SIXTH IN A SERIES OF SUBCOMMITTEE HEARINGS ON PROTECTING AND STRENGTHENING SOCIAL SECURITY

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

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U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Advisory of June 9, 2005 announcing the hearing	2

WITNESSES

U.S. government Accountability Office, Barbara D. Bovbjerg, Director, Education, Work force, and Income Security	5
The World Bank, Estelle James	16
Cato Institute's Project on Global Economic Liberty, Ian Vasquez	46
Center for Economic Policy Research, Dean Baker	60
Organisation for Economic Co-operation and Development, Edward Whitehouse	20
Thomas A. Roe Institute for Economic Policy Studies, David C. John	66
TOR Financial Consulting, Limited, David O. Harris	53
Watson Wyatt Worldwide, Julia Lynn Coronado	38

SUBMISSIONS FOR THE RECORD

Daniels, Margaret, Hurst-Euless-Bedford School District, Hurst, TX, statement	105
Fransen, Marilyn, Rapid City, SD, statement	105
Gathro, Ronald J., Springfield, MA, statement	107
Hahn, Bruce, American Homeowners Grassroots Alliance, Arlington, VA, statement	108
[Pending.]	

SIXTH IN A SERIES OF SUBCOMMITTEE HEARINGS ON PROTECTING AND STRENGTHENING SOCIAL SECURITY

THURSDAY, JUNE 16, 2005

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

The Subcommittee met, pursuant to notice, at 10:00 a.m., in room B–318, Rayburn House Office Building, Hon. Jim McCrery (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
June 9, 2005
No. SS–6

CONTACT: (202) 225–9263

McCrery Announces Sixth in a Series of Subcommittee Hearings on Protecting and Strengthening Social Security

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the sixth in a series of Subcommittee hearings on protecting and strengthening Social Security to hear the views of Members of the House. **The hearing will take place on Thursday, June 16, 2005, in room B–318 Rayburn House Office Building, beginning at 10:00 a.m. or immediately following the conclusion of the full Committee hearing.**

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:

The United States is not alone in facing the challenges of providing retirement security for an aging population. The world is undergoing a demographic transformation. By 2050, the number of individuals aged 60 years and over will increase from 600 million to almost 2 billion, according to findings by the United Nations Second World Assembly on Aging. As a result, the proportion of people aged 60 years and over is expected to double from 10 percent to 21 percent.

Many countries have already addressed the financial pressures that an aging population places on their social security programs, by reducing growth of traditional "pay-as-you-go" benefits, increasing tax revenues and creating personal accounts to help pre-fund future benefits. Policymakers in the United States can learn from the experiences of other countries by examining the effects of their choices on beneficiaries, public pension financing and their economies. While these choices are a reflection of a country's culture, values and previously existing social insurance system, they also provide a broad array of tested options for consideration.

In announcing the hearing, Chairman McCrery stated, "Many other nations face similar or even worse challenges, compared with the United States, in providing retirement security for seniors. Often these nations have updated their retirement systems by adding personal accounts to their programs, as well as modifying the benefit structure and taxes. As we examine options for strengthening Social Security for Americans, we can learn from what did or did not work well in other countries."

FOCUS OF THE HEARING:

The Subcommittee will examine the experiences of other countries in reforming their social security systems, including the effect of their choices in modifying traditional benefits and designing personal accounts on individual's benefits, social security financing, and the countries' economies.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, June 30, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item 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 submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies 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. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

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 MCCRERY. The hearing will come to order. Good morning, everyone. Welcome to our sixth Subcommittee hearing on protecting and strengthening Social Security. Today we will hear about changes that other countries have made to their Social Security promise as they, like us, cope with how both to ensure the retirement security of an aging population. Oliver Wendell Holmes, Sr., a physician and father of the great jurist, said, quote, "Knowledge and temper shouldn't be much used until they are seasoned." During our hearing this morning we will have the benefit of seasoned knowledge from around the world as we will hear from Aus-

tralia, Chile, Sweden, the United Kingdom, and others with experience in making significance reforms to their Social Security systems. Each nation's decisions are a reflection of their culture, values, and previously existing social insurance programs, and while the countries we will examine today have different economies and governmental structures from those of the United States, they face similar demographic changes. This gives us the opportunity to learn from their experiences what went well and what could be improved.

All countries, like the United States, first had to decide whether or not to act in advance of a demographic crush that would eventually lead to a funding crisis in their Social Security program. They then faced the same basic choices we are now considering on how best to strengthen their Social Security programs, reduce promised benefits, increase taxes, or increase rates of return by prefunding future benefits. As we will hear today, dozens of countries decided to prefund benefits through personal accounts. They have taken a broad range of approaches in designing and financing the personal accounts, which gives U.S. policy makers a wealth of tested options from which to learn. We will also hear about the modifications other countries have made in the benefits and financing of their traditional defined benefit programs, and how the combination of all their choices have affected individual beneficiaries as well as their countries' economies. I welcome our distinguished panel, some of whom have traveled great distances to appear before us today, and I look forward to hearing their views. Now, I would like to ask the Ranking Member of the Subcommittee, Mr. Levin, for his comments.

Mr. LEVIN. Thank you very much, and we do have an impressive array, and I look forward to the testimony. It is very true the United States is not alone in having dealt with this problem and we need the experience of other nations. I hope as we do that we will also continue to look at the experience of our Nation. I think there is much to learn from how we have handled Social Security, and it is my judgment that our experience has shown that the Social Security system has worked very well and should not be replaced. As I look at the experience of other countries, I think that it does raise questions of risk, of cost, also of reduction in benefits. So, we are anxious to hear what you have to say and draw upon the experience of other countries. Remembering the benefits that have accrued to our Nation, I hope we don't get lost in terms. As the Chairman knows, I think "prefunding" is now the word that is used instead of privatization, and we are very strong in our belief that privatization would be a serious mistake. So, let's get on. We have one, two, three, four, five, six, seven, eight. You exceed the record for the size of the panel, and this is going to be a busy day here on the floor. So, our colleagues may move in and out as they have other obligations, but we look forward to your testimony and I am sure there will be some serious questions. Thank you.

Chairman MCCRERY. Thank you, Mr. Levin. I do want to point out though that the two terms are not synonymous. "Privatization" and "prefunding" are not synonymous, and I think we will hear today that some countries have a blend of what you might term

privatization and a guaranteed benefit structure. So, I think we should wait and listen and try to learn from their experiences.

Mr. LEVIN. All for it.

Chairman MCCRERY. Not trying to characterize what we or anyone else is trying to do. With that we will begin this morning's hearing. Our first witness is a familiar witness before the Committee on Ways and Means, Barbara Bovbjerg. Ms. Bovbjerg is a respected member of the bureaucracy here in our Nation's Capitol. Believe it or not, there are those, and she is certainly one. She is the Director of Education, Work force, and Income Security for the U.S. government Accountability Office (GAO). Then we have Dr. Estelle James, Consultant and former Lead Economist at the World Bank; Edward Whitehouse, who is the Administrator, Social Policy Division, Organisation for Economic Co-operation and Development (OECD) in Paris, France; Julia Coronado, Senior Analyst with Watson Wyatt Worldwide; and Ian Vasquez, Director of the Cato Institute's Project on Global Economic Liberty; David Harris, Managing Director, TOR Financial Consulting Ltd., Suffolk, United Kingdom (UK); Dean Baker, Co-Director of the Center for Economic and Policy Research; David John, Research Fellow at the Heritage Foundation.

We are very pleased to have all of you with us this morning, and you have all submitted written testimony which will be included in its entirety in the record, and this morning we would ask that you summarize your written testimony in about 5 minutes. For those of you who may not be familiar with the process, there is a little machine on the front of your table and it is has got lights on it. The green light stays on about 4 minutes, then an amber light comes on, which will be on for about 1 minute; 4 plus 1 is 5. When the red light comes on that means your time is basically up, although I will certainly allow you a few extra moments if you are not finished rounding up your testimony. So, that is the procedure. Then, after each of you has testified, Members of the panel will ask questions that we would ask you to respond to. So, Ms. Bovbjerg, if you will begin.

STATEMENT OF BARBARA D. BOVBJERG, DIRECTOR OF EDUCATION, WORKFORCE, AND INCOME SECURITY, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. BOVBJERG. Thank you very much, Mr. Chairman, and thank you for the kind words. I am really pleased that you have invited me here again today to discuss other countries' experiences with public pension reform. Many countries, including the United States, are grappling with demographic change and its effect on their national pension systems and on their economies. Some nations have already undertaken pension reform, we may draw lessons from their experiences for the United States. Today I will present the preliminary results of our ongoing study for this Subcommittee of other nations' pension reforms. Our work examines the 30 member countries of the OECD plus Chile, the Nation that pioneered the use of individual accounts. I have organized my remarks around potential lessons from three general types of public pension reform approaches: first, adjustments within existing pay-as-you-go (PAYGO) systems; second, the creation of dedicated re-

serves for advanced funding; and third, reforms involving the creation of individual accounts.

First, lessons from changes to an existing system. Nearly all countries we studied have reduced benefits in their PAYGO systems as part of their reforms, and most have also raised contributions. Benefit reductions ranged from formula changes to reduced cost-of-living increases after retirement to creating a closer link between benefits and the contributions financing them. Contribution increases ranged from increasing contribution rates, to broadening the base on which contributions are levied, to increasing the number of years workers contribute. These changes were made to help ensure the financial stability of the existing system. At the same time, these countries took measures to ensure minimum retirement incomes. Most achieved this by providing a targeted means tested benefit. At least seven provided what they termed a basic retirement benefit of either a given amount per month or a minimum amount per year of contribution instead. Countries taking this approach were striving to achieve a careful balance between assuring benefit adequacy and maintaining incentives to work and save. Some like the UK retain such incentives by adopting so-called savings credits that allow retirees near the minimum pension level to retain a portion of any additional income they might earn.

Let me turn now to countries' use of pension reserve funds. Eighteen of the countries accumulate reserve funds, and one clear lesson is that early action matters. Establishing reserve funds well before they will be needed makes it substantially more likely that assets will accumulate in time to do some good. Also, somewhat obviously, walling off these assets solely for the purpose of financing retirement programs makes a difference. Succumbing to temptation to spend such reserves to fund other public priorities undermines their original purpose.

Finally, lessons regarding individual accounts. Eleven of the countries we examined restructured their pensions to incorporate some form of individual accounts. A major challenge for such accounts was how to pay for them. All countries creating individual accounts also made changes to their PAYGO systems to help reduce transition costs and to use budget surpluses as well. The countries that allow workers to opt in and out of the accounts had difficulty estimating costs and had to make additional changes to both the accounts and the PAYGO programs to compensate. One lesson here involves the tradeoff between allowing workers to maximize returns and ensuring benefit adequacy. Some countries address this issue by setting a guaranteed rate of return. Although this approach has assured a level of income adequacy, it also resulted in limited investment diversification which then brings returns below levels they might have otherwise achieved. All countries that adopted individual accounts also provide some sort of minimum benefit guarantee, but the guarantee itself can provide an incentive for risky investment decisions and a disincentive for voluntary contributions. The experience of other nations with individual accounts also suggests the importance of effective regulation. Some countries learned the hard way that regulating individuals' investment options was an important aspect of a program of accounts. Similarly, controlling fees and other administrative costs

that can erode account returns can help ensure the viability of such a system.

In conclusion, the countries we studied adopted different approaches that varied with the characteristics of their existing pension systems and with their economic and political conditions. Reforms adopted in one country are thus not easily replicated in another or, if replicated, don't necessarily lead to the same outcomes. Nonetheless, it is clear that effective reform requires cutting benefits, raising revenues, or both, and doing so well before the anticipated demographic changes take place. No matter what type of reform is undertaken, the sustainability of the pension system will depend on the health of the national economy. Reforms that offer incentives to postpone retirement, encourage employment and savings, and promote growth are most likely to produce an adequate and functionally sound system of retirement income over the long-term. That concludes my statement. I await your questions.

[The prepared statement of Ms. Bovbjerg follows:]

Statement of Barbara D. Bovbjerg, Director. Education, Workforce, and Income Security, U.S. Government Accountability Office

SOCIAL SECURITY REFORM

Preliminary Lessons from Other Countries' Experiences

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our preliminary findings concerning other countries' experiences with national pension reform. Many countries, including the United States, are grappling with demographic change and its effect on their national pension systems. With rising longevity and declining birth rates, the number of workers for each retiree is falling in most developed countries. A rising dependency ratio is straining the finances of national pension programs, particularly programs in which contributions from current workers fund payments to current beneficiaries—a form of financing known as "pay-as-you-go" (PAYG). Demographic and economic challenges are less severe in the U.S. than in many other developed countries—the birth rate is not as low, a greater number of older people stay in the labor force, and immigration continues to provide young workers. Yet projections show that the Social Security program faces a long-term financing problem. Because some countries have already undertaken national pension reform efforts to address demographic changes similar to those occurring in the U.S., we may draw lessons from their experiences. It is important to remember, however, that reforms in one country may not be easily replicated in another or may not lead to the same outcome.

We are in the process of preparing a report covering the experiences of countries that may be applicable to our own debate over reforms to the U.S. Social Security program—the 30 members of the Organisation for Economic Co-operation and Development (OECD) plus Chile, the nation that pioneered the use of individual accounts.[1] My remarks today are based on an ongoing study and our observations are preliminary. We are focusing on (1) adjustments to existing PAYG national pension programs, (2) the creation of national pension reserve funds to help finance PAYG pension programs, and (3) reforms involving the creation of individual accounts.

To date our study has included interviews with, and analysis of materials provided by, officials and interest group representatives in Washington, D.C., Paris, and London. We met with pension experts and country specialists at the OECD as well as French and British experts, officials, and interest group representatives. We conducted our review in accordance with generally accepted government auditing standards.

In summary, all OECD countries have, to some extent, reformed their national pension systems, and may offer lessons for the U.S. Countries' experiences adjusting

[1] The OECD is a forum for the governments of 30 market democracies to work together on economic, social, environmental, and governance issues. The OECD works to promote economic growth, financial stability, trade and investment, technology, innovation, and development co-operation.

PAYG national pension programs highlight the importance of considering how modifications will affect the program's financial sustainability, its distribution of benefits, the incentives it creates, and public understanding of the new provisions. Nearly all of the countries we are studying reduced benefits, and most have also increased contributions, often by increasing statutory retirement ages. Countries with national pension reserve funds designed to partially pre-fund PAYG pension programs provide lessons about the importance of early action and effective management. Some funds that have been in place for a long time have accumulated significant reserves to strengthen the finances of national pension programs. Countries that insulate pension reserve funds from being directed to meet social and political objectives may be better equipped to fulfill future pension commitments. In addition, regular disclosure of fund performance supports sound management and administration, and contributes to public education and oversight. Countries that have adopted individual account programs—which may also help pre-fund future retirement income—offer lessons about financing the existing PAYG pension program as the accounts are established. Countries that have funded individual accounts by directing revenue away from the PAYG program while continuing to pay benefits to PAYG program retirees have expanded public debt, built up budget surpluses in advance of the reform, cut back or eliminated the PAYG programs, or some combination of these. Important lessons regarding the administration of individual accounts include the need for effective regulation and supervision of the financial industry to protect individuals from avoidable investment risks. In addition, public education is increasingly important as the national pension system becomes more complex.

Background

Social Security's projected long-term financing shortfall stems primarily from the fact that people are living longer and having fewer children. As a result, the number of workers paying into the system for each beneficiary is projected to decline. This demographic trend is occurring or will occur in all OECD countries. Although the number of workers for every elderly person in the U.S. has been relatively stable over the past few decades, it has already fallen substantially in other developed countries. The number of workers for every elderly person in the U.S. is projected to fall from 4.1 in 2005 to 2.9 in 2020. In nine of the OECD countries, this number has already fallen below the level projected for the U.S. in 2020. This rise in the share of the elderly in the population could have significant effects on countries' economies, particularly during the period from 2010 to 2030. These effects may include slower economic growth and increased costs for aging-related government programs.

Historically, developed countries have relied on some form of a PAYG program and have used a variety of approaches to reform their national pension systems.[2] In many cases, these approaches provide a basic or minimum benefit as well as a benefit based on the level of a worker's earnings. Several countries are preparing to pay future benefits by either supplementing or replacing their PAYG programs. For example, some have set aside and invested current resources in a national pension reserve fund to partially pre-fund their PAYG program. Some have established fully funded individual accounts. These are not mutually exclusive types of reform. In fact, many countries have undertaken more than one of the following types of reform:

- **Adjustments to existing pay-as-you-go systems.** Typically, these are designed to create a more sustainable program by increasing contributions or decreasing benefits, or both, while preserving the basic structure of the system. Measures include phasing in higher retirement ages, equalizing retirement ages across genders, and increasing the earnings period over which initial benefits are calculated. Some countries have created notional defined contribution (NDC) accounts for each worker, which tie benefits more closely to each worker's contributions and to factors such as the growth rate of the economy.
- **National pension reserve funds.** These are set up to partially pre-fund PAYG national pension programs. Governments commit to make regular transfers to these investment funds from, for example, budgetary surpluses. To the extent that these contribute to national saving, they reduce the need for future borrowing or large increases in contribution rates to pay scheduled benefits.

[2] In other countries, "social security" often refers to a wide range of social insurance programs, including health care, long-term care, workers' compensation, unemployment insurance, etc. To generalize across countries, we use "national pensions" to refer to mandatory countrywide pension programs providing old-age pensions. We use "Social Security" to refer to the U.S. Old-Age, Survivors, and Disability Insurance Program since that is how the program is commonly known.

Funds can be invested in a combination of government securities and domestic as well as foreign equities.[3]

- **Individual accounts.** These fully funded accounts are administered either by employers or the government or designated third parties. The level of retirement benefits depends largely on the amount of each person's contributions into the account during their working life, investment earnings, and the amount of fees they are required to pay.

We are applying GAO's Social Security reform criteria to the experiences of countries that are members of the OECD as well as Chile, which pioneered individual accounts in 1981. We are assessing both the extent to which another country's circumstances are similar enough to those in the U.S. to provide a useful example and the extent to which particular approaches to pension reform were considered to be successful. Countries have different starting points, including unique economic and political environments. Moreover availability of other sources of retirement income, such as occupation-based pensions, varies greatly. Recognizing this, GAO uses three criteria for evaluating pension reforms:

- **Financing Sustainable Solvency.** We are looking at the extent to which particular reforms influence the funds available to pay benefits and how the reforms affect the ability of the economy, the government's budget, and national savings to support the program on a continuing basis.
- **Balancing Equity and Adequacy.** We are examining the relative balance struck between the goals of allowing individuals to receive a fair return on their contributions and ensuring an adequate level of benefits to prevent dependency and poverty.
- **Implementing and Administering Reforms.** We are considering how easily a reform is implemented and administered and how the public is educated concerning the reform.

Because each country is introducing reforms in a unique demographic, economic, and political context these factors will likely affect reform choices and outcomes. For instance, several European countries we are reviewing have strong occupation-based pension programs that contribute to retirement income security. In addition, some countries had more generous national pensions and other programs supporting the elderly than others. All countries also provide benefits for survivors and the disabled; often these are funded separately from old age benefit programs. Some countries are carrying out reforms against a backdrop of broader national change. For example, Hungary and Poland were undergoing large political and economic transformations as they reformed their national pension systems. All of these issues should be considered when drawing lessons.

In addition to the adjustments that countries have made to their existing PAYG systems, many countries have undergone other changes as well, indicating that change may not be a one-time experience. (See table 1.) Understanding the outcomes of a country's reform requires us to look at all of the changes a country has made.

Table 1: Countries' National Pension Reforms

Groups of countries undertaking different types of reform [a]			
Only adjustments to PAYG	**Adjustments to PAYG and National Pension Fund**	**Adjustments to PAYG and Individual Accounts**	**All Three Types**
Austria	Belgium	Australia	Denmark
Czech Republic [b]	Canada	Chile [d]	Sweden
Italy	Finland	Hungary	Switzerland [g]
Germany [c]	France	Iceland [e]	
Turkey	Greece	Mexico	

[3] Reserve funds act as budgetary devices, or "disciplinary" devices, especially where they have been recently created. They help contain expenditures. Such containment is needed to achieve sustainable fiscal surplus.

Table 1: Countries' National Pension Reforms—Continued

Groups of countries undertaking different types of reform [a]			
Only adjustments to PAYG	**Adjustments to PAYG and National Pension Fund**	**Adjustments to PAYG and Individual Accounts**	**All Three Types**
	Ireland	Poland	
	Japan	Slovak Republic	
	Korea	UK [f]	
	Luxembourg		
	Netherlands		
	New Zealand		
	Portugal		
	Norway		
	Spain		
	U.S.		

Source: OECD, International Social Security Association, and the Social Security Administration.

[a] Member nations of the OECD and Chile.

[b] The Czech Republic's defined contribution account program is not included as an "individual account reform" as it is a voluntary supplementary program. For a discussion of these accounts, see U.S. General Accounting Office, *Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts,* GAO–03–309 (Washington, D.C.: Mar. 10, 2003), p. 46–54.

[c] Germany's Riester pension program is not included as an individual account reform because it is a supplement to the mandatory national pension program, rather than an alternative. For a discussion of these accounts, see U.S. General Accounting Office, *Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts,* GAO–03–309 (Washington, D.C.: Mar. 10, 2003), p. 55–63.

[d] Chile is not an OECD country, but was included in our study because it pioneered individual account reforms.

[e] Iceland's mandatory occupation-based pension program allows for the creation of defined contribution individual accounts as a complement to defined benefit pensions. However, in practice, employers have not yet established these. Voluntary supplementary individual accounts are also available.

[f] The UK requires either participation in a state earnings-related pension program or an approved alternative including individual accounts.

[g] Switzerland's mandatory occupation-based pensions provide individual accounts that accrue credits at at least a minimum prescribed interest rate.

Adjustments to Existing PAYG Programs Show Importance of Sustainability, Safety Nets, and Incentives to Work and Save

The experiences of the countries that have adjusted their existing PAYG national pension programs highlight the importance of considering how modifications will affect the program's financial sustainability, its distribution of benefits, the incentives it creates, and the extent to which the public understands the new provisions.

PAYG Adjustments Prove Important to Financial Sustainability

To reconcile PAYG program revenue and expenses, nearly all the countries we studied have decreased benefits and most have also increased contributions, often in part by increasing retirement ages. Generally countries with national pension programs that are relatively financially sustainable have undertaken a package of several far-reaching adjustments. The countries we are studying increased contributions to PAYG programs by raising contribution rates, increasing the range of earnings or kinds of earnings subject to contribution requirements, or increasing the retirement age. Most of these countries increased contribution rates for some or all workers. Canada, for example, increased contributions to its Canadian Pension Plan from a total of 5.85 percent to 9.9 percent of wages, half paid by employers and half by employees. Several countries, including the UK, increased contributions by expanding the range of earnings subject to contributions requirements.

Nearly all of the countries we are studying decreased scheduled benefits, using a wide range of techniques. Some techniques reduce the level of initial benefits; others reduce the rate at which benefits increase during retirement or adjust benefits based on retirees' financial means.

- Increased years of earnings. To reduce initial benefits several countries increased the number of years of earnings they consider in calculating an average

lifetime earnings level. France previously based its calculation on 10 years, but increased this to 25 years for its basic public program.

- Increased minimum years of contributions. Another approach is to increase the minimum number of years of contributions required to receive a full benefit. France increased the required number of years from 37.5 to 40 years. Belgium is increasing its minimum requirement for early retirement from 20 to 35 years.
- Changed formula for calculating benefits. Another approach to decreasing the initial benefit is to change the formula for adjusting prior years' earnings. Countries with traditional PAYG programs all make some adjustment to the nominal amount of wages earned previously to reflect changes in prices or wages over the intervening years. Although most of the countries we are studying use some kind of average wage index, others, including Belgium and France, have adopted the use of price indices. The choice of a wage or price index can have quite different effects depending on the rate at which wages increase in comparison to prices. We see variation in the extent to which wages outpace prices over time and among countries.
- Changed basis for determining year-to-year increases in benefits. In many of the countries we are studying, the rate at which monthly retirement benefits increase from year-to-year during retirement is based on increases in prices, which generally rise more slowly than earnings. Others, including Denmark, Ireland, Luxembourg, and the Netherlands, use increases in earnings or a combination of wage and price indices. Hungary, for example, changed from the use of a wage index to the Swiss method—an index weighted 50 percent on price changes and 50 percent on changes in earnings.
- Implemented provisions that provide a closer link between pension contributions and benefits. Countries that have adopted this approach stop promising a defined level of benefits and instead keep track of notional contributions into workers' NDC accounts. Unlike individual accounts, these notional defined accounts are not funded. Current contributions to the program continue to be used largely to pay benefits to current workers, while at the same time they are credited to individuals' notional accounts. When these programs include adjustments that link benefits to factors such as economic growth, longevity, and/or the ratio of workers to retirees, they may contribute to the financial sustainability of national pension systems.

Several countries, such as Sweden and the UK, have undertaken one or more of these adjustments to their PAYG programs and have achieved, or are on track to achieve relative financial sustainability. Others, including Japan, France, and Germany, may need additional reforms to fund future benefit commitments.

Maintenance of a Safety Net and Work and Saving Incentives Proved Important

All of the countries have included in their reforms provisions to ensure adequate benefits for lower-income groups and put into place programs designed to ensure that all qualified retirees have a minimum level of income. Most do so by providing a targeted means-tested program that provides more benefits to retirees with limited financial means. Two countries—Germany and Italy—provide retirees access to general social welfare programs that are available to people of all ages rather than programs with different provisions for elderly people.

Twelve countries use another approach to providing a safety net: a basic retirement benefit. The level of the benefit is either a given amount per month for all retirees or an amount based on years of contributions to the program. In Ireland, for example, workers who contribute to the program for a specified period receive a minimum pension. Chile set a minimum pension equal to the minimum wage—about one-quarter of average earnings as of 2005. In addition, several of the countries we are studying give very low-income workers credit for a minimum level contribution. Other countries give workers credit for years in which they were unemployed, pursued postsecondary education, or cared for dependents.

In selecting between the many reform options, policy makers need to strike a careful balance among the following objectives: provide a safety net, contain costs, and maintain incentives to work and save. Costs can be high if a generous basic pension is provided to all eligible retirees regardless of their income. On the other hand, means-tested benefits can diminish incentives to work and save. The UK provides both a basic state pension and a means-tested pension credit. Concerned about the decline in the proportion of preretirement earnings provided by the basic state pension, some have advocated making it more generous. Others argue that focusing safety-net spending on those in need enables the government to alleviate pensioner poverty in a cost effective manner. However, a guaranteed minimum income could reduce some peoples' incentive to save. In view of this disincentive, the UK adopted

an additional means-tested benefit that provides higher benefits for retirees near the minimum income level. This benefit, called the savings credit, allows low-income retirees near the minimum pension level to retain a portion of their additional income. However, any loss of income due to means-testing still diminishes incentives to save. Without changes to pension rules, the proportion of pensioners eligible for means-tested income is expected to increase to include almost 65 percent of retiree households by 2050.

Implementation, Administration, and Public Education Are Important

The extent to which new provisions are implemented, administered, and explained to the public may affect the outcome of the reform. Poland, for example, adopted NDC reform in 1999, but the development of a data system to track contributions has been problematic. As of early 2004, the system generated statements indicating contributions workers made during 2002, but there was no indication of what workers contributed in earlier years or to previous pension programs. Without knowing how much they have in their notional defined accounts, workers may have a difficult time planning for their retirement. Some governments have had limited success in efforts to educate workers about changes in provisions that will affect their retirement income. For example, a survey of women in the UK showed that only about 43 percent of women who will be affected by an increase in the retirement age knew the age that applied to them.

Early Action and Effective Management Help Make National Pension Reserve Funds Successful

Another type of pension reform is the accumulation of reserves in national pension funds, which can contribute to the system's financial sustainability depending on when the funds are created or reformed and how they are managed. Countries that chose to partially pre-fund their PAYG programs decades ago have had more time to amass substantial reserves, reducing the risk that they will not meet their pension obligations. A record of poor fund performance has led some countries to put reserve funds under the administration of relatively independent managers with the mandate to maximize returns without undue risk.

Early Action Matters

Establishing reserve funds ahead of demographic changes—well before the share of elderly in the population increases substantially—makes it more likely that enough assets will accumulate to meet future pension obligations. In countries such as Sweden, Denmark, and Finland, which have had long experiences with partial pre-funding of PAYG programs, important reserves have already built up. These resources are expected to make significant contributions to the long-term finances of national pension programs. Other countries that have recently created pension reserve funds for their pension program have a tighter time frame to accumulate enough reserves before population aging starts straining public finances. In particular, the imminent retirement of the baby-boom generation is likely to make it challenging to continue channeling a substantial amount of resources to these funds. France, for example, relies primarily on social security surpluses to finance its pension reserve fund set up in 1999, but given its demographic trends, may be able to do so only in the next few years. Similarly, Belgium and the Netherlands plan on maintaining a budget surplus, reducing public debt and the interest payments associated with the debt, and transferring these earmarked resources to their reserve funds. However, maintaining a surplus will require sustained budgetary discipline as a growing number of retirees begins putting pressure on public finances.

Effective Management Can Contribute to Financial Sustainability

Examples from several countries reveal that pre-funding with national pension reserve funds is less likely to be effective in helping ensure that national pension programs are financially sustainable if these funds are used for purposes other than supporting the PAYGO program. Some countries have used funds to pursue industrial, economic, or social objectives. For example, Japan used its reserve fund to support infrastructure projects, provide housing and education loans, and subsidize small and medium enterprises. As a result, Japan compromised to some extent the principal goal of pre-funding.

Past experiences have also highlighted the need to mitigate certain risks that pension reserve funds face. One kind of risk has to do with the fact that asset build-up in a fund may lead to competing pressures for tax cuts and spending increases, especially when a fund is integrated in the national budget. For example, governments may view fund resources as a ready source of credit. As a result, they may be inclined to spend more than they would otherwise, potentially undermining the purpose of pre-funding. Ireland alleviated the risk that its reserve fund could raise

government consumption by prohibiting investment of fund assets in domestic government bonds.

Another risk is the pressure that groups may exert on the investment choices of a pension reserve fund, potentially lowering returns. For example, Canada and Japan have requirements to invest a minimum share of their fund portfolio in domestic assets, restricting holdings of foreign assets to stimulate economic development at home. Funds in several countries have also faced pressure to adopt ethical investment criteria, with possible negative impacts on returns. In recent years, some countries have taken steps to ensure that funds are managed to maximize returns, without undue risk. Canada, for example, has put its fund under the control of an independent Investment Board operating at arm's length from the government since the late 1990's. Several countries, including New Zealand, have taken steps to provide regular reports and more complete disclosures concerning pension reserve funds.

Individual Account Reforms Show the Importance of Funding Decisions and Ensuring Benefit Adequacy

Countries that have adopted individual account programs—which may also help pre-fund future retirement income—offer lessons about financing the existing PAYG pension program as the accounts are established. Some countries manage this transition period by expanding public debt, building up budget surpluses in advance of implementation, reducing or eliminating the PAYG program, or some combination of these. In addition, administering individual accounts requires effective regulation and supervision of the financial industry to protect individuals from avoidable investment risks. Educating the public is also important as national pension systems become more complex.

Approach to Funding Individual Accounts Affects Sustainability of National Pension System

It is important to consider how different approaches to including individual accounts may affect the short-term and long-term financing of the national pension system and the economy as a whole. A common challenge faced by countries that adopt individual accounts is how to pay for both a new funded pension and an existing PAYG pension simultaneously, known as transition costs. Countries will encounter transition costs depending on whether the individual accounts redirect revenue from the existing PAYG program, the amount of revenue redirected, and how liabilities under the existing PAYG program are treated.

The countries we are examining offer a range of approaches for including individual accounts and dealing with the prospective transition costs. Australia and Switzerland avoided transition costs altogether by adding individual accounts to their existing national pension systems, which are modest relative to those in the other countries we are studying.[4] Some countries diverted revenue from the existing PAYG program to the individual accounts. The resulting shortfall reflects, in part, the portion of the PAYG program being replaced with individual accounts and the amount of PAYG revenue being redirected to fund the accounts. For example, transition costs may be less in countries such as Sweden or Denmark where the contribution to individual accounts is 2.5 percent of covered earnings and 1 percent, respectively, than for Poland or Hungary, which replaced a larger portion of the PAYG program.

All of the countries we are reviewing also made changes to their PAYG program that were meant to help reduce transition costs, such as increasing taxes or decreasing benefits. In addition, Chile built a surplus in anticipation of major pension reform, and Sweden had large budget surpluses in place prior to establishing individual accounts. Countries also transfer funds from general budget revenues to help pay benefits to current and near retirees, expanding public borrowing. If individual accounts are financed through borrowing they will not positively affect national saving until the debt is repaid, as contributions to individual accounts are offset by increased public debt.[5] For example, Poland's debt is expected to exceed 60 percent of GDP in the next few years in part because of its public borrowing to pay for the movement to individual accounts.

It is sometimes difficult for countries to predict their transition costs. In particular, countries that allow workers to opt in or out of individual account programs

[4] Australia's national PAYG program consistently replaces approximately 25 percent of average wages (23 percent in 2005); Switzerland's national PAYG program replaced approximately 26 percent of average wages in 2005.

[5] Additionally, increased government debt may crowd out private sector access to lending markets and dampen the economic growth individual accounts are meant to access.

have had difficulty estimating costs. For example, Hungary and Poland experienced higher than anticipated enrollment from current workers in their individual account programs, leaving the existing PAYG program with less funding than planned. As a result, both countries had to make subsequent changes to their individual account and PAYG programs.

Balancing Opportunities to Realize High Returns and Benefit Adequacy Is Important

Countries adopting individual accounts as part of their national pension system have had to make trade-offs between giving workers the opportunity to maximize returns in their accounts and ensuring that benefits will be adequate for all participants. Some countries set a guaranteed rate of return to reduce certain investment risks and help ensure adequacy of benefits. These guarantees may, however, result in limited investment diversification with a potentially negative impact on returns. In Chile, for example, fund managers' performance is measured against the returns of other funds. This has resulted in a "herding" effect because funds hold similar portfolios, reducing meaningful choice for workers. All the countries with individual accounts provide some form of a minimum guaranteed benefit so retirees will have at least some level of income. Some experts believe that a minimum pension guarantee could raise a moral hazard whereby individuals may make risky investment decisions, minimize voluntary contributions, or, as in the case of Australia where the minimum guarantee is means-tested, may spend down their retirement assets quickly.

It is important to consider the payout options available from individual accounts, as these can also have substantial effects on adequacy of income throughout retirement. For example, an annuity payout option can help to ensure that individuals will not outlive their assets in retirement.[6] However, purchasing an annuity can leave some people worse off if, for example, the annuities market is not fully developed, premiums are high, or inflation erodes the purchasing power of benefits. Several countries also allow for phased withdrawals, in some cases with restrictions, helping to mitigate the risk of individuals outliving their assets and becoming reliant on the government's basic or safety-net pension. Some countries offer a lump-sum payment under certain circumstances, such as small account balances, and Australia allows a full lump-sum payout for all retirees.

Effective Regulation, Implementation, and Education Can Protect Individuals

Important lessons can be learned regarding the administration of individual accounts, including the need for effective regulation and supervision of the financial industry to protect individuals from avoidable investment risks. Some countries have expanded their permitted investment options to include foreign investments and increased the percentage of assets that can be invested in private equities. The experiences of countries we are studying also indicate the importance of keeping administrative fees and charges under control. The fees that countries permit pension funds to charge can have a big influence on the amount of income retirees receive from their individual accounts. Several countries have limits on the level and types of fees providers can charge. Additionally, the level of fees should take into consideration the potential impact not only on individuals' accounts, but also on fund managers. In the UK, for example, regulations capping fees may have discouraged some providers from offering pension funds. To keep costs low, Sweden aggregates individuals' transactions to realize economies of scale.

Some countries' experiences highlighted weaknesses in regulations on how pension funds can market to individuals. The UK's and Poland's regulations did not prevent problems in marketing and sales. Poland experienced sales problems, in part because it had inadequate training and standards for its sales agents, which may have contributed to agents' use of questionable practices to sign up individuals. The UK had a widely-publicized "mis-selling" scandal involving millions of investors. Many opened individual accounts when they would more likely have been better off retaining their occupation-based pension. Insurance companies were ordered to pay roughly $20 billion in compensation.

Countries' individual account experiences reveal pitfalls to be avoided during implementation. For example, Hungary, Poland, and Sweden had difficulty getting their data management systems to run properly and continue to experience a substantial lag time in recording contributions to individuals' accounts. In addition,

[6] The countries we reviewed require a range of annuity options, including, for example, inflation indexed, joint and survivor, or gender-neutral.

Hungary and Poland did not have an annuities market that offered the type of annuity required by legislation.

