SOCIAL SECURITY AND PENSION REFORM: LESSONS FROM OTHER COUNTRIES

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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TUESDAY, JULY 31, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:08 a.m., in room B–318 Rayburn House Office Building, Hon. E. Clay Shaw, Jr., (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE
July 24, 2001
No. SS–8

Contact: (202) 225–9263

Shaw Announces Hearing on Social Security and Pension Reform: Lessons from Other Countries

Congressman E. Clay Shaw, Jr., (R–FL), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on Social Security and pension reform: lessons from other countries. **The hearing will take place on Tuesday, July 31, 2001, in room B–318 Rayburn House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

Social insurance systems worldwide have enjoyed enormous success in reducing poverty among the elderly and the disabled, but, due to long-term demographic trends, are projected to face financing strains in the years ahead. In the next 30 years, one in four people in the developed world will be aged 65 or older, compared with one in seven today. Several countries, including the United Kingdom, Australia, Sweden, and Chile have responded to the challenges posed by an aging population by using individual accounts as part of a package of reforms to reshape their retirement programs.

President Bush formed a commission to develop recommendations for restoring fiscal soundness to Social Security. Among the principles guiding this commission is that "modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net." Numerous Social Security reform proposals introduced by Members of Congress include individual accounts. As the United States considers options to save Social Security, lessons can be learned from the experiences of countries that are implementing or have already implemented personal retirement accounts as part of their retirement programs.

Several countries have used personal accounts in different ways to reform their retirement programs. The United States can learn from their decisions about creating individual accounts and the issues associated with administering such a system, including centralized versus decentralized administration, investment choices and risk protections, pay-out options at retirement, and distribution of the accounts at marriage, divorce, or death. While these choices are a reflection of a country's culture, values and previously existing social insurance system, they also influence the administrative costs, rates of return workers experience, and the public's acceptance of the new system.

In announcing the hearing, Chairman Shaw stated: "The United States is not alone in struggling to address the financial challenges of retirement programs while insuring adequate benefits. The graying of the global population will put tremendous pressure on the public health and pension systems of industrialized nations. Without reform, the cost of financing old-age programs will grow at an unsustainable rate and consume a significant portion of these nations' national budgets. Given our shared challenges it makes good sense to learn from one another, particularly as more and more countries are using personal accounts as part of their strategies to reform their public retirement systems. Knowing more about their experiences will help us forge our own plan for strengthening Social Security."

FOCUS OF THE HEARING:

Witnesses will provide descriptions of other country's (primarily the United Kingdom, Australia, Sweden, and Chile) retirement systems after reform, with particular focus on the design of individual accounts, extent of choice in investments and payout of accounts, account administration, investment regulation, and consumer education. Witnesses will also discuss how reforms evolved in their countries and factors contributing to decisions regarding centralized versus decentralized administration and the degree of choice in investments and account payouts. To the degree possible, witnesses will provide information on administrative costs, rates of return on investments, and how reforms affected retirement income in their countries.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should *submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label*, by the close of business, Tuesday, August 14, 2001, to Allison Giles, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Social Security office, room B–316 Rayburn House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.**

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at "http://waysandmeans.house.gov/".

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman SHAW. This hearing will come to order.

Good morning. Today we focus on the lessons that we can learn from other countries who have worked to strengthen their public retirement systems. The challenges presented by an aging society are not unique to the United States. Throughout the world, many nations are confronted with seniors collecting benefits for a longer period of time, as life expectancy increases, while there are fewer workers supporting each retiree as birth rates fall.

But before we get to how Social Security might be strengthened, given the statement of my Democrat colleagues in response to the President's Commission to Strengthen Social Security's interim report, I want to revisit the question of whether Social Security needs to be strengthened at all. Let me begin by drawing your attention to the placards at the front of the room, and I quote:

"After the next 15 years—not 37 years—after the next 15 years, increasingly larger amounts of annual interest income must be used to meet the benefit payments and other expenditures, and the general fund of the Treasury will be drawn upon to provide the necessary cash. The accumulation and subsequent redemption of substantial trust fund assets has important economic and public policy implications that go well beyond the operation of the Old Age Survivors and Disability Insurance, OASDI, program itself."

Moving on now to the second placard: "The redemption of a Treasury security held by a trust fund requires that the Treasury transfer cash obtained from another revenue source, such as income taxes or borrowing from the public through the trust fund."

These quotes are from the 2000 annual report of the Board of Trustees, made up of the top economic and pension officials from the President Clinton administration, namely Lawrence Summers, Secretary of the Treasury, managing trustee; Alexis Herman, Secretary of Labor; Kenneth Afpel, Commissioner of Social Security; and this is among others. Donna Shalala was one that also signed the report. I was just reading it the other day.

These trustees conclude precisely the same thing as the President's Commission, that in approximately 15 years the system will face cash imbalances that will grow rapidly, and it is very important that we keep this in mind. It will have cash imbalances. There will not be enough coming into the trust fund to pay the benefits, and the trust fund will have to go to the Treasury and cash in the Treasury bills, and the Treasury will have to go to the taxpayers or borrow money in order to get the funds in order to pay off these Treasury bills.

Not only were the conclusions the same, but so were the explanations. Like other social insurance programs of industrialized nations, the aging of the population in the United States will result in fewer workers supporting each retiree. Many nations examined all the available alternatives, as we are doing now, and chose to use personal accounts to help sustain and supplement the benefits that have lifted seniors out of poverty and kept them out of poverty in this modern era.

For Social Security and the people who depend upon it, inaction is the greatest enemy. Each time the debate on Social Security delays progress, the cost and risk to the system increases. Some Democrats consider any type of personal account is radical. However, ignoring the system's problems until it reaches a crisis and faces the prospect of a 38-percent tax increase on all workers, including working mothers or low-income families, is what is truly radical and truly reckless.

Other countries are struggling with how to make ends meet, and their pension systems are in more immediate danger, since their populations are aging more quickly. Several countries, including Japan and the United Kingdom, have raised retirement ages. In addition to increasing taxes or reducing benefits, more and more nations, such as the United Kingdom, Sweden, Australia, and Chile, are using personal accounts as an important part of their retirement program. Even South Africa is.

Today we will hear from experts, some of whom have traveled great distances, regarding the similar challenges other countries have faced and their diverse approaches to modernizing retirement income security programs and establishing individual accounts as part of their programs. Given our shared challenge, and the fact that more and more countries are using personal accounts as their strategy to reform their public retirement system, it makes good sense to learn from one another. Knowing more about their experiences will help us forge our plan for strengthening Social Security.

Now, if there are some other areas and other ways to meet the challenge of the cash shortfall that we are going to start experiencing in 2016, I would like to know about it, because I do know that personal accounts have become controversial. They have been attacked by many of my colleagues, perhaps well-intended. But I think anyone who comes in and attacks these programs has the obligation to come forward with a plan on how we are going to take up the cash shortfall that is going to begin in 2016.

We are obviously going to have Treasury bills, that is the full faith and credit of the Federal government, that are going to extend well into the 'thirties, but how are we going to pay them off beginning in 2016? That is the dilemma that I see as the challenge before this Subcommittee.

I would now yield to the gentleman from California, Mr. Matsui, for his opening statement.

[The opening statement of Chairman Shaw follows:]

Opening Statement of the Hon. E. Clay Shaw, Jr., a Representative in Congress from the State of Florida, and Chairman, Subcommittee on Social Security

Today we focus on the lessons we can learn from other countries who have worked to strengthen their public retirement systems. The challenges presented by an aging society are not unique to the United States. Throughout the world, many nations are confronted with seniors collecting benefits for longer periods of time as life expectancy increases, while there are fewer workers supporting each retiree as birth rates fall.

But before we get to how Social Security might be strengthened, given the statements of my Democrat colleagues in response to the President's Commission to Strengthen Social Security's interim report, I want to revisit the question of whether Social Security needs to be strengthened at all. Let me begin by drawing your attention to the placards at the front of the room, and I quote—

"After the next 15 years, (*not 37 years*), increasingly larger amounts of annual interest income must be used to meet the benefit payments and other expenditures and the general fund of the Treasury will be drawn upon to provide the necessary cash. The accumulation and subsequent redemption of substantial trust fund assets has important economic and public policy implications that go well beyond the operation of the OASDI program itself."

Moving on to the second placard . . .

"The redemption of a Treasury security held by a trust fund requires that the Treasury transfer cash—obtained from another revenue source, such as income taxes or borrowing from the public—to the trust fund."

These quotes are from the 2000 Annual report of the Board of Trustees, made up of top economic and pension officials from President Clinton's administration, namely Lawrence Summers—Secretary of the Treasury and Managing Trustee, Alexis Herman—Secretary of Labor, Kenneth Apfel—Commissioner of Social Security, among others.

These Trustees concluded precisely the same thing as the President's Commission—that in approximately fifteen years the system would face cash imbalances that will grow rapidly.

Not only were the conclusions the same, but so were the explanations. Like other social insurance programs of industrialized nations, the aging of the population in the United States will result in fewer workers supporting each retiree. Many nations examined all the available alternatives, as we are doing now, and chose to use personal accounts to help sustain and supplement the benefits that have lifted seniors out of poverty in the modern era.

For Social Security and the people who depend on it, inaction is the greatest enemy. Each time the debate on Social Security delays progress, the cost and the risk to the system increases. Some Democrats consider any type of personal account 'radical.' However, ignoring the system's problems until it reaches a crisis and faces the prospect of a 38% payroll tax increase on all workers, including working mothers or low income families, is what is truly radical and reckless.

Other countries are struggling with how to make ends meet, and their pension systems are in more immediate danger, since their populations are aging more quickly. Several countries, including Japan, and the United Kingdom have raised retirement ages. In addition to increasing taxes or reducing benefits, more and more nations, such as the United Kingdom, Sweden, Australia, and Chile are using personal accounts as an important part of their retirement programs.

Today, we will hear from experts, some of whom have traveled great distances, regarding the similar challenges other countries have faced and their diverse approaches to modernizing retirement income security programs and establishing individual accounts as a part of those programs.

Given our shared challenges and the fact that more and more countries are using personal accounts as part of their strategy to reform their public retirement systems, it makes good sense to learn from one another. Knowing more about their experiences will help us forge our own plan for strengthening Social Security.

Mr. MATSUI. Thank you very much, Mr. Chairman. I appreciate your remarks, and I want to apologize. My Democratic colleagues, I think many of them are on the floor at this particular time. We have the Jordanian trade bill up now, and I know that Mr. Doggett, Mr. Cardin, and a number of others wanted to speak on that issue, but I believe that they will be here shortly.

And I want to also welcome the seven panelists, one of the first times we have had so many on one particular panel. I might just mention to the Chairman, because you did suggest that if anybody has any other ideas about how to fix Social Security, they ought to come up with them, at this very moment Mr. Stenholm and Mr. Kolbe in the triangle are having a press conference on support of their privatization proposal.

As we know, Speaker Hastert, Minority Leader Gephardt, and Ari Fleischer on behalf of the President yesterday all came out against Mr. Stenholm and Mr. Kolbe's proposal. And so it is my hope that the commission comes up with something that might be a little different, although I don't see how, but perhaps they will. And anybody who is interested probably should endorse Mr. Kolbe and Mr. Stenholm's proposal. That might be one way to get this debate joined, and we can then obviously begin to debate the real issues, rather than hear from the Chileans and a few others that have no relevance to the U.S. economy.

I might just point out a few things. In terms of the 2016 date, as I said earlier last week, there is no question that the commission was attempting to frighten the American people, and pit young people, those in the work force, against senior citizens at this particular time. And it is somewhat unfortunate because on the year 2016 we are going to have $5 trillion worth of payroll taxes that will be sitting in the Social Security trust fund, undoubtedly will be used, hopefully to pay down the debt, not spent on other expenditures.

In the meantime we will be accumulating interest on that $5 trillion at the rate of 6.9 percent per annum, and we won't really draw down on the surplus, the $5 trillion corpus of that trust fund, until the year 2025. And as we all know, it is not until the year 2038 that we actually do have a problem where there will be a benefit shortfall.

The benefit shortfall for the next 75 years is 12 percent, a fundamental problem and one that we need to address immediately. And with President Bush in the White House, and with the Republicans in control of the House, it would be my hope that they would come up with a proposal, or sit down with Democrats and Republican Members so that we can work out a bipartisan compromise.

In fact, I will make that request at this very moment, Mr. Chairman. Perhaps you and Mr. Thomas and the Republican leadership can sit down with Mr. Rangel, myself and Mr. Gephardt, and maybe even bring in the Democratic and Republican leadership, and see if we can come up with a proposal. I would welcome that opportunity, because we cannot leave the uncertainty that we currently have in the market today.

Now, let me just mention a few other things, if I may, and I will be very brief but I don't want this to go undiscussed. And I have the greatest respect for Mr. Hewitt. Mr. Hewitt, I might say that your report is not finalized yet, and I know Mr. Mondale, the cochair who you will be mentioning in your opening statement, has significant reservations about privatization just as I do. And so I would hope that these are your opinions and not necessarily the organization upon which are you are talking, because certainly there will be a lot more discussion about the report when it does become final.

And I might just point out, just by way of discussion here, in terms of my opening statement, that you mention in your statement on page 2 that Japan's health and welfare industry recently estimated that at current birth rates, there will only be 500 Japanese left in the year 3000. That is a rather startling statistic. I don't know the relevance of it, but 999 years from now I would be more worried, rather than 500 Japanese being in existence, that the human species would be in existence, given the fact that no one seems to be concerned about global warming in the administration, and a few other significant issues.

But the fact of the matter is that numbers don't really mean a lot when you talk about 1,000 years from now, maybe even 75 years from now. Seventy-five years ago I think Lindbergh was flying over the Atlantic, and if he would have been thinking about supersonic transportation and the kind of Internet operations we have now, he would probably think he was crazy. So we don't really know what the birth rate, population, will be in 75 years.

And let me just conclude by making a couple other observations. I mentioned Chile, and I didn't mean to pick on Chile, Mr. Rodriguez, but you know Sweden and Denmark and Australia, these other countries that we are talking about, Chile has a population of 20 million and a work force of 10 million. California has a larger population and work force than that, and I just might say that we wouldn't adopt the Chilean example.

But I don't know what relevance the population of that has and the others have when you have 270 million people, 200 million people in the work force. And I just might point out, I guess London, England is probably the closest thing that we have today in terms of financial relevance to this hearing and what our problems are.

But I might just point out there that in terms of the industrialized countries of the world, this is a shocking statistic but people ought to know it, the pension, public pension rate to our senior citizens is the lowest. Canada has 5.2 percent of gross domestic product (GDP) going to their senior citizens; France, 10.6; Germany, 11.1; Italy, 13.3; Japan, 6.6. We only give 4.1 percent of GDP to our senior citizens, the lowest of all these countries except for the U.K. In the year 2050 it is going to get worse in terms of the U.S.

And I might just point out also that in terms of the industrialized countries of the world, the United States has three times the rate of poverty in senior citizens than these other countries. And so I don't think that we are spending too much money on our senior citizens. I think, on the contrary, that perhaps we have a ways to go.

And maybe these other countries have to do something because they are spending a generous sum on their senior citizens, but we are not. In fact, if we cut Social Security, we would put 60 percent of the American senior citizen population into poverty.

In conclusion, Mr. Chairman, and I really appreciate this hearing, but I know we are going to have somebody from Prudential here today, Mr. Bedell-Pearce, and I would like him to explain some of the issues that perhaps I won't have an opportunity to ask him, but he should explain this. He calls it, I guess, mis-selling that occurred in England in the late 'nineties. And I just read here a statement that—if I can find it—I have it right here. Here it is. This is from the Guardian of August 10, 1998. I quote:

"Britain's biggest life insurer, the Prudential, was the center of a new controversy last night after a Guardian investigation revealed it is continuing to attempt to mis-sell petitions. When approached by Guardian investigators, Prudential agents (1) attempted to sell policies that maximized their earnings for their salespersons and the company; (2) recommended poorer value pensions; (3) quoted future growth figures banned by the Financial

Services Act; and (4) showed potential customers deliberately misleading competitors' statistics."

And I conclude by making this. Just 2 weeks ago the statement in a British newspaper stated:

"Ministers are concerned"—that is, the finance ministers are concerned—"that the financial problems of Equitable Life Pensioners could deliver a blow to the government stakeholder pensions." That is the second tier pension system. "About 1 million Equitable policyholders saw the value of their pension funds cut by 16 percent this week." That is the private sector pension program. "It certainly will not help us convince people to save if a big household name is cutting the value of its funds, but we believe it is an isolated case," one official said.

And perhaps you can comment on that. It is kind of interesting that we have somebody who benefits from private pension programs or privatization testifying on behalf of it, but there is nothing wrong with it, I suppose.

But in any event, I look forward to this hearing, Mr. Chairman, and look forward to the witnesses, and certainly the continuing debate on the issue of whether we should carve out 16 percent of Social Security payroll taxes and divert them to other sources to reduce the senior citizens' pension benefits and Social Security benefits.

[The following was subsequently received:]

Prudential plc
London, England

On the first point, the congressman referred to pensions mis-selling that took place in the "late nineties" and cited an article appearing in the UK newspaper "The Guardian" in 1998 where it was alleged that a Prudential representative had offered bad advice in relation to a pension product and where it was alleged that the salesman was motivated by potential commission earnings.

The oversight mechanisms introduced by Prudential and the rest of the industry after 1994 mean that there should not be a reoccurrence of product mis-selling but the conclusion reached by both the industry and the Government was that the more satisfactory approach is the regulate the product itself. With the new Stakeholder pension introduced in April of this year, the maximum management charge has been restricted to not more than 1% per annum and there are further rules on the shape and nature of the product.

As for the Guardian article in question, I am happy to clarify that Prudential expressed concern about the contents and met the Guardian to discuss the background. Despite Prudential and the regulator (The Financial Services Authority) requesting transcripts, the Guardian was unable to produce any supporting evidence to substantiate the allegation. Equally importantly, the alleged incident refers, not to a sale, but to a "fact finding" meeting the first stage of the early process, a process which, since 1995, had been subject to "second pair of eyes" independent oversight. We are confident that no sale would have been completed in this particular case.

On Equitable Life, the problems of this, the UK's oldest mutual life company, were truly unique to that company and resulted primarily from a combination of the issue of guarantees on certain policies which required reducing payments on non-guaranteed policies because the financial reserves of the mutual were inadequate. The Equitable case underlines the dangers of open-ended guarantees and provides an important warning to both commercial and State providers alike. Far from diminishing confidence in pensions or the life industry in general, sales of life products by other life companies have increased substantially since Equitable's problems emerged.

In short, neither pensions mis-selling nor the problems of Equitable can be cited as legitimate reasons to avoid the creation of individual accounts for retirement if the lessons of product regulation and the inadvisability of guarantees are taken on board. The UK government has had no hesitation in launching the new generation of Stakeholder pensions in partnership with the UK insurance industry, a partnership which is supported by both the public and the trade unions. Indeed, the Trades Union Congress (the representative body for unions in the UK) has appointed Prudential as its exclusive provider of stakeholder pensions for arrangements set-up by its Member unions.

Yours sincerely,

Keith Bedell-Pearce
Executive Director

Chairman SHAW. I would like to just briefly reply, and I don't want this to be a battle of opening statements, and any other Members that——

Mr. MATSUI. Mr. Chairman, can we go by regular order. I don't mind that, but then I wish to have an opportunity to reply. That is fine.

Chairman SHAW. Oh, yes, but I just want to make one point very clear. Last year Mr. Archer and I did meet with Mr. Gephardt and Mr. Hastert. We did meet with Mr. Rangel. I don't recall whether you were in those specific meetings. I think you were, but maybe I am wrong about that. And I would certainly accept your challenge to meet again. I think that is a very good suggestion, and I will be glad to repeat that and meet again.

Now, if you want to reply——

Mr. MATSUI. The only thing I would reply, I was in one of the meetings, Mr. Chairman, and at that meeting the Archer-Shaw bill was presented to us as the approach we needed to take. I recall Mr. Archer saying that this is the way we have to go. It wasn't really a discussion of negotiations. It was the discussion of whether we could support that bill.

My problem with your bill was the fact that by 2033 we would have had to borrow from the general fund, if there was a general fund surplus, $11.7 trillion, and I didn't think that that was something that was supportable by your own party. In fact, Mr. Hastert kind of backed away from it at that time and the meeting was terminated.

Chairman SHAW. Well, I would say that is totally incorrect. But in any event, your recollection is totally flawed, and I will supply you with the numbers of what the Archer-Shaw bill would have done.

I would like at this time to yield to Mr. Camp for purposes of introducing one of our panelists this morning.

Mr. CAMP. I thank the Chairman for yielding, as I am not a Member of this Subcommittee. And as the gentleman from California and I have discussed, I am sure that the person I would like to introduce will certainly attempt to answer your concerns later on.

But I just want to say that I attended a seminar with Keith Bedell-Pearce, who is chairman of Prudential and also affiliated with Jackson National Life, which brings income security to many Americans as well as people of the State of Michigan. And his knowledge of the public-private partnership in place in the United Kingdom to address retirement security I think will be of some help to this Subcommittee, and I look forward to hearing his testimony and to hear his insights on the pension system in the United

Kingdom, so that as we go forward on this very important debate, that we have at least the knowledge of experts from around the world on this subject.

And I certainly welcome the entire panel, as well. We have got a number of distinguished visitors, as well as David Harris, who I have met before and attended seminars with, as well. So I look forward to hearing the testimony this morning, and thank the Chairman for his indulgence.

Chairman SHAW. Thank you, Mr. Camp.

And to introduce the other witnesses, some of whom have already been partially introduced: Paul Hewitt, who is the director of Global Aging Initiative, the Center for Strategic and international Studies, welcome; Gary Burtless, who is a senior fellow at the Brookings Institute; Edward Palmer, who is the chief, Research and Evaluation, National Social Insurance Board in Stockholm, Sweden; Peter Orszag, Dr. Peter Orszag—and if I am mispronouncing your name, you can correct me when it is your turn—who is the president of the Sebago Associates in Belmont, California; Mr. Rodriguez, who is assistant director, Project on Global Economic Liberty at the Cato Institute, and I might add here at this particular point, I believe Chile had a Social Security system over 10 years before the United States did, so they have been very progressive in that area; and Mr. David Harris, who is a consultant, Watson Wyatt Worldwide, at Reigate—am I pronouncing that correctly?

Mr. HARRIS. Reigate.

Chairman SHAW. Reigate, Surrey, United Kingdom.

Welcome, all of you. We have all of your full statements that will be made a part of the record. You may proceed and summarize as you see fit. Mr. Hewitt?

STATEMENT OF PAUL S. HEWITT, DIRECTOR, GLOBAL AGING INITIATIVE, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. HEWITT. Mr. Chairman, in 1999 CSIS undertook a multiyear research program to assess the economic and financial consequences of population aging throughout the developed world. Our work began with the recognition that America is not the only nation that faces a sharp rise in old-age dependency over the coming decade.

The whole industrial world is aging, most of it a lot more rapidly than we are. The transition economies of the former Soviet bloc are aging faster than we are, and even such key emerging market countries as China, Korea, Taiwan, Thailand, Brazil, and Chile can all expect to have older age structures than we will by mid-century.

Given these trends, it is not surprising to find ourselves in the midst of a global revolution in pension reform. This common challenge holds great dangers for the global economy, not least because financial catastrophe in any one nation could tip others into crisis. But one advantage it gives us is that there is a rich record of reform from which we can draw.

Franklin Roosevelt liked to call State governments the laboratories of democracy, and the same could be said today of national governments the world over. Our own research effort, the Global

Aging Initiative, is evidence of this cross-national trend. Overseeing our work is a panel of 86 leading voices from three continents, reflecting an extraordinary diversity of political perspectives.

I am proud to note that both you, Mr. Chairman, and Congressman Matsui serve on the Global Aging Commission, together with five other Members of Congress from both sides of the aisle and seven current or former cabinet ministers from the EU and Japan. Another Member of the commission is also present on the dias today, Mr. Pomeroy. Thank you for participating in our project.

Two overarching points can be made about the revolution in pension reform. First, it is not driven by ideology. In Italy, pension reform has been spearheaded by the New Democratic Party of the Left, formerly known as the Italian Communist Party. Germany's individual account law was recently pushed through the Bundestag by Gerhard Schroeder's center-left coalition of Socialists and Greens. These reforms have been nicknamed the "Riester reforms" after Labor Minister Walter Riester, the former deputy national chairman of Germany's largest industrial union, IG Metall.

Some of the other Social Security reforms to be examined in this panel today were also championed by parties of the left. In every case, reform has reflected a pragmatic, non-ideological response to developments that now threaten sustainability of retirement systems everywhere.

The second observation that can be made is that retirement insecurity in the industrial world today stems from social insurance itself. It doesn't matter whether you are in Austria, Belgium, Greece, or Japan, public opinion polls reflect the same overwhelming fear among the young and middle-aged that social security will not be there for them when they retire.

This is not some international fad that will go away if we ignore it. By 2030, old age dependency ratios in Japan, Canada, and the major continental European countries are projected to roughly double, while in the U.S. this ratio will rise by somewhere between two-thirds and three-quarters. In every case, serious funding problems lie ahead.

In order to insure against this new insecurity, governments are having to work with the private sector. Increased reliance on funding underlies all of the major Social Security reforms of the past decade. Funded pensions, essentially retirement savings plans, have two key advantages over pay-as-you-go intergenerational transfers.

First, they are not directly affected by changes in the old-age dependency ratio. Whereas a declining ratio of workers to retirees immediately signals the need for higher taxes or reduced benefits, funded systems are only indirectly affected by population aging through structural changes to the broader economy.

A second advantage to funded pensions is that cross-border investment can shield individual retirement security from adverse national economic trends. This is an important consideration in countries where labor forces are expected to decline for the foreseeable future.

America's working-age population is projected to grow by about 11 percent between now and 2030. Most of this will come before

2010. But decades of below-replacement birth rate has left much of Europe and Japan facing substantial declines in both labor forces and total populations. It was mentioned earlier that Japan's Health and Welfare Ministry recently estimated that at current birth rates, there will be just 500 Japanese left by the year 3000. I think that number is around 1,000 by the year 2500. It tails off. But in Italy, Spain, Bulgaria, a whole series of other countries, birth rates are even lower. They have been projected to come up for a long time, for decades now, and they have gone in the other direction.

Over the next 10 years these demographic trends will begin to adversely affect our economies. Surging numbers of workers have accounted for between one-half and two-thirds of the rise in the developed world's output over the past half century. In future, declining labor forces are forecast to subtract 1 percent a year or more from the economic growth rates in some countries.

Pension funding will allow citizens in Europe and Japan to invest in multinational companies whose operations inevitably will shift to faster-growing markets abroad. In this way, the global economy provides an important resource for the aging nations of this world, but it is only a resource to nations that fund their pensions.

There is a lot we can learn from the reforms adopted in other nations. The UK has a voluntary savings scheme that becomes compulsory once you select it. Australia, Chile, Sweden, have adopted compulsory savings schemes. Each has its own contribution levels and unique fiduciary rules, administrative structures, and contingent guarantees. The experiences of these and the many other countries that have moved toward pension funding in recent years should be closely examined as part of any Social Security reform effort.

Of course, as was mentioned, compared to most other industrial countries, America is aging less rapidly; our Social Security benefits are less generous; our private pension system is more robust; and we continue to be the most favored destination for capital and talent the world over. Our situation, though still serious, is less dire, and this gives America important competitive advantages in the global economy. But we will squander these advantages if we fail to learn from other nations whose situation is different from ours only in degree.

Thank you.

[The prepared statement of Mr. Hewitt follows:]

Statement of Paul S. Hewitt, Director, Global Aging Initiative, Center for Strategic and International Studies

Mr. Chairman, in 1999, CSIS undertook a multi-year research program to assess the economic and financial consequences of population aging in the developed world. Our work began with the recognition that America is not the only nation that faces a sharp rise in old-age dependency over the coming decades. The whole industrial world is aging—most of it, a lot more rapidly than we are. The transition economies of the former Soviet bloc are aging faster than we are. And even such key emerging market countries as China, Korea, Taiwan, Thailand, Brazil and Chile can all expect to have older age structures than we will by mid-century. Given these trends, it's not surprising to find ourselves in the midst of a global revolution in pension reform. This common challenge holds great dangers for the global economy, not least because fiscal catastrophe in any one nation could tip others into crisis. But one advantage of global aging is that it has given us a rich record of reform from which to draw.

Franklin Roosevelt liked to call state governments the laboratories of democracy. The same could be said today of national governments the world over.

Our own research effort, the Global Aging Initiative, is evidence of this cross-national trend. Overseeing our work is a panel of 86 leading voices from three continents, reflecting an extraordinary diversity of political perspectives. Our co-chairmen are former Vice President Walter Mondale, former Prime Minister Ryutaro Hashimoto and former Deutsche Bundesbank President Karl Otto Pöhl. In addition to seven current or former cabinet ministers from Europe and Japan, seven senior members of Congress—four Democrats and three Republicans—serve on the Commission on Global Aging. I am proud to note that both you, Mr. Chairman, and Congressman Matsui, the ranking member of this subcommittee, are Commission members.

Two overarching points can be made about the revolution in pension reform. First, it is not driven by ideology. In Italy, pension reform has been spearheaded by the New Democratic Party of the Left—formerly known as the Italian Communist Party. Germany's individual account law was recently pushed through the Bundestag by Gerhard Schroeder's center-left coalition of Socialists and Greens. These reforms have been nicknamed the "Riester reforms" after Labor Minister Walter Riester, the former deputy national chairman of Germany's largest industrial union, IG Metall. Some of the other social security reforms to be examined in this panel today also were championed by parties of the left. In every case, reform has reflected a pragmatic, non-ideological response to developments that now threaten the sustainability of retirement systems everywhere.

The second observation is that retirement insecurity in the industrial world today stems from social insurance itself. It doesn't matter whether you are in Austria, Belgium, Greece or Japan, public opinion polls reflect the same overwhelming fear among the young and middle-aged that social security will not be there for them when they retire. This is not some international fad that will go away if we ignore it. By 2030, old-age dependency ratios in Japan, Canada and the major continental European countries are projected to roughly double, while in the U.S., this ratio will rise by somewhere between two-thirds and three-quarters. In every case, serious funding problems lie ahead.

In order to insure against this new insecurity, governments are having to work with the private sector. Increased reliance on funding underlies all of the major social security reforms of the past decade. Funded pensions—essentially, retirement saving plans—have two key advantages over pay-as-you-go intergenerational transfers. First, they are not directly affected by changes in the old-age dependency ratio. Whereas a declining ratio of workers to retirees immediately creates the need for higher taxes or reduced benefits, funded systems are only indirectly affected by population aging through structural changes in the broader economy.

A second advantage of funded pensions is that cross-border investment can shield individual retirement security from adverse national economic trends. This is an important consideration in countries where labor forces are expected to decline for the foreseeable future. America's working-age population is projected to grow by about 11 percent between now and 2030—most of this coming before 2010. But decades of below-replacement birthrates has left much of Europe and Japan facing substantial declines in both labor forces and total populations. Japan's Health and Welfare ministry recently estimated that, at current birthrates, there will be just 500 Japanese left in the year 3000. In Italy, Spain, Greece and several other nations, birthrates are even lower.

Over the next decade, these demographic trends will begin to adversely affect our economies. Surging numbers of workers have accounted for between one-half and two-thirds of the rise in the developed world's output over the past half century. In the future, declining labor forces are forecast to subtract one percent a year from economic growth rates in some countries. Pension funding will allow citizens in Europe and Japan to invest in multinational companies whose operations inevitably will shift to faster-growing markets abroad. In this way, the global economy provides an important resource for the aging nations of this world. But it is only a resource to nations that fund their pensions.

There is a lot that we can learn from the reforms adopted in other nations. Great Britain, Australia, Chile, and Sweden have adopted compulsory savings schemes, each with their own contribution levels and unique fiduciary rules, administrative structures, and contingent guarantees. The experiences of these and the many other countries that have moved toward pension funding in recent years should be closely examined as part of any U.S. Social Security reform effort.

Of course, compared to most other industrial countries, America is aging less rapidly; our social security benefits are less generous; our private pension system is more robust; and we continue to be the most favored destination for capital and talent the world over. Our situation, though still serious, is less dire, and this gives America important competitive advantages in the global economy. But we will squander these advantages if we fail to learn from other nations whose situation is different from ours only in degree.

Information on the Global Aging Initiative can be found at *www.csis.org/gai.*

Chairman SHAW. Thank you, Mr. Hewitt.

Mr. Burtless.

STATEMENT OF GARY BURTLESS, SENIOR FELLOW, BROOKINGS INSTITUTE

Mr. BURTLESS. Thank you very much. I am honored by the invitation to participate in this hearing. The goal of the hearing, as I understand it, is to learn what other countries can teach us about operating a national system of individual retirement accounts.

My written testimony concludes with an overview of these issues, and I describe some basic principles about designing such a system, principles that are based upon experiences overseas and here in the United States. I have done research in this area over the past 15 years. I am also guilty of co-authoring a book on U.S. Social Security reform and another one on the pension crisis in the five biggest industrial countries.

But my interest in this subject is not just academic. Over the past decade I have also advised a number of countries on how they can reform their pension programs to make them more solvent and protect the retirement incomes of their workers. Perhaps imprudently, a couple of these countries have even adopted some of this advice.

My oral statement, however, is not going to focus on the technical issues connected with how to design a safe and efficient individual account system. Instead, what I want to do is talk about a more basic question: Is the decision of other countries, like Chile or Sweden, Australia or Great Britain, to adopt an individual account system, really very informative about whether this would be a good idea for us?

The experiences with their new systems may be helpful in guiding the design of a similar system here in the United States, but do they really tell us whether such a system would be a good idea here? I don't think so. In the next couple of minutes, what I want to do is mention three key differences between the United States and countries that have made individual accounts part of their system. The differences make individual accounts less compelling for us than they are in these other countries.

First of all, compared with the situation in other industrial countries, the funding problem in Social Security is not particularly severe. One reason is that the American population is younger and is expected to remain younger than the populations of the other rich industrialized countries. This makes the traditional pay-as-you-go financing method more affordable for the United States than it is elsewhere.

Congress has also been much more cautious about liberalizing pensions than legislatures in other countries. Even if we faced the same aging problem as France, Germany, or Sweden, our financing problem would be smaller because our basic benefits are less generous and often start at a later age.

Incidentally, this also distinguishes us from Chile and other Latin American countries which have adopted individual accounts. The old pension systems in those countries often provided unaffordably generous benefits to favored groups in the population. Imprudent benefit expansions and widespread tax evasion made the old systems insolvent. The United States, fortunately, has never faced those problems.

Table 1 in my testimony gives you details about the demographic outlook and the public pension imbalances in the seven largest industrial countries. You will notice that the current U.S. pension system is in much better shape than the equivalent systems in most of the other G–7 countries, with the important exception of Great Britain.

A second factor distinguishing our situation from that in other countries is that we already have a well-developed system of individual and company pensions. To an extent that people often forget, the United States has a retirement system built in part on voluntary contributions by employers and their workers to company pension plans and to individual pension plans. More Americans are covered by employer and individual pension plans than is the case in most of the rest of the industrialized world.

There are some countries like the Netherlands and Switzerland where participation is even higher than in the United States, but we have a very high rate of participation already. Over half the U.S. work force is covered by an employer pension plan, and the percentage is higher still if you restrict your attention to people who are adults in full-time jobs and who have held their job for at least 1 year.

Thus, the case that our retirement system has a big hole because we lack a system of private funded pensions completely misses a big part of our existing system. Employers and Congress have been busy over the past half century in developing a private pension system, and then assuring that it is reasonably safe, that it is transparent, that it is well-regulated, and that it is nondiscriminatory.

I mentioned earlier that the U.S. has been more cautious than other countries with regard to liberalizing benefits. This holds down the cost of our basic system. An unwelcome side effect is that the United States has a much higher rate of old age poverty than the other rich countries. This brings up a third big difference between us and other industrial countries. The sorry facts are presented in Chart 1 of my testimony.

Among the 15 rich industrial countries where comparable evidence can be assembled, only Australia has a poverty rate among the elderly as high as ours. If you take out the United States and look at the rest of the countries, our rate is more than three times higher than that of the rest of the industrialized world.

Now, to me this is relevant to thinking about how we should fix our Social Security system. I don't think you want to take out funds from the system that does more than any other program to hold down the poverty rate among the elderly in the United States, and put those funds in a system of voluntary pensions. Anything that diverts funding from the basic pension program is something that I think in the long term is going to threaten the well-being of workers who have low or erratic earnings.

Thank you.

[The prepared statement of Mr. Burtless follows:]

Statement of Gary Burtless,* Senior Fellow, Brookings Institution

INTERNATIONAL EVIDENCE ON THE DESIRABILITY OF INDIVIDUAL RETIREMENT ACCOUNTS IN PUBLIC PENSION SYSTEMS

Summary

Social Security faces a long-term financing problem. The simplest and most logical solution to this problem is to trim promised benefits and increase payroll taxes modestly over the next two decades. These steps are politically unpopular, however, which explains the growing interest in supplementing or replacing traditional Social Security with a new system of worker owned and directed retirement accounts. A number of countries have already moved in this direction. However, the introduction of private accounts, by itself, does not solve the long-term problem facing public pension systems, including the Social Security system.

Some people who favor individual accounts believe we can learn from the experience of countries that have adopted such a system. While this is true, it is more pertinent to ask whether the experience of other countries sheds any light on the wisdom of replacing traditional Social Security, in whole or in part, with a system based on individual retirement accounts. The United States' situation differs significantly from that of other countries which have recently adopted individual account systems.

