET AL., supra note 63, at 642-69 (explaining introductory financial risk management strategies).
200 See discussion supra Part II.C.1.
201 In Poland, under the reformed cash-balance design, the contribution account necessary to fund the reformed benefits is nine percent of payroll. LINDEMAN, supra note 7.
202 The labor tax contribution rates would match the progressive nature of the income tax. See PRICE WATERHOUSE, supra note 86, at 353.
203 LINDEMAN ET AL., supra note 2, at 14. The employee would contribute the total costs of the system and the legal and economic burdens of contributions would be congruent. See generally PINERA, supra note 80.
204 Under the proposed hypothetical account design, forms of payment would be actuarially equivalent. Hence, an individual who would require a joint-and-survivor annuity form of payment would have their benefit reduced accordingly under the appropriate actuarial calculation.
205 If the accrual reference is a market interest rate, the expressed rate of interest reflects both a real interest rate and a rate of inflation. MISHKIN & EAKINS, supra note 42, at 58 (explaining that under the Fisher equation, the nominal rate of interest equals the real rate of interest plus inflation). Consequently, based on the Fisher principle, the accumulating benefit formula would be hedged against inflation. See Id.
Philippines. The method of tax collection and benefit distribution would be unchanged. However, the way in which benefits are characterized and tracked would be altered. While this does not directly address the challenges posed by informal labor, the incentives to evade social security tax would be reduced. In addition, the hypothetical account system would provide coverage for those who intermittently work in formal and informal labor markets, since there is no minimum number of required contributions.

B. The Philippines Should Add a “Pillar-Two” Component to Use Market Assets to Fund Income Security

The Philippines should add a pillar-two component to the proposed reformed SSS. The hypothetical account pillar-one provides a basic level of poverty protection, guaranteed by the Philippine government. A pillar-two component could augment this poverty protection by requiring each individual to accumulate assets for his or her own retirement. Under this system, a Philippine worker would be required to contribute a portion of his or her wages into a savings account. The account would be invested and should grow over time. At retirement, the account would provide a source of retirement income.

A pillar-two program provides a fully funded source of retirement income that gives the individual greater protection against risks than the pillar-one alone. There are specific advantages to adding a pillar-two design: 1) the individual has increased retirement income; and 2) there are collateral macro-economic benefits to having increased domestic capital managed by the private sphere. Consequently, these changes have the overall impact of increasing benefits to retirees while reducing the overall risk to the national government.

206 The Social Security Commission currently in operation in the Philippines coordinates tax collection, benefit tracking, payments and investment management. OFFICE OF POLICY AND RESEARCH, supra note 10, at 283.
207 See id.
208 See discussion supra Part IV.A.1.
209 Under a hypothetical account design, tying benefits to contributions actually paid minimizes labor market disincentives. LINDEMAN, supra note 7.
210 Id.
211 See discussion supra Part IV.A.
212 HOLZMANN, supra note 5, at 9-11.
1. Adding a Pillar-Two System Would Further Protect the Retiree

Adding a pillar-two program would further strengthen the stability of the retirement system for the individual participant. Under a pillar-two system, a percentage of wages are required to be transferred into savings accounts.

Participants in defined contribution systems have benefits from the second pillar equal to their contributions, plus earnings and interest, less any administrative fees. The individual, rather than the government, would select how the account is invested. Containment of fees and overall market performance are critical factors to the stability and adequacy of the income stream produced by defined contribution programs.

a. Using market assets exposes participants to uneven asset performance and changing asset values

Second-pillar financial performance is based largely on the performance of the financial markets. By spreading financial instrument ownership through pension accounts, the benefits associated with market appreciation can be widely enjoyed by the public. This design can be used to transfer state held assets, or to more broadly distribute market assets, in an effort to more equitably distribute the benefits of economic growth.

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213 The first-pillar would be maintained to provide a baseline of income. See discussion supra Part III.A.

214 For example, Chile requires ten percent of wages to be contributed to its retirement system. OFFICE OF POLICY AND RESEARCH, supra note 10, at 75. Note that Chile does not maintain a pillar-one, so a much smaller contribution would be appropriate.

