# SOCIAL SECURITY REFORM LESSONS LEARNED IN OTHER COUNTRIES

## HEARING

BEFORE THE

## COMMITTEE ON WAYS AND MEANS
## HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

FEBRUARY 11, 1999

**Serial 106–1**

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

56–189 CC WASHINGTON : 1999

## COMMITTEE ON WAYS AND MEANS



Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

# CONTENTS

# SOCIAL SECURITY REFORM LESSONS LEARNED IN OTHER COUNTRIES

**THURSDAY, FEBRUARY 11, 1999**

House of Representatives,
Committee on Ways and Means,
*Washington, DC.*

The Committee met, pursuant to notice, at 9:30 a.m. in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisories announcing the hearing follow:]

# *ADVISORY*

## FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
February 3, 1999
No. FC–5

# Archer Announces Hearing on Social Security Reform Lessons Learned in Other Countries

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on Social Security reforms in other countries. The hearing will take place on Thursday, February 11, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. Witnesses will include scholars of foreign public retirement programs as well as representatives of selected nations that have made program changes in recent years. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

**BACKGROUND:**

Despite its success in the past, the Social Security program faces a solvency crisis in the coming years. The United States however, is not alone. Increased life expectancies, accompanied by a surge in births following the Great Depression and World War II, portend enormous strains on public retirement programs around the world. The World Bank estimates that the number of people age 60 and over will triple between 1990 and 2030, placing particular stress on already-developed nations in Europe, Asia, and the Americas. Many industrialized countries, in particular, are finding that promised public retirement benefits are not sustainable given current demographic and economic trends. Several countries, including Germany, Japan, and the United Kingdom, have raised retirement ages prospectively. Others, including France, Italy, and Sweden, have begun to implement benefit reductions. Still others, including Chile, Mexico, and Australia, have attempted more comprehensive reforms by shifting towards a forward-funded approach based more on personal savings for retirement than strictly on pay-as-you-go public benefits.

In announcing the hearing, Chairman Archer stated: "Our country is not alone in facing a public retirement crisis. In fact, many countries have already implemented the types of changes we are just starting to debate in earnest. Whenever possible, we should seek to benefit from this international experience as we proceed down our own path to reform. This hearing will help us do just that."

**FOCUS OF THE HEARING:**

The hearing will focus on Social Security reform experiences in other countries, with a particular focus on lessons learned that can be applied as the United States considers Social Security reform options.

**DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Thursday, February 25, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

**FORMATTING REQUIREMENTS:**

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

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

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

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

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

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

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.

***** NOTICE — CHANGE IN TIME *****

# *ADVISORY*

**FROM THE COMMITTEE ON WAYS AND MEANS**

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
February 4, 1999
No. FC–5-Revised

## Time Change for Full Committee Hearing on Thursday, February 11, 1999, on Social Security Reform Lessons Learned in Other Countries

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the full Committee hearing on Social Security reforms in other countries, previously scheduled for Thursday, February 11, 1999, at 9:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, will begin instead at 9:30 a.m.

All other details for the hearing remain the same. (See full Committee press release No. FC–5, dated February 3, 1999.)

Chairman ARCHER [presiding]. The Committee will come to order. The Chair would invite Members, staff, and guests to take seats. The Chair would invite our first witness, Mr. Piñera, to sit at the witness chair.

Today's hearing focuses on Social Security reform lessons that we can learn from other countries. It is clear that the United States does not stand alone when it comes to the baby boomer retirement problem. Many industrialized countries are struggling with how to make ends meet as their citizens grow older and their work force, relative to the retired population, shrinks.

Several countries, including Germany, Japan, and the United Kingdom, have raised the retirement ages. France, Italy, and Sweden have begun to implement benefit reductions. Other nations, such as Chile, Mexico, and Australia, have reformed their systems through the creation of personal retirement accounts. What should the United States do? That is the question that we will be grappling with in this Congress.

President Clinton has put forward a framework of a plan around which, I believe, we can make progress. To ward off Social Security's bankruptcy, the White House proposes crediting the Social Security Trust Fund with an additional $445 billion over the next 5 years. Where does this money come from? It comes from payroll tax money that is already destined for the trust fund and invested in Treasury securities. This is why many have written that it is double counting. In order to extend the solvency of the trust fund, the administration's budget puts $445 billion in the trust fund twice. Can the President do that? Sure he can do that with a simple change in the law. Many Americans wonder how Washington's budget process works. But just because he can, doesn't mean that he should. As we reform Social Security, some things have got to change.

This morning, I am pleased to release an analysis of how the President's proposal impacts the national debt and the Social Security Trust Fund. To me, nothing is more important than saving Social Security so that our children and our grandchildren can enjoy the same comfort that today's seniors enjoy.

This analysis shows the administration's proposal increases the total Federal debt by $1.2 trillion between 1999 and 2004 and it increases the debt held by the government by over $1.5 trillion over the same period. These increases do not hurt the economy, nor do they crowd out private savings. They do, however, represent a large burden on our children and grandchildren who will have to repay this debt when it comes due in just 13 years.

In addition, under the administration's plan, Congress will now be required to vote to increase the debt ceiling 2 years from now, and that is the true barometer of whether we have increased the debt of our country. Under CBO's analysis, under current law, we will not hit the debt ceiling for as far as the eye can see.

Finally, this analysis shows that the debt held by the public, and that is the debt that hurts the economy by crowding out public savings, is higher under the President's plan than it would be under current law. One reason is because the President, like the Congress, doesn't use every penny of the surplus to pay down the debt. But it is also because the President's budget takes money out of the Social Security Trust Fund to pay for other government spending programs.

So, what does all of this mean? It means that in order to extend the trust fund solvency, the administration's proposal risks saddling our children with more debt. I believe that some time soon the President and the congressional leadership will begin the hard work to save Social Security. As we proceed, let us remember that extending the life of the trust fund is the purpose of our endeavor, but not if it is at the expense of our children. I think that it is better to begin the hard work of reforming the system so that we can indeed save Social Security for this generation and the next.

[The opening statement follows:]

**Opening Statement of Hon. Bill Archer, a Representative in Congress from the State of Texas**

Good morning.

Today's hearing will focus on Social Security reform lessons we can learn from other countries.

It's clear that the United States does not stand alone when it comes to the baby boomer retirement. Many industrialized counties are struggling with how to make ends meet as their citizens age.

Several countries, including Germany, Japan, and the United Kingdom have raised retirement ages. France, Italy and Sweden have begun to implement benefit reductions. Other nations, such as Chile, Mexico, and Australia, have reformed their systems through the creation of personal retirement accounts.

What should the United States do?

President Clinton has put forward a framework of a plan around which I believe we can make progress. To ward off Social Security's bankruptcy, the White House proposes crediting the Social Security trust fund with an additional $445 billion over the next five years. Where does this money come from? It comes from payroll tax money *already* destined for the trust fund. This my friends, is the famous double-count.

In order to extend the solvency of the trust fund, the Administration's budget puts $445 billion in the trust fund twice. Can the President do that? Sure he can. Welcome to way Washington works. But just because he *can*, doesn't mean he *should*. As we reform Social Security, some things have got to change.

This morning, I'm pleased to release an analysis of how the President's proposal impacts the national debt and the Social Security Trust Fund.

To me, nothing is more important than saving Social Security so our children and our children's children can enjoy the same comfort that today's seniors enjoy.

This analysis shows the Administration's proposal increases the *total* federal debt by $1.2 trillion between 1999 and 2004 and it *increases* the debt held by the government by $1.5 trillion over the same period. These increases do not hurt the economy nor do they crowd out private savings. The do, however, represent a large burden on our children and grandchildren who will have to repay this debt when it comes due in just thirteen years.

In addition, under the Administration's plan, Congress will be required to vote to increase the debt limit *two* years from now. Under current law, we won't hit the limit for at least *ten* years.

Finally, this analysis shows that the debt held by the public—that's the debt that hurts the economy by crowding out private savings—is higher under the President's plan than it would be under current law. One reason is because the President, like the Congress, doesn't use every penny of the surplus to pay down the debt. But it's *also* because the President's budget takes money out of the Social Security trust fund to pay for other government spending programs.

What's all this mean?

It means that in order to extend the trust fund's solvency, the Administration's proposal risks saddling our children with more debt.

I believe that sometime soon the President and the Congressional leadership will meet to begin the hard work of saving Social Security. As we proceed, let's remember that extending the life of the trust fund is the purpose of our endeavor, but not if it's done at the expense of our children. I think it's better to begin the hard work of reforming the system so we can indeed save Social Security for this generation and the next."

Chairman ARCHER. Now, we start our hearing this morning with a gentleman who has been ahead of the world, as it were, in recognizing the problems of a government Social Security Program, and initiating, almost singlehandedly, a new reform process which was ultimately adopted by the country of Chile and is still working today.

Before I recognize you, Mr. Piñera, for your comments and welcome you more warmly, I yield to my colleague, the gentleman from New York, Mr. Rangel, for any comments that he might like to make.

Mr. RANGEL. Thank you, Mr. Chairman, and I would like to welcome our foreign guest and expert in privatization of retirement funds. You put me at a complete disadvantage because I am not familiar with the protocol, and I am not much of a diplomat. So whatever is good for Chile I would assume is good for Chile. I am very anxious to see what impact this would have on our great democracy, but I assume that your plan went into effect before Chile had an opportunity to enjoy a democracy. I assume, further, that it was, and is still, mandatory. I assume that the economic conditions in the great Government of Chile are dramatically different than the economic conditions in the great Government of the United States of America.

It would be difficult for me to find out whether all of the people and economists in Chile support the position which you have taken today. And, you may ask, how do I know what position you have taken. Knowing my Chairman as well as I do, he would not have invited you unless you were supporting his position.

But, with all due respect to your government, I think that I will just withhold any comment except welcome to America, the land of democracy where debate is open and sometimes criticism is not very diplomatic. But you probably know all of that or you wouldn't have accepted our invitation. So, thank you so much for appearing.

[The opening statement of Hon. Jim Ramstad follows:]

**Opening statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota**

Mr. Chairman, thank you for calling this important hearing to discuss some of the reforms to public retirement programs that have been implemented in other nations.

As we all know, the demographic scenarios that are plaguing the financial future of the current Social Security system are not unique to the United States. Many other nations have already taken bold steps to tackle the complex problems facing their public retirement systems, and we should welcome this opportunity to learn from the pioneers in this area. We can learn a lot from our friends about what they have done that works well, and not so well, as we search for appropriate measures to preserve and protect this critical program for current and future beneficiaries.

I am hopeful that we can discuss, in a bipartisan, pragmatic way, how to truly restructure the system so it is financially solvent for the future. While I greatly appreciate the President's attention to this issue, I am concerned about the fact the President's proposal does nothing to ensure long-term solvency of the system. Rather, as U.S. Comptroller General David Walker testified before the Senate Finance Committee earlier this week, it "represents a different means to finance the current program."

That is how we handled Medicare in the last Congress. We made some short-term changes to keep the program operational for another 10 years. While that was necessary at the time, it forces us to revisit the issue and make even tougher decisions the second time through.

If we act soon, we have time to do this right. No senior wants a reduction in benefits. No worker wants to pay more in taxes. We have time to craft a plan that will increase benefits by increasing the rate of return on dollars set aside for retirement. We will also be able to take steps to encourage additional personal savings.

Thank you again, Mr. Chairman, for calling this important hearing. I look forward to hearing from today's witnesses about the pros and cons of the various efforts that have been tested across the world.

Chairman ARCHER. Mr. Piñera, I am not sure that you represent everything that I think, but I think that you represent a great deal of knowledge on this subject, and I believe that we can learn from all those people who have walked the path and not just walked the path whether they be in Chile, or whether they be in Great Britain, or whether they be in Australia, which are the two other countries from whom we will hear witnesses later today.