In comparison with most of the industrialized world, the United States does not face an acute funding crisis in its main public pension program. The Social Security system is better financed than pay-as-you-go systems in most other industrialized countries. The U.S. has a younger population than other developed countries, and the trend toward a grayer population is proceeding more slowly in the United States than it is elsewhere. If current immigration and fertility patterns continue, the fraction of Americans who are past the retirement age will never reach the levels expected in Japan and most of Western Europe.

One reason Social Security's financial position is comparatively healthy is that benefits are relatively low. As a result, the tax needed to pay for promised benefits after the Baby Boom generation retires will be lower than the *current* payroll tax rate needed to pay for benefits in other countries.

The relatively modest level of Social Security benefits causes the United States to be different from other countries in one crucial respect. Our old-age poverty rate is more than three times the poverty rate in other rich nations. Social Security pensions account for an overwhelming fraction of the income received by aged Americans who are at risk of becoming poor. We therefore face a much greater risk than other wealthy countries of pushing large numbers of the aged into poverty if we reduce the guaranteed pensions available to low-wage workers.

The United States also has less need for introducing individual account pensions. A large percentage of the workforce already participates in employer-sponsored plans or in voluntary individual retirement accounts. In comparison with most of the industrialized world, the assets accumulated in these plans represent an unusually large percentage of our national wealth. Though it is desirable to increase the percentage of workers who participate in individual retirement saving plans, it makes no sense to accomplish this worthy goal by weakening the retirement income protection and guaranteed benefits available to workers who have low or intermittent career earnings.

The crisis in public pension systems

The populations of the United States and other industrial countries are certain to grow older over the next five decades. By 2050 the ratio of people past age 64 relative to the number age 20–64 will exceed 45 percent in each of the seven largest industrial countries except the United States. In Germany, the aged dependency ratio will approach 55 percent; in Italy, it may reach 75 percent. Even though the United States will not age as fast, the American dependency rate is expected to be four-fifths higher in 2050 than it is today, rising from 21 percent to 38 percent (see Table 1).

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*The views expressed are solely my own and should not be ascribed to the staff or trustees of the Brookings Institution.

The projected budget cost associated with population aging is so large that most countries will be forced to make painful changes in their public pension programs. Policymakers may be tempted to follow the example of Chile and replace part or all of their national pension systems with private systems organized around individual retirement accounts. Advocates of this kind of reform point to Chile's success in introducing an individual account system to replace its failing pay-as-you-go system, which the government began to phase out in the early 1980s. So far, Chile's individual account pension system has received high marks for sound administration, good returns, and broad political acceptance. The expected surge in public retirement costs in rich industrialized countries has made policymakers in many countries receptive to the idea of including individual investment accounts in their nations' public retirement systems.

A number of countries in Western and Central Europe, in Latin America, and on the Pacific Rim have enacted major reforms in the past decade. A partial list includes Sweden, Germany, and Italy in Western Europe, most of the transition countries in Central Europe, Argentina, Mexico, and Uruguay in Latin America, as well as Australia, Canada, and Japan. Some countries decided to introduce voluntary or compulsory individual retirement accounts as part of their reforms. Others focused on overhauling the pay-as-you-go component of their existing public systems. The United States can learn lessons about reform from the experiences of other countries. The successes and failures of other countries can guide us in the design and administration of an individual retirement account system, if we choose to adopt such a system. But before considering these lessons, it is important to consider whether the decision of other countries to adopt individual account systems is really informative about whether that choice is sensible for the United States.

Differences in the outlook for public pensions. The United States differs in significant ways from countries that have moved toward individual retirement systems. Some differences would make it easier to introduce individual accounts, but many would make it much less advantageous to do so. In comparison with public retirement systems in most other rich countries, the U.S. Social Security system places much smaller burdens on active workers. There are three main reasons for this.

First, a relatively high birth rate and a high rate of immigration mean that the American work force will continue to grow far into the future. This difference with most of the rest of the industrialized world implies that a pay-as-you-go retirement system can provide pensions at a lower contribution rate than will be possible in other rich countries. The working-age population is growing slightly faster than 1 percent a year in the United States. It is already shrinking in Japan, and it will soon begin to decline in many other industrialized countries. The financing problem facing pay-as-you-go pension systems is thus less serious in the United States than it is in other rich countries.

Compared with national pension systems in many other countries, especially developing countries, the U.S. Social Security system is less costly to administer. Collection of payroll contributions is closely integrated with collection of the personal and corporation income tax, making contributions less costly for the government to collect and for employers to pay. There is a high rate of voluntary compliance with Social Security contribution requirements, in contrast with the situation in some other countries where workers and employers frequently evade contribution requirements, increasing the burden on employers and workers who honestly pay the required contribution. Finally, the Social Security Administration is more efficient than counterpart agencies in many other countries. Only about 1 percent of American workers' contributions are consumed in the administration of Social Security, leaving 99 percent of contributions for benefit payments and investments in pension reserves. Not only is the Social Security Administration efficient in comparison with public pension agencies in most other countries, it is remarkably efficient in comparison with private insurance and pension companies in the United States that perform similar functions.[1]

A third reason the pension financing problem is less severe in the United States is that the basic benefits provided by Social Security are lower in relation to wages than benefits provided by most other national pension systems. Because benefits are lower relative to average wages in the United States, the contribution rate needed to pay for them is also lower. Congress has historically been more cautious in rais-

[1] Excluding the cost of the disability program, the cost of administering Social Security is about $10 per person per year. This estimate is based on 1997 administrative costs of $2.1 billion and 182.6 million participants—145 million workers and 37.6 million beneficiaries. Peter Diamond estimates that the administrative cost of the U.S. Social Security system is only one-third to one-twelfth of the equivalent cost of administering private pension plans. (NBER Working Paper No. 4510, National Bureau of Economic Research, Cambridge, MA, 1993)

ing average benefits than legislatures in other industrial countries. Faced with the prospect of a long-term funding problem in Social Security, the United States was the first major country to increase its normal pension age. Congress raised the normal retirement age from 65 to 67 under the Social Security Amendments passed in 1983. Around that same year, governments in several West European countries were revising their pension and unemployment insurance programs to make it easier for workers between 55 and 64 years old to collect early pensions. This step was taken to alleviate Europe's worsening unemployment problem, but it added to the long-term financing problem faced by their public pension systems.

Table 1 summarizes the demographic outlook and pension fund challenges facing the seven largest industrial countries. The first three columns show the U.S. Census Bureau's estimates of old-age dependency rates in 2000, 2025, and 2050, respectively. High rates of fertility and immigration give the United States the lowest predicted dependency rate in 2025 and 2050. The comparatively low dependency rate combined with a modest level of pensions also give the United States the lowest level of spending on public pensions, measured as a percentage of GDP (column 4). Although pension spending will increase in the future, it will remain substantially lower than spending in the other G–7 countries, with the notable exception of Great Britain (see column 5). Revisions of the British pension system enacted in the 1980s will cause basic pensions to rise more slowly than average wages, almost guaranteeing that pension outlays will eventually shrink as a share of national income—assuming the current British system survives unchanged until 2050. Along with Britain's public pension system, the American Social Security system has the smallest gross and net liabilities (columns 6 and 7).

Low benefits and high poverty

The modest basic pension guaranteed by the U.S. system gives rise to a problem that is unusual in rich industrialized countries—a high poverty rate among the aged. Chart 1 shows poverty rates among the elderly in sixteen rich countries. The countries provide micro-census information to the Luxembourg Income Study in a way that allows researchers to calculate poverty rates in consistent way. I classify someone as poor if he or she is a member of a household that receives less than 40 percent of his or her country's median household income.[2] (Household income includes cash and near-cash income, such as food stamps, but payments for income and payroll taxes are subtracted. Reported incomes are adjusted to reflect differences in household size.) Under this definition, the old-age poverty rate in the United States is 12 percent—more than three times the average rate in the other 15 countries. Only Australia has an old-age poverty rate that is as high.

A principal goal of national pension systems, including ours, is to minimize poverty among the retired elderly. In view of the exceptionally high poverty rate of America's elderly, we should be more cautious than other countries in reforming our system in a way that threatens to reduce the guaranteed pensions available to workers who have low lifetime earnings. About 9 percent of aged Social Security recipients are poor under the official U.S. poverty definition. The Social Security Administration estimates that 48 percent of recipients *would be* poor if they did not receive Social Security benefits. Social Security pensions provide about four-fifths of the money income received by elderly Americans in the bottom 40 percent of the aged income distribution. For many of these aged Americans, the monthly benefits provided by Social Security are simply too low to remove them from the ranks of the poor. Any reform of the U.S. retirement system should be designed to prevent old-age poverty rates from rising even further above the rates in the rest of the industrialized world.

Private pensions

The United States differs from many other rich countries in having a well-developed system of funded private and employer-sponsored pensions. Slightly more than one-half of all active workers in the United States, including a large majority of the best paid employees, are already covered by an employer-sponsored plan.[3] By law, employer-sponsored plans are fully funded. In addition, many workers make voluntary contributions to Keogh plans (for the self-employed), 401(k) or 403(b) plans (for private company and nonprofit institution employees), or Individual Retirement Accounts (primarily for employees not covered by an employer pension plan). Private

[2] For purposes of comparison, the official U.S. poverty line for a four-person family was 42 percent of median household income in 1999.

[3] Among working American families in which the head of household is less than 65 years old, 57 percent of families have at least one member who participates in an occupational pension plan (EBRI, 2000).

and employer-sponsored pension plans now provide at least one-sixth of older Americans' nonwage incomes, and this fraction is certain to rise as an increasing share of workers reach retirement after long careers in pension-covered jobs.

Private and employer-sponsored pension plans cover a large percentage of active U.S. workers. As a result, these plans have accumulated more assets than private plans in most other industrial countries (see right-hand column in Table 1). Among the seven largest industrial countries, only the United Kingdom has accumulated such a large stock of savings in private pension plans. In comparison with the situation in most other G–7 countries, the U.S. pension system already relies to an unusual degree on private pensions funded with the voluntary contributions from workers and their employers.

Our long experience with funded employer-sponsored and individual pensions provides a healthy environment for extending individual pensions to a bigger share of the work force. The rapid expansion of 401(k) and IRA participation after 1980 shows that many American workers are comfortable with a major role in directing their own retirement saving. Most large employers offer sound retirement saving options to workers, and many have developed excellent education programs to inform their workers of the pros and cons of different investment options.

In addition, the United States is fortunate in having one of the world's best developed and most efficient capital markets. It has well regulated financial securities markets and well established institutions for providing financial services. Banks, insurance companies, and mutual fund companies compete intensively for the opportunity to manage workers' retirement savings. Unlike workers in much of the rest of the world, Americans can choose among dozens of firms willing to manage their retirement savings at reasonable cost.

But while the competitive and regulatory environment for individual pension accounts is healthy, the need for introducing individual retirement accounts as a component of Social Security is not very compelling. Compared with the existing Social Security program, a system of individual accounts would increase the administrative cost of providing pensions, increase the exposure of workers to financial market risk, and force many under-prepared workers to make choices about the allocation of their retirement saving, exposing many to the risk of making poor investment choices.

An important risk of an individual account system that is financed with resources diverted from the existing system is that the guaranteed public pension available to low-income workers would be reduced. This risk is much greater if individual retirement accounts are established with funds that have been diverted from the existing system. Most voters recognize that the future payroll taxes available to finance Social Security are not high enough to pay for promised future benefits. To eliminate the difference between future resources and future obligations, we must increase contributions or reduce benefits. If we divert part of the current payroll tax to establish new individual retirement accounts, benefits in the traditional program will have to be cut even further. Unless the new retirement accounts produce outstanding returns for low-wage contributors, many of them will lose more in traditional Social Security pensions than they will gain in benefits from their new accounts.

Investment risk in individual accounts

A common argument in favor of individual accounts is that they would permit workers to earn a much better rate of return than they are likely to achieve on their contributions to traditional Social Security. I have heard it claimed, for example, that workers will earn a negative real return on their contributions to Social Security, while they could earn 8% to 11% on their contributions to an individual retirement account if it is invested in the U.S. stock market.

This comparison is incorrect and seriously misleading. First, the claimed return on Social Security contributions is unrealistically low. Some contributors will earn negative returns on their Social Security contributions, but on average future returns are expected to be between 1% and 2%, even if taxes are increased or benefits are reduced to restore long-term solvency.

Second, workers will not have an opportunity to earn the stock market rate of return on all of their retirement contributions, even if Congress establishes an individual account system in the near future. Workers' overall rate of return on their contributions to the retirement system will be an average of the return obtained on their contributions to individual accounts and the return earned on their contributions to whatever remains of the traditional Social Security system. For an average worker, this overall rate of return will be much closer to the current return on Social Security contributions than it is to 8%.

Advocates of individual retirement accounts often overlook the investment risk inherent in these kinds of accounts. All financial market investments are subject to risk. Their returns, measured in constant, inflation-adjusted dollars, are not guaranteed. Over long periods of time, investments in the U.S. stock market have outperformed all other types of domestic U.S. financial investments, including Treasury bills, long-term Treasury bonds, and highly rated corporate bonds. But stock market returns are highly variable from one year to the next. In fact, they are substantially *more* variable over short periods of time than are the returns on safer assets, like U.S. Treasury bills.

Some people mistakenly believe the annual ups and downs in stock market returns average out over time, assuring even the unluckiest investor of a high return if he or she invests steadily over a 20- or 30-year period. A moment's reflection shows that this cannot be true. From March 2000 to March 2001 the Standard and Poor's composite stock market index fell almost 30% after adjusting for changes in the U.S. price level. The value of stock certificates purchased in March 2000 and earlier lost nearly one-third their value in 12 months. For a worker who planned on retiring in 2001, the drop in stock market prices between 2000 and 2001 would have required a major change in consumption plans if the worker's sole source of retirement income depended on stock market investments.

I have made calculations of the pensions that workers could expect under an individual account plan using information about annual stock market performance, interest rates, and inflation dating back to 1871.[4] I start with the assumption that workers enter the workforce at age 22 and work for 40 years until reaching their 62nd birthdays. I also assume they contribute 2% of their wages each year to their individual retirement accounts. Workers' earnings typically rise throughout their careers until they reach their late 40s or early 50s, when earnings begin to fall. I assume that the age profile of earnings in a given year matches the age profile of earnings for American men in 1995 (as reported by the Census Bureau using tabulations from the March 1996 Current Population Survey). In addition, I assume that average earnings in the economy as a whole grow 2% a year, the approximate rate of the past few years.

The attached chart shows the replacement rate for workers retiring at the beginning of successive years from 1911 through 2001. The hypothetical experiences of 91 workers are displayed in this table. The worker who entered the workforce in 1871 and retired at the beginning of 1911, for example, would have accumulated enough savings in his individual retirement account to buy an annuity that replaced 16% of his peak lifetime earnings (that is, his average annual earnings between ages 54 and 58). The worker who entered the workforce in 1961 and retired at the beginning of 2001 could purchase an annuity that replaced 33% of his peak earnings. The highest replacement rate (39%) was obtained by the worker who entered the workforce in 1960 and retired in January 2000. The lowest (6%) was obtained by the worker who entered work in 1881 and retired in January 1921. Nine-tenths of the replacement rates shown in the chart fall in the range between 9% and 32%. The average replacement rate is 18%.

To see the impact of recent financial market fluctuations on pensions, I calculated pension entitlements for workers who retired in March 2000, when stock market prices reached an all-time peak, and in March 2001, when stock market prices and bond yields had fallen sharply. The worker who retired in March 2000 would have received a pension that replaced 39% of his career high wage; the worker retiring in March 2001 would have received a pension that replaced 25% of his peak career wage. In other words, the pension replacement rate fell more than one-third in just 12 months.

No one denies that a retirement saving account invested in U.S. stocks offers workers the prospect of good returns *on average.* However, a lesson to be drawn from results in Chart 2 is that defined-contribution retirement accounts offer an uncertain basis for planning one's retirement. Workers fortunate enough to retire when financial markets are strong obtain big pensions; workers with the misfortune to retire when markets are weak can be left with little to retire on. Even in the four decades since 1960, the experiences of retiring workers would have differed widely. The biggest pension was 2.7 times the size of the smallest one. Social Security pensions have been far more predictable and have varied within a much narrower range. For that reason, traditional Social Security provides a much more solid basis for retirement planning and a much more reliable foundation for a *publicly mandated* basic pension.

[4] Stock market data are taken from Robert J. Shiller, Market Volatility (Cambridge, MA: MIT Press, 1989), Chapter 26, with the data updated by Shiller and me.

Design lessons from foreign experience

If the nation adopts a system of individual accounts, the experiences of other countries can help us choose a basic design and administrative procedures that minimize program costs, assure broad worker and employer compliance, and offer participating workers the best possible combination of investment choice, financial safety, and income protection. I have distilled some of the lessons from past research in a box at the end of my testimony entitled “Design principles for individual account pensions.”

To my knowledge, no other nation has adopted an individual account system that embodies all of these principles. I believe the design choices made by policymakers in Chile, Australia, and the United Kingdom can improved if individual retirement accounts are to play a central role in U.S. Social Security reform. Whether it makes sense to include such accounts in a reform of Social Security depends critically on the level of funding that will remain to pay for the traditional guaranteed pension. It makes no sense to introduce individual retirement investment accounts if the accounts are funded with money that is taken away from guaranteed traditional pensions for low- and moderate-wage workers.

BOX: Design principles for individual account pensions

If the United States adopts a system of funded individual pension accounts, Congress should take steps to reduce the administrative costs of such a system and to increase the protections available to workers and their survivors. These steps are highly desirable in any compulsory system of individual accounts. Even if contributions to the new individual accounts are voluntary, many components of the recommended system will be needed if workers’ contributions to the new system are taken out of their contributions to the traditional Social Security program.

- First, contributions should be collected centrally, preferably by the existing Social Security Administration. This minimizes collection and enforcement costs compared with any system that relies on decentralized collection and recordkeeping. The U.S. Social Security Administration is extremely efficient at tax collection, record keeping, and pension distribution. No private insurance or mutual fund company is even remotely close. What is more important, its contributions collection apparatus is already in place. Little modification is needed for it to collect and keep records on workers’ pension contributions. More important still, every employer in the nation who complies with the tax laws has already established the tax collection and earnings record keeping procedures needed to calculate and send contributions to the Social Security Administration. This is particularly important from the point of view of administrative costs, because most small employers would find it very costly to establish new contribution-collection procedures in addition to those they have already established for income and payroll tax withholding.
- Second, the new pension system should offer contributors a handful of alternative investment options, each designed to be appropriate for retirement saving. For example, each worker could choose among (1) Short-term interest-bearing securities, such as U.S. Treasury bills; (2) Long- and medium-term U.S. Treasury bonds; (3) Mortgage-backed marketable securities; (4) Corporate bonds; (5) An index fund of U.S. corporate stocks; (6) An index fund of European and Asian corporate stocks; and (7) An index fund of stocks in corporations that meet certain social standards (no arms production, no alcohol or tobacco production, no genetically modified food, etc.). The seventh option should be made available in order to minimize political controversy around the first six investment options. The great advantage of offering workers investment choice is that each worker is permitted to select a retirement saving portfolio that corresponds with his or her preferences regarding financial market risk and return. The enormous advantage of offering only a handful of options is that it will be much easier to educate workers about the risk and return characteristics of each option. In fact, when there are few investment options, newspapers and electronic media will perform this educational function at least once a year (and possibly every week).
- The Social Security Administration or other government entity that is responsible for collecting contributions would also be responsible for collecting and maintaining records about workers’ investment choices. In order to hold down average administrative costs, workers should be allowed to change their investment allocation only once every year for free. They should be charged the full average cost for the privilege of altering their investment allocation more frequently than once a year. If the government is not informed of the worker’s investment choice, the portfolio allocation should reflect an expert’s assessment

of the optimal allocation given the worker's age (for example, twenty-year-olds might be assigned an allocation of 80 percent U.S. corporate stocks and 20 percent corporate or U.S. Treasury bonds; workers near retirement might be assigned an allocation that contains more short-term securities and mortgage-backed securities and less corporate equities). The administrative cost of managing the system can be collected from workers as a percent of assets under management or as a percent of workers' annual contributions.

- As soon as pension contributions are collected from employers or self-employed workers, they should be invested according to the allocation instructions of contributing workers. Funds will often come to the government before it has received investment instructions from contributing workers (especially newly hired workers). In a centralized system, this is not an important problem. If there are only seven investment options, funds flowing in from employers can be allocated according to historical proportions observed for typical workers. The investment choices of individual workers have little effect on that percentage allocation. The advantage of this system is that contributions begin to earn appropriate investment returns immediately.
- Fifth, the U.S. Treasury should select private fund managers to handle asset accumulation under each of the investment options. Managing companies should be selected using a competitive process that appropriately weighs the qualifications of the bidding companies as well as the charges that they propose to charge for managing the assets. Private sector companies have become extremely efficient at managing investment funds and deciding how to vote corporate shares in their investment portfolios. It is hard to believe any entity of the U.S. government could perform these functions more effectively and at lower cost (though the U.S. Treasury could efficiently manage short- and long-term government debt portfolios that are restricted to U.S. Treasury securities). In addition to being efficient, the private management of fund accumulation offers an important political advantage. The investments would not be directly under the control of a government entity (although the choice of investment assets is ultimately determined and regulated by Congress).
- Sixth, upon retirement workers should be required to convert a minimum percentage of their pension accumulation into a monthly annuity payment. This minimum should be determined by (1) the amount of traditional Social Security benefits available to the worker and his or her spouse; and (2) the amount of monthly income needed to make the worker ineligible for means-tested Supplemental Security Income benefits. The goal of this policy is to prevent workers from using up their pension savings quickly and thereby becoming eligible for means-tested benefits. If a worker has accumulated too little savings in her retirement account to purchase an annuity that renders her ineligible for SSI, the entire balance of the account should be converted to an annuity upon retirement. If the worker's traditional Social Security pension, by itself, is high enough to render the worker ineligible for SSI, then workers should not be forced to convert any part of it into an annuity.
- Seventh, the Social Security Administration should handle the distribution of required annuity payments from the new individual-account system. Compared with private companies, it enjoys huge economies and vast experience in performing this function. Equally important, because a single government entity would be charged with converting pension accumulations into annuities, it could offer actuarially fair annuities to all older Americans, something that private insurance companies cannot do because of the problem of adverse selection and the requirement that the insurance company earn a market rate of return on its operations. One important advantage of using the Social Security Administration to convert pension savings into annuities is that it is in a much better position than a private firm to determine the minimum mandatory annuity conversion that a worker is obliged to accept. As noted above, workers should convert at least enough of their pension saving into an annuity to prevent them from becoming eligible for means-tested old-age benefits. The Social Security Administration is in the best position to determine how much annuity conversion is needed, because it has direct access to information about the worker's traditional Social Security pension. Another advantage of using a government entity for annuity conversion is that it will be easier to require that retired workers purchase annuities indexed to changes in consumer prices. Private firms that offer such annuities might go bankrupt or alternatively charge such high prices for indexed annuities that retired workers are left with very meager pensions.
- Finally, after pension savings have been converted to annuities by the Social Security Administration, the funds collected from workers should be turned over

to private fund managers. These fund managers should be selected in the same way as managers of the pension accumulation funds. However, in this case the basic portfolio allocation should be selected by an independent publicly appointed managing trustee. The selection and tenure of the trustee should be designed to provide insulation from political pressure and a reasonable degree of independence. The United States has been quite successful in protecting the political independence and integrity of the Federal Reserve Board and its Chairman. Similar procedures could be used to select and protect trustees of the annuity reserve fund. The purpose of the fund is to finance a stream of (indexed) annuity payments to an identifiable group of workers. The portfolio should not be selected by the individual workers, because they do not bear the investment risk. Instead, the portfolio should be chosen by the government, which ultimately bears the risk of poor investment performance.

Table 1: Dependency Rates and the Outlook for Pensions in G–7 Countries

Percent

Country	Aged dependency ratio [1]			Public pension expenditures/GDP [2]		Gross pension liabilities/ GDP in 1994 [3]	Net pension liabilities/ GDP in 1994 [4]	Private pension fund assets/ GDP 1994 [5]
	2000	2025	2050	1995	2050			
Canada	21	36	46	5.2	8.7	204	101	34
France	27	40	51	10.6	14.4	318	102	4
Germany	26	40	54	11.1	17.5	348	62	6
Italy	29	43	75	13.3	20.3	401	60	2
Japan	27	50	69	6.6	16.5	299	70	6
U.K.	27	37	50	4.5	4.1	142	24	68
U.S.A.	21	34	38	4.1	7.0	163	23	67

[1] The aged dependency ratio is the ratio of persons aged 65 and over to those who are 20–64. Source: U.S. Census Bureau.

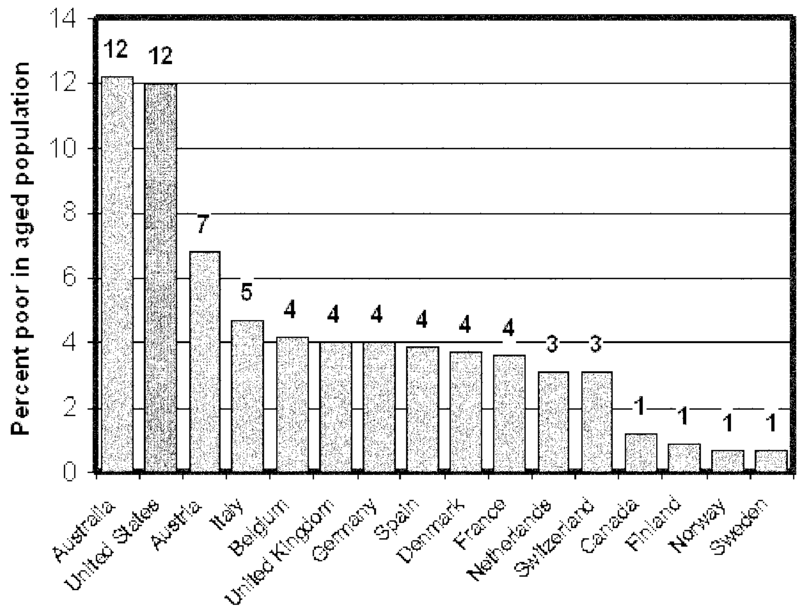
[2] Source: Roseveare et al. (1996). "Ageing Populations, Pension Systems and Government Budgets: Simulations for 20 OECD Countries." Economics Department Working Paper No. 168 (Paris: OECD).

[3] Gross pension liabilities are the discounted present value of future public pension payments. Source: Roseveare et al. (1996).

[4] Net pension liabilities are calculated by subtracting the present value of future contributions from discounted gross liabilities. Source: Roseveare et al. (1996).

[5] Source: E. Philip Davis (1997). "Can Pension Systems Cope? Population Ageing and Retirement Income Provision in the European Union." Special paper (London: Royal Institute of International Affairs).

Chart 1. Old-Age Poverty Rates in Major Industrial Countries (Middle 1990s)



Note: A person is classified as poor if he or she is a member of a household receiving less than 40 percent of median national income. Household income includes cash and near-cash income from all sources and excludes payments for income and payroll taxes. It is adjusted to reflect differences in household size.

Source: Smeeding, Rainwater, and Burtless. (2000). "United States Poverty in a Cross-National Context," LIS Working Paper No. 244, Luxembourg Income Study, Center for Policy Research, The Maxwell School. (Syracuse, NY: Syracuse University).

Chart 2. Replacement rate under individual account pension when retirement savings are invested in S&P composite stock, 1911-2001

Note: The worker is assumed to invest 2% of his annual earnings in the composite stock represented in the Standard & Poor's index. Dividends are reinvested in stocks. Each worker's career lasts for 40 years, and ends in January of the indicated year.

Source: July 2001 tabulations of author.

Chairman SHAW. Thank you. Mr. Bedell-Pearce?

STATEMENT OF KEITH BEDELL-PEARCE, EXECUTIVE DIRECTOR, PRUDENTIAL PLC, LONDON, ENGLAND

Mr. BEDELL-PEARCE. Mr. Chairman, just by way of introduction, the Prudential is one of the largest U.K. financial institutions. We have in the region of $70 billion of pensions assets under management, which I suspect pales into insignificance compared with, say, CALPERS, but it is about twice the total assets under management in Chile under their private arrangement. About 20 percent of the working population of the United Kingdom in defined contribution schemes are Members of Prudential's pensions arrangements, and about one in four of the personal pensions in existence in the U.K. are with the Prudential.

I should also explain that we are no relation of Prudential Insurance Company of America. That company was set up in the 1870s, and the Prudential's board at that time gave Prudential Insurance use of the Prudential name in America, unfortunately for nothing, and we do now know how the Russians feel about selling Alaska to the United States.

In 1952, Her Majesty the Queen sent out 255 telegrams. These were to people reaching their 100th birthday. In 1998, the year for which I last have figures, the number was 5,958. And I suspect in terms of the Queen's telegram bill it is only going to get worse, and the same applies as far as the cost of Social Security.

The impending explosion of the demographic time bomb has come as something of a surprise to some of the governments in continental Europe. It shouldn't have done, because the shape of population is one of the very few things that we can predict with some certainty 50 years out.

The problem in terms of making adequate provision for retirement is largely one of political time horizons. Our former Prime Minister, Harold Wilson, said that a week is a long time in politics. Well, if that is the case, 20 years is an eternity. To change Social Security and pensions requires a degree, a high degree of political consensus, and we have perhaps been fortunate, either by accident or design, to have that political consensus in the United Kingdom.

Bearing in mind that politics is the art of the possible, I have given some thought, based on lessons of the past, as to the shape of future U.K. pension systems going forward, and I would like to just spend a couple of minutes outlining what reforms I would make to the U.K. system, in the hope that there may be some parallels that you may be able to draw from these views.

Starting with the basic State pension, this is currently unfunded, on a pay-as-you-go system linked to general inflation rather than wage inflation. It therefore follows that the relative value of the basic State pension is diminishing over time, and in 20 years will be of very small value indeed. Indeed, at this point it is roughly about 20 percent of national average earnings, for an individual retiree, about $100 a week.

I would migrate this basic State pension over time to a funded system, with the funds vested and managed by an independent board of trustees, with asset management contracted out according to investment guidelines established for the national pension fund. And I pretty much have these guidelines in line with those set out in Gary Burtless' written testimony, which I found extremely interesting.

I would vest ownership in this basic State pension very clearly in the potential beneficiaries by following the Chilean model, at least in providing them with what I understand is a little red book which shows them their entitlement, because it is very clear from Chile that pride in ownership has been a very significant part in reinforcing the popularity of the Chilean system.

Second, I would have an earnings-related layer, and as at present in the U.K. this would be compulsory, and it would be either in the form of a State scheme—and at the moment this is unfunded—or with an opt-out to approve private schemes which are funded. I would change the State scheme from unfunded to funded, but still allow opt-out, and I would increase the compulsory contribution rate from about 4.9 percent at the moment to around 10 percent, which is slightly in excess of what prevails in Australia at this stage. The private sector provision: I would cap the annual management charge at 1 percent, the rate that currently prevails in the U.K. for what we call stakeholder pensions.

The third layer would be a voluntary private-funded provision with tax incentives, but limited to the relief on contributions at the basic rate of tax. And this is a substantial change, because at the moment tax relief is provided at the highest rate. This favors the savings classes, the people who would save in any event.

And I think that I would remove the earnings cap that we have at the moment but put a contributions' cap of 5 percent of earnings for the tax-privileged third layer. Contributions in excess of 5 percent could be made, but with no tax relief. Tax gains by the Treasury could be used to defray the cost of moving to a funded State system.

The final element, often forgotten, is income streaming from retirement through to death. In the U.K. there is a requirement to purchase an income stream annuity from an authorized provider on retirement, although there are some income draw-down facilities. I would strongly support continuation of this arrangement, rather than creating a generation of transient lottery winners with the opportunity to blow 40 years of savings, or even worse, leaving them on the on-deposit while making them easy prey to rapacious boiler house salesmen.

None of the changes I have suggested are without difficulty, but all fall within my test of the art of the possible. I believe there are close parallels in what I think is right for the U.K. with what might work in the U.S.A.

I would like to conclude at this point, but just add that I am very much looking forward to receiving my telegram in 45 years time from King Charles the Third, although I suspect it will be an e-mail by then, and almost certainly sponsored by Pfizer. Thank you.

[The prepared statement of Mr. Bedell-Pearce follows:]

Statement of Keith Bedell-Pearce[1] Executive Director, Prudential plc, London, England

Pensions: a British Success Story

Pensions provision has been one of the major success stories of post-war Great Britain. It is the result of successive Governments of both left and right aiming to achieve a proper balance between state and private sector provision, with the state providing a basic pension for everyone reaching retirement age (currently 60 for women and 65 for men) and encouraging additional provision by employers and individuals through a range of incentives, principally tax breaks.

The reason for this success is primarily the result of a continuing partnership between the State and private sector, originally established for pragmatic reasons of affordability and more lately maintained as the result of a policy endorsed by all political parties that beyond the basic State pension, retirement provision is primarily the responsibility of the individual.

Whilst pensions provision excites vigorous debate both inside and outside Parliament (the debate, in itself, being an important element in developing awareness of the need for adequate retirement provision), the area has avoided becoming a political football. There is, I suspect, something of an unspoken compact on this within the political arena, with a recognition that continuity and security of pensions provision is important to whichever party is in power, with those who are not in residence in Downing Street expecting to inherit what is in place in due course. Change, therefore, is a matter of evolution rather than revolution and is thereby more acceptable to the electorate. This is in sharp contrast with the position in most of the major continental European economies which, as a result of post-war "social contracts", rely predominantly on State run pay-as-you-go systems which are becoming progressively unaffordable as a growing retired population has to be supported by a diminishing workforce.

In Britain, however, it has not been all sweetness and light. Despite generous tax breaks, many people who can afford to provide for themselves fail to do so adequately and personal provision remains a significant problem for those on lower incomes.

[1] Prudential plc is a leading international financial services group (not related to the U.S. company with a similar name) and has been a key player in UK pension provision for more than 70 years.

One of the penalties of an evolutionary approach is that complexity is layered on complexity and this in itself becomes a disincentive for individuals to do anything for themselves.

Over the past 15 years, some fundamental structural weaknesses have been exposed such as in governance arrangements for occupational schemes (the so-called Maxwell scandal) and in the selling of personal pensions to those who would have been better off remaining in, or joining, their occupational schemes.

But despite these and other problems, confidence in the system in the UK remains high, perhaps because of the combination of continuing commitment of successive governments to make the system work and vigorous competition between providers in the private sector.

In this testimony, I will endeavour to do the following:

- outline the basic structure of pension provision in the UK
- identify where problems have arisen and how these have been addressed
- briefly review the challenges for the future and suggest how they might be met.

1. The basic structure of pensions provision in the UK.

The basic structure can be regarded as something of a layer cake. Starting at the bottom, we have the Basic State Pension. This is covered with a layer of icing for those for whom the Basic State Pension is their only income. This supplement makes up the difference between the Basic State Pension and what is known as the "Minimum Income Guarantee"and is essentially a means tested welfare payment.

The second layer of the cake proper is made up of earnings based pensions. These can take three forms:

- state provided arrangements
- private provision
- a combination of state and private provision.

The technical details of these arrangements can be found in Appendix A to this paper but it is sufficient to note here that individuals can substitute this part of their state arrangements with approved alternative private arrangements and are encouraged by financial incentives to do so.

The private element of the layer cake is made up of a number of components but the main division is between occupational schemes (equivalent to ERISA type arrangements) and personal pensions (equivalent to IRAs and 401(k)s).

Private arrangements fall into two broad categories:

- defined benefit
- defined contribution.

A "defined benefit" scheme is one where the employee on retirement receives a pension which is a percentage of his or her pensionable earnings, the percentage usually being related to length of employment. Defined benefit schemes are limited in practice to large occupational schemes where the employer has the size to take on what is effectively an open-ended guarantee of pension liabilities related to earnings levels many years into the future. Because of this commitment and related costs, there are now virtually no new defined benefit schemes being created and many employers are closing existing schemes to new employees. Defined benefit schemes always involve employer contributions and usually (but not always) employee contributions.

The alternative to defined benefit is "defined contribution", where payments are made into a scheme to build a pot of assets which on retirement is used to generate an income stream from retirement to death.

Defined contribution schemes can be occupational (employer sponsored) or private or a combination of both.

In all defined contribution schemes, the level of pension paid on retirement is a function of the size of the asset pot which is used to purchase a pension (an "annuity", a term which is somewhat different in meaning in the UK context than the US—see Appendix A for details) which is supplied by an insurance company on terms which are determined primarily by medium term interest rates and the actuarially assessed life expectancy of the individual concerned.

Pension funds enjoy complete freedom as to the asset classes in which they may be invested. Restrictions are a matter of actuarial prudence, not regulatory intervention. As a result, most funds have historically been invested predominantly in equities, in some cases in excess of 80%. Property (real estate) and fixed interest have tended to make up the balance at around 10% each. For a variety of financial and actuarial reasons, we have seen a move away from equities in the recent past but this asset class still makes up the majority of investments in most cases. Larger funds tend to make direct investments with the remainder investing on a pooled (mutual fund) or insured basis.

With personal pensions (and the new Stakeholder pension as explained below), investment has to be via an approved vehicle, in practice a mutual fund or insured scheme. Insured arrangements dominate in this area with two distinct arrangements on offer: unit linked (a mutual fund with an insurance wrapper) and with-profits (a managed fund where returns are smoothed over time).

Historically, this investment freedom within a regime of actuarial prudence and links to approved investment vehicles has proved to be very beneficial to both scheme sponsors and scheme members. Tax incentives apply to all private arrangements, with the rate of the tax break from the individual's perspective being at the highest rate paid by the individual. The shape of the tax breaks is shown by the following chart:

Money In	Asset Build Up	Pension Paid
Full tax relief	Exempt from income and capital taxes.	Fully taxed (except for tax free lump sums in some cases)

There are limits which vary by age to the amount of contributions that quality for tax relief. These limits are a percentage of qualifying earnings and for schemes entered into after 1988, there is a cap on qualifying earnings of circa $150,000.