215 ASHER, supra note 4.

216 Fees reduce the net benefit provided by pillar-two programs. ASHER, supra note 4. Since Chile adopted this design, account management fees have been reduced from 15% of accumulated assets in 1983 to 1.8% in 1993. SEBASTIAN EDWARDS, THE CHILEAN PENSION REFORM: A PIONEERING PROGRAM 18 (Nat’l Bureau of Econ. Res., Working Paper No. 5811, 1996). As of 1993, these costs are in line with U.S. and U.K. insurance companies and mutual funds. Id. Because of the fixed cost nature of the fee structure for most financial institutions, it is doubtful that a second pillar of less than 4-6% of payroll would be cost effective. LINDEMAN ET AL., supra note 2, at 16. While fees may be reduced over time, higher fees (especially early on) have a cascading effect on retiree wealth due to the compounding nature of the assets. See ROSS ET AL., supra note 63, at 116 (discussing future value formulas).

217 LINDEMAN ET AL., supra note 2, at 12.

218 Chile used the funds to buy formerly state-owned businesses. EDWARDS, supra note 216, at 3-5. The efficiency improvements to those assets and the resulting increase in market value was distributed broadly through the pension funds. Id. at 4. These new accounts could also be potential buyers for state owned financial assets. See discussion supra Part IV.A.2 (selling existing government stock market holdings would need to be conducted so that a financial market crisis is not created).
While the expected return is positive, and higher than the individual expects to receive under the pillar-one program, \(^{219}\) financial markets are inherently volatile. Financial instruments are priced to balance the ratio of expected return with the level of volatility. \(^{220}\) The impact of short-term volatility has significant effects on the security of retirement income from this pillar and leaves a sizeable difference in the value of the benefits received by different retirees. \(^{221}\) A balanced financial portfolio generally reduces the risk of loss associated with this volatility, but does so by reducing overall portfolio return when markets are rising. \(^{222}\) While the market usually outperforms government bonds, this increased performance only comes with increased volatility. \(^{223}\)

A sudden collapse of stock and bond markets would erase any asset accumulation in this pillar. Such a collapse would also have the lasting effect of decreasing benefits for future retirees because of the present value impact on future retirees of early contributions. \(^{224}\) Pillar-two programs place a heavy burden on general government economic policy \(^{225}\) to ensure that the financial markets are strong enough to support this social program.

\textbf{b. The expected benefits of using market assets to fund retirement income via a pillar-two component outweigh the potential risks}

Despite the potential risks, pillar-two programs provide substantial benefits to retirees. Assuming that the fees of investment managers do not excessively erode the expected investment return, the economic risk to the individual associated with the second pillar does not eliminate the expected benefits of investment gains.

Over the long term, benefits invested in this manner will provide returns similar to return on capital assets. These returns should be greater

\(^{219}\) Under the Capital Asset Pricing Model, investments in diversified portfolios are priced so that expected appreciation comes only with increased volatility. \textit{Robert Haugen, Modern Investment Theory} 212 (James Boyd et al. eds., 4th ed. 1997).

\(^{220}\) \textit{Id.}

\(^{221}\) \textit{Max Alier & Dimitri Vittas, World Bank, Personal Pension Plans and Stock Market Volatility} 21 (1999).

\(^{222}\) \textit{Id.}

\(^{223}\) \textit{Id. at 39.} Alier and Vittas examined a number of financial strategies to attempt to reduce the market risk associated with maintaining personal retirement accounts invested in market assets, but using financial modeling, they were unable to create an investment strategy using market assets that reduced the overall risk without losing substantial expected return of the financial assets. \textit{Id.}

\(^{224}\) \textit{Holzmann, supra} note 5, at 17.

than the rate of return on government bonds. \textsuperscript{226} This method of pillar-two investment has been successfully employed in other developing countries. In Chile, for instance, this type of benefit accrual greatly increased the retirement income to elderly populations. \textsuperscript{227} The stellar investment returns achieved by Chile, \textsuperscript{228} however, will be difficult to replicate in other nations. \textsuperscript{229} Despite this, experience shows that over time the expected benefits per contribution dollar from this pillar exceed those under a pillar-one design. \textsuperscript{230}

While there are disadvantages to a pillar-two design generally, these risks are manageable under a blended approach. Under this plan there would be no lifetime income guarantees or specific inflation protections provided by the government. The first-pillar hypothetical account program managed by the government ensures an above-poverty level of lifetime income to retirees. \textsuperscript{231} Pre-retirement inflation risk is presumed protected by market forces through asset pricing. \textsuperscript{232} Normally, financial assets are priced to give a rate of return in excess of inflation in addition to compensating for the level of volatility. \textsuperscript{233} Post-retirement inflation risks would also be hedged by individual asset selection. For instance, an individual would be able to

\textsuperscript{226} HAUHEN, supra note 219, at 212 (Under the Capital Asset Pricing Model, investments in diversified portfolios are priced so that expected appreciation comes only with increased volatility); see also THE WORLD BANK, supra note 127 (showing that private sphere asset managers exceed public asset manager performance).