Education becomes increasingly important as the national pension systems become more complex. It is particularly important for workers who may have to make a one-time decision about joining the individual account program. Several countries require disclosure statements about the status of a pension fund, and some provide annual statements. To help individuals choose a fund manager, one important component of these statements should be the disclosure of fees charged. Some countries have done a better job of providing fund performance information than others. For example, Australia requires its fund providers to inform members through annual reports clearly detailing benefits, fees and charges, investment strategy, and the fund's financial position. In contrast, Hungary did not have clear rules for disclosing operating costs and returns, making it hard to compare fund performance.

Concluding Observations

Demographic challenges and fiscal pressure have necessitated national pension reform in many countries. Though one common goal behind reform efforts everywhere is to improve financial sustainability, countries have adopted different approaches depending on their existing national pension system and the prevailing economic and political conditions. This is why reforms in one country are not easily replicated in another, or if they are, may not lead to the same outcome. Countries have different emphases, such as benefit adequacy or individual equity; as a result, what is perceived to be successful in one place may not be viewed as a viable option somewhere else.

Although some pension reforms were undertaken too recently to provide clear evidence of results, the experiences of other countries may suggest some lessons for U.S. deliberations on Social Security reform. Some of these lessons are common to all types of national pension reform and are consistent with findings in previous GAO studies. Restoring long-term financial balance invariably involves cutting benefits, raising revenues, or both. Additionally, with early reform, policy makers can avoid the need for more costly and difficult changes later. Countries that undertook important national pension reform well before undergoing major demographic changes have achieved, or are close to achieving, financially sustainable national pension systems. Others are likely to need more significant steps because their populations are already aging.

No matter what type of reform is undertaken, the sustainability of a pension system will depend on the health of the national economy. As the number of working people for each retiree declines, average output per worker must increase in order to sustain average standards of living. Reforms that encourage employment and saving, offer incentives to postpone retirement, and promote growth are more likely to produce a pension system that delivers adequate retirement income and is financially sound for the long term.

Regardless of a country's approach, its institutions need to effectively operate and supervise the different aspects of reform. A government's capacity to implement and administer the publicly managed elements of reform and its ability to regulate and oversee the privately managed components are crucial. In addition, education of the public becomes increasingly important as workers and retirees face more choices and the national pension system becomes more complex. This is particularly true in the case of individual account reforms, which require higher levels of financial literacy and personal responsibility.

In nearly every country we are studying, debate continues about alternatives for additional reform measures. It is clearly not a process that ends with one reform. This may be true in part because success can only be measured over the long term, but problems may arise and need to be dealt with in the short term. The positive lessons from other countries' reforms may only truly be clear in years to come.

Mr. Chairman and Members of the Subcommittee, this concludes my prepared statement. I'd be happy to answer any questions you may have.

GAO Contacts and Staff Acknowledgements

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Chairman MCCRERY. Thank you, Ms. Bovbjerg. Dr. James.

STATEMENT OF ESTELLE JAMES, PH.D., CONSULTANT AND FORMER LEAD ECONOMIST, THE WORLD BANK

Dr. JAMES. Thank you very much for inviting me. Over the past 20 years, more than 30 countries, spread across Latin America, Eastern and Central and Western Europe, Australia, and Hong Kong, have added privately funded managed plans to their mandatory Social Security systems. They did this for several reasons: to prevent public costs from rising, to increase national saving, to improve work incentives and therefore to augment economic growth, as the previous speaker said. Contributions to the accounts range from 2.5 percent of wages in Sweden, to 12.5 percent in Chile, and they are projected to supply between 30 and 90 percent of total benefits. It varies a lot across countries. In this discussion I am going to consider both income streams that come from the personal accounts, as well as the traditional defined benefit, as part of the country's Social Security system, so long as it is financed by taxes or mandatory contributions. In other words, I am defining Social Security as, in some sense, coming from these mandatory sources, whether it is the personal account or the defined benefit. I discuss how these countries financed the account, financed the transition, protected low earners and kept administrative costs low.

I am going the summarize my four major points, and then I will go on as long as I have time to explain where they come from. The major lessons I draw are: first, in comparison with other countries, current and projected benefits from and contributions to the U.S. Social Security system are relatively low. We are at the low end of the spectrum. That leaves us with the question, do we want to maintain those scheduled benefits or cut them, and this is really the central question that we are faced with. To maintain the scheduled level of benefits will cost more money than we are paying now. That is going to be the case, I believe, whether we do it through the personal account part or the traditional part. However, I think we will get higher returns and better economic incentives from this extra money if it goes into personal accounts. This obviously implies funding the account mainly through a small add-on. Although most countries in Latin America and Eastern and Central Europe with funded private plans used a carve-out from existing payroll taxes, several OECD countries used the mandatory add-on, and our initial conditions have more in common with these OECD countries as I will explain in a minute.

Second point, one reason why countries adopted personal accounts was to increase national saving and economic growth, making more goods and services available for everyone. This effect depends heavily on how the accounts and the transition are financed. National saving will increase if the accounts are funded by an add-on or if they are funded by a carve-out whose transition costs are not primarily debt financed. Chile is a very good example. Chile financed the transition to personal accounts out of a surplus on the rest of its public budget, both initially and even to this very day, and extensive analysis shows that this is largely responsible for the increased national saving that has fueled Chile's economic growth. Point number three: every country that has personal accounts also has a public safety net, so, it is certainly not an either/or proposition. The two definitely go together, and every country includes

a minimum pension, as the previous speaker indicated, to cushion financial and labor market risk.

Point number four, accounts can be organized through the retail market, as in most of Latin America and Eastern and Central Europe, or through the institutional market, as in several other countries, and in the United States we have the Thrift Saving Plan, which is an often cited example. The institutional market has much lower administrative and marketing costs because it benefits from greater economies of scale and bargaining power. There is also a tradeoff, and the tradeoff is less worker choice and less insulation from political pressures. So, those are my four points, and I just want to go back now and explain how I came to these conclusions, where those points come from.

First, the issue of funding the account through an add-on versus a carve-out. What did other countries do? Countries that include funded privately managed plans in their Social Security systems fall into two different groups: Latin America and Eastern and Central European countries on the one hand, and several OECD countries on the other hand. Now, in most Latin American and Eastern and Central European countries personal accounts were created during the nineties and early 2000s as a remedy for public systems that were already on the verge of insolvency, much further along than we are in this country. Payroll taxes were extremely high, often over 25 percent of wages. Tax evasion was also high. Workers retired well before age 60 and promised replacement rates were overly generous; for example, 70 to 80 percent of the worker's wage. An add-on contribution for the accounts clearly was not an option for this group. The new accounts were funded by a carve-out from the existing payroll tax, which was already too high.

In contrast, several OECD countries, such as Australia, Switzerland, Netherlands, and Denmark, started out with relatively modest public benefits, not very different on average from benefits in the United States but more redistributive. They had a different structure. In addition, in these countries, employers have long provided pension plans, on a voluntary or collectively bargained basis, to about half the labor force. That also has some similarities to the United States. As an alternative to increased public expenditures on pensions and as a way to raise national saving, in the eighties and early nineties these countries decided to make funded employer-sponsored plans mandatory for virtually the entire labor force. In effect, these plans became part of the Social Security systems because they were mandated through an add-on for employers that didn't already provide them. The add-on has reached 9 percent in Australia. The cost is actually higher in some of the other countries, and the combined target replacement rate is now 60 to 65 percent, obviously higher than ours.

Chairman MCCRERY. Dr. James, can you sum up so we can move on? We will get to a lot of this in questions.

Dr. JAMES. Okay, sure. I will just say the old employer plans were mainly Defined Benefit (DB), but they are increasingly Defined Contribution (DC) and many employers are also shifting their old plans to DC, so, they are moving in the distribution of individual accounts. In terms of transition costs, the countries that used an add-on did not face transition costs because they added

money. The ones that used a carve-out did face transition costs, and they financed these costs by downsizing benefits and through a mix of fiscal stringency and debt finance. Chile, as I mentioned, ran a surplus on the rest of its budget to finance the transition. In fact, even today they spend 2 to 3 percent of their Gross Domestic Product (GDP) on phasing out the old system, but no debt financing. It all comes out of surplus on the rest of its budget, which has enhanced its national saving. All of these countries include a safety net and minimum pension, which may come from a minimum pension guarantee, a flat benefit, or a means tested benefit. There are different forms, but they all have some kind of minimum pension. Administrative costs, as I mentioned, can be reduced by using the institutional market. We find this in the employer-sponsored plans and in some smaller countries like Bolivia, Kosovo, Panama, whose costs are quite low. So, I think if this plan is structured through the institutional market we can keep our costs low too.

[The prepared statement of Dr. James follows:]

Statement of Estelle James, Ph.D., Consultant and Former Lead Economist, The World Bank

Over the past 20 years more than 30 countries, spread across Latin America, Eastern, Central and Western Europe, Australia and Hong Kong, have added funded privately managed plans to their mandatory social security systems. They did this to prevent public costs from rising, to increase national saving and to improve work incentives. Contributions to the accounts range from 2.5% of wages in Sweden to 12.5% in Chile and they are projected to supply between 30 and 90% of total benefits. In this discussion I consider both income streams—that coming from the personal accounts as well as the traditional defined benefit—as part of the country's social security system, so long as it is financed by taxes or mandatory contributions. I discuss how these countries funded the accounts, financed the transition, protected low earners and kept administrative costs low. The major lessons I draw are:

1. In comparison with other countries, current and projected benefits from and contributions to in the U.S. social security system are relatively low. We need to decide whether we wish to maintain or to cut the scheduled level of mandatory retirement income—this is our central question. To maintain the scheduled level of social security benefits will cost more money than we are paying now, whether we do it through the personal account part or the traditional part. We will get higher returns and better economic incentives from this extra money if it goes into personal accounts—but this implies funding the accounts mainly through a small add-on. Although most countries in Latin America and Eastern and Central Europe with funded private plans used a carve-out from existing payroll taxes, several OECD countries used a mandatory add-on. Our initial conditions have more in common with these OECD countries.
2. One reason why countries adopted personal accounts was to increase national saving and economic growth—therefore more goods and services for everyone. This effect depends heavily on how the accounts and the transition are financed. National saving will increase if the accounts are funded by an add-on or by a carve-out whose transition costs are not debt-financed. Chile financed its transition out of a surplus on the rest of its public budget—and extensive analysis shows that this is largely responsible for the increased saving that has fueled Chile's economic growth.
3. Every country that has personal accounts also has a public safety net, including a minimum pension, to cushion financial and labor market risk.
4. Accounts can be organized through the retail market, as in most of Latin America and Eastern and Central Europe, or through the institutional market, as in several other countries and in the Thrift Saving Plan in the U.S. The institutional market has much lower administrative and marketing costs because it benefits from greater economies of scale and bargaining power (but the trade-off is less worker choice and less insulation from political pressures).

1. Funding the accounts through an add-on versus a carve-out

Countries that include funded privately managed plans in their social security systems fall into two different groups: Latin America and Eastern and Central Eu-

rope, on the one hand, and several OECD countries, on the other hand. In most Latin American and Eastern and Central European countries personal accounts were created during the 1990's and early 2000's as a remedy for public systems that were already on the verge of insolvency. In these countries payroll taxes were extremely high (often over 25% of wages), tax evasion was also high, workers retired well before age 60 and promised replacement rates were overly generous—for example, 70–80% of the worker's wage. An add-on contribution for the accounts clearly was not an option for this group. The new accounts were funded by a carve-out from the existing payroll tax, which was already too high.

In contrast, several OECD countries, such as Australia, Switzerland, Netherlands and Denmark, started out with relatively modest public benefits—not very different, on average, from benefits in the U.S., but more redistributive. In addition, in these countries employers have long provided pension plans, on a voluntary or collective bargained basis, which covered about half the labor force. As an alternative to increased public expenditures on pensions and as a way to raise national saving, in the 1980's and early 1990's these countries decided to make funded employer-sponsored plans mandatory for virtually the entire labor force. In effect, these plans became part of their social security systems, through an add-on for employers that didn't already provide them. The add-on has reached 9% in Australia, more in the other countries, and the combined target replacement rate is now 60–65%. The old employer plans were mainly defined benefit but the new ones are mostly defined contribution and many employers are also shifting their old plans to defined contribution (that is, to individual accounts).

I believe this add-on strategy for financing individual accounts would be the best for us too, except that I would organize it through workers, not employers, and I would aim for a much smaller add-on (of about 2%). This would hold our total benefit roughly where it is projected to be now, while allowing the traditional part of the system to become smaller and remain solvent.

2. Transition costs

The OECD countries did not face transition costs, because they did not divert money, they added-on. The Latin American and Eastern-Central European countries did face transition costs. They financed these costs in part by downsizing benefits and by a mix of fiscal stringency and debt finance. The transition has been intensively studied in Chile. Chile cut its obligations by raising retirement age substantially. It accumulated a budget surplus ahead of time to cover its early transition costs. The government is still paying 2–3% of GDP per year for the remnants of the old system, but it does so entirely by generating a surplus in the rest of its budget. In other words, no public debt finance is involved. Financing the transition without increasing the public debt is the major reason why Chile has increased its national saving, which in turn has increased its rate of economic growth.

If we in the U.S. want to use pension reform as a way to increase national saving, either we must use an add-on or we must come up with a plan for transition finance that does not depend heavily on enlarging the public debt. Otherwise, we will be canceling out the increased private saving with increased public dissaving.

3. Minimum pension and other safety nets

All these countries include a safety net and guarantees to protect low earners. Every one of them has a minimum pension of some sort—examples are a minimum pension guarantee in Chile, a flat benefit that goes to every older resident in the Netherlands, or a widespread means—and asset-tested benefit in Australia. This cushions the risk from the accounts and from the labor market. In Switzerland, Mexico and Estonia the safety net rises with years of contributions, to bolster work incentives.

4. Administrative costs—retail versus institutional market

Most of the countries in Latin America and Central-Eastern Europe used the retail market to put workers into funds. But some countries, such as Bolivia, Panama (civil service) and Kosovo, have experimented with the institutional market. Large employer funds in the OECD also use the institutional market.

In the retail market pension fund managers can freely enter the industry, they establish a direct relationship with workers, and administrative costs tend to be relatively high, because of high marketing costs, diseconomies of dealing with many small accounts and price-inelasticity of demand in retail financial markets. Costs start out well over 10% of assets. Even though they fall steeply with asset growth, in countries as advanced as the UK they still exceed 1%, which will reduce final pensions by 20%.

In contrast, in the institutional market records are usually centralized, the money in small accounts is aggregated, and a competitive bidding process is held to choose

a limited number of fund managers, among whom workers can choose. Administrative costs are cut by 2/3, because scale economies and bargaining power are larger and marketing costs are smaller. There is a trade-off of course—less choice for workers and greater danger of political pressure, if the bidding is organized by government. Sweden tries to mimic the fees of the institutional market while keeping the greater choice of the retail market, but it does so by imposing price controls. The institutional model is used by the U.S. Thrift Saving Plan and it was recommended by the President's Commission for our individual account system. I think this is appropriate for a system with many small accounts. After 7–8 years, administrative costs in this system would be.3%, which is lower than in other countries and also lower than in most mutual funds in our country.

Chairman MCCRERY. Thank you, Dr. James. Mr. Whitehouse.

STATEMENT OF EDWARD WHITEHOUSE, ADMINISTRATOR, SOCIAL POLICY DIVISION, ORGANISATION FOR ECONOMIC CO–OPERATION AND DEVELOPMENT, PARIS, FRANCE

Mr. WHITEHOUSE. Thank you. I shall try and be briefer. It is a great pleasure to be here, and I think it is very useful for this Committee to look at the international experience. As the previous speakers have said, there is a vast amount of experience on structural pension reform around the world, and I think there are some lessons that can be learned for the United States. As both of the previous speakers have pointed out, the starting point is rather different in the United States than it was in the countries of Latin America and Eastern Europe. To start with, the target benefit level under Social Security is relatively low. It promises about a 50-percent replacement rate after a full career. That compares with about 65 or 70 percent in the rest of the OECD countries, which was the target of the starting point in the Latin American and Eastern European countries as well. So, the carve-out question is rather different when you have a much bigger starting point in your public pension system than it is when the starting point is as it is in the United States.

In the first part of my written testimony, I put the U.S. pension scheme into an international context to try and show how the target benefit level compares with comparable countries, and also to look at income distribution analysis, which shows that currently, pensioners in the United States look to be doing quite well. Their incomes are quite large relative to most of the population as a whole. However, there is an issue of pension or prosperity, that on a standard international definition, 20 percent of older people in the United States are classed as poor, and that is double the average for the 30 rich countries who are members of the OECD, which is around 10 percent, and it is very much higher than countries such as France, Germany, and Britain, which have a much lower old age poverty rate. So, I think an issue that perhaps should be addressed in Social Security reform is thinking about what to do about poorer pensioners.

As far as personal accounts go, one major issue which Dr. James touched on, is this question of the administrative expenses, and we found particularly in Latin America there has been—in the early years of reform this has been very controversial—extremely large marketing expenses; rather wasteful competition between different pension providers who are essentially offering the same product,

because the portfolios of the different funds are very similar, the marketing being the sole reason for people to switch often between funds. There are very obvious ways the United States can avoid falling into that trap of this wasteful competition. Dr. James mentioned the Thrift Saving Plan (TSP). I am not sure that that can be a direct model for a personal account system because the TSP is for Federal Government employees, so, there is only one employer. When we are dealing with personal accounts, we are dealing with a multitude of employers, and so, I think something like TIAA–CREF might be a better example. Clearly, the United States is in a much better position in terms of its financial markets for organizing a system of personal accounts than was, for example, Chile or the countries of Eastern Europe, where capital markets there could best be described as nascent in times of reforms. There is a corollary of that, which is that therefore, the benefits to the U.S. economy of such a reform are commensurately lower. It is easier to organize, but the capital market development, which is so important in Latin America, so important in Eastern Europe, is already there. You have the most advanced capital market there is, already. So, the wider economic effects are likely to be smaller in the reform in the United States than they are in other countries.

The final issue I address in the written testimony is a rather complex one which I will try and summarize in 30 seconds. It is this issue of who is covered by the reform and what are the terms of trade for people switching to the new personal accounts. In reading the proposals of the President's Commission on Strengthening Social Security, people are likely to be offered a choice of where they can take some of their contributions out of Social Security and put them into their personal account, and then their Social Security benefits are reduced by that amount of contribution plus an interest rate. How that interest rate is set is going to be crucial to whether or not these personal accounts will actually work. Set the interest rates too high, no one is going to choose that option. Set the interest rate too low, and you have a huge fiscal problem. As I explained in detail in the written testimony, the UK made a very grave mistake when it introduced the individual accounts/pension option, because it gave people far too large an incentive to switch to the new individual account. So, I look forward to answering your questions. Thank you.

[The prepared statement of Mr. Whitehouse follows:]

Statement of Edward Whitehouse, Administrator, Social Policy Division, Organisation for Economic Co-operation and Development, Paris, France[1]

Countries around the world need to reform pension systems to meet demographic challenges and to reflect changes in labor markets and industrial, economic and so-

[1] Edward Whitehouse, a British national, works in the Social Policy Division of the OECD Secretariat in Paris. He is co-author of the recent report, *Pensions at a Glance*, a comprehensive study of pension systems in the 30 OECD countries (OECD, 2005). He has advised numerous governments on pension reform, including Hungary and Poland, and has written many studies of the pension system in the United Kingdom (such as Dilnot *et al.*, 1994 and Whitehouse, 1998). He previously worked as co-editor of the World Bank's *Pension Reform Primer*, a resource for people designing and implementing pension reforms around the world.

This testimony represents a personal view and commits neither the OECD Secretariat nor any of its member governments.

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cial structures. There are valuable lessons to be learned from other countries' experiences. But the inherent complexity of pension systems has, in the past, hampered effective transmission of policy experiences across borders.

This testimony is in four parts. The first puts the United States' pension system in an international context. It uses three kinds of evidence: calculations of pension entitlements at an individual level, comparisons of older people's incomes with the rest of the population and how public pension spending is likely to develop.

The second part looks at structural pension reforms that have introduced some kind of mandatory 'individual accounts' (defined-contribution pension plans) as a substitute for all or part of public, earnings-related pensions. These have now been introduced by 10 countries in Latin America and more than 10 in Eastern Europe.

The third part of the testimony investigates an important but often overlooked feature of fundamental pension reform. Are the new defined-contribution accounts mandatory or voluntary? Which age groups are covered? If there is a choice, what are the terms of trade between remaining only in the public pension program and switching to a mixed public/private pension?

The issue of administrative charges for defined-contribution pensions is addressed in the fourth part. How large are these fees in different countries? What policies can help keep charges low?

1. The pension system of the United States in an international context

There are three main approaches to comparing pension systems between countries. The most common is the 'fiscal' approach, which looks at current and prospective pension expenditures. This is useful for assessing the financial sustainability of a retirement-income system, but it gives only the total for pension spending and is silent on how that spending is distributed among older people. The second method is income-distribution analysis. This compares the incomes of today's older people with the incomes of the population as a whole. This is a backward-looking measure, since the incomes of today's pensioners depend on past rules of the pension system and past economic conditions. The third method is a microeconomic approach, calculating prospective pension entitlements for today's workers. Unlike fiscal projections, this looks explicitly at the distribution of pensions among workers of different characteristics. Unlike income-distribution analysis, it is forward-looking, assessing the pension promises made to today's workers under today's rules.

Microeconomic approach

The OECD recently published the first comprehensive, microeconomic analysis of pension entitlements in the report *Pensions at a Glance* (OECD, 2005). This first report (in what is hoped will be a biennial series) calculated prospective pensions of full-career workers at different levels of earnings.[2] The analysis includes all mandatory sources of retirement income: resource-tested benefits (including social assistance), basic and minimum pensions, public, earnings-related schemes and mandatory private schemes (both defined-benefit and defined-contribution). The calculations use common macroeconomic and financial assumptions to isolate the effect of pension-system design from these other factors. The parameters used are those applying in 2002, although subsequent reforms that have been legislated are assumed to be fully in place. The results, therefore, show the long-term stance of the pension system.

The two charts below (Figure 1) show the 'net replacement rate'. This is the pension, net of any income taxes and contributions due, divided by individual earnings, again net of taxes and contributions. Both charts show selected countries: OECD (2005) provides data for all 30 member countries of the OECD.

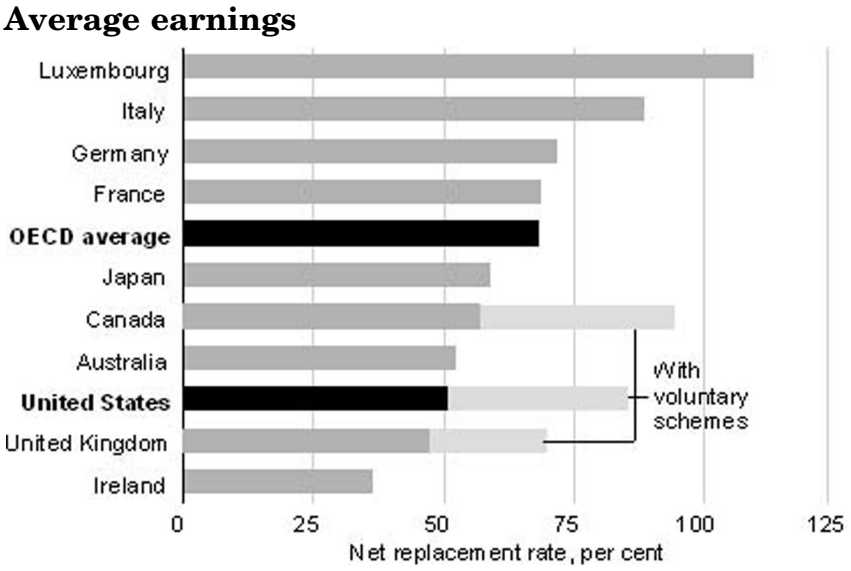
The left-hand panel shows the net replacement rate for a full-career with earnings equal to the economy-wide average each year. The highest net replacement rate is in Luxembourg, where the pension entitlement is calculated to be 110 percent of earnings when working. At the other end of the scale, the lowest net replacement rate is in Ireland, where it is 37 percent. The OECD average net replacement rate for an average earner is 69 percent. The replacement rate in the United States is low: along with Ireland and the United Kingdom shown in the charts, only Korea, Mexico and New Zealand have lower net replacement rates at this earnings level.

The right-hand panel shows the position of a low earner. The OECD average replacement rate at half-average earnings is 84 percent. This is higher than the replacement rate for an average earner because most OECD countries, the United States included, have redistributive pension systems. At this earnings level, the replacement rate in the United States is 61 percent. This is the lowest among the

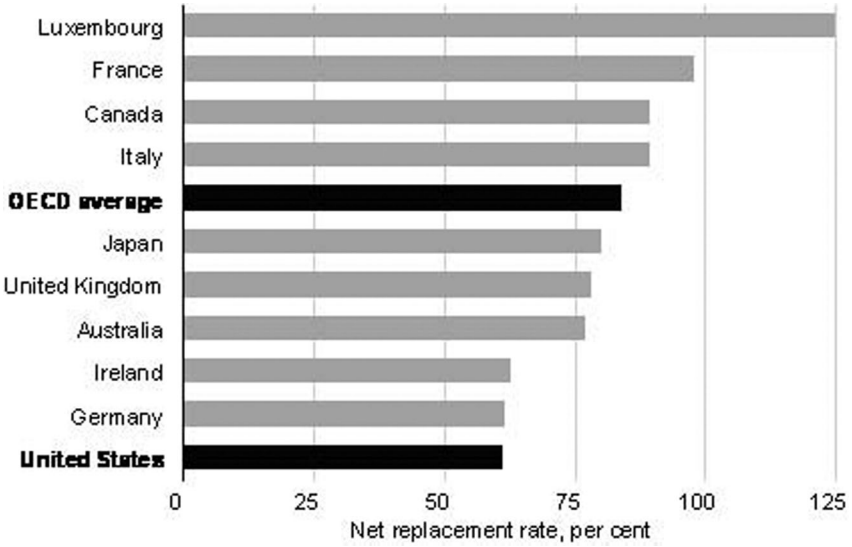
[2] Ongoing work is extending the analysis to include people with long absences from the labor market due to caring for children or long-term unemployment.

OECD countries apart from Mexico and the Slovak Republic. Countries with wholly flat-rate pensions, such as Ireland, with means-tested public schemes, such as Australia, or with predominantly flat-rate systems, such as the United Kingdom naturally have a large difference between the replacement rate at average and at low earnings. The main reason that low earners have very low pensions in the United States, despite the progressive benefit formula in social security, is the low value of the safety-net benefit. The means-tested program, supplemental security income (SSI), provides a minimum income worth 20 percent of average earnings. The safety-net retirement income across all 30 OECD countries is worth nearly 30 percent of average earnings (on average).

Figure 1. Prospective net replacement rate for full-career worker



Half-average earnings



Source:OECD (2005)

In countries with low mandated pension replacement rates, there is space for voluntary retirement-income provision to develop. In Canada, the United Kingdom and the United States, for example, both company and individual pensions are widespread. The chart for the average earner therefore shows the entitlements under a 'typical' pension plan for these three countries. In Canada and the United Kingdom, this is a defined-benefit plan. For the United States, it is a 401(k), into which the worker and his employer are assumed to pay contributions of the national average (9.5 percent of earnings).[3] With these voluntary programs, the replacement rates for these three countries look rather closer to continental Europe. But these replacement rates are conditional on having a full-career covered by a voluntary plan. The issue then turns to the following questions. Are some people saving enough in defined-contribution schemes? Do people have significant gaps where they are not covered by a voluntary, private pension? How will the penalty to changing jobs in defined-benefit plans affect retirement incomes?

Income-distribution analysis

Figure 2 shows two charts that summarize the information relating to older people in the OECD's latest cross-country study of income distribution (Förster and Mira d'Ercole, 2005).[4] Again, selected countries are presented here while the original paper provides information for many more.

The left-hand panel shows the net income of 66–75 year olds as a proportion of the net income of the population as a whole. The OECD average is 87 percent. In the United States, the figure is the highest of the OECD countries at 97 percent. Most of the OECD countries are clustered closely together. One reason that the United States performs well on this measure, while mandatory replacement rates under social security are so low, is due to voluntary, private pension provision. But the main reason is due to the importance of labor-market income in the United States, even among these 66–75 year olds. Earnings make up 30 percent of the gross income of this age group in the United States. In most of Europe, this figure is only around 10 percent. Australia, Canada and New Zealand lie between the two, with around 20 percent of gross income of older people coming from earnings.[5]

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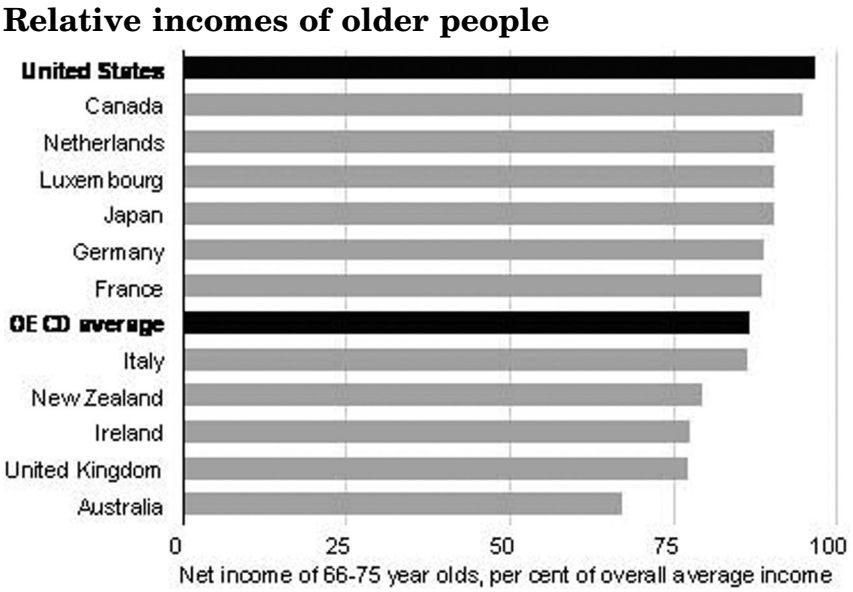
[3] The average contribution rate is taken from the Employee Benefits Research Institute/Investment Company Institute (EBRI/ICI) survey of 401(k) plans. OECD (2005) provides details of the modeling for Canada and the United Kingdom and calculations for a typical defined-benefit plan for the United States. It also includes a sensitivity analysis of the results.

[4] See also Disney and Whitehouse (2001, 2002).

[5] The low measure of relative incomes of older people in Australia reflects the fact that many withdrawals from private pensions are in the form of lump sums rather than income streams.

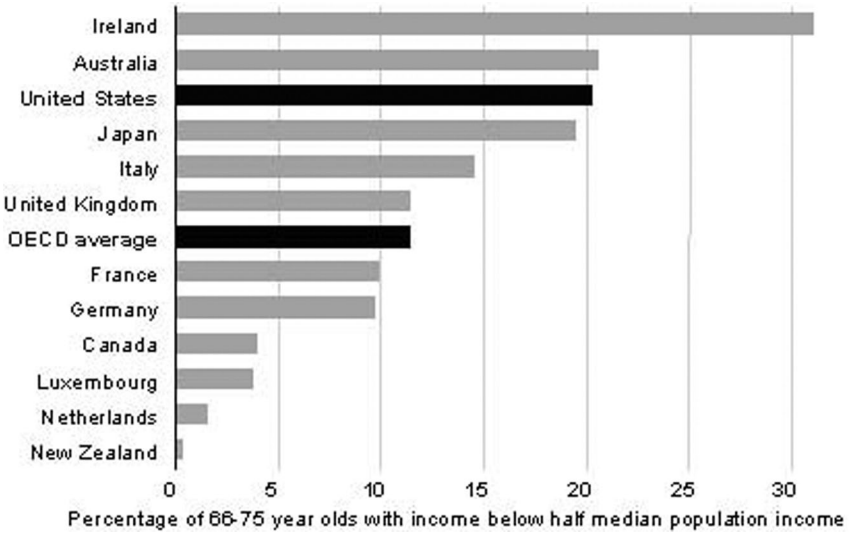
The right-hand panel shows the old-age poverty rate for the same, selected countries. This is defined as the percentage of 66–75 year olds with an income below half the population median. In addition to Australia and Ireland (shown in the chart), only Greece, Mexico and Portugal have a higher old-age poverty rate than the United States. The OECD average (11 percent) is nearly half the rate in the United States. This reflects the low value of SSI relative to safety-net incomes for older people in other OECD countries and narrow coverage of low-income workers by private pensions.

Figure 2. Income distribution measures



These are not measured in income-distribution analysis. This is also an important factor in Ireland and the United Kingdom, although to a more limited extent.

Old-age poverty rate



Note: all incomes are household incomes adjusted for household composition using an 'equivalence scale'

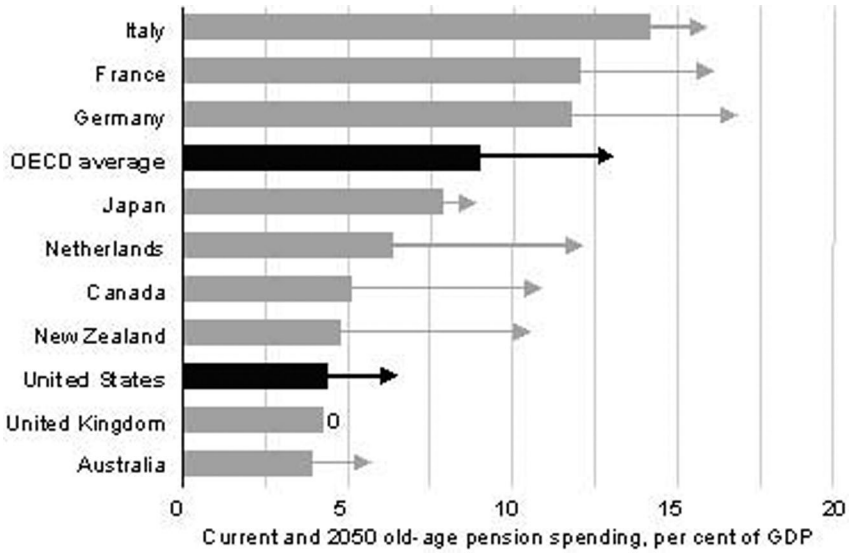
Source: Förster and Mira d'Ercole, 2005

Fiscal projections

The OECD has also compared the effects of aging on a range of public spending programs. The chart below (Figure 3) looks at public spending on pensions alone. Public pension expenditure in 2000 averaged 7.5 percent of gross domestic product (GDP) across 21 countries. (Other countries' data are available in Dang, Antolín and Oxley, 2001.)

Italy had the highest spending on this measure, nearly double the OECD average. Australia's spending, at 3 percent (less than half the average) was the second lowest. The United States spent around the same as the United Kingdom, around 4.5 percent of GDP. The arrows show how spending will change between 2000 and the projected peak (between 2030 and 2050). Italy's series of pension reforms have reduced the growth rate of pension spending. It is expected to peak at 16 percent of GDP, less than in France or Germany (on the policies in place in 2000). The peak in the United States is estimated to be 6 percent of GDP, compared with an OECD average of 10 percent.

Figure 3. Current and projected pension spending



Note: peak values are in 2050, except Italy and the United Kingdom (2030), France and the United States (2035) and Netherlands (2040)

Source: Dang, Antolín and Oxley (2001)

2. International experience of introducing individual accounts

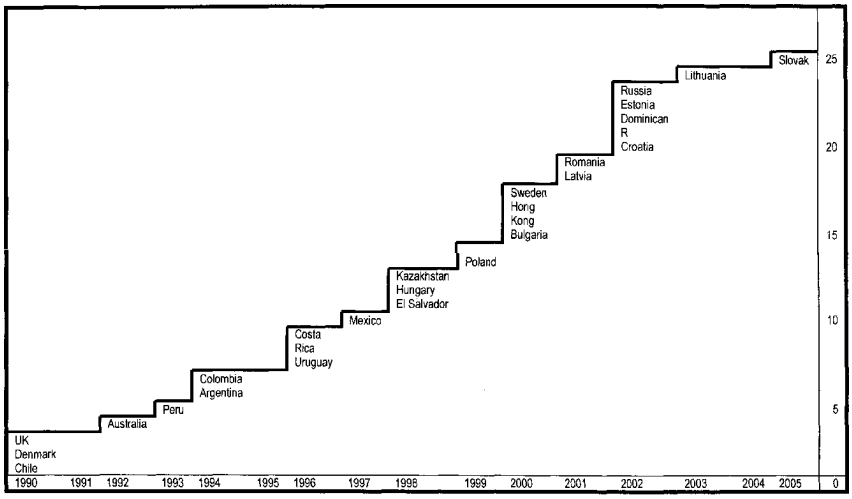
Some 25 countries around the world have now introduced individual accounts as a substitute for all or part of their public, pay-as-you-go pension schemes. The spread of these schemes through Latin America from the mid 1990s and through Eastern Europe in the years since then is quite dramatic. Many more countries are at various stages of the reform process, including Lebanon and Ukraine.