But your background is outstanding. As Minister of Labor, I believe, at the time that this program was initiated by you in Chile, you worked very, very hard and very thoughtfully in trying to design a program. We can learn from you, as we can learn from people from all over the world.

As great as America is, we can still learn from others, and we are happy to have you here this morning. I would encourage you, if you would, to make as concise, as possible, your verbal remarks to the Committee, and we will, without objection, include your entire written statement, if you have one, in the record. I am sure that Members, during the inquiry period, will get at an awful lot of aspects of your knowledge of Social Security, and I hope that we will have time for every Member to inquire.

So, with that format, welcome. We are happy to have you here, and we will be pleased to hear your testimony.

## STATEMENT OF JOSÉ PIÑERA, PRESIDENT, INTERNATIONAL CENTER FOR PENSION REFORM, AND COCHAIRMAN, PROJECT ON SOCIAL SECURITY PRIVATIZATION, CATO INSTITUTE

Mr. PIÑERA. Thank you very much, Mr. Chairman. I am really, really honored to be here. I am very grateful to every one of the Members for being so openminded as to discuss an idea like this.

Thank you, Mr. Rangel, for your views. I remember that I met you in Chile when you visited us, of course. And I remember that I told you that even though every idea has to be applied in different ways in different countries, we have benefited in Chile, enormously, from the ideas of your Founding Fathers. I believe that the ideas of democracy, of freedom, of liberty, are universal ideas. And what I come today to explain to you is that we have applied precisely those principles to Social Security. So, I would never say that the system within Chile is a Chilean system. It is basically a system that respects human dignity, human freedom, and, in that sense, it is very American.

As you know, I studied in the United States. I got a lot of my ideas in this country. It was precisely during my graduate studies here that I was worried about the problems of poverty in old age. And I was astonished by the fact that workers were contributing a very high proportion of their wages, one-eighth of their wages in the United States, to a Social Security system. But at the same time, they were anguished about their retirement benefits in old age. And it was here, in America, when I began to think about how to save a national retirement system by transforming it into a fully funded system that will not depend on demographics in order to provide the benefit to the people in old age.

And when we did it in my country 20 years ago, it was exactly that. We saved a national retirement system by transforming it into a system of private, individual accounts. In Chile, every worker puts the equivalent of your FICA taxes in a passbook account. Every worker has a passbook like this, and every month, instead of sending the FICA tax to a government body where they do not know really if that money is there, is invested, they do not understand the concept of a trust fund, but they understand very clearly the idea of investing their money in a passbook account of their own. They have a property right over this money. This money accumulates during their whole working life, and when they reach retirement age, they do not look at whether the macroeconomic numbers allow the government to pay them a benefit, but they have huge capital of their own in the account, and, with that, they get an annuity for life indexed to inflation. So, every worker in Chile does not have the anguish in old age of depending on, for example, a congressional election on whether they will keep or reduce, because of living increases, but they do have an indexed annuity for life.

Now, the essence of the system, sir, is that we are allowing every worker, even the poorest worker of the country, to benefit from the extraordinary force of compounded interest. Every investor knows that if you keep money in an account for 40 years, the money gets interest over interest and, therefore, grows exponentially. And people who have high incomes have always had savings accounts and have, therefore, been able to benefit from that force. But, regrettably, the common worker, the simple worker, the person who, at the end of the month, after paying food, shelter, taxes, does not have additional income to save in an account. They have not been able to benefit from compounded interest. So, the essence of the Chilean system is to allow every worker, and especially the very poor, to benefit from the extraordinary force of compounded returns over their whole life.

When I explained the system to the Chilean workers 20 years ago, I used a very conservative rate of return of only 4 percent above inflation, and I told them, "If you are able to get 4 percent, you will accumulate a huge amount of money in your account." Well, the system has performed beyond all of our dreams because the average rate of return of the system during the last 18 years, as you can see by the table has been 11 percent above inflation on average every year. Therefore, this has been an enormous benefit to Chilean workers, and this has transformed every worker into a shareholder. In America, something like 40 percent of American citizens own an IRA account or a 401(k) account, therefore they benefit when the stock market goes up. In Chile, every single worker is a shareholder, and, therefore, whenever the economy grows faster, whenever companies do better, they are able, also, to benefit from the well-being of the economy.

The system has been in place for 20 years. We placed three very important rules for the transition from the old system to the new one. The first one was that we guaranteed the benefits of the elderly people. So, every person who was already receiving a benefit in the Chilean system has nothing to fear from the reform. We gave a government guarantee that we would not take away our grandmother's check because those are promises made and those are promises that must be kept.

The second important rule is that every young person who enters the work force goes into the system on the passbook account because we couldn't keep open the door of a system that we knew that because of demographic forces would not be able to pay benefits in the future.

And the third rule, and I would say that it is a very important rule, was that we gave every worker who was already in the labor force, the option to stay in the government-run Social Security system, if they like it, or to move to the new system. So, it was a completely voluntary choice of every worker. So, by definition, nobody can be worse with a reform like this because, if someone doesn't like investing in the market, if someone doesn't like a passbook, if someone doesn't like compounded interest, they simply stay where they are. And those who move to the new system will recognize their past contributions through what we call a recognition bond, that is, a government bond that the government pays when the person reaches retirement age. So, someone who is 50 years old, if he moves from one system to the other, we have, when they reach the retirement age, both the accumulated savings in the new account plus the recognition bond.

Now, the extraordinary result has been that 93 percent of Chilean workers have chosen the new system even though there has been the usual discussion about market risk and so on, but people understand that, if you have a very conservative portfolio, you can reduce market risk to almost zero. So, people in Chile put all their money in government bonds. You could do it in the United States. Your government bonds are giving you, for 30 years, a rate of return of 5.5 percent while Social Security is giving 2 percent to the current workers and will give 0 percent to a young man who is entering the work force today. So, if someone is very worried, very risk adverse, he can invest only in government bonds and still get, in America, 5.5 percent of compound return over 30 years. If you put 50 percent in bonds and 50 percent in shares, maybe you get the 11 percent that we got in Chile. So, you can have a very conservative, safe portfolio. And I do agree that that is a very important concern for a worker, and the system should provide the alternative of very conservative investment.

The system has worked, sir, extremely well. Under three different governments the system has been kept exactly like it is. Those of you who have visited Chile, and I see a lot of faces here, have seen that the workers are happy with the new system. They are shareholders of the country. They are owners of the country's capital.

And in that sense, the system, I do not believe that it can be qualified as being of the right or of the left. This is basically a system for the 21st century rather than the pay-as-you-go system that, as we all know, was created in the 19th century by a German Chancellor, by Prince Otto Von Bismarck. So, Mr. von Bismarck exported the idea to Chile in 1925, then to the United States in 1935.

But I do believe that a system that is a tax-and-spend system, unfunded, is really not consistent with the basic American values. And that is why I believe an idea like this could work in the United States even better than it has worked in Chile.

Thank you, sir.

[The prepared statement follows:]

**Statement of José Piñera, President, International Center for Pension Reform, and Cochairman, Project on Social Security Privatization, Cato Institute**

Mr. Chairman, distinguished members of the committee:

My name is José Piñera and I am a Chilean citizen. I learned to love your country during the four years that I spent at Harvard University, earning a Master in Arts and a Ph.D. in economics. Today, I am president of the International Center for Pension Reform and co-chairman of the Cato Institute's Project on Social Security Privatization. As Minister of Labor and Social Security from 1978 to 1980, I was responsible for the creation of Chile's private Social Security system.

I want to thank Chairman Archer for his invitation to me to testify in the U.S. House of Representatives. In keeping with the truth in testimony requirements, let me first note that neither the Cato Institute nor the International Center for Pension Reform receives any government money of any kind.

I believe there is no economic issue facing the world today that is more important than converting unfunded pay-as-you-go Social Security systems into fully funded systems of individual retirement accounts. For that reason, there has been great international interest in the pioneering Chilean Social Security model. This is a global crisis, affecting all countries, large and small, wealthy and poor, including the United States.

I am here to share with you an idea, a powerful idea that can improve the lives of all Americans. That idea was implemented in Chile 19 years ago when we approved the Social Security reform.

### THE CHILEAN USA SYSTEM [1]

On Nov. 4, 1980, Chile approved a law to fully replace a government-run retirement system with a fully funded privately administered system of Universal Savings Accounts (USAs).

The new system began to operate on May 1, 1981 (Labor Day in Chile). After 18 years of operation, the results speak for themselves. The main goals of the reform have been achieved: much better retirement benefits for all workers and control over their retirement savings. But there have been other important consequences. By improving the functioning of both the capital and the labor markets, the USA system has been one of the key initiatives that, in conjunction with other free-market reforms, have pushed the growth rate of the economy upwards from the historical 3 percent a year to 7.0 percent on average during the last 13 years.

In a recent work, UCLA Professor Sebastian Edwards has stated that, "The Chilean pension reform has had important effects on the overall functioning of the economy. Perhaps one of the most important of these is that it has contributed to the phenomenal increase in the country's saving rate, from less than 10 percent in 1986 to almost 29 percent in 1996."[2] He goes on to say that, "The pension reform has also had an important effect on the functioning of the labor market. First, by reducing the total rate of payroll taxes, it has reduced the cost of labor and, thus, has encouraged job creation. Second, by relying on a capitalization system, it has greatly reduced—if not eliminated—the labor tax component of the retirement system."

Under Chile's USA system, what determines a worker's retirement benefits is the amount of money he accumulates during his working years. Neither the worker nor the employer pays a social security tax to the state. Nor does the worker collect government-funded retirement benefits. Instead, during his working life, he automatically has 10 percent of his wages deposited by his employer each month in his own, individual USA. A worker may contribute an additional 10 percent of his wages each month, which is also deductible from taxable income, as a form of voluntary savings.

A worker chooses one of the private Pension Fund Administration companies (Administradoras de Fondos de Pensiones, or AFPs) to manage his USA. These companies can engage in no other activities and are subject to government regulation intended to guarantee a diversified and low-risk portfolio and to prevent theft or fraud. A separate government entity, a highly technical "AFP Superintendency" (Superintendencia de AFPs, or SAFP), provides oversight. Of course, there is free entry to the AFP industry.

Each AFP operates the equivalent of a mutual fund that invests in stocks and bonds. Investment decisions are made by the AFP. Government regulation sets only maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio; and the spirit of the reform is that those regulations should be reduced constantly with the passage of time and as the AFP companies gain experience. There is no obligation whatsoever to invest in government or any other type of bonds. Legally, the AFP company and the mutual fund that it administers are two separate entities. Thus, should an AFP go under, the assets of the mutual fund—that is, the workers' investments—are not affected.

Workers are free to change from one AFP company to another. For this reason there is competition among the companies to provide a higher return on investment, better customer service, or a lower commission. Each worker is given a USA passbook and every four months receives a regular statement informing him how much money has been accumulated in his retirement account and how well his investment fund has performed. The account bears the worker's name, is his property, and will be used to pay his old age retirement benefits (with a provision for survivors' benefits).

As should be expected, individual preferences about old age differ as much as any other preferences. The old, pay-as-you-go system does not permit the satisfaction of such preferences, except through collective pressure to have, for example, an early

[1] This section follows José Piñera, "Empowering Workers: The Privatization of Social Security in Chile." Cato's Letter No. 10, Cato Institute (1996).

[2] Sebastian Edwards, "The Chilean Pension Reform: A Pioneering Program." In M. Feldstein, ed., Privatizing Social Security, Chicago, Ill.: University of Chicago Press (1998).

retirement age for powerful political constituencies. It is a one-size-fits-all scheme that exacts a price in human happiness.