The UK has gone further than most countries in moving the balance for pension liabilities from the private to the public sector. For an individual retiring recently, their average income can be broken down as follows:

Sources of Pensioner Incomes 1995/6—UK

	Disability benefits	5%	
State Sources	Means-tested benefits	10%	
51%	Basic pension*	33%	Sources of pension split 36% State 24% Private or otherwise expressed in proportion 60/40.
	Earnings-related pension*	3%	
	Occupational pensions*	24%	
Private Sources	Investment income	16%	
49%	Earnings	8%	
	Other	<1%	

Source: "We all need pensions—the prospects for pension provision": An independent report to the UK Department of Social Security by the specially formed Pension Provision Group, June 1998.

If we focus on pensions alone (highlighted with an asterisk), these figures demonstrate that 60 per cent of the total "pension" provision currently comes from the State whilst only 40 per cent comes from the private sector.

Personal pensions, introduced by the Conservative Government in 1988, are an investment vehicle for individuals which can be used as a partial substitute for State pension provision. However, such substitution was only relevant for those more than 10 years from retirement and therefore this trend has yet to show through in the incomes of new pensioners. The Labour Government, elected in 1997, soon announced its intention to develop policy measures to help move this ratio from 60/40 to 40/60 by the year 2050.

The British pension system is already in a much stronger fiscal position than that of most other countries. In marked contrast to nearly all other OECD countries, State-funded old-age spending in Britain, as a proportion of GDP, is forecast to *decrease* from 4.5 per cent of GDP in 2000 to 4.1 per cent in 2050. In comparison, spending in the U.S. is projected to increase from 4.2 to 7.0 per cent. The difference between the British experience and that of other countries stems in part from more favourable demographic trends, but more significantly from reductions in the State pensions programme and the use of funded private pensions as an alternative to at least part of the unfunded public pension.

In its Green Paper (Government policy discussion document) in 1998, the current UK Government proposed the principle that the public and private sectors should work in partnership to ensure that, wherever possible, people are insured against foreseeable risks and make provision for their retirement. This was a continuation of a policy started as far back as 1978 when the Government first introduced rebates to allow part of the State Earnings Related Pension (SERPS) to be substituted by private defined benefit occupational pension provision. Contracting out was extended to defined contribution vehicles including personal pensions in 1988. The proposed success measures for this partnership principle are that:

- at the end of the process of reform, there should be a guarantee of a decent income in retirement for all,
- there should be an increase in the amount of money going towards retirement savings and insurance, but without increasing the proportion borne by the State,
- there should be an extension of high-quality private pension provision to a greater proportion of the working population (with the definition of "work" being extended to include carers), and
- there should be an increase in public confidence in the quality and regulation of private sector savings, pensions and insurance products.

The Conservative Government established personal pensions as a way of encouraging wider voluntary pension provision. They were also developed as a vehicle to facilitate individuals contracting out of the SERPS and into a private pension on a defined contribution basis. At retirement, a pension had to be purchased to provide for a basic level of post-retirement inflation protection, with the State still providing protection against higher rates of inflation thereafter. This protection was removed in 1997.

SERPS, or the corresponding rebates, represent a compulsory element of the State system that has been the subject to continuing change. The proposed change from an earnings related basis to a flatter rate of benefit is expected to take place sometime after 2006. The level of compulsion, and the benefits that it will provide, is designed to try to reduce the amount of means-testing necessary. We expect the policy of compulsion to be reviewed again by the Government in 2003.

The "Stakeholder pension" (see Appendix A) is not a fundamentally distinct concept from its predecessors since it is either an occupational or a personal pension. The key feature, however, is that product regulation has been introduced so that underlying assets and charging levels are pre-specified by Government. The system is being changed through a combination of self-assessment, regulatory pressure and Government regulation. The Government intends to build popular confidence in pension savings by introducing Stakeholder pensions as a new, more accessible and cheaper vehicle, designed to appeal to those on low to moderate incomes. It is hoped that Stakeholder pensions may eventually become as familiar to the UK consumer as 401(k)s are in the US.

2. Problems in the UK pension market

The evolutionary nature of pensions development has inevitably given rise to problems, and whilst hindsight is a wonderful thing, the commitment to the overall system from Government, providers, scheme sponsors and above all, the population as a whole means that the lessons learned have been applied. Some of the issues are now discussed in more detail below.

Advice to contract out: Advice is an important issue. If there is a public policy intention that individuals should be encouraged to switch from public to private pension funding, then that incentive should be tangible and clearly advantageous. It is unproductive to create a regime in which consideration of an individual's age, future salary, likely future voluntary contributions or attitude to risk is necessary before it is possible to judge whether contracting out is attractive. The original rebates offered an incentive, whereas the current rebates mean that the most obvious choice for someone within SERPS is to stay there. We understand that when SERPS changes to the new Second State Pension, in or after 2006, there may be a disincentive for higher paid employees to remain within the State scheme.

The decision to contract out, and the associated advice, applies on a year by year basis. There is no question of making a decision for life. There is also no question of switching accrued SERPS benefits to a private scheme - principally because accrued SERPS benefits are unfunded and such a policy would be expensive for the State. Moreover, the current Government has no policy intention of allowing switching from the basic state pension to private pensions, although that was a feature of Conservative policy during the recent UK election.

Advice to make additional contributions: The original expectation was that once an individual had set up their own personal pension to accept rebates, then they would make further voluntary contributions on top. This proved not to be the case. In general, data show that fewer than 50 per cent of employees enrolled in personal accounts make any voluntary contributions. Appendix A includes an outline of the alternative investment products which might provide a better form of saving in the UK than does a pension, even for retirement needs. This complicates the choice and highlights the need for advice.

This problem also arises with the new Stakeholder pension. Although this new arrangement gives easy access to a pension scheme and deduction of pension contributions from salary, the need for advice remains. The limitation of charges to 1 per cent of the fund makes no provision for advice. This may be charged for separately. However, experience in the UK suggests that people do not want to pay a fee for advice—although it is probable that at least part of the market will go that way, the lower paid are unlikely to want to pay an additional flat fee. The commission structure that these fees have replaced offered some form of redistribution since commissions were proportional to contributions.

The problem of providing advice to low earners is even more relevant when we recognise that some low paid workers will lose state entitlements under the Minimum Income Guarantee (the absolute state safety net designed to ensure a minimum standard of living in retirement) if they make voluntary pension contributions. At present, State benefit may be lost £ for £ for any private income. The dilemma of whether or not to save at all is being reduced by the proposed introduction of a so-called "pension credit" which will ensure that the entitlement is not lost £1 for £1 of weekly income from a private pension but only £0.40 per £1.

Charges: Whilst the charges for a basic personal pension receiving only the SERPS rebate were kept low, the costs of personal pensions generally have been much higher, including the extra costs of commission. Indeed, since the charging structure seeks to recover the full cost of the initial expenses even if the policy is terminated after only a few years, charges on early termination may be as much as 50 per cent of the premiums paid. For a pure rebate policy the administration of the contribution is as simple as possible with electronic transfer of rebates. Similarly with few initial expenses, these problems on early termination do not apply to these policies.

However, personal pension administration costs have historically been high. The regulatory practice has been to quote an annual reduction in yield, equivalent to an average fund charge (see Appendix B). Although such figures might seem low at between 1% and 3% of the fund, expressed as a percentage of the fund's value after 25 years, even a 1% annual charge on a single premium represents more than 22 per cent of the fund's value over 25 years.

But these criticisms are set to become a thing of the past. The introduction of Stakeholder pensions is now causing the UK pensions market to reduce charges significantly. Indeed, the charges on new pension contracts were reduced in preparation for the introduction of Stakeholder pensions, whilst even the charges for existing contracts have now, generally, been reduced to Stakeholder levels. Changes have had to be made in sales, marketing and administration to reduce expenses commensurately. This is leading to a reduction in individual advice resulting in more workplace direct offer sales with no personal advice.

It should be noted that the maximum 1% charge on Stakeholder pensions is low even by comparison with equivalent products in the US. Whilst it may be difficult to compare like with like, a fact-finding visit to the US in 1999 by a group of pension specialists reached the conclusion that the equivalent charge in the U.S. was between 1.4% and 1.7% depending on the level of technology support, in practice this being internet access and self-service.

The fact that with Stakeholder pensions there is only a low fund charge and no transfer charge means that the criticisms of high charges in comparison with premiums on early termination will disappear.

Pensions Mis-selling: Publicity overseas about the UK personal pensions market is often dominated by mention of what is described as pensions mis-selling. For the sake of clarity, it should be emphasised that these examples of inappropriate advice did not relate to the decision as to whether to contract out of SERPS and to invest the rebate in a personal pension. Indeed, the regulator commissioned a review of this and confirmed that in view of the incentives built in to the level of rebate, contracting out during the first few years of personal pensions was reasonable advice.

Pensions mis-selling occurred largely in relation to incorrect or no advice on the most appropriate scheme for voluntary contributions *in addition to* the rebate and on whether to transfer from another scheme. Despite the fact that the introduction of personal pensions was designed to coincide with the new regulation of the conduct of business under new sales and marketing rules introduced as a result of the Financial Services Act in 1988, mis-selling arose because of a systematic industry-wide misunderstanding across almost the whole of the retail financial services market about the implications of that complex piece of legislation.

The introduction of personal pensions in 1988 also coincided with a relaxation of Social Security legislation which prevented employers from making membership of their pension scheme an absolute condition of service, despite the fact that the presence of an employer contribution almost invariably makes membership of the scheme better than a personal pensions alternative. This fact was, sadly, often not communicated to those who had chosen not to join their occupational pension scheme. Although membership of an occupational pension scheme was not regarded as a regulated investment under the legislation, the regulator later in the 1990s decided that any salesman who had recommended a personal pension to someone who had not joined their employer's scheme was likely to have been guilty of mis-selling.

As regards advice to transfer the value of deferred rights in an occupational pension scheme to a personal pension, the problem was the result of inadequate transfer values from the occupational scheme. Here the problem stemmed less from the decision to transfer, but more from the fact that the amount of the transfer value was often unlikely to reproduce as much as the deferred benefit, under any reasonable investment strategy. Although transfer values were required to be "fair", this was measured by comparison with other scheme members rather than the absolute amount of the transfer value. Hence if a scheme was underfunded it was unlikely to offer a sufficient enough transfer value for the purposes of the standards effectively set by the Financial Services Act when judging whether such a transfer was good advice. It was also a feature of many schemes that their transfer values made no allowance for discretionary increases once the pension would have started. Eventually, in about 1993, in advance of any action by the regulator, personal pension providers introduced systems to analyse the transfer value.

A thorough case by case review by providers of transfers, opt-outs and non-joiners is seeking to ensure that no-one has lost out as a result of bad or inappropriate advice. Indeed, the review has gone further and has also effectively compensated many people for the fundamental change in economic conditions that has occurred over the last 10 years. As personal pensions are defined contribution and occupational pensions are most likely to have been defined benefit, the policyholders are, in effect, also being compensated for any adverse effect of the additional investment risk that they assumed.

Investment performance: The UK Government has recently announced a review into the UK markets for medium and long-term savings products purchased by retail customers. The stated purpose is to identify the competitive forces and incentives that drive the industries concerned, in particular in relation to their approaches to investment, and where necessary, to suggest policy responses to ensure that consumers are well served. A similar review relating to occupational pensions proposed a set of the principles of investment and the retail review will look at their applicability in the retail markets.

The review will examine such important influences as:

- the drivers underlying competition,
- information flows to consumers, and consumers' understanding of them,
- the nature and quality of consumer advice,
- advisers' incentives and skills,
- charging structures for products,
- the principles of governance within the relevant products.

A significant proportion of personal pensions invest in "with-profits" funds in the UK, and that class should be considered separately, although there should be little if any difference in the underlying fund performance, other than that such funds are likely to remove any innate conservatism that exposed investors may feel.

With-profits: Contributions which are paid into a with-profits fund are pooled with those of other policyholders and invested in a wide range of assets. Depending upon the size of the capital base supporting the with-profits fund, a large proportion of the fund will be invested in equities, although to reduce the possible risks there will be diversification into both overseas equities and property. Over the long term, real assets are not only the most likely to provide the best long-term returns but also provide protection against inflation.

Bonuses are set annually to give each with-profits policyholder a return on the contributions paid which reflects the earnings of the underlying investments whilst smoothing out the peaks and troughs in investment performance. The importance of such an approach is clear for personal pensions (and indeed any defined contribution pension arrangement) where the individual is taking the risk of volatility in the market close to retirement. Such smoothing also takes into account the expected future trends in underlying investment performance.

If we look at the Prudential with-profits fund over the last 5 years, depending on when the premium was invested in 1995, the 5 year growth rate for with-profits ranged between 80 per cent and 84 per cent, whereas for an equivalent discretionary fund, the range would have been between 61 per cent and 96 per cent. In order to operate a with-profits fund, a company needs to hold a substantial amount of capital in order to provide the benefits of smoothing and guarantees whilst investing a high proportion of the fund in real assets. This was one of the problems for

Equitable Life, where, largely because that institution was a mutual with no ability to call on shareholder funds for support, the capital base was inadequate to carry the costs associated with current market conditions. We will return to this below.

Over time, the fund will pay policyholders their fair shares reflecting the long-term performance of the fund less the costs of any smoothing and guarantees supported by the capital. The balance of the fund that is not expected to be paid out to the current generation of with-profits policyholders is the working capital of the fund. It is sometimes called the "inherited estate" or "orphan assets" and provides some of the solvency capital that the regulator requires companies to hold.

Equitable: Bad news spreads quickly and the US investor may have heard about the demise of this, the oldest of UK life insurers. Equitable offered defined contribution pensions on a with-profits basis. It is important to point out that the situation at Equitable is specific to the approach adopted by that particular company and not a symptom of any more general problems in the UK pensions market, or in the concept of with-profits itself.

A number of factors conspired to work against this policyholder-owned company, thus causing it to need to ask its policyholders (other than those with guarantees) to meet the costs of liabilities that the directors had not anticipated. With-profits policyholders in a policyholder-owned company participate in the overall profits and losses of the company, and in this case the losses were quite substantial. Operating on the basis of distributing as much of its investment return as possible to policyholders it held very low reserves. When the recent changes in economic conditions, resulting in lower interest rates, triggered relatively generous interest rate guarantees the company had expected to call on those policyholders with the guarantees to share the costs. However, the costs were not only substantial but also had to be shared by all the policyholders, without any orphan assets to call upon.

The lesson from the Equitable experience is that guarantees are both expensive and potentially risky. Hence, in the context of providing a private alternative to a scheme where a benefit is "guaranteed" by public finance, whilst it might be tempting to insist that guarantees be built in, the costs would be self-defeating. It is possible that a Government may be in a better position to provide such guarantees itself, although it is worth noting that public pension "promises" can be changed. What private scheme would be allowed to defer maturity by 5 years and in so-doing require increased contributions and payment over a shorter period of time, as has happened recently in the UK with the change in female State retirement age from 60 to 65? Interestingly, the change was made with little or no adverse public comment. Similar changes elsewhere in Europe have brought protestors onto the streets.

Adverse selection in the Annuity Market: We should not just focus on the fund build-up prior to retirement. In the UK, strict rules govern the retirement benefit which has led to a substantial annuity market. The annual market for the purchase of annuities at retirement currently stands at approximately £9bn in the UK—approximately £6bn in guaranteed annuities backed by bonds (broadly equivalent to a fixed benefit annuity in the US), £1bn in with-profit annuities backed by equities (broadly equivalent to a variable annuity in the US), and £2bn left in a fund with regular income drawn down periodically.

There is an often-repeated allegation that annuities offer many retirees a poor investment. This is primarily a problem of perception rather than fact. First, when setting annuity rates, companies make assumptions about mortality which have recently underestimated the anticipated average lifespan—this represents an unexpected bonus for average retirees. Second, although annuity rates have fallen over the last 10 years this is due to both the increase in life expectancy and the fall in interest rates. Third, there is criticism that for some people who die early their return is very poor—this is a feature of any form of insurance where those who do not have a claim pay part of the benefit for those that do. In the case of an annuity, insurance is against living longer than expected, where the underpayment to those who die early is used to meet the costs of the long-lived.

A legitimate criticism relates to adverse rate setting against lower income groups. Based on the assumption that on average lower income groups have a shorter life expectancy than the better off, then companies should, in theory, offer them better annuity rates.

Governance: The development of the occupational pensions success story in the UK has also reflected the need for any regime to evolve. The most recent example is the introduction of the Pensions Act 1995 which followed the Maxwell Affair and the subsequent Pension Law Review's recommendations to improve the governance of occupational pension schemes.

The death of Mr Robert Maxwell in a boating accident led to the revelation of misuse of pension scheme assets in some companies in the Maxwell business empire.

In response, the UK House of Commons Select Committee on Social Security identified weaknesses in the regulatory framework and made a number of recommendations—these included the establishment of a committee to carry out a thorough review of the regulation of occupational pensions.

As a result, the Secretary of State for Social Security established the Pension Law Review Committee. Its over-riding recommendation was to clarify the roles and responsibilities of sponsoring employers, trustees and their advisers, and the establishment of a regulator to whom "the whistle could be blown in the event of wrongdoing".

If "whistle-blowing" were to have any impact, it is important to have a regulator to respond. The Occupational Pensions Regulatory Authority (OPRA) was set up in 1997 with the following responsibilities:

- Scheme trusteeship.
- Minimum funding requirements.
- Modifications to trust deeds and scheme rules in appropriate circumstances.
- Scheme wind-up and breaches of the requirements for the use of surplus in such circumstances.
- Transfer payments.
- Breach of pension scheme regulations.
- Contravention of scheme requirements.
- Contravention of the requirement to pay the regulator's levy.

These important issues remain under ongoing review. However, we regard the ability to review such matters periodically and implement appropriate changes as a strength not a weakness of the occupational pensions regime in the UK.

3. Challenges for the future

Retirement provision for the low paid: The obvious difficulty is that the low-paid have insufficient funds to save. The UK Government accepts that it has a role in providing a safety net and will use the public pensions and benefits regime to provide a minimum income in retirement.

Some of the issues that need to be resolved are:

- Should the low paid be encouraged to save?
- Are pensions the best savings vehicle for their retirement?
- How much more generous can the State safety net become before it acts as a disincentive for average earners?

Increasing the level of compulsion: The current social security regime in the UK includes an element of compulsion.[2] Other countries have introduced compulsion in pensions provision at an even higher level. Some believe that the extension of compulsion will need to be a significant part of the solution in the UK.

Some of the issues that need to be resolved are:

- Is it appropriate to compel pension contributions from those who cannot afford it?
- Is it appropriate to compel pension contributions when accessible shorter term savings would be better advice?
- Should employers be compelled to make pension contributions or will that simply represent unwanted salary sacrifice?

Operating within a 1% market: The historical criticisms of the high charges in the UK pensions market have led to a very strict 1% charge cap for the new regime of Stakeholder pensions. The challenge for the whole industry is the extent to which radical changes will be necessary to operate within that environment.

Some of the issues that need to be resolved are:

- Is there sufficient capacity within the UK market to operate at that level?
- Will there be pressure to further reduce the 1% maximum limit as funds grow?
- Does a 1% charge cap necessarily produce a better overall return for the customer?

The future of advice: The interaction in the UK market between pensions and other savings products with different advantages will continue to make advice important. This is further aggravated by the State safety net which may not only act as a disincentive to save but may be used as a reason to claim mis-selling in future if that safety net continues to be improved.

Some of the issues that need to be resolved are:

- Can "best advice" be expected in future?
- Are decision trees an adequate alternative to personal advice?

[2] In the UK, at present, employees pay contribution of 10% of their salary between £87 and £575 per week and employers pay 11.9% on all earnings above £87 per week. This entitles the employee to sickness, maternity, disability, unemployment and pension benefits.

• Should individuals be allowed to claim if they lose future means tested benefits through having saved?

Financial Education: Most pensions markets accept the need for simplification both of their administration systems and of the choice presented to customers. At the same time it is recognised that greater resources need to be put behind a campaign to increase general financial education.

Some of the issues that need to be resolved are:

• Can general financial education be expected to cover anything more than a superficial understanding of the need to save?

• Will a financially literate population simply seek to maximise their State entitlements from the Welfare system or tax relief?

• Does financial literacy help an individual to manage their own financial risk?

APPENDIX A

The UK Pension System

The British pension system consists of two tiers, a flat-rate pension provided by the State called the Basic State Pension and a second tier consisting of supplementary pensions provided by either the state (SERPS), the employer, or through individual accounts

Basic State Pension (BSP): The BSP is indexed to inflation rather than to real wage growth and has therefore declined over time relative to average earnings, falling from approximately 20 per cent of average earnings in 1977-78 to 15 per cent in 1996-97. Prior to 1980, BSP benefits were indexed to earnings; the change to a price index allows for significant cost savings, estimated to be two per cent per year. The normal retirement age is 65 for men and will increase from age 60 to age 65 for women in small steps between 2010 and 2020. Workers are entitled to the full BSP if they have contributed for 44 or more years for men and 39 years for women. While the majority of workers have additional pensions to supplement the BSP, about 12 per cent of workers have only BSP alone and do not participate in one of the second tier programmes. However, the BSP benefit is currently below the Minimum Income Guarantee (MIG) provided by the State. Thus, for those with no second tier pension benefits, the income floor is the amount legislated through the welfare system and not that obtained from the pension system. Furthermore, because MIG is indexed to earnings the gap is expected to increase over time. Average earnings in the UK are currently around $35,000.

Earnings based pensions

The second tier of the British pension system offers three options for workers all of which base benefits either directly on earnings (i.e. defined benefit or "DB" plans) or on earnings-based contributions to a retirement fund (i.e. defined contribution or "DC" plans).

State Earnings-Related Pension Scheme (SERPS): The first option is participation in a public programme called the State Earnings-Related Pension Scheme (SERPS) which began in 1978. This programme is the default for workers who do not opt out of the public system and into an employer-based or personal pension. It is financed on a pay as you go basis. Benefits are a function of average "reckonable earnings," (i.e. earnings between a lower and upper limit, currently approximately 15 per cent and 110 per cent respectively of national average earnings). Lifetime earnings are adjusted for earnings growth when determining initial benefits, although after retirement SERPS benefits are adjusted for price inflation rather than earnings.

The self-employed are not members of SERPS.

Pension reforms in the 1980s gave workers the opportunity to participate in private pension plans in lieu of SERPS; this was known as "contracting out" (a term not to be confused with the generally unwise practice of "opting out" of a scheme sponsored with employer contributions and taking out a personal pension instead—this was part of the well-publicised Pensions Mis-selling). Contracting out applies to SERPS only and not to the BSP. It also only applies to future benefits and not those already accrued. About one-half of those who were members of SERPS in 1985 have since contracted out. Workers who contract out and choose a private plan receive a rebate on contributions. In 1996-97 about 30 per cent of workers were contracted into SERPS (about 26 per cent in SERPS alone and 4 per cent in both SERPS and an employer-sponsored occupational scheme). The data shows that workers enrolled in SERPS are more likely to be female than workers opting out, and they are disproportionately low-income workers—this is both because in the UK females are more likely to be on low incomes and because of an inconsistency in the rates of rebate for males at some ages.

On-top voluntary contributions cannot be made to SERPS.

Occupational pension schemes: As an alternative to SERPS, workers can participate in employer provided pensions (occupational pensions) and approximately 33 per cent do so (as noted above, an additional 4 per cent have both occupational pensions and SERPS). Most such plans are defined benefit plans (where it is the benefit that is earnings linked) but as in the U.S. there is a trend towards defined contribution plans (where it is only the contribution that is earnings linked). By law the minimum benefit available from an employer provided pension must approximately equal the benefit from SERPS, but benefits are typically more generous. For a worker with 40 years of employment, defined benefit pension plans provide up to two-thirds of their final salary. While pension contributions are made pre-tax, eventual benefits are subject to tax. There is, however, a one-time option at retirement to make a tax-free lump sum withdrawal of up to 150 per cent of final salary or 25 per cent of the value of the plan, thus reducing the future pension in payment by that equivalent amount. Retirement benefits must now be indexed to inflation up to an annual inflation rate of 5 percent.

As in the US, a drawback of these defined benefit pensions is that workers can appear to lose substantial pension wealth from changing jobs but recent reforms have sought to improve the portability. In the UK, the final salary on leaving employment must be indexed to inflation up to an annual inflation rate of 5 per cent when calculating the pension payable at retirement.

Voluntary contributions (up to a specified limit of overall employee annual contribution) can be paid into a defined benefit plan, although these normally purchase benefits on a separate money purchase basis rather than by purchasing so-called "added years" (i.e. effectively increasing the notional period of employment on which the overall defined benefit is based).

Personal Pensions: A second alternative to SERPS is a personal pension. These instruments are similar to IRAs. Investments in personal pensions are composed of the rebate the worker receives for opting out of the SERPS plan along with any additional voluntary contributions the worker makes subject to a specified limit—that limit is at least £3600 gross of tax relief (about 15 per cent of national average earnings) although age related contribution rates increase that limit for many. In 1996-97 of the approximately 25 per cent of employees enrolled in personal accounts, about three-fifths made no voluntary contributions. The rebate is calculated by the Government Actuary so that on realistic assumptions it will provide approximately the same as the SERPS benefit foregone, although estimates are that for young workers even this low level of contributions will yield a larger pension benefit than SERPS. These personal pension plans have the advantage of being fully portable with respect to job changes but, as with any defined contribution pension, at the cost of letting the worker assume all of the investment risk.

Stakeholder Pensions: Recent reforms introduced in April 2001, now require any employer with more than 4 employees to make access available to a defined contribution scheme known as a Stakeholder Pension, or to a suitable alternative pension scheme. The Stakeholder scheme may be either an occupational scheme or a personal pension, either in a scheme operated by trustees or a Stakeholder manager. The key feature that Stakeholder pensions introduced is that, although no employer contribution is required, the scheme is subject to a form of product regulation not previously seen in the pensions market in the UK. They have minimum standards for charges (a maximum charge of 1 per cent of the fund), low minimum contributions (schemes have to accept one-off payments as low as £20 (i.e. only about $30), and transfers must be allowed to another pension scheme without charge. In general, contributions will be by deduction directly from salary rather than by direct debit from the bank and this may make it easier for individuals to maintain their commitment to voluntary contributions once they begin. These schemes are expected to improve the opportunities for those who do not have the option of occupational pensions. It should be noted, however, that they also extend access to children (there is no lower age limit), to those without income (the personal pension limits apply with a minimum of £3600 per annum for anyone) so anyone can make a pension contribution of £3600 gross of tax relief (effectively offering the advantages of tax relief to those not required to pay tax), and existing pensioners up to age 75. Although it is much too early to tell, there is some anecdotal evidence that these schemes might be being used by some as a way of gaining even more tax relief rather than by the lower paid target market.

Outcomes

The overall impact of the UK pension system is that the average income of the elderly has risen substantially since SERPS benefits were introduced. The after tax income of "pensioner units" (single pensioner or couple) increased by 64 per cent in real terms from 1979 to 1996/1997 compared to an increase of 38 per cent in earnings over the same period. However, the upper portion of the income distribution has fared substantially better than the lower. Gains in real income varied from 28 per cent for single pensioners in the bottom fifth of the distribution to approximately 80 per cent for married couples in the highest fifth. This difference is due to the growth in occupational pensions (up 162 per cent in real terms between 1979 and 1996/97) and investment income (up 110 per cent). Furthermore, those elderly who receive only the BSP have seen a deterioration in their relative incomes as the BSP benefit has remained approximately constant in real terms despite growth in earnings.

Major Reforms over the last 20 years to reduce the future cost of BSP and SERPS

Reforms of the 1980s and 1990s centred on reductions in the generosity of the public pension system and incentives for firms to offer private pensions and for workers to choose such plans or to invest in personal savings plans. The major changes included:

- Indexing State pensions to prices rather than wages.
- Plans to gradually raise the retirement age for women from 60 to 65 in monthly steps from 2010 to 2020.
- Reductions in SERPS benefits of approximately two-thirds by changing the benefit formula from 25 per cent of "reckoned earnings" to 20 per cent, increasing the number of years of employment used in the calculation from the best 20 years to an average of all years, cutting spousal benefits for widow(er)s from 100 per cent to 50 per cent, and reducing wage indexing.

An important aspect of these reforms was the decrease in the generosity of public pensions. The changes were possible politically for several reasons. First, the SERPS regime was relatively new, having begun in 1978, and therefore had few pensioners drawing benefits. Second, its complexity made it difficult for people to understand the changes. Third, many of the changes were phased in gradually and the impact was not apparent. For example, the change to inflation indexing rather than wage indexing for benefits will save a substantial sum but will not result in a noticeable difference in benefits for several years. Fourth, the possibility of opting out of the government programme is likely to have decreased opposition to the cuts. Finally, some argue that the most important factor was that public pensions account for a much smaller fraction of retirement income in Britain than in other countries, making decreases in benefits more tolerable.

Although each of those reforms reduced both the future cost and the value of public pensions, from 1988 to 1993, the rebate into a personal pension included an incentive to induce workers to contract out of SERPS. Personal pension schemes were launched as providing greater choice to individuals and with increased portability, being initially developed under the name portable pensions. More recently, the greater flexibility of withdrawals on retirement from personal accounts has increased their attractiveness.

The current government has focused reforms on low-income workers:

- Introducing a minimum income guarantee (MIG) separate from the BSP beginning in 1999, at a level above the BSP, with that gap set to rise since MIG will increase at least in line with earnings whilst BSP increases with earnings.
- Replacing SERPS in April 2002 with a new State Second Pension (S2P) that eventually (possibly as early as 2006/7) pays a flat rate benefit although contributions are expected to remain earnings based. The goals of the S2P are to get more middle income workers out of SERPS and into private plans (once Stakeholder pensions have become established) and to provide more retirement benefits to low income workers. S2P ensures a higher minimum pension for workers with incomplete earnings histories than SERPS and covers the disabled and those who provided childcare.

Other tax advantaged schemes

Any summary of the UK pension system should be set within a wider context. In most countries a key feature of the pension system is that they are tax advantaged (in the UK that means tax relief on contributions and gross roll up on investment, but with the exception of up to about 25 per cent of the fund being able to be taken as a tax free cash sum the pension in payment is subject to income tax). Unlike in some other countries, there is no provision to access those funds before retirement (which itself cannot be before age 50)—although a transfer value may be taken (for example on a change in employment) that is only payable to another pension scheme and not directly to the individual.

The locked-in nature of a pension, means that other tax advantaged savings schemes offered in the UK may appear more attractive in meeting individual needs in planning their savings regime, including saving for their retirement. Not only is the pension taxed in payment, it also has to be taken as a regular and fairly inflexible stream of income—it cannot for example be used up before age (say) 75 at which point an individual might believe that their income needs will have reduced. This makes non-pensions products potentially attractive even for retirement planning.

In the UK, individual savings accounts, national savings schemes and employee share option schemes offer tax relieved alternatives to more conventional pension savings. These arrangements may allow immediate access, can be taken after a term unrelated to any pre-set retirement age (the Government has suggested that it is inclined to increase the minimum age at which a private pension can be taken from 50 to 55), and do not involve benefits as a stream of income. In some cases the benefit may be subject to a tax on capital gains, so they may be a tax advantage in spreading the benefit over a small number of years. The flexibility of these contracts mean that pensions may not be the automatic natural basic block of retirement provision that they are in other countries. This has advice implications, and possibly leads to an expectation that someone should be directing the consumer towards the most appropriate purchase.

Annuities

We should not just focus on the fund build-up prior to retirement. In the UK, strict rules govern the retirement benefit which has led to a substantial annuity market. For example, the fund accumulated from the SERPS rebates cannot be taken in cash at all. The whole of the fund has to be taken as an income, from age 60 at the earliest, providing an escalating pension linked to inflation subject to a maximum of 5 per cent on the basis of the individual and their assumed spouse on a unisex basis. Such unisex and unistatus provision is otherwise virtually unknown in the UK market, although the absence of choice at retirement (other than to defer it) reduces the risks associated with such an approach.

An “annuity” in the UK means the provision of an income stream on pre-agreed terms either for a defined period or until death. This is quite distinct from the fixed and variable annuity products sold in the USA.

For defined contribution schemes, the benefits are generally provided by an annuity purchased in the competitive UK insurance market. Since these annuities are purchased outright at retirement, the investment mix in the accumulating pension fund is changed from equities to gilts or corporate bonds close to retirement in order to reduce the volatility of the benefit to be purchased. An alternative approach, known as “income drawdown”, is possible whereby the fund remains invested (probably in equities) and regular benefits are drawn out of the fund, broadly in line with the benefits that would otherwise have been purchased under an equivalent annuity. In any case an annuity must be purchased by age 75.

The fund accumulated from the voluntary contributions can have 25 per cent of it taken as a tax free cash sum at retirement from age 50 at the earliest, and the balance must be used to purchase an annuity in the form selected by the individual. Rates are gender-based, and some addition may be allowed if the individual can demonstrate a shorter expected lifespan (for example, as a result of a smoking addiction). Again, an income drawdown approach is possible, although the same requirement exists to purchase an annuity by age 75.

APPENDIX B

Personal Pension Charges

If the Subcommittee is looking at the flat fund charge equivalent of the charging structure used on monthly and stand alone premiums of various terms on personal pensions, the following tables show the industry average and the effect of the advent of Stakeholder. Naturally, we would expect these charges to reduce substantially for equivalent products in the future as they are moved down ever closer to 1%.

Monthly Premiums of £200 per month

Term	5 years	10 years	15 years	20 years	25 years
2000 Survey	3.3872	2.0632	1.6113	1.3728	1.2341
1997 Survey	4.8782	2.7415	2.0064	1.657	1.4406

One Stand Alone SP of £10,000

Term	5 years	10 years	15 years	20 years	25 years
2000 Survey	1.934	1.4547	1.2777	1.1902	1.1248
1997 Survey	2.3031	1.5955	1.3161	1.1827	1.1065

Source: Money Management surveys October 1997 and October 2000, covering personal pensions only showing the position as at 1 July 1997 and 2000 respectively.

1. Prudential plc is a leading interantional financial services group (not related to the U.S. company with a similar name) and has been a key player in UK pension provision for more than 70 years.

2. In the UK, at present, employees pay contribution of 10% of their salary between £87 and £575 per week and employers pay 11.9% on all earnings above £87 per week. This entitles the employee to sickness, maternity, disability, unemployment and pension benefits.

Chairman SHAW. Thank you. Mr. Palmer.

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Mr. PALMER. Thank you, Mr. Chairman. I would like to begin with a brief overview of Sweden's new pension system.

During a series of steps in the 1990s, Sweden converted a two-tier defined benefit system dating from 1960 into a combination of notional defined contribution (NDC), pay-as-you-go accounts, and financial defined contribution schemes. Reform was driven by the threat of future large contribution rate increases, redistributional unfairness in the design of the old system, and a goal of providing a framework that would promote mandatory saving through the pension system but with privately managed assets.

The overall contribution for the two schemes together is 18.5 percent of earnings, with a split of 16/2.5 percent between the notional and the financial account systems. The annuity in both schemes is based on lifetime account values and life expectancy at retirement. The accounts in the NDC system earn an economic rate of return, whereas the accounts in the financial system earn of course a market rate of return.

The main goal, I think, in the Swedish reform was to create financial stability, and this has been the overriding goal, the idea that commitments in the future should be met but people today should be able to realize that this is the underlying goal of both the pay-as-you-go and the financial account systems. In addition, the NDC and financial account system shift the costs of early exit from the labor force to the individual, and this has been a very important part of the reform in Sweden.

I might also add that there was a political consensus behind this reform. Eighty-five percent of the parliament, five of the at that time seven political parties, and certainly the five main political parties in Sweden, got together and were all behind this reform, and still are.

I am going to turn now to the financial account system. The driving forces behind the construction of the Swedish financial account scheme were desire to hold down costs while enabling people to choose among a large number of financial portfolio opportunities. In order to do this, a separate agency, the PPM, Premiepensionsmydigheten, which stands for Premium Pension Authority, was created within the social insurance administration, and they are in charge to manage the financial account system. The PPM is a clearinghouse for fund transactions. It keeps individual accounts, and it will be the sole provider of annuities in the financial account system.

Let me briefly summarize the flows of money and information in this system. Contributions to the financial scheme are collected annually, together with all other social insurance contributions and taxes in general, by the national tax authority. Information on payments is transferred on an individual basis to the National Social Insurance Board, and from them to the PPM. Money from new contributions is transferred through the National Debt Office, which administers all financial transactions in Sweden, to the participating funds, following the receipt of an order from the PPM.

The idea behind the system is really to eliminate the problem of having the high pressure salesmen beating on your doors, and to this end the PPM has been set up as a clearinghouse for all fund transactions. You might regard it as a sort of a broker for all of Sweden. Orders to buy and sell fund shares together are executed jointly on each transaction day by the PPM. The PPM is the sole provider of annuity products in this scheme, also.

Participants can choose between single and joint life annuities, and annuities can be fixed or variable rate. I should mention that lump sum payments or phased withdrawals over shorter periods than a full life are not among the products offered.

A few words about participation criteria for fund managers, fund choices, and administrative costs. All funds licensed to operate as investment funds in Sweden and/or the European Union are allowed to participate in the system. In addition, funds must conclude an agreement with the PPM, agree to provide information to the PPM upon request, agree not to charge withdrawal fees, and provide a periodic report of administration charges.