It is important to note that these reformed pension systems are very diverse, despite the common theme of individual accounts. Bolivia, Chile, El Salvador and Mexico, for example, have shifted nearly all retirement-income provision to the defined-contribution plans (although all of them retain publicly provided minimum pensions. In contrast, Argentina retains a large basic scheme (expected to provide around two-thirds of total pension benefits in the long term). Costa Rica and Uruguay retain earnings-related public schemes (which are likely to provide more than three-quarters of total benefits). All countries in Eastern Europe retain public, earnings-related plans as a complement to the new defined-contribution schemes. The balance between the two again varies. Half or more of pension benefits in the long term are likely to come from the funded component in Croatia, Latvia and Poland, compared with a third in Hungary and 16 percent in Bulgaria, for example.

Differences in the relative role of public and private provision in these new pension systems also arise because of differences in the size of the mandatory contribution. In Bulgaria, for example, the contribution is just 2 percent of earnings and it is 2.5 percent in Sweden. Contribution rates in Latvia and Lithuania were initially set low (2 and 2.5 percent respectively), but are planned to increase over time to 10 and 5.5 percent respectively. In Latin America, total contributions (including survivors' and disability insurance and administrative charges) exceed 10 percent of earnings in Chile, Colombia and El Salvador.

The mandatory contribution to the superannuation guarantee in Australia is 9 percent. Contribution rates are also fairly high in Hungary (8 percent), Poland (7.3 percent) and the Slovak Republic (9 percent). The minimum contribution to personal pensions in the United Kingdom (for individuals choosing that option) varies with age, from 3.8 to 9 percent. Again, the other elements of the pension system differ. In Australia, for example, the individual accounts were added onto the public, means-tested pension. In the United Kingdom, those choosing the personal-pension option are also entitled to public basic and means-tested pensions.

Table 1. The spread of defined-contribution pension schemes: Latin American, Eastern Europe and beyond



Source: Palacios and Whitehouse (1998), European Commission (2003), OECD (2001, 2002, 2005), Chlon (2000) and Acuña (2005)

3. Coverage of individual-accounts schemes

The transition from a public-sector, pay-as-you-go pension system into one in which individual, privately managed pension accounts form part of the mandatory retirement-income system does not directly affect those receiving pensions at the time of the reform. Nevertheless, such a reform could affect all current and future workers. A critical policy choice, therefore, is whether current and future workers should be allowed, encouraged or forced to switch part of their pension provision to the new private element. There is a spectrum of possible policy options. At one end, all workers, including new labor-market entrants, might be allowed choose to stay in the pay-as-you-go system or switch part of their contribution to the funded plan. At the other end of the spectrum, rights in the old scheme are frozen and all new rights of all workers are earned in the defined-contribution, funded plan. In between are policies where only some workers must join the new funded element, usually defined by age.

The experience of 19 reforming countries (Table 2) covers the full spectrum of possible outcomes. However, this masks some important differences. In Mexico, for example, people who contributed to the old system can switch back to the public scheme on the day they retire. So there is an implicit guarantee that the return on investment in the private scheme is at least as large as the (implicit) return on contributions to the public plan. As new labor market entrants are not offered the same guarantee, Mexico's policy is probably closer to those of Chile or Hungary than to those of Bolivia and Kazakhstan. Switching back to the public plan is also possible indefinitely in Colombia and the United Kingdom and for a limited period in Argentina, Hungary and Poland.

Who should be covered by structural pension reform?

It is readily apparent from Table 2 that most countries have focused the pension reform on younger people. Among the Latin American countries Chile, El Salvador and Uruguay all required new labour-market entrants (and in the last two, younger workers) to switch. Similar policies were adopted throughout Eastern Europe and in Sweden.

There are three main reasons why restricting switching to younger people is a sensible policy. First, changing the pension entitlements for older workers is difficult, because they have made their labour-market and savings decisions based on the expectation that the current system will remain. They can not retrospectively change these decisions to reflect the change in the pension system.

Secondly, the compound-interest effect means that defined-contribution pensions put greater weight on earlier years' contributions than accruals in earnings-related schemes (such as social security). With only a short period for investment returns

to accumulate, there is less point in older workers switching. This is strongly reflected in people's behavior during structural pension reforms. In the United Kingdom, for example, around 25 percent of 20-34 year olds took out a personal pension in 1987/88, compared with 10 percent of 35–49 year olds and virtually no one over age 50.[6] There was a similar pattern in Latin America, with switching rates of 80–90 percent among under 35s in Argentina, Chile and Colombia. Among 50 year olds, just under half switched in Argentina and Chile and less than 10 percent in Colombia.[7] The results from Eastern Europe also confirm this.

Thirdly, restricting the switch to a smaller group of workers means that it is possible to afford to divert a larger slice of contributions into the new individual accounts. With fewer accounts with larger balance, the administrative costs can be kept lower.

Table 2. Rules for voluntary and mandatory switching in structural pension reforms

Country	Mandatory switching	Voluntary switching	No switching	Option to return
Latin America				
Argentina		entire labor force		yes, for 2 years
Bolivia	entire labor force			no
Chile	new entrants	current labor force (during first five years of operation)		no
Colombia		entire labor force		yes, indefinitely
El Salvador	labor force <36	labor force 36–55 (f − 50) during first 12 months	labor force >55 (f>50)	no (yes during first 18 months after introduction)
Mexico	entire labor force			yes, indefinitely (not for new entrants)
Peru		entire labor force		yes, for 2 years
Uruguay	labor force <40, higher income		?	no
Eastern Europe/Central Asia				
Bulgaria	labor force <40			
Croatia	labor force <40	labor force 40–50 (during first year of operation)	labor force >50	
Estonia	new entrants	labor force <61, those 56–60 can join until 10/2002	labor force >60, >55 after 10/2002	

[6] See Disney and Whitehouse (1992*a*,*b*) and Whitehouse (1998).
[7] See Disney, Palacios and Whitehouse (1999) and Palacios and Whitehouse (1998).

Table 2. Rules for voluntary and mandatory switching in structural pension reforms—Continued

Country	Mandatory switching	Voluntary switching	No switching	Option to return
Hungary	new entrants	entire labor force (during first 20 months of operation), <30 again from 01/2003		yes, until 12/2003 (also for new entrants of 2002), indefinitely in case of disability
Kazakhstan	entire labor force			no
Latvia	labor force <30	labor force 30–49	labor force >49	
Poland	labor force <30 (except for agriculture)	labor force 30–50 (only during first year of operation)	labor force >50	no
Romania	labor force 20+ years before retirement	labor force 10–20 years before retirement		
Slovakia	new entrants	current labor force (during first 18 months of operation)		
Other				
Sweden	labor force <45		labor force <45	no
UK		entire labor force		yes, indefinitely

Source: Palacios and Whitehouse (1998), European Commission (2003), OECD (2001, 2002, 2005), Chlon (2000) and Acuña (2005)

What should the 'terms of trade' be for people choosing to switch?

The terms of trade under which people can exchange pay-as-you-go pension rights for contributions to their individual pension account is a fundamental design issue.

The United Kingdom, for example, made a very serious mistake in setting these terms of trade, underestimating the incentive given to younger workers to switch. This also meant that the government seriously underestimated the numbers that would switch.[8] The government forecast 300 000 would take out personal pensions, and a contingency plan allowed for a maximum of 500 000. In the end, 3.2 million people switched in 1987/88. As described above, switching rates were strongly related to age, just as the incentive structure would suggest.

The financial implications were substantial. Between 1988/89 and 1995/96, the government paid λ17.7 billion into people's personal pension accounts ($32 billion at today's exchange rate). Actuarial estimates put the long-run saving on pay-as-you-go benefits at £9.2 billion. The net cost—£8.5 billion, $15 billion—arises because the government did not adjust the payment into personal pensions to reflect different returns at different ages until 1996. With age-related rebates, the annual net cost was cut from £1.8 billion to £0.5 billion a year. It is now probably around zero.

However, the opposite risk is also possible: that the terms of trade are set so that it is not worth most people switching. This would undermine the whole reform. There is a difficult balance to be struck between successful reform and financial prudence.

[8] See Disney and Whitehouse (1992*a*,*b*) and Whitehouse (1998).

4. Administrative charges for defined-contribution pensions around the world[9]

The issue of administrative charges for defined-contribution pensions has become central to pension-reform debates in many countries. How can we measure administrative charges? How large are they in practice? How can governments keep them low?

Countries' different approaches to charges

Table 3 summarizes different countries' policies on charges. At the top are the systems with the least regulation on charges. Countries lower down impose direct regulations on the structure or level of charges or regulate industry structure with important indirect effects on charges paid.

Measuring charges

Measuring the price of financial services is more difficult than comparing the cost of other goods or services. Providers can levy many different kinds of fees. There are examples of both one-off and ongoing charges. Some fees are proportional and some are fixed rate. Some are levied on contributions, some on the value of assets in the fund, some on investment returns.

These different kinds of charge accumulate and interact in complicated ways over the lifetime of membership of a pension plan. This leads to the second problem: how to summarize these charges in a single number to compare charge levels both between different providers in a single country and across countries.

The measure of administrative charges most familiar to investors and policy-makers alike is the 'reduction in yield'. This adds together all the charges over the lifetime of a pension policy, and expresses them all as a percentage of assets. An alternative approach is to measure charges as a proportion of contributions. This is the same as calculating the charges over the lifetime of the fund as a proportion of the balance accumulated at retirement. This second measure is known as the 'reduction in premium' or the charge ratio.

Table 3. Strategies on administrative charges for pensions

No restrictions	Australia Hong Kong United Kingdom (personal pensions) United States (401k)
Cross-subsidies to low-paid workers	Mexico
Limits on charge structure	Argentina Chile Hungary
Partial ceiling on charges	Poland
Variable ceiling on charges	Sweden
Competitive bidding, multiple portfolios	United States (thrift savings plan)
Fixed ceiling on charges	El Salvador Kazakhstan United Kingdom (stakeholder pensions)
Competitive bidding, single portfolio	Bolivia

more restrictive

Source: Whitehouse (2000*a*,*b*,*c*; 2001)

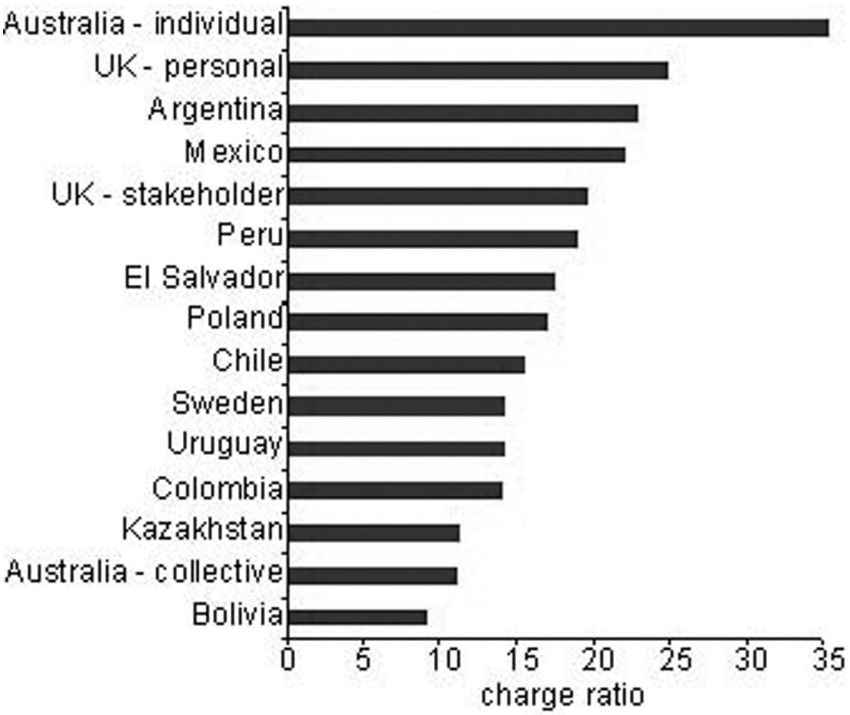
Source: Whitehouse (2000*a*,*b*,*c*; 2001)

[9] This section summarises the analysis of Whitehouse (2000*a*,*b*,*c*, 2001). See also James *et al.* (2000) and Shoven (2000).

International comparisons

Figure 4 summarizes data on charges for 13 countries with mandatory funded pension systems. Even very similar pension systems with similar approaches to charges deliver very different levels of fees in practice. Among Latin American countries with individual accounts systems, the average charge ratio varies from under 15 percent in Colombia to nearly 25 percent in Argentina. Looking at all systems, average charges range from under 10 percent in Bolivia to 35 percent in Australia's retail superannuation funds. As noted above, the three cheapest systems offer very limited choice of provider and/or investments. As a rule-of-thumb, a charge ratio of 20 percent over a 40-year pension plan equals a reduction in yield of 1 per cent.

Figure 4. Paying for pensions: the charge ratio for individual accounts in 13 countries



Note: charge ratio: total charges over the lifetime of the pension as percentage of accumulated balance at retirement. The calculations assume 40 years' contributions and 3.5 percent annual real return. Australia: 'collective': industry-wide funds; 'individual': 'master trusts' (provided by financial-services companies)

Source: Whitehouse (2000*a*,*b*,*c*; 2001)

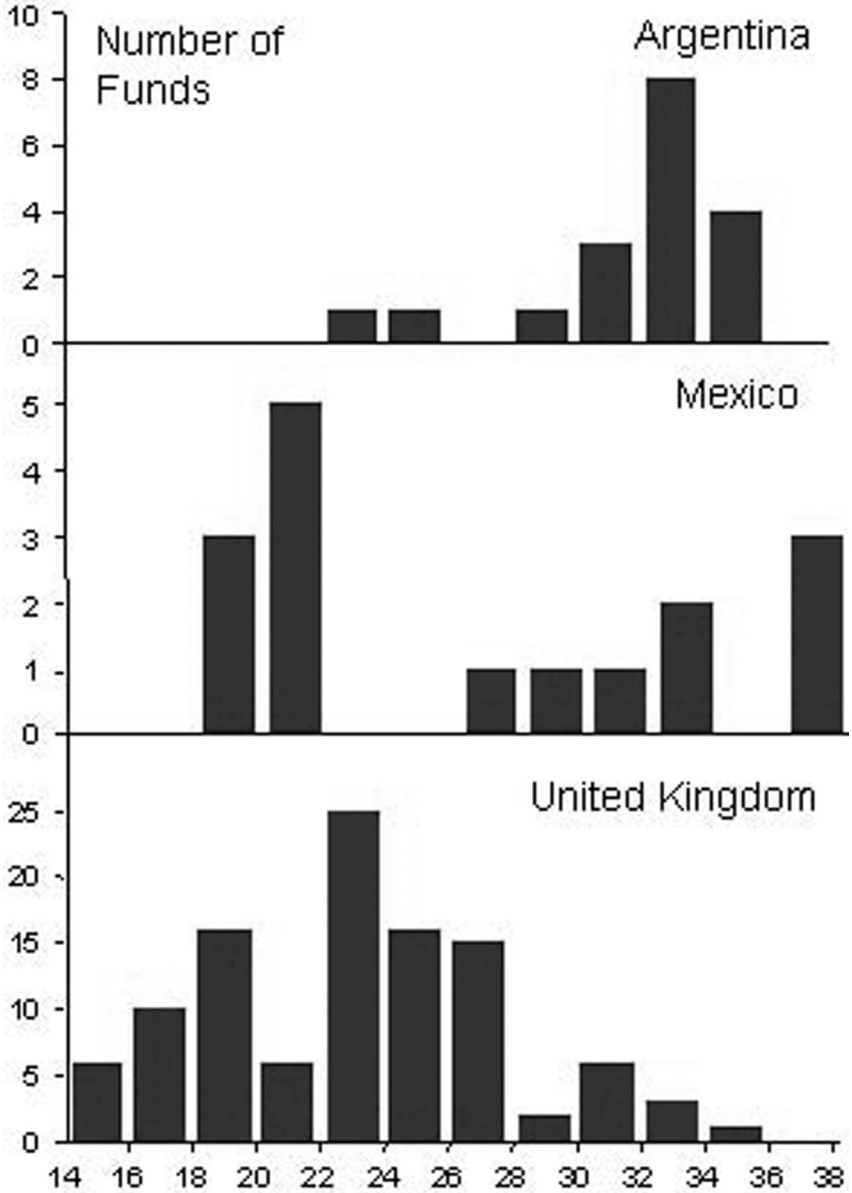
Charges levied by different providers

Most studies of administrative fees for pensions look only at the average. But the average disguises a huge range of different charge levels between different providers. Figure 5 shows the distribution of charges in three countries. In the United Kingdom, the cheapest funds levying 15 percent of contributions and the most expensive, 35 percent. The range in Mexico is 17 to 37 percent. Even in Argentina, with the narrowest range, charges vary between 23 and 36 percent, meaning that the most expensive fund costs over 50 percent more than the cheapest.

These large ranges raise a difficult question: why do consumers choose expensive funds? Improved levels of service, for example, are unlikely to explain such a large differential. There is evidence in the United Kingdom that funds with higher charges perform better, but the out-performance is insufficient to offset the higher

charge burden on typical pension policies. Perhaps some consumers fail to take proper account of the burden of charges. The most likely reason, particularly in Latin America, is excessive marketing (see below).

Figure 5. Distribution of charge ratios across funds: Argentina, Mexico and United Kingdom



Source: Whitehouse (2000*a,b,c,* 2001)

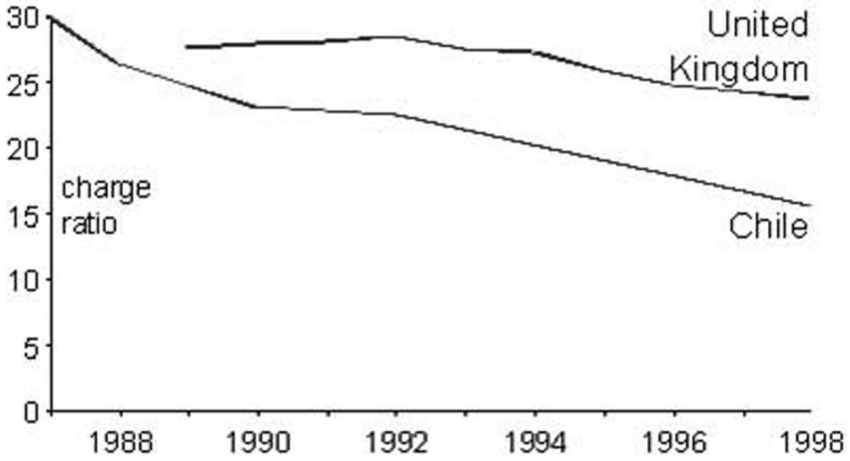
Policy options for charges

1. No regulation

An important assumption of the calculations above is that charges remain constant until pensions are withdrawn. But pension providers' revenues, especially from charges on fund assets, are back-loaded while expenses are front-loaded because of set-up costs. Also 'learning by doing' and the consolidation of the pension fund industry in most reforming countries might put downward pressure on costs over time.

Most mandatory funded pension systems were introduced within the last five or ten years. But reforms in Chile and the United Kingdom have been in place for longer. Average charges have declined in both countries (Figure 6): by almost one half in Chile (from 30 to 15.5 percent) and one sixth in the United Kingdom (from 27.5 to 23.5 percent). If other countries follow this pattern of declining charges over time, then the charge ratio measures above, which assume constant charges, are over-stated.

Figure 6. Evolution of average pension administrative charges, Chile and United Kingdom



Source: Whitehouse (2000*a,b,c,* 2001)

2. Improve disclosure

Measuring the impact of charges on pension fund returns is very complicated. The minimum government policy should therefore be a requirement for funds to disclose charges in a standard format. This will help consumers make informed comparisons between different funds. Regulators can make the task easier by producing 'league tables' of charges. The supervisory authorities in Latin America regularly provide comparative information on different pension fund managers, and the Financial Services Authority in the United Kingdom has issued data on the charges for a wide range of financial products.

A second step to bring charges to consumers' attention is to levy charges on top of (rather than out of) mandatory contributions. This encourages shopping around because charges reduce current net income rather than future pension benefits. Four Latin American countries have adopted this approach. A related issue is ensuring that whoever pays the charges makes the choice of pension provider. In Australia, employers choose the superannuation fund, but the charges are effectively borne by their employees in the form of a reduction in the money flowing into their funds. There is a potential 'agency' problem because employers pick the pension while employees pay the pension charges.

The third policy related to disclosure is educating consumers about the effect of charges on their investments. For example, over the life of a pension policy, a charge of 1 percent of assets per year adds up to a charge ratio of 20 percent. Few investors appear to be aware of the major impact that fees can have.

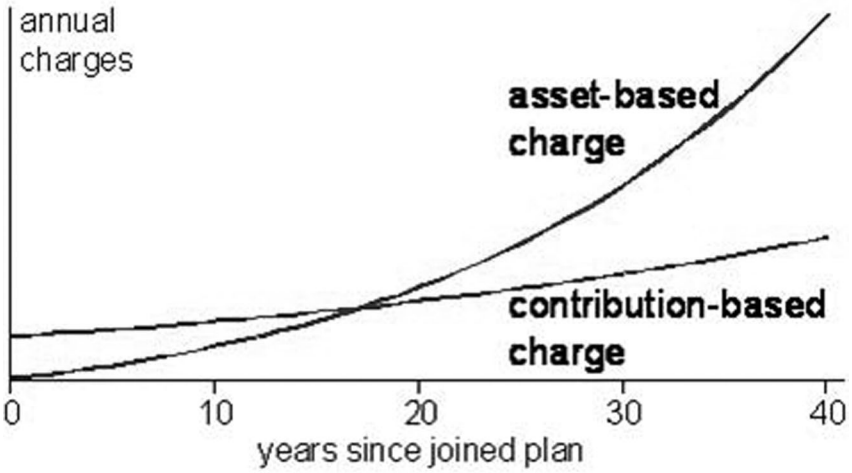
3. Facilitating comparison of charges

By ensuring all providers stick to a common charge structure, it is easier to compare fees between them. Unregulated charging regimes can be very complex and confusing. A regulated fee structure, in contrast, can mean there is a single 'price' that consumers can compare across providers. And a single proportional charge, on assets or contributions, means that the relative cost of choosing a different provider does not vary with earnings or contributions.

The important policy option for governments taking this route is the type of charge to be permitted. There are four features of the two charges important in making this choice.

The first is the time profile of charge revenues. Fees on contributions generate more up-front revenues than fees on assets (Figure 7). This allows providers to cover their start-up costs more quickly. This might boost competition by encouraging more entrants to the pension market when the system is established.

Figure 7. Pension funds' revenue streams under different types of charge



Source: Whitehouse (2000*a,b,c,* 2001)

A second issue is the incidence of the levies across different types of consumer. If there are fixed costs per member—and the evidence suggests that these are sizeable—then levies on assets redistribute from people with large funds to people with fewer assets in their plan. Older workers, with larger funds on average, would cross-subsidize younger workers, for example. Contribution-based charges redistribute from people with high levels of contributions (typically higher earners) to people with low levels of contributions.

Indeed, there would be no revenues from people who do not contribute. This might be because they have lost their job, withdrawn from the labor force or moved into the informal sector of the economy. But pension providers would still have to bear the cost of administering these people's funds. Asset-based fees ensure a continuing flow of revenues from non-contributors, but this means that the fees bear more heavily on people who withdraw from work early.

Finally, a charge on fund value encourages providers to maximize assets, both by attracting funds from other providers and, more importantly, by maximizing investment returns.

The choice between the asset-based and contribution-based approach is finely balanced. Unsurprisingly, different countries have taken different options. Levies on contributions are the norm in Latin America, while the United Kingdom has opted for asset-based fees. The government's main arguments were fund managers' performance incentives and the continuing revenue stream from members suspending contributions.

4. Ceilings on charges

Quantitative restrictions on charges are rare. Only El Salvador, Kazakhstan, Poland, Sweden and the United Kingdom, in the new stakeholder plans, have such limits.

The problem with this approach is the risk that governments set the 'wrong' ceiling. Too high a limit would be ineffectual. Too low a ceiling might mean that fund managers could not cover their costs. This will restrict competition and choice. It could even lead to the failure of weaker providers, undermining public confidence in the system. Ceilings all too often become a de facto minimum charge as well as the legal maximum. Price competition, beyond meeting the regulatory requirement, would be curtailed.

The experience with the new stakeholder pensions in the United Kingdom has, however, been encouraging. Providers initially said that the 1 percent ceiling would be too low. However, a number entered the market, a few even undercutting the ceiling.

5. Treatment of low earners

A common reason for any regulation of charges is to protect low-income workers. This is particularly important in mandatory funded pension schemes. It would be manifestly unfair if low earners saw most or even all of their contributions eaten up in charges.

Regulating charge structures can provide a significant degree of protection. Limiting fees to proportional charges (either on assets or contributions) means that there are no fixed charges, which bear disproportionately on the low-paid. Nevertheless, most countries provide a minimum pension guarantee, a universal flat-rate pension or social assistance incomes in retirement. People with persistently low earnings are unlikely to build up a funded pension above the minimum level.

A sensible solution is to exempt low paid workers from the requirement to contribute to a funded pension or to allow them to opt out. The United Kingdom, for example, will aim the new stakeholder schemes at people earning more than 55 percent of average earnings. Australia excludes workers on less than 15 percent of average pay, and has plans to allow people earning between 15 and 30 percent of the average to opt out.

An alternative approach is to cross-subsidize low-paid workers' accounts directly. The Mexican government ensures a contribution of at least 5.5 percent of the minimum wage. Coupled with a tax-credit system that boosts the incomes of low-paid workers, this encourages Mexicans into the formal sector. Together, these policies promote broader coverage of the pension system. A second advantage of direct subsidies is that they make the redistribution from higher-paid to lower-paid workers transparent.

6. Alternative institutional structures

The pension plans discussed above are mainly decentralized: people choose between a range of competing pension fund managers. An alternative approach is some sort of collective mechanism.

Australia's collectively provided industry funds, for example, charge just one third of the price of funds that single employers buy from financial-services companies. Australian experts have proposed that this intriguing gap reflects 'a difference in governance, historical ethos, institutional practices and industry structure.' Industry funds, with a captive membership, have no need for marketing or a sales network. And information, services and investment choice tend to be more limited in the industry funds than they are in the retail sector.

A step further is to move to a single, publicly managed fund. However, research has shown that public management has typically led to poor returns. Even with good management, the state as a large shareholder raises corporate governance concerns that are very difficult to resolve.[10] Centralized record-keeping (as in Latvia and Sweden, for example) can, nevertheless, reduce costs.

Another institutional means of keeping costs low is to 'piggy-back' on existing structures. For example, employer pension plans in the United Kingdom have been able to contract out of the public, earnings-related scheme since it was introduced in the late 1970s. The United States already has a large, employer-based pension infrastructure, including 401(k)s. Costs might be lower if individual accounts were merged with these plans. Such a policy would, however, require careful attention to the regulation and supervision of these plans, particularly 401(k)s.

[10] See Iglesias and Palacios (2000) and Palacios (2002).

7. Restricting choice of funds

The main cost of strict regulation of charges is the reduction in pension members' choice. Low-cost regimes, such as the thrift savings plan (TSP) for federal employees in the United States, offer only a small range of funds, often indexed to avoid the extra cost of active management. (TSP charges are also low because the scheme only deals with one employer.) Bolivia offered no choice of fund initially and only a choice between two funds after a few years.

This restriction of choice has a cost. Pension members are unable to choose investments that suit their preferences. For example, older members might want to invest more conservatively than younger people, but both can be constrained by a 'one-size-fits-all' fund.

The counterpart to restricted choice is limits to competition, which might result in poorer service and performance than a deregulated, decentralized market.

8. Avoid excessive marketing costs

The Latin American pension reforms have been, to varying degrees, plagued by excessive marketing costs. Pension funds have competed fiercely to persuade people to switch between them. Given that the portfolios of the different funds were, until recently, highly uniform, there was little economic reason for this churning of members. More recent reformers have sought to avoid this problem. In Sweden, for example, the contribution to the new individual accounts is only 2.5 percent. There was therefore a risk that administrative expenses could eat up a substantial proportion of these contributions. Individuals can choose to invest there money in any mutual fund. But record-keeping is centralized (which might also cut costs) and fund managers do not know who their members are (so reducing the inventive for excessive marketing expenditure).

9. Promote consolidation

The potential for economies of scale in managing pension funds has important consequences for public policy on charges and industry structure. The evidence, unfortunately, is inconclusive. Figure 5 showed the very broad distribution of charges across providers in three countries with mandatory funded pension systems. Despite this variability, there is no relationship between fund size and charges.

Various studies have suggested anything from under 100,000 to 500,000 members as the minimum to achieve efficient scale. In mutual fund markets, which share many of the features of pension markets, some studies have suggested that the fall in costs with size comes to a halt once funds reach $0.5 billion. Others suggest this could be as high as $40 billion.

Currently available evidence does not demonstrate that highly centralized approaches to managing funded pensions will significantly reduce costs. And the potential gains must be balanced against the cost of stifling competition, which in the medium term should act as a spur to innovation and cost control.

Conclusion

Governments should, at the very least, ensure clear and transparent disclosure of charges so that people can compare different companies' fees. A program of financial education that spells out the large impact charges have on pension values would also be useful. There is a good case also for regulation of the structure of charges, which can significantly ease comparisons between providers. However, imposing a ceiling on charge levels has the risk that limits are set at the wrong level, discouraging entry to the pensions market and reducing competition.

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Chairman MCCRERY. Thank you, Mr. Whitehouse. Ms. Coronado.

STATEMENT OF JULIA LYNN CORONADO, SENIOR RESEARCH ANALYST, WATSON WYATT WORLDWIDE

Ms. CORONADO. Thank you, Mr. Chairman. I will be talking about Sweden's reform. Like most industrialized nations, Sweden

has a public pension system that is financed on a pay-as-you-go basis. A rapidly aging population implied a projected discrepancy between payroll tax revenue and benefit payments that was twice the country's GDP in 1996. Prior to reform, the Swedish system paid out benefits according to an aggressive DB formula, and on average replaced about 75 percent of pre-retirement earnings at age 65. The primary impetus for reform was to achieve a system whose financing was stable given demographic uncertainties and economic fluctuations. Given the high level of payroll taxes in Sweden, a consensus emerged that the macroeconomic implications of balancing the system through an increase in the payroll tax were decidedly undesirable. To create a sustainable system, policy makers sought to balance social protection of the vulnerable with the need for a tight link between contributions and benefits, in order to provide appropriate economic incentives and to enhance the efficiency of the system.

The new public pension system in Sweden is a DC scheme funded mainly on a PAYGO, with a small funded component. A 16 percent payroll tax funds a notional DC account on behalf of each worker. The account is notional in the sense that there are not separate accounts for each worker, and benefits are funded through current payroll tax revenue. The account grows with payroll tax contributions as well, at a rate of return that is based, in large part, on the growth rate of average wages. Upon retirement, the balance in the notional account is converted to an annuity. In addition to the notional account, workers contribute 2.5 percent of their wages to an individual account administered by the government and through which workers can invest in any 5 of over 700 mutual funds of their choosing. Upon retirement, the participant can choose to convert their balance in the individual account to either a fixed or variable rate annuity that is purchased directly from the government.

A number of macroeconomic stabilizers are built into the rate at which benefits accrue. If the system is in actuarial balance then the accounts are credited annually with the growth rate in average wages. However, the growth in average wages does not necessarily reflect the growth in the contribution base if cohorts are either growing or shrinking. Thus, in the event that an actuarial deficit or surplus opens up, policymakers have built in the ability to deviate from average wage indexation. Upon retirement, the annuity rate will depend on the expected survival probabilities for each cohort so that participants bear the risk of future improvements in life expectancy through lower replacement rates, although the government continues to bear the risk for changes in mortality after retirement. Thus, the reform transfers much of the economic and demographic uncertainties directly into benefit levels, leaving the financing of the system remarkably robust to changing economic conditions.

In exchange for this added uncertainty, participants have much more flexibility in how they take their retirement benefits. Retirement can be taken as early as 61, but participants will realize a steadily higher replacement rate the longer they work. This is a far more powerful incentive in a DB system, as the replacement rate increases not only with the actuarial adjustments to benefits, but

also with the added pension rates earned through more years of contributions and returns. Benefits in the notional and individual accounts do not have to be claimed at the same time and workers can claim full or partial benefits in either, so that retirement in Sweden will likely evolve in a much more varied process across individuals and cohorts.

The individual accounts are administered by a new government agency that acts as a record keeper, a clearinghouse for investment transactions, a broker on investment fees, and the sole provider of annuities. The Swedish administrative model was designed to avoid the high costs in other public pension systems. Once the funds have been allocated to the accounts, employees can choose a maximum of 5 from over 700 mutual funds. Sweden opted for a relatively unrestricted choice as a way of encouraging competition, allowing for diversification in a relatively small country, and mitigating the potential for political interference in investment management. In addition to allowing for risk taking, however, facing such a vast number of choices is potentially overwhelming to investors. Yet, in the first round of investment choices made by investments in 2000, more than two-thirds of participants made active choices choosing on average three-and-a-half funds of different types.

I am running out of time so, let me skip to this. We can get to more of the individual details of the individual accounts in questions. Just another key point to make is that the government negotiates a fee structure with the participating mutual funds. On average, this has resulted in an expense ratio of 61 basis points of assets. This is much higher than the six basis point expense ratio in the TSP, however the system is in a startup phase. The system is currently projecting an expense ratio of 30 basis points in 10 years. So, what can the United States learn from the Swedish experience is, at first blush, passing the uncertainty on to benefit levels may seem draconian, but it should be kept in mind that Sweden had an extremely high level of benefits prior to reform. The post reform replacement rates are much more comparable to the current U.S. Social Security system. Sweden has also taken the approach of partially funding retirement benefits, which will have positive macroeconomic ramifications going forward. Finally, their design for the individual account tier deserves a very detailed examination should the United States pursue such a policy. The centralized clearinghouse model balances costs with private market incentives and seems to be very promising. That concludes my remarks. I will take questions.

[The prepared statement of Ms. Coronado follows:]

Statement of Julia Lynn Coronado, Senior Research Analyst, Watson Wyatt Worldwide

Sweden's Public Pension Reform: Lessons for the United States

Overview of the Swedish Reform Process

Like most industrialized nations, Sweden had a public pension system established in the early part of last century that was financed on a pay-as-you-go basis (PAYG), meaning that current payroll taxes funded the benefits of current retirees. Such a system was made feasible by a growing population in which the generations of young outnumber the elderly by a considerable margin. However also in concert with most other industrialized nations, Sweden saw a sea change in the demo-

graphics of its populations in the latter part of the century. As shown in Table 1, life expectancies in Sweden have risen considerably while birth rates have declined. The ratio of elderly to young has already more than doubled as a result. Sweden's population has aged more rapidly than the U.S. with a ratio of elderly to young that is closer to Japan's. A rapidly aging system places pressure on PAYG pension schemes as the working population has to pay higher taxes to finance a given level of benefits for the ever larger cohorts of elderly.

Table 1—Selected Demographic Characteristics Placing Pressure on PAYG Social Security Systems

	Life Expectancy at Birth		Fertility Rate		Ratio of Elderly to Youth*	
	1950	2010	1950	2010	1950	2010
Sweden	71.8	81.1	2.21	1.34	0.51	1.34
United States	68.9	79.2	3.45	1.93	0.37	0.69
Japan	63.9	83.3	2.75	1.43	0.17	1.62

Source: United Nations, World Population Prospects (2000).
*Ratio of people over 60 to people under 20.

The aging population implied a projected discrepancy between payroll tax revenue and benefit payments. In 1996 the projected actuarial deficit of the system was estimated at $500 billion, or twice the countries GDP. It was projected that the payroll tax would have to rise from just under 20 percent to something in the neighborhood of 30 percent to fund promised benefits. This compares with the current projected unfunded liability in the U.S. Social Security system of $11 trillion over an infinite horizon, or 1.2 percent of GDP. In the absence of any changes to the system, the payroll tax in the United States would have to rise from the current rate of 12.4 percent to a projected 18 percent by 2079.[1]

Table 2—Timeline of the Swedish Social Security Reform

1984	A commission is appointed to study options for reforming the social security system.
1990	The commission presents its recommendations, including keeping the basic structure of the system intact, raising the retirement age and requiring more years of work to qualify for a full benefit.
1991	The government changes hands. A new commission is appointed with a mandate for more fundamental reforms.
1994	The second commission presents its recommendations; essentially a blueprint for the reform eventually enacted. These are approved "in principle: by Parliament and a working group is established to draft the necessary legislation.
1998	Parliament passes most of the legislation for the reform.
2000	The first investment choices by participants are processed for the individual account component of the system.

Source: Annika Sunden, "How Will Sweden's New Pension System Work?" Center for Retirement Research Issue Brief 3, 2000, Boston College, and Edward Palmer, Testimony Before the Subcommittee on Social Security of the House Committee on Ways and Means (2001).