The USA system, on the other hand, allows for individual preferences to be translated into individual decisions that will produce the desired outcome. In the branch offices of many AFPs there are user-friendly computer terminals that permit the worker to calculate the expected value of his future retirement benefits, based on the money in his account, and the year in which he wishes to retire. Alternatively, the worker can specify the retirement benefits he hopes to receive and ask the computer how much he must deposit each month if he wants to retire at a given age. Once he gets the answer, he simply asks his employer to withdraw that new percentage from his salary. Of course, he can adjust that figure as time goes on, depending on the actual yield of his retirement fund or the changes in the life expectancy of his age group. The bottom line is that a worker can determine his desired benefits and retirement age in the same way one can order a tailor-made suit.

As noted above, worker contributions are deductible for income tax purposes. The return on the USA is also tax-free. Upon retirement, when funds are withdrawn, taxes are paid according to the income tax bracket at that moment.

The Chilean USA system includes both private and public sector employees. The only ones excluded are members of the police and armed forces, whose social security systems, as in other countries, are built into their pay and working conditions system. (In my opinion—but not theirs yet—they would also be better off with an USA). Self-employed workers may enter the system, if they wish, thus creating an incentive for informal workers to join the formal economy.

A worker who has contributed for at least 20 years but whose retirement fund, upon reaching retirement age, is below the legally defined minimum receives benefits from the state once his USA has been depleted. What should be stressed here is that no one is defined as "poor" a priori. Only a posteriori, after his working life has ended and his USA has been depleted, does a poor retiree receive a government subsidy. (Those without 20 years of contributions can apply for welfare-type benefits at a lower level).

The USA system also includes insurance against premature death and disability. Each AFP provides this service to its clients by taking out group life and disability coverage from private life insurance companies. This coverage is paid for by an additional worker contribution of around 2.6 percent of salary, which includes the commission to the AFP.

The mandatory minimum savings level of 10 percent was calculated on the assumption of a 4 percent average net yield during the whole working life, so that the typical worker would have sufficient money in his USA to fund benefits equal to 70 percent of his final salary.

Upon retiring, a worker may choose from two general payout options. In one case, a retiree may use the capital in his USA to purchase an annuity from any private life insurance company. The annuity guarantees a constant monthly income for life, indexed to inflation (there are indexed bonds available in the Chilean capital market so that companies can invest accordingly), plus survivors' benefits for the worker's dependents. Alternatively, a retiree may leave his funds in the USA and make programmed withdrawals, subject to limits based on the life expectancy of the retiree and his dependents. In the latter case, if he dies, the remaining funds in his account form a part of his estate. In both cases, he can withdraw as a lump sum the capital in excess of that needed to obtain an annuity or programmed withdrawal equal to 70 percent of his last wages.

The USA system solves the typical problem of pay-as-you-go systems with respect to labor demographics: in an aging population the number of workers per retiree decreases. Under the USA system, the working population does not pay for the retired population. Thus, in contrast with the pay-as-you-go system, the potential for intergenerational conflict and eventual bankruptcy is avoided. The problem that many countries face—unfunded social security liabilities—does not exist under the USA system.

In contrast to company-based private retirement systems that generally impose costs on workers who leave before a given number of years and that sometimes result in bankruptcy of the workers' retirement funds—thus depriving workers of both their jobs and their retirement rights—the USA system is completely independent of the company employing the worker. Since the USA is tied to the worker, not the company, the account is fully portable. The problem of "job lock" is entirely avoided. By not impinging on labor mobility, both inside a country and internationally, the USA system helps create labor market flexibility and neither subsidizes nor penalizes immigrants.

An USA system is also consistent with a truly flexible labor market. In fact, people are increasingly deciding to work only a few hours a day or to interrupt their working lives—especially women and young people. In pay-as-you-go systems, those flexible working styles generally create the problem of filling the gaps in contributions. Not so in an USA scheme where stop-and-go contributions are no problem whatsoever.

THE TRANSITION

Countries that already have a pay-as-you-go system have to manage the transition to an USA system. Of course, the transition has to take into account the particular characteristics of each country, especially constraints posed by the budget situation.

In Chile we set three basic rules for the transition:

1. The government guaranteed those already receiving retirement benefits that they would be unaffected by the reform. It would be unfair to the elderly to change their benefits or expectations at this point in their lives.

2. Every worker already contributing to the pay-as-you-go system was given the choice of staying in that system or moving to the new USA system. Those who left the old system were given a "recognition bond" that was deposited in their new USAs. (It was a zero coupon bond, indexed and with 4 percent real interest rate). The government pays the bond only when the worker reaches the legal retirement age. The bonds are traded in secondary markets, so as to allow them to be used for early retirement. This bond reflected the rights the worker had already acquired in the pay-as-you-go system. Thus, a worker who had made social security contributions for years did not have to start at zero when he entered the new system.

3. All new entrants to the labor force were required to enter the USA system. The door was closed to the pay-as-you-go system because it was unsustainable. This requirement assured the complete end of the old system once the last worker who remained in it reaches retirement age (from then on, and during a limited period of time, the government has only to pay retirement benefits to retirees of the old system).

After several months of national debate on the proposed reforms, and a communication and education effort to explain the reform to the people, the social security reform law was approved on November 4, 1980.

Together with the creation of the new system, all gross wages were redefined to include most of the employer's contribution to the old system. (The rest of the employer's contribution was turned into a transitory tax on the use of labor to help the financing of the transition; once that tax was completely phased out, as established in the social security reform law, the cost to the employer of hiring workers decreased). The worker's contribution was deducted from the increased gross wage. Because the total contribution was lower in the new system than in the old, net salaries for those who moved to the new system increased by around 5 percent.

In that way, we ended the illusion that both the employer and the worker contribute to social security, a device that allows political manipulation of those rates. From an economic standpoint, all the contributions are ultimately paid from the worker's marginal productivity, because employers take into account all labor costs—whether termed salary or social security contributions—in making their hiring and pay decisions. By renaming the employer's contribution, the system makes it evident that workers make all contributions. In this scenario, of course, the final wage level is determined by the interplay of market forces.

The financing of the transition is a complex technical issue and each country must address this problem according to its own circumstances. The implicit pay-as-you-go debt of the Chilean system in 1980 has been estimated by the World Bank at around 80 percent of GDP.[3] (The value of that debt had been reduced by a reform of the old system in 1978, especially by the rationalization of indexing, the elimination of special regimes, and the raising of the retirement age.) A World Bank study stated that "Chile shows that a country with a reasonably competitive banking system, a well-functioning debt market, and a fair degree of macroeconomic stability can finance large transition deficits without large interest rate repercussions."

Chile used five methods to finance the transition to an USA system:

1. Since the contribution needed in a capitalization system to finance adequate social security levels is generally lower than the current payroll taxes, a fraction of the difference between them was used as a temporary transition payroll tax without reducing net wages or increasing the cost of labor to the employer (the gradual elimination of that tax was considered in the original law and, in fact, that happened, so that today it does not exist).

[3] World Bank, Averting the Old Age Crisis (1994).

2. Using debt, the transition cost was shared by future generations. In Chile roughly 40 percent of the cost has been financed issuing government bonds at market rates of interest. These bonds have been bought mainly by the AFPs as part of their investment portfolios and that "bridge debt" should be completely redeemed when the retirees of the old system are no longer with us.

3. The need to finance the transition was a powerful incentive to reduce wasteful government spending. For years, the budget director has been able to use this argument to kill unjustified new spending or to reduce wasteful government programs, thereby making a crucial contribution to the increase in the national savings rate.

4. The increased economic growth that the USA system promoted substantially increased tax revenues. Only 15 years after the social security reform, Chile started running fiscal budget surpluses of around 2 percent of GNP.

5. Privatization of state-owned companies in Chile were another way to contribute, although marginally, to finance the transition. Of course, this had several additional benefits such as increasing efficiency, spreading ownership, and depoliticizing the economy.

## THE RESULTS

The USAs have already accumulated an investment fund of $31 billion, an unusually large pool of internally generated capital for a developing country of 15 million people and a GDP of $70 billion.

This long-term investment capital has not only helped fund economic growth but has spurred the development of efficient financial markets and institutions. The decision to create the USA system first, and then privatize the large state-owned companies second, resulted in a "virtuous sequence." It gave workers the possibility of benefiting handsomely from the enormous increase in productivity of the privatized companies by allowing workers, through higher stock prices that increased the yield of their USAs, to capture a large share of the wealth created by the privatization process.

One of the key results of the new system has been to increase the productivity of capital and thus the rate of economic growth in the Chilean economy. The USA system has made the capital market more efficient and influenced its growth over the last 18 years. The vast resources administered by the AFPs have encouraged the creation of new kinds of financial instruments while enhancing others already in existence, but not fully developed. Another of Chile's social security reform contributions to the sound operation and transparency of the capital market has been the creation of a domestic risk-rating industry and the improvement of corporate governance. (The AFPs appoint outside directors in the companies in which they own shares, thus shattering complacency at board meetings.)

Since the system began to operate on May 1, 1981, the average real return on investment has been 11 percent per year, almost three times higher than the estimated yield of 4 percent. Of course, the annual yield has shown the oscillations that are intrinsic to the free market—ranging from minus 2.5 percent to almost 30 percent in real terms—but the important yield is the average one over the long term (see Table 1).

Retirement benefits under the new system have been significantly higher than under the old, state-administered system, which required a total payroll tax of around 25 percent. According to a recent study, the average AFP retiree is receiving benefits equal to 78 percent of his mean annual income over the previous 10 years of his working life. As mentioned, upon retirement workers may withdraw in a lump sum their "excess savings" (above the 70 percent of salary threshold). If that money were included in calculating the value of the benefits, the total value would come close to 84 percent of working income. Recipients of disability benefits also receive, on average, 70 percent of their working income.

The new social security system, therefore, has made a significant contribution to the reduction of poverty by increasing the size and certainty of old age, survivors, and disability benefits, and by the indirect but very powerful effect of promoting economic growth and employment.

When the USA was inaugurated in Chile in 1981, workers were given the choice of entering the new system or remaining in the old one. One fourth of the eligible workforce chose the new system by joining in the first month of operation alone. Today, more than 95 percent of Chilean workers are in the new system.

Social security is no longer a source of political conflict. A person's retirement income will depend on his own work and on the success of the economy, not on the government or on the pressures brought by special interest groups.

Real annual rate of return of Chile's private social security system

(Note: rate of return above inflation)

| Year | Rate |
|---|---|
| 1981 | 12.6 |
| 1982 | 28.8 |
| 1983 | 21.3 |
| 1984 | 3.5 |
| 1985 | 13.4 |
| 1986 | 12.3 |
| 1987 | 5.4 |
| 1988 | 6.4 |
| 1989 | 6.9 |
| 1990 | 15.5 |
| 1991 | 29.7 |
| 1992 | 3.1 |
| 1993 | 16.2 |
| 1994 | 18.2 |
| 1995 | −2.5 |
| 1996 | 3.5 |
| 1997 | 4.7 |
| 1998 | −1.1 |
| Annual Average: | 11.0 |

Source: Official Government Statistics (SAFP).

For Chileans, USAs now represent real and visible property rights—they are the primary sources of security for retirement. After 18 years of operation of the new system, the typical Chilean worker's main asset is not his used car or even his small house (probably still mortgaged), but the capital in his USA.

Finally, the private social security system has had a very important political and cultural consequence. Indeed, the new social security system gives Chileans a personal stake in the economy. A typical Chilean worker is not indifferent to the behavior of the stock market or interest rates. Intuitively he knows that his old age security depends on the wellbeing of the companies that represent the backbone of the economy.

## The Global Social Security Crisis

The real specter haunting the world these days is the specter of bankrupt state-run social security systems. The pay-as-you-go social security system created by Chancellor Otto Von Bismarck has a fundamental flaw, one rooted in a false conception of how human beings behave: it destroys, at the individual level, the essential link between effort and reward—in other words, between personal responsibilities and personal rights. Whenever that happens on a massive scale and for a long period of time, the result is disaster.