\textsuperscript{227} In Chile, average replacement rates under the new system (as of 1995) were 78\%. EDWARDS, supra note 216, at 23. This is much higher than the average of 50\% under the old system. Id.

\textsuperscript{228} There is some contention over the actual real net rate of return the participants have enjoyed. Barbara Kritzer, Social Security Privatization in Latin America, 63 [UNITED STATES] SOC. SEC. BULL. 1, 21 (2000). CB Capitales, a Chilean investment company, estimated that the average net return to the AFP participant between 1982 and 1998 was only 5.1\%. Id.

\textsuperscript{229} Businesses were sold to fledging pension funds at a discount, and at the time of privatization were poorly managed. Edwards, supra note 216, at 4. Little government effort was expended in restructuring the entities so as to attain full market value of the assets. Id. The decreased cost of the assets initially acquired by the pension funds from the Chilean government increased the eventual return to the funds, which over time has increased the accumulated value of the assets and made the system more fully funded. See Ross et al., supra note 63, at 341 (calculating financial returns involves comparing the current price with purchase price).

\textsuperscript{230} Investment assets would be priced for a risk premium. See HAUHEN, supra note 219, at 212. (presuming that asset valuation under the Capital Asset Pricing Model the expected return of financial assets increases only as market volatility increases).

\textsuperscript{231} See discussion supra Part IV.A.

\textsuperscript{232} Under the Fisher equation, the nominal rate of interest on government bonds equals the real rate of interest plus inflation. MISHKIN & EAKINS, supra note 42, at 58. Further, other potential investments under the Capital Asset Pricing Model are priced by reference to these potential investments. HAUHEN, supra note 219, at 212. Thus all market assets, if the markets are efficient, are priced to exceed the rate of inflation.

\textsuperscript{233} Id.
buy an inflation-adjusted annuity to reduce this risk. By making any such election optional, any forced forms of payment subsidies are eliminated.\footnote{Required annuity provisions using common assumptions transfer value from those who live shorter lives to those who live longer lives. See discussion supra Part II.B. This difference in life expectancy is predictable based on the risk level of lifetime occupation. See discussion supra Part II.B.}

2. \textit{Adopting a Second Pillar Program Will Have Collateral Advantages on Economic Development in the Philippines}

Aside from strengthening individual retirement protections, the adoption of a defined contribution program will create general economic benefits. Such a model has been successful in stimulating economic growth in other developing countries.\footnote{After adopting this type of system, Chile has experienced rapid economic modernization and is widely recognized as having the most open, stable, and liberalized economy in Latin America. \textit{The World Bank, The World Bank Group Countries: Chile}, http://www.worldbank.org/html/extdr/offrep/lac/c12.htm (last visited Nov. 20, 2001) [hereinafter \textit{The World Bank, Group Countries}]. At the time of the social security transition, Chile was under military rule. \textit{Edwards}, supra note 216, at 8.} The formation of privately managed pension funds creates substantial long-term capital accumulation\footnote{In Chile, the pension funds created the largest group of institutional investors in the Chilean stock market. \textit{The World Bank, Group Countries}, supra note 235.} controlled by institutional investors.\footnote{The development of contractual savings institutions like pension funds is associated with increased efficiency of the banking system and greater resilience to credit and liquidity risks. \textit{Gregorio Impavido et al., Contractual Savings Institutions and Banks' Stability and Efficiency} I (2001)} This capital provides the means for further economic development controlled by the private sphere. The presence of alternative financial institutions also provides relief on the banking system,\footnote{See \textit{discussion supra Part IV.A.2.}} which strengthens the financial system and can broaden the availability of capital.