Hence, Sweden was under considerable pressure to address the projected shortfall in its public pension system. The process of reform began in 1984 with the appointment of a commission to study options and issues for achieving balance. This commission reported its findings to Parliament in 1990. The report favored keeping the basic defined benefit framework intact while reducing benefits through increasing

[1] *2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

the retirement age and requiring more years in the labor force for a full benefit. In 1991, however, the government changed hands and the new coalition government favored more fundamental changes to the system. A new commission was appointed to review the situation, and this group presented its recommendations to Parliament in 1994. These were passed "in principle" and a working group was named to write the necessary legislation. The main package of legislation required to establish the new system was passed in 1998. The lengthy reform process in Sweden reflected the need for broad political support to reform such a comprehensive system.

The Swedish Social Security System Prior to Reform

Prior to the reform, the system was financed through payroll taxes and paid out benefits according to a progressive defined benefit formula. Taxes were collected and benefits paid out in a two-tier structure that separated the social insurance and retirement saving functions of the system. The first tier was a non-means tested flat benefit that was designed to provide a basic floor of support and was funded through a nearly 6 percent payroll tax levied on employers. This first tier was fairly generous providing a benefit in 1995 that was equal to roughly 18 percent of the average wage rate. The second tier of benefits was explicitly earnings-related and was meant to function as retirement saving by replacing a similar fraction of pre-retirement earnings above the first tier of benefits. It was based on a participant's highest 15 years of earnings and required 30 years of earnings to qualify for a full benefit. It was financed by a 13 percent payroll tax on employers. Taken together, the two tiers of benefits implied a progressive benefit structure since the first tier replaced a higher fraction of earnings for lower income workers. On average the system replaced over 70 percent of pre-retirement earnings.

The primary impetus for reform was to achieve a system whose finances were stable given demographic uncertainties and economic fluctuations. Given the high level of payroll taxes in Sweden, a consensus emerged that the macroeconomic implications of balancing the system through an increase in the payroll tax were decidedly undesirable. To create a sustainable system, policymakers sought to balance social protection of the vulnerable with a need for a tighter link between contributions and benefits in order to provide appropriate economic incentives and enhance the efficiency of the system. Along these lines, a number of other inequities and inefficiencies were identified that policymakers sought to address through the redesign of the system. Two perceived shortcomings of the system are of note in comparing the Swedish reform to the situation in the United States.

The first of these were problems associated with the fact that benefits in Sweden were indexed to prices rather than wages. The result of price indexing was volatility of replacement rates through economic cycles when wages grew either more slowly or more rapidly than prices. In addition, because benefits were paid up to a ceiling that was also indexed to prices, over time real wage growth implied that the system was evolving into a flat benefit system and the link between taxes paid and benefit received was eroding. It is worth noting that current proposals for price indexing benefits in the United States would also likely result in volatility in replacement rates and lead the system toward a flat benefit structure.

The second perceived shortcoming of the Swedish social security system prior to reform worth noting is that the system, which features a formula designed to result in a progressive replacement rate, was not considered to be as progressive in practice. This owed largely to the use of the 15 highest earning years in determining the benefit level, a formula that redistributes from those with long working lives and flat earning profiles who are typically lower wage workers, to those with shorter work histories and steeper earnings profiles.[2] Such capricious redistribution has also been noted in the current U.S. social security system by the President's Commission to Strengthen Social Security. A number of research papers have shown that, owing to the spousal benefit and the lack of distinction between households and individuals, the current system in the U.S. does more redistribution between high and low earners within households than across households.[3] Policymakers in Sweden made transparency of redistribution a priority in the reform effort.

The Swedish Public Pension System Post Reform

The new public pension system in Sweden is a defined contribution scheme funded mainly on a PAYG basis with a small funded component. A 16 percent payroll tax levied equally on employers and employees funds a notional account (NDC) on behalf of each worker. The account grows with payroll tax "contributions" as well

[2] See Annika Sunden, "How Will Sweden's New Pension System Work?" Center for Retirement Research Issue Brief 3, 2000, Boston College.

[3] Interim Report of the President's Commission to Strengthen Social Security, August 2001.

as a rate of return based in large part on the growth rate of average wages. Upon retirement the balance in the NDC is converted to an annuity using an assumed 1.6 percent real average salary growth rate and the expected life expectancy for the cohort. After retirement benefits will be adjusted for salary growth that differs from 1.6 percent. In addition to the NDC, workers contribute 2.5 percent of wages to an individual account administered by the government and through which workers can invest in any 5 of over 650 private investment funds of their choosing. Upon retirement the participant can choose between a fixed or variable rate annuity that is purchased directly from the government.

A number of macroeconomic stabilizers are built into the rate at which benefits accrue. If the system is in actuarial balance then the accounts are credited annually with the growth rate in average wages. However the growth in average wages does not necessarily reflect the growth in the contribution base if cohorts are growing or shrinking. Thus, in the event that an actuarial deficit or surplus opens up, policymakers have built in the ability to deviate from average wage indexation. In addition, balances are adjusted upward each year to credit surviving members of a cohort with the balances of the deceased and downward for administrative costs. Upon retirement, the annuity rate will depend on the expected survival probabilities for each cohort so that the beneficiaries bear the risk of future improvements in life expectancy through lower replacement rates, although the government continues to bear the risk for changes in mortality after retirement. Thus the reform transfers much of the economic and demographic uncertainties directly into benefit levels leaving the financing of the system generally quite robust to changing economic conditions.[4]

In exchange for this added uncertainty, participants have much more flexibility in how they take their retirement benefits. Retirement can be taken as early as 61 but participants will realize a steadily higher replacement rate the longer they work. This is a more powerful incentive in a defined benefit system as the replacement rate increases not only with the actuarial adjustment as in a defined benefit system, but also with the added pension rights earned through more years of contributions and returns. Benefits in the NDC and the individual accounts do not have to be claimed at the same time and workers can claim full or partial benefits in the both the NDC and from the individual accounts so that retirement will likely evolve into a much more varied process across individuals and cohorts.

The individual accounts are administered by a new government agency that acts as a record-keeper, a clearinghouse for investment transactions, a broker on investment fees, and the sole provider of annuities. The Pension Premium Agency takes requests for allocations and trades, aggregates them and submits them in bulk to the participating mutual funds much as private pension plans in the U.S. currently manage their defined contribution accounts. The mutual funds thus do not have any information on individual participants. The Swedish administrative model was designed to avoid the high costs in other public pension systems with individual accounts such as Chile and the U.K.[5] Contributions are collected through the government tax authority so as to minimize the burden on employers. Employers remit the entire payroll tax and the money is allocated to individuals accounts approximately 18 months later when income tax statements are filed and reconciled. In the interim the funds are invested in a government bond fund.

Once the funds have been allocated to the accounts, employees can choose a maximum of five funds from over 700 funds representing 85 fund companies currently registered to participate in the Swedish system. Some of these funds are highly specialized in particular sectors or countries allowing for substantial risk taking by participants. Sweden opted for relatively unrestricted choice as a way of encouraging competition, allowing for diversification in a relatively small country, and mitigating the potential for political interference in investment management.[6] In addition to allowing for risk taking, however, facing such a vast number of choices is potentially overwhelming to investors. Yet in the first round of investment choices made by investors, more than two thirds made an active choice with the average participant selecting 3½ funds of different types. In addition, surveys have indicated that many

[4] The central government does bear risk through the pension subsidy for lower wage workers and earnings credits granted to stay at home parents and unemployed, both of which are financed with general revenues and can fluctuate with changing demographic and economic conditions.

[5] See discussion in Edward Palmer "The Swedish Pension Reform Model: Framework and Issues" (2001).

[6] See R. Kent Weaver "Design and Implementation Issues in Swedish Individual Accounts" Social Security Bulletin vol 6 no 4 (2004).

of those who did not make an active choice did so intentionally as they preferred to invest in the default fund.

Such a high level of active participation was facilitated by a massive media campaign by both the government and private mutual fund companies. Investors received, and will receive annually, a catalog of all the funds and their characteristics as well as educational materials on investing. Subsequent years have featured substantially lower levels of active participation. This is part because the new participants are generally young new entrants to the labor force, but is also possibly influenced by the very poor stock market returns of recent years combined with the relatively positive performance of the default fund and the lack of intense media focus.[7] Because the agency that administers the funds must pass the cost of investor education on through higher fees, it does not have the incentive to provide extensive education materials. While participants receive the catalog of funds and a personal statement each year, the level of information in the media has declined substantially years following the start-up. This raises the broader issue of who should be responsible for financial education in a system where all members of society are required to participate in financial markets.

Another key issue in an individual account system is the design of the default fund. In Sweden the default fund is a broadly diversified equity fund. If active choices by new entrants remain low, this fund will manage an increasingly large pool of assets. This fund was set up to have an independent professional staff and has achieved competitive returns at low costs to date. However the fund decided independently to refrain from investing in particular companies based on international labor and environmental concerns and politicians have publicly criticized the fund for its lack of Swedish investments so that the potential for political influence on investment choices is already apparent.

Among private funds, the government negotiates a fee structure with participating mutual funds that is designed to discourage participation by high fee funds and encourage the selection of low fee funds by participants. Participants to date have paid administrative fees of 22 basis points of assets and investment fees averaging 39 basis points of assets for a total expense ratio of 61 basis points. Expenses are thus quite a bit higher than the 6 basis point expense ration the Federal Employee Thrift Savings Plan which is frequently cited as a potential model for the U.S. in administering individual accounts. Nor does it represent a substantial improvement over the Chilean and British models. However the system is in its start-up phase and so expense ratios will decline as a fraction of assets under management as balances increase. In year 2020 the administrative fee is projected to be 5 basis points and the asset management fee 25 basis points. The Swedish experience does indicate that the first generations in the new system of individual accounts can disproportionately bear the start-up costs.

Lessons for the United States

If people continue to retire at the same ages they have in recent decades, the combination of longer life expectancies and lower fertility rates imply the likelihood of slower rates of improvement in our standards of living. Changes to PAYG public retirement programs become the mechanism for allocating the resulting economic disappointment.[8] Sweden faced the fiscal challenges of its aging population head on through a massive scaling back of benefits. While at first blush this may seem draconian, it should be kept in mind that Sweden provided an extremely high level of benefits prior to reform, providing replacement rates at age 65 upwards of 75 percent. Through the process of reform Sweden created a system with a much clearer link between contributions and benefits that eliminated disincentives for labor supply at older ages. In the future, the likely outcome of Sweden's system is that people will postpone retirement in order to maintain their standards of living. This increase in labor supply will have positive implications for macroeconomic stability. One concern is that such a reduction in benefits should be clearly communicated as such. The Swedish government does send out a yearly statement, "the orange envelope" giving all individuals a forecast of their future pension. It is important in a pension program that benefit generosity is clearly understood by participants in order that they can make their personal saving decisions accordingly. Nearly 90 percent of Swedes are covered by employer-sponsored pensions and so most participants already have a vehicle for any additional saving they wish to undertake. It also remains to be seen whether the automatic stabilizers that ensure the financial

[7] Weaver (2004).

[8] Steven A. Nyce and Sylvester J. Schieber, *The Economic Implications of Aging Societies: The Costs of Living Happily Ever After*, Cambridge University Press (2005).

stability of the system through adjustments in benefits will be politically sustainable in the long run.

Sweden has also taken the approach of partially funding retirement benefits in the public system through the establishment of individual accounts. This will also have positive macroeconomic ramifications going forward. The costs of the public system will be reduced over time as benefits will be partially funded through compound interest and more capital will be channeled into productive use in the private sector.

Sweden's design for their individual account tier is certainly worth a detailed examination should the U.S. pursue such a policy. The centralized clearinghouse model has much to recommend it in terms of cost efficiencies over the long run. It is difficult at this early stage in the Swedish system to draw conclusions about the investment choices of participants, however issues surrounding the design of default options and investor education are not easily resolved and the Swedish example may provide valuable lessons about what policies are and are not effective. Indeed the Swedish government recently appointed an inquiry to review ways to reduce the number of funds, evaluate communication and administrative and investment costs among other elements of the system. They will submit their final report this fall.

Table 3—Comparison of Swedish and U.S. Social Security Systems

	Sweden		United States Current System
	Pre-Reform	Post-Reform	
Taxes	19% payroll	16% payroll for notional defined contribution account + 2.5% deposited into individual account + approximately 1% payroll worth of general revenue	12.4%
Benefits	Non means tested flat Benefit equal to roughly 18 % of average wage rate Earnings related pension calculated using 15 highest earning years indexed for inflation and requiring 30 years of earnings for full benefit Normal retirement age of 65. Early retirement age of 60. Provided an average single worker with a replacement rate around 70+ percent of pre-retirement earnings	Benefits based on the balances in the notional defined contribution account and the individual account. A guaranteed pension paid directly from the states budget is available at age 65 to people earning on average below 45 percent of the average wage. Full benefits require that the individual been living in Sweden for 40 years. Retirement can be as early as 61. Under intermediate assumptions provides an average single earner with a replacement rate around 46 percent at age 65.	Progressive benefit formula related to earnings calculated on 35 years of a participant's highest earnings indexed to average wage growth and requiring 10 quarters of earnings for a full benefit. Normal retirement age phasing to 67. Early retirement age of 62. Provides an average single worker with a replacement rate of about 40 percent of pre-retirement earnings.

Table 3—Comparison of Swedish and U.S. Social Security Systems—Continued

	Sweden		United States Current System
	Pre-Reform	Post-Reform	
System Finances	Payroll tax rate would have to rise to approximately 30 percent to fund promised benefits	Payroll tax fixed. Benefits and general revenue contribution fluctuate to balance system.	Payroll tax will have to rise to roughly 18 percent to fund currently legislated benefits.

Chairman MCCRERY. Thank you, Ms. Coronado. Mr. Vasquez.

STATEMENT OF IAN VASQUEZ, DIRECTOR, PROJECT ON GLOBAL ECONOMIC LIBERTY, CATO INSTITUTE

Mr. VASQUEZ. I appreciate the opportunity to testify today about the Chilean private pension system, especially because it has become the model for countries doing the same thing around the world or considering doing such reform. In 1981, Chile became the first country in the world to replace its bankrupt PAYGO pension system with an investment-based privately managed system of individual retirement accounts. Chile's pioneering reform created a fully funded system whose principal features are individual choice, clearly defined property rights, and the private administration of accounts. By linking effort and reward, the reform offers proper investment and work incentives, and that has contributed to Chile's impressive rates of growth. It is said that the reform itself is probably responsible for up to a quarter of the increase in the growth rate and up to a third of the increase in savings rates in the country. Today, 95 percent of Chilean workers have joined the system. The pension funds have accumulated assets of some $58 billion, which represent about 75 percent of Chilean GDP, and the average real rate of return on the pension funds has been 10.24 percent.

The way the system operates is clear and simple. Every month workers deposit 10 percent of the first $22,000 of earned income in their own individual pension savings accounts, which are then managed by specialized fund administration companies of their choice. These companies invest the workers' savings in a portfolio of bonds and stocks that are subject to regulations, and at retirement, use the funds in their accounts to purchase annuities or make programmed withdrawals, or they can take a combination of the two. 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.

The reform itself had clear and simple rules when it began. Workers already in the labor force were given a choice to join the new system or to remain in the old. Those who chose to switch to the private system were given "recognition bonds" that reflected past contributions to the public pension program and that are paid by the government when the worker retires. New entrants into the labor force were required to join the new pension system, thus eventually ending the unsustainable PAYGO system. The benefits

of those already retired were not affected. In the new private system, workers have become owners of the means of production, or "worker capitalists," as Jose Pinera, the architect of the program, likes to say. This is a real paradigm shift in Chile because it reflects a move from a consumption-based system to an investment-based system, and has depoliticized a large part of the Chilean economy.

Critics of the system, however, often point to high administrative costs, the lack of portfolio choice, low participation rates, and so on. Some of these criticisms are misinformed. Some are highly misleading. Some were a reflection of over-regulation within the system itself. For example, administrative costs in Chile are 0.66 percent of assets under management, and this compares favorably to the U.S. mutual fund industry, where the costs are more than 1 percent. Another criticism sometimes heard is that the coverage under the new system is low. In fact, in Chile about 30 percent of the working population is self-employed and not required to join the system. By any measure, coverage in the new system is more complete than coverage under the old system, as I show in a graph in my written testimony.

As the system has matured, Chilean authorities have taken important steps to liberalize the pension system further. The most important structural reform of recent years has been the introduction of multiple investment funds. The pension fund companies now can offer five different funds to each worker that range from very low risk to high risk, and this has the advantage of allowing workers to make prudent changes to the risk profile of their portfolios as they get older. Other reforms have taken place to continue to improve the system, and I think others can be introduced. One of the most important reforms to the system that I would suggest is liberalizing the commission structure even more, so that pension fund companies can charge different rates to different customers. In summary, the Chilean private pension system is a success story by any measure and deservedly continues to be the model for rich countries and poor countries around the world.

[The prepared statement of Mr. Vasquez follows:]

Statement of Ian Vasquez, Director, Project on Global Economic Liberty, Cato Institute

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to testify today on Chile's private pension system, especially since it has become the model for countries around the world that have reformed their public pension systems or are considering doing so.[1]

In 1924 Chile was the first country in the hemisphere to implement a state-run retirement system. In 1981, Chile became the first country in the world to replace its bankrupt pay-as-you-go pension system with an investment-based privately managed system of individual retirement accounts. The problems that are currently putting pressure on workers and public retirement programs in so many countries also plagued Chile's government-run system, ultimately making it fiscally unviable: payroll taxes were high and saw large increases, the implicit debt of the public system was over 100 percent of GDP, the ratio of workers to retirees saw a significant and continuous decline, and the government was contributing to more than a third of the public pension system's revenues.[2]

[1] I thank Jacobo Rodríguez from whose work I have borrowed liberally and with permission.

[2] Jacobo Rodríguez, "Chile's Private Pension System at 18: Its Current and Future Challenges," Cato Institute Social Security paper no. 17, 1999, p. 3.

Chile's pioneering reform addressed the above problems by creating a fully funded system whose principal features are individual choice, clearly defined property rights, and the private administration of accounts. By linking effort and reward, the reform offers proper investment and work incentives, and has contributed to Chile's impressive growth rates.

Since the private pension system was implemented, labor force participation, pension fund assets, and benefits have increased. Today, 95 percent of Chilean workers have joined the system; the pension funds have accumulated assets of some $58 billion, amounting to more than 75 percent of Chilean GDP; and the average real rate of return on the pension funds has been 10.24 percent.[3]

The Chilean Private Pension System

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.(There are currently six competing pension fund companies in Chile.) 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. Fund managers can invest up to 30 percent of the portfolio overseas, a measure that allows workers to hedge against currency fluctuations and country risk. 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); or a worker can choose temporary programmed withdrawals with a deferred lifetime annuity.

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 small—about 0.1 percent of GDP.[4] (Of course, that cost is not new; the government also provided a safety net under the old program.) Those who have not contributed for 20 years and have not accumulated sufficient funds to meet the minimum pension can apply for a lower welfare-type pension.

When the reform began, workers already in the labor force were given a choice to join the new system or remain in the old. Those who chose to switch to the private system were given "recognition bonds" that reflected past contributions to the public pension program and that are paid by the government upon a worker's reaching the legal retirement age. New entrants into the labor force were required to join the new pension system, thus eventually ending the unsustainable pay-as-you-go system. The benefits of those already retired and receiving a pension at the time of the reform were not affected.

The transition to the private system was financed in a number of ways. It should be noted that the net economic costs of moving from an unfunded pay-as-you-go system to a fully funded system are zero. That is to say, the total funded and unfunded debt of a country does not change by moving from an unfunded system to a funded one. There is, however, a cash flow problem when moving toward a fully funded retirement system. In the case of Chile, transition costs can be broken down into three different parts. First, there is the cost of paying for the retirement benefits of those workers who were already retired when the reform was implemented and of those workers who chose to remain in the old system. That makes up by far the largest share of the transition costs at present. These costs will decline as time goes by. Second, there is the cost of paying for the recognition bonds given to those workers who moved from the old system to the new in acknowledgement of the contributions they had already made to the old system. Since these bonds will be redeemed when the recipients retire, this cost to the government will gradually increase as transition workers retire (but will eventually disappear). It is worth stressing that these are new expenditures *only* if we assume that the government would renege on its past promises. The third cost to the government is that of providing a safety net to the system, a cost that is not new in the sense that the government also provided a safety net under the old pay-as-you-go system.

To finance the transition, Chile used five methods. First, it issued new government bonds to acknowledge part of the unfunded liability of the old pay-as-you-go

[3] For detailed statistics of the Chilean pension system, see the website of the Superintendencia de AFPs, the Chilean government regulator of the private pension system, www.safp.cl.

[4] Ministry of Finance, Chile.

system. Second, it sold state-owned enterprises. Third, a fraction of the old payroll tax was maintained as a temporary transition tax. That tax had a sunset clause and is zero now. Fourth, it cut government expenditures. And, fifth, pension privatization and other market reforms have contributed to high growth in Chile, which in turn has increased government revenues, especially those coming from the value added tax.

In sum, the transition to the new system has not been an added burden on Chile because the country was already committed to paying retirement benefits. On the contrary, the transition has actually reduced the economic and fiscal burden of maintaining an unsustainable system.

In the new private system, workers have become owners of the means of production, or "worker capitalists," in the words of José Piñera, Chile's former minister of labor and social security who implemented the reform.[5] This paradigm shift from a consumption to an investment-based system has positively impacted the country's political economy by reducing class conflict and depoliticizing a large part of Chilean economy.

Commonly Heard Criticisms of the Chilean System

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. Some of those criticisms are misinformed. For example, administrative costs are less than 1 percent of assets under management, a more favorable figure than management costs in the U.S. mutual fund industry. Other criticisms are highly misleading. To the extent the criticisms are valid, shortcomings in the private system typically result from 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 or 4 percentage points, depending on the type of fund, or 50 percent below the industry's average real return in the last 36 months). That regulation forces the funds to make 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.

The following is a closer look at some of the more frequently heard criticisms of Chile's private pension system.

"The Administrative Cost are Too High"

Critics often claim that the commissions that workers pay to the pension funds are exorbitant. 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 2.37 percent of taxable wages, by the total contribution (10 percent plus the commission). This calculation fails to take into account that the 2.3 percent includes the life and disability insurance premiums (about 0.95 percent of taxable wages on average[6]) that workers pay, which are deducted from the variable commission, and thus overstates administrative costs as a percentage of total contributions.

The proper way to measure administrative costs is as a percentage of assets under management. In Chile, the administrative costs of the private pension system are

[5] See José Piñera, "Liberating Workers: The World Pension Revolution," Cato's Letter no. 15, 2001.

[6] Rubén Castro, "Seguro de Invalidez y Sobrevivencia: Qué Es y Qué Le Está Pasando," Documento de Trabajo no. 5, Superintendencia de AFP, May 2005, p.12.

0.66 percent of assets managed.[7] The Chilean pension fund administrators' association calculates that the commissions the industry charges are 0.63 percent of assets under management, far lower than such fees charged by other fund managers including U.S. mutual funds that charge about 1.38 percent.[8]

Prior to the above findings, others have calculated similarly low administrative costs. Chilean economist Salvador Valdés 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.[9] The Congressional Budget Office estimated in 1999 that the administrative costs of private retirement accounts in Chile "can be equivalently expressed as 1 percent of assets."[10] When administrative costs are compared to the old government-run system, the criticism is even less convincing. 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.[11]

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 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.

"The Coverage Under the New System is Low"

Critics also say that some 30–40 percent of Chilean workers are not participating in the private system. Although the number of Chileans participating in the private system is actually greater than the work force (some Chileans affiliated to the private system have left the work force), only about 61 percent of those participating in the employed work force regularly contribute to their private accounts. According to the Chilean pension fund regulatory agency, that method of calculation underestimates real coverage because it counts only workers who have contributed in a particular month even though other workers who made contributions in previous months will also receive benefits from the system. Including workers who have contributed within the past year, coverage in the private system amounted to 69.7 percent of the work force, which is greater than that of the previous public system in the four years prior to the reform. From 1976–1980, coverage under the old system "averaged 67 percent of the workforce, with a clear downward trend."[12]

Others have also found that coverage in the private system is greater than that of the old system. Measuring coverage as those who contribute on a regular monthly basis, the percentage of the employed work force covered in the private system (more than 60 percent) is superior to the coverage of the old system before reform (54 percent in 1980) and it has been increasing. See graph below.[13]

Several factors explain why coverage is not higher in Chile. The self-employed, who represent about 30 percent of the work force, are not required to participate in the private system. Only about 6 percent of the self-employed contribute on a regular basis. Workers who are unemployed also do not contribute to the system (the unemployment rate has been between 8–10 percent in Chile in the past five years.) Moreover, of the 3.4 million people affiliated with the private pension system, 1.44 million—including students or women who have stopped working to care for chil-

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[7] Superintendencia de AFP, *The Chilean Pension System* (Santiago: Superintendencia de AFP, 2003), p. 154.

[8] Asociacion AFP, "The AFPs Charge Lower Commissions Than Other Institutions, Both Local and Foreign," Research Series paper no. 42, June 2004, available at www.afp-ag.cl.

[9] Salvador Valdés, "Las Comisiones de las AFPs ¿Caras o Baratas?" *Estudios Públicos,* Vol. 73 (Verano 1999): 255–91.

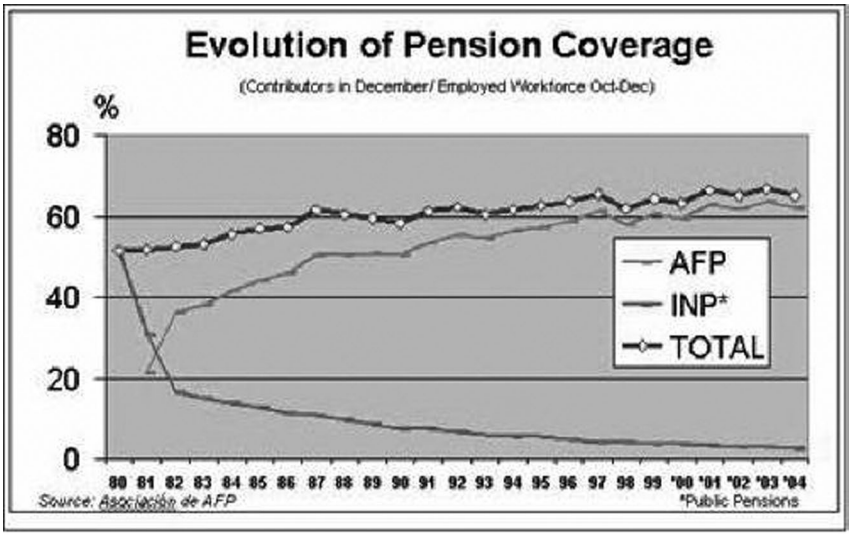
[10] Congressional Budget Office, *Social Security Privatization: Experiences Abroad,* sec. 2, p. 7 (January 1999).

[11] Raúl Bustos Castillo, "Reforma a los Sistemas de Pensiones: Peligros de los Programas Opcionales en América Latina." In Sergio Baeza and Francisco Margozzini, eds., *Quince Años Después: Una Mirada al Sistema Privado de Pensiones* (Santiago, Chile: Centro de Estudios Públicos, 1995), pp. 230–1. 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.

[12] The Chilean Pension System, pp. 120–23.

[13] Asociación AFP.

dren, for example—are not currently in the work force.[14] There is also a large informal economy, which is typical of developing countries. Lastly, the evidence suggests a strong relationship between economic development and the level of coverage around the world (higher per capita incomes correlate with higher coverage).[15]



In short, the level of coverage under the system does not reflect negatively on the private pension system itself. To the extent that coverage could improve, factors not inherent to the private system, such as rigidities in the labor market and the size of the informal economy, would have to be addressed by other public policies. In addition, only beginning around the year 2025, when the first generation of workers who have contributed during their entire working lives begins to retire, will it be fair to compare the private system with the old system.

"Too Many Workers Will Depend on the Minimum Pension and the System Will Impose Large Costs"

The Chilean finance ministry estimates that the average number of minimum pensions that it will be supplementing per month in 2005 will be 65,000. The costs of doing so are minimal and currently stand at 0.1 percent of GDP. Part of the reason that the cost is low is that the government does not provide the full amount of the minimum pension since a worker has some assets in his/her account. On average, the government provides 20–30 percent of the capital needed to finance the minimum pension. Indeed, the public cost of financing pensions, most of which is made up of meeting the obligations of the old system, is projected to continue falling (see Table 1).[16]

Table 1: Civil Social Security Deficit Forecast

Year	Public Pensions	Recognition Bonds	Welfare Pensions	Minimum AFP Pensions	Total
2002	3% GDP	1.2% GDP	0.4% GDP	0.1% GDP	4.7% GDP
2010	2% GDP	1.2% GDP	0.4% GDP	0.27% GDP	3.87% GDP

[14] Ibid.

[15] Robert Holzmann, Truman Packard, and Jose Cuesta, "Extending Coverage in Multipillar Pension Systems: Constraints and Hypotheses, Preliminary Evidence and Future Research Agenda," in Robert Holzmann and Joseph E. Stiglitz, eds. *New Ideas About Old Age Security* (Washington: World Bank, 2001), p. 454; and Asociación AFP.

[16] Ministry of Finance and Asociación AFP, "The AFP System: Myths and Realities," August 2004, available at www.afp-ag.cl.

Table 1: Civil Social Security Deficit Forecast—Continued

Year	Public Pensions	Recognition Bonds	Welfare Pensions	Minimum AFP Pensions	Total
Difference	**−1% GDP**	**0% GDP**	**0% GDP**	**0.17% GDP**	**−0.83 GDP**
REDUCTION OF FISCAL SPENDING ON PENSIONS: −0.83% OF GDP					

(Source: Ministry of Finance: Budget Department, Macroeconomic Aspects of the Draft Law for the Public Sector, 2002; and Asociación AFP)

It is estimated that the percentage of members affiliated to the private pension system that will receive government supplements for the minimum pension (only those who have contributed 20 years are eligible) will vary between 1.9 and 10.5 percent depending on the rates of return.[17]

"Workers Change Pension Fund Administration Companies Too Frequently"

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. Transfers have since fallen to about 228,000 per year.

Liberalizing the Chile's Private Pension System

It is clear that some of the regulations mentioned above have become outdated and may negatively affect the future performance of the system. Fortunately, Chilean authorities have taken some important steps in addressing the challenges of a more mature system.

The most important structural reform in recent years is the introduction of multiple investment funds. Up until 2000, the pension fund management companies could only manage one fund. That year, the regulatory framework was changed to allow the AFPs to offer a second fund, invested only in fixed income instruments. That reform proved to be insufficient, as very few workers decided to switch their savings from the diversified fund to the fixed-income one. Indeed, consumer demand for the fixed-income fund was negligible. What was needed was to let pension fund management companies manage more than one variable-income fund.

Chilean authorities finally adopted this reform in early 2002 when they instituted a rule that mandated AFPs to offer 5 different funds that range from very low risk to high risk. One advantage of having several funds administered by the same company is that that could reduce administrative costs if workers were allowed to invest in more than one fund within the same company. This adjustment also allows 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. Table 2 shows the maximum percentages of equity investment allowed in each fund:

Table 2

	Maximum Percentage Allowed	Mandatory Minimum Percentage
Fund A	80%	40%
Fund B	60%	25%
Fund C	40%	15%
Fund D	20%	5%

[17] Asociación AFP; the rates of return assumed are 3 percent, 5 percent, and 7 percent.

Table 2—Continued

	Maximum Percentage Allowed	Mandatory Minimum Percentage
Fund E	Not Allowed	Not Allowed

The introduction of a family of funds is an important step and consumers are behaving as one would expect—that is, by diversifying their investments across the menu of funds. Other steps that have been taken in the recent past include:

- The lengthening of the investment period over which the minimum return guarantee is computed to 36 months from 12 months and the widening of the band from 2 to 4 percentage points for some type of funds;
- The further liberalization of the investment rules, so that workers with different tolerances for risk can choose funds that are optimal for them; and
- The expansion of consumer choice with the signature of a bilateral accord with Peru that allows workers from those two countries to choose the pension system with which they want to be affiliated.

Other specific steps that Chilean regulators should take to ensure the continuing success of the private pension system include: Liberalizing 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); letting other financial institutions, such as banks or regular mutual funds, enter the industry;[18] giving workers the option of personally managing their accounts through the world wide web; and reducing the moral hazard created by the government safety net by linking the minimum pension to the number of years (or months) workers contribute.

Those adjustments would be consistent with the spirit of the reform, which has been to adapt the regulatory structure as the system has matured and as the fund managers have gained experience. In summary, the Chilean private pension system, despite minor shortcomings, is a success story by any measure and deservedly continues to be the model for rich and poor countries around the world that are considering reforming their retirement systems.

Chairman MCCRERY. Thank you, Mr. Vasquez. Mr. Harris.

STATEMENT OF DAVID O. HARRIS, MANAGING DIRECTOR, TOR FINANCIAL CONSULTING, LIMITED, SUFFOLK, UNITED KINGDOM

Mr. HARRIS. Thank you, Mr. Chairman, for the opportunity to testify before you and your colleagues today on the Australian pension model and the lessons that can be learned by the United States in respect of the continued examination of Social Security reform and options around the world. As a former resident of the Washington area in the late nineties who has an interest in Social Security, I am heartened that Social Security is again a prominent issue for the Administration and Congress to consider.

Mr. Chairman, achieving Social Security reform in the United States, as you and your colleagues would be aware, is not an easy problem to resolve. In the UK, where I am now a resident, Prime Minister Blair and his cabinet equally grapple with the fundamental need to engineer successful pension reforms to their first and second pillars, which my friend David John from the Heritage Foundation will elaborate on. Grasping the thorny nettle of Social Security or pension reform is largely driven by the sobering reality that, in the future, legislative bodies will have to either increase

[18] 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.

taxes or cut benefits to maintain Social Security and pension promises. Yet, for Australia, a longtime friend of the U.S. whose citizens share much in common, the need and implementation of major Social Security reforms has already occurred as a priority. It is interesting to note it was promoted by trade unions and the Social Democratic Labor Party then in government who embraced in the eighties the need to compel its work force to save a certain percentage of their income for retirement purposes.

It is important to note that in 1993 only 40 percent of the work force was covered by some voluntary retirement saving, with only $32 billion Australian dollars held in pension assets. In effect, the second pillar pension retirement system in the mid-eighties was transformed through contributions partly funded by centralized wage deferrals. Individual retirement accounts blossomed out of a landscape where many workers simply did not have access to retirement accounts. Today, 26.2 million individual retirement accounts exist for the 9.2 million workers.

Under the first pillar of the Australian retirement model, individuals are provided with Social Security, which is equivalent to 26 percent of my mother's average total weekly earnings. My mother's view of retirement: if she paid her taxes she would be entitled to an old-age pension. In the eighties the government, in an effort to contain the future costs of pensions, introduced an income to assets test and, with the combination of compulsion, began to address the issue of fundamental Social Security reform. Three percent was considered by the then Labor government as simply not enough. An expansion of the compulsory contribution system was managed eventually, in 1992 and 1993, through the taxation system. The then government proposed a system whereby employers would contribute 9 percent, individuals 3 percent, and government would provide a 3 percent uplift for lower income workers.

In 1996, the Labor government moved into opposition and the new Conservative Liberal Coalition retained only the policy of seeing employers contributing nine percent of individual salaries into retirement accounts. Today, Australians, on top of making contributions of 9 percent on a compulsory basis, contribute two to three percent of their salary on a voluntary basis in retirement accounts. As Trevor Matthews, chief executive officer of Standard Life UK, who, as an Australian, formerly ran a leading life insurer, said, Australian pension reforms were achieved through working with political, economic, and commercial realities in order to solve Australia's aging population. Achieving consensus among stakeholders was critical to its success.

There are many myths that surround the Australian retirement model, Mr. Chairman, which I have highlighted in my written testimony. Simply put, Australia moved away, like Chile and Switzerland, from voluntary retirement savings to compelling and providing limited incentives to workers to save for their retirement. Today $495.4 billion U.S. dollars are held in pension assets for over 9 million workers. Seventeen percent of these assets are invested abroad, with the primary source of investment being in the United States.

Yet, no international pension model is perfect. Australia needs to address a plethora of individual retirement accounts that have

grown up. Every worker has nearly three individual accounts on average. With respect to taxes, the contributions are taxed, the investment returns on the fund are taxed, and the fund flows going out of the retirement account are taxed. This approach is unique to Australia, and some of your colleagues may consider rather immoral. In conclusion, some of the lessons the United States can learn from Australia include her Labor and trade union support for Social Security reform, the need for incentives to low-income workers and the self-employed, an effective communication and education campaigning transition, but also a cost effective regulation, and the ability to contain administrative cost structures for the growth in individual retirement accounts. Once again, thank you for the invitation from this Generation Xer to appear before you today.

[The prepared statement of Mr. Harris follows:]

Statement of David O. Harris, Managing Director, TOR Financial Consulting Limited, 1996 AMP Churchill Fellow, Suffolk, United Kingdom

Mr. Chairman, I am very pleased to appear to discuss social security reform in Australia. As each year passes the need for reform becomes more pressing for many countries as populations rapidly age. Moreover, generous promises linked with social security programs will make it inevitable that radical reforms will have to be considered. This may mean cutting benefits or increasing retirement contributions via taxation. I've described compulsory retirement saving as being the equivalent to the great white shark for those who know they have to deal with the rising tide of ageing. They don't want to confront compulsion but they know that it is 'out there'. Only three countries rely heavily on private mandatory saving policies for retirement, these include Australia, Switzerland and Chile.[1] Australia faced the challenge 13 years ago. Not only did we survive, we succeeded. The Australian retirement model offers clear proof that radical pension reform can be achieved and benefit an entire nation. Women, minority groups and 'blue collar' workers, in particular, have seen significant benefits flow to them from having the ability to manage their own retirement savings.