Two exogenous factors aggravate the results of that flaw: (1) the global demographic trend toward decreasing fertility rates; and, (2) medical advances that are lengthening life. As a result, fewer workers are supporting more and more retirees. Since the raising of both the retirement age and payroll taxes has an upper limit, sooner or later the system has to reduce the promised benefits, a telltale sign of a bankrupt system.

Whether this reduction of benefits is done through inflation, as in most developing countries, or through legislation, the final result for the retired worker is the same: anguish in old age created, paradoxically, by the inherent insecurity of the "social security" system.

The success of the USA system in Chile has led seven other Latin American countries to follow suit. In recent years, Peru (1993), Argentina (1994), Colombia (1994), Uruguay (1995), Mexico (1997), Bolivia (1997), and El Salvador (1998) undertook similar reforms. It is possible that before entering the new millennium, several other countries in the Americas will have implemented USA systems instead of unfunded government-run social security ones. This would mean a massive redistribution of power from the state to individuals, thus enhancing personal freedom, promoting faster economic growth, and alleviating poverty, especially in old age.

Mr. Chairman, let me conclude with a warning about the damaging moral effects of unfunded social security and other entitlement programs issued at the dawn of the New Deal:

> The lessons of history, confirmed by evidence immediately before me, show conclusively that continued dependence on relief induces a spiritual and moral disintegration fundamentally destructive to the national fiber. To dole out relief in this way is to administer a narcotic, a subtle destroyer of the human spirit. It is inimical to the dictates of sound policy. It is a violation of the traditions of America.[4]

That warning was issued by President Franklin Delano Roosevelt in his 1935 State of the Union address.

I believe that the road is clear in the United States to replace a Bismarckian program with a system that is so inherently consistent with American values.

Thank you very much.

Chairman ARCHER. Thank you, Mr. Piñera.

Mr. Crane will inquire.

Mr. CRANE. Thank you, Mr. Chairman.

It is a real honor to have this opportunity to visit with Dr. Piñera. The only unfortunate thing in his resume is that he got his Ph.D. in economics at Harvard rather than at the University of Chicago, but I will say that Chicago School of Economics all the way.

We had the privilege of meeting with José when our Trade Subcommittee was down in Chile in 1995, and the trade trip had a few moments set aside for José to explain to us what he had done there, miraculously, in saving their universal savings account. I think that we borrowed from Bismarck, we call ours SS, and yours is USA. Is that not correct?

Mr. PIÑERA. Yes.

Mr. CRANE. At any rate, I thought I would pass that on to you, Charlie, just in case there was any confusion.

But at any rate, I enjoyed that visit enormously. But the thing that was so striking to me was your explanation to us. At the time you started down that path it was a big gamble, like throwing dice at the craps table, and you were not sure how many, even though it was voluntary, how many workers would jump onboard and how attractive a potential program it might be. And that you were overwhelmed with the percentage that did, at the very beginning. And, at that time, I think, you told us it was just a little over 90 percent, now it is up to 93 or 94 percent that have gotten into the program. I mean, it was the most exciting part of the trip that we had down there, was the visit with you. And I say that because it opens up the door of the possibility of us, who are faced with this awesome problem of dealing with our own Social Security system, which is in big trouble, down the line, dealing with it along the positive lines you gave us.

I would like to ask you one question, though, and that is, when you originally created the program down there, how did you get the message out to individual Chileans that they had this opportunity, and convey to them, a potential for a return that exceeded the existing program?

Mr. PIÑERA. Well, that is a very interesting question, sir. I believe that when you are doing a reform like this you have the duty

[4] Franklin D. Roosevelt, The Public Papers and Addresses of Franklin D. Roosevelt, Vol. 4, The Court Disapproves: 1935, Random House (1938).

to educate, to inform, to debate the system. So, we had a great effort of communication and education.

The most important part of the effort was 3-minute television comment by me every week. I went on television as a Secretary, and I said that I would like to have 3 minutes, because I generally believe that people do not like a government official for more than 3 minutes on television. And they have now the zapping machine so they can immediately make it go away. Of course, Fidel Castro has never heard this thesis from me.

So, I worked exactly 3 minutes. And I believe, sir, that people understand these issues when they are explained in simple terms. I believe that it is a grave mistake of some economists from Harvard or Chicago, to use jargon to explain simple things. When you tell people that you can put the money in an account like this—I even remember that I used a Spanish term. In Chile we say "la plata donde tos offos la vaya," "the money where your eyes can see." And everywhere that I went, I said, "Would you like the money where your eyes cannot see it?" Because in the Social Security Administration you don't know where the money is. Or whether you would like it in a passbook. You know, Chileans can go to an ATM machine every month, put the passbook, and immediately know the amount of the contribution, the compounded interest, and the total amount. My Secretary goes every month and goes to my office in the morning and tells me how rich she is, and therefore how much respect, not that only me, but everyone should show to someone who has, I don't remember $60,000 or $70,000, in her account already.

So, I believe, sir, that it was not a gamble. I believe that you can trust it when you explain the ideas to them in simple, but truthful, terms. And that is how it worked in Chile.

Mr. CRANE. Well, I commend you, José. Our time is limited here, and your time, too, I know. But I appreciate the fact that you make these periodic visits up here. Maybe more than periodic. And your association with a think tank to help disseminate good, sound policy. And yours is the shining example, that I am aware of, worldwide in this area. And you are to be heartily congratulated. You have had a major influence already, but you will continue to expand that influence. And hopefully, people like Clay here, can take advantage of that. He is having the hearings right now with a view to our reforms here in the United States. But your example and your experience down there is so commendable that I think that you are the shining light as far as this investigation goes.

And I yield back the balance of my time, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

It is going to take me a little time, Dr. Piñera, to leave the system that was created by Franklin Roosevelt in order to get to the one that you have been able to create. Listening to my friend, Congressman Crane, I am inclined to suggest to my President that he take our surplus and invest it in Chilean stock here. Then we will make certain that everything is secure.

I think that Mr. Crane asked you how did you sell this to the Chilean people. But at the time that this system went into effect, it was mandatory, wasn't it? I mean, the Chileans never had a vote on this, and there was no Parliament and no congressional question. Wasn't it under General Pinochet? I mean, when this system went in, it just went in. It was mandatory, wasn't it?

Mr. PIÑERA. The pay-as-you-go system, sir, was mandatory before this. What we did was to give workers a choice between a mandatory pay-as-you-go system——

Mr. RANGEL. Yes.

Mr. PIÑERA [continuing]. To a mandatory system of individual accounts. Of course, in both cases, the system is mandatory. But we gave workers the choice to choose one way, basically a pay-as-you-go, or another way, the passbooks. And workers were free to choose one.

Mr. RANGEL. Once you make the decision, can you change your mind? If you go into the passbook system, can you take your money out of that system any time you want, or do you have to wait until the retirement age is at hand?

Mr. PIÑERA. No, you have to wait, sir, until your retirement age because, like the definition, you cannot use the same money for two different purposes. Regrettably. So, if you have a retirement system, the money should be there for retirement.

But we do have an option that maybe you are interested in, sir, and it is the following. We know that some people want to work forever until 90 years old, but some people want to retire at 55 because they have grandchildren or they want to write a novel.

Mr. RANGEL. I am familiar with that. They can take it out and put it in an annuity, or do something else with it. But let me ask some other questions.

One of the concerns that we have about privatization in the United States is whether or not there is any guaranteed income, notwithstanding a negative market. Is there a guarantee? A minimum? A ground floor? A safety net in case the Chilean stock market is negative?

Mr. PIÑERA. Absolutely, sir. Everyone, as I said, has a passbook. But, if someone reaches retirement age and has accumulated in his passbook a given amount of money—let's imagine in this glass, this amount of water—and not all this, but should be the minimal, the government from Federal revenues made like this, sees the glass so that everyone has at least the minimum retirement income. So the system assures everyone a safety net, but above the safety net you get extra net from your passbook account.

Mr. RANGEL. And the market has not been as positive in recent years as it was when this system started. Has there been any need for the Chilean Government to pour in that additional money for current retirees?

Mr. PIÑERA. Not yet, sir, precisely because of the diversification rules. Last year, when the stock market in Chile went down by 25 percent because of the Asian, the Russian, the Brazilian crisis, the funds' return went down only 1 percent. That seems magic. Twenty-five percent down the stock market, but the funds, 1 percent. Why? Because the funds are invested also in bonds, in mortgages, in international shares. And even with that minus 1 percent of 1998, the average return over 18 years is still 11 percent above inflation on average every year.

Mr. RANGEL. Did your government urge workers, because of the condition of the market, to delay retirement?

Mr. PIÑERA. No. The government cannot tell the people when they should retire. I do know that Vice President Gore misinterpreted, maybe, the translation of some official in Chile and included that in one of his addresses, but that has been corrected by the Chilean official by saying that the government has nothing to do with telling people when they should retire. That is completely against the whole philosophy of the system.

Mr. RANGEL. We're talking about Deputy Secretary for Social Security, Patricio Tambolini? That is the same controversy that you say that the Vice President misunderstood?

Mr. PIÑERA. Yes, I just think that he quoted a Superintendent. But anyway, it is definite that neither the President nor the Secretary nor anyone has a right in Chile to tell people when to retire. It would be like telling people when to buy a car or when to buy a house. It may be a personal opinion, but it is not in the philosophy of the system, sir.

Mr. RANGEL. No, I agree. We are also concerned with the cost of administration.

Let me, again, welcome you to the United States. I didn't know that you were Harvard trained, or at least I forgot it. This is like your second home, so, welcome home.

Mr. PIÑERA. Thank you, sir, and we welcomed you also to Chile when you went, and I hope that you can go again and keep being informed about this system.

Mr. RANGEL. I look forward to it.

Chairman ARCHER. Mrs. Johnson.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

Dr. Piñera, thank you very much for being with us. Could you discuss with us how the government goes about certifying the companies that manage the investing funds? And have you had any occasion to decertify any of your fund managers. And, you know, just that whole mechanism. How do you keep politics out of the decisions about fund managers and the fund investments and those kinds of things. If you could talk a little bit about the politics and the mechanism of that fund management, I would appreciate it.

Mr. PIÑERA. Well, that is a very important element, Miss, because the whole idea of the reform has been the depoliticization of Social Security. That is, Social Security is not any longer a main political issue in Chile. Representatives of the people, of course, debate health, education, crime, but not Social Security because this is a system that works on its own.

Now, how can politicians certify? We put in the law certain basic requirements to be a certified manager. The requirements are that—our objective requirements, that is—have a given amount of capital, have never had a problem with the Securities and Exchange Commission of Chile—this is a very objective test. If a company can meet that test, a Chilean or a foreign company—because we allow a 100-percent ownership of a foreign company of the Chilean mutual fund. And we do have Citibank there, we have American International Group, we have AETNA Life Insurance—so, a lot of your companies have understood that this is a worldwide megatrend, and they want to be in Chile. They are in Chile.

So, the companies are certified through a very objective, completely depoliticized system, and there has been, in 19 years, never a problem. And if a company were to feel treated in a nonobjective way, they can go to the Supreme Court because the rules are very, very clear.

Mrs. JOHNSON OF CONNECTICUT. And could you also talk a little bit about the early retirement options? Under our system, you really have no early retirement option until 62, and then, of course, you get a reduced benefit. What are the rules under the Chilean system?