As previously discussed, the Philippine government currently owns substantial stock in private corporations.\footnote{See \textit{discussion supra Part IV.A.2.}} Under the proposed pillar-one program, stock ownership is no longer an appropriate investment, but selling the stock presents a substantial risk to the stock market.\footnote{See \textit{discussion supra Part II.B.}} The asset base provided by a defined contribution program could provide the means to eliminate the national government's ownership of publicly traded securities.\footnote{See \textit{Lindeman et al.}, supra note 2, at 19 n.21 (describing the transition of a single-pillar to a multi-pillar program by using the selling the previously accumulated financial assets, the sale of which is offset by the new second-pillar accounts).} The proposed reform creates both buyers and sellers in the market place, and could be structured to avoid any financial market
shocks. The divestiture of national government ownership of publicly traded securities would improve the use of existing capital and reduce the risks associated with changing the first-pillar.

3. **The Risk Exposure to the National Government is Reduced**

Aside from the private sphere economic benefits and increased available capital, a pillar-two program could reduce the overall risk exposure of the national government. Under pillar-two defined contribution systems, benefit accumulation is mirrored by the funded accounts. Assets and liabilities are directly linked, both on a systemic and individual level. The national government is not exposed to any demographic or market financial risks relating to benefit formulas or investment choices from the pillar-two component. Further, because of the ability to divest the currently held market assets, the overall risk of the pillar-one transition and the financial risks associated with the overall program are reduced.

While not serving as a guaranty, the national government can still enhance the income from a pillar-two program through tax subsidies. Enhanced tax treatment, either through a tax deduction or a tax credit for contributions, can increase the overall income to retirees; individual costs are regressive when a deduction-based subsidy is used but more equitable when a tax-credit is used. The costs of the subsidy would depend on when the assets are contributed; the costs of subsidies could be financed over time, rather than only during retirement.

C. **The Philippines Should Adopt a “Third-Pillar” Private Sphere Mechanism to Supplement Retirement Income**

While third-pillar programs can take a variety of forms, the Philippines should adopt third-pillar private sphere mechanisms in the form of tax-subsidized personal savings accounts to enhance retirement income.

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242 See id.
243 See THE WORLD BANK, PENSION PRIMER, supra note 127, at 1-4 (demonstrating that because of political influence, the assets managed by public managers under-perform those managed by private managers).
244 ASHER, supra note 4.
245 Id.
246 See discussion supra Part IV.B.
247 Vittas, supra note 178, at 4.
248 Id.
Tax-subsidized savings accounts, or "individual retirement accounts" are discretionary personal savings accounts that provide tax incentives for earmarking the assets for retirement. This Comment recommends that a third-pillar program supplement the above described first-and-second pillar systems.

Aside from further diversifying the source of retirement income, third-pillar systems are funding programs that can be easily changed to meet social needs that equitably increase retirement income over the long-term. There are also countrywide economic benefits to adopting this type of system. Under a pillar-three system the government provides tax subsidies to encourage the worker to save for his or her own retirement. The worker would affirmatively elect to contribute funds to a special retirement savings account, in return for which the government would receive a tax credit.

I. Subsidized Individual Retirement Accounts Provide Enhanced Retirement Income and Maintain Lifestyle Expectations for the Aging

Third-pillar individual retirement accounts could create enhanced retirement income for the aging, and allow the individual to determine his or her lifestyle during retirement. Third-pillar systems, as a complement to second-pillar systems, use market assets to fund retirement income. Instead of forcing an individual to save like a second-pillar, third-pillars encourage saving through tax subsidies. These systems exchange tax benefits for asset utilization during retirement. For example, in the United States individuals are given a tax incentive to contribute money to private retirement plans, such as IRAs or 401(k)s, but face an additional tax penalty if the money is withdrawn before retirement. The non-mandatory nature of these funds shifts the role of these third-pillar systems from

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250 Generally, there are three tax flows that can be taxed: contribution, accumulation, and distribution. ASHER, supra note 4. In the U.S., individual retirement accounts provide incentives in each of these areas to provided targeted benefits; a regular IRA is a deductible (functionally pre-tax) contribution, tax-free accumulation, and taxed on distribution. I.R.C. §§ 219, 408 (2002). A Roth IRA is an after-tax contribution, tax free accumulation and tax free distribution. Id. § 408A. A non-deductible IRA is taxed on contribution, tax-free accumulation, and earnings are taxed when distributed. Id. §§ 219, 408.

251 In the United States, the tax expenditure for retirement plans is the second largest tax expenditure, and is in excess of $100 billion annually. STAFF OF THE JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2001-2005 18 (2001).