The U.S. has had its own success in generating capital through individual saving. But it has not avoided the current questions around retirement saving: what will be 'sufficient' and what financial instruments will provide it? No-one in the past, when economic and social systems were being formed, could have anticipated the rapid ageing of populations throughout the world.

An overview of Australian retirement system

Australia and the UK stand out as countries that have faced up to the discomfort of significant retirement reforms. Both have taken the route of a more fully funded, defined contribution system but their approaches have differed in terms of politics, or government and the role of organized labor and business. These three vested interests, individually or combined, can encourage or discourage reform.

This fact was well understood when Australia reformed its retirement system in 1987 and 1992. In 1983 the Australian Labor Party led by 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 a significant reduction in wage growth.

The ALP is fundamentally a social democratic party based on largely collectivist principles. It has strong links with the trade union or organized labor movement through the Australian Council of Trade Unions (ACTU). Superannuation was provided through traditional employer-sponsored plans on a voluntary basis. Surprisingly perhaps it was the trade union movement which began the momentum for changing Australia's retirement system. They saw increasing superannuation coverage as a major priority.

The Old Age Pension was seen as an important source of income for retirees who have limited resources to sustain themselves in retirement. Its impact on Australia's GDP is seen in Table 2. Many older Australians who retired in the past failed to

[1] Australian Bureau of Statistics, 1998 Year Book Australia (Canberra, Australia: AGPS, 1998), p215.

build up sufficient retirement savings; a common perception was that they were entitled to an old age pension after paying taxes all their working life and this view was encouraged by many governments. In the 1980s, however, the Commonwealth Treasury and the Federal Government were not happy with the direction of expenditure on the first pillar of Australia's retirement framework. This concern was compounded by the demographic picture for the next century where the percentage of the population aged over 65 was expected to rise from 15% of the population to 23% by 2030 and the percentage aged over 85 was expected to more than double from around 2%.

The newly elected Federal Government began by ensuring the long-term viability of the Old Age Pension at its then current level. Maximum payments, by the mid 1980s, were determined through a comparatively stringent income and asset tests. The full pension payment now 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. This shift required a strong political resolve. More through timing than luck, though, a popular Federal Government with trade union support was able to convince the nation of the problems Australia would confront in the future if it did nothing about addressing its aging population. This 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.[1]

Before the introduction of mandated, second pillar, superannuation accounts, the coverage of superannuation was limited to roughly 40 percent of the Australian workforce. Typically, those covered were employed in middle class, 'white collar' jobs where women and people from minority groups were under-represented. 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. 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 pay. By the mid 1980s the union movement had shifted its stance whereby it would play a more direct and active role in the day-today operations of superannuation, via industry funds. These industry funds, grouped around a particular economic sector of the Australian economy, brought union and employer representatives together as trustees to manage the administration and investment of many thousands of individual retirement accounts. The increasing involvement of the union movement challenged some industry participants' views that administration and investment decisions would be distorted in favor of policies that stressed mutuality rather than economic reality.

There was another reason for the trade union movement's interest in pensions. Between August 1986 and August 1996, the level of trade union membership declined from 46 percent to 31 percent. This coupled with the decline in traditional union-based industries, such as heavy manufacturing, reinforced the unions' enthusiasm for reforms they felt would increase their profile and relevance.

By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. The government insisted that it was in the "public-interest" to have a national, compulsory, employment-related retirement income scheme in place[2] Award superannuation, set at 3% of an individual's yearly income, was introduced. This 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, sponsored by employer and employee or-

[1] Australian Bureau of Statistics, 1998 Year Book Australia (Canberra, Australia: AGPS, 1998), p215.

[2] 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), p5.

ganizations in one or more industries, were established to receive the 3% award contributions.

A further 3% round of award superannuation was made in 1990–91 before the government acted more decisively on reform. In August 1991 the Government's indicated its intention to introduce a Superannuation Guarantee Levy from July 1 1992. 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 reforms was substantial, some opposition was expressed by then Australian Democrats (a minor 'left leaning' political party) leader Senator Kernot who favored a single, government-controlled, national portable system, similar to that of a national provident fund. But the Government's proposed legislation quickly generated wide acceptance through working in 'partnership' with organized labor, business interests and industry associations.

The use of government inquiries or private sector research helped to highlight the inadequacies of Australia's level of retirement system provision. These inquiries were seen to be delivering independent views or recommendations and the Federal Government felt vindicated in implementing a mandated retirement system.

Another means by which the Federal Government was able to engineer significant change to the retirement system was through an effective public education campaign in 1994–1995, co-ordinated by the Australian Taxation Office. The total cost of the campaign was $AUS 11 million and the message was that the new retirement system would not only benefit the individual but the nation as a whole. 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 used by the government to hear, interpret or receive objections to the planned reforms and this encouraged a spirit of 'consensus' to be generated amongst many stakeholders of differing political ideologies.

Finally the 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 consequences of proposed reforms could be simulated and understood by superannuation industry participants and bureaucrats alike. Unlike in Chile, where individual retirement account reforms created a totally new financial infrastructure, much of the superannuation infrastructure in Australia already existed under the voluntary system. 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.

Australian business saw the reforms in terms of nurturing the capital market and the 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 that increased costs would be levied on employers as contributions lifted 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, but small business strongly opposed the reforms arguing principally that the increased cost burden linked with an expanded retirement provision would cause many business failures. In fact business played only a moderate role in supporting the government's reform agenda and this was co-ordinated, in part, by large financial providers who would develop or modify the financial infrastructure of such mandated retirement accounts.

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

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

	Employer's Prescribed Rate of Employee Support (%)
July 1 2000–June 30 2001	8
July 1 2001–June 30 2002	8
July 1 2002–03 and subsequent years	9

In March 1996, the 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 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 salary on retirement.

The impact of compulsion

The criticisms levelled at Australia's pension system, usually by those who are looking at it from the outside, belong to what I've called the 7 Myths. Typically these run along the lines of:

1. Compulsion in Australia started a recession;
2. Australia had a successful voluntary second pillar pension framework (so why move to compulsion?);
3. After compulsion net savings fell;
4. The industry made free with fees and charges;
5. Australians make free with their retirement savings—spend the lot and then fall back on the State pension;
6. Compulsion was introduced for ideological reasons by the a union backed Labor Government rather than as an answer to socio-economic need;
7. The second pillar savings level of 9% is insufficient to replace income.

None of these myths is borne out by the facts. In fact pension adequacy has been improved in the second pillar and Australia has been proofed against future demographic change. Expensive Defined Benefit plans, the supposed gold standard of some politicians and Employee Benefit Consultancies (EBCs) have become all but extinct. At September 2004 the breakdown of benefit structures included 297,327 accumulation funds, 182 defined benefit plans and 309 hybrid plans. At the same time superannuation coverage of all workers has been maintained at a level of 88%.

Compulsion has dramatically raised retirement savings and improved the future prospects of baby boomer and Generation X retirees. Comparatively low administration costs, wide investment choice and minimal mis-selling have protected consumers from detriment.

One of the reasons why Australia has been so successful in keeping administrative costs low and 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. 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, in part, to returns being maximized and administrative fees being minimized.

Sound regulation, transparency and significant improvements in the competency levels of distributors eg. financial advisers and financial planners, has raised public confidence in the retirement system and nurtured a steady increase in the level of voluntary contributions made into superannuation accounts. The Australian government has announced that it will encourage lower income families and workers to bolster their retirement savings via government co-contributions by widening the

eligibility criteria for the Government's co-contribution scheme (whereby the Government matches an eligible member's after-tax superannuation contributions dollar for dollar, up to a prescribed annual maximum, and subject to an income test).

Total superannuation assets held by 9.2 million workers now stand at nearly $649 billion[3] ($US495.4) for just over 9 million workers compared with $32 billion in 1993. A large percentage of them are invested in equities (49%), interest bearing securities (16%) and 17% or $108 billion are invested in overseas equities.

Administration costs do 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. An authoritative survey, conducted by the Association of Superannuation Funds of Australia (ASFA), estimated that an average of $1.28 ($US0.97) per member per week was made for overall administration costs in 1999–2000. It should be noted that this figure has declined from $1.66 ($US1.27) per week two years earlier. Expressed in another way, costs as a percentage of assets in June 2000 were calculated to be 1.29%.

Table 2: 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
UK	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).

What we could have done better

Australia has pursued an independent line on taxation of superannuation and one I find hard to agree with. Contributions are taxed at a rate of 15 percent, along with possible additional taxation of 15 percent for members earning over a certain threshold. A further 15 percent is levied on the investment income of each superannuation fund and finally the benefits can be subjected to varying tax treatment of between 0–30%, depending on timing of the contributions. As you can see the Commonwealth Treasury's faith in the politicians getting taxation revenues back from retirees' retirement nest eggs was very low when this taxation approach was adopted in 1992. Continual change to the way superannuation is taxed has caused much confusion for plan participants and trustees and industry associations are pushing for a comprehensive review.

Another negative feature is the sheer volume of accounts. Workers have an average of three, I have four. A new plan for a new job has created unnecessary duplication and administrative cost. Many funds are now seeking to streamline the transfer process by administration protocols.

It has to be said that the system has not delivered benefits to current pensioners whose circumstances have deteriorated over the past 10 years. A state pension indexed to prices and pegged at 26% of male total average weekly earnings has reduced their purchasing. The full benefit of compulsory superannuation reforms will not 'crystalise' until well into this century.

[3] Statistics, Superannuation Trends September 2004 Australian Prudential Regulation Authority.

What next?

Around 30% of employees in Australia already have fund choice and the Choice of Fund Act 2004 will give a further 40% of employees this freedom from 1 July 2005. Employers can meet their obligations under the Act by entering into a certified agreement with their employees. If workers do not choose a fund, employers must make contributions to a fund that satisfies the requirement to offer a minimum level of life insurance cover. The level of insurance premiums will not be regulated. Employers will give their workers a standard choice form which will provide basic information and highlight what should be considered before a fund is selected such as: level of fees and charges and the type of investments a fund offers.

The Howard government's reason for choice of funds is partly ideological in my view but is described as providing a more flexible and adaptable retirement system—one of the benefits should be portability—and more appropriate for flexible workplace arrangements which allow workers to reduce their hours as they approach retirement and to work beyond 65. The new legislation will allow people to access their superannuation from their preservation age without having to retire and it will allow them to develop strategies in transition to retirement for example working part-time and supplementing their income with some of their superannuation. It is not intended to enable people to dissipate their superannuation savings before retirement, however, and the Government is taking measures to ensure that savings are drawn down in a regular and orderly way.

The government has announced further measures to encourage lower income families and workers to bolster their retirement savings via government co-contributions which match after-tax superannuation contributions dollar for dollar up to a prescribed annual maximum and subject to an income test.

Lessons for the U.S.

As indicated, lessons do exist for the U.S. in regard to how Australia has addressed its ageing populations and they can be summarised in five major points:

- Partnership with the trade unions
- Incentives for low income workers and the self-employed
- Information and education
- Cost effective regulation
- Contained administrative costs under the creation of numerous individual retirement accounts

And, finally, persuading all stakeholders that change had to happen and that it was for the benefit of the nation as a whole.

Chairman MCCRERY. Thank you, Mr. Harris. Dr. Baker, you must feel a little bit like General Custer, but I invite you to wade in. I assure you, you will survive the hearing.

STATEMENT OF DEAN BAKER, PH.D., ECONOMIST AND CO-DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH

Dr. BAKER. Well, thanks. I appreciate the opportunity, but given the relative merits of the argument I figure it is a balanced panel.

Chairman MCCRERY. So did General Custer.

Dr. BAKER. I expected better. I would like to make four main points about the lessons I can get from various efforts of privatization around the world: first, that we could say it increases risk as opposed to the guaranteed benefits product by current systems. Second, the universal experience has been that of it increasing administrative costs by a factor or 20, 30 or 40, so, very huge increase in administrative costs. Thirdly, the programs are not popular with workers, and the evidence on this that I am looking to is the increase in participation rates, or I should say lack of increase of participation rates in the developed world in response to privatization, which was the main purpose of the reforms, and that turns out to

have been very limited, if any at all. Fourth, transition costs are, in fact, borrowing. We can't tell the functional market. What we can tell them, but they won't believe, is that it will be repaid with later benefits in 30 or 40 years, and there is evidence on that.

So, to go through each of those in turn, first off, the increase in risk. This is sort of straightforward. We have two basic types of risk we can talk about. One is bad investment choices. The best example here is probably in England where we had the mis-selling scandal there in early 1990, where a lot of financial companies made promises they couldn't deliver on. You also have the problem that in many cases people take too little risk which, say, under President Bush's proposal, would guarantee they would lose because they would not compensate themselves for the money they would put into those accounts. What has been proposed as a counter by many people is that they will educate workers, as in Chile. For example, they actually have education classes on their accounts in their high school. As an economist, we ordinarily like to think there is an opportunity cost in time. I don't know that is the best use of a single mother's time in the evening to be studying Chile's accounts rather than spending time with her kids, or if we are talking about in schools, I don't know if it is better they spend time studying their accounts rather than learning math, science, or language competency. That is a judgment that would have to be made.

The second type of risk, of course, is timing risk. Markets have ups and downs, nothing we can do the about that. In Chile, one of their government ministers actually suggested people delay their retirement for a few years because the market had temporarily depressed accounts. President Bush's proposal says we will shift people out of stocks into bonds at 55. I am sorry to say this, but that just changes the risk that the market will be down when you are 55 rather than when you are 65. Same story, so, there is no way around that.

The second point, the cost. Lots of evidence on this. The administrative costs of these accounts are 15 to 20 percent of the money that goes into them. There is a really big confusion on this. President Bush's commission said that they could do it for 30 basis points, 30 cents. It is important to understand it is 30 cents, three-tenths of 1 percent, of the stock. A dollar might be in that account for 40 years. If your taxes or administrative costs are three-tenths of a cent on that dollar, after 40 years that is 12 percent. Okay, so, the average administrative costs any administrator would get would still be 6 percent, about 12 times the cost of the current system. So, as I say, the existing cost, if we look at systems that exist in the world, are in the order of 30 to 40 times, 15 to 20 percent of the money that is put into the system. I should also point out that annuities have a cost estimated at 15 to 20 percent. These are very large expenses. If we applied them to the U.S. system, we would be talking about somewhere in the order of $75 billion a year being wasted on administrative expenses, if the whole system were done through a privatized system like that in Chile. President Bush's commission said that a government run system could be much more efficient than the market. Perhaps that is true, but

even then we are still talking about a system that would cost us 10 to 15 times as much as the current system.

My point about the systems not being popular, again, if we look at participation rates in the countries that did reforms, World Bank did a study on this. In Latin America, in most cases, there were very low increase in participation rates. The other point, very interesting on this, in Chile where we have the best model, as you heard here, a very high percentage of the workers appear to be targeting the minimum benefit. That is very interesting because most workers are voting with their feet for a DB system in the middle of a DC system. I take this as evidence it is not terribly popular.

The last point I want to make is, that financing transition costs is borrowing. President Bush has argued, or his staff has argued, that it is okay that we run large deficits to finance the transition because they will be repaid 30 or 40 years out with lower benefits. We could look around the world. No country has attempted to finance this transition purely through borrowing. We had the model of Chile where they actually ran very large surpluses, 4 percent of GDP. That would be equivalent of $500 billion a year in the United States. Perhaps the closest example to President Bush's model is Argentina where they did not make adequate cuts in other expenses or adequate increases in other taxes, and as you may remember, Argentina defaulted on its debt in 2001. It is worth pointing out that if Argentina had not privatized its system and that money had continued to go to the government, Argentina would have had a balanced budget in 2001, the year it defaulted. So, long and short, I will summarize by saying, I don't think the record is terribly successful. I think we do have a very successful system here, and I would suggest that we use great caution too in looking into any reform. Thank you.

[The prepared statement of Mr. Baker follows:]

Statement of Dean Baker, Ph.D., Economist and Co-Director, Center for Economic and Policy Research

Mr. Chairman and Members of the Subcommittee:

I want to thank the Subcommittee for inviting me to testify on the experiences of other countries who have privatized their Social Security systems. At this point there are a large number of countries, mostly in the developing world, who have partially or completely privatized their Social Security systems. There are four basic generalizations that can be made based on the experiences of these countries:

1) Privatization invariably increases risks for workers. These risks take three forms: the timing of the worker's retirement, the risk associated with the worker's choice of assets, and the risk of having a low income during a working lifetime. The latter point refers to the fact that most traditional Social Security systems, including the system in the United States, are designed to be redistributive to low-wage earners. A system based strictly on individual accounts is not redistributive, although redistributive features can be added to the system.
2) Privatized systems vastly increase the administrative costs of operating a Social Security system. The most efficient privatized systems have annual administrative costs for the retirement program that are 30 to 40 times as high as the current system in the United States. When the costs of annuities are included, financial intermediaries can take as much as 30 cents of every dollar placed in the system.
3) Privatized systems have not proved very popular with the workers they are supposed to benefit. One of the main reasons for introducing defined contribution systems in developing countries is that a privatized system was supposed to extend coverage to the large segment of the workforce employed in the infor-

mal sector, most of whom were not covered by the traditional Social Security system. There has been little change in participation rates in the countries with privatized Social Security system. In most cases, the vast majority of workers have voted with their feet against the privatized systems by opting not to participate.

4) Financial markets view borrowing to cover transition costs as real borrowing. The Bush administration has argued that the transition costs associated with switching from the current Social Security system to a system of private accounts should not be viewed as real debt, since the borrowing would be associated with lower Social Security benefits in the future. The evidence from other countries is that financial markets focus on current balance sheets, not speculation about benefit levels in the distant future. Every country that has privatized their Social Security system has attempted to at least partially fund the transition with a combination of tax increases and spending cuts. Argentina, which defaulted on its debt in 2001, is the most prominent example of a country that failed to take adequate steps to offset the cost of the cost of its transition.

I would also add the additional observation that private accounts do not by themselves increase national wealth. This is important in the context of promoting private accounts as a way to increase returns to retirees. Since private accounts do not actually increase wealth, at best they can be a mechanism for redistributing money from the working population to retirees. If Congress intends to redistribute money from workers to retirees, then there are arguably more efficient mechanisms to accomplish this goal.

I will elaborate on each of these points in turn.

Risk

Countries that have privatized their Social Security systems have subjected retirees to all three forms of risk noted above, the risk of market timing, the risk associated with asset choice, and the risk of low income during a working lifetime. In the first case, it is a basic fact about financial markets that they are volatile. Even if the average return on equities exceeds the return on riskless assets, there is considerable variation in this return. In Chile, the longest standing experiment with a privatized system, a government minister recommended that workers delay their retirement for a few years after a downturn in the national stock market.

There is no way to avoid this market timing risk. The Bush administration's suggestion that workers be forced to switch out of stocks approximately 10 years before retirement does little to change the story. If the market plunges just before a worker reaches this switch date, then he or she is almost as bad off as if the plunge occurred just before his or her retirement.

A second sort of risk is associated with the choice of asset. This risk can result from a worker either being too conservative or taking too much risk with their accounts. Many workers are ill-informed about financial markets and may only feel comfortable holding very safe assets with low returns. In the case of the proposal President Bush outlined in his State of the Union Address, this could result in workers losing money on their individual accounts, since they would lose more from their Social Security benefit than they would gain from the investments in their accounts.

Workers can also engage in speculative investments that end up losing money. This happened to some extent in England where there was a "mis-selling scandal" in the mid-nineties. Many financial firms had sold accounts to workers by promising returns on the accounts that workers would not actually realize. The British government eventually forced these firms to make good on these promises. In some cases, where firms had gone out of business, the government was forced to pick up itself the cost of fulfilling these promises.

These risks can be minimized by restricting choice. If the government gives workers a very narrow range of options, then the risk of bad asset selection is reduced. (Of course, this assumes that the government knows better than individual workers how best to invest their money.)

In principle, insofar as workers are too conservative with their investment choices because they are ill-informed about financial markets, the problem can be addressed with better education. However, this raises two additional problems. First economists usually believe that time has an opportunity cost. Time that workers spend learning about financial markets is time that they could have spent with their children or on other activities. If we are designing a system that requires that tens of millions of workers get additional education on financial markets, then we have decided that this is the best use of their time. (In Chile, the schools now have sessions that teach people about the retirement system. This means that time that could

have been spent developing math, science, or language skills is instead being used to teach people how to manage their Social Security accounts.)

The other problem with trying to educate workers on their retirement investments is that it is not clear who should be doing the educating. Many of the country's top financial advisors were recommending that people invest in stock even at the peak of the nineties bubble. It is not clear that advice from such experts would be beneficial to most workers.

Finally, a system of private accounts, by itself, is not redistributive to low wage workers. This means that if a mechanism is not put in place to ensure that workers who put little into these accounts because of low earnings, still have an adequate retirement income, then many low wage earners could end up as losers. While most countries with privatized systems have put some sort of minimum benefit in place, this is not universally the case. For example, Peru does not have a minimum benefit in its system.

It is also important to realize that putting a redistributive mechanism in place today, does not guarantee that it will be there twenty or thirty years in the future. Any redistributive mechanism attached to private accounts will always be subject to political risk. The intention of the designers of the system will matter little if political support does not exist to retain redistributive mechanisms in the future.

Expenses

There is now a large body of research that shows that the administrative costs of a privatized system of individual accounts vastly exceeds the costs of a centralized defined benefit system like the one in the United States. The administrative costs of the Chilean system have averaged close to 15 percent of the money placed in the accounts each year, while the cost of the British system have averaged close to 20 percent. Administrative costs are much greater in these systems because of the costs associated with servicing an individual account, the costs associated with marketing to individuals, and the profits of the firms who administer these accounts.

In addition to the annual costs associated with operating these accounts, there are also costs associated with turning the accounts into annuities at retirement (which is not generally required). Research indicates that insurance companies charge between 10 and 20 percent of the value of a sum to convert it to an annuity. Roughly half of this fee is associated with the adverse selection that results when annuitization is not mandatory. (Only relatively long-lived individuals are likely to buy annuities.) The other half is due to the administrative costs and profits of the financial firms that issue annuities.

A single centralized system of accounts (which does not exist in any of the countries that have opted for privatization) could in principle lower costs, especially if it minimized workers' choices in selecting investments and switching between investments. President Bush's Social Security commission estimated that a bare-bones centralized system would cost roughly ten times as much as the current system. (There has been considerable confusion about this point because of how the commission framed its cost estimate. The commission estimated that the administrative cost would be 0.3 percent of the *stock* of money in an account. This means that the fee on a dollar placed in an account would be 0.3 percent for *each year* that dollar is in the account. Some dollars will be in an account for forty years, while some dollars placed, in the account just before a worker retirees, will be there for just a short time. If a dollar is a worker's account for an average of twenty years, then this 0.3 percent fee will be paid twenty times, making a total administrative cost of 6.0 percent, compared to a cost of just 0.5 percent on the dollar placed in the Social Security system.)

President Bush's commission also argued that a centralized government run system can radically reduce the cost of issuing annuities. While a centralized system may in principle be vastly more efficient than the current market system, there would still be a problem of adverse selection in any system where buying annuities is optional, as President Bush has proposed. This means that a worker with an average life-span could expect to lose between 5 and 10 percent of their money under such a system, compared to what they would receive with an actuarially fair annuity.

Popularity

The World Bank recently completed a study of the privatized Social Security systems in Latin America.[1] One of the main criticisms of these systems is that they

[1] Gill, I, T. Packard, and J. Yermo, 2005, *Keeping the Promise of Social Security in Latin America*, Stanford, CA: Stanford University Press.

have not substantially increased participation over the rates achieved under the traditional defined benefit systems. The argument that these systems would increase participation claimed that workers view their current Social Security contribution as a tax, whereas they would see their contribution to a private account in a different light. The fact that participation has changed little after privatization, in some cases not even growing more rapidly than what would have been expected if past trends had continued, indicates that workers do not view contributions to these accounts very differently than they do contributions to the traditional defined benefit system.

It is worth noting that in Chile, the most developed system, a large percentage of the workers target the minimum benefit. This minimum benefit allows any worker who has been in the system for twenty years to turn over their account to the government, and then get a guaranteed benefit that is tied to the value of the minimum wage. In effect, these workers are voting with their feet for a defined benefit system.

Transition Costs

In the short-term, the switch from a traditional pay-as-you-go Social Security system to a defined contribution system implies a large increase in the government deficit, since the same benefits must still be paid to current retirees, even though the government is collected much less in Social Security contributions. Every country that has opted to privatize its Social Security system has attempted to at least partially cover these transition costs by reducing its deficit, or building up a surplus, with some combination of tax increases and spending cuts. For example, the Chilean government increased the size of its annual surplus to 4 percent of GDP (the equivalent of a surplus of $500 billion in the United States in 2005) at the point where it implemented its privatization plan.

They felt the need to cut their deficits or increase their surpluses precisely because these governments did not believe that the financial markets viewed their implicit commitments to pay Social Security benefits in the distant future as being the same as actual government debt. The one important example of a government that did not take sufficient steps to offset the borrowing needed to finance its Social Security privatization was Argentina. In 2001, it was paying real interest rates of more than 20 percent on its debt, because lenders did not have faith in the government's ability to pay off its debt.

By contrast, in 1994, the year Argentina put its privatization plan in place, the country was generally regarded as one of the most creditworthy countries in the developing world. Had it not been for the privatization of its Social Security system, Argentina would have been running balanced budgets between 1994 and 2001.

The United States is approaching the question of Social Security privatization at a time when it faces much larger deficits than any of the other countries that have gone this route. The experience of Argentina suggests that it is likely to face a very high price in financial markets if it does not couple privatization with large tax increases and/or spending cuts.

National Wealth and Privatization

No economist believes that the United States would be increasing national wealth if it borrowed $200 billion a year and invested this money in the stock market. It is possible that this will reallocate income, as the government can benefit from the gap between the return on equities and the interest paid on government bonds, but this is not creating additional wealth for the country as a whole. Similarly, it cannot increase national wealth if it borrows $200 billion a year and hands $2,000 a year to 100 million families and tells them to invest it in the stock market. This would simply be changing the allocation of national income.

This is important to recognize because one of the goals often claimed by proponents of privatization is increasing the rate of return on Social Security contributions. Insofar as the money is simply borrowed, as President Bush has proposed, then any increase in the rate of return due to privatization is simply coming at the expense of the rest of the population. This could be seen fairly directly in the case of Chile where accounts earned double-digit real rates of returns through the eighties. The main asset of Chile's private accounts in the eighties was Chilean government bonds, which paid double-digit real interest rates. In effect, Chile's workers received high returns on their accounts because Chile's taxpayers paid high interest rates on the money their government borrowed to finance the accounts. It may have been desirable to transfer money from Chile taxpayers to Chile's retirees, but this could have been done without going the route of privatization.

In short, it is important that policy makers recognize the distinction between using private accounts as a way to redistribute income—which they may be to some extent—and a mechanism to increase national wealth, which they surely are not.

(There is a separate issue of whether private accounts in the United States will be able to earn the rate of return claimed by proponents of privatization. Stock returns come from either capital gains or dividend payouts. No analyst has yet passed the "No Economist Left Behind Test," which asks for a set of dividend payouts and capital gains, consistent with the Social Security trustees profit growth projections, that add to the 6.5–7.0 percent returns assumed in analysis of Social Security privatization. Given current price to earnings ratios and low projected profit growth, there is no plausible set of dividend yields and capital gains that will produce 6.5–7.0 percent real stock returns.)

Mr. Chairman, this concludes my testimony and I would be happy to answer any questions from you or other Members of the Subcommittee.

Chairman MCCRERY. Thank you, Dr. Baker. Mr. John.

STATEMENT OF DAVID C. JOHN, RESEARCH FELLOW, THOMAS A. ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION

Mr. JOHN. Thank you for having me, and also for looking at this rather important set of experiences around the world. I am going to concentrate on the UK's experience. Let me start by just—I think it is obligatory for conservatives dealing with the UK to quote Winston Churchill, so, I have to do my Winston Churchill quotes, which is that he reminded us that the United States and UK are two people, separated by a common language. This is especially true in pensions. We have similar wordings of terms in areas of pension reform, and in the United States, we actually do deal with some specific issues that are very similar to what the UK has, but each of the countries' systems has been shaped by very special national circumstances and by past experience. Eight years ago, many conservatives wrote that the UK would serve as a perfect model for a U.S. system of Social Security accounts. Frankly, we were wrong. More recently, a group of more liberal writers have been writing say that the United States, UK experience proves that any form of personal retirement accounts cannot work in the slightest, and that is wrong also. One of the key things to remember again is that the UK has special circumstances. There has been reference, for instance, to a mis-selling scandal in the UK pension plan. The mis-selling scandal did happen, and it was extremely serious. However, it actually resulted from a very specific example and circumstance in the UK marketplace; namely, that they did not have a retail market in mutual funds and similar investments. Therefore, these investments were sold by ill-trained insurance agents who did an exceedingly good job selling insurance but, not a good job selling investments.

Most of the poor advice actually had to do with whether an individual would redirect a portion of their Social Security taxes into a personal account, thereby losing employer-matched contributions, or stay in an employer account where they would take advantage of these additional contributions. The net result was that the UK very sharply increased its retail regulation, and it also required these companies to make repayments. Now the UK system is also different in that they tied their pension system to an employer sys-

tem, which was predominantly a DB system similar to United Airlines, Bethlehem Steel, and so forth, at precisely the time that that type of pension system was essentially failing due to a variety of circumstances that actually have nothing to do with Social Security. This has affected the results in the UK market. Nevertheless, there are six lessons that the United States can learn from the UK—and the actual system itself is described in my written testimony. Number one, if you build it they will come, works for baseball, especially in Iowa, but it doesn't necessarily work for a pension plan. In the UK, the government set up something called stakeholder pensions, which are relatively simple, low-cost pensions that were required to be offered by small businesses that had more than four employees.

Unfortunately, the administrative costs were relatively low and probably too low, with the net result that 350,000 employers did set up this type of pension plan. Better than 80 percent of the pensions are empty without having any contributions in the slightest. About half of the money that went into the stakeholder pensions has actually been transferred from other existing accounts. The UK Trade Union Congress has charged that the stakeholder pension experience has actually been more of a boon for upper income workers seeking additional tax shelters than anything else.

Second, simplicity is essential. Adair Turner, who heads up the UK Pension Commission, which we will be reporting this fall, recommending changes in their pension system, points out that the UK system is probably one of the most complex in the world. The net result of that is that a recent poll showed that precisely 6 percent of the UK population feels that they understand the pension system that is out there very well. It is a matter of great concern, however, to the average worker. A poll in October, in advance of the election that was held in May, showed that the question of pensions was number one on workers' minds at that point. Second, they have a pension credit, which is means tested, which must be applied for. It is not a simple delivery system. The net result is that only 60 percent of those people who are eligible actually receive this pension credit. For the most part, the 40 percent who do not are the ones who need it the most, the most elderly, and the most poor.

Number three, programs can have unintended motivational consequences. The pension credit is means tested, and it requires a 40-percent penalty on existing savings, with a net result that 20 million workers in the UK who have incomes between 16,000 and 65,000 have stopped saving. This is 15 percent, roughly 20 percent of the overall problem in the UK. Fourth, index pricing requires a minimum benefit. The basic State pension was price indexed 25 years ago. The net result is that most people who only receive that, about 12 percent of the work force, are actually living in poverty. There are two very positive mentions to this. Number one, accounts do work. Even with the serious problems that the UK experience, the UK has pension savings equal to 70 percent of their GDP, which is the most in Europe. The overall cost of their public pension system is one of the lowest in the world. Second, this is key, the UK governments, both Labor and Conservative, when they have found programs that promised more than they could deliver,

changed the benefits. They actually went through and reduced benefits. There have been a number of instances in the last 25 years where the State benefits have been altered.

Now, in October 2005, just to conclude here, the Pension Commission is going to report. The expectation is that they are going to require more savings, perhaps in the form of an Australian mandatory system, rather than less. The expectation also is that they are going to come up with a comprehensive approach rather than a continued bit by bit by bit, which has proved to have rather serious problems. The key lesson is that the UK is fixing their system while the United States is still working on it. The UK is likely to have a consensus by the end of this year or early next year. The question is whether we are strong enough to do the same. Thank you.

[The prepared statement of Mr. John follows:]

Statement of David C. John, Research Fellow, Thomas A. Roe Institute for Economic Policy Studies, The Heritage Foundation

I appreciate the opportunity to appear before you today to discuss what we in the United States can learn from the United Kingdom's experience with public pension reform. This is an extremely important subject, and I would like to thank both Chairman McCrery and Representative Levin for scheduling this hearing. Let me begin by noting that while I am a Research Fellow at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

The crisis faced by the UK public pension system

In 1997, just eight years ago, reforms made to the United Kingdom's pension system under both Conservative Party and Labour Party governments were regarded as a model for avoiding the fiscal problems caused by the imminent retirement of millions of baby boomers. Studies by international organizations and a variety of think tanks showed that rather than the huge increase in retirement-related costs that threaten to engulf most Social Security systems, the UK faced a future where these costs would be relatively stable in terms of the percent of GDP that would be devoted to paying for retirement benefits. The combination of reductions in government paid benefits and generous incentives for workers to finance their own benefits through personal or work-related pension plans looked like a complete success.

This impression did not fade quickly. As recently as four years ago, testimony about the UK system by a leading British insurance executive to this subcommittee was entitled: "Pensions: A British Success Story."[1] However, the last few years have been hard on the UK pension system. Due to poor planning, constant government tinkering, the closure of many corporate pension plans and other factors, all political parties recognize the need for a comprehensive pensions overhaul. A UK government pensions survey to be issued this week is expected to reveal that only one out of every six private sector employees can expect to have a "decent" pension when they retire[2]

The British pensions system has become a national issue. As a result, a late October 2004 poll showed that UK voters regarded their pension system as the number one issue that needed to be addressed in the May 2005 general election. A total of 54 percent of those polled listed pensions as one of the top four issues, above such usual political concerns as health care, crime and immigration. While in fact, pensions played a small role in the election, public concern remains high, and pension reform is expected to be a major issue in the coming year.

As a partial response, the government of Prime Minister Tony Blair established a blue ribbon Pensions Commission under former Confederation of British Industry head Adair Turner that is charged with issuing two reports. The first, issued in October 2004, paints a gloomy picture of the current system, while the second, scheduled for fall 2005 elections, will propose solutions.

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[1] Statement by Keith Bedell-Pearce, Executive Director of Prudential, plc to the Subcommittee on Social Security, Committee on Ways and Means, July 31, 2001.

[2] "Crisis looms for 'private' pensioners," *Scotland on Sunday*, June 12, 2005. Available at: http://news.scotsman.com/index.cfm?id=645242005 (June 13, 2005).

Two nations separated by a common language: the relevance of the UK experience to the U.S. Social Security debate

The British pension experience does have significant lessons for the American Social Security debate. However, those lessons are different from recent claims made by opponents of President Bush's proposed changes to the American Social Security system. Although there are superficial similarities between personal accounts in the UK system and those proposed for the American Social Security system, a closer examination shows major differences.

First, the accounts in the UK mainly invested in either employer-sponsored defined benefits pension plans or to individual investment plans similar to the American IRA. The American proposal, on the other hand, is completely separate from any employer-sponsored pension plans, and would be limited to investment through a centralized, government-managed investment platform similar to the Thrift Savings Plan (TSP), which is only open to U.S. government employees and to military personnel.

Further, the accounts did not cause most of the problems faced by British pension system. Instead, the overall UK situation closely parallels the problems faced by U.S. defined benefit pension plans such as those recently turned over to the Pension Benefit Guarantee Corporation by United Airlines and Bethlehem Steel.

Finally, to the extent that personal accounts are a significant problem in the UK, this is mainly due to design flaws and poor planning that were present from the beginning, misguided short-term fixes that had unforeseen consequences, and the bursting of the late 1990's stock market bubble. While the British experience shows mistakes for Americans to avoid, it does not prove that adding personal retirement accounts (PRAs) to the American Social Security system will be a failure.

The structure of the UK public pension system

The UK pension system is extremely complicated. There are two levels of state pensions, which are supplemented in some cases by two additional programs aimed at increasing the state pensions of lower income retirees. In addition, there are a variety of employer-related and personal pension plans. To make matters more confusing, workers have the ability to shift a portion of the taxes that fund the second state pension into either their employer-provided pension plan or a personal account. Finally, different governments over the past twenty years have revised and re-named various parts of the state pension system, changing benefit levels, tax treatment of pension contributions, and even account structures seemingly at random. The result is a constantly changing array of programs that are confusing to the British and can bewilder foreign observers.