Mr. PIÑERA. Well, that is exactly what I was explaining to the question of Mr. Rangel. In Chile, everyone can begin to retire money from his account from the moment that he or she has accumulated enough capital to buy an annuity equal to at least 50 percent of his last wages. So, even though the mandatory contribution to the passbook is 10 percent of wages, you can put another 10 percent in tax free. And, therefore, some people, for example, that want to retire at 55, they go to a mutual fund company, they sit in front of a friendly computer, and they ask the computer, "How much money should I save if I want to retire at 55?" The computer makes a calculation with historic rate of return, and they tell him that, for example, 14.3. And what about if I want to retire at 57? In that case, 12.8.

So, basically, we have given back to the people the right to retire whenever they want as long as they save enough for retirement. They cannot retire early with someone else's money, because that would be, of course, an abuse.

Mrs. JOHNSON OF CONNECTICUT. And also, Dr. Piñera, is it possible to save more some years than others? For instance, if you have a high paying 2 years, can you up your savings? And then, if you move to another job where you earn less, can you lower your savings as long as it is 10 percent? In other words, can you float between the 10- and 20-percent contribution levels?

Mr. PIÑERA. You can always move between the 10- and 20-percent contribution levels. But when you choose the early retirement option, that is, when you have been able to buy that annuity for 50 percent of your wages——

Mrs. JOHNSON OF CONNECTICUT. Yes, once it is bought. But up to that point, you may do that, cancellation and then oh, I don't want to retire early after all. But during your working years, can you elect to contribute say, 14 or 15 percent, and then later on, a few years later, elect to go back down to the 10 percent?

Mr. PIÑERA. You could do it a few months later.

Mrs. JOHNSON OF CONNECTICUT. Yes, OK.

Mr. PIÑERA. You could do it at any moment. It is your money. It is your future. It is your decision.

Mrs. JOHNSON OF CONNECTICUT. You can actually determine at what pace you want to save throughout your working life as long as it doesn't go below 10 percent? And when you want to retire?

Mr. PIÑERA. Exactly.

Mrs. JOHNSON OF CONNECTICUT. Thank you very much.

Mr. PIÑERA. And you can go on——

Mrs. JOHNSON OF CONNECTICUT. A construction worker who had a very good season could up their investment and retire earlier.

Thank you.

Mr. PIÑERA. Could I just add one point? You can go on working after 65 years, and in that case, you do not have to pay the 10 percent. You can retire from your account, and all the wages that you get are your wages. To me this is very important because I simply cannot understand the fact that on a given moment, on your 65th birthday, the day before you have been working many years, and the day after you don't know what to do in the morning. In Chile you can say that I imagine now that I will work now half a day. I will work 3 hours a day. We have stopped this contradiction that on a given day you are a worker and on the next day someone who has nothing to do.

Mrs. JOHNSON OF CONNECTICUT. Interesting. Thank you very much, that is important.

Chairman ARCHER. Mr. Houghton.

Mr. Houghton is not here.

Mr. Camp.

Mr. CAMP. Thank you.

Dr. Piñera, could you state for the Committee what the savings rate is in Chile?

Mr. PIÑERA. Around 25 percent of GNP. Up from 10 percent before this reform was done. But I cannot say, sir, being very honest, whether the whole difference has been because of this reform because we were doing several reforms at the same time. There have been some experts who have said that this reform has been the most important one, but not the only one. So, I wouldn't want to give to this reform more than it is due.

Mr. CAMP. I understand that a majority of the personal account assets are invested in government bonds. Are these Chilean bonds or the bonds of other countries?

Mr. PIÑERA. Both. Most, of course, are invested in Chilean bonds, but now we are in the process of allowing the pension funds to invest abroad, and they are investing in U.S. Treasury bonds, German Treasury bonds, and so on. That is the decision of the fund managers according to some levels of certification criteria.

Mr. CAMP. Is this a requirement of participating in the personal accounts?

Mr. PIÑERA. No there is no requirement whatsoever to invest a penny in a government bond. There can be a fund that could say that we do not invest in government bonds, and they can invest zero.

The only requirements are ceilings. That is, you have to invest no more than 6 percent in government bonds, no more than a certain percent in shares. But you should never put a floor because the moment you put a floor, it is a possibility of confiscating the money because then the government can issue a bond at the rate of interest lower than the market.

So, never put a floor, but, yes, put a ceiling in order to ensure putting the eggs in different baskets.

Mr. CAMP. Were there any cash incentives offered to workers to go into these personal accounts?

Mr. PIÑERA. No, there was not a cash incentive from the government, but what happened that the contribution rate in the new system is lower than the contribution rate of the old system. So, when the worker moved from the old to the new system, he got a take home pay increase of around 4 to 5 percent. Not of government money, but of his own payroll tax money because the new contribution rate was lower than the old one.

Mr. CAMP. I realize also that you testified to the safeguard that if your savings don't get up to a certain level when you opt to retire that the government then makes the glass full. How did the people in Chile react to the concept that income would depend on stock and bond performance? Can you talk about that a little bit to the Committee, please?

Mr. PIÑERA. Initially, of course, there was lot of questions, and that is why, as I said before, I employed almost 1 year of my time, after we had decided on this system, to explain it to the workers. I went to hundreds of trade union meetings, townhall meetings. And when I explained to people that they should not invest—that is, that they have the choice to invest in a very risk-adverse way, the people began to understand. You see, when you tell people, "Look, if you do not like this, if you want to sleep very well, even though you may have to eat a little less well, you can put all the money in Treasury bills."

So, when you tell people that you have a fallback position, that if they are extremely risk averse, you can put all the money in government bonds, then people say, "OK, I have the fallback position, but I would like to have some shares."

And what happened, generally, sir, is that the 20-year-old young person prefers a lot of shares, because he knows, as we all know, that over a 40-year period, the share market has given people a much better return than bonds.

But what I always tell workers who approach me in the street—because they have seen me on television—that when they are 50, 55, 60, they should begin to move to a fully bond fund so that they can sleep very well in the years prior to their 65th birthday.

Mr. CAMP. Thank you.

Chairman ARCHER. Mr. Matsui.

Mr. MATSUI. Thank you very much, Mr. Chairman. Thank you, Dr. Piñera.

I would like to follow up on what Mr. Rangel said. The Chilean Deputy Secretary for Social Security, Secretary Tambolini, was the one that Mr. Rangel was referring to. Now, granted, under your system in Chile, one cannot require a person not to retire under the law, but there is no question, at least from press reports that I have read and have before me right now from Chilean newspapers, that the Secretary did recommend to the work force that they withhold their retirement because there was a negative growth in the account at the time. Now, are you denying that took place? You don't have to tell me—I know that the government can't require it. I am just saying that that was a recommendation. Isn't that the truth?

Mr. PIÑERA. Well, first, sir, I can deny absolutely that Mr. Tambolini is the Secretary.

Mr. MATSUI. I'm sorry. Say that again.

Mr. PIÑERA. He is not the Secretary.

Mr. MATSUI. I said as Deputy Secretary.

Mr. PIÑERA. No, he is the Deputy Secretary.

Mr. MATSUI. I'm sorry?

Mr. PIÑERA. He is the number two in the Ministry, not the number one.

Mr. MATSUI. All right.

Mr. PIÑERA. OK, I would like that to be clear.

Mr. MATSUI. I'm just asking you, did he say that or not say that?

Mr. PIÑERA. I don't know, sir, what every Chilean official says. How can I deny or confirm what this number two person——

Mr. MATSUI. Did you read it in the paper?

Mr. PIÑERA. No.

Mr. MATSUI. So, you don't read the papers?

Mr. PIÑERA. No, I don't——

Mr. MATSUI. All right, thank you.

I would feel a little more comfortable if the plan were more than 19 years old. I am somewhat troubled. It sounds a lot better than the prior system, and I certainly commend you and those in the Pinochet government for instituting this new system. Obviously it wasn't very good under the dictatorship that existed prior to 1981. And so, this is much better.

But the issue for us is whether or not, in the next 30 or 40 years it is going to be a good system. And it appeared to be very much tied to the economy of the country, particularly since the country deals so much with Asia, and the Asian financial markets. Because in the last few years, since 1995, we have actually seen rather sluggish growth. And the fund, as a result of that, has been somewhat sluggish. And would you care to comment on that?

Mr. PIÑERA. Yes, sir. I disagree that it will have to hinge on the performance of one economy because the funds are being allowed increasingly to diversify internationally, and the Chilean pension funds are investing a fraction internationally, in the U.S. market, in the European market and so on. So, ultimately it will be a worldwide portfolio.

So, of course, if you are telling me that in the next 40 years the world economy will be in crisis, I will grant you a point. But, as you understand, you will have much more important problems than the Chilean pension system.

Mr. MATSUI. If I could just comment on this.

My problem on this is that, of course, I am reading off of secondary documents, but a study by Sebastian Edwards of the Chilean pension system said that throughout the eighties, 40 percent of the rate of returns were attributed to the performances of just two electric utility companies. Is that incorrect?

Mr. PIÑERA. That may be correct, sir.

Mr. MATSUI. Well, if that is correct, then two companies accounted for 40 percent of 11 percent of growth. Is that correct? So, if those two companies had not had that kind of growth——

Mr. PIÑERA. No, I have not done that calculation.

But, if so, those two companies are two of the largest companies in Chile. They are private companies. They have performed so well in the market. So, I definitely do not see the point.

Mr. MATSUI. No, no, I appreciate you being honest about this.

So, two companies attributed to 40 percent of the growth of the fund. And if those companies had faltered, perhaps the fund would not have performed the way it did—but I appreciate that because that shows the kind of risk that we are talking about, and this system is the final safety net. This is the one thing that obviously keeps that senior citizen out of poverty—now let me just ask the last question.

Mr. PIÑERA. Just 1 minute, sir, I have not said that I accept that judgment.

Mr. MATSUI. But you did say it is true.

Mr. PIÑERA. No, I said that I don't know.

Mr. MATSUI. All right.

Mr. PIÑERA. I said that I don't know. In principle, I believe that it is wrong, because the total amount that the funds can invest in the share is 25 percent of the fund. So, if they can invest a total of 35 percent of the funds in shares, I cannot see how two companies can be 40 percent. I think that is an arithmetic mistake.

Mr. MATSUI. I do believe that you said that, but I accept your ambiguity on this issue.

Let me just—well, my time has run out.

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Dr. Piñera, thank you very much for your testimony here today. Your expertise is very impressive, and I really appreciate your being here.

You said in your written testimony, and I am quoting now, "there is no economic issue facing the world today that is more important than converting unfunded PAY–GO Social Security systems into fully funded systems of individual retirement accounts."

Given that statement and your experience and philosophy, I was wondering if you could comment on the competing proposal out there, the President's proposal, that would have the government invest in equity positions in the capital markets?

Mr. PIÑERA. Well, first of all, I have the utmost respect for the President of the United States, and second, I am very grateful that the President invited me to speak at the White House summit.

So, having said that, I believe that that proposal is very bad. I believe that is going backward to the time when government owned shares in the businesses of the country. I believe that the whole world is going in precisely the opposite direction. Government is taking care of problems of crime, equality of opportunity, but not government investing in the markets. I would not go so far as to say that is socialism because socialism is the complete ownership of collective assets. But that is clearly a step in that direction.

And so, as a Chilean, I am astonished that a country like the United States would propose that the Federal Government own shares and vote those shares in shareholder meetings of business companies.

Mr. RAMSTAD. I would just respond, Dr. Piñera, that you are in good company. Several weeks ago, our Federal Reserve Chairman, who is highly respected, Alan Greenspan, sat in that very chair and said exactly the same thing that you just did.

Let me ask you another question in my remaining minute or two. You also said, in your testimony, that self-employed workers may enter this system if they wish, it is permissive. I have a high percentage of self-employed workers in my district. Let me ask you, are there incentives for the self-employed to establish USA accounts? And what happens if they don't? Is there a safety net for them?