252 ASHER, supra note 4.

211 Id. § 72(t).
welfare maintenance to lifestyle maintenance. Third-pillar systems place the financial control solely in the hands of the individual. Nevertheless, in order to benefit under a third-pillar design, an individual must have the financial capacity and desire to save current income for future retirement.

a. Creating appropriate tax subsidies

In designing tax-subsidized individual retirement accounts, there are equitable concerns regarding to whom the system benefits accrue. Because the primary mechanism for inducing participation is through a current above-the-line tax deduction or income exclusion, the design of the system benefits the more affluent worker. The benefits of the private sphere system are inversely allocated along the marginal tax rate (benefits increase to the more affluent) where a deduction is used. Where a tax credit is used, benefits are tax neutral (equally benefiting the poor and affluent workers). Income limitations and phase-outs can be used to limit the availability of the tax subsidy for the more affluent. Under a phase-out, a worker who earns more than a given amount would be precluded from receiving any tax subsidy. These redistribution tools can be combined to achieve a more equitable distribution system.

For example, in the United States, Congress has made specific provisions to attempt to restructure the monetary benefit for targeted low-income participants. Congress revised the tax code to allow a tax credit up to fifty percent of the deferral or contribution, in addition to the tax deduction or exclusion, which applies to lower income individuals who make contributions to either an employer or individual retirement plans. These distributional efforts do not have to solely focus on income. Congress also provided age-specific relief for additional accumulation eligibility. In the Philippines, an appropriate subsidy would be a tax credit equal to twenty percent of the contribution to the retirement account. This would

256 See LINDEMAN ET AL., supra note 2, at 11.
257 Vittas, Designing Mandatory Pension Schemes, supra note 178.
259 See id. § 402(a).
260 Vittas, Designing Mandatory Pension Schemes, supra note 178.
261 id.
262 See I.R.C. § 219(g) (limiting of deduction based on adjusted gross income).
263 See, e.g. id.
264 See id. §§ 219 (providing a tax-deduction for IRA contributions), 25B (giving low income taxpayers an a tax credit, which applies in addition to the deduction, for retirement savings).
265 id. § 25B.
266 id. § 414(v) (providing additional catch-up contributions permitted for those over age 50).
provide an equal incentive for all taxpayers, and is tax-neutral. The phase-out could be applied to limit the benefits for the more affluent or to limit the revenue loss.

b. The risk exposure to adopting individual retirement accounts is minimal

The risks created by a third-pillar individual retirement account design are minimal. Benefits in third-pillar programs are fully funded through accumulating accounts.\(^{267}\) As a result, the national government is not exposed to any economic or demographic risks by adopting an individual retirement account program.\(^{268}\) The government's financial commitment to individual retirement account plans is limited to any tax-based subsidies provided.\(^{269}\) Long-term fiscal projections are given so that the cost of the various savings subsidization methods can be evaluated before the adoption of the program.\(^{270}\) The fiscal impact on maintaining the supplemental systems could be reported annually as part of the general government expenditures.\(^{271}\)

2. The Formation of Private Pension Funds Has Positive Effects on Economic Growth

The formation of private investment funds has positive effects of economic growth. The creation of private pension assets helps develop an institutional class of shareholders,\(^{272}\) which can help lead to better corporate governance. In the United States pension funds comprise nearly fifty percent of the institutional assets.\(^{273}\) Pension funds create pressure for better corporate governance,\(^{274}\) and can have a major impact on the operations of

\(^{267}\) See discussion supra Part IV.C.1.

\(^{268}\) There is no risk exposure because the benefits come solely from the individual accounts. See discussion supra Part IV.C.1.

\(^{269}\) This assumes that there are no performance guarantees. But cf. 29 U.S.C. §§ 1301-1453 (2001) (creating the Pension Benefit Guaranty Corporation under Title IV of ERISA, which provides government-backed payment guarantees of private sphere pension benefits in the United States).

\(^{270}\) See, e.g., STAFF OF JOINT COMMITTEE ON TAXATION, supra note 252, at 18.

\(^{271}\) See, e.g. id.

\(^{272}\) Vittas, Pension Funds and Capital Markets, supra note 129, at 4 (noting that generally pension funds become the dominant class of institutional investors.).

\(^{273}\) MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 117 (Robert C. Clark et al. eds., 8th ed. 2000).