The Basic State Pension: The most basic level of public pension benefits in the UK is the Basic State Pension, which pays a flat-rate pension to all workers who have both worked and paid taxes for at least a minimum period. Currently, women are allowed to retire at age 60, while men are only allowed to retire at age 65. The retirement age for women will increase to 65 between 2010 and 2020 starting with women born in April 1950. Approximately one in eight retirees receives only the Basic State Pension.

Currently, the Basic State Pension pays single people GBP 82.05 ($148.50) per week and couples GBP 131.20 ($237.50) per week. This equals $7,722.50 per year for single people and $12,348.50 annually for couples. As a comparison, the U.S. Social Security system paid individual retirees an average of $11,460 annually as of December 2004. Benefits are indexed to the change in prices, and are adjusted every April.

In order to qualify for the Basic State Pension, men must work and pay taxes for at least 44 years, and women must work and pay taxes for at least 39 years. However, workers who are unemployed, unable to work due to illness, or who stay home to care for a family member may receive credits that can replace some of the required earnings years. U.S. Social Security benefits are based on the worker's highest 35 years of employment, and do not give any form of credit for these situations.

The State Second Pension (formerly SERPS): Since 1978, the UK has also had a second level of public pension that is based—at least in part—on past earnings. Starting in 2007, this pension level will also pay a flat rate benefit. Prior to 2002, the State Second Pension (S2P) was known as the State Earnings-Related Pension Scheme (SERPS), and paid benefits that are much more directly linked to earnings than the new S2P is to be.

Workers receive credit towards their S2P benefits for income earned between 15 percent and 110 percent of national average earnings. Overall, they pay National Insurance Contributions (NIC) (which help to fund several different benefits including the Basic State Pension) equal to 11 percent on income between about GBP95 per week ($172 per week or about $8,941 annually) and GBP 625 per week ($1,131

per week or $58,825 annually) and 1 percent on incomes above that level. In addition, employers pay 12.8 percent on all income above GBP 95 per week. Both the income levels and tax rate are subject to change annually, and if the employee has contracted out of the S2P, taxes rates are different.

Workers have the ability to "contract out" of this pension level and re-direct a portion of their taxes into either their employers' pension plan or a personal plan. In the case of an employer pension, the tax level is reduced, while for an individual pension plan, the government pays a portion of taxes directly into the plan. If a worker contracts out, he or she receives credit for those benefits only on a prospective basis; benefits already earned are not affected.

Since 1978, the UK has changed benefits payable under both SERPS and S2P several times. These changes are more fully reviewed below, but the mixture of changes combined with the ability of workers to jump in and out of this pension level have resulted in some workers gaming the system, and make it very hard to determine benefits. The S2P is intended to improve benefits to low and moderate income workers, and gives workers who earned under GBP 12,100 annually (about $21,900) credit for earning that level.

Means tested benefits: In addition to these two public pension levels, low income workers can qualify for additional means tested benefits. The Pension Credit is intended to ensure a minimum retirement income of at least 30 percent above that paid by the Basic State Pension. These benefits are reduced by 40 pence for every pound that an individual receives above the Basic State Pension level, and must be applied for. In addition, low income retirees are eligible for non-cash benefits that mainly rebate some or all of the local ("council") taxes they pay and a portion of their rent payments.

Employer and personal pension plans: As mentioned above, UK workers have the ability to re-direct a portion of their NIC into either their employers' pension plan or a personal pension plan. The UK had a highly developed defined benefit (DB) pension system, but it has been hit with a series of reverses similar to those that have hit DB plans in the U.S. As a result, the majority of these private sector plans have been closed to new entrants and replaced with less favorable defined contribution plans.

Stakeholder Pensions: Since October 2001, employers (including small businesses with more than 4 employees) that do not offer workers another pension plan have been required to offer their employees a "Stakeholder Pension" plan. Designed by the government, and intended to be a simple and low cost pension system that would especially appeal to moderate income workers. Fees for these plans were initially capped at one percent of assets under management, and plans were required to accept an opening deposit as low as GBP 20 ($36). After initial enthusiasm, this plan has widely been regarded as a failure, and in an effort to revive it, the UK Department of Work and Pensions increased the allowable fee to 1.5 percent of assets under management for the first ten years an account is open in December 2004. At the same time, it also reduced the regulatory burden (in the form of a required level of investment counseling) for certain types of simple investment products.

What Americans should learn from the UK public pension system

Simplicity in program design and administration is essential: The UK system is overly complex both in its design and in its administration. To some extent, this is the unintentional consequence of program changes intended to correct specific problems, but the end result is a system that is extremely difficult for even professionals to understand.

As a result, a December 2004 survey found that only 6 percent of felt that they understood the pension system very well, while 29 percent did not know about key tax benefits. Not surprisingly, only 5 percent of those polled felt that they were "very confident that they would have enough to live on in retirement, and only 3 percent thought that state benefits would provide a comfortable income.

Unfortunately, this complexity also applies to the administration of certain benefits. The Pension Credit, a means tested benefit intended to improve the retirement incomes of lower income retirees, must be applied for, and is not automatic. Retirees are required to answer a complex survey in order to qualify, and despite the fact that individuals could answer the questions over the phone, many have not bothered to apply for the benefits. As of September 2004, 40 percent of those eligible had not claimed their benefits. Experts believe that most of those who have not claimed the credit are those who need it the most—the lowest income retirees. Interestingly, the government had assumed that 30 percent would not claim benefits in its planning.

Programs can have unintended motivational consequences: A side effect of the Pension Credit has been to reduce pension savings by low and moderate income workers. While the 40 pence per pound of income above Basic State Pension levels

reduction in this benefit is actually significantly lower than the program that it replaced, the net result has been a sharp drop in pension savings. A June 2005 study found that almost 20 million workers earning between GBP 9,000 and GBP 25,000 annually ($16,200 to $45,000) are not saving for retirement because they fear that a means tested system would penalize them for their savings. In the aggregate, the means tested program is estimated to reduce annual pension savings by about GBP 3.7 billion a year ($6.7 billion).

Constant change increases confusion: Change has been a constant feature of the UK public pension system since the 1980's. Programs and new benefit levels have been created, revised, and re-named many times. A side effect of this has been to increase confusion among UK workers.

Looking at SERPS alone, the program was created in 1978 and promised to pay benefits based on the 20 best years of a worker's earnings. In 1986, SERPS benefits were changed to being based on all earnings between the age of 16 and retirement, and in 1995, changes to the pension formula further reduced benefits. In 2001, SERPS was replaced with the S2P, while the benefit formula was made more generous to lower income workers, and after 2007, the S2P will become another flat-rate pension. In 2002, thousands of workers who had contracted out of SERPS and its successor received letters from their financial services companies advising them to contract back in, as the amount they were savings was unlikely to be enough to equal what the government was likely to pay. Even though most benefit credits earned prior to these various changes were grandfathered in, workers can be excused if they feel completely confused and unsure what their benefits will be.

The availability of individual accounts does not alone solve problems: Despite massive publicity and fanfare when they were first offered in April 2001, Stakeholder pensions have largely been a failure. Even though about 305,000 employers started these pension plans for their employees, and that number grew to about 350,000 by the end of 2003, 82 per cent of those remained as "empty boxes" with no members, while only 13 per cent of employer-based pensions have contributions from employers. To make matters worse, only about 1.5 million plans were sold by the end of 2003, and sales have steadily dropped annually since then. Even these poor numbers do not indicate new savings, for about half of all Stakeholder plans were funded with money transferred from another existing plan. In addition, a significant number were estimated to be set up by wealthier individuals in order to claim the tax benefits of opening such an account.

Merely designing an "ideal" account structure and making it available does not guarantee that industry will aggressively sell it—especially if there is an unrealistic cap on fees. In the UK case, one key error seems to have been including marketing charges in the fee cap rather that limiting it to fees directly associated with the individual's account. Faced with such a limited profit potential, companies were unwilling to spend the amount necessary to continue to promote Stakeholder accounts. While the December 2004 fee increase may help, these plans have been labeled a failure, and are unlikely to revive as a significant retirement investment vehicle.

Price indexing can reduce benefits below poverty: Since 1980, the Basic State Pension has been calculated using price indexing rather than growth in wages. As a result, the flat rate pension amount has dropped to only about 17 percent of average wages (GBP 82.05 ($148.50) per week and couples GBP 131.20 ($237.50) per week or $7,722.50 per year for single people and $12,348.50 annually for couples). The roughly 12 percent of retirees who only receive this pension have incomes that are below poverty level. If the wage indexing had been retained, the benefit levels would equal GBP 109 a week ($197.29 week—$10,259 year) for individuals and GBP 174 a week ($314.94 week—$16,377 year) for couples.

This is not to say that changing the method of indexing is a mistake, but that policy makers must be aware that doing so could result in unacceptably low benefit levels. As a result, such a move should be accompanied with a benefit floor that guarantees an adequate minimum retirement income level.

Poor planning increases costs: When SERPS was created 1978, the UK government failed to conduct accurate longer-term studies of the cost that these benefits would impose on their government. Its failure to estimate benefit payments after 2007, despite the fact that most younger 1978 workers would only be retiring then was a key reason why benefits had to be revised in both 1986 and 1995.

This was also seen after the 1998 SERPS changes that were intended to encourage workers to contract out of SERPS and into either an occupational or personal pension plan. The government estimated that only between 500,000 and 1.75 million workers would take advantage of this option, while by 1993, almost 5 million workers (about 85 percent of those most likely to benefit from contracting out) actually did.

A 1990 government study showed that while about GBP 9.3 billion (about $17 billion) would be paid by the government in the form of rebates and special bonuses into accounts, the cost of paying SERPS benefits in the future would only decline by about GBP 3.4 billion (about $6.2 billion). Pensions expert Edward Whitehouse has an even higher estimate of GBP 12 billion (about $22 billion) revenue lost in return for the same level of reduction in future benefit payments.

A retail-based account system requires close monitoring: The most famous problem with the UK system, the so-called "mis-selling" scandal, is widely misunderstood in the U.S. When individuals were allowed to move out of SERPS into personal accounts in 1988, many were poorly advised by ill-trained insurance agents, and either moved out of employer-based plans that included an employer contribution and into personal plans that did not include that employer contribution, or failed to make an appropriate level of additional voluntary contributions that would be necessary to reach their retirement goals.

The mis-selling scandal resulted more from a sales force that was used to selling conventional insurance products and did not themselves understand the products they were selling than from other reasons. The fact that the agents' compensation was also tied to commissions exacerbated the situation.

As a result, however, a thorough investigation was conducted, and companies where mis-selling had occurred were required to compensate their customers. In addition, a new financial regulator, the Financial Services Authority, was created from several smaller and weaker regulators, and it has, if anything, overly compensated by requiring levels of disclosures to individual customers far in excess of those required in the U.S.

For Americans, this problem is interesting, but does not apply to Social Security reform proposals. For one thing, the SEC and other financial regulators have long monitored sales to individuals and require significant consumer disclosures. More importantly, the proposed U.S. Social Security reforms are based on a government-managed centralized investment system, and neither individual companies nor agents and brokers will not be allowed to participate.

Conclusion

It would be a mistake to assume that the UK pensions experience has only been one of failure. The opposite is actually true. The country still has a higher level of pension investments, about 70 percent of GDP, than any other country in Europe, and the cost of public pension benefits is substantially lower than most countries in the world. In addition, roughly 50 percent of the workforce is covered by some level of private pension.

While the current UK government is responsible for some of the problems in their current system, most notably the Pension Credit that has destroyed the incentive to save for many of their workers, others have resulted from the collapse of the defined benefit pension system and problems caused by mistakes by earlier governments. The current government is also responsible for the Pensions Commission, whose recommendations are expected to result in an overall reform of their system.

However, their experience teaches Americans that even well intentioned individual changes can only make matters worse. In addition, it is important to consider the overall structure of the complete pension system. The UK has well learned this lesson, and the expected October 2005 final report of the Pension Commission is expected to give a full picture of proposed changes in light of the complete pension system.

It is important for Americans to remember that much of the UK experience results from special circumstances unique to that country, and that they do not apply to the United States. In addition, it would be a serious error for Americans to assume that the lesson of the UK experience is to discourage individual accounts, whether as part of Social Security or as part of 401k or other retirement savings options. The opposite is rather the case.

Personal accounts are a source of strength, both in the UK pension system and in their economy, and the current government has been actively seeking ways to increase the number of workers who have them. It would be both ironic and sad for Americans to draw the opposite conclusion from their experience at the same time that the UK is working to build individual pension savings.

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Chairman MCCRERY. Thank you, Mr. John. I thank all of you for your excellent testimony. Dr. James, in her testimony, talked about a mandatory add-on. By that, I took her to mean that the government would mandate that everybody have an account. It wouldn't be voluntary, it would be a mandatory account, and she talked about the government's financing that mandatory add-on account through a tax increase, basically, funding those accounts with general revenues from the government. So, you are saying—well, that is the question I want to get into. Let us assume, rather than the President's voluntary account proposal, we talked about a mandatory account that the government would fund. We wouldn't mandate that the taxpayer take another, say, 4 percent of his income out of his pocket to fund his account, but it would be funded by the government. Obviously, there are three ways to do that. The government could issue more debt, general debt, the government could cut spending elsewhere, or the government could find a new revenue source or increase an existing revenue source, increasing the tax take sufficient to fund those accounts. If we were to cut spending to fund the accounts or increase taxes to fund the accounts, we would automatically increase national savings, would we not? Does anybody disagree with that?

Dr. JAMES. As long as there is no offsetting effect going on.

Ms. CORONADO. By household.

Dr. JAMES. Government impact would be positive.

Chairman MCCRERY. Well, it is the same. The people who are investing, you are saying there would be a decrease in private investment?

Dr. BAKER. Right. As long as there was no offsetting decrease somewhere else.

Chairman MCCRERY. As long as there is no decrease in private investment, there would be a net increase in national savings; correct?

Dr. BAKER. If you assumed that is the definition.

Chairman MCCRERY. Well, I am trying to get to some basics here. Mr. Whitehouse in his testimony said that given the size of the U.S. economy and the maturity of our financial markets, capital markets, a change such as those that took place in South America wouldn't have as big an effect on the economy. So, I guess

one thing I would like for you to comment on, would it be wise for the United States, or would it not make much difference, if we were to mandate personal accounts, not take the money from the payroll tax, but have the government fund those accounts from some other source. Would it be wiser to fund it with an increase in general revenues, or an increase in debt, or an increase or a decrease in other spending? Any comments on that? Let us assume we could do any of those.

Dr. BAKER. I can give you a typical economist answer. It depends on what you are trying to do. Is the point to increase national saving, in which case that would have the same effect as any other sort of cut and spending or increase in taxes. So, if that is how to fund it, yes, that is one point to increase national savings.

Chairman MCCRERY. Is that a good thing to increase national savings?

Dr. BAKER. I do think we need to increase national savings. We do have a deficit that is too large. I don't know if that is the only way to increase national savings, but that is one way to do it. The second idea is, do we have to increase retirement security, and then you have to ask if that is the best way to do it. The question is, what are the goals here? Then the question is—you could advance both of those goods, but the question is, is this the best way to advance them?

Chairman MCCRERY. Any other? Mr. Whitehouse.

Mr. WHITEHOUSE. As I said in my testimony, the target benefit level under Social Security on this level is quite low by international standards. I don't see that as a particular problem, but it is for most Americans who have to make a voluntary provision either on their own, through an Individual Retirement Account (IRA), or through their employer. The issue for me is people who are not saving enough for retirement. Now, the average contribution rate to 401(k)s is 9.5 percent. That is, if people maintain that for a full year, going to be enough to give them a pretty comfortable retirement. It is the people who are not covered by private pensions who concern me and the people who are not saving enough in those private pensions. If one were to save—to add on to Social Security a mandatory 4-percent contribution to some form of account—and clearly the people who are in 401(k)s already, they are not going to change their behavior, but you are going to pick up the people who are currently going to be relying solely on Social Security in their retirement, and they are not going to have a very comfortable retirement.

Chairman MCCRERY. Well, I didn't understand that last comment. If we keep the current system and then add on a 4 percent account?

Mr. WHITEHOUSE. The people who are saving already in that 401(k) are in the company plans. They don't need to change. They are doing that already, but there are some people who are not saving enough.

Chairman MCCRERY. Right, but why wouldn't the 4 percent add-on account not help those who are not saving enough?

Mr. WHITEHOUSE. It would make them save. They are not saving at the moment.

Chairman MCCRERY. It would help them.

Mr. WHITEHOUSE. Yes, it would help them. Those are the people who concern me. They are not saving enough. We are having this debate in the UK at the moment about how—the importance of compulsion in this. I think the United States performs very well. Most people are saving enough for retirement. People who are currently retired, most of them, are in a good position. There is a missing sort of 25 percent of the work force who are not saving enough now, and 25 percent of pensioners who are on very low incomes.

Chairman MCCRERY. Dr. James?

Dr. JAMES. Yes. Just following up, and so I can explain what I meant by my comment, if we want to maintain the currently scheduled benefit level from the total—from what I see as the total mandatory plan—that will require additional funding. That is why I thought of a mandatory add-on. The question is where should the funding go? Better off going into an individual account, in my opinion, than into the Social Security Trust Fund. There is a danger if it goes into the Social Security Trust Fund that it will be borrowed by the Treasury and actually increase Treasury borrowing more than we would have otherwise. In that case, the extra money would not be increasing national saving, it would leave us with a bigger debt at the end. So, that is a rationale for putting the money into individual accounts where the money is actually invested in productive assets, and does not—is less likely to—increase Treasury borrowing. In addition, as Ed Whitehouse said, what this really does is to make sure that everyone saves some minimal amount. I think the proportion that is not saving enough through 401(k)s is probably greater than 25 percent when you take into account the amount that they save, the consistency of saving through a lifetime, and the likelihood that they will keep it in the 401(k) until retirement. I believe the proportion with insufficient voluntary saving is greater than 25 percent. That is basically the reason for the mandate. The people who are already saving through 401(k)s might actually reduce that saving if they had to put the money into an add-on, which would be a little bit of an offsetting factor.

Chairman MCCRERY. If you took it out of their pockets, yes.

Dr. JAMES. Yes, if you took it out of their pockets.

Chairman MCCRERY. There may be an offset, yes.

Dr. JAMES. Now, your method might have a somewhat different effect.

Chairman MCCRERY. Ms. Coronado?

Ms. CORONADO. If I could make one general comment about the general revenue financing of this. You are sort of weakening—through that method of financing, you are weakening the link between the taxes paid and the benefits received. If one of the goals of addressing the aging problem is to strengthen the incentives to keep working, and if your work results in higher benefits in the future, then that is a good thing for the stability of the system. General revenue financing weakens that link because it is not if I work more, or if I work harder, or if I work a year longer I am going to have more benefits, it is just going to come from the government. That sort of financing actually creates more of the dependency mentality rather than the right incentives for retirement, delaying retirement.

Chairman MCCRERY. I understand that link, but I also understand the current fiscal situation of the United States, which is we are taking in more than we need to pay benefits right now. The surplus that we are taking in is really general revenue. Don't kid yourself. We are spending every penny of it for defense, for other things. To me, it doesn't make a whole lot of difference whether it is general revenues or payroll tax revenues. We are using that money as if it were general revenues and have been for quite some time, and will be for the next 11, 12, 13 years, depending on whose numbers you believe. I am not really hung up on that. I am worried about Mr. Whitehouse's concern about providing for a minimum level of retirement security for everybody in this country. I don't really care how we do it, except I want to do it in a fiscally sound way. The Social Security system, as it is currently built, is a ticking time bomb. As Dr. James alluded to, if we just increase payroll taxes we are just going to add more debt, in effect. That is what I want to avoid. That is why, to me, this concept of pre-funding through personal accounts is a no brainer, as evidenced by the rest of the world that is doing this.

Why is the concept so hard for some to grasp that we are going to have to pay the bill now or pay later? The way we are financing this thing now, we are costing ourselves money. We are paying ourselves interest. We are promising ourselves to pay ourselves interest over time. That is swell if you are prepared to raise taxes enough to cover the bill. The rest of the world has seen that if we take advantage of capital markets, if we take advantage of the private sector to pay us interest over time, that is going to help us pay our bills for this minimum security that we want to provide for the people in the United States. What is wrong with that analysis? Dr. Baker, I am sure you have some comment.

Dr. BAKER. Glad you asked.

Chairman MCCRERY. Frankly, I am anxious to hear you because it is unassailable. The rest of the world has reached that conclusion, so, what is wrong with it?

Dr. BAKER. Well, the rest of the world hasn't reached that conclusion.

Chairman MCCRERY. Well, they seem to be headed that way.

Dr. BAKER. That is not clear. Actually the World Bank study of Latin American reform programs suggested that they should view these privatized systems as transitions to it moving to a system like the United States where you have a well-defined benefit system and a well-working voluntary system like our 401(k) employer-based system. I won't assume that the rest of the world is moving toward that at all. The second point you asked me what is wrong with the logic. The logic is unassailable. The point here is the national savings rate. Now, if you are concerned—it strikes me as very peculiar. I don't spend that much time on this at all, but the Social Security system is a system that is currently running a surplus. It is the rest of the budget that is $600 billion in deficit. If the Congress is concerned that we have inadequate national savings, it could address that tomorrow by doing something about the rest of that deficit. That affects how rich we will be 10, 20, 30 years in the future. It is national savings, it is not Social Security, per se. So, you say, okay, we are going to give you this add-on, and you

say, we are going to finance it either—well, if we do it by borrowing, debt is not going to affect anything at all. If we are going to do it by raising taxes, we could have done it anyhow. We can do it by cuts in other programs. That is fine. If you have the programs you want on the chopping block.

Chairman MCCRERY. If we raise taxes now, Dr. Baker, to fund something that is going to pay us interest, to me that makes more sense than waiting to raise taxes even more to cover the interest that we promised ourselves. I see everybody else on the panel nodding. I just want the record to reflect that.

Dr. BAKER. I would go back to the point that Dr. Coronado made, however. If you are thinking about raising taxes, I think it is better to raise them and put that into the individual accounts, so that the individual doesn't think of it as a tax. It is actually something that is actually revenue.

Chairman MCCRERY. Actually, revenue neutral. If we put it all back into private accounts for individuals, then it is basically a revenue neutral approach. We have given back in the form of personal account money, in a personal account, every penny that we have raised in taxes. So, it is not really a tax increase. It is something that is revenue neutral.

Dr. BAKER. You do have the administrative taxes though.

Chairman MCCRERY. We have raised taxes, Mr. Pomeroy, on the one hand—don't laugh—and we have given it all back on the other hand.

Mr. POMEROY. Mr. Chairman, I did not mean to snicker.

Dr. JAMES. Could I just make a point on the administrative costs? The administrative costs of this plan would actually be lower than the average individual pays today when they save in 401(k)s or in mutual funds. The plan could be set up to provide an opportunity for people to save and invest their savings at lower administrative costs than they face now in the voluntary market. That is a plus of the system, not a minus.

Chairman MCCRERY. Thank you. I have taken far too much time, but I appreciate the responses of the panel, and I appreciate the patience of my colleagues. Mr. Levin.

Mr. LEVIN. Well, I was going to ask some questions, but I think I need to——

Chairman MCCRERY. You may. You may also take up some more time.

Mr. LEVIN. I would like to say a few things about what you said. It is really strange that those who favor replacing the Social Security system because of the present budget situation are those who have voted for policies that have helped create——

Chairman MCCRERY. Mr. Levin, let me just interrupt here because I am not here to defend the President's plan. You keep referring to the President's plan.

Mr. LEVIN. Let me finish.

Chairman MCCRERY. Well, I just want to make it clear that I am prepared to talk with you about not replacing the current Social Security system but adding to it, making it better. I would love to have that discussion, rather than you continue to characterize us as wanting to do away with the current Social Security system.

Mr. LEVIN. That is what the President has proposed.

Chairman MCCRERY. It is up to the Congress to dispose. The President may propose what he wants. It is our job to dispose. We can only do that through a dialog.

Mr. LEVIN. I am all in favor of a dialog, but the President set a path in the State of the Union, on a strictly partisan basis, to say, "I want privatization." It would diminish dramatically the replacement rate that you already say is relatively low compared to other plans, and also would create massive debt. Now—let me just finish.

Chairman MCCRERY. Okay.

Mr. LEVIN. We have made clear that that is unacceptable. We will not agree to replace the Social Security system. We will not agree to the diminution of the replacement rate. We will not agree to this massive borrowing. The President is the chief legislator in this country whether he is a Democrat Republican. He has the power to propose, and he also has the power to dispose. He can veto anything that we pass. It is totally misguided to say, all right, the President is out there, let's go on, but we have said yes. Once the President of this country says that he is willing to set aside the privatization proposals, we have always said we are willing to sit down and talk about how we shore up the Social Security system. There is a shortfall. We want to address it without replacing the system.

The President continues to say that privatization is a condition for his acceptance of any plan. He is out campaigning saying that today while the American people are telling him that is not acceptable. The American people are not willing to have privatization of our Social Security system or whatever you want to call it. So, it is up to the President to remove the barrier to our sitting down and having a discussion as to this shortfall. Now, it is interesting you say the Social Security moneys are general revenue moneys. When it is your policies—I agree there was 9/11. That is part of it. There was a recession. We don't have to argue about who caused it at this point. There have been a lot of policies, including tax cut policies, that have not benefited savings in this country, and I think, have undermined this country.

So, you use these huge deficits as an excuse to replace Social Security. They aren't general revenue moneys unless this Congress acts as if they were. In the nineties we took steps to make sure that we were not going to use Social Security moneys for general revenue purposes. We had a projected $5.6 trillion surplus not using Social Security moneys. So, you are saying because your policies have led us to use Social Security moneys, we therefore need to change the system, and that is simply not acceptable. It is not acceptable to us. You say—I want to say a word about the increasing of savings. Look, you can do it through various devices, but there are some program cuts that will not increase savings. If you cut education programs, or if you cut some other programs and force people to use their moneys without any government help, you are not going to increase the savings rate. You are essentially displacing private savings. If you will have the President say the same thing that you will, take them—go beyond the barrier of privatization, we will sit down. He created that barrier, not the Democrats, he did. You shake your head no. He is the one who proposed it. He

is the one who continues to insist that they must be part of any plan. I was going to ask some questions.

Chairman MCCRERY. Go ahead.

Mr. LEVIN. Let me just ask one or two, if I might. It really reinforces what I have said. We each used this, the issue of other countries, I think, to support our own positions. Mr. McCrery, you have been very fair in creating panels. I think this is kind of an exception to the rule you have followed.

Chairman MCCRERY. Thank you, Mr. Levin.

Mr. LEVIN. It is kind of a McCrery exception. I kind of chuckle when the Heritage Foundation says it doesn't take a position on plans. No, I take my hat off to you. You have been—as Cato has been—very clear for decades. You want to replace Social Security with a private system, or whatever you call it. Well, I will quote back what you said and what Cato has said. Let me just emphasize this issue of borrowing, because you said in your testimony—I will just ask one question of Ms. James, Dr. James, excuse me. If we in the United States want to use—this is on page four. If we want to use pension reform as a way to increase national savings, we either must use an add-on or we must come up with a plan for transition finance that does not depend heavily on enlarging the public debt. The President's proposal, in addition to all of its other ramifications, involves massive debt, which it said in some cases, including Mr. Shaw's comments, over decades would be offset. We just are not willing, and most Members have not been willing to accept more massive debt on top of the trillions we already have, with the belief that 40, 50 years from now that that massive debt will be counteracted. So, I think this hearing is serving a useful purpose, and to the Chairman, as soon as we have an acknowledgment that private savings are not a condition for a discussion of the shortfall, we will sit down, that you say we will take it off the table.

Chairman MCCRERY. Say that again?

Mr. LEVIN. That we will take it off the table?

Chairman MCCRERY. Before that.

Mr. LEVIN. We will sit down.

Chairman MCCRERY. Before that.

Mr. LEVIN. What we are saying is the President has made it a condition that there be privatization, a diversion of Social Security moneys. We are not willing to accept that as a basis for negotiation.

Chairman MCCRERY. Okay. Once again, that is the President's proposal to divert money from the trust fund and to finance it with debt. Once again, the President may propose all he likes. It is up to the Congress to dispose of those recommendations. If you would like to sit down, along with some of your colleagues, and discuss alternative ways to finance personal accounts so that we may prefund some of these obligations we know we have in the Social Security system, I am perfectly willing to do that, as, I believe, are other Republicans in Congress.

Mr. LEVIN. Is it your understanding that either diversion of Social Security moneys or borrowing would be part of your proposal?

Chairman MCCRERY. We wouldn't go in with that understanding, but we could go in certainly putting that on the table, and discussing it and seeing what we can come up with.

Mr. LEVIN. That is the status quo, that the—it is that that has been the barrier, Mr. Chairman, and that the President take the barrier away.

Chairman MCCRERY. Well, let us take the barrier away.

Mr. LEVIN. Well, you take it away.

Chairman MCCRERY. I have——

Mr. LEVIN. Well, you haven't taken it away.

Chairman MCCRERY. We will try.

Mr. LEVIN. Take it away and we will go.

Chairman MCCRERY. In plain words, it is gone. You and I can sit down and start from scratch and try to construct something that makes enough sense to enough of us so that we can pass something to do something very good for future generations of Americans as well as current generations.

Mr. LEVIN. Well, I think the Democratic Party—and I will finish—we have always favored strengthening Social Security.

Chairman MCCRERY. You have.

Mr. LEVIN. As long as the premise is—as it was in 1983—strengthening it, not replacing it, if that is the clear understanding, we can sit down. That has not been the proposal either of the President or from your party.

Chairman MCCRERY. Well, I appreciate very much your offer to sit down, and I will look forward to taking you up on that. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman. I can't help but wonder what some of these folks from across the pond must be thinking about, some of the things we are hearing here today.

Mr. LEVIN. They hear more in the House of Commons.

Mr. SHAW. We see it sometimes on C-SPAN, so, we are doing this to sort of make you feel at home, I guess. I would like to—I have to use some of my time to set the record straight. I do not know of one single time the President of the United States has put as a condition to sitting down with Democrats that they have to agree with his plan or they have to agree with individual accounts. I do know—and you heard it here today—that the Democratic leader on the Subcommittee on Social Security said that it is—that the President put his plan aside as a condition to sit down and negotiate, yet he has no plan to bring to the table. How can you negotiate with somebody who has no plan? That doesn't make any sense to me. I think the President—and the President has made it very, very clear to this Congress—that he is welcoming all ideas to save Social Security. He has one idea. Quite frankly, my idea is different than his. I put mine on the table, and I made him very much aware of it. The reason that I support individual accounts, I don't know any other way out of this box. Mr. Whitehouse, you said that 401(k)s were bringing in an average of 9.5 percent; is that correct?

Mr. WHITEHOUSE. That is the Employee Benefits Research Institute—Investment Company Institute surveys of 401(k)s, the largest survey, they have average contribution, both employee and employer, comes to 9.5 percent.

Mr. SHAW. Do you think it is reasonable then to assume that individual accounts might well throw off the same percentage?

Mr. WHITEHOUSE. You mean that people would voluntarily contribute more than the amount diverted into them.

Mr. SHAW. I am sorry?

Mr. WHITEHOUSE. That people would make additional voluntary contributions to the account.

Mr. SHAW. Is the rate of return 9.5 percent?

Mr. WHITEHOUSE. No, no, no, that is the contribution rate.

Mr. SHAW. Oh, I am sorry.

Mr. WHITEHOUSE. That is the amount of earnings that people put in.

Mr. SHAW. What is the rate of return? That is the important figure that we are talking about.

Mr. WHITEHOUSE. I would say that over time that the real rate of return on pension funds in the United States is probably about 4 or 5 percent, real, over a very long period. I don't have the exact numbers, but that would be my guess.

Mr. SHAW. So, we should probably assume that would be the return we will get on the individual accounts?

Dr. BAKER. Actually not——

Mr. SHAW. I didn't ask you. If I could—listen I have already heard you talk. I know you are an economist, but your assumptions are really over the top. Mr. Whitehouse.

Mr. LEVIN. He is in trouble with the panel.

Mr. WHITEHOUSE. I wouldn't like to make an over-the-top assumption and forecast the future. I am not very comfortable with that. In our work at the OECD we tend to assume a 3.5 percent real rate of return on private funded pensions, which I think is a reasonable, conservative sum.

Mr. SHAW. What is the mix on that? I know that the actuaries at Social Security are—I believe that they have come in with over 5 percent assumed return, and I think that is with about 25 points being paid out.

Mr. WHITEHOUSE. I think Dr. James here, who was on the Commission——

Dr. JAMES. We used, with a 50/50 portfolio, we used a 4.6 percent net return. I am assuming that the administrative costs would be 30 basis points, that was 4.9 percent minus 0.3, so, it came to 4.6. That is for 50/50 portfolio. Of course, it depends on what portfolio you assume, as you know, and what you assume about the future.

Mr. SHAW. All right. Mr. Vasquez, you testified on the Chile plan. As part of your testimony, you were talking about some 30 to 40 percent of the workers are self-employed and do not have to pay into any type of an account. What percentage of the workers who have employers and are not self-employed, what percentage of them opt to go into the personal account?

Mr. VASQUEZ. Most of the workers are in the personal accounts. The issue is the level of contributions, and though self-employed have the option of affiliating with the private pension system, most of them do. They are not obligated to contribute, and that is why you see within the labor force—why 30 percent of the labor force, which is self-employed, is not regularly contributing. They are put-

ting their money into other types of investments, like their own businesses and that kind of thing. So, you see an increase in the rate of coverage of the work force from the time that the reform began, and it is now higher than it was before the reform happened under the old system. The World Bank just published a study this year that found since the reform was introduced, the contribution rates of people who were entering the work force after 1981 have increased significantly compared to prior to the reform.

Mr. SHAW. So, what Dr. Baker said, that people are voting with their feet and leaving these plans is simply not true?

Mr. VASQUEZ. No, I totally disagree with that. He used the measure of minimum pensions as some sort of an example—today there are about 65,000 minimum pensions that are being paid by the government. Let us remember that when you talk about a minimum pension, the government is not paying the entire minimum pension. It is topping up what the people who have accumulated money can't make up. So, it ends up paying maybe 20 or 30 percent of that. That represents about 12 percent of the actual pensions that the system is paying. The vast majority of people who are in the system getting pensions are, if you want to talk about it as voting with their feet, voting in favor of the private sector.

Chairman MCCRERY. Thank you.

Mr. SHAW. Thank you.

Chairman MCCRERY. Thank you, Mr. Shaw. Mr. Neal.

Mr. NEAL. Thank you very much, Mr. Chairman. I also want to thank Chairman McCrery for not only the talent and caliber of the witnesses, but for the opportunity to address the witnesses. I wish that happened more often in the full Committee, but I think you have really done a good job with the Subcommittee. I am also pleased that he acknowledged a certain reality today when he said that the Social Security surplus is being used to fund a lot of surplus government expenditures. He mentioned defense and he mentioned a number of other things, but there is also another reality. It was used to fund the tax cuts, $2 trillion worth of tax cuts, over the next 10 years, and then to say there is a problem in the Social Security Trust Fund? After we ripped $2 trillion out?

One of the problems of the modern Congress here is this is the Stepford Congress. This Congress has abrogated its authority. We don't ask questions about Iraq, we don't ask questions about changed policy numbers in terms of the Medicare debate and prescription drugs. We don't ask questions about people who edit reports on global warning. Nobody is dragged before this Congress to ask a question. Even in the European system or the British system members get up—Prime Minister Blair's own party, they resign, they go at it with him. Pretty good. That never happens in this Congress.

To argue that the President doesn't dictate what the majority party in Congress does is disingenuous. Whatever he says with this Congress, majority, it goes, and everybody knows it. They speak with one voice on everything, and you can see the disarray in Iraq and across the world now because of it. The job of Congress is to ask occasionally, just occasionally, maybe a few questions about policy. Let me ask and make a couple of points. The witnesses today have extolled the virtues of privatization. You have advo-

cated that the U.S. adopt this approach. At the same time we have heard some pretty glaring facts. There have been, quote, mis-selling scandals in the UK. Administrative costs have skyrocketed, eating away at people's benefits in many of these countries. When given the option—I want to come back to you, Mr. John, because you raised a good point about the mis-selling issue. For those of us like Mr. McCrery, Mr. Levin, and Mr. Shaw who were here during the Savings and Loan debacle, we know that part of the problem was that people who weren't qualified to get into that business got into that business, and that is something we should be mindful of.

We have also heard that when given the option large numbers of workers don't participate in the savings programs in the UK, and in Chile. We have also heard that price indexes eroded the value of benefits quite significantly. I think that as we focus on the benefits of the proposals that have been offered today, it is also fair to focus on some of the weaknesses. The idea is not necessarily to strengthen capital markets, the idea is to provide security in retirement. We have not heard either of the witnesses speak to the notion of disability. We haven't heard the witnesses speak to the question of survivors' benefits, what happens to widows, what happens to children. Maybe we could hear from the witnesses—Dr. James you are nodding your head, would you speak to that, please?