Mr. PIÑERA. Yes, but let me be very clear, sir, that that is not a structure feature of the system. Twenty years ago we didn't have the enforcement power to bring the self-employed into the system. If I were doing it today, I believe that we could do it.

So, for America, for example, I would definitely include the self-employed in the new system as they are included today in the old system. So, that is a very distinctive Chilean characteristic because of the informality that was there 20 years ago. So, the self-employed can go into it, there is no special incentive to do it. They are free to do it or not. And there is a kind of welfare safety net for them also.

But I want to stress that in America, definitely if you go to a system like this, the self-employed should be included in the system.

Mr. RAMSTAD. Let me ask you a final question, Dr. Piñera. How high are the administrative costs for the USA accounts? I know David Harris will testify in a few minutes about the very, very low administrative costs in Australia. How about the Chilean experience?

Mr. PIÑERA. They are, today, around 1.2 percent of assets managed coming down, of course, because that depends a lot on the size of the economy, and the time the reform has been going on. Since Chile is a country of only 6 million workers, obviously, initially, the costs were much higher. But the long-term perspective is that those costs will go down definitely to a lower level than 1 percent especially given the enormous advances in information technology. This is an industry very intensive in processing millions of accounts. And, as we know, the technological revolution is allowing today to process information at very, very low costs.

Now, some people are confused, sir, on that because some people take that cost proportion out of the contribution, and it is generally that in a pay-as-you-go system. But in a fully funded system, you must compute the cost as a proportion of assets managed not as a proportion of the contribution. And in that it is today around 1.2 percent, and it should go down, and I believe it will go down more in the future.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman.

Welcome, Dr. Piñera. It is great to have you before our Committee again today and to hear more about the system that you established in Chile so many years ago.

I wanted to ask you sort of a big question, but before I ask you, I would like to have you review for me what you said in bits and pieces to other people about the retirement age issue. In our current system, we are having a big battle over whether retirement should stay at 65 years old. We have changed it so it phases into 67. It is a big issue here, as big as whether we should increase taxes to pay for our system, and that sort of thing. And I was wondering, could you tell me, once again, how the Chilean system treats retirement in a way different from the way we do?

Mr. PIÑERA. Of course. That is a very, very important question. I remember that when we were designing the system, I was always astonished by the fact that we allow, in our free societies, the political process the right to tell us when we should stop working or not. We have so many other free choices in our societies. You go into a supermarket, as we all do, and you have enormous choice. But, in terms of retirement, the political body decides a given year, 65, 62, 67.

What we did in Chile was basically to diffuse that issue by allowing workers to retire at any moment if they had accumulated enough money to fund a reasonable retirement benefit, and we define it as 50 percent of last wages. It could be 60. It could be 70. We said 50 percent.

And with that, you see, the whole issue has lost explosive force, because it is people, ultimately, who decide when they retire. We only keep the 65 for the minimum safety net. And if you want to access the safety net, you must work until 65. But if you are not accessing the safety net, you can retire at whatever age you want as long as you are going to be able to save enough to fund that annuity.

And this is very important, Ms. Dunn, because I have seen so many people who simply want to go on working after 65. They believe that they begin dying after 65 if they do not work. And in America, if they do, they are penalized very strongly by the tax system. In my country, basically they get the wage of their job and the money that they are retiring from their accounts. So, we have almost eliminated the concept of the retirement age.

What we do have is a concept of a threshold to retire your money. It is a threshold to retire money, not a threshold of age. And, with the incredible medical advances that are lengthening life in America and all over the world, I believe that this can be a very important issue because people at 70 or at 75 may want to work 1, 2, 3, 4 hours, and they should not be penalized for doing that precisely because they are adding to the labor force and contributing to the growth of the economy.

Ms. DUNN. And there is no earnings limit on them, either, like we have on Social Security?

Mr. PIÑERA. Oh, no.

Ms. DUNN. The question that I—my big question, it is big to me because you've viewed the American system for years now, and you have a special viewpoint from which you observe what is going on in our system. Would you share with us any thoughts that you have had on the kind of system that we could employ that would give the worker the maximum opportunity to invest in diversified assets and, therefore, through compounding be much better off than that worker is under our current system.

Mr. PIÑERA. Well, I believe that the concept that the President has proposed of a universal savings account is a great name. It is a wonderful name. The problem is that it is not universal at all. Because, by definition, as I understand it, it is a voluntary savings account, and I believe that the poorest workers in America do not have money at the end of the month to make voluntary savings, so the people who open a USA account will be precisely those who are not at the bottom of the income ladder, and they will get matching Federal funds.

So, if I could, very respectfully, propose something, I would say, keep the name. Keep the USA account name, I love it. But allow workers to put their FICA taxes into the account. And specifically, I would allow the worker to put the full worker contribution into the account.

As you know, the total contribution is 12.4 for old age and disability. We are not debating disability. Let's keep disability exactly as it is. In that case, the total contribution is 10.6, 5.3 the worker and 5.3 the employer. My suggestion would be, why don't you allow the worker to put the full worker contribution, 5.3 percent of his wage, into the USA account, and you keep the other 5.3 paid by the employer, to finance the transition. So, the employers finance the transition. That tax is kept for 10, 20, 30 years until all the elderly benefits that are promised are paid. The worker 5.3 percent goes in full to a USA account. I believe that in that case, the name will mean what it says. It will be universal. It will be truly a system of universal retirement or savings accounts for all American workers.

So, you have the name already. Put the money.

Ms. DUNN. OK, thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Welcome.

First, let me ask you about the investments because you used rather strong language about the President's proposal, and I don't think that you want to come across as doctrinaire. So, let's understand the Chilean system.

What percentage of investments are in government-issued securities? According to the report that we have from CBO, it is 41 percent. Is that accurate?

Mr. PIÑERA. Yes, sir. I would say, yes.

Mr. LEVIN. OK, and then, 17 percent are in mortgage bonds, correct?

Mr. PIÑERA. Yes, sir, private mortgage bonds.

Mr. LEVIN. OK, so that would be over half, close to 60 percent in those kinds of fixed securities.

Mr. PIÑERA. Yes, sir.

Mr. LEVIN. And then, it says that 28 percent is in domestic equities, and, because of global turmoil, that exposure was reduced by AFPs, Administradoras de Fondos de Pensiones, to less than—in Chilean equities, was reduced to less than 20 percent. Is that accurate?

Mr. PIÑERA. Yes, sir.

Mr. LEVIN. So, I think that everybody should understand that the contrast isn't so dramatic. These are funds that invest with some considerable conservatism. Isn't that true?

Mr. PIÑERA. Absolutely, sir.

Mr. LEVIN. So, there is a further restriction by the government on the investments, right? I mean, are these restrictions from the government or are they self-imposed by the AFPs?

Mr. PIÑERA. As I said earlier, sir, they are by law, and they are only ceilings.

Mr. LEVIN. OK, but there are ceilings.

Mr. PIÑERA. Yes, but——

Mr. LEVIN. So, AFPs can't do anything that they want.

Mr. PIÑERA. As long as they do not invest more than the allowed ceiling.

Mr. LEVIN. OK, so there are ceilings——

Mr. PIÑERA. Yes, sir.

Mr. LEVIN [continuing]. Imposed by the government.

Mr. PIÑERA. By you all, by the Congress, sir.

Mr. LEVIN. By the government.

Mr. PIÑERA. But not by the executive branch.

Mr. LEVIN. I don't care who does it. By the government. In a sense, that is a form of socialism, no?

Mr. PIÑERA. No, sir——

Mr. LEVIN. I mean in your language——

Mr. PIÑERA. No, no, sir. Socialism, as defined by the dictionary, is when the government owns businesses, productive activities. The means of the—the exact words, of course, of Marx, is the means of production.

If the government puts a ceiling on a portfolio of a mandatory retirement system, that is regulation. I would grant it all that that is a regulation. But we have regulation, and we should have regulation.

Mr. LEVIN. OK, so——

Mr. PIÑERA. But that is not owning the means of production, sir, at all.

Mr. LEVIN. And so, it is government regulation?

Mr. PIÑERA. Oh, yes. As traffic lights and many others.

Mr. LEVIN. All right.

Now, let me ask you—and I hope that others will get into that because, as I understand it, there were even more restrictions at the beginning.

Now, let me ask you about the percentage that goes for expenses of the investment. According to CBO, the fees and commissions consumed 23.6 percent of workers contributions in 1995 and reduced the average real rate of return over the period of 1981 to 1995 from 12.7 percent to 7.4 percent. Is that basically accurate?

Mr. PIÑERA. I am not sure, sir, because I do not compare commissions to contributions, but commissions to assets managed. As I said earlier——

Mr. LEVIN. Why don't you? I mean it is relevant to look at the portion of an employee contribution that goes for fees and commissions, isn't it?

Mr. PIÑERA. No, I believe, sir, that in the mutual fund industry in America, you will never see an ad where they say that the commission is this proportion of your contribution. What they say is that the commission is this proportion of the funds managed.

Mr. LEVIN. OK, I know, but that's what mutual funds advertise. But we are looking at the comparison of this Social Security system with the American Social Security system or any other.

What percentage of assets is consumed by the administration of Social Security?

Mr. PIÑERA. As I said initially, sir, 1.2 percent of assets managed. And I understand, sir, your anxiety, but the point is that a fully funded system is not the same as a pay-as-you-go, that is why, in a fully funded system, investment systems, like mutual funds, you always quote the commissions as a fraction of assets managed.

Mr. LEVIN. I don't have time—I would like you to dig out somewhere your understanding of what the asset-per-asset cost of Social Security is in the United States. And this 1 percent, is it 1 percent a year?

Mr. PIÑERA. One percent a year of assets managed.

Mr. LEVIN. So, over 20 years, it would be 20 percent.

Mr. PIÑERA. Well, yes, but each year, you get, sir, an 11-percent rate of return. So, you get an 11-percent rate of return, and you pay 1 percent for whomever is managing, and you are very happy with 10.

Mr. LEVIN. OK, but that 11 percent isn't guaranteed.

Mr. PIÑERA. No guarantee, only 19 years. No, no guarantee, but we have only had it for 19 years. But it is not guaranteed, sir, because the future is not guaranteed, regrettably.

Mr. LEVIN. Thank you.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Dr. Piñera, I thank you for the opportunity to inquire. I also especially want to thank you for your hospitality during our recent congressional delegation to Chile in investigating, among other things, this particular issue.

There are a couple of issues that I am particularly concerned about. Going back to Mrs. Johnson's question of a little while ago, what is the level of regulation of fund managers? How successful has your system of regulation been, and can you draw any conclusions from it that would be relevant if we were to set up a similar system of fund managers and a series of funds and give workers an opportunity to move their assets between those funds? What level and nature of regulation of those fund managers would be appropriate based on the Chilean perspective?

Mr. PIÑERA. Yes, sir. Here I would like to be much more careful because the level of regulation depends enormously on the state of each country's capital market. And definitely my country's capital market 20 years ago was completely different from the best, most sophisticated capital markets in the world. So this is an issue where definitely it should be different in America than in Chile.

Now, what we did in Chile was to be very conservative. As the gentleman, Mr. Levin, was asking me, and he was absolutely right, I took enormous pains at the beginning of our system to make it safe. Because when I went around the country discussing the new system with workers, they, rather than asking me, "Will we get 7, 8, or 9?" They were always asking me, "Is there any chance that we will lose our money?" You cannot enjoy a high rate of return if you are also afraid that you may lose all of your money.

So, the principle that I used, and I explained it on television, this is a very structural, even revolutionary, reform, but we did a very conservative, prudent execution.

So, at the beginning the regulation was very high. And it has been going down over the years with experience, with the working of the market. Even today, for example, I would say that there is more regulation than I would like. In Chile, I am on the record advocating a lifting of some of the regulation of the first years because inertia has been kept down.