Funds are required to compute share values and report them electronically to the PPM on a daily basis. Since the PPM invests assets on behalf of participants, it is the sole client for any given fund.

Part of the agreement concluded with the PPM includes accepting a system of rebates established by the PPM. What this means in practice is that the fund can levy normal charges minus a possible rebate. The rebate depends on the amount of PPM assets held by the fund in question.

Individuals bear the costs of their own fund choices. I might choose a fund which has cost of 0.4 percent, somebody else, 1.5 percent. It is up to me.

The first fund choices were staggered throughout the country in September-October 2000. There were 460 registered funds to choose from. People were given a month to choose, and the money of non-choosers, about 30 percent of all participants, went to a public-managed non-chooser fund which has a distribution of assets 80/20 between equities and bonds.

Participants chose, on average, 3.4 funds, which gave a total of over 11.5 million fund choices. Over 72 percent of those making a choice chose an equity fund. The market fund getting the largest share of total assets got 4 percent. The 10 largest funds got 23 percent of all assets. The conclusion, then, is that the assets were fairly well distributed among very many funds.

Administration costs, let me conclude with these. The costs actually depend on individual choices, since I can chose a fund which could cost 0.4 or 1.5 percent of assets held. The average for choices made in the year 2000 was 0.65. The PPM can charge a rate of 0.3, which gives for 2000 an average administration cost of 0.95 of total asset holdings.

Finally, I should mention that unless individuals make new fund choices, contributions are distributed in accordance with their last fund choices. Information on fund values is available daily through the major newspapers, and by Internet, through the administration.

How have people reacted? I think, according to the mass media response, which has been very positive, and the high rate of participation, it seems as if this has been very well accepted by the Swedish public.

Thank you.

[The prepared statement of Mr. Palmer follows:]

Statement of Edward Palmer, Professor, Social Insurance Economics, Uppsala University in Sweden, and Chief of Research and Evaluation, Swedish National Social Insurance Board,[1] Stockholm, Sweden

SWEDEN'S NEW PENSION SYSTEM [2]

An Overview of Sweden's New Pension System

In a series of steps in the 1990s, Sweden converted a two-tier defined benefit scheme from 1960 into a combination of notional defined contribution (NDC) pay-as-you-go and financial defined contribution (FDC) schemes. The reform was driven by the threat of future large contribution rate increases, redistributional unfairness in the design of the old system and a goal of providing a framework that would promote mandatory saving through the pension system—but with privately managed assets.

The overall contribution rate for the two schemes together is 18.5% of earnings, with a split of 16/2.5 between the notional and financial account schemes. The annuity in both schemes is based on lifetime account values and life expectancy at retirement. Accounts in the NDC system earn an economic rate of return, whereas accounts in the FDC scheme earn a financial rate.

About 90 per cent of the Swedish labor market is also covered by contractual pension arrangements that top off the public pension. This was also a consideration in establishing the parameters for coverage in the new public system. During the 1990s, contractual schemes for private sector blue-collar and municipal government employees (generally, persons working with health care, education, social assistance, other public services provided locally, and local public administration) have converted to financial defined contribution following the reform of the public system. Blue-collar workers have a contractual supplement of an additional 3% on earnings, and municipal workers can have a supplement of up to 4.5%, depending on regional arrangements. (See Palmer 2000, 2001a and b.) Consequently, the pension portfolio for over half of Swedish employees contains a large total mandatory/quasi-mandatory FDC component, in which participants choose their own investment portfolios. Presently, private white-collar workers are mostly covered by advance funded de-

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[2] The reader interested in learning more about the Swedish pension reform is recommended to visit the administration's web sites at *www.pension.nu* and *www.ppm.nu.*

fined benefit schemes, and can also make their own fund choices within this framework. There is also discussion on converting private white-collar contractual schemes into defined contribution schemes, in line with the reform of the public system.

Appendix 2 provides an illustration of replacement rates for a person born in 1975, with the present life expectancy forecast for this cohort. This individual begins working at age 22 and the table illustrates replacement rates for different ages of retirement for ages from 61 through 70. In the illustration, the contractual benefit is based on a contribution rate of 3.5%, on top of the 16% (NDC) and 2.5% (FDC) contribution rates in the public system. This means that 27% of total contributions go to the financial account systems and that the outcome will depend on the market rate of return for this 27% of contributions. If we look at the replacement rate for an individual retiring at age 65, a real market rate of return of 2% would yield an overall replacement rate of 54%, while a return of 6% would yield a replacement rate of 70%.

Lastly, it is important to note that the reform creates mandatory insurance without redistribution—other than over the individual's own lifetime, and the redistribution from men to women embodies in the unisexual life expectancy factor used to compute annuities. Redistribution is financed through general revenues, instead of through the insurance system, with the most important example being a new guarantee benefit for low-income pensioners. Also, all non-contributory credits are financed with general revenues, and money is transferred to the NDC and FDC schemes to support these credits. As a part of the reform, a separate deduction for pensioners was abolished putting all forms of pension income and earnings on the same tax status. (A detailed summary of the Swedish reform is provided in Appendix 1.)

The Process of Legislation and Implementation

The concept for the reform was published in the autumn of 1992. It was passed by Parliament in 1994 with a majority vote of about 85%, supported by both the governing liberal-conservative block and the Social Democratic opposition. Ownership from a broad political spectrum was viewed from the beginning as being an important condition for the long-run stability of the reform.

Since 1994, representatives of the political parties responsible for the reform have constituted an implementation group with the purpose of working through all the legislative details. Most of the necessary legislation was passed in 1998, although at the time of this writing, some legislation still remains.

The first step in implementation was to set off contributions to start individual financial accounts. Beginning in 1995, contributions were paid into a blocked, interest-bearing account at the National Debt Office. In following years, new contributions were paid in and held in the blocked account in the interim until the individual accounts and the administrative apparatus had been created. The interim account is still used to hold new contributions, with interest, until tax forms of all participants have been processed and approved through the standard tax procedures.

Sweden has had computerized individual accounts since the 1970s. Nevertheless, the systems were dated and did not satisfy the requirements of the new schemes—or for that matter those of a modern administration. In addition much new information had to be created, in some cases retroactively from 1960. As a result, it took some time to create the accounts needed for the new system.

The technical conversion of old-system accounts from 1960 into NDC accounts was completed in December 1998. At the same time, individual financial accounts were created for the contributions that had been paid since 1995. The first individual account statements were sent out in the spring of 1999, with an extensive mass medial campaign and ensuing discussion and renewed debate. Since 1999, account statements are sent out to all participants in the spring of each year. Owing to a delay in the development of IT support for fund choices and accounting, the debut for individual fund choices in the financial account scheme was postponed from the early autumn of 1999 to the same time in 2000.

Joint account statements for the NDC and FDC schemes are sent to participants in the spring of each year. In addition to general information, statements include personal "forecasts," assuming individual earnings follow the most recent outcome, 2% real average wage growth in the future and a real rate of return in the financial market of 6%. The former is close to the long-run (100 year) rate of growth in productivity and the latter corresponds to a bond and equity fund with real rates of return similar to those experienced over the past half century, with a bond/equity mix of around 40/60. Not surprisingly, these assumptions have been criticized as being both too optimistic and too pessimistic. On the other hand, the debate itself has served to focus public attention on the new system.

The implementation of the new pension system also provided a much-needed impetus for the National Social Insurance Board to focus on developing modern information services for participants. In addition to the yearly statements and other information available at local offices, people can access information on their accounts not only through their local offices, but using the internet. In fact, there is an internet program for calculating your own pension. The user provides his/her own assumptions about personal earnings growth, non-contributory periods, alternative rates of return, and ages for and degrees of (partial or full) retirement. The latter is especially useful for older individuals who want to examine different exit alternatives.

The PPM is the Clearing House for Fund Transactions, Keeps Individual Accounts and will be the Monopoly Annuity Provider in the FDC Scheme

The PPM (*Premipensionsmyndigheten*)—or Premium Pension Authority in English—is the agency within the social insurance administration that administers the financial account scheme. The focus of development of the administration has been on holding back administrative costs. The principal responsibilities of the PPM are to enter into contracts with funds applying to participate in the system, execute purchases of fund shares on behalf of the participants, collect and make available information on fund shares, keep the individual accounts of the system and provide the insurance products specified by the law.

The flow of funds and information in the administration of the financial accounts can be summarized as follows:

- *Contributions* for the financial account scheme are collected together with all other social insurance contributions (and taxes in general)—by the National Tax Authority. Information on payments is transferred on an individual basis to the National Social Insurance Board (NSIB), which also keeps all the social insurance accounts. Money from new contributions is transferred through the National Debt Office, which administers all the financial transactions of the Swedish State, to the participating funds, following the receipt of an order from the PPM.
- The PPM is a *clearinghouse* for all fund transactions. Choices for new entrants and requests to buy and sell fund shares for all other participants are grouped together and executed jointly on each transaction day by the PPM. Participating funds are required to report fund values to the PPM electronically and on a daily basis. The PPM keeps the individual accounts of fund shares and values are computed for all trading days.
- The PPM is the sole *provider of annuity products*. Participants can choose between single and joint life annuities. Annuities can be fixed or variable rate annuities. (Lump-sum payments or phased withdrawals over shorter periods than a life are not among the available alternatives.) A fixed annuity is "purchased" from the PPM and entails moving fund assets to the PPM. Alternatively, the participant can leave his/her money in market funds and accept a recalculated annuity on an annual basis.

FDC Fund Participation Criteria and Fund Administration Costs

All funds licensed to operate as investment funds in Sweden and/or the European Union, are allowed to participate in the system. In addition, funds must conclude an agreement with the PPM, agree to provide information to the PPM upon request, agree not to charge withdrawal fees and provide a periodic report of administration costs charged. Funds are required to compute share values and report them electronically to the PPM on a daily basis. The PPM invests assets on behalf of participants, and is the sole client for any given fund. Part of the agreement concluded with the PPM includes accepting a system of rebates established by the PPM. What this means in practice is that the fund can levy its normal charge minus a possible rebate to the PPM, depending on the normal charge and the amount of PPM assets held. (See Appendix 3.) Individuals bear the costs of their own fund choices.

As a result of individual fund choices in December 2000 about 70% of total assets were allocated to private market funds and 30% to the public fund for non-choosers. Private fund choices resulted in the distribution of costs shown in Table 1, with an average cost of 0.72% of PPM assets. The publicly managed fund for non-choosers charges a fee of 0.48% of assets.

For both systems together, the average cost for fund administration, given the distribution of individual choices in 2000, was 0.65%. By regulation the PPM is allowed to charge up to 0.3%, annually, of total PPM assets, to cover the costs of both its clearinghouse and insurance functions. These costs are to be distributed proportionately among the insured. This gives total administration costs of 0.95% of total assets, based on the year 2000 distribution of choices and actual fund charges.

Table 1. Distribution of assets among market funds by fee category

Cost category (Percent of PPM fund assets)	Number of funds	Percent of total capital
– 0.24	6	3
0.25–0.49	92	48
0.5–0.74	63	7
0.75–0.99	51	2
1–1.24	125	28
1.25–1.49	81	11
1.5–1.74	32	1
1.75–7 0		

FDC Fund Choices

Around 4.4 million participants were given the opportunity to make their first fund choice(s) beginning September 11, 2000. To avoid administrative overload, information was sent out to six separate regions of the country at intervals of one week, ending October 26. People were given a month to respond and after this deadline non-choosers were allocated to the public fund for non-choosers.

To help participants make informed choices, a brochure listing all registered funds, their investment profile, historical performance, degree of risk and administrative charges were sent to all participants. As it turned out, some funds had no or only a short record of operation and thus little or no performance information could be provided. The PPM spent the equivalent of around 7 million dollars on a mass media campaign. In addition, large insurance companies and other large fund managers advertised heavily especially in the radio and TV media immediately prior to and during the first choice period.

About 3 million persons—or 67 per cent of all participants—made an active choice from among the 460 funds registered with the PPM at the time. Slightly more women (68%) than men (66%) made active choices, and this was true for all age groups and throughout most of the country. Younger persons were slightly less active: Active fund choices were made by around 58% of participants in the age group18–22 and 63% of participants age 23–27.

Participants chose on average 3.4 funds, which gave a total of over 11.5 million fund choices. The number of active fund choices was a little over 10 million. Around 1.4 million participants were "non-choosers." Over 72% of those making active choices chose funds holding only equities, and another approximate 25% chose either mixed bond-equity or generation funds that enable the individual to adjust his/her risk profile to remaining years to planned retirement.

About 30% of available funds ended up in the publicly managed non-chooser fund. This fund presently has a portfolio with a split of around 80/20 between equities and bonds. The private fund getting the largest share of total assets (of 56 billion Swedish kronor—or around 5.6 billion dollars) held 4% of the PPM assets in December 2000. The top 10 funds together attracted 23% of all assets. Among these was only one foreign owned fund, and this fund was number 9 in terms of assets held in the ranking of the top 10 private funds.

Unless individuals actively make new fund choices, all new contributions are distributed to their existing fund choices in accordance with the portfolio shares they made at the time of their last choice. Information on fund values is available daily in major Swedish newspapers and through the internet link to the administration.

Summary Remarks

Prior to the introduction of the financial account system nearly half of all Swedes had some personal experience with financial market funds, and there was, in addition, opposition from important quarters. Most noteworthy in this respect is that, although they were initially opposed to the advance funded component of the public system, the central blue-collar union changed its mind and negotiated a shift from its own defined benefit supplement to a defined contribution supplement that closely resembled the new public FDC component! Both the blue-collar union (LO) and the Confederation of Employers (SAF) supported the move towards NDC. Blue-collar workers, who usually have long, but flat earnings profiles—compared to managers and professionals—could easily see the advantages in fairness to their members in introducing notional and financial account schemes in social insurance. For employers there was a clear advantage to a system with a contribution rate that, in principle, will be fixed forever.

How have people in general reacted? With the reform, all participants were provided the opportunity to choose the construction of their own portfolios in the public scheme, and 67% made an active choice. There was widespread mass medial coverage of the events surrounding the first opportunity to make fund choices, and the whole process appeared to go very smoothly—judging by the lack of negative press coverage. In short, it appears that the Swedish people have accepted the reform and with it a paradigm change in the provision of social security.

Appendix 1. Summary of the New Swedish Pension System

1. Individual accounts—contributions

- *Persons born prior to 1938 are outside the new system. Generally, participants born 1938 and after have two accounts in the new system: one Notional Defined Contribution (NDC) and one Financial Defined Contribution (FDC).*
- *Contributions are paid on earnings above the minimum level at which income must be declared for tax purposes (presently about 900 dollars per year) and up to a ceiling of about 29 000 dollars, using an exchange rate of 10 kronor per dollar. (The Swedish krona has fluctuated between 5.5 and 11.0 kronor per dollar since 1995 and is presently close to its lowest level.)*
- *The transition rule is that persons born in 1938 will receive 4/20 of their benefit from the new system and 16/20 from the old system; persons born in 1939 5/20 and 15/20 etc. Persons born in 1954 and later are completely in the new system. (The new system proportions are also used to determine payments for the transition cohorts to the FDC scheme.)*
- *The contribution rate is 18.5% on earnings. (Eventually to be split equally between the employee and employer.)*
- *A 16% contribution rate goes to the pay-as-you-go system and is noted on the individual's NDC account.*
- *A 2.5% contribution rate goes to the individual's financial account. Individuals choose one to five registered funds. Funds of non-choosers go to a publicly managed default fund. There is no limit when or how often participants can switch funds and (presently) no individual charge on switching funds.*

2. Non-contributory rights and rights for periods of sickness, disability and unemployment covered by social insurance

- *Non-contributory rights in conjunction with child birth, higher education and (conscripted) military service are financed by general revenues and money is transferred from the general state budget to the NDC and FDC social insurance schemes to cover these.*
- *Childbirth credits are given for a maximum of four years per child, although only one credit can be earned at any given time (two children born two years apart give 6 credit years in total). The credit can be claimed by either parent, but to date is usually claimed by the mother. Claimants are entitled to the most advantageous of: 1) contributions based on 75% of average earnings for all covered persons; 2) contributions based on 80% of the individual's own earnings the year prior to child birth: or 3) a supplement consisting of a fixed amount, indexed over time to the (covered) per capita wage.*
- *Periods of sickness, disability and unemployment covered by social insurance provide financed rights in both the NDC and FDC schemes. Benefits for sickness and unemployment are treated as earnings in computing contributions. An imputation of future earnings is performed for disability (the rules remain to be legislated in the autumn of 2001), and contributions are transferred from the disability scheme to finance these rights. The sickness and unemployment schemes pay for the employer share of the contribution for sickness and unemployment. A disability benefit is converted into an old-age benefit at latest at age 65.*

3. Account values

Accounts in both the NDC and FDC schemes grow with:

- *New contributions and transfers to the system for non-contributory rights*
- *A rate of return based on the growth in the average wage rate in the NDC scheme and the return on the individual's fund(s) in the FDC scheme*
- *Inheritance gains. Inheritance gains derive from the accounts of persons who die prior to the retirement age. They are distributed among survivors in the same birth cohort as the deceased.*

4. Calculation of a benefit

- *A full or partial (25%, 50%, 75%) benefit can be claimed from the NDC and/or FDC scheme separately or together at any age from age 61. There is no upper age limit. A benefit can be combined with continued work. Contributions paid* *on earnings from work always yield enhanced account values. A person who claims a partial benefit and/or combines a benefit with work will have the benefit recalculated, based on new account values, upon permanent retirement.*

• *The annuity is calculated as:*

Annuity = Account value/unisexual life expectancy from retirement and

— in the NDC scheme assuming a real annual return of 1.6% during retirement

—in the financial account system taking into account the return on the funds of annuity recipients.

• *In the NDC scheme permanent life expectancy factor is determined for a cohort in the year in which its members turn 65, even for individuals who claim a benefit before or after this age.*

• *The annuity in the NDC system is indexed to the CPI, however a yearly adjustment (up or down) is made for trend divergence of real per capita contribution growth from the growth norm of 1.6% used in calculating the original annuity value.*

• *Even benefits of pensioners born 1937 and earlier are indexed from 2002 with inflation plus the difference between 1.6% and the actual outcome.*

• *In the financial account system the participant can choose either a fixed or variable life annuity. In the latter case he/she chooses the investment fund and the annuity is recalculated annually. A joint life annuity is also offered. A survivor benefit can also be subscribed to during working years.*

• *Although early retirement is possible for persons born in 1938 in 2001, most persons born in 1938 are expected to claim benefits in 2003, which has been a "normal" retirement age for over two and a half decades, in part owing to contractual arrangements covering about 90 per cent of employees. In addition, a guarantee supplement cannot be claimed until the age of 65, which for persons born in 1938 is in the year 2003.*

5. The guarantee benefit

• *The guarantee benefit is available from age 65. It is an inflation-indexed supplement (with a specified maximum) to the total benefit provided by the NDC and FDC earnings-related schemes.*

• *The guarantee is financed with general revenues. Together with a means-tested housing allowance, it will usually be sufficient to meet the subsistence norm established by the National Welfare Board. Since it is prorated with regard to years of residence, with 40 years needed for a full amount, it is possible that late-working-life immigrants may nevertheless fall under the subsistence norm and be in need of social assistance, provided by local authorities.*

• *The initial level of the guarantee was set at a high enough gross value to align it after-tax with the commensurate benefit in the old system.*

6. Taxation

• *Individual earnings and pension benefits have the same income tax status. The reform eliminated a separate tax deduction for pensioners.*

7. Administration

• *The tax authority collects contributions (together with other taxes).*

• *NDC accounts are kept by the National Social Insurance Board. The Board also keeps track of all contributions for and pays NDC, FDC and guarantee benefits together.*

• *The FDC accounts are managed by a state monopoly—the PPM. The PPM places one daily order per fund, aggregating all orders to buy and sell. The PPM is the single provider of FDC annuities.*

8. Reserve funds in the NDC scheme

• *The NDC system has a buffer fund that arises due to fluctuations in the sizes of birth cohorts, but which will also pick up remaining imperfections in the practical design of the scheme. Reserves, accumulated within the framework of the old system, were approximately 450 billion kronor at the end of the year 2000. (GDP was around 2100 billion kronor.) These reserves will help in financing the transition period—when the large cohorts born in the 1940s are only partially within the new system.*

9. Financial stability of the NDC system

• *Two main sources of potential financial instability remain. The first source of instability arises because life expectancy is calculated from the known life courses of contemporaneous cohorts at the age when the retiring cohort has reached age 65. Neither of the two more stable alternatives—continuous adjustment after retirement or basing the factor on a cohort-specific projection—was* *chosen. The second source of instability is the choice of using the growth in the average wage for indexation, whereas it is well known that the growth of the contribution base (which also takes into account the size of the contributing labor force) must be used to guarantee financial stability—a fixed contribution rate. To counter these a balance index has been constructed.*

- *The balance index: An evaluation of the present value of assets and liabilities is made, based on current information, to construct a balance index. When the valuation of assets falls short of the valuation of liabilities, the index falls under unity and both account values and benefits are deflated by the index. Positive indexation occurs in a recovery until the balance index reaches unity again. (See Settergren, 2001)*

Appendix 2. Replacement Rates

The following tables provide an illustration of how the system works and the replacement rates an individual born 1975 with earnings from age 22 can expect based on different market rates of and present life expectancy estimates for a person in the 1975 cohort. The tables are from Palmer (2000) and Palmer (2001b), which also explains the characteristics and logic of the new system in greater detail. Note that benefits are affected by three factors. The first is additional contributions. The second is indexation and market returns on account values not converted into benefits. The third is unisexual life expectancy from the time of retirement. For the older worker, the latter two are generally more important.

Table 1. NDC. An example with an individual who begins work at 22 and works every year until he/she decides to retire fully at sometime between age 61 and 70. Contribution rate on earnings=18.5 %. Values in US dollars.

Age	**Earnings.** *Individual growth of 2 % per annum*	**Capital index.** *2 % per annum*	**Capital balance.** *End of year*	**Unisex life expectancy.** *Swede born 1975*	**Annuity.** *Based solely on life expectancy*	**Replacement rate.** *% of earnings last year*	**Unisex life expectancy and 1.6% growth.** *Swede born 1975*	**Annuity.** *Based on life expectancy and a real return of 1.6%*	**Replacement rate.** *% of earnings last year*
22	27061	1.000	5006						
23	27602	1.020	10213						
24	28154	1.040	15626						
::	::	::	::						
..	..	::	::						
:		:	::						
::	..	:	:						
60	57432	2.122	414368						
61	58580	2.165	433493	24.24	17096	0.30	19.69	21043	0.37
62	59752	2.208	453217	23.41	18516	0.32	19.14	22654	0.39
63	60947	2.252	473567	22.59	20061	0.34	18.58	24397	0.41
64	62166	2.297	494526	21.78	21746	0.36	18.02	26287	0.43
65	63409	2.343	516150	20.97	23568	0.38	17.45	28342	0.46
66	64677	2.390	538438	20.16	25603	0.40	16.88	30580	0.48
67	65971	2.438	561411	19.36	27814	0.43	16.30	33024	0.51
68	67290	2.487	585088	18.55	30262	0.46	15.72	35716	0.54
69	68636	2.536	609488	17.76	32944	0.49	15.14	38654	0.57
70	70009	2.587	634629	16.96	35927	0.52	14.54	41906	0.61

One of the advantages that can be claimed for the combination of NDC and financial account schemes is that workers can combine work (full or part-time) with a partial or full benefit from either or both of the social insurance schemes. See Palmer (1999).

Table 2. Replacement Rates. Annuity as a per cent of last earnings.

Age	PAYG. Contribution rate of 16 %	Public Second Pillar (2.5%) + Group Occupational (3.5%) Return of : 2%	5%	8%	Total. Public PAYG and Second Pillar plus Group Occupational Return of: 2%	5%	8%
61	0.32	0.12	0.23	0.47	0.44	0.55	0.79
62	0.33	0.13	0.25	0.52	0.46	0.58	0.85
63	0.35	0.14	0.27	0.57	0.49	0.62	0.92
64	0.37	0.15	0.29	0.63	0.52	0.66	1.00
65	0.39	0.15	0.31	0.69	0.54	0.70	1.11
66	0.42	0.16	0.33	0.76	0.58	0.75	1.18
67	0.44	0.17	0.36	0.83	0.61	0.80	1.27
68	0.47	0.18	0.39	0.92	0.65	0.86	1.39
69	0.50	0.19	0.42	1.01	0.69	0.92	1.51
70	0.53	0.20	0.45	1.12	0.73	0.98	1.65

Note. The individual's earnings are assumed to grow at a real rate of 2 % per year throughout the earnings career. The rate of growth used for indexation of capital in the PAYG system is 2 %.The pay-as-you-go, second-pillar and occupational annuities are all based on unisex life expectancy and a real rate of return on capital from retirement of 1.6 %.

Appendix 3. Fee Schedule for administrative costs for private asset managers participating in the FDC scheme

The authority administering the financial account system, the PPM, is the sole client for the system. The PPM has at most one (net of purchases and sales) transaction in fund shares per day vis á vis any specific fund manager—and normally the transaction amount will be very small relative to the amount of total assets managed on behalf of the PPM. On the other hand, a large amount of money will be transferred on an annual basis, in conjunction with the transfer of new contributions covering a whole year.

The fund manager's cost of administrating PPM assets should be very low under these circumstances. For this reason, the PPM uses a fee schedule designed to keep asset management costs low for participants, and fund managers must agree to use the fee schedule to participate in the scheme. The way it works is that managers are allowed to charge what they normally charge in the way of administration fees, but will pay a rebate to the PPM if their administration fees exceed a specified amount, determined by a formula. The following table (Palmer 2000) illustrates how the rebate schedule works in practice. Generally speaking, the larger the stock of PPM assets held by the fund, the less it is allowed to charge for administration.

Fund Manager Charges

Normal Administrative cost, % of fund's PPM assets	Flat rebate rate, of fund's PPM assets	Incremental Rebate factor	Rebate payable of fund's PPM assets	Administrative cost after rebate, % of fund's PPM assets
1. Managers holding less than 70 million SEK in PPM Funds				
1.5	0.4	0.25	0.275	1.225
1.0	0.4	0.25	0.15	0.85
0.5	0.4	0.25	0.025	0.475
0.12	0.4	0.25	0	0.12
2. Managers holding 70 to 300 million SEK in PPM Funds				
1.5	0.35	0.65	0.7475	0.7525
1.0	0.35	0.65	0.4225	0.5775
0.5	0.35	0.65	0.0975	0.4025
0.12	0.35	0.65	0	0.12
3. Managers holding 300 million to 500 million SEK in PPM Funds				
1.5	0.3	0.85	1.02	0.48
1.0	0.3	0.85	0.595	0.405
0.5	0.3	0.85	0.17	0.33
0.12	0.3	0.85	0	0.12

Fund Manager Charges—Continued

Normal Administrative cost, % of fund's PPM assets	Flat rebate rate, of fund's PPM assets	Incremental Rebate factor	Rebate payable of fund's PPM assets	Administrative cost after rebate, % of fund's PPM assets
4. Managers holding 500 million to 3000 million SEK in PPM Funds				
1.5	0.25	0.95	1.1875	0.3125
1.0	0.25	0.95	0.7125	0.2875
0.5	0.25	0.95	0.2375	0.2625
0.12	0.25	0.95	0	0.12
5. Managers holding 3000 to 7000 million SEK in PPM Funds				
1.5	0.15	0.95	1.2825	0.2175
1.0	0.15	0.95	0.8075	0.1925
0.5	0.15	0.95	0.3325	0.1675
0.12	0.15	0.95	0	0.12
6. Managers holding more than 7000 million SEK in PPM Funds				
1.5	0.12	0.96	1.3248	0.1752
1.0	0.12	0.96	0.8448	0.1552
0.5	0.12	0.96	0.3648	0.1352
0.12	0.12	0.96	0	0.12

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Chairman SHAW. Thank you. Dr. Orszag.

STATEMENT OF PETER R. ORSZAG, PH.D., PRESIDENT, SEBAGO ASSOCIATES, INC., BELMONT, CALIFORNIA

Dr. ORSZAG. Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify. My testimony this morning will focus on the United Kingdom, and I want to underscore the importance of looking to the U.K. for lessons on voluntary individual accounts.

Unlike many other countries that involved in adopting individual accounts, the U.K. is an industrialized economy like we are. It shares many of our traditions, our language, and it is more similar to us than many of the other countries to which we often look for insight into individual accounts.

But, more importantly, the U.K. is the only industrialized economy that has adopted a voluntary system of individual accounts, in which individuals can partially opt out of the State-run system and into an individual account. As you know, President Bush has endorsed such a voluntary approach to individual accounts in the United States. Other OECD, Organization of Economic Cooperation and Development, countries have adopted individual accounts, but they have been mandatory. The U.K. is the only advanced economy that has made them voluntary, and therefore it is particularly telling to see what we can learn from the U.K. experience.

Now, voluntary accounts probably sound innocuous at worst and quite promising at best when you first hear about them. After all, how can you be opposed to something if participation is voluntary? What I want to emphasize is that the U.K. experience underscores many of the problems associated with voluntary accounts, and I want to focus on five issues associated with the U.K. experience.

First, one crucial challenge in a voluntary system is how to provide advice to workers about whether to opt into the individual accounts. In the United Kingdom, as already was mentioned, in what has become known as the mis-selling scandal, individuals were deceived as to the benefits of individual accounts by financial firms. High pressure sales tactics were used to persuade workers to switch out of occupational funds and into unsuitable individual account plans. Financial firms are now being forced to repay amounts estimated at more than $15 billion to the individuals who were misled.

Second, to offset the incentive of younger workers to disproportionately opt into individual accounts, the U.K. has adopted an age-related rebate scheme. The government places a rebate into your individual account, but the amount of the rebate depends on how old you are. And you need to do that in order to offset the inherent tendency of younger workers to disproportionately opt into individual accounts relative to older workers, basically because the power of compound interest operates for more years for younger workers than older workers.

In any case, age-related rebates have not entered the U.S. debate at all. They are very confusing to many workers, but if you don't implement such a system, younger workers have a much stronger incentive to opt into individual accounts than older workers.

Third, in designing a system of voluntary accounts, you have to worry about the incentives to opt into the individual accounts by earnings level. Higher income taxpayers generally get a less good deal under Social Security than lower earners, and therefore would have a stronger incentive to opt into individual accounts. This is exactly what we find in the U.K. The partial withdrawal of higher income workers has left behind a pool of disproportionately lower earners in the State-run system in the U.K.

Issue number four is annuitization, that is, converting upon retirement the accumulated balance in your account to a payment per month or per year that lasts as long as your lifetime. In the U.K., the balance that you build up from the tax rebates funded by the government in an individual account, the so-called protected rights, must be converted into an annuity upon retirement, and that annuity is restricted so that it ends with the life of the annuitant or the spouse, leaving nothing for heirs after annuitization.

A final and crucial issue associated with the U.K. experience involves administrative costs. Along with two colleagues, I recently completed an exhaustive World Bank study of administrative costs in the United Kingdom. We concluded that over a working career, fees would reduce account balances for the typical worker by 43 percent relative to the balances that would accrue in the absence of administrative costs. Other studies by actuaries and financial analysts in the United Kingdom have reached similar conclusions.

This 43-percent estimate includes the cost of converting the account balance to an annuity upon retirement. Without such annuitization costs, the administrative costs in the U.K. system would reduce account balances for the typical worker by 36 percent. These high administrative costs dramatically reduce the retirement income from individual accounts. They also indicate that competition alone is not sufficient, or at least was not sufficient in the U.K., to reduce fees to reasonable levels.

Indeed, in response to the high charges imposed on individual account holders, the U.K. government has recently adopted reforms to cap the fees that can be charged by individual account providers. The political viability of such caps—their fees are now capped at 1 percent per year—in the United States is unclear.

In conclusion, although they may initially sound attractive, voluntary individual accounts involve a variety of very difficult administrative issues. The experience in the United Kingdom should serve as a particularly forceful indicator of the potential problems associated with such voluntary accounts.

The U.K. has witnessed a scandal in which vulnerable members of society were given misleading advice regarding the benefits of individual accounts, and has suffered from high administrative costs that sharply reduce the retirement benefits associated with such accounts. The government has recently been forced to impose a cap on the fees that can be charged on individual accounts by financial firms. In summary, although voluntary accounts may sound innocuous, the experience in the U.K. suggests that they may not be that at all.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Orszag follows:]

Statement of Peter R. Orszag,[1] Ph.D., President, Sebago Associates, Inc., Belmont, California

"Voluntary Individual Accounts: The Lessons from the U.K. Experience"

Mr. Chairman and Members of the Subcommittee, my name is Peter Orszag. I am currently the president of an economic consulting firm, and will join the Brookings Institution next week as a Senior Fellow in Economic Studies. It is an honor to appear before the Subcommittee to discuss Social Security reform and the lessons that we may be able to draw from experiences in countries that have adopted personal retirement accounts.

My testimony this morning will focus on the United Kingdom, which has had a system of voluntary individual accounts for more than a decade. The U.K. offers two important advantages in providing lessons for the Social Security debate in the United States.

First, although cross-country comparisons are fraught with difficulties, the U.K. is similar in many ways to the United States. In addition to our shared language and traditions, both the U.K. and the U.S. are advanced industrialized economies.

[1] Dr. Peter Orszag is the President of Sebago Associates, Inc., an economic policy consulting firm. He will join the Brookings Institution as a Senior Fellow in Economic Studies in August 2001. In the current or previous two fiscal years, Sebago Associates has held contracts on Social Security issues with the Social Security Administration (through the Center for Retirement Research at Boston College), the Securities and Exchange Commission, and the Office of Policy Development in the Executive Office of the President. None of these contracts addressed international Social Security issues and therefore are not relevant to the subject matter of, or my representational capacity at, this hearing. In his appearance before the Subcommittee, Dr. Orszag does not represent any organizations, clients, or entities. A curriculum vitae for Dr. Orszag has been provided in a separate document.

Many of the other countries cited in the debate over individual accounts are developing economies, which face substantially different challenges than we do. Drawing lessons for the United States from the experiences of these developing economies is particularly difficult.

Second, the U.K. is the only industrialized nation of which I am aware that allows individuals to opt out of its state-run Social Security system and into an individual account. Other industrialized countries have adopted individual accounts, but have made them mandatory. The U.K. thus provides an important case study on the operation of voluntary individual accounts.

As you know, the Bush Administration has endorsed such voluntary accounts. One of its guiding principles for Social Security reform is that "Modernization must include individually controlled, voluntary personal retirement accounts, which will augment Social Security."[2] I hope that the experience with voluntary accounts in the U.K. will prove helpful to you in evaluating the potential costs and benefits of such accounts here.

Voluntary individual accounts likely seem innocuous at worst, and quite promising at best, to many who first hear about them. After all, how can anyone be opposed to such accounts if participation is voluntary? Unfortunately, as I hope to illustrate through the experience in the U.K., the reality is more complicated.

I. Background on the U.K. pension system

The pension system in the United Kingdom is complicated.[3] It consists of two tiers: a flat-rate basic state pension, and an earnings-related pension. The government provides the first tier, which is not related to earnings. The second tier, which can be managed by an individual, his or her employer, or the government, depends on an individual's earnings history.

Basic State Pension

The first tier of the U.K. pension program is called the basic state retirement pension (BSP). The BSP is a pay-as-you-go system. Under the BSP, a portion of the National Insurance Contribution (NIC) payroll tax finances a flat-rate benefit for retirees. In other words, once a worker qualifies by working for a sufficient number of years, this basic benefit does not vary with the worker's earnings level. The full benefit payments amount to about £70 (or about $100) per week per person. Currently, about 11 million pensioners, or virtually the entire population of retirees, receive a basic state pension. Such pensions currently provide about one-third of total income for retirees.

The State Earnings-Related Pension Scheme and Opting Out

The second tier of the U.K. system offers three different alternatives to workers. Roughly one-quarter of full-time British workers currently choose the most basic option, the State Earnings-Related Pension Scheme (SERPS). SERPS is similar in some senses to our Social Security system: It is run by the government and provides an earnings-related defined benefit pension. When it was first introduced in 1978, SERPS was relatively generous. Over time, a series of reforms made the program less attractive to middle- and upper-income workers.[4] Beginning in April 2002, SERPS will be replaced by the State Second Pension, which will provide substantially improved benefits for lower- and moderate-earners.

Workers who opt out of SERPS receive a NIC tax rebate and, as a result, do not accrue SERPS benefits. Since their subsequent pensions are in effect not financed out of NIC taxes, the government provides a payroll tax rebate to reflect reduced future SERPS payments. The tax rebate then finances an employer-provided pension or an individual account. The two opt-out options are:

- *Individual Accounts.* Since 1988, one way to opt out of SERPS has been through an individual account. About 25 percent of workers in the United Kingdom are currently enrolled in individual accounts. The government's payroll tax

[2] President Bush has also recently appointed a commission to examine how to design and implement voluntary individual accounts (see http://www.commtostrengthensocsec.gov). Former Senator Daniel Patrick Moynihan is one of the co-chairs of that commission. Senator Moynihan previously sponsored legislation in 1998 (S. 1792) that included voluntary individual accounts.

[3] For more detailed discussion on the features of the U.K. pension system, see Lillian Liu, "Retirement Income Security in the United Kingdom." ORES Working Paper 79, Social Security Administration, 1998; and Mamta Murthi, J. Michael Orszag, and Peter R. Orszag, "Administrative Costs under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom," in Robert Holzmann and Joseph E. Stiglitz, eds., New Ideas about Old Age Security (The World Bank, 2001).

[4] For a description of the reforms, many of which were designed to encourage movement to either employer- or individual-based pension systems, see Lillian Liu, "Retirement Income Security in the United Kingdom," ORES Working Paper 79, Social Security Administration, 1998.

rebate finances contributions into individual accounts that are roughly equivalent to three percent of average annual earnings for American workers covered by the U.S. Social Security system. Roughly half of those who have these accounts contribute an additional amount on top of the government rebate.