Dr. JAMES. Yes, I was actually just in Chile to study disability and survivors' benefits. I was there for two weeks. In fact, that is been an under-studied topic. If you like, I can tell you what their system is. It is a novel system. I don't know if you would like to hear the details about that. Basically, they use the individual accounts and turn it into a DB. They guarantee that a disabled person will get 70 percent of his last 5 years average earning. From the point of view of the recipient, it is actually a DB, but it is a DB that uses the money in the accounts. The pension fund is required to buy a group insurance policy that will top up the account enough to purchase an annuity of that value, and, because it uses the money in the accounts, it costs quite a bit less than most other countries. It costs about 1 percent of earnings per year.

Mr. NEAL. What about survivors' benefit?

Dr. JAMES. Same for survivors, it is part of the same program. I haven't completely analyzed it yet, but that is the basic system.

Mr. NEAL. I know that——

Dr. JAMES. It is something we need to talk about.

Mr. NEAL. My time is running out. If I could go back to Dr. Baker here. Many of the witnesses have focused on lessons we could draw from countries that have had some problems with private accounts. They have also extolled those virtues, as I indicated a moment ago. What are the best lessons for us to learn, you think, as we get down the road in the Social Security debate. I meant what I said about Mr. McCrery in terms of the witnesses. He really has done a good job with these panels.

Dr. BAKER. Well, just to repeat a couple of points. First off, there is no way to escape the risk that we are replacing a system of guaranteed benefit with risk. I know it is actually the intention of many people to cut benefits, and use the privatization as a way to cut benefits. So, you have had the problem in England where you are facing a situation where future generations of retirees will

have much lower benefits, at least relative to their wage income, than current generations. Thirdly, there is a lot of illusion here about rates of return. In Chile you had very high rates of return in the eighties primarily because their main asset, Chilean government bonds, paid very high interest. That is in one pocket, and out the other pocket.

At the risk of disagreeing with Representative Shaw, I raised this issue of stock returns to all the economists in the debate, and I have asked a very simple question. If you think you will get very high return on stocks, give two numbers—we call it the No Economist Left Behind Test—the return on dividends and capital gains. That is the only way we get money from stocks that add to your assumption on returns, 6.5, 7 percent. Steve Goss, Chief Actuary at the Social Security Administration (SSA), said yes, you could get that if price/earnings ratios first fell by one-fifth. The fact is, no economist can support those numbers. I might be wacky here, but I stand by my arithmetic.

Mr. NEAL. Finally I would say, Mr. Chairman, that President Bush did indicate that his proposal for Social Security—and he spent a lot of time traveling this country for a guy who doesn't have a proposal—would include lower benefits. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Neal. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Ms. Bovbjerg, I just want to get some respect here on the problem. Just recently, David Walker testified before our Committee. I am going back to this. I think I brought this up the last time you were here, that in about the year 2020, the revenue coming into the Treasury will only cover entitlements and interest on the Federal debt. There will be nothing left in discretionary spending. By 2040, the revenue line just comes in a little bit above interest on the debt. There is nothing for the entitlements, nothing for Medicare, Medicaid, Social Security. We keep hearing that Social Security will—the benefits will have to be cut by 23 percent, but looking at that revenue line by 2040, there will be no Social Security, there will be no Medicare, there will be no Medicaid. There will only be revenue enough for interest on the debt. Is that chart accurate that you provided for us?

Ms. BOVBJERG. It is our simulation, and it is based on presuming that everything pretty much stays the same in the outyears. We use the SSA and Congressional Budget Office (CBO) assumptions. We also assume that discretionary spending would grow with the economy. We assume that the tax provisions would not expire in that particular scenario. It presumes essentially that you are going to make up the difference with debt, and I know that Mr. Walker has spoken a number of times before the full Committee about the economic dangers of continuing on that course.

Mr. LEWIS. When the fact is that the average family is paying basically 40 percent of their income in local, State, and Federal taxes, how much higher would the taxes have to be to cover all of our unfunded liabilities and debt?

Ms. BOVBJERG. Oh, it would have to really be tremendous. I think that one of the things I remember the last time I was here is you asked me about a $45 trillion number.

Mr. LEWIS. Yes.

Ms. BOVBJERG. I decided, since I wasn't completely sure what was in that, I wouldn't comment on that. I looked at that number, and that is really kind of mashing together all the obligations, the things that we think are going to be coming up with in the future. It is arguable whether that is—that is not a budget number, that is not a CBO number.

Mr. LEWIS. Right.

Ms. BOVBJERG. It would really represent a significant draw on our economy. One of the things I was thinking about in terms of how you finance certain things is that we don't have a lot of slack.

Mr. LEWIS. Right.

Ms. BOVBJERG. To finance more things with debt. Just remember, we haven't decided yet how we are going to deal with the health care problem.

Mr. LEWIS. Exactly. If we were just dealing with Social Security, maybe we could increase taxes to deal with that, but when you are dealing with the other entitlements. This is a lot bigger problem that just saying, well, we can increase taxes. That burden would—when you are looking at a number that is four times the size of the American economy, my goodness, 50 years ago or more the government started on a path of a charge account to pay for retirement and health care in this country. If you look at Social Security and then the Great Society and all of the programs, it is basically a charge account on coming generations, and you don't have the assets to back it up with. It is going to be a crushing situation if we do don't do something, and I think Social Security is the easiest problem to fix. That is all. Thank you.

Chairman MCCRERY. Thank you, Mr. Lewis. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. I do want to sincerely indicate my appreciation to this panel like the other ones that you have had. I think that you have displayed constructive leadership in your discussion of issues. I meant no disrespect. Let me just—first of all, let me set the stage. Ms. Bovbjerg, if I get the essence of your testimony, it is that we can learn from one another across the community of nations, but in the end we each have our own idiosyncratic issues, and we need to tailor our plans to reflect individual circumstances ranging from national values to state of the economy. Would that be correct?

Ms. BOVBJERG. Absolutely.

Mr. POMEROY. Let me move to a line that strikes me from your testimony, Ms. Coronado. I found the discussion of the Swedish plan to be interesting, but on pages four and five, you discuss the way adaptations have been made relative to the increasing life expectancies of populations, bottom of page four, top of page 5: "Upon retirement, the annuity rate will depend on expected survival probabilities for each cohort so that the beneficiaries bear the risk of future improvements in life expectancy through lower replacement rates, although the government continues to bear the risk for changes in immortality after retirement or you retire. If your group is living longer, your rate, your pension, is going to go down relative to the income replacement rate."

Then you say that the reform transfers much of the economic and demographic uncertainties directly into benefit levels, leaving

the financing of the system generally quite robust to changing economic circumstances. This is a case to me of us fixing the macro problem and ignoring the micro problem, the micro problem being the circumstances of an individual's finances. Let me just reflect upon changing the—transferring the economic and demographic uncertainties directly into benefit levels. We have talked a bit about longevity risk and longevity indexing. I think we will talk about it some more. It is a very interesting concept that I have some very serious concerns about, depending on how you address it. One way I wouldn't want to address it is one that reduces benefits because people are living longer, because as people are living longer you are going to have more years in retirement to have to deal with elevating costs. I think you made an honest statement there, but I don't think we want that to be a guiding principle of ours. I think we want to, in the end, come up with a reform proposal that holds micro right at the forefront of what we are trying to do, because we don't want to have people——

Ms. CORONADO. Keep in mind——

Mr. POMEROY. We don't want to have a healthy system on the one hand, and people that are old and broke on the other. So, we have to figure that out. In the next paragraph you talk about how they have structured this in a way that also encourages work while people can work, and moves them into interesting notions of phased retirement that we could probably learn from.

Ms. CORONADO. Right.

Mr. POMEROY. The core is how do we protect an adequate benefit over the long-term. Frankly, I have some concerns about this. Chilean statistics that have concerned me, Mr. Vasquez, are that women, especially older women, are disproportionately falling on the minimum guaranteed rate. Their earning power is less for accumulated and private accounts. Then, their years of receiving payment are longer. So, if you are—something like 65 percent of women, depending on the minimum State pension—I am raising a concern of where that replacement rate is. What is the replacement rate? What is the minimum rate in terms of a dollar and a cent per month?

Mr. VASQUEZ. Currently it is about $120 or so.

Mr. POMEROY. It is $120 a month. Sixty-five percent of women are depending on that minimum rate?

Mr. VASQUEZ. This is an improvement.

Mr. POMEROY. It may be an improvement, but it is no guiding light for the United States to aspire to for this kind of $120 minimum payment for elderly women.

Mr. VASQUEZ. Chile is much poorer——

Mr. POMEROY. Let me just ask you something across the panel. I will start with Dr. Baker. My time is so short. I don't mean to unfairly cut you off. I got what I was asking for with that question. It seems to me that longevity risk—the heart of providing a pension program that works over the long haul—entails keeping people in a pool so that we have a mix of life expectancies, and so that those that are dying earlier, in the end, are not drawing upon the system nearly to the extent of someone who lives long, so, you have a cross subsidy. You operate a risk pool, a longevity risk pool.

Now, I do not understand how you run a private account for everybody. We are not in a pool any more. I got mine, you got yours, we are all individual, and you have that kind of risk sharing on longevity risk. So, I think one of the reasons we are so opposed to the private account going in is it is antithetical, in my opinion, to making sure that people have adequate benefits in their old age. Especially in times of increased life expectancy. That is terribly problematic. Mr. Chairman, I don't know if you want to allow me time to go across the panel, but I am done talking and I would like a response to that question.

Chairman MCCRERY. Sure. If anyone would like to respond.

Dr. JAMES. If I could answer your question about the Chilean minimum benefit. It is 25 percent of the average wage. You have to take into account the average wage in the country. For someone over the age of 75, it is actually 28 percent of the average wage. We don't have a minimum benefit like that in our own country currently.

Mr. WHITEHOUSE. This is around 19 percent worth of average earnings. So, the minimum safety net level for all people in the United States is below——

Mr. POMEROY. I would hope we could do better than 25 percent replacement rate in terms of longevity risk protection. Let us get to that question. Dr. Baker.

Chairman MCCRERY. Wait.

Mr. POMEROY. Okay. Across the panel.

Chairman MCCRERY. Across the panel.

Mr. POMEROY. Longevity risk protection.

Ms. CORONADO. May I say something?

Mr. POMEROY. Longevity risk protection in private accounts. How do these two interact?

Dr. JAMES. People buy annuities. At the point they buy the annuities the longevity risk is pooled, and the vast majority of people in Chile buy annuities.

Mr. POMEROY. Private insurance, not social insurance.

Dr. JAMES. It is through the private annuity market. They get back—studies of what they get back indicate they get back their full premium when you discount at the risk-free rate. It is privately provided, but it is a pretty good deal. It is price indexed.

Mr. WHITEHOUSE. Sweden is not alone in having these longevity adjustments. Germany just introduced one. You have the same sorts of things in Italy and Poland. The idea is that the benefit will fall as life expectancy increases. I think the designers of the system hope that people will, as a result work longer, and so, they will retire later in these programs. As life expectancy increases they will work longer, and get the same benefit.

Mr. POMEROY. To offset the falling benefit by working longer.

Mr. WHITEHOUSE. Absolutely, that is the incentive.

Ms. CORONADO. That is the incentive of the system. In Sweden, it is still the government that is sole provider of the annuities. It isn't even going to the market to deal with load factors. The government is providing the annuity. It is very low cost, therefore, and you are pooling risk across the entire population, it is just that you are doing it on a cohort-by-cohort basis. So that as trends continue, and we don't know whether people are living longer and longer or

whether that will sort of ameliorate a bit. Somebody has to pay for that.

Mr. POMEROY. We are all victims of the notch baby issue. I think that cohort-by-cohort would raise some interesting political issues here.

Mr. VASQUEZ. I would just emphasize that the minimum pension in Chile is greater as a share of the average wage than it is here, in the United States. Also, that studies have shown that women are doing much better now under the new system than they were under the previous system.

Mr. POMEROY. Chile, old Chile to new Chile.

Chairman MCCRERY. Any other members of the panel want to make a brief comment?

Mr. HARRIS. I would just make a comment with regard to Australia, Congressman. There is a bedrock that all Australians will get, that is 26 percent of male total average weekly earnings, if they need it. Now I probably won't need it when I retire, hopefully I have saved enough through thrift so that that safety net will not come into operation due to the income and assets test. I think it is important to share with you that it was the trade unionists and social Democrats in Australia who said you have to give the individual the ability to save, and that is important in an IRA-oriented system.

Chairman MCCRERY. Final word, Dr. Baker.

Dr. BAKER. On the question of annuities. If you allow people to opt out, as President Bush proposed, invariably, adverse selection occurs, which reduces benefit by 10 percent. Also, in the Chilean system, many workers don't work enough to get the benefits. So, to compare apples to apples, that would be conservatively less than 25 percent for those who don't get the minimum benefit.

Chairman MCCRERY. Mr. John, very briefly.

Mr. JOHN. Very brief. I would just like to point out that my 19-year-old daughter is guaranteed to lose about 28 percent of her Social Security benefits due to the fact that she will retire 10 years after the U.S. trust fund expires, and that is not exactly risk free.

Chairman MCCRERY. Mr. Ryan.

Mr. RYAN. All right. Thank you. Two questions, but first I just want to make an observation based upon what we have been talking about here. There is one area where I think all of us have reached consensus, both sides of the aisle. It is a statement I hear politicians from left and the right making. That is, whatever we do, we are not going to change benefits for people over the age of 55. I think that is the number we use these days, those who are in or near retirement. We have all come up with the notion that we are going to figure out a way to make sure that those benefits are locked in, guaranteed, dependable for people aged 55 and above. That leads us to the rest of us, the rest of the country. Mr. Harris, you called yourself a Gen-Xer, what is a Gen-Xer? I don't know where that age break is.

Ms. CORONADO. It is 1964.

Mr. HARRIS. Those born between 1964 and1972.

Mr. RYAN. Thank you. I didn't even know that. So, I am a Gen-Xer then.

Mr. HARRIS. You're welcome.

Mr. RYAN. My generation is expected, at best, to get a 1-percent rate of return on our payroll taxes when we retire. Now, when I retire, we may or may not have the money to pay our benefits. My three children are expected at best to get a negative 1-percent rate of return on their payroll taxes. When 80 percent of the American people pay more in payroll taxes than they pay in income taxes, this is a big deal. We should be asking ourselves, can't we do better for our money? When we hear from the other side, take off the table any idea of pre-funding your retirement, of utilizing capital markets to get ahead, and then we will talk, that just sounds ridiculous to me, especially when we are not even bringing another alternative to the table. It is basically saying we will either raise taxes or cut benefits to fix this problem.

That means that negative 1 percent rate of return that my kids are getting, and we are $4 trillion short of paying them their benefits, is going to go less than negative 1 percent rate of return. You are telling my generation that the 1 percent rate of return I hope to get, future generations will get less than that. To me that is not fair. We should talk about how to make this system not just fair today, but fair for all generations. That is a point I want to make that is lost in this room every time we have these hearings. Now, Dr. Baker, I had a couple of questions I want to ask you. First, I went through your testimony here. You make some interesting points. You argue that Social Security's financing shortfalls are exaggerated and the system is in far better shape than most perceive, it is not a crisis. Am I paraphrasing fairly accurately?

Dr. BAKER. I don't think that is my testimony, but I will stand by the statement.

Mr. RYAN. I read it in one of your papers here. Then you argue that the slower economic growth projected by the Social Security trustees implies lower returns in market investments like stocks and bonds. In your paper, which I have here in your binder, you argue that a 4.6 rate of real return on stocks is consistent with the trustees' economic growth projections, which is a lot lower than their 6.5-percent growth projections by the SSA actuaries; therefore, you argue that personal accounts wouldn't be a very good deal.

That is a very interesting point, but I am not sure they are consistent with one another, because you also argue in your paper that as stock returns fall, so do bond returns. I think you say that bond returns would go from 3 percent to about 2.1 percent. If bond returns are low, then a couple of things have to happen. First, personal accounts invested in stocks wouldn't be such a bad deal after all, because what matters most is premiums paid to stocks over bonds. Second, any debt incurred in transition financing would have a lower interest rate and, therefore, bear a lower cost. Third, a lower bond rate in this country would mean that the current system's deficits would be much bigger than we are currently projecting. The 75 year actuarial deficit would grow about 30 percent, and the infinite rise in deficit we had calculated would about double if you go to a 2.1 percent bond rate.

It seems to me if we accept your argument regarding economic growth and investment returns, then personal accounts are still a good deal; relatively speaking, transitional costs are more afford-

able and the current system's problems become much, much larger than we are now calculating them to be.

Dr. BAKER. Well, let me point out a couple of things. First, in terms of calculating the current system's problems, people like to put this in a way to make it very dramatic and scare people. Very frankly, I don't think there is anybody in this room, probably anybody in the country, that really has a very good sense of numbers like a $4 trillion deficit or $11 trillion over an infinite horizon, or the $44 trillion number we heard here. I like to express things as a share of GDP. Now, if you use a lower discount rate, GDP rises as well, so that $44 trillion we expect as the share of future income would be about 6 percent. You would still end up with about 6 percent, as a share of future income. Now, you get a more dramatic number in terms of trillions if you use a lower discount rate, but that doesn't change the nature of the economic problem.

In terms of how individual accounts stack up if you have a lower return on stocks and also a lower return to bonds, I am very skeptical of what sort of return you will have on bonds and what sort of return you will have on stocks, but again, given the gross assumption of the trustees—those are not my assumptions, they are their assumptions—the return we could expect on stocks is about 4.5 percent. I am more agnostic on bonds. I coauthored that paper; I will just say that. I am, for the moment, willing to say 3 percent, but if you want 2.1 percent, fair enough. The point is, that gaps about 2.4 percentage points. The gap that is currently assumed by the CBO and by the actuaries in analyzing individual accounts, is on the order of 3.5 to 4 percentage points. If your gap is just 2.5 percentage points, 2.4 percentage points, you assume that 50-50 mix, whatever mix you want, and then you would assume administrative costs. Therefore, you are ending up with a very small premium.

Mr. RYAN. It sounds like a self-defeating argument if you are saying the trend is that bonds will be lower, then transition costs are lower, returns are better for stocks relative to bonds, but more importantly, our projected problems get higher. Let's just say it is—2.1 percent from 3 percent. It doesn't seem like a big difference, but that doubles the infinite-horizon forecast and adds 30 percent to the 75-year window.

Mr. BAKER. It also doubles our income, those horizons do. So, it is proportional. The share of our income doesn't change. That would be the relevant measure.

Mr. RYAN. You are saying the notion that we should measure Social Security's finances in and of itself is a notion we shouldn't use?

Mr. BAKER. Well, it is not terribly meaningful. Again, it is relative to our income. If Botswana had a debt of a trillion dollars, it is devastating. Us having a debt of——

Mr. RYAN. Do you think it is meaningful that DB plans are measured, in and of themselves, as to their health and financial safety and security?

Mr. BAKER. They aren't measured in and of themselves. They are measured relative to their future contributions.

Mr. RYAN. So, with reference to Bethlehem Steel's DB plan, it is irrelevant whether we measure that one on its own or in the context of the broader economy?

Mr. BAKER. No. I am saying it is measured relative to its contributions. If you expected more money coming in, then whatever liabilities it had today would be of less consequence.

Mr. RYAN. Anyone else wish to comment on that? I think I still have a second. I can't see from here, but administrative costs—again, I am using that excuse.

Mr. LEVIN. One advantage of being a senior Member.

Mr. RYAN. That is why Mr. Rangel chooses to sit down here, because he can't see the light.

Chairman MCCRERY. You are two and a half minutes over, Mr. Ryan.

Mr. RYAN. I am hopeful we will have a second run. I want to ask you about administrative costs. Literally, I want to understand how you come up with $75 million per year administrative costs.

Chairman MCCRERY. You can be thinking about that as we go to the next Member. Ms. Tubbs Jones.

Ms. TUBBS JONES. Thank you, Mr. Chairman, and thank you, ladies and gentlemen, for coming this morning, now this afternoon. Mr. Ryan and I are in the same class. Fortunately, I am 55, and so, supposedly I am guaranteed a benefit. I am not confident that I am guaranteed a benefit if, in fact, we decide to go to individual accounts. I couldn't sit here—Mr. Ryan, you are my good friend and colleague. What was ridiculous in my mind was the tax cut for the top 1 percent, which put us in a situation where we could not fund many of the programs that the people in the country are relying on, like education.

Mr. RYAN. Would my friend from Ohio yield for a second, ma'am?

Ms. TUBBS JONES. Absolutely not. So, seeing how you thought it was ridiculous, I just wanted to put something that I thought was ridiculous on the record. Let me, first of all, ask each one of you, what is happening with health care for seniors in the countries? I am going to leave you out, since you have been with us so many times already, Ms. Bovbjerg.

Ms. BOVBJERG. I am not much offended.

Ms. TUBBS JONES. Dr. James, what is happening with health care in the country that you looked at?

Dr. JAMES. Well, I looked at the world.

Ms. TUBBS JONES. You testified today—I don't have but 5 minutes, so, you can't tell me about the world.

Dr. JAMES. Every country—if you are asking about health care costs, every country faces the problem of high and rising health care costs. There is a wide variety of solutions and——

Ms. TUBBS JONES. For example, our seniors right now are faced with a significant problem of having to pay a lot of money for prescription drugs. Many of our seniors are using more, or most, of their Social Security benefit to pay for their prescription drug benefit. I am just curious about what is happening around the world, because as we talk about retirement security, the lack of health care for the seniors that are in retirement is a significant

issue. If we will just go down the line—again, I don't have but 5 minutes and can see the light, so, I have to be guided by the light.

Dr. JAMES. Let me just say that health care is much more complicated than Social Security, as I am sure you know.

Ms. TUBBS JONES. Mr. Whitehouse.

Mr. WHITEHOUSE. I will answer about the UK, as that is where I am from, even though I do live in France now.

Ms. TUBBS JONES. I should say, Bon jour, comment allez-vous?

Mr. WHITEHOUSE. Merci, tres bien. We are very wedded—great political consensus on that—to our system of the National Health Service, which many Americans describe as socialized medicine. We are very happy with that because it is a system which delivers a pretty reasonable level of health care. It is not that wonderful, but it gives a pretty reasonable level of health care, and it is extraordinarily cheap. We are probably spending, possibly half of the percentage of GDP on health care.

Ms. TUBBS JONES. Do you buy prescription drugs in bulk?

Mr. WHITEHOUSE. We have a very complicated pharmaceutical pricing regulation system. For seniors, prescription drugs are free, as they are in France, as well.

Ms. TUBBS JONES. Ms. Coronado, before I go to your answer on health care, I read with interest a paragraph on page three of your statement. It says, "The first of these problems associated with the fact that benefits in Sweden were indexed to prices rather than wages. The result of price indexing was volatility of replacement rates through economic cycles when wages grew either more slowly or more rapidly than prices." You go on to say, "It is worth noting that current proposals for price indexing benefits in the United States would also likely result in volatility in replacement rates and lead the system toward a flat benefit structure." Expand on that for me for a moment, if you would.

Ms. CORONADO. The pressures that these systems face require either raising taxes or cutting benefits, and price indexing is proposed as a way of phasing in basically a reduction in replacement rates over time. It is associated because, ultimately what we are worried about in retirement is replacing a certain fraction of pre-retirement income and maintaining a standard of living. Price indexing has some problematic characteristics when you are trying to achieve that.

Ms. TUBBS JONES. Do you suppose that is why now the administration has created this new term called progressive.

Ms. CORONADO. Progressive price indexing just basically puts a floor on that, but you are still going to have the same problems in the middle and upper tiers when the real value of benefits is basically going to be declining over time as a way of achieving balance.

Ms. TUBBS JONES. Let me ask Mr. Vasquez about health care.

Mr. VASQUEZ. Well, I don't pretend to be an expert on health care. In Chile, I can only say that, to the extent that people who are retiring today in Chile are better off, they are going to be able to deal with their health care needs in a better way. The whole discussion about health care is something much more——

Ms. TUBBS JONES. Do you know whether or not people pay for their own health care? Is there a Medicare kind of program? Prescription drugs?

Mr. VASQUEZ. Yes, but I don't pretend to be an expert on that. There was some limited reform, where people contribute their own money to a private account. Again, that was a reform that was far more limited than the pension reform.

Ms. TUBBS JONES. Mr. Harris, I would love to ask you and Dr. Baker and Mr. John, but I am out of time. Maybe somebody else will ask the same questions. I thank you all of you for your responses and your presentations today. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Ms. Tubbs Jones. I would advise all Members that assuming we don't have—we are not interrupted by votes—I will allow a second round of questioning if anybody has any other questions and our panelists are agreeable to staying. Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman. I think this hearing has been really helpful from the standpoint of your goals to try to build an educational base. As we tackle this problem, learning from other countries, the consequences of ignoring a growing retirement mass and some of the impacts of the decisions that are made to address the retirement, I think is very helpful. I am going to spare the panel a question, from the standpoint of, we are fortunate, as we look at solvency and sustainability, and can we grow the money in the United States—we are fortunate that we can also look at some proven models right in our own communities and neighborhoods.

The Galveston plan, for example, has been in existence a quarter of a century. They invest only in interest-bearing accounts, and throughout that quarter of a century had an average return of about 6.5 percent. The TSP that many of us are putting our precious payroll dollars into over the years has averaged a 7.5 percent return. Our Texas teachers, which is a very large group—that plan has operated now over half a century, and the average return here is, in the last decade, about 10 percent—even through Enron, even through the recession in the dot-com bust a good, solid return. When I talk to average people in those plans, and I tell them, you are in a risky scheme, you are in a guaranteed gamble and you really need to come under Social Security instead, they look at me like I am crazy, because they have real accounts with real assets that have grown gradually and steadily, never in a direct linear way, there is risk in everything, but in a very good, solid way—and as a result, their retirement checks are much, much, much larger than Social Security. I think Mr. Chairman, it is really helpful from a global perspective, to see the experiences that this panel has outlined and then to be able to translate that, meld that with some proven models that are right around us in this room. The combination of the two, I think are very helpful, so, I will yield back my time.

Chairman MCCRERY. Thank you, Mr. Brady. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman, and thank you for also indicating that we could have a second round. I think that is generous and also lends itself to meaningful discussion. I would also point out, as some of my colleagues have, that while this has been a phenomenal panel and we appreciate your testimony, it is

undeniably an unbalanced panel because of the private witnesses, not including the government witness; six of the seven have either written or spoken in support of privatization. While I think it is important to have a full discussion, it would also be helpful to be able to air all perspectives, to be able to come up with meaningful policies. So, I do thank you for your testimony.

Chairman MCCRERY. Mr. Becerra, I won't count this against your time. That is the second time we have had that comment, and I appreciate it because you are right, you are accurate. We did offer your staff the opportunity for more witnesses to express your point of view. Dr. Baker, and he is a mighty force, but he is the only one that they chose. I appreciate your observation. It is not my—by our that it turned out that way.

Mr. BECERRA. I see our staff chattering in the back, so, I won't try to dispute what the Chairman has said, only to say that I think it is important to try to have as ample a discussion as possible. I do appreciate, Mr. Chairman, that I think you have been, and you have made every effort to try to be, fair and have good discussion, so, that is not a concern. I do believe that when we finally have a chance to sit down—and I think we will get there, especially if someone like the Chairman is helping conduct those opportunities—we will want to have heard from as many people as possible, from every perspective.

Chairman MCCRERY. Absolutely.

Mr. BECERRA. As we sit here and look at this panel, while it is great to have six perspectives and only one to counter, at least to provide a different perspective, it does make it difficult to get a full sense of what is out there. Again, be that as it may, you have been very generous in doing these hearings. I thank you for that, and I thank you for not counting that against my time. Just a quick point on budget perspective because we are seeing this discussion about how we don't have the money to deal with Social Security, therefore we have to replace it with privatization. Ms. Bovbjerg, you responded to some degree about that. I don't know if you know the numbers, but if you take the tax cuts that the President has proposed and, as you indicated in your assumptions, you project them out as if they were permanent. If you were to take those tax cuts that went mostly to wealthy folks and extended them out, the cost of those tax cuts, isn't it correct, are far more than the cost of making sure Social Security is solvent for that same period of time?

Ms. BOVBJERG. Mr. Becerra, I don't know what those numbers are. I believe we might have provided something like that for the record, perhaps before the full Committee. I will check and——

Mr. BECERRA. You can check, but I can tell you right now that everybody that has done an estimate on this will tell you the cost of the tax cuts that went mostly to wealthy people were somewhere between three to five times greater than the cost of providing solvency for Social Security for that same period. If we want to talk about being fiscally responsible—in fact, if you want to talk about being fiscally responsible, you can avoid extending tax cuts that are going mostly to wealthy folks at a time when people are saying "the sky is falling" for Social Security. Indeed you could probably take only the tax cuts that went to the wealthiest 1 percent of

Americans, and with that, just with that, you have almost enough to take care of any solvency problems that Social Security has in the long term. Going back to the whole issue of Social Security and privatization that we have seen throughout the world, please tell me if I am wrong, but in every case where we talk about the mistakes in some of these privatization systems, the losers have either been the retirees or the taxpayers. When a mistake—the euphemism "mistake" is used whether it is because somebody got charged a lot in fees or because bad investment advice was given, the mistakes have cost either the retiree, because he or she will have less money in his account, or the taxpayers, who have to bail out the system to correct that.

Dr. JAMES. Not exactly correct, no. In the UK, I believe there is a lawsuit which has resulted in about an $11 or $12 billion settlement.

Ms. BOVBJERG. It is $20 billion.

Dr. JAMES. That will come from the companies.

Mr. BECERRA. Well, Dr. James, you made my point: $11 billion is going to go back to the retirees, because the companies took the money from the retirees.

Mr. WHITEHOUSE. They are not retired yet. They are the workers.

Mr. BECERRA. You made the point that I was trying to express, and that is that the ones that are contributing the money when so-called "mistakes" are made, are the ones most likely to lose, unless they, of course, happened to be successful in some litigation. I guarantee you that if you tell the American seniors that that is what they have to rely on, going to court so they can get their retirement benefits, I suspect, Dr. James, you are going to have a hard time passing this in Congress. Dr. Whitehouse, you mentioned rate of returns in private pensions average somewhere around 3.5 percent, real rate of return, about 3 percent. Have you examined the rate of return for the thousands of Enron employees in this country who saw Enron go bankrupt?

Mr. WHITEHOUSE. Minus 100 percent would be my guess of that.

Mr. BECERRA. What about the United Airlines employees who today are relying on a bankruptcy court to determine how much they are going to get out of their retirement?

Mr. WHITEHOUSE. That is a DB plan. The 401(k)s do have some of those problems, and I believe this House is addressing these issues of large quantities of money in employer stock. The optimal employer stock in your pension plan is zero because your future welfare already depends on the success of that company, your earnings in that company. So, the way 401(k)s have been structured have not been regulated perhaps as they should have been in the past.

Mr. BECERRA. Let me ask you one last question, as I see the light is red, and I know the Chairman has said we will have a second chance for questions. Mr. Vasquez, in the case of the Chile privatization model in 1981, when the military dictatorship decided to scrap the old DB system that was in place, that had a lot of problems because of abuse and underfunding and so forth that had oc-

curred, and replaced it with a privatization system, they didn't include themselves in that privatization plan, did they?

Mr. VASQUEZ. The military was not included and that was a big mistake. Today, they are having financial difficulties and they are facing the same sorts of problems as public pension systems.

Mr. BECERRA. They still haven't included themselves in that?

Mr. VASQUEZ. The architect of that program, Jose Pinera, always said it is a mistake for the military to be left out and they have a deficit in their public pension.

Mr. BECERRA. Having recognized that mistake—24 years later, having recognized that mistake, have they now included themselves in the privatization plan?

Mr. VASQUEZ. No, and that is a political problem.

Mr. BECERRA. That is—the test of any plan that you propose is, are you willing to be part of it, and in this case, it seems that some of the leaders aren't.

Mr. VASQUEZ. The Chilean Minister of Labor is part of it, and he was advocating the military to take part in it.

Mr. BECERRA. Mr. Chairman, why don't I stop there, and if you have a second round, if we have any further questions, I will ask it.

Chairman MCCRERY. Thank you, Mr. Becerra. Mr. Rangel, distinguished Ranking Member of the full Committee, do you have any questions you would like to ask the panel?

Mr. RANGEL. No, but I do want to compliment you, as other Members have, for the selection of such qualified panelists to assist us to see how this has worked in other countries; and just once again, say publicly that I don't doubt that we all want to reach the same end and make certain that we provide the President with a bipartisan bill. So, therefore, Mr. Chairman, at some point we are going to have to make a political judgment in terms of what we can do with this information that we are getting, so that in the parts of the bill that we are agreed on, we will be able to have the pros and cons of the different approaches to this serious problem. I really think that you have made a great first effort as the Committee moves toward trying to reach a solution. I hope we can enjoy that same activity in terms of the political questions that we will have to face when we seriously face the problem. Thank you so much.

Chairman MCCRERY. Thank you, Mr. Rangel. Now, are there any Members that would like to have a second round of questioning? Mr. Ryan, you may proceed.

Mr. RYAN. Mr. Baker, I just wanted to ask you, you mentioned $75 billion. Where did that number come from? How did you come up with that? What you said at the end of the testimony sort of caught me off guard.

Dr. BAKER. Sorry. Very, very simple calculation. What I was saying was, suppose the United States were like Chile, where our entire system was funded through individual accounts.

Mr. RYAN. You said whole 12.4 percent payroll tax.

Dr. BAKER.If you just look at the benefits that we are taking, roughly $500 billion a year in benefits. In Chile, the administrative costs are roughly 15 percent of what goes into the system; 15 percent of $500 billion is $75 billion a year.

Mr. RYAN. That is an interesting computation. What if you added the rate of return that you would get by going to—did you add the rate of return, say that 4.6 percent the actuaries use, or the 5.2 percent on a different blended stock? Did you change that, or did you adjust for an increased rate return that would be attributed to bonds and stocks versus the current system?

Dr. BAKER.I was just saying, given that amount of payout, given that you had 500 billion a year in payout, given administrative expenses that are roughly equal to 15 percent of what gets paid in, paid out each year that gets you $75 billion in administrative fees.

Mr. RYAN. Are you saying 15 basis points or 15 percent?

Dr. BAKER. Fifteen percent. Again, there is a confusion here. A lot of people have exploited, I think, and misled a lot of people on this. This President's commission expressed their cost as 30 basis points of the stocks. If I have a dollar in that account for 40 years, I am paying three-tenths of a cent for 40 years. Over that 40-year span, I have paid a cost of 12 cents, 12 percent. Now, these systems actually have much higher costs. In Chile, it is around 1 percent which—you take that over 40 years, that would be 40 percent. Now, most money isn't in there for 40 years, but if you just take an average—say it is in there 15 years—that gets you the 15 percent.

Mr. RYAN. I have a lot of questions. I see everybody shaking their heads as well. I will let Mr. Vasquez and Mr. John and anybody else who wants to comment on that.

Mr. VASQUEZ. I will quickly say that the proper way to measure administrative costs is costs, fees, as a percentage of assets managed. In Chile that is 0.66 percent, and that is better than the mutual fund industry here in the United States. So, if you are going to be worried about administrative costs, we should also be worried about all the mutual funds here in the United States. We might as well propose nationalizing and monopolizing that. The issue in Chile is that Chileans have control over their Social Security, control over their retirement, and that is something that gets lost in technical analysis about administrative costs, even though the administrative costs are very, very low in Chile.

Mr. RYAN. Mr. John?

Mr. JOHN. Twelve percent over 40 years, that assumes there is $1 in the account and there is only that $1 in that account for the entire 40 years. The one advantage of any account, whether it is TSP or 401(k), or just a plain old Christmas account, is that it is joined by lots and lots of friends that come along as the account grows. Therefore, you especially have more friends joining those dollars toward the end of the period, and they are only in there for a very brief period of time.

Dr. BAKER. It is less than 5 percent.

Mr. JOHN. Three-tenths of 1 percent is actually an incredibly low amount. You are talking in terms of 30 cents per $100, and that is just an astonishingly good deal.

Dr. BAKER. Ten times the cost of the current system.

Ms. BOVBJERG. May I jump in on administrative costs for a minute? We did a report for this Committee several years ago on the range of administrative costs and how those compounded over a working lifetime. The range that we developed came from talking

to a lot of people with different proposals and looking at a lot of different ways to think about individual's accounts, and it ranged from one-tenth of a percent to 3 percent. Now, admittedly, the 3 percent maximum assumed that the accounts were in a very decentralized system. When we looked at the difference between one-tenth of a percent and even 1 percent over a long, working lifetime, a 45-year working lifetime, it was a 22 percent difference in the administrative costs that came out of an individual's account. My point here is that account administration matters a lot. This is something that has not always been done well in other countries, and something I did want to say in my testimony.

Mr. RYAN. It has been very beneficial to hear from everybody on how to do this and how not to do it. Mr. Harris.