\(^{274}\) See Aaron Lucchetti, Restricting Options: Key Fund Managers Get Tough on Issue of Executive Pay, WALL ST. J., Apr. 15, 2002, at C1; see also Vittas, Pension Funds and Capital Markets, supra note
publicly held corporations. In developing economies, it is fair to expect similar impacts.\textsuperscript{275}

The development of contractual savings also enhances the strength of the financial system. As non-bank financial intermediaries such as pension funds or mutual funds develop, the credit risk borne by the banking sector declines.\textsuperscript{276} Across a wide sample of nations, there is a direct, positive correlation between the percentage of financial assets owned by non-bank financial intermediaries (including private pension funds) and level of national income.\textsuperscript{277}

\textbf{D. Design Reform Conclusions}

The Philippines maintains a social security system that is outdated and unsustainable. There are other models available that would manage demographic and financial risks and improve the use of domestic capital. These changes are readily adaptable to the Philippines’s existing administrative capacities and would not materially alter the financial costs that are already committed to providing income security for the elderly. The proposed reforms would reduce the risks associated with the social security system and likely increase benefits.

Moving to a pillar-one hypothetical account style benefit formula would allow social security liabilities to be managed like a bond portfolio, which could be effectively pre-funded using government debt obligations to reduce the program's financial risk. The hypothetical account design would provide a baseline of inflation protected retirement income for life. The increased flexibility of the timing of retirement empowers the individual to take more control over their working lives.

\textsuperscript{129}, at 4 (examining the role of pension funds in corporate governance, in various nations, with specific emphasis on the interaction of pension funds of the election of independent directors).

\textsuperscript{275} \textit{See generally} \textsc{Dimitri Vittas et al., Pension Funds in Central Europe and Russia: Their Prospects and Potential Role in Corporate Governance} (1995) (evaluating the expected impact of pension fund assets on corporate governance in developing economies).

\textsuperscript{276} \textsc{Georgior Impavido et al., The World Bank, Contractual Savings Institutions and Banks' Stability and Efficiency} 12 (2001). Once there are other institutions able to extend credit, banks can either securitize and resell more risky investments or not be the source of initial funding. \textit{See} Vittas, \textit{Pension Funds and Capital Markets}, supra note 129, at 4 (attributing in part the development of securitization to the investment and risk management needs of pension funds). \textit{See also} \textsc{James White, Secured Transactions Teaching Materials} 137-38 (2000) (arguing that securitization lowers the costs of funds, improves liquidity, spreads credit risks, lowers a depository institutions reliance on interest income, and increases the capital adequacy of financial institutions).

\textsuperscript{277} \textsc{Thorsten Beck et al., A New Database on Financial Development and Structure}, fig. 1 (1999).
An additional second-pillar defined contribution system would enhance the retirement income of the population through the use of fully funded accounts. These assets could help develop a class of institutional investors that would enhance the financial system and spur economic development. The benefits of economic growth, as expressed through financial asset appreciation could be spread broadly through the use of mandatory retirement accounts. The individual would also have the ability to choose when to receive distributions from the second-pillar account, allowing greater personal financial control during retirement.

Adding the availability of a third-pillar supplemental savings would allow an individual to determine his or her own lifestyle during retirement. Under such a program, assets are accumulated and invested, providing a source of domestic capital. Like pillar-two programs, the assets in a pillar-three program would be controlled by institutional investors and help enhance corporate governance. The tax subsidies could be targeted at specific income groups, age groups, or more discrete populations. Over time the program could be modified easily to respond to changing social and economic needs.

V. CONCLUSION

If the Philippines moves to a multi-pillar program it would provide greater security for the individual, while reducing its own risk exposure. Under a multi-pillar program, the individual has broader resources available, with greater flexibility to determine what retirement income level is appropriate and the timing of the retirement income payments. The national government would continue to provide financial support of retirement income, but the levels of absolute guarantees would be reduced. Under the proposed cash-balance design, the total financial commitment is made explicit, which is easier to track over time. Under the defined contribution and personal retirement account programs, the government’s level of commitment is limited to the annual tax subsidies.

If the government does not undertake reforms, the SSS will be further undermined until it is insolvent, effectively eliminating an important economic safeguard for the people of the Philippines, or forcing the government to make hefty investments from the general fund. The Philippines should undertake social security reform now, before the population shifts further and social expectations make adjustment politically impossible.