- *Employer-Based Pensions.* About half of all workers participate in an employer-sponsored pension plan (often referred to as an "occupational pension"). Occupational pensions can be either defined benefit or defined contribution plans.

To summarize, roughly one-quarter of workers belong to the state-run program (SERPS). One-quarter opt out of SERPS and into individual accounts, and one-half opt out of SERPS and into employer-based pensions.

II. Design of Voluntary Individual Accounts

The individual accounts adopted in the U.K. illustrate many of the difficult implementation issues that any system of voluntary accounts in the United States would face:

Consumer protection and financial advice

One crucial challenge in a voluntary system is how to ensure that workers make good decisions about whether to opt into the individual accounts. This concern is particularly relevant to the U.K. experience.

In the United Kingdom, in what has become known as the "mis-selling" scandal, individuals were deceived as to the benefits of individual accounts. High-pressure sales tactics were used to persuade workers to switch into unsuitable individual account plans. Sales agents had often sought too little information from potential clients to provide proper advice.

The U.K. regulatory authorities began an investigation of this mis-selling phenomenon after the problem became apparent in the early- to mid-1990s. As a result of this investigation, financial firms are being forced to repay amounts estimated at more than $15 billion to the individuals who were given misleading advice. In addition, regulators have adopted a more aggressive enforcement stance for the advice offered to individuals.

If voluntary individual accounts were adopted in the United States, careful attention would have to be given to ensuring that individuals were given responsible advice regarding whether they should opt for such accounts. Two issues arise with regard to such advice and financial education. First, an important question involves who should provide the advice: independent analysts, the government, the financial firms offering the accounts, or some combination thereof. The U.K. experience suggests that allowing advice to be provided by the financial firms themselves may cause significant problems, even in the presence of comprehensive and good-faith regulation. Second, the costs of providing the advice should not be under-estimated. Even in the United States, financial literacy levels are surprisingly low. For example, according to the Securities and Exchange Commission, more than half of all Americans do not know the difference between a stock and a bond; only 12 percent know the difference between a load and no-load mutual fund; only 16 percent say they have a clear understanding of what an Individual Retirement Account is; and only 8 percent say they completely understand the expenses that their mutual funds charge.[5]

Temporary or permanent opt-out choices

If workers are allowed to partially opt out of Social Security, is the choice a permanent one? Or would an individual be allowed to opt out in some years and opt back in others? Either approach has potential problems. Making the choice irrevocable could strand some workers who realize they made a mistake in opting out. But allowing workers to move back and forth between the two systems could increase the opportunities for gaming both systems, as well as increase the administrative burdens and costs for the Social Security Administration, which would have to track the choices that workers made each year regarding whether to divert payroll contributions to individual accounts or to remain within the pure Social Security system.

The U.K. has chosen to allow workers to switch back and forth between the state-run system and individual accounts. This policy decision means that workers must decide on an ongoing basis whether to opt into individual accounts, and has raised the costs associated with providing advice to workers on the best option available to them. The data on switching are unfortunately limited because of the complexity

[5] Arthur Levitt, Speech at the John F. Kennedy School of Government, Harvard University, October 19, 1998.

of the system, but it appears that switching among the options is more likely when workers change jobs.

Age-related incentives to opt into individual accounts

If participation in a system of individual accounts is voluntary, and if workers can switch back and forth between the individual account and the state-run system, workers will typically find it more attractive to opt into the individual account when young and then into the state-run system when old.

For example, consider two workers earning $25,000 a year. One worker is aged 60 and intends to retire in five years. The other worker is aged 25 and intends to retire in 40 years. Both are given the option to put two percent of their wages into an individual account. If the older worker puts two percent ($500) of her wages into an individual account and earns five percent per year (after inflation) on the balance in the account, her account will accumulate to $638 (in inflation-adjusted dollars) upon retirement. However, if the younger worker puts two percent ($500) into an individual account and earns the same rate of return per year as the older worker, the $500 will accumulate to more than $3,500 upon retirement because interest will compound for a much longer number of years. If both workers would receive $750 more in lifetime Social Security benefits if they did *not* opt to contribute the $500 to the individual account, the older worker should choose not to contribute to the account (since $638 is less than $750) while the younger worker should choose to do so (since $3,500 is more than $750). If switching back and forth between the two systems is allowed, a worker would likely find it advantageous to opt into individual accounts when young and then back into the state-run system when old.

To offset the incentive of younger workers to disproportionately opt into individual accounts, the U.K. has adopted an age-related tax rebate scheme. Workers who opt into an individual account obtain a rebate on their payroll taxes, which is used to fund the individual account contribution. But the rebate rate is larger for older workers and smaller for younger workers. The purpose of these age-related rebates is to offset the impact of age on the incentives to opt into individual accounts. The age-related rebates, however, further complicate the administration of the system and are confusing to many workers.

Disproportionate incentives for higher earners to opt into individual accounts

In designing a system of voluntary accounts, one must also consider how the incentives to opt into individual accounts vary by earnings level. For example, the existing Social Security system in the United States is progressive: higher-income workers receive lower rates of return than lower-income workers, even after taking into account the longer life expectancies of higher earners. Higher-income taxpayers would therefore generally have a stronger incentive to partially opt out of the Social Security system than lower-income taxpayers, since Social Security represents a less attractive deal for higher earners than lower earners.

The tendency of higher earners to find individual accounts more attractive is precisely what has occurred in the U.K.: Higher earners have disproportionately opted out of the state-run system. Indeed, the majority of Britons who remain enrolled in SERPS today earn less than £10,000 annually. It may be possible to design voluntary individual accounts that would provide stronger incentives for lower earners to opt into them, but the challenges in doing so are substantial. In any case, the U.K. has not pursued that path.

The partial withdrawal of higher-income workers under a voluntary system of individual accounts leaves behind a pool of disproportionately lower-income workers. The partial withdrawal of higher-income workers from Social Security consequently would weaken the system's ability to accomplish redistribution toward such lower-income workers. As Harvard economist David Cutler has emphasized:

> "We typically think that giving people choice is optimal since people can decide what is best for them. Thus, the economic bias is to believe that, if people want to opt out of social security, they should be allowed to do so. In the context of social security privatization, however, this analysis is not right. Allowing people to opt out of social security to avoid adverse redistribution is not efficient; it just destroys what society was trying to accomplish. . . . An analogy may be helpful. Suppose that contributions to national defense are made voluntary. Probably, few people would choose to contribute; why pay when you can get the public good for free? Realizing this, we make payments for national defense mandatory. The same is true of redistribution. Redistribution is a public good just as much as national defense; no one wants to do it, but everyone benefits from it. As a result, making contributions to redistribution voluntary will be

just as bad as making contributions to national defense voluntary. We need to make redistribution mandatory, or no one will pay for it." [6]

Such factors suggest that voluntary individual accounts pose unique challenges, which is why most proponents of individual accounts would make them mandatory. But other features of the U.K. system highlight some of the issues that must be addressed in any system of individual accounts, including mandatory ones. Such issues include:

Choice of providers and investments

The U.K. has a decentralized system of individual accounts, somewhat similar to the rules governing Individual Retirement Accounts in the United States. The individual accounts in the U.K. can be held at a wide number of financial institutions. The assets in the individual accounts can be held in a variety of different forms, and are not restricted to broad market index funds. An alternative would mimic the more centralized approach of the Thrift Savings Plan, by restricting where the accounts could be held and the types of assets they could hold.

This choice involves a difficult tradeoff: Decentralized systems, such as the one in the U.K., typically involve substantially higher administrative costs than more centralized systems.[7] They also expose individuals to the possibility of making particularly poor investment choices, and therefore require even more aggressive financial education efforts than centralized plans.

Although centralized systems of individual accounts are preferable to decentralized systems because they reduce administrative costs and ensure diversified portfolios, such centralized systems tend to generate less political enthusiasm. They also raise many of the same political issues (such as the choice of which firms are included in the index funds) that would be involved in allowing the government to invest directly in private assets.

Fee regulations

As explained below, administrative costs on individual accounts in the U.K. have proven to be extremely high. The government has recently adopted a series of reforms to cap the fees that financial providers can impose on a new type of individual accounts, called Stakeholder Pensions. The previous experience with individual accounts in the absence of fee regulations suggests that competition alone is insufficient to reduce fees to reasonable levels (see below).

Annuitization

The SERPS program in the United Kingdom automatically provides an inflation-adjusted annuity to beneficiaries. Systems of individual accounts often mandate that accounts be converted into an annuity upon retirement (in other words, the account value is exchanged for a monthly or annual payment that is made as long as the retiree or the retiree's spouse is alive) to ensure that individuals avoid outliving their savings. The regulations governing when an annuity must be purchased in the United Kingdom are complicated. They require that the portion of an individual account funded by tax rebates (as opposed to any additional contributions) must be fully annuitized. The annuity must be purchased at some point between age 60 and age 75. The portion of an individual account funded by additional contributions (beyond the tax rebate) does not have to be entirely annuitized. In particular, up to 25 percent of the accumulated balance from this component of the individual account can be withdrawn tax-free in a lump sum. If workers die before annuitizing their account, the balance of the account enters their estate.

Many supporters of individual accounts highlight the potential of such accounts to provide payments to heirs. It is crucial to realize, however, that providing a payment to heirs requires that a retiree receive a lower monthly annuity payment and have less to live on in old age. The iron laws of finance demand such an outcome, since the same dollars can be used for only one purpose. Thus, each dollar that a pensioner can bequeath to heirs means a dollar less to support retirement income, because the pool of funds available to finance retirement benefits is reduced. This iron law holds for all pensions—Social Security, private pensions, and individual accounts.

Annuities in the U.K. illustrate this tradeoff. To ensure adequate retirement income, individual accounts accumulated from tax rebates must be annuitized using

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[6] David Cutler, "Comment on Gustman and Steinmeier, 'Privatizing Social Security: Effects of a Voluntary System,'" in Martin Feldstein, editor, Privatizing Social Security (University of Chicago Press: Chicago, 1998), page 358.

[7] Estelle James, James Smalhout, and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph E. Stiglitz, eds., New Ideas about Old Age Security (The World Bank, 2001).

a basic annuity, under which the payments end with the death of the annuitant. In other words, following annuitization, heirs receive nothing from the individual accounts that had been accumulated from tax rebates.

For those who made additional contributions to their accounts (beyond the tax rebates), other options are available. For example, more complicated annuities offer a guaranteed payment period. Under these annuities, the heirs receive some payment if the annuitant dies before the end of the guaranteed period. In the U.K. market, for example, a 65-year-old single man who had accumulated a £100,000 account could turn that balance into an annuity payment of about £9,000 per year for as long as he lived.[8] That would, however, leave nothing for his heirs. To obtain a 10-year guaranteed payment period, he would have to accept a lower annuity payment per year. In the U.K. market, the cost involved would reduce his annuity per year by about £550, or roughly 6 percent.[9] And that would provide a payment to his heirs only if he died before age 75. If he died after age 75, the annuity payments would end with his death and the heirs would receive nothing. The U.K. market data highlight the unavoidable tradeoff between the provision of retirement income and the provision of a bequest to heirs.

III. Administrative costs

A final and crucial lesson to be learned from the U.K. experience with voluntary accounts involves administrative costs. Operating individual accounts entails various costs that reduce the account balances. The level of administrative costs in a system of individual accounts would depend on a number of factors, including: how centralized the system of accounts was and how limited the investment choices were; the level of service provided (e.g., whether individuals enjoyed unlimited telephone calls to account representatives, frequent account balance statements, and other services); the size of the accounts; and the rules and regulations governing the accounts. The higher the administrative cost, the lower the ultimate benefit a worker would receive (all else being equal), since more of the funds in the accounts would be consumed by administrative costs and less would be left to pay retirement benefits.

Administrative costs for voluntary accounts are likely to be substantially higher than for mandatory accounts, since voluntary accounts involve administrative complexities not present in a mandatory system. For example, voluntary systems require tracking which workers have opted into the individual account system; a mandatory system can instead rely on comprehensive worker records. Voluntary systems also require the provision of more advice to beneficiaries, since beneficiaries need to decide whether to opt into individual accounts (and to opt partially out of Social Security). Evidence from the United Kingdom shows that the voluntary individual account system there has produced significantly higher administrative costs than under mandatory individual account systems in other countries.

Along with two colleagues, I recently completed a World Bank study of administrative costs in the United Kingdom.[10] We focused on the system of individual accounts before the new type of individual accounts, with capped fees, were introduced.

We concluded that over a working career, the historical fees in the U.K. would have reduced account balances for the typical worker by *43 percent* relative to the balances that would accrue in the absence of administrative costs. Other studies by actuaries and financial analysts in the United Kingdom have reached similar conclusions.[11] (The 43 percent estimate includes the cost of converting the account balance to an annuity upon retirement. Without such annuitization costs, the historical administrative costs in the U.K. system would have reduced account balances for the typical worker by 36 percent.) These high administrative costs dramatically reduce the retirement income from individual accounts.

These charges indicate that competition alone is not sufficient, or at least was not sufficient in the U.K., to reduce fees to reasonable levels. Indeed, in response to the high charges imposed on individual account holders, the U.K. government has re-

[8] See http://www.annuity-bureau.co.uk/rates.html.

[9] See http://www.annuity-bureau.co.uk/annuity-optional.html

[10] Mamta Murthi, J. Michael Orszag, and Peter R. Orszag, "Administrative Costs under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom," in Robert Holzmann and Joseph E. Stiglitz, eds., New Ideas about Old Age Security (The World Bank, 2001). For a summary, see Peter Orszag, "Administrative Costs in Individual Accounts In The United Kingdom," Center on Budget and Policy Priorities, March 1999, available at http://www.cbpp.org.

[11] See John L. Shuttleworth, "Operating costs of different forms of pension provision in the U.K.," Coopers & Lybrand, June 27, 1997, and John Chapman, "Pension plans made easy," Money Management, November 1998.

cently adopted reforms to cap the fees that can be charged by individual account providers. The political viability of such regulations in the United States is unclear.

Conclusion

Although they may sound attractive, voluntary individual accounts involve a variety of very difficult administrative issues. The experience in the United Kingdom should serve as a particularly forceful indicator of the potential problems associated with voluntary individual accounts. The United Kingdom has witnessed a scandal in which vulnerable members of society were given misleading advice regarding the benefits of individual accounts and also has suffered from high administrative costs under its voluntary individual account system that sharply reduce the retirement benefits those with such accounts eventually receive. The government has recently been forced to impose a cap on the fees that can be charged on individual accounts by financial firms.

Finally, it is important to remember that voluntary individual accounts do nothing in and of themselves to improve Social Security's financial condition. To the extent that they divert current revenue away from Social Security, they could exacerbate the Social Security shortfall. Individual account contributions equal to two percent of taxable payroll, in and of themselves, would increase the 75-year long-term deficit within Social Security from 1.9 percent of taxable payroll to 3.9 percent of taxable payroll. Policy-makers considering a system of voluntary individual accounts in the United States should carefully examine the potential costs involved. The fact that the accounts are voluntary does not mean they are not harmful.

Chairman SHAW. Thank you.

Mr. Rodriguez.

STATEMENT OF L. JACOBO RODRIGUEZ, ASSISTANT DIRECTOR, PROJECT ON GLOBAL ECONOMIC LIBERTY, CATO INSTITUTE

Mr. RODRIGUEZ. Thank you, Mr. Chairman, distinguished Members of the Subcommittee.

In 1981 Chile replaced its bankrupt pay-as-you-go retirement system with a fully funded system of individual retirement accounts managed by the private sector. That revolutionary reform defused a fiscal time bomb that is ticking for countries with pay-as-you-go systems, under which fewer and fewer workers have to pay for the retirement benefits of more and more retirees. More important, Chile created a retirement system that, by giving workers clearly defined property rights in their pension contributions, offers proper work and investment incentives; acts as an engine of, not an impediment to, economic growth; and enhances personal freedom and dignity.

Since the Chilean system was implemented, labor force participation, pension fund assets, and benefits have all grown. Today, more than 95 percent of Chilean workers have voluntarily joined the system; the pension funds have accumulated $36 billion in assets, a figure that is equivalent to about 35, 40 percent of Chilean GDP; and the average real rate of return has been 10.9 percent per year.

If imitation is the sincerest form of flattery, the Chilean system should be blushing from the accolades that it has received. Since 1993, eight other Latin American nations have implemented pension reforms modeled after Chile's. In March 1999, Poland became the first country in Eastern Europe to implement a partial privatization reform based on the Chilean model. In short, the Chilean system has clearly become the point of reference for countries interested in finding an enduring solution to the problem of paying for the retirement benefits of aging populations.

Although the basic story of Chile is well known, it is worth recapping briefly. Every month, workers deposit 10 percent of the first $22,000 of earned income in their own individual pension savings accounts, which are managed by the specialized pension fund administration company of their choice. Those companies invest workers' savings in a portfolio of bonds and stocks, subject to government regulations on the specific type of investment and the overall mix of the portfolio. Contrary to a common misconception, fund managers are under no obligation, nor have they ever been, to buy government securities, a requirement that would not be consistent with the notion of pension privatization.

At retirement, workers use the funds accumulated in their accounts to purchase annuities from insurance companies. Alternatively, workers can make programmed withdrawals from their accounts. The amount of those withdrawals depends on the worker's life expectancy and those of his dependents.

The government provides a safety net for those workers who, at retirement, do not have funds in their accounts to provide a minimum pension. But because the new system is much more efficient than the old government-run system, and because to qualify for the minimum pension under the new system, a worker must have contributed at least 20 years, the cost to the taxpayer of providing a minimum pension funded from general government revenues has so far been very close to zero. Of course, that cost is not new. The government also provided a safety net under the old program.

The bottom line is that workers are retiring with better, more secure pensions and increasingly at an early age. For instance, since the early retirement option was introduced in 1988, the average monthly pensions for workers retiring early have ranged from $258 to $318. By comparison, during the period 1988 to 1998, the representative worker in the United States retiring at age 62 under Social Security is getting monthly benefits that range from $506 to $780.

That is an indication of the efficiency of the private system in Chile, not just in comparison with the old Chilean government-run system but also in comparison with the government-run system here in the United States, a country where per capita income is more than five times higher than in Chile. Chilean workers who retire at 65 are also getting benefits that are higher relative to per capita income than the benefits U.S. workers get under Social Security.

Through their pension accounts, Chilean workers have become owners of the means of production in Chile, and increasingly of the means of production of other Latin American countries, and consequently have grown much more attached to the free market and to a free society. This has had the effect of reducing class conflicts, which in turn has promoted political stability and helped to depoliticize the Chilean economy. Pensions today do not depend on the government's ability to tax future generations of workers, nor are they a source of election-time demagoguery. To the contrary, pensions depend on a worker's own efforts and thereby afford workers satisfaction and dignity.

Critics of the Chilean system, however, often point to high administrative costs, lack of portfolio choice, and the high number of transfers from one fund to another, as evidence that the system is inherently flawed and inappropriate for other countries, including the United States and the industrialized countries of Europe. Some of those criticisms are misinformed.

For example, administrative costs are about 1 percent of assets under management, a figure similar to management costs in the U.S. mutual fund industry. To the extent the criticisms are valid, they result from a single problem, excessive government regulation. And I would be happy to discuss during the Q and A how government regulation creates distortions and how those distortions could be eliminated.

All the ingredients for the system's success—individual choice, clearly defined property rights and contributions, and private administration of accounts—have been present since 1981. If Chilean authorities address some of the remaining shortcomings with boldness, we should expect Chile's private pension system to be even more successful in the years to come than it has been in the first 20 years. And unlike a pay-as-you-go system, a fully funded individual capitalization system can anticipate fewer problems as it matures.

Thank you very much.

[The prepared statement of Mr. Rodriguez follows:]

Statement of L. Jacobo Rodríguez, Assistant Director, Project on Global Economic Liberty, CATO Institute

My name is L. Jacobo Rodríguez and I am the assistant director the Project on Global Economic Liberty at the Cato Institute. I would like to thank Chairman Shaw for inviting me to testify. In the interest of transparency, let me point out that neither the Cato Institute nor I receive government money of any kind.

In 1981 Chile replaced its bankrupt pay-as-you-go retirement system with a fully funded system of individual retirement accounts managed by the private sector.[1] That revolutionary reform defused the fiscal time bomb that is ticking for countries with pay-as-you-go systems under which fewer and fewer workers have to pay for the retirement benefits of more and more retirees. More important, Chile created a retirement system that, by giving workers clearly defined property rights in their pension contributions, offers proper work and investment incentives; acts as an engine of, not an impediment to, economic growth; and enhances personal freedom and dignity.

Since the Chilean system was implemented, labor force participation, pension fund assets, and benefits have all grown. Today, more than 95 percent of Chilean workers have joined the system; the pension funds have accumulated $36 billion in assets; and the average real rate of return has been 10.9 percent per year.[2]

If imitation is the sincerest form of flattery, the Chilean system should be blushing from the accolades it has received. Since 1993 eight other Latin American nations have implemented pension reforms modeled after Chile's. In March of 1999 Poland became the first country in Eastern Europe to implement a partial privatization reform based on the Chilean model. In short, the Chilean system has clearly become the point of reference for countries interested in finding an enduring solution to the problem of paying for the retirement benefits of aging populations.

Although the basic story is well known, it is worth recapping briefly. Every month workers deposit 10 percent of the first $22,000 of earned income in their own individual pension savings accounts, which are managed by the specialized pension fund

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[1] A lengthier treatment of the Chilean reform can be found in L. Jacobo Rodríguez "Chile's Private Pension System at 18: Its Current State and Future Challenges System at 18: Its Current State and Future Challenges." *Cato Institute*, Social Security Paper no. 17, July 30, 1999 http://www.socialsecurity.org/pubs/ssps/ssp-17es.html.

[2] For more statistical information on the Chilean system, see the official website of the Superintendencia de AFPs, the Chilean government regulator of the private pension system, at http://www.safp.cl.

administration company of their choice. Those companies invest workers' savings in a portfolio of bonds and stocks, subject to government regulations on the specific types of instruments and the overall mix of the portfolio. Contrary to a common misconception, fund managers are under *no* obligation to buy government securities, a requirement that would not be consistent with the notion of pension privatization. At retirement, workers use the funds accumulated in their accounts to purchase annuities from insurance companies. Alternatively, workers make programmed withdrawals from their accounts; the amount of those withdrawals depends on the worker's life expectancy and those of his dependents. The government provides a safety net for those workers who, at retirement, do not have enough funds in their accounts to provide a minimum pension. But because the new system is much more efficient than the old government-run system and because, to qualify for the minimum pension under the new system, a worker must have at least 20 years of contributions, the cost to the taxpayer of providing a minimum pension funded from general government revenues has so far been very close to zero. (Of course, that cost is not new; the government also provided a safety net under the old program.)

The bottom line is that workers are retiring with better, more secure pensions and, increasingly, at an early age. For instance, since the early-retirement option was introduced in 1988, the average monthly pensions for workers retiring early have ranged from $258 (in 1989) to $318 (in 1994). By comparison, the representative worker in the United States retiring at age 62 is getting monthly benefits that range from $506 to $780 under Social Security.[3] That is an indication of the efficiency of the private system in Chile, not just in comparison with the old Chilean government-run social security system, but also in comparison with the government-run system in the United States, a country where per capita income is more than five times higher than in Chile. Chilean workers who retire at 65 are also getting benefits that are higher relative to per capita income than the benefits U.S. workers get under Social Security.

Through their pension accounts, Chilean workers have become owners of the means of production in Chile and, consequently, have grown much more attached to the free market and to a free society. This has had the effect of reducing class conflicts, which in turn has promoted political stability and helped to depoliticize the Chilean economy. Pensions today do not depend on the government's ability to tax future generations of workers, nor are they a source of election-time demagoguery. To the contrary, pensions depend on a worker's own efforts and thereby afford workers satisfaction and dignity.

Critics of the Chilean system, however, often point to high administrative costs, lack of portfolio choice and the high number of transfers from one fund to another as evidence that the system is inherently flawed and inappropriate for other countries, including the United States and European countries. Some of those criticisms are misinformed. For example, administrative costs are about 1 percent of assets under management, a figure similar to management costs in the U.S. mutual fund industry. To the extent the criticisms are valid, they result from a single problem: excessive government regulation.

In Chile pension fund managers compete with each other for workers' savings by offering lower prices, products of a higher quality, better service or a combination of the three. The prices or commissions workers pay the managers are heavily regulated by the government. For example, commissions must be a certain percentage of contributions regardless of a worker's income. As a result, fund managers are prevented from adjusting the quality of their service to the ability (or willingness) of each segment of the population to pay for that service. That rigidity also explains why the fund managers have an incentive to capture the accounts of high-income workers, since the profit margins on those accounts are much higher than on the accounts of low-income workers.

The product that the managers provide—that is, return on investment—is subject to a government-mandated minimum return guarantee (a fund's return cannot be more than 2 percentage points below the industry's average real return in the last 12 months). That regulation forces the funds to make very similar investments and, consequently, have very similar portfolios and returns.

Thus, the easiest way for a pension fund company to differentiate itself from the competition is by offering better customer service, which explains why marketing costs and sales representatives are such an integral part of the fund managers' overall strategy and why workers often switch from one company to another.

Government restrictions on fees and returns have probably created distortions in the optimal mix of price, quality and service each fund manager would offer his cus-

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[3] Information taken from the Office of the Chief Actuary, Social Security Administration, http://www.ssa.gov/OACT/COLA/IllusAvg.html.

tomers under a more liberalized regime. As a result of those restrictions, fund managers emphasize the one variable over which they have the most discretionary power: quality of the service. (Before the airline industry was deregulated in the United States, airlines competed on service, rather than on price. That service might be thought of as the equivalent of "wasteful administration costs" in the absence of price competition. Similarly, banks in the United States competed on service before deregulation of the banking industry allowed them to engage in other forms of competition, such as offering better interest rates or lower fees.)

Although, in the eyes of the Chilean reformers, restrictions made sense at the beginning of the system in a country with little experience in the private management of long-term savings, it is clear that such regulations have become outdated and may negatively affect the future performance of the system. Thus, in addressing the challenges of the system as it reaches adulthood, Chilean authorities should act with the same boldness and vision they exhibited 21 years ago. They should take specific steps:

- Liberalize the commission structure to allow fund managers to offer discounts and different combinations of price and quality of service, which would introduce greater price competition and possibly reduce administrative costs to the benefit of all workers.
- Let other financial institutions, such as banks or regular mutual funds, enter the industry. If financial institutions were allowed to establish one-stop financial supermarkets, where consumers could obtain all their financial services if they so chose, the duplication of commercial and operational infrastructure could be eliminated and administrative costs could be reduced.
- Eliminate the minimum return guarantee or, at the very least, lengthen the investment period over which it is computed.
- Further liberalize the investment rules, so that workers with different tolerances for risk can choose funds that are optimal for them.
- Let pension fund management companies manage more than one variable-income fund. (At present, and since the spring of 2000, AFPs have been able to manage a second fund made up completely of fixed-income instruments. Consumer demand for that type of fund has been to date negligible.) One simple way to do this would be to allow those companies to offer a short menu of funds that range from very low risk to high risk. That could reduce administrative costs if workers were allowed to invest in more than one fund within the same company. This adjustment would also allow workers to make prudent changes to the risk profile of their portfolios as they get older. For instance, they could invest all the mandatory savings in a low-risk fund and any voluntary savings in a riskier fund. Or they could invest in higher risk funds in their early working years and then transfer their savings to a more conservative fund as they approached retirement.
- As Latin American markets become more integrated, expand consumer sovereignty by allowing workers to choose among the systems in Latin America that have been privatized, which would put an immediate (and very effective) check on excessive regulations.
- Give workers the option of personally managing their accounts. Thanks to the emergence of the World Wide Web as an investment tool, individuals could gain greater control over their retirement savings if they decided to administer their accounts themselves.
- Reduce the moral hazard created by the government safety net by linking the minimum pension to the number of years (or months) workers contribute.
- Adjust contribution rates in such a way that workers have to contribute only that percentage of their income that will allow them to purchase an annuity equal to the minimum pension. In other words, if a high-income worker can obtain an annuity equal to the minimum pension by contributing only 1 percent of his income, he should be able to do so and decide for himself how to allocate the rest of his income between present and future consumption.

Those adjustments would be consistent with the spirit of the reform, which has been to relax regulations as the system has matured and as the fund managers have gained experience. All the ingredients for the system's success—individual choice, clearly defined property rights in contributions, and private administration of accounts—have been present since 1981. If Chilean authorities address some of the remaining shortcomings with boldness, then we should expect Chile's private pension system to be even more successful in its adulthood than it has been during its infancy and adolescence. And unlike a pay-as-you-go system, a fully funded individual capitalization system can anticipate *fewer* problems as it matures.

[Attachments are being retained in the Committee files.]

Chairman SHAW. Thank you, Mr. Rodriguez.
Mr. Harris.

STATEMENT OF DAVID O. HARRIS, RESEARCH ASSOCIATE AND 1996 AMP CHURCHILL FELLOW, WATSON WYATT WORLD-WIDE, REIGATE, SURRY, UNITED KINGDOM

Mr. HARRIS. Mr. Chairman, Members of the Committee, I am pleased to have the opportunity to discuss the Social Security reform experiences of Australia.

For many countries, the need for Social Security reform is becoming more chronic as populations rapidly age. Moreover, through generous promises linked with Social Security programs in many developed nations, major economic and social reforms will likely have to be implemented against the backdrop of either cutting benefits or increasing associated contributions to Social Security programs like that found in the United States.

It should be stressed from the outset that I do not think that one particular country has provided solutions to all the challenges of executing successfully Social Security reform. Moreover, I believe international experiences provide a composite of important emulations or experiences that the United States can take on board.

Thus, in the case of Australia, many cultural links and social behaviors are shared in common, which can help smooth or translate important features into the American context. Both countries, for example, experienced a sharp baby boom in the middle part of the 20th century. In effect, both countries' demographic profiles are very similar.

I will now turn to the current Australian retirement system. The old age pension in Australia is seen by many as providing both a foundation and an important source of income for those retirees who have limited resources to sustain themselves in retirement. In effect, it is a non-earmarked pay-as-you-go system. Its origins date back to 1909, where a flat rate benefit was provided to individuals upon reaching a prescribed retirement age. Policy planners during this period in Australia turned their back on the notion of an earmarked pay-as-you-go model that Bismarck had used to forge a single Germanic state.

A common perception in the past by many workers with regard to their old age pension was that they were entitled to an old age pension after paying taxes throughout their working lives. Largely, this view was encouraged by many governments, but in the eighties increasingly the commonwealth treasury and the Federal government expressed concerns over the direction of expenditure for providing for the first pillar in Australia's retirement framework. Increasingly, expenditures in providing the first pillar were linked to a greater concern that the population of Australia was rapidly aging. Today these benefits are means tested and equate to a maximum of 20 percent of male total average weekly earnings.

Clearly, to engineer or make such a significant shift in the overall retirement structure of any country requires a strong political resolve, a basis of consensus between political parties, and a vision for the future of the nation's citizens. In Australia's case, more through coincidence and luck, a popular Federal Government, through trade union support, was able to convey to the nation the impending problem that Australia would confront if it did nothing about addressing its aging population.

I want to stress to you today, it was a social democratic, trade union supported political party, like the Democratic Party of the United States, that continues to support the need for ongoing retirement reforms. For trade unions, which had strongly supported the election of a Federal Labor government in 1993, increasing superannuation coverage was seen as a major priority.

Before the introduction of mandated second pillar superannuation accounts, the extent of coverage of superannuation was limited only roughly to 40 percent of the work force. Typically, employees who were covered by superannuation were middle class, white collar jobs that usually denied benefits of coverage to women and people from minority groups.

By 1986, circumstances were ideal for change. A compulsory 3-percent employer contribution was generated through centralized wage-fixing. Such an approach proved difficult to administer, and did gain increases in the levels of contributions. Again, the time was ripe for change, and by 1992 the Superannuation Guarantee Charge Act implemented, saw employees required to contribute up to 9 percent of their salary by July 1, 2002, into a retirement or individual retirement account. Additionally, Mr. Chairman, it should be noted that on average, average contributions to individual accounts on a voluntary basis equate to 4 percent on top of the compulsory level.

Another method by which the Federal Government was able to engineer significant change was through a comprehensive public education campaign in 1994–1995. The Australian Government spent $11 million educating the people on the value of their individual retirement accounts.

I would like to speak just briefly with regard to the taxation of superannuation in Australia. Australia has pursued a course which is quite unique, and which on the whole I cannot agree with, in terms of the design and the overall rate of taxation applied. Australia has adopted a tax-tax-tax approach to its retirement, taxing the contributions at 15 percent, taxing the return at 15 percent, and taxing the contribution at over 15 percent. While this is quite unique, increasing criticism and increasing debate centers on whether this approach will continue.

The profile of the second pillar of Australia's retirement system depicts both a diversity and an adequacy of return that reflects strong and vigorous competition amongst financial services participants. I would like to now turn briefly to the mechanics associated with selling, distribution, and withdrawal of benefits from superannuation accounts.

As a former insurance regulator, I can suggest one of the reasons why Australia has been so successful in keeping administrative costs low and also avoiding problems associated with mis-selling is through an effective, cost efficient system of regulation. Strict rules govern how superannuation policies are sold.

It should be also noted that today individuals have between five to seven investment choices associated with their superannuation accounts, on average. This intense competition between market participants has led to, in part, returns being maximized and administrative fees being minimized. The success of consumer policy and integrated distribution platforms has meant that large scale consumer detriment has been minimized in Australia.

I would like to now just briefly turn to some of the statistical and demographic highlights. By March 2001, the Australian superannuation system had $497.1 billion invested, or $253 billion U.S. dollars. For just over 9 million workers, this level of retirement savings is considered to be quite significant, with the level of coverage of the population being 91 percent. It is important to know that 19.8 percent of these assets are invested internationally. It is also worth noting that out of these assets, 42 percent is invested into equities.

Like the United States, Australia has a demographic profile that depicts a significant baby boomer population, and this is depicted in Appendix 1.

Just moving on, administrative costs continue to be a sensitive issue within the Australian political and financial services environment. These costs can vary widely between the types of superannuation funds found in Australia. Through an authoritative survey conducted by the Association of Superannuation Funds of Australia, an average estimate of $1.28 Australian or 65 cents U.S. per member per week was made for overall administrative costs. It should be noted that this figure has declined significantly in the last two years. Expressed in another way, cost as a percentage of assets in June 2000 was calculated to be 1.29 percent. It is anticipated that the levels of costs as a percentage of assets will decline as the system matures.

It should be noted for the record, as an aside, that in respect to the administrative data presented by Dr. Orszag from the United Kingdom, I must concur with the reservations expressed by Edward Whitehouse of Axia Economics in his paper, 1999, that criticizes the associated analysis and assumptions.

My conclusions are, for the United States, the challenges of Social Security reform may seem immense if not impossible from initial observations. Yet what countries like Australia demonstrate is the ability for a nation to give its people a greater ability to craft out a sufficient and appropriate level of retirement wealth to meet expected future needs and demands.

Certainly no one country's experience with regard to Social Security reform can be easily translated to another. Yet what countries like Australia can demonstrate to public policy planners in the United States is the strong propensity that the individual is ideally placed to determine his or her own retirement needs.

Having worked, finally, in the United States and as a member of the Social Security Trust Fund, I look forward to the progress of Social Security reform in this country that I admire greatly. Thank you.

[The prepared statement of Mr. Harris follows:]

Statement of David O. Harris,* Research Associate and 1996 AMP Churchill Fellow, Watson Wyatt Worldwide, Reigate, Surrey, England

Mr. Chairman, I am pleased to appear before the House Ways and Means Subcommittee on Social Security to discuss the social security reform experiences in Australia. For many countries, the need for social security reform is becoming more pressing as populations rapidly age. Moreover through generous promises linked with social security programs in many developed nations, chronic economic and social reforms will likely have to be implemented against the backdrop of either cutting benefits or increasing associated contributions. The ongoing success of the Australian retirement model is clear proof that successful pension reforms can be achieved in developed nations that benefit the entire nation as a whole. Women, minority groups and "blue collar" workers have seen significant benefits flow to them in having the ability to efficiently craft out their own retirement savings structures.

For the United States great economic progress was nurtured through the ability of the economy to generate efficient forms of capital through individual saving in the last century. In the twenty first century the crucial dilemma confronting most Americans will be to generate sufficient retirement savings and what financial instruments will be best placed to satisfy this function. While Roosevelt in 1934 envisaged a strong and vibrant social security program for all Americans, nobody during this point in history could have anticipated the rapid aging of populations throughout the world. Simply put countries like Australia, Chile, Sweden and the United Kingdom have moved towards encouraging individuals to save on an individual retirement basis so offsetting the rapid aging of each corresponding population.

Political Economy Linked with Pension Reform

When comparing globally the approach of many countries towards the reform of their mandated retirement provision; Australia, Chile, Sweden and the United Kingdom stand out as countries who have grasp the "thorny nettle" of considering and implementing significant retirement reforms. Although all three have signaled, through pension reforms their intentions to move towards a more fully funded, defined contribution system, distinctions exist between the three countries' approaches to reform in terms of the structure of political institutions, role of organized labor and business. These three important factors or vested interests individually or combined can both encourage and discourage reform of retirement systems from occurring.