Mr. HARRIS. There has been a lot of talk, probably too much talk, on that. There is a correlation between high administrative costs in individual accounts. I have been flying 7,200 miles in last the 24 hours. By the time I get back to the UK, I think it is important to clear up this inaccuracy. I think it is important to note that in Australia an average member of a plan pays 97 cents per member, per week. Expressed in another way, the cost as a percentage of assets in June 2000 were calculated as 1.29 percent of assets in the management, and that has fallen to 1.03 percent. In the UK, there is a stakeholder pension account which has a maximum administrative cost for everything—originally at 1 percent, now set at 1.5 percent. The correlation between high administrative fees and charges or costs in individual accounts is a fallacy.

Dr. JAMES. Could we just put the administrative cost issue in context, that this money is being saved, it is being invested, it is earning a rate of return? So, some of the benefits that are paid at the end come not directly from the dollar of contribution that was paid at the beginning, but from the rate of return that was earned all along the way, which far exceeds the 30 basis points that we are talking about; and therefore, as compared with the PAYGO system, you should be able to get the same benefit at the end for a lower initial contribution. I think——

Mr. RYAN. That is the point I was hoping to make, Dr. James. I will just conclude.

Chairman MCCRERY. Mr. Whitehouse.

Mr. WHITEHOUSE. We had this implicit comparison of the administrative expenses of running funded systems and on the old PAYGO systems. I just did a check on the laptop, earlier, on the data I have on administrative expenses in Latin America. The PAYGO schemes were costing something like 30 percent of the benefit expenditure in administration. So, the old systems that were in place before that were probably more inefficient than the new systems are now. So, as Dr. James says, there are extra services you are getting for those contributions, but it is not true to say that they are necessarily, vastly administratively more inefficient.

Mr. RYAN. Thank you, Mr. Whitehouse. Let me conclude with this. We heard mentioned three times that if we just repealed the tax cuts for the top 1 percent we could fix all these problems. I am not exactly sure what tax cuts are being referred to, but I am assuming that marginal income tax rate cuts—and one thing that occurred in the tax cut, we brought the marginal income tax rate—

remember, over two-thirds of those who pay that are small businesses, Subchapter S corporations, Limited Liability Companies, we brought their tax rate down to the level that large corporations pay, the corporate tax rate.

What is more important is, contrary to the projections that we were giving in Congress as to what those would, quote, unquote, "cost," we have actually exploded those projections. Last year, receipts coming from those individual tax rates grew at double-digit rates. This year, just this quarter, receipts from individual income tax rates are up 16 percent. The corporate tax rates are up 47 percent this year from these lower tax rates. So, it is a matter of fact that the projections that estimated that, quote, unquote, "cost" to revenue lost to the tax cuts did not materialize and, more importantly, we are receiving higher revenues from those lower tax rates. So, to try and extrapolate the, quote, unquote, "cost" to revenue lost from tax cuts based on old projections, which have already been disproved as a means to try and pay for Social Security, is just a comparison that now current history, current facts, have disproved. With that, I would like to yield.

Chairman MCCRERY. Thank you, Mr. Ryan. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman. Thanks again for the second round. Just to comment on my friend from Wisconsin's comments, if indeed that is the case, that we have seen such great returns from the corporate tax, income taxes that are being paid, I would hate to see what condition we would have been in if, we are suffering from an over $600 billion deficit, as it is. If that is what we are getting, and this is as good as it gets with a $600 billion deficit, woe is the day we get into another recession with corporations having helped us with——

Mr. RYAN. If the gentleman will yield, it helped reduce the deficit since the tax cuts passed by $150 billion. So, our deficit would have been higher.

Mr. BECERRA. That is a number that can be used, but when you take into account the trillions of dollars the tax cuts have cost, it is going to be a matter of balancing things out. I think many of us believe that had we not gone the route of cutting taxes so heavily and so skewing it toward the wealthy, that we could have still got some of these returns done, some things that would have helped the business community without having cost the Treasury so much money, which now we will be paying for quite some time in deficit interest payments.

Chairman MCCRERY. We would urge both Members to confine your questions to the subject at hand because these panelists have spent an awful lot of time here.

Mr. BECERRA. Let me do that then. Going back to Chile, Mr. Pomeroy pointed out that 65 percent of women who are retiring fall within this minimum benefit for retirement under this privatized plan in Chile; and in many cases, they are receiving this minimum amount not because they have earned it necessarily, but because their actual private account would have paid them less, but because there is a minimum account amount that the government says you are entitled to, the government then has to make up the difference. Here we would call that welfare. So, we are making sure that—or, Chile is making sure that its retirees, regardless of their

condition and regardless of the wisdom of their investment or the production of their investment, they will receive a minimum benefit, as minimal as that might be $140, $145.

In many cases those individuals who are receiving that minimum benefit would be receiving even less were they to rely solely on their private account return; and only because the government is guaranteeing them the $140 to $145 a month pension are they able to receive even that. I am not sure if those calculations are made to determine the costs through a welfare system for retirees, that taxpayers have to pay for now that they are retired, that didn't earn enough out of these private accounts. I would be interested in—perhaps in writing, if you could supply figures—because we are short on time, if you could provide some remarks on what has been done to deal with the fact that in some cases the governments have had to, in essence, put seniors on welfare in order to get them a minimum payment.

The other point I wanted to make—and you can comment if you wish on this—we put in the abstract all the time, a number of stories have been written about the Chile privatization model. An example was provided for in, I believe, the New York Times. A gentleman by the name of Dagoberto Sain, who is a 66-year-old laboratory technician who was planning to retire because of a recent heart attack, he earns about $950 a month and he had been told by his pension plan that after nearly 24 years of contributions, that he will be able to receive a 20-year annuity. It will pay him, until he is 88, a total of $315 a month.

His comment was—I am quoting from the article—"Colleagues and friends with the same pay grade, who stayed in the old system, meaning the Social Security tax system, people who work right alongside me, are retiring with pensions of almost $700 a month, good not until they are 86, but until they die. I have a salary that allows me to live with dignity," and all of a sudden when he prepares to retire, "I am going to be plunged into poverty all because I made the mistake of believing the promises they made to us back in 1981"—and 1981, of course, is the date that they started their privatization system.

I know there are a number of concerns that are being raised by people in many of these countries, and I know there are aspects that need to be explored, as well, where some people have done very well. I think the difficulty for us is, how do we make sure that we don't have the hills and valleys for seniors after 40 years of work in this country, and make sure that everyone knows that they will be able to retire in dignity. So, with that, I will allow anyone who wishes to comment, but understanding my time is quickly expiring.

Mr. VASQUEZ. First of all, on the minimum pension—yes, that is a minimal welfare type of program in Chile; and that costs about 0.1 percent of GDP, and it is minimal. That is a superior and far more efficient way of providing welfare than the previous system. As far as the anecdote that you provided from the New York Times, in my view it is——

Mr. BECERRA. It is not an anecdote. It is a real-life case of an individual.

Mr. VASQUEZ. It is an anecdote of a person that is very difficult to analyze because there is not enough information in the article as to how many years prior to it he was working. Was he working for the government before and then he switched? There are many people in Chile who were working for the government, and when they switched into the private system, the government didn't pay them the full recognition bond that other people in the private sector got because the government had been under-reporting their wages. Those people have suffered from the move to the private system precisely because the government didn't pay them the full amount, and the way to fix that is, get the government to pay them the full amount that they were owed. I suspect he may have been one of those people, but there is no way of telling from the article.

Dr. JAMES. The article also contains obvious factual errors. For example, he could not have gotten a 20-year annuity; that is not one of the allowable payouts in Chile. He would have to have gotten a lifetime annuity, so, he may have colloquially said, It is a 20-year annuity, but in fact it could not have been. Perhaps it was a life annuity that promised to pay his estate for 20 years if he died early, but it would continue to pay him for as long as he lived. If you look at the replacement rate—that is, the ratio between the benefit that he gets and his initial wage; I don't remember the exact numbers there, but I think if you go back to it, you will find it is actually a pretty good replacement rate for 20 years of contributions, probably quite a bit higher than he would get for 20 years of contributions in the United States as a replacement rate.

Mr. BECERRA. Again, you could be right, but that goes contrary to what he said he would be receiving, a $358 pension instead of a $700 pension.

Dr. JAMES. The article was factually incorrect.

Dr. BAKER. Just on the point about the welfare program, obviously, systems of accounts are not redistributive; they are neutral. If on top of that you have some guaranteed minimum benefit, that is a form of redistribution, conceivably a form of welfare; and that will presumably enjoy the same political support as other welfare programs do in this country.

Mr. BECERRA. Mr. Chairman, thank you.

Chairman MCCRERY. Thank you, Mr. Becerra. I think one lesson we have learned from this hearing today is you can't believe everything you read. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. This is for the whole panel. Among the countries that have undertaken reform, primarily have solely by reducing benefits and raising taxes. What is the financial status of their Social Security system, right now? Will they have to go back and make more significant changes in benefits and taxes in the foreseeable future?

Ms. BOVBJERG. It depends on how sustainable their changes have been. By the way, this country would be included as a country that has made changes to the PAYGO system, and of course, we are revisiting the changes. One of the things that I have been really struck by in looking at 31 countries is how normal it seems for governments to go back and revisit these changes. Pension reform is a work in progress in most places, depending on how sustainable the changes are.

Dr. BAKER. If I can make a quick comment on that, how we think about this. It is not clear it is desirable to put in a system and then never re-examine it, because it is basically a fundamental democratic issue. How much money do we want to put aside during our working lifetime to support us at what level of income during our retirement? At what age do we want to begin to collect those benefits? Whatever we might think is a good idea in 2005, people might think very differently about in 2025 or 2040. So, the fact that they might revisit that at some future point, to me at least, is not an obvious indictment of the system.

Mr. LEWIS. Do you think this is the time we need to address this issue with Social Security?

Dr. BAKER. Let me put it this way: There are a lot of other issues that present much more immediate problems.

Mr. HARRIS. In Australia, Congressman, there is a fundamental need that an acknowledgement exists for consensus. This is a very important point to establish—that both major political parties realize that consensus is important to drive through pension reform, Social Security reform. They acknowledge that 9 percent compulsory contributions is simply not enough, and the Labor Party, if you like, still remains wed to the idea of 15 percent contributions by the individual in the second pillar. It is important also to note is that the old age pension increasingly is becoming less and less important for Australians as more and more people leave that program through the income and assets test.

Mr. LEWIS. Let me add another question to that. Is there a way to—if you take personal accounts off the table, is there a way to fix our Social Security system for the long term? Any ideas on that?

Mr. WHITEHOUSE. By contribution rates would be an obvious solution, which other the countries have adopted. If you look at the fiscal position of Social Security versus all the other OECD countries, the spending is already among the lowest among OECD countries, about 4.5 percent of GDP. The average for the OECD countries is about 8 percent of GDP. You have Italy there at the top already spending 14 percent of GDP on pensions, and that is forecasted to rise, even though they have had some fundamental reforms there. The answer, I am afraid, on the other side of the pond has been a mixture of tax writers, contribution writers, and benefit cuts.

Dr. JAMES. In addition to that, one of the things that happens in the very long run is that conditions never turn out to be what you predicted initially. So, no matter what you do now to fix it, 10 or 20 years down the road, there will be surprises. So, I think it would be useful to think about what kinds of built-in stabilizers you can put into the system so this Committee doesn't have to hold hearings every 5 or 10 years to fix it again. One of the surprises always comes from longevity increases, which are often greater than predicted. So, we have talked about indexing benefits to longevity. Another way of looking at it is to index the retirement age to longevity. If longevity increases, it is not unreasonable to expect that people would spend some of those years working more, and you can put a built-in mechanism in there, which would make it politically easier for you Congressmen and women, down the road.

Mr. LEWIS. We are talking about similar demographic areas or concerns, too. We are coming up on two people working for one person on retirement, so——

Ms. CORONADO. The Swedish system was in a much more dire demographic situation than the United States, and they did follow the route of building in some of these macroeconomic stabilizers, although it will remain to be seen when those actually have to kick in, whether that will itself induce a revisitation of the system. That is how they chose to set the system on a fiscally sustainable course, and then it could be revisited.

Mr. LEWIS. Thank you.

Chairman MCCRERY. Mr. Levin.

Mr. LEVIN. Briefly, thanks again. Last—almost the last thing that was said, I think struck a chord, at least with me, that in order to tackle these issues, there has to be consensus. This issue started off on the wrong foot in that regard. Instead of there being an effort to sit down across party lines across the Rotunda and with the White House, it was started very differently. I do think consensus is an absolute essential. You can't tackle any of these long-term issues otherwise, including the tax issue, and that was done with the opposite of consensus. So, I think that is one bit of your experience, some of you, that I think should be taken seriously. Second, Mr. Chairman, is how often we have to do this. I do think there are other issues that may be more pressing in terms of fiscal impact. I think that is true. We acknowledge that. I would assume every 20, 30 years we will sit down.

For example, the assumptions as to growth may turn out to be very wrong at 1.7 or 1.8. I realize that if that turns out to be wrong, it will have an impact not only on dollars that are coming in, but also on wage indexing. That is true, and I am not an economist, and I don't know exactly what the relationship would be. Immigration issues, as we look at them today—and they are a very difficult issue here—we may find out 10 or15 years from now that work force estimates were wrong, and the ratio of workers to recipients may have turned out to be incorrect. Even a two-or three-tenths of a percent change is a major change, I take it, in our calculation. That is why, for all those reasons, there has been a major resistance to upsetting the Social Security apple cart, a system that in this country has worked so well.

Let me finish with one other point about administrative costs. I do think one of you said that this country is really different. I think the person—I think it was the person who ran the TSP who warned us that in terms of administrative costs, it was going to be very different with huge numbers of people paying in, employers paying into a system, than it is in other countries; you can't equate them. I think it was he, or somebody else, who thought that the private account proposal was therefore unworkable. I just think we need to look at the entire administrative picture.

Last, I just wanted to emphasize what has been said. I think you have tried to create an atmosphere of fairness here, of objectivity, even though we have some basic disagreements. I don't always know what the staff says to each other. These staffs are talented people who work very, very hard, but they don't always say to us what they say to each other. So, for example, as to the hearing next

Tuesday, I think it was said that we were allocated one witness, and I hope you might talk with the staff and see if we could be allocated more than one witness for next Tuesday.

I didn't mean to lump all of you together—and if I did that, I should not have, even though I think there is a disequilibrium here. I think it would be useful if these hearings proceed to do what you really intend to do, and that is to make sure that we have a full airing because, while I think we started on the wrong foot—I am sure of that, the way this has turned out—at some point we are going to have to get on the right foot. I don't mean left or right. I mean the effective foot.

Chairman MCCRERY. Thank you, Mr. Levin, and I agree with you that this panel has been excellent in their expertise certainly. I think it is something that we all took advantage of today and all appreciate. I appreciate your comments. I have one final question to take advantage of this expertise. One concern that has been expressed about personal accounts in the context of Social Security—and I think it is a legitimate concern that needs to be addressed—that low-wage workers and workers without continuous attachment to the workforce—women who have had to stay at home to raise children or those who have gone through times of unemployment—may have small personal account balances. In your studies of other countries' systems, has this problem been addressed in their personal account systems? If so, how?

Ms. CORONADO. I could start with the Swedish system. They actually give credits to one of the parents of small children up until they are school age, so, there is a fixed credit that get applied to your individual account and your notional account for child rearing. Likewise, your unemployment benefits count as income in the determination of your benefits. They have tried to address those issues through the individual account mechanism.

Mr. LEVIN. Has it affected the birth rate?

Ms. CORONADO. No. The birth rate is very low in Sweden.

Dr. JAMES. This problem is a problem in every contributory scheme. It is not specific to individual accounts. Any time you base your payout on contributions, on amounts or years of contribution, you have to deal with this issue. Some countries simply have a flat benefit for every old person out of general revenues. Then they don't have to deal with the issue. As long as it is contributory, you do have this problem.

Chile has this issue certainly, because developing countries have it more so than Sweden. They deal with it partly through the minimum pension guaranty, which everyone gets who has contributed for at least 20 years; and that is a kind of insurance for low work participation, low contribution densities, as they call it. In fact, those are the main people who would end up getting the minimum pension guarantee, people who have not contributed for their entire working life. Once you have contributed for your entire working life, your own pension would far exceed the minimum pension guaranty. Chile also has a social assistance program which is means tested for people who have not contributed for 20 years. It pays approximately half to two-thirds of the minimum pension, and on a means tested basis, people can apply for that.

Mr. WHITEHOUSE. Could I add something? I do have a section in my written testimony on treatment of low earners, and one further example is the case of Mexico where the government pays a fixed amount. I think it is—when it was introduced, it was a peso a day into all the workers' accounts regardless of their incomes. So, that is one way you can—by putting a flat rate amount into everyone's account as well as, say, 4 percent of earnings, a way you can help the low earners out. That is another international example.

Chairman MCCRERY. Anyone else?

Mr. HARRIS. Congressman, in Australia, for low-income earners there is a rebate system where the government will assist them on a dollar-for-dollar basis up to a certain level in terms of making co-contributions, if you like, into their individual accounts. With regard to smaller accounts, they are rolled up into what is called eligible rollover funds. They are high-volume, low-margin individual managed funds where a number of accounts are pooled together and literally put out into the market; and the charges on those are very low, and there is also some regulatory capping of pricing or charges that can be applied to those small accounts.

Chairman MCCRERY. Thank you. Mr. John.

Mr. JOHN. In the UK they have a series of credits for things like unemployment, inability to work due to illness, or family situation. Also, under the new State second pension, if an individual earns—which is the individual related component, if an individual earns under 12,001 pounds a year, they are credited as though they had actually earned that much, so, there actually is a subsidy for low-income workers in that case.

Chairman MCCRERY. Thank you very much, once again, for your excellent testimony and your patience in answering our questions. We hope to report back to you in the not-to-distant future that we have changed our system to meet the fiscal obligations that we face and also meet the obligations of a society to its elderly. Thank you.

[Whereupon, at 1:00 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Margaret Daniels, Hurst, Texas

I am a retired elementary school secretary for the Hurst-Euless-Bedford School district in Bedford, Texas. I became a secretary for the school district while my children were in secondary school to have my working hours more in accord with theirs. I previously worked in banks under Social Security. I began drawing my own Social Security when I was 62 years old. I have been affected by the WEP offset for my own pension. However, that does not affect me as much as the GOP offset will should my husband pass away before I do. I would like to be able to draw the portion of his Social Security benefits that I would even if I had never worked during our marriage. I know this is a hard decision for you to make at this time. I believe Texas is one of the last sixteen states to not have repealed this. My daughter-in-law is a teacher in Louisiana and I believe will also be affected. Your consideration of this matter in your committee will be greatly appreciated.

Statement of Marilyn Sprang Fransen, Rapid City, South Dakota

I was a music teacher in Colorado from 1963 to 1975. When I quit teaching I went into business and took out in cash what had been put into the retirement association. I was married with two children and felt "burned out" by the demands of teaching.

In 1981 I returned to the school district but in the capacity of an elementary office manager or secretary. I felt that my work was every bit as important to the education of the children of this school as my teaching had been, perhaps more so, because I knew the demands upon teachers and I aided them in every way I could. I also became nurse: surrogate Mommy; liaison between teachers, administrators, parents, and other community; and believed that I accomplished much toward making the school run smoothly and efficiently. I stayed happily in that position for sixteen years and bought back some of the teaching years' retirement benefits so that I could retire in 1998.

Because I retired as a classified employee and not a certified employee my retirement is only adequate and just above poverty level. I was never informed about the GPO/WEP laws that came into effect in 1983. I had realized that no Social Security had been taken from my salary those years but I also knew that as a married spouse and later as a divorced spouse I would be eventually eligible for half of my ex-husband's benefits as a supplement. I realize now that my divorce lawyer was not aware of the laws either. Also, because of the animosity of my ex-husband I was driven into bankruptcy, and I truthfully believe my lawyer for that process was not aware, also, of the laws. I finally learned about my predicament *when I applied for my benefits after turning 62 in July 2002*!

It came as a complete shock. I contacted friends and co-workers in the school district where I was employed and learned that they, also, were in ignorance about the effects these laws would have on their lives. They didn't and still don't believe me. The laws are so complicated to understand. I've had three years to try to verbalize what I believe has happened to me and it is still hard to make sense of it. I am weary of this problem and worried about how I will be able to live out my senior years on such a limited budget.

Because of the loss of much needed Social Security supplemental benefits I am forced to work again despite health issues. I try to make enough each year to put money into an IRA. How unfortunate for me that I wasn't aware of this problem when I was working those years 1983 to1998 in the schools. I could have been investing money in other ways then for this time in my life.

I have been actively trying to contact Senators, Congressmen, the White House, AARP, NEA, and anyone who will listen to my plight and, always it seems, it falls on deaf ears. I have given up hope that the GPO will ever be repealed but, to me, the most unfair law is the WEP. Now that I have been forced back to work I am contributing to Social Security with the knowledge that I will never get back the benefits in total that people in the other 35 states of the U.S. not affected by WEP will get. My retirement from the school district which I served is so little how could anyone believe it is "a protection against double dipping by highly paid State Employees" to deny me my full benefit?

I am convinced that the WEP arm of the SS Pension Offset Law is unconstitutional. I am being denied, after the fact, the *right to pursue happiness* in being able to provide ably for myself in my declining years!

It is too late for me to make up the loss of several hundreds of dollars a month for the rest of my life. What difference should it make upon my eligibility for complete benefits that I worked at very low pay for 20+ years as a school secretary? It is absurd that this badly written law should have not had a **floor** on it so that people in my salary range wouldn't be victimized in this way. **I am also convinced that this law discriminates against *women* who are in lower wage slots in the states that are affected. Most of my co-workers in classified positions—cooks, kitchen managers, office clerks, bus drivers, custodians, nurses, teacher instructional aides, and etc.—were women by a large percentage as they are in most every school. We all know very well that statistics bear out the fact that these women live longer than their spouses and will suffer either widow-hood or divorce in their later years when supplementary benefits will be critical to them!**

Classified personnel have no one to lobby for them, no national associations that I have been able to find; and, frankly, do not comprehend what is being done to them. As I stated before I am having great difficulty convincing them that this law even exists. It is not particularly humorous to me that one senator in one of the affected states admitted to an acquaintance that he didn't even understand the law when he signed for it's legislation in 1983!

I am praying that the wrong will be made right. I am praying that my country's governmental representatives will see the injustice I am seeing. And I am praying that when I reach my own 40 credits in a year or so I will be able to receive my full benefits and not something lowered by a complicated formula thought out erroneously in 1983!

Please consider my situation and do the right thing.

Statement of Dr. Ronald J. Gathro, Springfield, Massachusetts

Teacher Recruitment & Retention Issues

On the Springfield Public Schools website www.sps.springfield.ma.us under (Teacher Resources/Teachers Helping Teachers) the following quote can be read: ***"It's alarming but true: studies have shown that 35% of teachers leave the profession during the first year. By the end of the fifth year, 50% of teachers have left he field!"*** WOW!

Before going further, what is the profile of new teachers in Springfield? This statement is based on observation of participants in Springfield's Teacher Licensure Program over the past three years. This program assists new teachers in getting their Preliminary License (generally pass the Communication & Literacy Test and a subject matter test) and their Initial License. The rules on obtaining an Initial License vary according to what you bring to the table but for many it involves taking the equivalent of 18 credits (6 courses) of appropriate Educational Professional Development.

What is the profile of a new teacher? Most people would say a new teacher just graduated from college with an appropriate education degree (major or minor) and is in their early 20's and raring to go! My observations at the Professional Development Center where teachers take courses for Licensure or attend New Teacher Orientation, is that this profile fits probably less than 25% of the new teachers in Springfield. I think it would be worthwhile to research new teacher profiles for the past 3 to 5 years. Most of the new teachers are career changers, most over 30, many pushing 50 or more. These people like me have had their careers terminated for some reason and are faced with major career and life choices. One acceptable choice appears to go into teaching.

Many of the new teachers I have met in the system have one or more master's degrees and need only the educational component to become fully certified under the No Child Left Behind Act.

Allow me to give my profile. I am 48 years old and entered the Springfield Public School system at the age of 46. I am a degreed engineer (Ph.D.). I worked in local industries for 23 years of my professional career. I taught part time at Western New England College in the School of Engineering part time for twenty of the past twenty-three years. When my last job terminated, given the state of manufacturing in western Massachusetts and northern Connecticut where good jobs are hard to come by, I decided to give teaching a try at the high school level. With strong family ties, a spouse with a good job (25+ years) and good benefits, it is extremely hard to leave the area. Therefore, teaching (math in my case) became an obvious option. Not being certified / licensed means that only Springfield would consider hiring me. I was hired in 2002 on a waiver from the state. I took the Mathematics test and the Literacy and Communications test to obtain my Preliminary License. I am currently enrolled in Springfield's Licensure Program. This program takes between 3 and 5 years (5 being the state limit) to obtain your initial license.

In 2003, at the Professional Development Center, I took the first class in the program. Over 20 new teachers were participating in the class. This past August, I took the second class in the program. There were 14 teachers enrolled; 13 from last year and 1 new one. After discussing what happened to the other 7+ teachers, the group accounted for over half leaving the system because they didn't like teaching or they got better job offers from other local cities and towns. More than ½ left teaching altogether! I think that if the economy turned around maybe another 4 to 5 would leave teaching because of the bureaucracy and return to industry or business. For many it is frustrating to deal with what is going on.

In my case as many others, I took a pay cut from $72,000 per year to $42,000 per year and with a Ph.D. I am at the top pay scale, new-teachers without masters degrees get closer to $30,000. For most of the people at my class, their pay cuts were in the range of 25% to 50%. The problem is they couldn't find work in their chosen profession and are faced with the challenge of changing professions. In many cases, this career change involves obtaining another masters degree after completing these 18 credits of education. Most of us have never taught at the high school, middle school or elementary level before. Based upon my college teaching experience, I was not prepared for the issues confronting me at my high school! Additional education is generally mandated by law (No Child Left Behind), however it is the teacher that has to pay for it, out of their own pocket. In any industry that I worked in prior to this, if the employer mandated additional education, it was the employer who paid for it not the employee. If the employee wanted additional (not mandatory)

education, the company typically paid a substantial portion of the cost ranging from 70% to 100%. The level of reimbursement may be dependent upon the grades attained.

HOW DOES THIS RELATE TO SOCIAL SECURITY?

On top of all of this, after becoming a teacher most of us find out that when we retire we will be faced with the Windfall Provisions/Government Pension Offset act. This law reduces the amount of social security we can collect simply because we work as teachers in the state of Massachusetts for a period of time at the end of our careers. Once you work as a teacher for 10 years, this law will impact you and possibly your spouse depending on the retirement options you chose. Since I worked in Industry for 23 years and I will work as a teacher for between 17 and 20 years (retiring between 62 and 65) the WEP/GPO will cost me personally between $2,900 and $3,800 per year. This represents about a 12% reduction of my retirement income. When I retire after 17 years at age 62, I will only receive about 69% of my highest 3 years average salary at retirement. This is less than the career teacher who gets 80% and typically leaves earlier.

After all this, you might ask why did I enter into the teaching profession? Simply put, I discovered that I loved teaching when I taught at the college level and given the loss of my career, teaching was a natural progression. My mortgage holder prefers to be paid monthly and teaching pays substantially more than unemployment or welfare. I teach at Putnam Vocational Technical High School. It is an under-performing school as designated by the state of Massachusetts. Teaching at Putnam is a challenge but it is fun as I can relate real uses of what we are learning in math class to what the students are doing in shop and what they will do for a living after graduation. I can answer the proverbial student question: "When will I ever use this stuff, Mister?" Putnam is a good fit for me and I enjoy it there.

The congress has been educated with respect to the national shortage of certain teaching specialties such as Mathematics, Science, etc. There are a vast number of professionals who when facing economic downturns (layoffs vs. relocation), would gladly change professions, as I have done, if the change was made to be less painful!

What is needed to solve the Teacher Recruitment & Retention Issue?

- Eliminate the WEP/GPO (Windfall Elimination Provision/Government Pension Offset) from Social Security. This costs individuals vast sums of retirement income when they have already taken an earnings reduction during their working career.
- Money for training new teachers/career changers. Money to hire more teachers and reduce class sizes.
- Money to hire or develop Special Education Teachers who are qualified in the appropriate subject matter i.e. math, science, history, etc. Currently, many special education teachers are in classrooms helping in subject areas where they have no academic clue regarding what is being taught. These are great people being wasted.
- Money to be used for new classroom books and equipment.
- Money to be used for curriculum development and improvement.
- Money to provide more in service training time for new teachers (less than 5 years of service).
- Money to provide a reasonable number of course electives and offerings that make sense of each school. Many schools cut back on electives when resources are tight.
- Money to pay for mandatory advanced degrees for teacher certification.

SOCIAL SECURITY NEEDS TO DO ITS PART IN SOLVING THE TEACHER SHORTAGE ISSUE BY REPEALING THE WEP/GPO!

Statement of Bruce Hahn, American Homeowners Grassroots Alliance

The American Homeowners Grassroots Alliance (AHGA) appreciates the opportunity to submit this testimony to the Ways and Means Subcommittee on Social Security on the subject of Protecting and Strengthening Social Security. Social Security is a critically important and widely supported tool that supports our nation's retirees. For most it is not the only source of retirement income, and it was never intended to be the sole source of retirement income. As members of the Ways and Means Committee look at ways to strengthen Social Security we urge that you simultaneously consider other programs and incentives to expand retirement savings.

To the extent that other programs may be created or enhanced to increase broad based U.S. retirement savings, the pressure to assure higher future social security program payout rates will be mitigated. For that reason we recommend that the focus of the Subcommittee be broadened to include all elements of retirement savings reform.

Retirement savings reform and other tax reform efforts are inextricably linked from both a policy and political standpoint. No matter what plans to strengthen Social Security and enhance other retirement savings are eventually adopted, there will be costs associated with them. Other pending tax reform proposals, including a variety of tax provisions that will expire in coming years unless extended will also be subject to the same budget pressures, so it makes sense to try to address these issues simultaneously.

It also makes political sense to address these issues as part of a larger effort. The Social Security debate has become quite polarized, but other alternatives to increase retirement savings and other elements of the tax reform debate are at this point less partisan. A broader approach will no doubt be more complex but under the best circumstances may avoid gridlock and lead to a tax reform package that can be supported by a majority of the populace as well as Republicans and Democrats in Congress.

We commend President Bush for his courage in addressing the issue of Social Security. You can debate the timetable, but the projections make it clear that this issue must be addressed. It is much better to begin work on social security reform today, while there are more options, than in the future, when Congress will have fewer options. We believe that the President's proposal has much to recommend but that thoughtful supporters of a strong Social Security program have pointed out some real challenges as well. We urge the Committee to take the best of the Administration's package and modify it so as to address the legitimate concerns of many thoughtful Social Security supporters who have made alternative suggestions. It is also important to keep in mind that Social Security is only one part of the puzzle in retirement savings, and that other unrelated retirement savings incentives may be key to expanding retirement saving in the U.S. To the extent that other programs are successful in increasing retirement savings the pressure for higher future social security payouts will be lessened.

For most homeowners the single largest form of savings they can tap for retirement is their home equity. In many cases homeowners retiring today can use the equity in their pre-retirement homes to purchase for cash a very nice retirement home without having to draw upon any other retirement savings. Based on our informal discussions with many recent retirees this is extremely common, and may even be the dominant source of retirement home funding. For retirees, who often have more modest ongoing financial needs than their children or grandchildren, the economics of a reasonable retirement lifestyle that doesn't involve a monthly mortgage payment is not nearly so daunting as it would be for a couple or individual with only social security and income from relatively modest savings and/or pension.

In the last decade U.S. home ownership has expanded 10 million to nearly 75 million, thanks to economic circumstances, and home ownership programs enacted by Congress and promoted by the Bush and Clinton Administrations. To the degree that these programs have contributed to the expansion of home ownership, they are almost certainly very cost-effective contributors to retirement savings. Home financing has always been highly leveraged. A home that costs $100,000 and appreciates a modest 3% per year provides a substantially higher return relative to it's fractional down payment, and a huge return on that down payment if the equity is allowed to accumulate over the life of its ownership (or is rolled into successor primary residences).

As appreciating and marketable assets (in most cases) the downside risk to the government's programs that stimulate home ownership is reduced by a home's underlying utility and likely long term appreciation. For this reason we believe that expanded home ownership incentives, especially for those at the margin of home affordability and with good indicators of fiscal responsibility, should be a significant component of a comprehensive tax reform package that has, as one of its primary objectives, the growth of U.S. retirement savings. Such a package has to take into account existing negative incentives, such as the fact that some low income home buyers would be giving up subsidized rent if they became homeowners

Home equity as a savings vehicle has several additional advantages. Serious observers of human behavior of savings patterns have noted that inertia plays a significant role. If someone participates in a company 401K program they are likely to stay in, and if they don't now they are unlikely to participate in the future. To an even greater degree a mortgage is a forced savings plan relative to the growing home equity because your mortgage lender probably won't let you opt out of future

payments. In addition because the amount of the equity can't easily be precisely measured at any given time, and accessing that equity through refinancing requires time and effort, there is a good chance that home equity will be left in place and will continue to grow.

There are many ways to increase home ownership and the attendant long term savings through home equity growth. They include the expansion of many existing programs and worthy new policy proposals such as home ownership tax credits and other tax incentives to encourage the use of existing equity for the purpose of home financing. They all deserve consideration. The criteria against which all proposals should be measured are cost effectiveness and the degree to which they create home ownership opportunities for those who otherwise would be unable to afford it.

Of course home ownership is not the only way to increase retirement savings (albeit very likely one the most cost-effective under the right circumstances). President Bush's personal account proposal is based on the correct historical observation that the stock market outperforms the formula that drives social security payments. Some substantial concerns have been raised about other aspects of the proposal, but many critics of the President's proposal would not object to the personal account concept if it were funded as a separate program not tied to the existing Social Security program. Budget realities largely drive the need to integrate personal accounts into the existing Social Security system. If revenue could be found to fund incentives for personal accounts through other parts of the tax reform process, personal accounts could make significant contribution to peoples retirement savings, even if it were reduced from its current scope.

President Bush has expressed his willingness to be flexible on his personal account proposal, and given that flexibility there is a basis for a bipartisan approach that could include other concepts to stimulate retirement savings as part of a broad tax reform package. Some other worthy proposals include:

- Make permanent the 401k improvements enacted in 2001 and which sunset in 2010. We suggest that the concepts in the Administration's personal savings account proposal be blended with an enhanced, means tested version of proposal to expand 401k/IRA or other retirement saving incentives.
- Make 401K participation automatic rather than opt in. Savings patterns suggest that once people participate in retirement savings programs they will stay in. The lowest participation rates (which are declining overall) are among low and moderate income workers. Consider additional incentives for employees (such as faster vesting) and employers (such as incentives to make it easier and cost effective for small businesses to use outside plan administrators).
- Make the tax credit for IRAs and workplace retirement plans permanent (many of the benefits expire in 2006). Increase the contribution limits and make the incentives permanent.
- Expand allowed contributions into health savings account IRAs, and allow annual surpluses to be rolled into retirement years when healthcare costs will typically rise.
- Allow for tax deduction of private mortgage insurance (PMI) premiums and condominium fees as these are both also costs of home ownership.
- Repeal the "new homes tax", a protectionist tariff which adds approximately $1,000 to the cost of a new home through the taxation of Canadian softwood lumber.
- **Create a first time home buyers tax credit of 10% of the home's price, capped at $6,000 and a** new home ownership tax credit to encourage development and rehabilitation of resident-owned housing for those of affordable to low and moderate income.
- Provide tax credits to homeowners and builders to encourage higher standards of energy efficiency in new home construction and remodeling.
- Tax the proceeds of annuities at the rate of dividends rather than ordinary income.

The cumulative cost of all of these proposals would be substantial. Given federal budget realities some of these suggestions will have to be dropped and many of those that survive will have to be means-tested to focus their benefits on segments of the population that are currently unable to increase their savings and segments of the population that could be saving more but do not feel the incentive for savings that was instilled in our nation's generations who experienced the Great Depression.

Restrictions on existing tax incentives, including some that benefit homeowners, will have to be enacted to generate additional revenues to pay for new incentives.

What benefits will have to be trimmed? To generate additional revenue the current $250,000/500,000 capital gains exemption on home sales might be limited to the application of the proceeds to worthy purposes (there are currently no restric-

tions on the use of the proceeds). There are some indications that there is an unfortunate and growing trend towards tapping real estate equity for the purposes that do not either contribute to savings or other worthy uses. While there are many productive ways to reinvest real estate equity, we consider the use of tax-favored real estate equity withdrawals for such purposes as fancy vacations a questionable use of this favorable tax treatment. Worthy purposes might include income producing investments upon retirement, home remodeling (since it contributes to equity), the purchase of a second home or a more expensive primary residence (same rationale), education (a worthy investment in the minds of most), and other similarly meritorious investments.

This same philosophy should be applied to all other tax incentives. To the extent that they contribute to individual wealth building, competitiveness, and productivity, they should be retained. Absent evidence that they are making a contribution to those goals, or that their contribution is limited, they should be more precisely targeted to achieve their intended objectives, cut back, or eliminated.

The American Homeowners Grassroots Alliance is a national consumer advocacy organization serving the nation's 75 million homeowners. AHGA engages in policy issues that significantly impact homeowners and home ownership.