But, very frankly, sir, beyond saying that in America there should be also some prudent rules of regulations, I would not go so far as to suggest a specific one because I believe that has to be done according to your capital market situation.

Mr. ENGLISH. It seems to me, from our previous discussions, that you have had a number of fund managers who have proven, over time, to be insolvent and have had their portfolio taken over and effectively broken up by the government. How has that proceeded? Has it proceeded to your satisfaction in Chile? And has Chile's system of regulation been able to shield individual pensioners in this manner?

Mr. PIÑERA. Absolutely, sir, because we set up a system in which there are two different legal and economic entities.

One is the managing company, and the other one is the pension fund. The money of the workers is here in the pension fund invested in a very conservative portfolio. The managing company only manages the pension fund and charges a commission, but it has no ownership, whatsoever, of the pension fund. So, if a managing company spends more on salaries than they get on commissions, the managing commission may lose its capital, but not a penny of the workers' money is touched because the workers' money is in a completely different legal and economic and financial entity. And that is why, during 19 years, not a penny of workers' money has ever been lost.

If a managing company has a problem, the supervisory body, our Securities and Exchange Commission, simply takes charge for 60 days of the fund and tells the worker, "100 percent of your money is there, choose another company." But, the problems of the managing company have nothing to do with the very safe situation of the pension fund.

And I advocate that complete separation—that is not the case in a bank, for example. In a bank the money is mixed because the bank offers a rate of return a priori. In our system, the rate of return is a derived rate of return—whatever the portfolio gives goes to the worker. And when you have that, the pension fund by definition cannot go bankrupt, because you are not making a promise of a rate of return. Whatever is the rate of return, minus the commission, goes to the worker. So the rate of return can fluctuate, but the pension fund, by definition, cannot go bankrupt as can a bank who is offering a given rate of return to its depositors.

Mr. ENGLISH. Thank you, Dr. Piñera. Thank you, Mr. Chairman.

Chairman ARCHER. Dr. Piñera, does the 11 percent average return include the commission, or is it 11 percent after the commission has been paid?

Mr. PIÑERA. No, it is before the commission.

Chairman ARCHER. Before the commission.

All right. Thank you. Mr. Watkins.

Mr. WATKINS. Dr. Piñera, good to see you again. It is always very intriguing to listen to you. I enjoyed the trip to Chile and visiting with a lot of the leadership. Also, I enjoyed visiting with some of the Chilean workers.

I have been watching the eyes and some of the faces of the people here as you explained the Chilean system. I think that, if we put it to vote, a lot of the young people here would like something like the Chilean system.

I might say that I did take a kind of sidestep out of the group and visited with some of the individuals on the street about the system in Chile. Overall, they had a strong feeling that they like the system. Like many of us, they would like the return on their investment to be even better. We understand that.

I think that for the next generation, we're all trying to find a way for them to have a high rate of return on their investment. Also, we need to make sure that our elderly feel secure if some structural changes are made along the way. I believe that is the real bridge that we have got to cross.

I know that there are some different ways to move into a structurally different system. I would like to ask you to mention and explain some of the transitions. Like you said, the glass is filled, is there a guarantee there, in the end, for those who participate? We know that right now there are about 93 percent that have opted to go into the new system and about 7 percent have remained in the present system. They had the choice. For those who make that choice to go in the new system, will they, in the end, have a minimum-type benefit? What are the guidelines for the minimum benefit? Would you mind going through—I read part of it here, also,—the three steps in the transition so that people might hear it?

Mr. PIÑERA. Well, yes. As I mentioned, sir, the first rule of the transition, I believe, that is extraordinarily important in America, is to guarantee the elderly that they will get their benefits. Because, as you know, sir, the Social Security system in America does not grant property rights to the elderly people. There is a 1960 Supreme Court ruling called *Nestor* v. *Flemming* in which the Supreme Court says that you do not have property rights over your contributions. In other words, the U.S. Congress can tomorrow change the benefit levels and the worker cannot say that you are changing something that is mine. So, in that sense, the elderly in America really do not have the total certainty that they will have forever their benefits. If you were to have a demographic crisis in the year 2010, 2015, or 2020, the U.S. Congress may decide—I hope not—but may decide in that Congress to slash benefits. And the elderly have no legal rights to their benefits. And this, I think, is very serious, because this is called a Social Security system, and I am not secure when my benefits depend on whatever is the political composition or the political orientation of a Congress of a year when I retire.

So, when we did it in Chile, the first thing, sir, was to guarantee the elderly, with a law, that their benefits would be financed by the government. That is, we basically gave them property rights over that benefit.

The second rule, and this is very important, is the choice between the old and the new system. I already explained that you move from one system to the other with a recognition bond. And the recognition bond, sir, is very important to people who are 45, 50, 55 years old because the young people were willing to move from the old to the new system even without a recognition bond. As they do in America—you are always asking young people in America, "Would you move to the new system even if the government were not to recognize—" and they say they would move tomorrow even with zero recognition bond.

But, someone who is 50 years old would have trouble deciding whether to move or not if you do not recognize his accrued rights under the old system. That is why we did this recognition bond procedure. I remember that Chairman Greenspan, to whom I explained this concept, testified to the fact that the recognition bond mechanism is a very safe and very sound mechanism to undertake a transition.

And the third rule, and finally, is that young workers, who have never been in the labor force, enter the USA account system. And this is important because we know that in 30, 40, 50, 60 years, whenever those who are still in the old system fade away, at that moment you will have one universal system of private, individual accounts with a safety net, with regulations by the state, but, basically, a fully funded system of individual accounts.

Mr. WATKINS. You do have safety nets all the way?

Chairman ARCHER. The gentleman's time has expired.

Mr. Cardin.

Mr. McNulty.

Mr. Jefferson.

Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman.

Dr. Piñera, I thank you very much for being with us again here in this country and for providing us with your testimony. And let me also applaud the accomplishments of the Chilean people. There probably is no other country in Latin America that has prospered and has done as well for its people in the last decade or so as has Chile. So, I think that we have to applaud them. And perhaps one of these days we will be able to work together in reaching a free trade agreement which has been discussed in the past.

I want to go through a little bit of the two systems that Chile had and now has a bit because, to some degree, I think what we face is somewhat different from what you encountered when you had the monumental task in the late seventies to reform your system. And I am looking more, at this point, at what the Congressional Budget Office sent us in terms of its analysis of some of the different systems out there.

In terms of Chile, they indicate that the system that was originally set up in the twenties got to the point where it was very poorly managed over the years, and the government had to constantly raise benefits to keep up. And by the late seventies, I am quoting, "the system's assets were gone, and it had become a pure pay-as-you-go system." Now, as you are probably aware, in the United States, we don't have a pure pay-as-you-go system. We have assets. Unlike the system that you encountered in the seventies, we have a surplus right now of some $100 billion this past year, and I believe that it is somewhere between $600 or $700 billion over what we actually need. And, as we continue forward for the next several years, we will get into the trillions before we start to draw it down. So, there is a difference there.

I was also notified by the CBO that there was a lack of uniformity in the Chilean Social Security system. There were over 100 different types of retirement regimes that as a result, I am quoting again, "total contributions by employers and employees in 1973 varied between 16 and 26 percent of wages." And that is far beyond what we have in our total contribution between employer and employee which is 12.4 percent. If we were to do that, we would have to tax American citizens beyond the 12.4 percent, something to the degree of another 3 percent on top of that. If we were to go to 26 percent, we would have to double the taxes that Americans currently pay into Social Security, which, of course, we are not going to do. So, what you faced in the seventies certainly is not where we are today.

And, as a result of those differences in the Chilean retirement regimes, you had extremely large differences in retirement benefits. "Some workers," and I am quoting, "could retire with a large pension at age 42, but many blue-collar workers could not qualify for retirement benefits until age 65. In addition, some, but not all pensions have automatic cost-of-living adjustments."

In 1955, the Chilean system had 12 active contributors per retiree, so 12 people were working for every person that was retired back in the fifties. By 1979, 25 years later, you only had 2.5 workers per retiree. Now, you went from 12 workers per retiree to 2.5 workers per retiree in 25 years. In 25 years, we are going to go from what is already not a good number—about 3 to 4 workers, to about 2 workers. But it is going to take us 25 years to lose 1.5 or 2 workers. In 25 years, you lost 10 workers per retiree. Obviously, not everybody was dying as a worker. I suspect that a lot of it had to do with the fact that a lot of folks were evading the Social Security system and going into the underground economy. We don't have that problem as you had then. In fact, I think that one of the real things that you saw in Chile is that the system had decayed to the point where not only was the government having to increase how much it would charge in taxes, contributions, but it was also finding fewer people participating. The end result is that by 1980, you had a deficit equal to 2.7 percent of your GDP for your Social Security system. In the United States, we currently run a surplus. So, it is apples and oranges.

But, if you were to take the model that Chile has, and I don't think that it is appropriate to do so directly, what you did was you took that system where you had 16 to 26 percent contribution taxes and you said, "OK, you only have to contribute 10 percent of your wages." This amount is much less than the prior 16 to 26 percent, so I can imagine that everybody said, "That's great." Then you add 3 percent on top of that for disability and the life insurance. That is 13 percent. Then I believe that you also—I indicated that the Chilean system then took the employer contribution which varied, I guess, from about 8 to 13 percent or above our 6.2 percent of employer contribution, and made that into a tax—not a tax, I'm sorry, you converted that tax into an employee increase in wages so that you wouldn't see a reduction in employee overall wages. So, the employer portion of the tax never went back to the employer directly. It went to the employee to make sure that the base of wages did not fall. So, in the end, you went from a system that went from

16 to 26 percent to a system that had 10 percent plus 3 percent, that's 13 percent, and then, if you include the employer portion that had to be put from taxes onto an employer to wages of an employee, that was another 8 to 13 percent. So, you went to a system that had about 10, 3, that's 13, and then if you add 8, that is 21 percent; if you add 13 it is 26 percent. So, whatever way you cut it—if we were to try to do what you did, we would have to increase the take that we get from employees from the total of 12.4 percent shared equally between employee and employer to something beyond that.

So, I think while you——

Chairman ARCHER. The Chair is constrained to tell the gentleman that his time has expired. Perhaps we may have time for a second round.

Mr. BECERRA. And I will conclude there, Mr. Chairman.

In other words, the point that I think that there is a difference between what the Chileans faced in the seventies and what we face today.

Thank you, Mr. Chairman, and thank you, Dr. Piñera.

Mr. PIÑERA. Don't thank me, if I have not been able to answer anything. So, thanks to you. [Laughter.]

Don't thank me, I wasn't able to——

Mr. BECERRA. If the Chairman would yield me some time, I would love to let you respond.

Mr. PIÑERA. Well, we Latins, we speak a lot.

Chairman ARCHER. I think that in fairness, the Chair should accommodate Mr. Piñera to respond.

Mr. PIÑERA. First of all, I want to thank Mr. Becerra about his initial comments about my country. And second, of course, you have taken a big interest in the issue.

But I, sir, will not try to—I will take the side of your President basically. That is, it is your President who has been saying that you should save your country's system. So, if you use words so strong as "saving the system," I imagine that you have some problem. So, your defense of no problem in America, by trying to compare it to whatever problem the Chilean system had, I really believe has been answered by your own President. That is, you, too, have a problem. Is it the same problem or not with Chile, that is completely irrelevant.

Mr. BECERRA. That's irrelevant?

Mr. PIÑERA. Yes. The level of the problem is irrelevant because what I am proposing is a solution. Because, for example, France has even a worse problem than the United States, so would it mean that this system would not work in France? No.

The degree of the problem is not something that impinges upon the importance and the benefits of the solution. It may have a lot to do with the transition. But you do have a problem in America. I do believe that a system of individualized savings accounts is much better than the one you have today.