"Only three countries rely heavily on private mandatory saving policies for retirement, these include Australia, Switzerland and Chile."[1] Australia's experience to date with the initial reforms of its retirement system in 1987 and subsequently in 1992 have generally been viewed as positive. In 1983 the Australian Labor Party (social democratic) led by Mr. Bob Hawke MHR came to power. The ALP was determined to deregulate Australia's economy so as to compete more effectively on a world level. A vital ingredient in achieving this goal was seen to be significant reductions in wages growth. With this as a backdrop, the need for change in the retirement policy of Australia was also sharply defined by the Labor Government in 1983. Like its counterpart in the United Kingdom, the Australian Labor Party is fundamentally a social democratic party based on largely collectivist principles. It had and still remains strongly linked with the trade union or organized labor movement, through its peak body, the Australian Council of Trade Unions (ACTU). Superannuation during this time was provided through traditional employer sponsored plans on a voluntary basis. Surprisingly for some in the United States, it was the Australian Labor Party, a social democratic political party who, with trade union (organized labor) support began to generate the momentum for change of Australia's retirement system. In the first instance the newly elected Federal Government began the process of ensuring the long-term viability of the Old Age Pension at its current level. Maximum payments per fortnight by the mid 1980s were now determined through the interaction of a comparatively stringent income and asset tests.

The Old Age Pension in Australia is seen by many as providing both a foundation and an important source of income for those retirees who have limited resources to sustain themselves in retirement. Many older Australians who are or have retired in the past often have not built up sufficient retirement savings. A common perception in the past by many workers was that they were entitled to an old age pension after paying taxes all their working life. Largely this view was encouraged by many

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*The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

[1] Hazel Bateman and John Piggott: "Mandating Retirement Provision: The Australian Experience", The Geneva Papers on Risk and Insurance (Oxford, United Kingdom: The International Association for the Study of Insurance Economics, January 1999), Vol. 24 No. 1, p. 95.

governments but in the 1980s increasingly, the Commonwealth Treasury and the Federal Government expressed concerns over the direction of expenditure for providing the first pillar of Australia's retirement framework. Increasingly expenditures in providing the first pillar were also linked to a concern over the demographic position of Australia in the next century.

> "For Australia the percentage of the population aged over 65 is expected to rise from 15% of the population, 2.9 million, to 23% by 2030, that is, 5 million people. The percentage aged over 85 is expected to more than double from around 2% to more than 5% amounting to 650,000 Australians over 85."[2]

The full pension payment under this pillar represents approximately 26% of male total average weekly earnings. Maximum payments per fortnight are calculated on a flat basis and are reduced accordingly, based on income and asset tests.

Clearly to engineer or make such a significant shift in the overall retirement structure of any country requires a strong political resolve and vision for the future of a nation's citizens. In Australia's case, more through coincidence and luck a popular Federal Government, through trade union support was able to convey to the nation the impending problems Australia would confront, if it did nothing about addressing its aging population. This theme of the realization and admittance of a future retirement hurdle was best summarized in the Better Incomes: Retirement into the Next Century statement which expressed a commitment to:

> "maintain the age pension as an adequate base level of income for older people" but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce."[3]

For trade unions, which had strongly supported the election of a Federal Labor government in 1983, increasing superannuation coverage was seen as a major priority. Before the introduction of mandated, second pillar, superannuation accounts, the extent of coverage of superannuation was limited to roughly 40 percent of the workforce. Typically employees who were covered by superannuation were employed in middle class, "white collar" jobs where usually women and people from minority groups were under-represented. Brandishing this as a major bargaining tool, the trade union movement set about convincing the Federal Government that the level of superannuation coverage needed to be extended, via compulsory contributions into individual accounts. As early as the 1970s, the trade union movement in Australia had expressed reservations in how the retirement framework of Australia excluded certain workers based on income and profession. Many of the younger trade union officials argued for a more comprehensive system of retirement provision that in effect required all workers to be proactive in contributing and managing their own retirement needs. Some had noted the successes of the national provident funds, as seen in Malaysia and Singapore. Significant dissatisfaction also existed amongst the labor movement over the extent and coverage of non-management or "blue collar" workers. Moreover the union movement also realized that comprehensive wage increases were becoming increasingly difficult to successfully negotiate and that deferred savings benefits may be an alternative to simply striving for an increase in workers net pay. Initially the union movement's policies was effectively to increase employee coverage of superannuation but by the mid 1980s the union movement had shifted its stance whereby it would play a more direct and active role in the day to day operations of superannuation, via industry funds. These industry funds, grouped around a particular economic sector of the Australian economy saw union and employer representatives come together as trustees to manage the administration and investment of many thousands of individual retirement accounts. The increasing involvement by the union movement in superannuation matters challenged some industry participant's views that effective administration and investment decisions would be distorted in favor of policies that stressed mutuality rather than economic reality.

Notwithstanding the active policy position taken by trade unions in Australia regarding superannuation for employees, a more pragmatic view of such support is linked with the steady decline in trade union membership. Between August 1986 and August 1996, the level of trade union membership reported by employees declined sharply from 46 percent in 1986 to 31 percent in 1996.[4]

Such a significant decrease coupled with the decline in traditional union based industries such as heavy manufacturing further reinforced the union's enthusiasm to

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[2] Susan Ryan, "Quality of Life as It Relates to Australia's Aging Population or Living to 100 in a Civilized Society", Association of Superannuation Funds of Australia, Speech, 1997.

[3] Senate Select Committee on Superannuation: "Safeguarding Super", June 1992, p. 7, Canberra, Australia.

[4] Australian Bureau of Statistics, 1998 Year Book Australia (Canberra, Australia: AGPS, 1998), p. 215.

support such retirement reforms as they felt that they were in effect increasing their profile and relevance for existing and potential members.

By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. The Federal Government argued that as the Australian economy was undergoing a period of significant economic readjustment from a largely primary producer to becoming more services orientated, the old age pension structure and its related drain on public finances could not be sustained. Effectively the government insisted that it was in the "public-interest" to have a national, compulsory, employment-related retirement income scheme in place.[5]

This aspect of the Australian political environment and how the government of the day felt that it was acting in the best interests of all Australians would be later echoed in 1992 by then Hon. Treasurer Dawkins, when he commented that the retirement income scheme in place would provide "a coherent and equitable framework in which retirement incomes objectives can be progressed" and [would] permit a higher standard of living in retirement than if we continued to rely on the age pension alone."[6]

Continuing wages pressure and demands by the union movement on the government for a comprehensive superannuation policy to be initiated saw the introduction of award superannuation, set at 3% of an individual's yearly income. This amount was paid by the employer in the form of a wage increase granted by the Conciliation and Arbitration Commission, a Federal government body. Newly created industry funds were effectively given a tremendous boost with this political decision. These funds are sponsored by employer and employee organizations in one or more industries and were established initially to receive the 3% award contributions. Ongoing debate about the aging population and growth in superannuation funds continued into the late 1980s.

With a delay to the 1990–1991 wage case occurring, where the ACTU and the Government supported a further 3% round of award superannuation the then government saw its opportunity to act in a decisive manner towards retirement saving. In August 1991 the then Treasurer foreshadowed the Government's intention of introducing a Superannuation Guarantee Levy which would commence on July 1, 1992. In a statement Security in Retirement, Planning for Tomorrow Today given on 30 June 1992, the then Treasurer, the Hon John Dawkins MP, reaffirmed the government's position and direction on the aging of Australia's population and the need for compulsory savings for retirement:

> "Australia—unlike most other developed countries meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments."[7]

The Superannuation Guarantee Charge Act 1992 requires all employees to contribute to a complying superannuation fund at a level that increased from 3% p.a. in 1992 to 9% per annum by July 1, 2002. Although support for the Federal Government's comprehensive superannuation reforms was quite pronounced, some opposition was expressed by then Australian Democrats (a minor "left leaning" political party) leader Senator Kernot. She in contrast favored a single, government-controlled, national portable system, similar to that of a national provident fund. Although this approach gained some initial minor support the Federal Government's proposed legislation quickly generated wide acceptance through working in "partnership" with organized labor, business interests and industry associations.

In effect by embracing traditional opposition groups linked with significant government reforms, criticism that may have hampered the passage of important legislation, relating to superannuation reforms was largely minimized. A further effective tactic used by the then Federal Government was to employ government inquiries or private sector research to highlight the inadequacies of Australia's level of retirement system provision at the beginning of the 1990s. With these inquiries being seen as delivering independent views or recommendations, the Federal Government via the media felt vindicated in implementing a mandated retirement system. Equally the Federal Government argued that all Australians would be better off if

[5] Sue Taylor, "Australia's Mandatory Occupational Superannuation Regime: An Evaluation of Opposing Claims—Is it a Policy Built on Justice, Fairness, and Security in the Public-Interest or the Entrenchment of the Power and Privilege of Politically Effective Interest Groups?" (Melbourne, Australia: 1999 Colloquium of Superannuation Researchers, July 8–9 1999), p. 5.

[6] Senate Select Committee on Superannuation, "Second Report on Security in Retirement" AGPS, (Canberra, Australia: 1992), p. 9.

[7] The Hon John Dawkins, MP, "Security in Retirement, Planning for Tomorrow Today" AGPS, (Canberra, Australia: 30 June 1992), pp. 1–2.

Australia's level of national savings were increased and thus superannuation in part was seen to be addressing this problem.

Another method by which the Federal Government was able to engineer significant change to the retirement system was through the use of an effective public education campaign in 1994–1995, that was co-ordinated by the Australian Taxation Office. Overall the total cost of the public education campaign amounted to some $AUS 11 million. Through the comprehensive use of the electronic and print media, the Federal Government displayed strong political savvy in being seen as introducing a retirement system that not only benefited the individual but the nation as a whole. These two themes of individualism and collectivism were to be stressed throughout the media campaign. Two further factors that allowed political institutions to achieve significant reforms in Australia was that the Westminster system of government that had been inherited from the United Kingdom, which allowed the relatively quick passage of debate and the implementation of the Federal Government's retirement reform agenda.

With a controlling majority in the Lower House (House of Representatives) and minority parties holding the balance of power in the Upper House (Senate), no real effective delays in the reforms were encountered. The Senate Select Committee on Superannuation, a parliamentary appointed committee was also used effectively by the government to hear, interpret or receive objections to the planned reforms. Such a process of feedback and exchanging views encouraged a spirit of "consensus" to be generated amongst many stakeholders of differing political ideologies. Finally the very existence of well established, professional industry associations in the form of the Life Insurance Federation of Australia (LIFA) now the Investment & Financial Services Association (IFSA) and the Association of Superannuation Funds of Australia (ASFA) ensured that the affects and consequences of proposed reforms could be simulated and well understood by superannuation industry participants and bureaucrats alike. Unlike Chile where individual retirement account reforms created a totally new financial infrastructure, much of the superannuation infrastructure in Australia had already existed under the previous voluntary superannuation system. Thus important stakeholders and vested interests like life insurance companies supported the reforms based on self interest but also recognized how the existing financial infrastructure would be well placed to implement the government's retirement proposals. In effect the Federal Government had garnered support for their reforms from traditional stakeholders who had been strong critics of their previous economic policies. Such a shift in support in some ways overwhelmed any organized opposition to these reforms.

Similarly in Australia, business saw the advantages of reforms to retirement policy in terms of nurturing the capital market and overall level of national saving. Some concerns were raised over the active involvement of trade unions in the day to day operations of superannuation funds but these concerns were alleviated through adjustments in regulatory settings. A major concern for business after the broadening of compulsion in 1992 was the increased costs that would be levied on the employer as contributions lifted eventually to 9 percent by 2002. Larger business interests in many cases offered such contributions already on voluntary basis through their in-house corporate superannuation funds. Yet it was small business that strongly opposed the reforms arguing principally that the increased burden of cost linked with an expanded retirement provision would cause many business failures. In summary business played only a moderate role in supporting the government's reform agenda. This tacit support was co-ordinated in part by large financial providers who would develop or modify the financial infrastructure of such mandated retirement accounts. Some moderate opposition from business interests also centered on the political concept of individualism, in that the concept should not force individuals to save for their retirement using a particular financial product or mechanism.

Table 1: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar

	Employer's Prescribed Rate of Employee Support (%)
July 1, 1997—June 30, 1998	6
July 1, 1998—June 30, 1999	7
July 1, 1999—June 30, 2000	7
July 1, 2000—June 30, 2001	8

Table 1: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar—Continued

	Employer's Prescribed Rate of Employee Support (%)
July 1, 2001—June 30, 2002	8
July 1, 2002–03 and subsequent years	9

In March 1996, the then Labor Federal Government lost office and was replaced by a conservative, Liberal Coalition Government under Prime Minister John Howard. It had been the intention of the Australian Labor Party, with trade union blessing to further expand the compulsory nature of superannuation by gathering a 3 percent contribution from individual workers and providing an additional 3 percent to certain workers who met pre-defined income criteria. In total this would have meant that many workers' individual superannuation contribution accounts would have been receiving total contributions of 15 percent. Treasury estimates suggest that over a forty-year period these contributions would translate out to be approximately 60 percent of one's salary on retirement.

With regard to the taxation of superannuation, Australia has pursued a course which is quite unique and which on the whole I cannot agree with in terms of design and the overall rate of taxation applied. Based on Andrew Dilnot's model developed at the Institute of Fiscal Studies in London, Australia's taxation of superannuation can be described as TTT. Taxation of contributions at a rate of 15 percent, along with possible additional taxation of 15 percent for members' contributions earning over a certain threshold. A further tax of 15 percent is levied on the investment income of superannuation fund and finally the benefits can be subjected to varying tax treatment of between 0–30%, depending on timing of the contributions.

The profile of the second pillar of Australia's retirement system depicts both a diversity and adequacy of return that reflects strong and vigorous competition among the financial services industry in Australia. Through a trustee structure, superannuation funds are managed in the most efficient and effective manner for members.

I would like to now turn briefly to the mechanics associated with selling, distribution and withdrawal of benefits from the superannuation account. One of the reasons why Australia has been so successful in keeping administrative costs low and also avoiding the problems associated with mis-selling is through effective and cost efficient regulation. Strict rules govern how superannuation policies are sold and switched. Moreover consumers are required to receive minimum levels of information about the superannuation products at the time of sale and also on a regular basis. Clearly it is felt that, as this is the largest financial transaction that a consumer will enter into in their life, effective disclosure should be provided to encourage transparency in the transaction. Increasingly superannuation account holders are being provided with greater investment choices. Some retail funds for example offer between 5–7 investment choices and proposed legislation by the Federal Government will force employers to offer choice of funds. Additionally specialized administration companies have developed services that allow superannuation fund trustees to outsource much of their investment and administrative functions. This intense competition has led to in part returns being maximized and administrative fees being minimized.

The success of consumer policy and integrated distribution platforms has meant that large scale consumer detriment has been minimized in Australia with its move towards a more fully funded system. Through sound regulatory transparency and significant improvements in the competency levels of distributors e.g., financial advisers and financial planners public confidence in the overall retirement system has continued to increase significantly. This perception of security has nurtured a steady increase in the level of overall voluntary contributions made into superannuation accounts. In effect through sound regulation has come an acceptance by most Australians that saving for one's retirement is beneficial on both an individual and national basis.

Statistical and Demographic Highlights

By March 2001 the Australian superannuation system had combined assets of $A497.1 ($US253.00) billion. For just over 9 million workers this level of retirement savings is considered to be quite significant. It is important to note that 19.8% of these assets are invested internationally. Furthermore a large level of the superannuation assets are invested in equities and unit trusts. This investment category has grown sharply during the "bull market" period and is now estimated to be 42% of superannuation assets in Australia.

Table 2: Overview of the Australian Superannuation Industry—June 2001

Type of Fund	Total Assets ($billion)	Number of Funds (March 2001)	Members (000's)
Corporate	78	3,283	1,504
Industry	42	142	6,875
Public Sector	108	94	2,776
Retail (including RSAs)—RSAs	102	278	11,168
Small Funds	76	214,025	433
Annuities, life office reserves etc	44	na	nq
Total Assets/Funds/Members	497	217,882	22,756

Source: APRA Bulletin, Australian Government Publishing Service, June 2001.

Like the United States, Australia has a demographic profile that depicts a significant baby boomer population. As seen in Appendix 1, Australia and the United States demographic profile will continue to deteriorate over time. Such an effect is compounded by the growing cost of each nations pensions unfunded liability. Moreover the seriousness of both countries' demographic positions are highlighted in the two tables linked with life expectancy and the elderly/youth ratio. Yet it should be noted that both countries' demographic positions are much healthier when compared with countries like Germany or France.

Administration costs continues to be a sensitive issue within the Australian political and financial services environment. These costs can vary widely between the types of superannuation funds found in Australia. Through an authoritative survey conducted by the Association of Superannuation Funds of Australia (ASFA), an average estimate of $1.28 ($US0.65) per member per week was made for overall administration costs in 1999–2000. It should be noted that this figure has declined from $1.66 ($US0.84) per week two years earlier. Expressed in another way, costs as a percentage of assets in June 2000 was calculated to be 1.29%. It is anticipated that this level of costs as a percentage of assets will decline as the system matures.

Conclusions

For the United States the challenges of social security reform may seem immense if not impossible from initial observations. Yet what countries like Australia demonstrate is the ability for a nation to give its people a greater ability to craft out a sufficient and appropriate level of retirement wealth to meet expected future needs and demands. Certainly no one country's experiences with regard to social security reform can be easily translated to another. Yet what countries like Australia can demonstrate to public policy planners in the United States is the strong propensity that the individual is ideally placed to determine his or her own retirement needs. Give people certainty with regard to a retirement or social security model and they then can best prepare for their own retirement. This harnessing of the individual's need to maintain retirement security in retirement will increasingly become a major political and social issue in both Australia and the United States during this century.

Appendix 1

Table 3: Life Expectancy of Selected Developed Nations

	1950–1955	1960–1965	1970–1975	1980–1985	1990–1995	2000–2005	2010–2015	2020–2025	2030–2035	2040–2045
AUSTRALIA	69.57	70.91	71.70	75.21	77.60	78.74	79.74	80.67	81.48	82.29
CANADA	69.08	71.44	73.15	75.92	78.50	79.47	80.40	81.20	82.00	82.80
CHILE	54.75	57.92	63.44	70.57	74.21	75.65	76.88	77.95	78.84	79.61
CHINA	40.76	49.53	63.18	66.56	68.37	71.18	73.49	75.53	77.15	78.46
FRANCE	66.52	70.96	72.35	74.72	77.15	78.75	79.70	80.60	81.45	82.24
GERMANY	67.50	70.30	71.00	73.80	76.00	77.82	78.89	79.84	80.67	81.45
IRELAND	66.91	70.29	71.28	73.10	75.34	77.36	79.09	80.57	81.37	82.16
ITALY	66.00	69.92	72.11	74.54	77.16	78.83	79.80	80.69	81.46	82.24
JAPAN	63.94	68.96	73.30	76.91	79.50	80.34	81.09	81.86	82.65	83.44
NETH	72.11	73.38	73.96	75.98	77.26	78.39	79.34	80.27	81.06	81.86
SWEDEN	71.81	73.54	74.72	76.27	77.86	79.34	80.62	81.60	82.39	83.19

Appendix 1—Continued

Table 3: Life Expectancy of Selected Developed Nations

	1950–1955	1960–1965	1970–1975	1980–1985	1990–1995	2000–2005	2010–2015	2020–2025	2030–2035	2040–2045
SWISS	69.23	71.67	73.81	76.16	77.67	79.13	80.04	80.91	81.69	82.49
UK	69.18	70.76	72.01	74.04	76.17	77.97	78.95	79.95	80.80	81.59
USA	69.02	69.96	71.30	74.48	75.66	77.35	78.67	79.67	80.57	81.36

Source: United Nations: World Population Prospects 1950–2050 (1998 Revision).

Table 4: UN Elderly/Youth Ratio for selected developed countries

	1950–1955	1960–1965	1970–1975	1980–1985	1990–1995	2000–2005	2010–2015	2020–2025	2030–2035	2040–2045
AUSTRALIA	0.24	0.23	0.22	0.28	0.37	0.47	0.62	0.77	0.90	0.97
CANADA	0.20	0.18	0.20	0.29	0.40	0.55	0.73	0.91	1.04	1.06
CHILE	0.09	0.10	0.10	0.12	0.15	0.22	0.31	0.43	0.58	0.65
CHINA	0.10	0.10	0.09	0.10	0.15	0.24	0.35	0.54	0.83	1.01
FRANCE	0.38	0.36	0.39	0.46	0.50	0.67	0.80	0.95	1.09	1.15
GERMANY ..	0.32	0.40	0.46	0.58	0.69	0.92	1.14	1.31	1.57	1.57
IRELAND	0.29	0.28	0.28	0.27	0.31	0.42	0.50	0.63	0.76	0.90
ITALY	0.24	0.29	0.34	0.43	0.65	1.06	1.34	1.66	2.01	2.15
JAPAN	0.11	0.14	0.22	0.30	0.45	0.97	1.26	1.44	1.54	1.66
NETH	0.21	0.24	0.28	0.37	0.50	0.63	0.91	1.19	1.38	1.43
SPAIN	0.20	0.23	0.27	0.30	0.49	0.82	1.01	1.26	1.72	2.18
SWEDEN	0.35	0.40	0.49	0.62	0.72	0.77	1.09	1.18	1.26	1.29
SWISS	0.32	0.32	0.37	0.50	0.62	0.68	0.93	1.19	1.49	1.62
UK	0.37	0.39	0.41	0.52	0.61	0.67	0.84	0.96	1.11	1.15
USA	0.24	0.24	0.26	0.35	0.43	0.46	0.59	0.78	0.91	0.93

Source: United Nations: World Population Prospects 1950–2050 (1998 Revision).

Table 5: Projected future state spending on pensions as a percentage of GDP

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
United Kingdom	4.5	4.5	5.2	5.1	5.5	4.0	4.1
United States	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: OECD, cited in Johnson (1999).

Chairman SHAW. Thank you. Thank you, Mr. Harris.

I think, in listening to the various testimonies of the witnesses with regard to other countries, I think there is a tendency in the United States to feel that we invented everything that is good, which of course is not true. And I think that the purpose of this hearing is to reach out to other countries who have had, and I think as Mr. Hewitt correctly stated, perhaps a worse problem than we have but nevertheless the same problem that we have. And just as we followed, I knew we followed Chile and now I know that we followed Australia in setting up a Social Security system, I think it is also important that we listen to the other countries that have aging populations as we do.

When Social Security was first put in existence, I think in 1935 or thereabouts, I am close, there were about 40 workers per retiree. This made a very, very flattened and very efficient pay-as-you-go system as a triangle or as a pyramid. But as the age of the population grows, we find now we have gone from 40 workers per retiree down to a little over three workers per retiree.

One of the witnesses correctly stated, it was Mr. Bedell-Pearce, I think, that aging of population and demographics of population is probably one of the most accurate predictions that we can make, and those in the position of making predictions tell us that we are going to be shrinking down to a little over two. Obviously, we have to do something. Obviously, a pay-as-you-go system cannot continue to work.

Mr. Matsui mentioned the bill that Mr. Kolbe filed last week, talking about the—and that particular bill actually showed, at least the newspaper account showed actually a diminution in the benefits for people that were 10 years from retirement. That is exactly what I am hoping that, by acting now, we can avoid.

Mr. Burtless, you made reference in your testimony to the tremendous coverage that we have and the advantage that we have as to many of our workers covered by private pension. What I was listening for and didn't hear is, how are we going to continue to hold the benefits at this level for those that are not covered by a private pension?

The Social Security Administration, under the previous administration, told us, and they have been very specific about this, that we are facing about a $22 trillion deficit over the next 75 years. How do you propose to pay those payments, if we maintain the system as it is today?

Mr. BURTLESS. Well, I have testified before this and other Committees frequently on this subject. I favor an increase in the normal and early age at retirement. I favor modest increases in the payroll contribution rate. And I think it is OK if the trust fund is invested in higher yielding securities than U.S. Treasury bonds. I am not strong on that because I don't think economically it makes much difference what we invest them in, but it certainly lowers the contribution rate that would be required of workers.

Having said that, let me say I am no opponent of individual or company pensions. I favor them. In fact, I would favor an obligation that employers establish programs so that their workers can save simply. For small employers, if this obligation is too burdensome, I think that the Federal Government should provide the withholding and the recordkeeping of contributions to individual accounts. This would permit pension contributions to occur at very little cost to the small employer community.

Chairman SHAW. How, to what age? Do you have a model that you have developed showing this, and if so, how high would we have to raise the retirement age in order to sustain the benefit level that we have today? And how high would the taxes, the payroll taxes on American workers, have to be raised in order to sustain the system at its existing level with a higher retirement age?

Mr. BURTLESS. I think that the best source of information about what an increase in the retirement age, either the early or the normal retirement age, the impact of that on the balance and the long-term solvency of Social Security can be obtained from Steve Goss, the Chief Actuary of Social Security. I don't pretend to be an expert on the actuarial calculations.

Chairman SHAW. Are you telling us that you don't know how high you would have to raise the taxes or how high you would have to go on the retirement age in order to sustain the——

Mr. BURTLESS. Well, we know. We know that roughly a 2-percentage point increase in the current payroll tax for old age and survivors and disability pensions, bringing it from 12.4 to 14.4 percent of wages, would cover the expected cost of the system over the next 75 years.

If, in addition to that tax increase, you changed the investment portfolio of the Social Security Trust Fund from all government bonds to some combination of other assets, a safe combination, then that 2-percentage point increase is not entirely needed. You could increase the contribution rate less because the investment earnings of the fund would cover a larger share of the benefits.

Chairman SHAW. So what you favor is the trust fund actually investing in the private sector. Is that correct?

Mr. BURTLESS. I don't think——

Chairman SHAW. There is no other place to go, if you are not investing in government securities. I assume you would be buying stocks and bonds in the private sector.

Mr. BURTLESS. Yes. I think that, at a minimum, we could invest in mortgage-backed securities, in corporate bonds (where there is no issue of how the government votes the shares), and in real estate. There are a lot of assets that the government can hold with an arms-length relationship, and that would have higher expected yield over 75 years, than Treasury bonds.

Chairman SHAW. Am I correct, in summing up your testimony, that you would agree that the existing system is not sustainable unless we raise the retirement age, increase taxes, and/or invest the trust funds in something other than government securities, or a combination of all three?

Mr. BURTLESS. That is exactly right. That is what it takes to fix Social Security.

Chairman SHAW. Thank you. I wanted to be sure that that was——

Mr. BURTLESS. You could also do large transfers from the rest of the government budget, of course. That was proposed by President Clinton.

Chairman SHAW. Yes.

Mr. BURTLESS. In other words, there is a fourth solution. The three that you mentioned are the three that would fix up Social Security in the more or less traditional way that Congress has used to fix Social Security——

Chairman SHAW. I assume that all of the witnesses, then, would certainly agree—perhaps you would disagree as to the solution to the problem, but you would agree that the existing system as a pay-as-you-go system cannot be sustained. Am I correct on that? Even though you may disagree with how we should go about changing it.

[Witnesses nod.]

Chairman SHAW. I thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Let me say this. Mr. Burtless, when the Chairman mentioned $22 trillion being the amount of obligation, by your not responding to that number, you are not suggesting that number is correct, are you? Because the Social Security actuaries have actually said that the amount of the deficit over the next 75 years is $3.1 trillion.

Chairman SHAW. Would the gentleman yield on that?

Mr. MATSUI. Well, no. Let me ask him a question. And if you bought out the system, it would be between $8 and $11 trillion, not $22 trillion. Is that your understanding?

Mr. BURTLESS. My understanding is that the liabilities of Social Security, if we closed it down tomorrow, we stopped taking in new revenues and we just delivered on the promises that have already been made, we are talking about $10 trillion, roughly.

Mr. MATSUI. Right, right.

Mr. BURTLESS. We have $1 trillion in the bank, and the $9 trillion difference represents the amount of money that we have given to our parents, grandparents, great-grandparents over the last 50 years in excess of their contributions into the system and the investment earnings that their contributions have earned. That is the unfunded liability at this point.

Mr. MATSUI. And that comes to about $3.1 trillion.

Mr. BURTLESS. I think the $3.1 trillion is a different calculation. It is the following: How much money is promised and will continue to be promised from now on, and how much revenues can we see coming into the system from now on? Now, let's discount those two numbers back to the present. The $3 trillion is that difference.

Mr. MATSUI. Let me, if I can complete my questions, in terms of this about raising taxes or cutting benefits or investing in the market, if you have private accounts, can you solve the problem overnight and not do any of those things?

Mr. BURTLESS. I served on a commission that examined issues connected with privatization, and I thought every Member of this panel agreed that privatization in and of itself doesn't solve any of the problems. There is one political problem that it may reduce. Many people are fearful that if the government owned a portfolio that included voting shares in America's companies, that is a very dangerous thing to do. And so if instead the surplus were accumulated in 140 million little accounts of individual workers, this political problem would disappear. But privatization does nothing to alleviate the economic problem facing Social Security.

Mr. MATSUI. If I could just interrupt you, then you are basically saying no. It doesn't solve this problem just by private accounts.

Mr. BURTLESS. No.

Mr. MATSUI. In fact, if you read the Richard Stevenson piece in the New York Times on Sunday, on the Kolbe-Stenholm legislation, one would find that actually taking out 16 percent of payroll or 2 percent of 12.4 percent, actually makes the problem worse. I think in the article it said that instead of 2016, the shortfall begins to occur in 2007. Is that correct?

Mr. BURTLESS. That is right. If the system is left unchanged, it is going to run out of funds in 2038. If we give away 2 percent of payroll taxes to individual contributors over the next 38 years, well, the cookie jar will be empty much, much sooner.

Mr. MATSUI. Right. Dr. Orszag, you mentioned only the British system, and you didn't mention Sweden and Australia and obviously other systems as well, particularly Chile. Was it because you didn't study those, or have you studied those systems?

Dr. ORSZAG. The real reason that I focused on the U.K. in my testimony is that it provides the best example of a country that does what President Bush has suggested.

Mr. MATSUI. And the other ones really are not comparable.

Dr. ORSZAG. They all differ in some way. Either the system is mandatory, unlike what President Bush is proposing, or it is employer-based, unlike what President Bush is proposing.

Mr. MATSUI. And with respect to Chile, you know, there is this talk about general fund moneys. Chile, if I recall, Mr. Pinochet was still the leader of Chile in 1981 when they went over to the privatized system, and weren't they disposing of a lot of the government-owned property and selling it, and so that went into the overall budget of Chile. Is that correct?

Dr. ORSZAG. There were a lot of changes that were occurring at the same time, including privatization and——

Mr. MATSUI. And we don't know what went into the pension system and what didn't. Is that correct?

Dr. ORSZAG. That's right, money is fungible. It is very hard to trace what dollar went to what purpose.

Mr. MATSUI. And in the English system, when they converted over to that second tier, which is the private tier, you know, voluntary private tier, there was some general fund monies as well. Is that correct?

Dr. ORSZAG. The tax rebates reduce tax revenue, yes.

Mr. MATSUI. Right, and the tax rebates would have gone to the general fund otherwise.

Dr. ORSZAG. That is correct. They would have been part of the National Insurance Fund.

Mr. MATSUI. Right. Let me, if I may just ask, let me ask in terms of the British system, my understanding is, just from reading some of the British newspapers, that there is a $15 billion pound problem in terms of the so-called mis-selling. Can you explain that? That comes to, I think, U.S. dollars, anywhere from $15 to $20 billion. Is that correct?

Dr. ORSZAG. Yes. The numbers vary. And just to explain very briefly, the problem really involved people who had been in an employer-provided plan, an occupational scheme, and were lured into individual accounts, and the question is whether that was an appropriate change for them or not. And the numbers that you are mentioning, $15 to $20 billion, are the amounts the financial firms are now ponying up to make the individuals whole who were misled.

Mr. MATSUI. And apparently, and I know my time has expired but I think we will get a second round, 1.5 million people actually have this problem, and not all of them have been paid yet. This has been now, what, three or 4 years. Is that right? Five years, perhaps?

Dr. ORSZAG. The numbers are still a bit fuzzy because it hasn't all played out yet.

Mr. MATSUI. And let me just, Mr. Burtless, I read your written testimony and you talked about going all the way back to 1871 and then projecting I guess 30 years in terms of, you know, the market and how much the market actually would have benefited individuals. And you indicate a one year difference between 2000, if a person retired, and then if a person retired in 2001, there would have been a reduction of one-third of one's Social Security benefits. Can you just explain that, because I think that was a fascinating analysis that you did.

Mr. BURTLESS. How much risk is associated with the high returns people are sometimes promised in individual retirement accounts that are invested in the United States stock market? The calculation is this: Workers start to work when they are 22, and they stop working when they are 62. They save 2 percent of their salary every year, and then when they retire they take their savings to an annuity company and they purchase an annuity. How much money do they have, if we just follow the actual stock market performance over the last 130 years?

Well, you can look at about 90 or 91 different workers, because that is how many 40-year periods there have been in those 130 years, and you can say, "Okay, well, what would this person's pension have been upon retirement under this assumption?" And the calculation that you just mentioned was performed for someone who retired at the end of March 2000, and performed again for a person who retired at the end of March 2001.

The reason that there was such a big decline is because of course the stock market declined in real terms in the United States by almost 30 percent. But in addition the annuity company, the company that sells you an annuity, has to invest its funds. It makes its guess about how much it is going to be able to earn on the funds it invests by what the yield is on Treasury bonds. The Treasury yield, the long-term yield, fell considerably between March 2000 and March 2001.

So there were two things that adversely affected the retiree. Number one, the stock market fell, so the value of his lifetime savings fell about 30 percent. And, then in addition he had to pay a higher price to get an annuity. The result was that the value of the annuity fell from an all-time high in March 2000, by roughly a third in March 2001.

Mr. MATSUI. It was a third, I thought, or 30 percent. So if I could just conclude, two people who had the same investment in stock, basically the same stocks, if one retired 12 months sooner than the other, they would have about a third reduction in their lifetime retirement benefits or projected retirement benefits. Is that correct?

Mr. BURTLESS. That is correct. If the government received many letters on the Social Security benefit notch, which was far, far smaller than this, you can imagine the flow of mail into Capitol Hill if this kind of a plan is adopted.

Mr. MATSUI. Yes. If we thought the notch baby was a problem, well. Thank you, Mr. Chairman.

Chairman SHAW. Mr. Matsui, are you speaking of treating the next generation different than this generation?

Mr. MATSUI. I don't understand what you mean.

Chairman SHAW. As far as creation of a new notch?

Mr. MATSUI. No, not at all. In fact, that is what I am worried about.

Chairman SHAW. That is exactly what this Committee is worried about, and that is why we are having a hearing, because I very much want to be sure that we do everything in our power not to treat our children any differently than we are treated. I don't want them having to pay a higher payroll tax, like Mr. Burtless referred to. I don't want them having to work any longer unless it is just simply for a question of them living longer.

And particularly by the legislation that we are going to pass, and I want to just give Mr. Burtless just an opportunity——

Mr. MATSUI. Mr. Chairman, in view of the fact that you responded, may I just respond back to you? Because we talked about the younger generation. My concern about the younger generation is that if you take 2 percent of payroll which they can put in an account, or 16 percent of the payroll tax in an account, and you make whole the current generation of retirees, you have got to come up with the difference someplace, and that means you probably have to increase taxes on that young population. And so you are basically double-taxing them for one set of retirement——

Chairman SHAW. Well, every witness here has said that the present plan cannot be sustained, and actually the memorandum that you, Mr. Matsui, sent out to your Democrat colleagues pointed up the fact that it could not be, that the present system could not be fully funded at its existing level——

Mr. MATSUI. Oh, no one is questioning that.

Chairman SHAW. Unless something is done. But I do want to give Mr. Burtless an opportunity to correct something that he said, and I don't think you meant to be as flip about this. When you talk about giving away some of the payroll taxes, surely you are not saying that putting money in an individual retirement account which is going to be used to offset an unfunded liability of the Social Security Administration upon retirement of that worker is giving it away, is it? You didn't mean to say that, did you?

Mr. BURTLESS. From the point of view of the obligations of the existing Social Security system, yes, it is giving it away. Because of all the calculations——

Chairman SHAW. Wait a minute. How in the world can you say that? If we set up individual retirement accounts for future workers that are going to retire 20 years from now, and as a requirement they are going to take those individual retirement accounts back to the Social Security Administration and they are going to be used to help fund their retirement, you call that giving it away?

Now, I am not one of those that is in favor of taking the individual retirement accounts out of the payroll taxes, and the plan that I have produced does not do that. What I do is simply take the money out of the Treasury and send it away. But I don't think putting money away for tomorrow's retiree is giving it away.

Dr. ORSZAG. Mr. Chairman, if I may, I might be able to clarify one thing. What you are referring to is using the income from an individual account and offsetting the Social Security benefits.

Chairman SHAW. Well, the income and principal.

Dr. ORSZAG. Right. Without that linkage between the income from an individual account and the traditional Social Security benefit, then it would be giving it away, from the perspective of Social Security. That linkage is crucial for your plan, and I think Mr. Burtless would agree that given that linkage, then there could be some effect on the actuarial balance. But the linkage is the key, between the income from the individual account and the traditional benefit.

Chairman SHAW. Yes. Well, I can understand that, but also when we talk about the deficit, the pending deficit in the Social Security Trust Fund, and we start talking about it being $3 trillion, that is in terms of today's dollars if you had that money to put away somewhere and let it grow, which we don't have over $3 trillion to set it out some way and let it grow. So in terms of today's dollars, you might be able to say that.

But when you are talking about what is going to be the deficit over the next 75 years, I think all, everyone would agree that it is going to be $22 trillion. And it is not in terms of today's dollars, it is in terms of what is going to be mounting up over a period of time. And the real disaster out there, and we will all be dead and gone by the time it really gets out there, but when you get into the 75th year, it is growing so quick every year that if you take it out to 100 years, God knows what it is. It is huge, and it would bring down the economy of the United States. It would bring down any economy. And this is exactly what we are trying to avoid, and this is what we have got to plan for.

Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Harris, did you want to weigh in on this? You looked like you had something to say.

Mr. HARRIS. I think there is—you know, we can argue about the facts, the figures and the numbers. I think we have to really look closely here at empowering not so much the baby boomer generation but generation X and beyond.

And I think what we did in Australia did, and certainly in the United Kingdom, and there has been a lot of criticism in the United Kingdom, but the most productive thing that both these countries have done is given the individual generation X's and Y's or whatever the ability to craft out their own retirement needs, to harness cynicism and be constructive about crafting out their own retirement needs. And I think that is positive, I think this is healthy, and I think that is what this country was built on, was the individual and individual aspirations.

Mr. LEWIS. Well, I agree. I have a son and a daughter that are going to be burdened with a substantial and significant increase in their taxes, payroll taxes, and then what are they going to get for that? They are going to get an increase in their age limit to retire, and then get less benefits. So I think that is not fair in any——

Mr. HARRIS. It is going to be tough political to ask a Congressman like yourself, do you cut benefits or do you increase taxes? I wouldn't like to be in that position.

Mr. LEWIS. Well, as the Chairman mentioned a while ago, we are talking about a pyramid here. It was fine in the beginning, but when you are on the short end of that stick, you are going to come up losing, and that is exactly what is happening.

Mr. Burtless, you mentioned that the elderly in this country compare unfavorably with other countries in regards to poverty. Wouldn't increasing taxes or reducing benefits to achieve solvency increase elderly poverty even further?

Mr. BURTLESS. Increasing taxes on the working-age population in order to protect the guaranteed pension under Social Security does not boost the poverty rate of the aged at all. It——

Mr. LEWIS. But reducing benefits?

Mr. BURTLESS. But reducing benefits, exactly as you suggest, would tend to increase the poverty rate of old Americans, depending on how the reduction in benefits is structured.

Mr. LEWIS. OK. Thank you.

Chairman SHAW. Mr. Becerra.

Mr. BECERRA. Mr. Chairman, thank you very much. To all the witnesses, thank you for your testimony, for being here.

Let me ask a question that takes us away a little bit from the questions that have been asked earlier, and ask if any of you have a particular comment with regard to the fact that we have had an increased amount of immigration in this country over the years as compared to some of the other more industrialized nations, the G–5 nations which are often compared. Has immigration in this country over the last couple of decades helped our country deal with the impending problem of Social Security and funding it into the future?

Mr. HEWITT. I would be happy to take a shot at that. It has had a huge impact.

Mr. BECERRA. Positive or negative?

Mr. HEWITT. A very positive impact. Immigrants have a higher rate of birth when they first come here. Eventually they adopt the birth rates of the majority. But most of the population and labor force growth that we will experience over the next 50 years, which sets us apart from the other industrial countries, is the direct result of assumed high rates of immigration. So our demographic profile is different precisely because of that reason.

If I can also just throw in a side issue here, it is, the fact that the U.S. population is slated to grow by 46 percent over the next 50 years is one of the main reasons why it is so much more difficult for the United States to meet the Kyoto environmental accord requirements, because then our major trading partners like Japan and the European Union, because their populations are slated to shrink over this same period, and part of that is indeed because they accept lower rates of immigration.

Mr. BECERRA. And I don't want to make light of the fact that we have to watch population growth trends, regardless of what country or any part of the globe, but does anyone disagree with what Mr. Hewitt has just said with regard to immigration?

Mr. HARRIS. Thank you, Congressman. I wouldn't tend to disagree with Paul's comments, but there is some divided opinion on whether immigration or increased levels of immigration ultimately solves your aging population. I refer to Robert Brown of Canada, who is a leading academic in the field of actuarial science, where he has expressed concerns that Canada and Australia, two leading countries with large levels of immigration have seen immigration levels increase but at the same time family reunion schemes increase as well. So the net initial factor is that there is a younger immigrant coming in, in the case in Canada and Australia, initially, but then increasingly family reunion schemes see older, if you like, immigrants coming in and following on. So, if you like, the impact of the benefit of immigration in the long term is diluted slightly.

Dr. ORSZAG. If I could just add that in the United States, the Social Security actuaries have examined this question. If you look at the partial effect of higher levels of immigration, it clearly shows up as an improvement in Social Security's long-term financing.

Mr. HEWITT. If I can just add one minor point——

Mr. BECERRA. Very quickly, if I could get to——

Mr. HEWITT. The U.N. has estimated that if the United States were to use immigration to retain the same level of old age dependency, workers/retiree ratio, that by 2050, 72 percent of the U.S. population would be immigrants or their children.

Mr. BECERRA. Wow. Dr. Orszag, let me ask you a question with regard to private accounts and the creation of those accounts. Some have said that when you talk about savings, that this country has not done its best job in trying to get our country, our people, to save, whether private accounts or national savings altogether, which includes government savings as well.

Some folks have also said that if you create these private accounts, you might just displace current savings activities by individuals who would view these private accounts as a way to continue the savings they are otherwise doing, whether it is a savings account, a regular savings account, passbook savings account or checking account, or maybe in the stock market, but now you are required or called upon to save in these private pension accounts or Social Security accounts, that that might just displace your own private or personal activity in savings accounts. Is there a chance that, in creating these private savings accounts, all we are doing is supplanting current savings activities that Americans undertake?

Dr. ORSZAG. Yes, and in answering that question, I want to emphasize the importance of the recent bipartisan agreement to ensure that Social Security surpluses are devoted to paying down public debt. Given that, if you divert revenue from the Social Security Trust Fund into individual accounts, and individuals don't respond at all in their behavior, all you are doing is reducing government saving by $1 and increasing private saving by $1 with no increase in national saving. Then you need to consider how individuals could respond. For example, if $1 in an individual account is more tangible than $1 of reduced public debt, and so someone says, "Well, I've got $1 in my individual account, I don't need to put as much into my 401(k) or IRA or other type of saving," the net effect could actually be a reduction in national saving.

Mr. BECERRA. Thank you. Thank you, Mr. Chairman.

Chairman SHAW. Mr. Pomeroy.

Mr. POMEROY. Mr. Chairman, over here? Really? Great.

Chairman SHAW. I was looking at him, indicating that I wasn't going to go to him, I was going to go to you.

Mr. POMEROY. No one has ever been that nice to me before. I want to thank you for calling on me to inquire, and for holding this hearing. I think this has been one of the more interesting panels that I have had the opportunity to listen to as a Member of this Subcommittee. I appreciate it a lot.

I think that the perspective we can learn from international experience is very important. On the other hand, I do think it also has to be kept in perspective. Some of those, you wonder what the reaction of some would be that so favor, for example, the Chilean experience, if it was proposed to them, "Well, Chile has reduced their crime rate. We should adopt the Chilean crime code." I mean, you know, they would say, "Let's look at it but let's not, I mean, let's make our own judgments here. This is a very different country, a very different circumstance." So, too, is it as we evaluate the situations leading up to the reforms and how they are implemented.

Mr. Harris, you used to be an insurance regulator?

Mr. HARRIS. Yes, sir.

Mr. POMEROY. So did I.

Mr. HARRIS. Yes, I know that.

Mr. POMEROY. A very twisted and shared common experience.

As you say at the end of your testimony, the individuals are ideally placed to really shape their own decisionmaking. Would you include in that voluntary, whether or not they ought to participate in private accounts as a voluntary matter, and whether or not the decision to annuitize should be voluntary?

Mr. HARRIS. I have got some sympathy for this view. I think the individual is best placed to determine the requirement for having, if you like, the appropriate tools for ideal public education facilities, information. What was crucial in the Australian experience, and other countries, but certainly Australia, was that politicians like yourself mounted a very effective public education campaign to allow the individual to have necessary, if you like, information appropriate decisions.

Going on to your second question about annuitization, I think I have some support for compulsory annuitization. I am concerned in some countries, in our case in Australia, where individuals had in the past relied on lump sum payments and saw them quickly eroded.

Mr. POMEROY. I think that is going to be a very major issue facing our private retirement system under our defined contribution experience, and Mr. Chairman, I would commend that topic to you for one we should explore on the private savings side, somewhere, whatever Committee has jurisdiction of that one, or the whole Committee.

The Chairman, the co-chairman of this, President Bush's retirement or Social Security Commission, Senator Moynihan, has spoken favorably about the voluntary nature of a private account system and the opposition to mandatory annuitization. Mr. Burtless, what would be the compound effect of those two features in a private account format that could be contemplated?

Mr. BURTLESS. Well, I agree with Peter Orszag that a problem with voluntary withholding from the Social Security system is that the people who are likely to opt out are the people such as myself who have high earnings and therefore have very good investment opportunities outside of Social Security. But it is unfortunately the case that it is also people like me that pay for the benefits of a lot of older people and people with lower incomes. So I fear that the selective withdrawal of people from the traditional Social Security system is going to adversely affect the level of benefits that we can pay under the guaranteed pension program to the people who remain in the traditional system.

Mr. POMEROY. Right. In other words, right now a moderate wage earner gets a higher portion of their income replaced under Social Security than a more affluent level wage earner. Is that correct?

Mr. BURTLESS. Yes.

Mr. POMEROY. And making it voluntary, you would tend to have the higher earners opting out, leaving the lower earner, probably leaving the lower earner with a lower income replacement rate, in other words, less relative benefit. Correct?

Mr. BURTLESS. I think the loss of revenues from my contributions to Social Security, and from people like me, would mean that the basic guaranteed pension under Social Security would have to be scaled back more than would be the case if we just tried to reform the current compulsory system.

Your second question had to do with compulsory annuitization upon retirement. In my testimony I suggested if we do have a system of individual accounts, then prudence requires that we require people to annuitize at least enough of their saving in this plan so that they do not immediately spend all of that nest egg and then become eligible for means tested benefits.

Mr. POMEROY. Right. I have got one more question I have got to ask, but I do think those two points, voluntary participation and voluntary annuitization, show that in the end choice, although wonderful, can vastly undermine the security of the Social Security system.

Mr. BURTLESS. Right, right.

Mr. POMEROY. A final question for Mr. Palmer. At the outset of your testimony, you indicate that there was an unfairness, a redistributional unfairness in the design of the old system. Would you— I am really out of time, so I am trying to figure, will we have a chance to go around?

Chairman SHAW. Well, let me, I am going to get the feeling of everybody.

Mr. POMEROY. All right. I yield back. Thank you, Mr. Chairman. I will get to you later.

Chairman SHAW. Mr. Hulshof.

Mr. HULSHOF. Thanks, Mr. Chairman. As you know, a couple of weeks ago when you came to my district, for those of you who perhaps were unaware, we had an official field hearing of the Social Security Subcommittee in Columbia, Missouri, which is my hometown, and it was a very interactive format, I think roughly 250 to 300 people on the campus. We had all age groups represented.

And it was very interactive in the sense that we had Ron Gephartzbauer. Probably many of you know Ron, who is an actuarial expert, and he presented various options to fix the long-term solvency of Social Security, and then we had people at tables who tried to come up with a 100-percent solution. And we weren't thrusting our opinions upon them, but we really were listening.

I am happy to report to you, Mr. Chairman, that one of the college classes who spent that afternoon with us, Dr. David Weber's class, then took that hearing as their beginning point, and each of the students, the 20 or so students from probably 20 years of age to 25, then wrote papers on this long-term solvency problem, and probably 18 out of those 20 papers that were turned in, I am told, focused on some individual personalization or private account as part of a solution. So I hope, Mr. Harris especially, you talked about cynicism, and perhaps skepticism is a milder term as far as what our task is, and I hope that we can get beyond that, and I think I certainly appreciate you all being here today.

Just in the couple of minutes that I have got, Mr. Burtless, you mentioned the flow of mail that Members of Congress receive and have received on the notch issue. I don't plan to be here in the year 2038, I will just make that public announcement now, at least in Congress in 2038. I don't want to be a Member of Congress, or it would be interesting to converse with a Member of Congress about flow of mail if inaction is what Congress ultimately concludes to do as far as those benefit cuts that are inevitably going to occur if we do nothing.

Were you a Member of the Brookings Institute back in 1983, during the——

Mr. BURTLESS. I was.

Mr. HULSHOF. During the Greenspan? Because I wasn't here then, either, but reading back, higher taxes, lower benefits, that sound eerily familiar to something, that discussion that occurred 18 years ago. And I thought that the Greenspan Commission, by increasing payroll taxes and raising the retirement age, that is, lowering benefits, was going to fix Social Security, and yet here we are just 18 short years later talking about, at least from your testimony, talking about the same solutions.

Mr. BURTLESS. It is certainly true that if you establish a fully funded pension system, and people are willing to live with the pensions that the financial markets will deliver to them on their retirement, it is certainly the case that you can fix the problems of the pension system once and for all.

But, bear in mind, that is the system we had in 1935. Americans found it unsatisfying then. They thought that relying completely on private markets to give them their retirement incomes, 6 years after the 1929 crash, wasn't really enough. They wanted some other source of support that doesn't depend on how financial markets operate over the course of their career. In particular, workers didn't want to depend solely on financial markets, which might fall very near the point of their retirement.

Mr. HULSHOF. Mr. Bedell-Pearce, this is just a comment to you, but the mark of a good American politician is to take an unrelated subject and try to weave it into something completely unrelated, so let me attempt to do that.

Mr. Burtless, you mentioned that the liberalized pension laws that we have passed, and you are exactly right, the tax relief measures that the President signed have liberalized those pension laws. I would be remiss, however, if I didn't say to my colleagues, though, as you know the Senate put a sunset on those pension changes, and H.R. 2316 that Mr. Ryan and I have cosponsored would make permanent those tax relief measures, and I would urge your sponsorship of that legislation.

How did I do, Mr. Bedell-Pearce? Did I weave that in appropriately?

Mr. BEDELL-PEARCE. Very well.

Mr. HULSHOF. Thank you. I do want just, seriously, in about the 30 seconds or a minute that I have left, Mr. Burtless, in your testimony in answer to Mr. Matsui you talk about potential variation of retirement income due to stock market fluctuations. In your example, you assume that everyone remains 100-percent invested in the stock market up until the time they choose to retire. Was that part of your assumptions?

Mr. BURTLESS. Right, but this is based on a larger research program in which I also look at different kinds of investment strategies that people could follow.

Mr. HULSHOF. I thought the answer, though, to Mr. Matsui's question was 100-percent participation in the stock market.

Mr. BURTLESS. That is exactly right. That is what gives you the highest expected return over your career, but also exposes you to larger than average risk. That is the tradeoff.

Mr. HULSHOF. So therefore, if workers in their advancing years gradually phase out of stocks into less variable investments like Treasury bonds——

Mr. BURTLESS. They would have a smaller expected pension but they would have a less variable one.

Chairman SHAW. OK. In the interests of time, thank you. We are going to try to finish up.

Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. And Mr. Chairman, I want to make a brief statement and then ask a question. If it could be answered for the record later in writing, I would appreciate it. And then I would yield to Mr. Doggett, so that we can get to the floor for votes.

It seems to me that we are talking about two separate issues here on which there is virtually no disagreement. They are very much related. The first deals with adequately financing our current Social Security system, and I think, Mr. Burtless, you pointed out, and rightly so, that if all of a sudden we are going to change the philosophy and go to 100 percent away from pay-as-you-go and we want to fund it completely, we just transfer $9 trillion and take over that liability, send it to an insurance company. No, we don't even send it to an insurance company. They would probably do a little less because they get a better return. But that is what it would cost.

No one is talking about that. No one is talking about moving completely away from having current workers help pay for current retirees, but that if we want to finance it under the current system, then we either have to put some new revenues in equal to about 2 percent of payroll—we can do that through a better return on the Social Security system, or transferring in general tax revenues to do it, that will work—or reduce benefits, which we use different terminology for, such as raising the age of retirement or integrating with private accounts, but it is a reduction of the obligations of the Social Security system.

The second issue is one there is also no disagreement, and that is, we have got to do a better job of enforcing private accounts in this country. We have got to increase individuals' ability to put money away for their own retirement. I don't think anybody disagrees with that. And the only part of the tax bill that I really liked was that bill that had the name Portman-Cardin attached to it and was signed by the President, that sort of helped that along.

I guess my point, though, is that as we look at moving toward individuals taking on more personal responsibility, one thing is clear: When you are moving from a defined benefit system to a defined contribution system, you not only have the market risk that Mr. Matsui refers to, and rightly so, but you have the investment risk, whether individuals really will get adequate education and be informed, and how do you deal with the inherent conflicts that are out there, with people who are selling products also being involved with giving advice?

And I would be curious as to how other countries have dealt with that. We don't have time for a verbal response. If there is a written response or material, I would appreciate that.

And the second is, how do you deal with protecting to make sure that individuals don't invade those funds? Under our current retirement systems, you can invade and pay a penalty, or without penalty, use it for education or health care or first time homeownership and all these other temptations that are out there. How do you make sure that it is really there for retirement, if we are going to be relying more and more upon individuals' own private investments in retirement in the future?

And if you all could help us with what is happening in other countries in regard to those two issues, I would certainly appreciate it.

Mr. Chairman, I would yield the balance of my time to Mr. Doggett.

[The following was subsequently received:]

Cato Institute
Washington, DC 20001–5403

1. There are three points that I would like to make. First, in Chile there was a roughly 6-month period between the day on which the reform was approved (4 November 1980) and the day on which the new system started (1 May 1981). In that time, the architect of the reform, Dr. José PiZera, who was then the Chilean Minister of Labor and Social Security, would appear once a week on national television for three minutes each time to explain different features of the system.[1] Second, the Pension Fund Administration companies also perform an educational campaign, explaining the main features of the system in flyers that are available at the branch offices of those companies.[2] During a recent trip to Chile, I walked into a branch office of a Pension Fund Administration company in downtown Santiago and I asked the saleswoman some basic questions about the Chilean system. I found her to be very polite, helpful and knowledgeable of the system. Third, the Pension Fund Administration companies are supervised by a highly technical and very transparent government agency that imposes stiff penalties to those companies that commit fraud or provide misleading information to their clients. Furthermore, that regu-

[1] See José PiZera (1991) *El Cascabel al Gato*. Santiago: Editorial Zig-Zag.

[2] I would like to request that the Subcommittee make the attached copies of those fliers part of the congressional record.

latory agency provides very clear and concise information about the private pension system.[3]

2. In Chile, workers are only allowed to use the savings accumulated in their pension savings accounts for retirement purposes. If a worker has enough funds accumulated in his account to obtain an annuity that is equivalent to at least 120 percent of the minimum pension, as defined by the Chilean congress, and to 70 percent of his average salary over the last 10 years of his working life, that worker may withdraw in a lump sum those excess savings and use them for any purpose.

Other countries, such as Mexico, for instance, allow workers who have been unemployed for at least 45 days to withdraw the lesser of 10 percent of the cumulative balance in their account or the equivalent of 75 times their daily taxable base salary if they have contributed to the account for at least 250 weeks and have made no withdrawals in the previous 5 years. Workers with 150 weeks of contributions may withdraw from their account the equivalent of their monthly salary if they are getting married. Although it would probably be best that the savings be used for retirement purposes only—especially in the presence of a government guarantee of some kind, which creates a moral hazard—workers should be the ones deciding what to do with their money.[4]

L. Jacobo Rodriguez
Assistant Director

Chairman SHAW. Mr. Doggett.

Mr. DOGGETT. Thank you very much, Mr. Chairman.

Our colleagues, Mr. Kolbe and Mr. Stenholm, I think their proposal was referred to earlier in this hearing, have come forward with a proposal that recognizes that if Social Security cannot indefinitely meet all of its obligations as currently structured, that you have to do one of two things, either raise taxes or cut benefits, and they propose a little of both. I don't agree with their proposal, but I think they are at least honest in the way that they look at this whole issue.

And I would suggest, after listening to the recommendations of the President's Commission, that the most instructive experience from abroad that we have is not necessarily that that we received some testimony on today, but it is a few hundred years back in the era of the alchemist. Because if we have a Social Security fund that is already stretched now in its ability to meet its responsibilities, and we suddenly siphon off some percentage of it for private individual accounts, out of that same fund that is already stretched to the limit, unless alchemy has received a new level of ability to generate something from nothing, we will put even more demands on the fund and we will reduce guaranteed benefits to many Americans.

We had Secretary Thompson testify about Medicare here a few weeks ago in front of the Committee, and he made it clear that the discussion of guaranteeing benefits was going to be only for those who are nearing retirement, that is, people about my age or just slightly lower at maybe 50. And everyone else who might have been paying into the Social Security system for 20 or 25 years has no guarantee that their benefits will be there. They are left to the risk of the market.

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[3] The official website of the Superintendencia de AFPs, as the regulatory body is known, can be found at http://www.safp.cl.

[4] See L. Jacobo Rodríguez "In Praise and Criticism of Mexico's Pension Reform." *Cato Institute Policy Analysis* no. 340, April 14, 1999.

And so I think it is interesting to hear about the experiences in other countries. We can learn something about it. But we face the basic mathematics that this is a fund that we need to work on to be sure that it can indefinitely meet its current responsibilities, and you don't do that by siphoning off the money for a new social experiment, which is what the President's Commission with all of its Members committed to do that before they were ever selected for the Committee.

With those brief comments, I would yield to my colleague from North Dakota, who I know had another question.

Mr. POMEROY. Just a very quick one for Mr. Palmer. Looking at the chart that is attached to Mr. Burtless' testimony, you see the United States at 12-percent poverty rate in seniors, Sweden at 1 percent. Looking at that 12-percent figure for the United States, a very unfortunate way to be a leading country in that category, I think you would have a hard time making the case that our benefit structure under Social Security is unfairly redistributed. Do you have a comment on that?

Mr. PALMER. Yes. I could perhaps respond to your first comment also.

Sweden does very well in its present system, and most probably in the future system, in taking care of low-income earners. In the future there will be a guaranteed benefit which will cover all low-income earners in Sweden, so I would suspect that we will continue to be as we are today in that respect.

Chairman SHAW. I am going to have to break this up now so we can make the vote, but I do want to at least point out here that this is the last hearing where we will have Jeff McLynch, who is the Democrat staff Member on this Committee. He leaves us effective this week. We want to thank him for his service to the Committee. We have worked together on some occasions, and it has been a pleasure, Jeff, to have you, and we wish you Godspeed.

[Applause.]

Chairman SHAW. I also want to thank this fine panel. In our rush to get to vote, I don't want to neglect you. We do have some more questions that we will send to you and ask for your response in writing.

[Whereupon, at 12:04 p.m., the hearing was adjourned.]

[Questions submitted from Chairman Shaw to the panel, and their responses follow:]

Center for the Strategic and International Studies
Washington, DC 20006
September 10, 2001

1. "You spoke about changes in the old-age dependency ratio as a disadvantage of pay-as-you-go systems. Could you describe the economic, demographic, and political risks to which pay-as-you-go systems are exposed? Do you believe, as some have argued, that the United States (or for any country for that matter) can economically 'grow' its way out of the funding crunch?"

Pay-as-you-go systems rely on tax payments, and as such are prone to financing crises when tax receipts do not grow as fast as beneficiary populations. In most developed countries the pension population is expected to rise by roughly 70 percent over the next forty years, while real GDP is expected to grow by roughly half that much. In addition, European and Japanese working age populations are destined to shrink by roughly 10–15 percent over the same period—producing a near-doubling of "dependency ratios" of pensioners to workers. This leaves huge unfunded health and pension shortfalls that eventually could require a tax increase equivalent to 20 percent of payroll or more in most developed countries. Because such tax increases may prove economically counter-productive and could generate tax resistance, especially in continental European countries where payroll taxes already average above 30 percent, there is a significant political risk to current and future benefits. Finally, to the extent that these shortfalls could lead to large budget deficits in countries that already carry a high national debt burdens, pay-as-you-go systems pose an economic risk as well.

Demographic risk is heightened by the uncertainty surrounding medical technology. Currently, U.S. retirees collect Social Security for an average of 19 years. Each additional year of life expectancy therefore adds about 5 percent to retirement costs. Since 1950, average life expectancy has grown by 11 years in Europe, 8.6 years in the U.S.; and 17.6 years in Japan. Over the next 50 years, lifespans are projected to rise another 6.1 years in Europe; 5.1 years in the U.S.; and 6.5 years in Japan. In other words, governments are forecasting a significant slowing of longevity gains. Yet, many leaders in the biomedical field predict that we are nearing significant breakthroughs in cures for a number of diseases which attack the aged. Clearly, such breakthroughs, while welcome, could dramatically worsen financing pension prospects.

Europe and Japan are facing unprecedented economic risks as a result of depopulation. Shrinking numbers of workers and consumers will constitute a worsening drag on economic growth for the foreseeable future. After 2025, Europe's economic growth rate is projected to average .5 percent a year, while in Japan it is projected to average 6 percent. For this tepid growth to occur, however, productivity gains will need to remain at their historical average of 1.4 percent a year. Militating against rising productivity in depopulating countries is the fact that shrinking domestic markets (with fewer consumers each year) will tend to see very low returns to capital. Such trends would tend to drive domestic savings abroad in search of higher returns.

While America does not expect to undergo depopulation between now and 2040, very slow growth among working age populations (20–64 years), will remove what has been an important source of economic stimulus. The workforce expanded by about 11 percent a decade from 1950–2000, but will slow to less than 2 percent a decade from 2010–2040. After 2025, GDP growth in the U.S. will slow to about 1.6 percent a year—again, assuming historical rates of productivity growth. For the U.S. to "grow its way out of" fiscal strains resulting from the deteriorating dependency ratio under its pay-as-you-go financed Social Security system, productivity growth would have to remain significantly above the long-term trend for decades.

2. "Do you think that more countries will turn to using individual accounts in their Social Security systems as populations age, and why?"

Clearly, there has been a trend toward the adoption of individual accounts as mechanisms for compulsory retirement provision. This trend is likely to continue for three basic reasons.

First, being defined-contribution schemes, individual accounts are fully funded and, as such, do not contribute to deficit spending pressures. Moreover, where governments provide financial guarantees for retirement security, as underscored by the experience under the U.S. Employee Retirement and Income Security Act (ERISA), it is less costly to insure a funded than an unfunded retirement system. Second, individual accounts can help to insulate populations in depopulating countries from adverse national economic trends. In countries where declining numbers of workers and consumers combine to limit returns on investment, the ability to invest in faster-growing markets abroad will become a key source of retirement security. Third, defined contribution schemes entail no actuarial penalty for delaying retirement. Both rising longevity and the prospect of worker shortages suggest that longer work lives may be in store in most of the developed world.

3. "What has been the experience of countries that invested through Trust Funds rather than through individual accounts? Have they performed well? Have their investment decisions been influenced by political considerations? Are they doing better or worse than countries that invest through individual accounts?"

According to the World Bank, the investment of Provident Fund moneys by the governments of Malaysia and Singapore have achieved lower rates of return, on average, than have individual account investments in other countries. It should also be pointed out, however, that Japan, which has a robust private pension system, has also experienced low rates of return. Meanwhile, in Canada, initial reports are that trust funds being invested by the government have achieved returns on par with privately managed pension funds. Under ERISA, private pension managers are required to invest retirement savings solely in the best interests of the client. These strictures seldom apply elsewhere in the world, but conceivably could be applied to the investment of U.S. trust funds. Meanwhile, provident fund moneys have been invested in infrastructure and other government programs, which have tended to lower rates of return. There are concerns that similar pressures would arise in the U.S., should Congress decide to invest trust fund assets in markets. In Canada, for example, 80 percent of trust fund moneys must be invested in domestically registered companies. But rates of return on individual accounts can also be reduced by the imposition of non-economic fiduciary rules—such as the requirement that a share of pension funds be invested in government debt instruments or within national borders.

4. "What do you think the U.S. could learn from the pension reforms in Sweden, Chile, the United Kingdom, and Australia?"

There are four main lessons. First, individual accounts are popular where they have been introduced. Working people tend to like them for their transparency, and to feel more secure once they are in place. This is inevitably the case where concern about governmental fiscal capacity is the principal source of individual retirement security. Second, administrative costs can be held to acceptable levels. While it is difficult to implement individual accounts for the entire working population, it is possible to hold costs down through passive investing and limiting opportunities for course-correcting by the accountholders. Third, the transition from unfunded to funded retirement systems can be expensive and take a long time to implement. In the cases of Sweden, Australia, and Chile, the individual account was financed through additional payroll levies. Fourth, the experiences of these and other countries that have moved toward individual accounts in recent years belies the argument that privatization is an "ideological attack" on Social Security. As often as not, the reformers have been from the "left". Rather, reform has come from the frank recognition that government finances in the future will be too precarious for individuals to depend on for a comfortable retirement.

Paul S. Hewitt

Prudential plc,
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September 11, 2001

Question 1. Why did the United Kingdom decide upon asset-based fees for the new stakeholder pension rather than contribution-based fees or flat fees?

The UK wants stakeholder pensions to be as simple as possible for the customer. In particular it is important that the charges are transparent and easy to compare. This leads to the conclusion that there should only be one type of charge (be it asset-based, contribution-based or flat fee), otherwise comparison is difficult. The UK has used the overall reduction in yield as part of disclosure of more complicated charging structures for several years, although it is not clear that customers understand that concept.

Flat fees would be inappropriate since they would have been comparatively large for lower rate contributors, who are one of the target groups for stakeholder pensions. However, flat fees can be charged for advice in addition to the asset-based fee.

The choice between asset-based and contribution-based fees should reflect the actual incidence of costs for the provider and the way those vary during the lifetime of the investment. Given the option to vary the type of asset held, this indicates a need to reflect the actual asset choice, which may vary from 1 year to the next. It is clear, however, that neither a contribution-based fee nor an asset-based fee truly reflects the actual incidence of costs.

To quote from the government's paper on the proposed charging structure:

- "Requiring charges to be levied as a percentage will be beneficial to those with relatively small pension funds. Where charges are levied as a fixed cash sum, there can be a disproportionate effect on those with small savings. In cases where Members stop paying into a scheme, a fixed charge can erode the value of savings if the investment returns are lower than the fixed charge.
- Requiring schemes to apply only percentage charges will mean some pooling of costs between scheme Members. This is a feature of most collective arrange-

[1] Prudential plc is a leading international financial services group (not related to the U.S. company with a similar name) and has been a key player in UK pension provision for more than 70 years.

ments. The government considers that pooling of costs in this way within stakeholder pension schemes is appropriate, in order to deliver the benefits of transparency and flexibility which a percentage charge brings."

Question 2. Could you describe how regulation of personal pensions works in the United Kingdom? What agencies or organizations are involved and what are their responsibilities? How have the regulatory structure and requirements imposed on personal pension providers changed since the mis-selling scandal to avoid future incidents of mis-selling?

Approval of personal pensions is initially required from the Inland Revenue in order for the scheme to be given the tax advantages granted to UK pensions. The pension providers have to operate the scheme within the rules of approval in order to maintain those tax advantages.

Personal pension schemes are provided by institutions currently regulated under the Financial Services Act (to be replaced by the Financial Services and Markets Act as from 30th November 2001). The overall regulator is to be the Financial Services Authority (FSA), which will regulate both the prudential supervision and the conduct of business of the relevant financial institutions.

Pensions mis-selling was one of many issues that informed the thinking about regulatory arrangements. The switch from separate regulators to a single regulator (the FSA) will ensure consistency of treatment of all regulated institutions and allow the regulator to act more quickly than was possible under the previous system of self-regulation.

One aspect of regulation not covered by the FSA is on employers involved in the processing of premiums. Responsibility for ensuring the pension contributions deducted at source by an employer are transmitted efficiently to the scheme rests with the Occupational Pensions Regulatory Authority, who have a similar role in relation to occupational pension schemes (OPSs)—they are responsible for the regulation of all aspects of OPSs covered under the Pensions Act 1995.

The requirements upon personal pension providers have not changed fundamentally—they were, and still are, required to avoid mis-selling. It has always been clear that encouraging employees to leave their active membership of an OPS and join a personal pension was very likely to be bad advice. The training and competence scheme for salespeople has been improved since the mis-selling of 1988–1993.

Before the regulators' mis-selling review in 1993, most personal pension providers had already started to introduce systems to allow someone thinking of transferring the value of their past benefits to compare the deferred benefit that they were proposing to give up under their OPS to the benefits that they might reasonably anticipate under an alternative personal pension.

The mis-selling review itself clarified the scope of the Financial Services Act. Although Membership of an OPS was not, itself, classified as an investment under the Act, "best advice" did require someone to be encouraged to find out more about the OPS alternative if it could be better than a personal pension. Since most employers in the UK do not contribute to an employees personal pension, an OPS is very likely to be the individual's best choice.

Question 3. Could you describe the types of information the public is required to receive regarding investment choices and what entity provides that information (e.g. the government, the fund manager, and so forth)? Why did the United Kingdom decide to deliver information in that particular way?

Again this is undergoing a process of ongoing development, not least with the introduction of the Financial Services and Markets Act which gives the FSA responsibility for promoting public understanding of the financial system.[2] The FSA is also reviewing the current system of disclosure in the light of technological developments and increasing access to the Internet, together with customer research suggesting that some aspects of the detailed information disclosure are failing.

There is already a thorough system of disclosure. Anyone seeking advice is required to be given suitable advice, which requires initially that the flow of information be from the individual to the adviser. Based on that fact-find, the advisor will

[2] Extract from the FSA strategy document for promoting public understanding of the financial system. "Work to achieve this aim falls under two main headings:

- Education for financial literacy—to provide individuals with the knowledge aptitude and skills base necessary to become questioning and informed consumers of financial services and manage their finances effectively;
- Consumer Information and Advice—to provide impartial information and generic advice to help enable consumers to plan their finances and make informed choices, while not being prescriptive or recommending individual products and services, or telling people to save."

explain the choice of investment products, and within that the choice of provider and the choice of investment from the product/provider combination. The adviser will pass on information prepared by the providers, which will include the investment principles relevant to the particular funds. The adviser will also prepare a letter explaining the significant features of the background fact-find on which the advice was given. This combines delivery both face to face and in writing (and potentially over the Internet), with generic and individual advice reflecting the particular needs of the person being advised.

During the course of the accumulation of a pension, the private schemes are required to provide annual benefit statements. This annual disclosure of information is gradually being extended to include further information regarding the specific scheme investments. Pension providers are increasingly expected to publish their statements of investment principles including any investment policy that they might have on ethical and environmental issues. Projections of an individual's State benefits are also available on request.

Both the regulator and the Government produce generic information on other aspects of the investor's choice, including the operation of State entitlements. The regulator has also introduced a set of "decision trees" to help an individual in the choices associated with the new stakeholder pensions. Again, this combines face to face and written material, since a number of pathways on the decision trees highlight the need for individual advice.

In order to help simplify the investment choice for someone who has chosen to contribute to a stakeholder pension but does not want to take advice over the choice of individual funds, every stakeholder scheme is required to nominate a suitable default investment option.

Question 4. The United Kingdom's system allows people to opt back into the second tier of the government pension plan if they are unhappy with the private system. What percentage opts back into the government program, and what is the primary reason for doing so?

Although the UK system allows for opting back in, the individual is not required to give a reason for so-doing. However, our experience is that in almost all cases the decision to opt back into the State second tier pension is based on advice from the private pension provider. This advice relates to the comparative advantage of the rebate offered by the UK Government as compared with the benefit being given up. For example, there is a cap on the maximum rate of rebate (which is age-related) which means that at the oldest ages the individual would be best advised to rejoin the State second pension.

The advice to opt out may also depend on the salary of the person involved, since the second tier of the government pension plan is earnings related. It may also depend on the individual's other on-top voluntary contributions. Hence, as an individual's circumstances change, it may be natural to opt back in.

Question 5. The United Kingdom's system has been criticized for having high administrative costs. Is it correct that the government's rebate to persons contracting out to Appropriate Personal Pensions (APPs) takes into consideration that administrative costs are higher and provides a more generous rebate? Does the government end up absorbing some of the additional administrative costs?

The level of the rebate depends on the type of private scheme that the individual is contracting out into. As explained in the answer to question 6 below, the type of private scheme determines the method and timing of the payment of the rebate and this is reflected in the level of the rebate. For example, the rebates to contract out to an appropriate personal pension [3] (APP) are age related, whereas those for those contracting out into a defined benefit pension scheme they are not.

The level of rebate recommended by the Government Actuary to the Secretary of State depends on a number of assumptions, of which the administrative costs are one. However, it is not surprising that the assumed administration costs are higher where the scheme can be a standalone APP with no additional voluntary contributions as compared with a defined benefit scheme offering larger overall benefits.

Question 6. How much time passes between the time personal pension contributions are earned and when they are paid to the worker's account? Are the contributions invested or credited with interest in the interim?

[3] Personal pensions are an alternative to the State Earnings Related Pension Scheme (SERPS). These instruments are similar to IRAs. Investments in personal pensions are composed of the rebate the worker receives from for contracting out of the SERPS plan along with any additional voluntary contributions. The part of the personal pension that comprises the rebate is known as an Appropriate Personal Pension.

Contributions are invested as soon as they are received. Employers are required to ensure that contributions deducted from salary are paid to the provider, by the 19th of the following month, for investment in the workers' accounts. No interest is credited in the interim.

Contributions are paid net of basic rate tax relief. Tax relief is reclaimed by the provider directly from the Inland Revenue and is received on average 2 weeks after the contribution. Providers can choose whether they regard the tax relief as also being invested at the time when the net contribution is received, or invest the two elements separately on their different dates of receipt.

If the question relates to the rebate, they are paid to the personal pension scheme after the end of the year in which they are earned. They will not be triggered until the employers tax returns for the fiscal year concerned have been submitted. On average, rebates are received about 6 months after the end of the tax year. There is no interest specifically paid for the time that has passed, although this is allowed for in the calculation of the rebate. This also partly explains a difference between the rebate on an APP and an OPS. The Government has decided that in the case of an OPS, the employer simply pays reduced National Insurance contributions and hence there is almost no delay in crediting this to the scheme.

Question 7. Peter Orszag stated that administrative costs eat up 43% of an account's value over a worker's lifetime. However, research by Edward Whitehouse indicates costs are much lower. Would you agree that Dr. Orszag's calculation is too high, and why?

Dr Orszag's work was surprising, not least because it represented a very particular form of analysis. 43% is a very startling figure until you recognize that it compares an investment being administered with an equivalent investment giving exactly the same investment performance but assuming no costs whatsoever. The analysis demonstrates particular issues, and could usefully be extended to similar products in other regimes, provided it fully reflects the potential negative consequences of not administering the product in that way.

One area of particular surprise to providers was that quarter of the overall cost calculated came from the purchase of an annuity. It is generally recognized that people are living longer than was assumed when annuities were purchased—this should imply that there is an overall benefit to the individual and this appears not to have been built in to the analysis. Instead, the costs reflect the fact that annuity providers base their assumptions on the profile of people who purchase annuities rather than on that of the population in general.

The other reason why Dr Orszag's work is potentially misleading is that although it indicates what lessons can be learned from such analysis, they relate to a regime which has progressed. The personal pension regime in the UK is generally falling into line with stakeholder pensions. Here there is a maximum fund charge of 1% per annum and there is no charge on transfer.

Edward Whitehouse's paper published by the OECD,[4], provides a useful comparison across 13 countries including the UK, Australia and Sweden. We note that he refers to Dr Orszag's analysis, concluding that this "substantially overstates the average charge burden resulting from transfers". He calls upon evidence from the British Household Panel Survey to question the rates of transfer extrapolated by Dr Orszag.

Question 8. How much do you think companies will charge for investment advice on top of the maximum stakeholder fee?

Many in the UK believe that the market for investment advice in the UK will move over to a fee basis. This will be fully transparent and will be paid by all those seeking advice including those who make no investment as a result. This will allow the fee to reflect the time spent in the consultation.

Question 9. Will companies be able to profitably operate with the 1% limit on fees in stakeholder plans? How will they cut costs to stay profitable?

Commercial companies are choosing to operate in this market where the charge cap applies. It should be assumed that companies believe that they will be able to operate profitably within this limit.

The product offering is more limited than was the case with personal pensions. The UK has a history of operating a type of fund investing predominantly in equities where the overall return is smoothed to reduce volatility. These "with-profits" funds offer guarantees and demand capital support that cannot be met from within the 1% limit. These products are thus, in general, not being offered in stakeholder plans. There is a particular emphasis on tracker funds in order to keep costs to a minimum.

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[4] Private Pension Series, Private Pension Systems—Administrative Costs and Reforms, No 2.

The UK market is following the US in seeking to encourage the maximum use of technology using a business to business approach, whereby an employer provides front-end administration on their Intranet. By so-doing, the individual and the human resources function can ensure that employer aspects of salary deduction are in place, leaving the stakeholder plan to focus on the operation of the pure scheme-related administration. Even so, the charge cap in the UK is lower than the charges that would currently be made on equivalent schemes in the US.[5]

Question 10. Under what circumstances can the personal pension be passed to the worker's estate?

Personal pensions will almost invariably provide a death benefit of the return of the fund if death occurs before retirement. If death occurs after retirement, the appropriate personal pension, used for contracting out, has to provide a joint life benefit which will continue to the surviving spouse. The annuity arising from voluntary contributions will depend on the individual's choice at retirement. Annuities purchased with a guarantee that payments will continue for 5 or 10 years irrespective of the survival of the individual will be paid into the worker's estate.

Since 1995, there has been an alternative method of taking income from a personal pension. Instead of purchasing an annuity, income can be withdrawn from the fund within limits set by the Government Actuary. There are detailed rules, but the important aspect in relation to the question is that the fund that remains on the death of the individual will be passed to the worker's estate. Income drawdown cannot continue beyond age 75[6] at which point an annuity must be purchased and the circumstances referred to in the previous paragraph apply.

Question 11. How are personal pensions handled in cases of divorce? Are married workers required to take a joint and survivors annuity at retirement? How much does the annuity provide to the surviving spouse?"

A personal pension fund forms part of the total assets to be split between the divorcing parties. Wherever possible, divorcing couples will try to ensure that existing arrangements do not require costly sale and repurchase (of, for example, a house) and hence they are similarly likely to keep personal pension arrangements unchanged. However, either before or after retirement, pensions can either be shared (ie. payment to both parties but contingent on the combined circumstances of both) or split (ie. payment as required at the time of divorce and with the future operation of the distinct funds contingent on the circumstances of each individual partner).

Married workers with a personal pension are not required to take a joint and survivors annuity at retirement, except for the Appropriate Personal Pension element wherein they are also required to include a limited level of protection against price inflation.

In general a spouse's pension is likely to provide 50% of the amount that would have been payable to the original scheme Member. The payment to the surviving spouse will then continue to be paid in the same manner (for example, with limited price inflation).

Keith Bedell-Pearce
Executive Director

National Social Insurance Board
Stockholm, Sweden
September 12, 2001

Note that the publicly mandated financial account scheme, translated literally from Swedish the Premium Pension System, is managed by a public agency, Premiepensionsmyndigheten, which is referred to here using its Swedish acronym, the "PPM."

Question 1: Could you explain more about how Sweden minimizes individual investment risk (e.g. minimum benefit guarantees, etc.)?

1. The individual bears the risk of his or her own portfolio choice(s) in the Swedish financial account scheme. To help minimize the risks involved and to aid the participant in making an informed choice the following can be observed:

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[5] Whilst it may be difficult to compare like with like, a fact-finding visit to the US in 1999 by a group of pension specialists reached the conclusion that the equivalent charge in the U.S. was between 1.4% and 1.7% depending on the level of technology support, in practice this being Internet access and self-service.

[6] There is ongoing debate in the UK about the requirement for compulsory annuitisation at age 75.

(A) The basic requirement for a fund to operate in Sweden is that the fund complies with the rules of the EU directive on Undertakings for Collective Investment in Transferable Securities, the UCITS—directive. The Swedish regulations are an implementation of the directive. The Swedish regulations contain however some provision with regard to the disclosure of costs that are not included in the directive. However, to participate in the public scheme funds must provide share price information electronically to the PPM on all banking days. Fund values are published in the major newspapers on a daily basis and people can change funds at any time, if they so choose.

(B) The PPM has produced two publications—the Fund Catalogue and the brochure with instructions, guidance and so forth. The information includes systematically presented and easily comparable measures of risk and historical data on returns for all funds. People can gain some assistance in judging their personal risk profile with the help of questions in one of the brochures. The same information—and considerably more, for example on fund particulars, can be found on the PPM Web site "http://www.ppm.nu/">www.ppm.nu

(C) There is a general guarantee level that is available from age 65 and is financed with general revenues from the state budget. A full guarantee requires 40 years of residence in Sweden between the ages of 16 and 65. An individual has a right to a full guarantee amount if he or she no earnings-related benefit at all. Otherwise, the guarantee works as a supplement to whatever the individual has from the NDC and FDC schemes up to the maximum level that is guaranteed.

Question 2: Does Sweden provide any special accommodations for small FDC accounts? If so, what accommodations?

2. Sweden provides no special accommodations for small FDC accounts. Accounts are kept for everyone who has been registered in the system at sometime. Note that fund transactions can occur on any working day, but all transactions for a given fund are performed daily on a net (all purchases minus all sales) basis. The participating funds keep no individual accounts.

Question 3: How much time elapses between when contributions are earned and when they are deposited in the worker's investment choice? Are the funds invested or credited with interest during the iterim?

3. Around 18 months lapse on average between when funds are collected and when they are actually available for individual investments. This is because of the general taxation procedures: By law, Sweden establishes how much a person has earned (and contributions that should have been paid) after individuals and employers have filed their yearly tax returns. Money is kept on an interim account at the National Debt Office (Treasury) and earns a bond rate of return.

Question 4: How often can workers change their investment choices? Are they any additional charges for frequent changes in investment allocations?

4. Workers can switch funds as often as they like, free of cost to themselves. This way of dealing with switching is seen as being important especially in the initial years of the scheme. Also, fund switches have no tax consequences (like capital gains tax), which is a difference compared to the treatment of normal holdings in private investment funds.

Question 5: You mentioned in your testimony that the average administrative costs are less then 1%. Do you expect that the government's 0.3% share of the total charge will decrease as the system matures? Do you think the investment funds charges will decrease as the system matures?

5. First, the fee that PPM charges, 0.3 per cent, is at present not sufficient to cover total PPM costs, so the PPM is building up a debt in the National Debt Office. As the system grows, the money corresponding to the 0.3 per cent will grow too and after a few years the PPM will be able to pay back its debt. The debt will be fully paid off by the year 2018. From then on the PPM fee will be lowered to, perhaps, 0.1 per cent. (In fact, the PPM will probably have to lower the fee to 0.25 or 0.20 earlier to make the debt "last" all the way to 2018).

Second, as the system grows, the total assets held by funds will also grow. The PPM's rebate system reduces the actual fee for PPM as a fund's holdings of PPM assets increase. This will press fees down toward a level of 0.4 per cent—according to the PPM rebate schedule. This means that the long-run fee for the PPM and the average fund held by individuals could stabilize within the range of 0.5–0.7 per cent, depending on the distribution of individual choices among.private funds and where the PPM fee actually ends up.

Question 6: Is Sweden concerned that advertising and competition to attract investors could drive up administrative costs?

6. The Swedish scheme is designed to minimize advertising. There was considerable advertising when participant's made their first choices, probably because fund

managers realized that most people would not switch very often. There will be advertising peaks every year as people receive their account statements. However, there was relatively little advertising when account statements were sent out in 2001. This suggests that advertising costs will not be high. However, even here we will have to wait a while and analyze what happened.

Question 7: What is the administrative cost for annuitization?

7. The cost of creating and managing annuities is included in the overall fee of the PPM (see above).

Question 8: You mentioned workers receive an overall replacement rate of 54% from both the government-run pension and the employer pension, at a conservative interest rate. What do you estimate is the replacement rate for just the government portion of benefits (notional defined-contribution benefits plus funded defined-contribution benefits)?

8. Assuming a 5% real rate of return on financial assets, the public system, including both the NDC and FDC components, will give a replacement rate of around 52% at age 65 and 56% at age 66, for an individual who works all years from age 22—given present life expectancy estimates. (This can be derived from Table 2 in the appendix to my written statement.)

Question 9: How do you share individual accounts in the event of divorce? Can a man voluntarily give a portion of his account to his spouse if he chooses?

9. Spouses and registered partners can transfer their yearly FDC account increments to each other. The transfer must be one whole year's account increment. Spouses notify the intended transfer to a local insurance office by January 31 in the year in which the contributions are paid. The transfer continues, unless one of the spouses notifies the insurance otherwise. Money cannot be transferred back again, and the contribution is reduced by 14% upon transfer.

The reduction factor of 14% reflects the PPM actuary's assumptions about:

- how much more money will be transferred from men to women than vice versa
- how much longer women will live, compared to men
- an estimate of average fund returns
- to what extent transfers will be determined by the participant's knowledge of his or her own health conditions.

Question 10: How will the government invest the funds of a worker choosing a fixed annuity at retirement?

10. People can choose to keep their money in the investment funds of their choice even during the withdrawal period, or they can transfer all their funds to the PPM and claim a fixed annuity. The PPM will invest its funds in accordance with the rules in the Insurance Business Act (1982:713), i.e. the same rules that apply to private life insurance companies. This means a mix of equity (at present 25 per cent) and bonds of different kinds (75 per cent) but also an opportunity to expand some time in the future into, for example, real estate.

Question 11: Why did the government decide to include stocks in the "non-choosers" fund?

11. It was believed that on average the equity market would perform better than the bond market and that for this reason a mixed portfolio would be "fairer" than a pure bond fund for persons with little or no knowledge of financial markets, and who presumably would be among the main "participants" in this fund.

Question 12: Who decides how the non-choosers fund is invested? How does Sweden insure political considerations do not influence the fund's composition?

12. The Board of Directors are responsible for formulating a strategy for the "non-chooser" fund and the manager for executing it. The fund is to operate according to normal fund principles, and is audited. In principle, the audit should uncover investments that are not motivated by normal financial market considerations. (At the time of the introduction of the new system, Sweden already had some experience of public funds investing in the private equity market. Even within the framework of the old system, a small share of the reserve assets were invested in equities. The first equity fund in the PAYGO reserve system was established in 1974, and has been rated as one of Sweden's most successful funds on the equity market.)

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1. What percentage of retirees draws a minimum pension from the government? How is that figure expected to change over time as personal accounts buildup?

As of January 1999, the last month for which I have data, the government had supplemented 19,715 pensions, including 6,050 old-age pensions, out of over 300,000 pensions, in its role as the financial guarantor of last resort in the new private system. Because the new system has tougher requirements to qualify for the minimum pension and is far more efficient than the old one, the cost to the Chilean taxpayer of providing a general safety net is lower than under the old system. I would expect that figure to decrease over time, if the pension funds continue to have returns that are above 4 percent in real terms.

2. Chile has been criticized for having high administrative costs? Do you believe this criticism is accurate? What has the rate of return been net of administrative costs?

The often-cited figure of 18–20 percent represents administrative costs as a percentage of current contributions, which is not how administrative costs are usually measured. This figure is usually obtained by dividing the commission fee, which is on average equivalent to 2.3 percent of taxable wages, by the total contribution (10 percent plus the commission).[1] This calculation fails to take into account that the 2.3 percent includes the life and disability insurance premiums (about 0.7 percent of taxable wages on average) that workers pay, which are deducted from the variable commission, and thus overstates administrative costs as a percentage of total contributions.[2] Also, if, for instance, the mandatory contribution were lowered to 5 percent of total wages instead of 10 percent, then administrative costs measured as a percentage of the total contribution would increase from 18.69 percent to 31.51 percent (2.3/(2.3 + 5)), even if those costs measured in absolute terms or as a percentage of assets under management remained the same.

When administrative costs are compared to the old government-run system, the criticism is not accurate. Chilean economist Raúl Bustos Castillo has estimated the costs of the new system to be 42 percent lower than the average costs of the old system.[3] However, comparing the administrative costs of the old system with those of the new one is inappropriate, because the underlying assumption when making that comparison is that the quality of the product (or the product itself) being provided is similar under both systems, which is certainly not the case in Chile.

Furthermore, the Congressional Budget Office reported in 1999 that, “In Chile, the country with the longest experience with private retirement accounts, [administrative costs] can be equivalently expressed as 1 percent of assets, which is similar to costs of mutual funds in the United States.”[4] The CBO report goes on to say that, “It is difficult to convert a charge on contributions to a charge on assets (typical for a U.S. mutual fund). The calculation depends on the rate of return and the length of the investment horizon and therefore does not yield a single figure.”[5] Chilean economist Salvador Valdés has estimated the average annual cost of the AFP system to be equivalent to 0.84 percent of total assets under management over the life cycle of the worker, which is lower than the average cost of the mutual fund industry in Chile but higher than other savings alternatives.[6]

To the extent that such administrative costs are still considered too high, that is the result of government regulations on the commissions the AFPs can charge and on the investments these companies can make. The existence of a “return band” prevents investment product differentiation among the different AFPs. As a result, the way an individual AFP tries to differentiate itself from the competition is by offering better service to its customers. One way to provide better service would be to offer a discount on the commission fee to workers who fit a certain profile—e.g., workers who have maintained their account for an extended period of time or who contribute

[1] 2.3/(10+2.3) = 0.1869, or 18.69 percent.

[2] Commissions are also overstated in the case of workers who receive gifts or outright lump sums from sales agents as an enticement to transfer from one AFP to another.

[3] See Raúl Bustos Castillo, “Reforma a los Sistemas de Pensiones: Peligros de los Programas Opcionales en América Latina.” In Baeza and Margozzini, pp. 230–1.

[4] See Congressional Budget Office, *Social Security Privatization: Experiences Abroad,* sec. 2, p. 7 (January 1999).

[5] Ibid., sec. 3, p. 11.

[6] See Salvador Valdés, “Las Comisiones de las AFPs Caras o Baratas?” *Estudios Públicos,* Vol. 73 (Verano 1999): 255–91.

a certain amount of money to their accounts; however, government regulations do not allow that. Those regulations state that the AFPs may only charge a commission based on the worker's taxable income and expressed as a percentage of that income.

Another reason administrative costs are not as low as they could be is that AFPs have a monopoly in the administration of pension savings accounts. Mutual funds, banks, insurance companies, and individuals themselves are not allowed to manage those accounts. The existence of this monopoly (which is part of the fragmentation of the financial services industry in Chile across product lines) prevents the establishment of one-stop financial supermarkets, where consumers can obtain all their financial services if they so choose.[7] Such supermarkets would substantially reduce administrative costs by eliminating the duplication of commercial and operational infrastructure.

The average rate of return net of administrative costs for the average retirement savings account has ranged from 7.18 percent to 7.50 percent, depending on the type of account, from 1981 in April 2001, according to the Chilean government agency that regulates the industry.

3. Some people say that women and low-wage workers will disproportionally end up receiving the minimum benefit guarantee, increasing income disparity. Do you believe this is correct, and why?

That claim is partially accurate. It is true that women and low-wage workers are likely to accumulate less than the average worker. Women because they tend to earn less than men, have more irregular professional lives and may stop contributing to their accounts at age 60 (that age is set at 65 for men). (Women also tend to live longer, a factor that also contributes to making the average pension for women lower than the average pension for men, all things being equal.) All those characteristics are common to women everywhere and not just Chilean women and should not be considered features of the Chilean system. Since the new system gives every worker property rights in his or her contributions, every worker with 20 years of contributions will receive at least the minimum pension. That was not the case in the old pay-as-you-go government system, a system that especially penalized women (and other workers) with irregular professional lives.

Low-wage workers in general accumulate less than average workers because they are low-wage workers. Low-wage workers also tend to start working at an earlier age than other workers, which conceivably can make up for the smaller amount contributed per period, and to have a shorter life expectancy, which conceivably can allow workers to make larger withdrawals per period of time than other workers with a longer life expectancy.

Therefore, it is not correct to say that women and low-wage workers will disproportionally end up receiving the minimum pension. The reform was undertaken under the assumption that if a worker contributes to his account 10 percent of his salary for 35 years, and the real rate of return on his investment is 4 percent on average, he will have enough funds accumulated in his account upon retirement to fund a pension that is equivalent to 70 percent of the average salary over the last 10 years of his working life.

I think that focusing on whether income disparity increases under a private system or not is mistaken. What matters is that poor workers (as well as rich ones) have property rights in their contributions and can invest their savings in productive investments, so that they live their old age with comfortable means, even if other workers are much wealthier. The income disparity between Bill Gates and I, for instance, matters nothing to me. What matters to me is that Bill Gates has developed the tools that allow me to become a more productive worker and, consequently, earn a higher salary, which in turn allows me to live more comfortably now and in my old age.

4. You mention that the current commission structure encourages funds to seek out higher-wage workers. How would your suggestions to liberalize commission structure (allow funds to offer discount and different combinations of price and service) affect low-wage workers? Would funds be interested in attracting low-wage workers?

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[7] Allowing banks and other financial institutions to enter the AFP industry might present potential conflicts of interest. In principle, so long as those institutions compete under the same rules as other market participants, they should be allowed to administer the pension savings accounts of Chilean workers. It is likely that in a market environment banks would have to develop effective separations between the banking department and the administration of pension accounts to attract and protect workers' investments. Furthermore, the banks may invest in instruments of a higher quality to allay any fears that the public might have about the safety of the investments.

AFPs are not allowed to offer discounts for permanence, for making voluntary contributions, for groups, or for maintaining a specific balance in an account. For instance, if workers were able to negotiate group discounts, then their bargaining power would significantly increase. That would allow them to negotiate lower commissions, which would benefit low-wage workers the most. Funds would continue to seek out low-wage workers so long as the marginal cost of administering the account of a low-wage worker (of a group of low-wage workers) does not exceed the marginal revenue derived from administering those accounts. If the administration companies were allowed to adjust their service to the ability and desire of workers to pay for those services, low-wage workers would have nothing to lose if the commission structure were liberalized. Those concerned that the services provided to low-wage workers would drop to unacceptable low levels need not be, as the government already mandates a minimum of services that AFPs have to provide to their clients.

5. If the worker dies before retirement, what happens to the account balance? What if the worker dies after retirement?

If a worker dies before retirement, the balance in his account belongs to the beneficiaries of his estate, as workers now have property rights in their contributions. If a worker dies after retirement and if he chooses the programmed withdrawal option, then the balance in his account belongs to the beneficiaries of his estate. If he chooses to purchase an annuity from an insurance company, the balance in his account upon retirement is used to purchase the annuity and the account is closed, so money is left to the beneficiaries of his account.

6. The government has started allowing companies to lower their variable fees while raising flat fees. What effect will this have on workers at different wage levels?

Increases in flat fees and reductions in variable fees would eliminate the cross-subsidy from high-wage workers to low-wage workers that is present today.

7. Why did Chile choose to primarily base administrative fees on contributions and not assets?

When the system began, AFPs were allowed to charge fixed and variable commissions on assets under management, fixed and variable commissions on contributions, or any combination thereof. AFPs were not allowed to offer discounts for permanence, group discounts, discounts for making voluntary contributions, or for maintaining a specific balance in the account. In 1987, the commission structure was changed by eliminating all commissions on assets under management.[8] This change had the effect of providing a cross subsidy to (1) workers who do not contribute to their accounts regularly, because the fund manager is still providing a service (administering the account of those workers) for which he is not receiving compensation; and (2) to low-income workers, because the administrative costs of managing the account of wealthier workers are not proportionally higher than the administrative costs of managing the accounts of low-income workers, although the commissions paid by high-income workers *are* proportionally higher than those paid by low-income workers. In that sense, it cannot be said that the commission structure is fair, because some workers are paying more than others are for the same type of service.[9]

The rigidity in the commission structure prevents the AFPs from adapting the quality of their service to the ability to pay for that service of each segment of the population and also explains why the AFPs have an incentive to capture the accounts of high-income workers and attempt to do so by offering them better customer service.[10] AFPs will continue to spend money until the marginal cost of trying to capture new accounts is equal to the marginal revenue derived from those ac-

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[8] The issue of the commission structure has generated a vast literature in Chile. See, for instance, Salvador Valdés, “Comisiones de AFPs: Más libertad y menos regulaciones.” *Economía y Sociedad* (January/March 1997), pp. 24–26; Salvador Valdés, “Libertad de Precios para las AFP: Aún Insuficiente.” *Estudios Públicos* 68 (Spring 1997), pp. 127–47; José de Gregorio, “Propuesta de Flexibilización de las Comisiones de las AFP: Un Avance para Corregir las Ineficiencias.” *Estudios Públicos* 68 (Spring 1997), pp. 97–110; and Alvaro Donoso, “Los Riesgos para la Economía Chilena del Proyecto que Modifica la Estructura de las Comisiones de las AFP.” *Estudios Públicos* 68 (Spring 1997), pp. 111–126.

[9] The unfairness does not come from the fact that some workers are paying more than others for the same type of service. In a free-market economy sellers should be able to price discriminate if they wish to in order to capture the consumer's surplus. The problem here is that the government is mandating this price discrimination.

[10] Critics of privatization often point to the giving of toasters and other consumer goods as incentives to switch from one AFP to another as proof of the excesses of the Chilean system. Retail banks in the United States engage in similar practices on college campuses without any negative effects to the banking system or consumers. Of course, these practices have decreased as the banking industry has been deregulated and banks in the United States have found other ways of competing with each other, such as offering better interest rates or lower fees.

counts. In addition, the AFPs generally do not charge entry fees, even though the law allows them to do that, which means that consumers do not pay a penalty by changing from one AFP to another.[11]

8. How does the government certify the companies that offer individual accounts? How does the government keep politics out of the decision on what companies to certify and what investments they may use?

There is free entry and exit into the industry, even for foreign companies, provided that certain capital requirements, which are specified in advance, are met. The minimum capital required to create an AFP is 5,000 Unidades de Fomento (UF), a Chilean indexed unit of account. If an AFP has 5,000 affiliates, then the minimum increases to 10,000 UF; if it has 7,500 affiliates, then it increases to 15,000 UF; and when an AFP reaches 10,000 affiliates, the minimum capital requirement increases to 20,000 UF. By specifying clear and simple rules in advance, the whole process of creation of management companies is completely depoliticized. The government agency that regulates the industry sets, within the framework of the law, general investment rules in conjunction with the Central Bank of Chile. Both the Central Bank and the regulatory agency are highly technical and independent agencies.

9. Could you explain in more detail how the government's rate of return guarantee works? For example, doesn't the government require that investment returns exceeding certain amounts be set aside for buffering returns in case they fall below certain prescribed amounts in the future? Doesn't the government guarantee funds that go bankrupt? How many funds have gone bankrupt and at what cost to the government?

Each year each AFP must guarantee that the real return of the AFP is not lower than the lesser of (1) the average real return of all AFPs in the last 12 months minus 2 percentage points and (2) 50 percent of the average real return of all AFPs in the last 12 months. If the returns are higher than 2 percentage points above the average return of all AFPs over the last 12 months, or higher than 50 percent of the average return of all AFPs over the preceding 12 months, the "excess returns" are placed in a profitability fluctuation reserve, from which funds are drawn in the event that the returns fall below the minimum return required. For instance, if the industry's average return for the preceding 12 months is 10 percent and an AFP has a return of 17 percent, then the "excess returns" are 2 percentage points (10 percent plus 50 percent of the average return, which is 5 percent, equals 15 percent, which is the threshold in this case). If, on the other hand, the industry's average return is 2 percent and an AFP has a return of 4.5 percent, then the "excess returns" are 0.5 percentage points (2 percents plus two percentage points equals 4 percent, which is the threshold in this case, since it is higher than 2 percent plus 50 percentage of the average, 1 percent, which would be equal to 3 percent. Should an AFP not have enough funds in the profitability reserve, funds are drawn from a cash reserve, which is equivalent to 1 percent of total assets under management. If that reserve does not have enough funds, then the government makes up the difference and the AFP is liquidated. To date, no AFP has gone bankrupt, although three have been liquidated for not meeting the minimum capital requirements, so the cost to Chilean taxpayers has been zero. It is also worth noting that the system establishes two different legal entities for the management company and the fund it administers, which is the property of workers. So, it is possible that a management company go bankrupt (that is, its net worth is negative) without it affecting the fund.

10. Could you describe the pay out requirements for personal accounts?

The new private system provides workers with three different types of retirement benefits:

(a) **Old-Age Pensions.** Male workers must reach the age of 65 and female workers the age of 60 to qualify for this pension. However, it is not necessary for men and women who reach these respective ages to retire, nor do they get penalized if they choose to remain in the labor force. No other requirements are necessary.

(b) **Early Retirement Pensions.** To qualify for this option, a worker must have enough capital accumulated in his account to purchase an annuity that is (1) equal to at least 50 percent of his average salary during the last 10 years of his working life; and (2) at least 110 percent of the minimum pension guaranteed by the state.[12]

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[11] Entry fees are usually given back (or a part thereof) by sales agents as a rebate to their customers as an enticement to switch from one AFP to another. Exit fees are not allowed by law in an effort to promote competition.

[12] There is now a bill before the Chilean congress that would increase the percentage from 110 percent of the minimum pension to 150 percent.

(c) **Disability and Survivor's Benefits.** To qualify for a full disability pension, a worker must have lost at least two thirds of his working ability; to qualify for a partial disability pension a worker must have lost between 50 percent and two thirds of his working ability. Survivor benefits are awarded to a worker's dependents after the death of said worker. If he did not have any dependent individuals, whatever funds remain in his pension savings account belong to the beneficiaries of his estate.

Types of Pensions. There are three retirement options:

(a) **Lifetime Annuity.** Workers may use the money accumulated in their accounts to purchase a lifetime annuity from an insurance company. This annuity provides a constant income in real terms.

(b) **Programmed Withdrawals.** A second option is to leave the money in the account and make programmed withdrawals, the amount of which depends on the worker's life expectancy and those of his dependents. If a worker choosing this option dies before the funds in his account are depleted, the remaining balance belongs to the beneficiaries of his estate, since workers now have property rights over their contributions.

(c) **Temporary Programmed Withdrawals with a Deferred Lifetime Annuity.** This pension option is basically a combination of the first two. A worker who chooses this option contracts with an insurance company a lifetime annuity scheduled to begin at a future date. Between the start of retirement and the day when the worker starts receiving the annuity payments, the worker makes programmed withdrawals from his account.[13]

In all three cases a worker may withdraw in a lump-sum (and use for any purpose) those funds accumulated in his account over and above the money necessary to obtain a pension equal to at least 120 percent of the minimum pension and to 70 percent of his average salary over the last 10 years of his working life.

11. If a worker takes programmed withdrawals, but outlives his account balance, what happens? Is there a safety net to insure he still has a source of income?

If a worker outlives the balance in his account, then the government provides the minimum pension, as defined by the Chilean Congress, if that worker has contributed to his account for a minimum of 20 years. If a worker does not have at least 20 years of contributions, he may apply for a welfare-type pension that is lower than the minimum pension. So, yes, there is a safety net under the Chilean private pension system, as there was one under the old government-run system. However, since the new system is far more efficient than the old one, the cost to the Chilean taxpayer is considerably lower.

12. Chile has been criticized in the past for having high rates of transfers between funds. What actions has the government taken to help reduce transfer rates?

Because of investment regulations and rules on fees and commissions, product differentiation is low. Thus companies compete by offering gifts or other incentives for workers to switch to their companies. Switchovers increased dramatically from 1988, the year when the requirement to request in person the change from one AFP to another was eliminated, until 1997, when the government reintroduced some restrictions to make it more difficult for workers to transfer from one AFP to another. The number of transfers in 1998–2000 decreased to less than 700,000, less than 500,000 and slightly more than 250,000, respectively, from an all-time high of almost 1.6 million in 1997.

L. Jacobo Rodríguez
Assistant Director

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[13] This option is ideal for workers who are about to retire at a time when the value of their accounts is down.

Watson Wyatt Worldwide
Surrey, England

Congressman E. Clay Shaw, Jr.
Chairman,
Subcommittee on Social Security
Committee on Ways and Means
B316 Rayburn House Office Building
Washington, DC 20515
UNITED STATES

Dear Congressman Shaw:

Social Security and Pension Reform: Lessons from Other Countries—Questions

Thank you for the opportunity to speak before the Subcommittee on Social Security concerning Australia's approach toward Social Security reform. Detailed below are my responses to your questions in respect to my testimony of 31 July 2001.

Question 1: Could you explain what steps Australia takes to minimize individual investment risk?

1. Australia in respect to its second pillar does not adopt a position whereby systematic attempts are made to minimize individual investment risk. Indirect methods are used to provide consumers with an ability to identify and evaluate investment risk through effective disclosure of key features linked to associated retirement products. In effect regulators argue that through increasing the "transparency" of the retirement vehicle consumers will be best placed to evaluate their individual propensity toward investment risk. Additionally the role of the intermediary is in some part crucial in minimizing investment risk for the consumer. Central to the intermediary/ client relationship is the "know your client" rules whereby the intermediary should highlight or be aware of adverse investment risk that could affect consumers.

Question 2: How does Australia accommodate lower-wage workers to help insure their accounts are not consumed by administrative costs? Could you tell us more about Retirement Savings Accounts and the extent to which workers choose this type of account?

2. The structure of the superannuation industry in Australia accommodates lower-wage workers through specific types of low cost, high volume retirement accounts. Industry funds that are largely affiliated with trade unions offer retirement accounts with low fees as a result of lean administrative structures and distribution structures that are highly efficient and effective. Second Retirement Savings Accounts (RSAs), offered largely by banks provide low cost/high volume alternatives for consumers and product providers alike. These products have limited investment options and are mainly invested in fixed interest securities. In effect these products contain or reduce risk and minimize associated administrative costs. Such products are ideal for consumers who enter or leave the work force on a regular basis. RSAs are in part similar to certain aspects of the Thrift Savings Plan (TSP) in terms of providing consumers with easily understandable, low cost alternatives to that provided by commissioned intermediaries. An annual statement is normally provided to consumers that reflect the overall balance, fees charged and rates of return generated on the account. With the relatively high levels of market returns linked with equity based retirement accounts in recent years, the comparatively low investment returns generated by RSAs has meant that these accounts are generally unpopular. Additionally with little if any commissions being associated with intermediaries who sell RSAs such products have only reached a level of $A3.1 billion at March 2001. This is a growth of 6.1% since March 2000 with the share of total superannuation assets in RSAs remaining at less than 1%.

Question 3: Could you provide a brief description of the regulatory structure and rules that govern how superannuation policies are sold and switched? Could you describe the type of information workers are required to receive when buying superannuation products and on a regular basis?

3. Comparatively speaking Australia has suffered little if any consumer detriment linked with the sale and distribution of superannuation products. In 1998 the Australian government decided to separate regulatory responsibility for superannuation accounts between solvency (Australian Prudential Regulatory Authority) and consumer protection regulators (Australian Securities and Investment Commission). In respect of the selling of superannuation accounts consumers are required to have a needs analysis prepared by the intermediary that provides an analysis of his or her financial position and also details the recommendations made or attributed to

the corresponding retirement product. Such use of a needs analysis is fundamental to the "know your client" rules that are central too much of the regulation surrounding the selling and switching of retirement policies. Equally for switching a retirement policy, a needs analysis has to be completed by the intermediary justifying the move of the policy based on sound economic or financial grounds. Along with being provided with a needs analysis the consumer is required to be given a customer information brochure (CIB) that details the key features and policy illustrations of the product and also how complaints will be handled on both an external and internal basis. Finally a Customer Advice Record (CAR) is provided to the consumer that details the financial relationship that the intermediary has with the product manufacturer.

Question 4: Why did Australia choose to not regulate the structure or level of administrative charges, except in the case of small accounts?

4. Sound economic advantages exist for why administrative charges were not regulated in Australia with respect to financial services. It was the Federal Labour government's view of the day that market forces were best placed to set associated fee or administrative charges on these retirement products. It was felt that with appropriate disclosure consumers would be best placed to evaluate fee and commission levels and thus move toward product manufacturers who offered retirement products that were better value for money. Additionally the Federal government was concerned that if fee levels were set at a very low level market distortions would take place and that limited distribution of superannuation policies would take place. On an economic basis it was also argued that market efficiencies would be stifled if companies simply set administrative fees at a maximum permissible level.

Question 5: The Australian system has been criticized for having a substantial portion of the population take their account as a lump sum and end up receiving need-based benefits. What fraction annuitizes their accounts? How will the affect government expenditures on retirees in the future relative to the system prior to reform?

5. This criticism is quite dated and outmoded with respect to individuals taking lump sums versus annuity benefits. Alterations in taxation policy have meant that in recent years it has become less favourable for individuals to take a lump sum benefit. Often retirees take a retirement benefit as a lump sum, pay out their mortgage and invest the remainder in an allocated pension product. An allocated pension has grown sharply in Australia since their introduction in 1992. The product operates through a calculation of life expectancy versus the sum invested. Using associated actuarial calculations, an annual pension is paid until the initial amount capital plus net returns are exhausted. Such products are more advantageous compared with traditional annuity products in that the rates of return have been significantly higher and that the consumer has greater flexibility to pass capital residues onto their spouse or siblings. Lump sums, excluding outward transfers, accounted for 79% ($5.6 billion) of the benefits paid during the March quarter. The remaining 21% ($1.5 billion) of benefits were paid in pensions. Outward transfers accounted for 57% of all fund withdrawals during the March quarter. As mentioned, much of the lump sum payments are reinvested into traditional allocated pension products. You will note in my testimony that I provided estimates of Australia's expenditure as a percentage of GDP for its corresponding first pillar. Anecdotal evidence indicates that overall expenditure will be contained as average superannuation balances progressively increases over time.

Question 6: Why do so few workers annuitize their accounts, and why do even fewer choose a lifetime annuity despite tax incentives to do so?

6. This question has been largely answered in Question 5. I would add that annuity rates in Australia are low by comparison with Europe and North America as a result of a smaller population base. In contrast pension streams generated by allocated pension products are much higher which has led to a rapid increase in this type of retirement product held by Australians. It seems on a cultural level that Australians are more reluctant to purchase annuities as they see life insurance companies largely benefiting if an individual dies too early rather than living too long.

Question 7: How many investment choices are workers in corporate, industry, or public sector funds provided?

7. The number of investment choices varies widely between the various types of superannuation schemes. As an average between 5–7 investment choices are largely provided by superannuation schemes as whole. Moreover employees are demanding greater investment choice in their superannuation schemes as they recognize that a diversified portfolio is crucial in maximizing overall retirement returns. In general industry funds have lower levels of investment choice compared with corporate or retail superannuation, although this general observation is changing rapidly as in-

dustry funds increase their abilities to publicly offer services to the broader work force.

Question 8: What happens to account balances if a married worker divorces or dies before retirement?

8. The question is largely dependent on the approach and the rules linked with the superannuation trust deed. Generally pre-determined spouse benefits will be provided by the plan based on certain levels of coverage and Membership of the superannuation scheme. Intended legislation will see superannuation balances considered in the divorce settlements of married or defacto couples in Australia. At this stage some ambiguity still exists over how differing types of superannuation accounts will be treated after divorce. This point is particular relevant with regard to corporate defined benefit plans and how associated superannuation will be segregated or transferred into the non-members' (spouse's) name.

Finally on a more personal level Congressman Shaw I would like to express my deepest regret over the terrorist attack launched against the United States of America this week. I do hope that the Committee and its staff are safe and well and that this senseless act can be resolved speedily.

Yours sincerely,

David O. Harris
Consultant

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