And my final comment, sir, will be that, precisely because—and I do agree with you that your system today is not as bad as the Chilean system was. The only difference is that you have a window of opportunity to do this in a much less exasperated way as we had to do in Chile.

Mr. BECERRA. I agree with you.

Mr. PIÑERA. But that is not an argument at all for not doing. It is just precisely that you can do it better, and I admire, precisely, the leaders of your country that can pose a discussion like this 10 years before you begin to have the deficit so that you can solve the problem much better.

But, again, and I conclude, that has nothing to do with the fact that the best solution is universal savings accounts but filled with FICA taxes.

Mr. BECERRA. And I understand what you said. I just was saying that we have to be careful which templates that we use.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has more than expired. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and Dr. Piñera, I want to thank you for traveling here today to testify. You are very articulate and very enthusiastic about your program which has succeeded in your country. And I want to thank you for being here.

I find that as we look at the issue of Social Security—and, of course, our goal is not only to save Social Security, but to make it secure for the next three generations and beyond and all people, like my own parents, that are on Social Security today, our system is secure for them. You know, for these elderly and retiree, it is the new generation that is just entering the work force that has the most at stake in today's debate as we look for our solutions. And that is why your input is so important.

Of course, usually when we look at what are the solutions, everyone wonders how it will affect their own pocketbook when it is their turn to receive benefits. There was a national survey done last year, and they asked the 20-year-olds, a group that we call the X generation, what they thought about Social Security, and they discovered that more young people believe in flying saucers than thought that they were going to receive Social Security when it is their turn. So, there is also a question of confidence in whether the Congress and the President are going to work in a bipartisan way to save Social Security, and I hope that we do because that is the challenge that is before us.

As we have looked at Social Security and our own system—of course, we have looked at our own system and how it impacts individuals and their own pocketbooks, and we have seen some places where our own system discriminates. And, actually, we have an issue where there is a marriage penalty where a married couple often receives less benefits than two single people. And we have a story that is kind of part of the folklore about an elderly married couple that gets divorced so that they have more money to live on. And that is certainly something that we do not want to see.

The question that I have for you and your system—you know, where we have a system where sometimes in many cases where elderly, married couples receive less benefits than two single elderly people. Under your personal accounts, how do your personal accounts treat married couples? Do husband and wife in Chile, do they receive twice what one single person does under their circumstances? Could you explain how married couples are treated?

Mr. PIÑERA. OK. Well, it depends on whether both are working or not. If only one is working, when he or she reaches retirement, the law demands that he buy what we call a family annuity. That is, he cannot go and say, OK, we need an annuity for me, and if I die, forget the wife and forget the children. No. He must buy the package that is defined by law. That is called a family annuity so that if he were to die, the widow and the orphans will be completely protected. OK?

Now, if both of them work, both of them have their own personal account. And exactly the same situation happens. Now when both of them work, what happens is that when they reach retirement age, we give workers two payout options. One, the one that is chosen by most workers, is simply to transform the capital into an annuity for life so that they can live very quietly because they know they will always have that money.

But we do give them a second option that is very interesting, especially for married couples. That is that you can keep the money in the account and make what we call programmed monthly withdrawals. And they are programmed according to the life expectancy of the family.

The big difference is that in the second case, if you were to die a few years after you begin retiring your money, the whole capital goes to your heirs as inheritance. And this is very important, especially for a woman. You see, because in that case, the woman, let's say that she works, she can get her own annuity, maybe lower than the man because they live longer. I must recognize that, but I cannot change that.

But at the same time she can get an inheritance from the husband. So if the husband dies earlier than the woman, as they generally do, and the woman works, the woman will get her own annuity from her own personal account. And if the husband has chosen the programmed—withdrawal option, she will also get the inheritance of the husband's account, all those—everything he accumulated, if he purchased an annuity plan, does that—If he purchased an annuity plan, as I said, he must have a family annuity. In that case, if I remember well, the wives get 50 or 60 percent of the annuity. It depends on the family annuity plan.

He has some choice there, but he doesn't get—she doesn't get 100 percent, she gets, say, 60 percent of the annuity.

Mr. WELLER. And the children receive something as well?

Mr. PIÑERA. And the children under 18 receive, each one, 10 percent of the annuity of the husband.

Mr. WELLER. OK.

Mr. PIÑERA. You see, so it's a family—we protect the family. We do not allow individuals to say, forget the family. No. The family is an entity. So he or she must buy what we call a family annuity with the provision. But the beautiful thing again is that the other person can have also a personal account. And there is no penalty whatsoever—I am also very surprised in America that sometimes when the wife works and they both retire, there is a huge penalty on the married working couple.

And we do know that we are going to a world where both persons would probably work in the future. So you have basically a penalty on a married couple working. And that is something that is counter in treatment. Why you want to penalize people who want to work? We, on the contrary—we allow them to reap the full benefit of their savings, either in the form of the annuity or in the form of the inheritance if it is a monthly program withdrawal system.

Mr. WELLER. We're concerned about that marriage penalty, and there's one in the Tax Code as well.

Mr. PIÑERA. I know.

Mr. WELLER. Thank you, Doctor.

Chairman ARCHER. Mr. McInnis.

Mr. MCINNIS. Thank you, Mr. Chairman. Mr. Chairman, listening to the comments of our guest, the doctor here, reminds me of people that continued to fight at the turn of the century the need for buggy whips in buggies. We needed to preserve that industry even though times had changed. I think your program is excellent. And I don't understand why some of my colleagues fight success. I don't understand where the resistance to this is coming from.

I'm afraid that some of the resistance to what you're saying is coming as a result of people who are too afraid to admit that the past policies of this government under Social Security have been a failure. That our system is a failure. And that the egos—I think the egos of some of these people will not allow them to say: "All right, this has failed. Let's improve it."

But that's said, doctor. Let me ask you—I'm curious, what happens with the young worker, say a worker who is 23 or 24 and is injured on the job, so he has not had an opportunity to accumulate—or killed on the job—has not had an opportunity to accumulate any kind of savings? Then, in our country, for example, the kids can get Social Security benefits and so. How do you fund that? How do you fund those kind of things?

Mr. PIÑERA. Thank you for your first comment, sir. That is a very interesting question. I can explain the complement to the old age retirement system, to the passbook system, we ask every worker to buy a disability and survivor insurance that is taken as a group insurance by the company. That is, the moment you enter into a company, you put 10 percent into the passbook, and you put another one-half of 1 percent or a little higher, and this company then makes a bidding process with an insurance company to insure all the workers affiliated with this company for disability and survival.

So if that worker were to die at 28, the insurance company will have to give his widow a disability—a survivor pension. If he were to become disabled, he will get for life a disability pension. In other words, we have complemented an old-age retirement system with a disability system, but a disability system that is also with the same logic of market discipline.

And this is very important, sir, because traditionally my country and as I understand, in many countries in the world, even though every decent people wants to give a disability pension to someone who is really disabled, and as high as possible, there is enormous fraud because disability is a gray area. In some cases it is very clear. But in some cases it is a gray area. And in some countries there is enormous abuse and fraud in terms of disability.

What we do in Chile, the disability is not decided by a government official, who has every incentive to give away the benefit because he is not paying it, of course.

Mr. MCINNIS. Yes.

Mr. PIÑERA. So he feels very good, very well, giving away the disability benefit paid by the taxpayers. The disability decision is made in Chile by a board of six members: Two representing the worker, who are members of the company, two representing the life insurance company, that is trying to see whether the person is really disabled because they will have to pay—and if they disagree, they do not disagree if the person is totally disabled——

Mr. MCINNIS. Yes, I know.

Mr. PIÑERA. If they disagree because it is basically a pain in the back, then they go to two deans of medical schools, who settle the issue. The disability rates have gone to less than 50 percent of what they were before because nobody dares to abuse the system when they know that there will be a countervailing force of someone saying, "Let's look very closely whether you are disabled or not."

I remember I explained this only some months ago to the Italian Prime Minister, and he was very happy because Italy has just done a study, and do you know, sir, that they found something like—I don't remember—it's 500 or 1,000 people who were having disability payments for blindness but they arrived to collect the check driving a taxi. In Italy they have blind taxi drivers. [Laughter.]

And Mr. Prodi told me this extraordinary abuse, but some political official is a friend of that person, and the person simply, when the exam is done, he says I see nothing. OK. A disability payment, paid by the General Treasury.

In our country, you see, the two representatives of the insurance company will follow the person, and if they found that he is driving a taxi the next day, he will not only be retired from his disability payment, but probably he will face some kind of—so it's very important also, sir, to really pay to the disabled all the amount that they deserve. I believe any decent person would like that, but also we must be careful not to accept abuse and fraud with general taxpayers' money as it happens in so many countries in the world.

I do not know in this country, sir.

Chairman ARCHER. Ms. Thurman.

Ms. THURMAN. Thank you, Mr. Chairman. Doctor, how are you?

Mr. PIÑERA. How are you?

Ms. THURMAN. I think I might be the last one unless they do a second round. First of all, I want to associate my remarks with some of my colleagues in thanking you for being here and the successes that you have had. And as you can tell, this is a lively debate between two parties as to where we think the reforms should go and the best way to go. And so we're really trying to understand the system.

I need to ask a couple of questions, and I happen to have been with you when we talked a little bit about the transfer. I want to understand because there was an important point that you made earlier about the fact that employers no longer pay into this system. This is now strictly up to the worker. Correct?

Mr. PIÑERA. Correct. But it is always the worker who pays the total FICA taxes. I know that in the law, people create the illusion that half the contribution comes through the worker and half from the employer. But really, every employer knows and you, Ms. Thurman, know very well that the total contribution ultimately comes from the worker productivity. Anyone who is an employer takes into account the total cost of the worker, and if the law says the employer must pay 6.2, what the employer does is basically take down the wage of the worker. So it has always been a total worker contribution. And what we have done is to make it transfer.

Ms. THURMAN. The issue here is that when you transformed into the new system, the employer was told by the government that they had to raise the wages to meet the percentage difference in what they were contributing before.

Mr. PIÑERA. Yes. You're absolutely right.

Ms. THURMAN. So they had to—the employer in some way does pay?

Mr. PIÑERA. Yes. We call it relabeling. I don't like the name. The government raising the wage. The government relabels the employer contribution as worker contribution.

Ms. THURMAN. But they said to businesses that they had to raise it by 11 percent or whatever that was. Correct?

Mr. PIÑERA. Correct.

Ms. THURMAN. So now the employee is paying into the system 10 percent of their wages. And then you said they have to buy a disability and a family plan. And that is how much then? And that's mandatory?

Mr. PIÑERA. Yes, that is mandatory.

Ms. THURMAN. According to our CBSs, it is about 3 percent.

Mr. PIÑERA. Two point five. The final is 2.5, and yours is 2.4. So it is incredibly similar, the total amount.

Ms. THURMAN. OK. So kind of back to one of the questions that was asked earlier. On the disability part of it, while we have a distant system with workers' compensation and other things, but in the disability part, if a member of the family is injured—the wage earner is injured—or they die, and there is a disability and they die at a very young age, how are those payments made? And who picks up that cost? Is it a risk shared across their whole portfolio or everybody else's portfolio? How does that work for the worker and his family? And how do they receive those benefits? Do they buy it through an annuity? Do they get a monthly stipend? What happens there?

Mr. PIÑERA. They get a monthly benefit for life paid by the insurance company that has been receiving the premium. So if the disability comes, the insurance pays the disability. It's like any insurance. Basically, we have transformed the disability system into a private insurance system, but mandatory.

Ms. THURMAN. OK.

Mr. PIÑERA. But let me be very clear that in America, I believe, because of other reasons, that you maybe should keep the disability system as it is today for a second reform. I believe that it is much more logical to address the problem of the old-age retirement system, that is the 10.6 percent, and that's why my proposal very definitely is, allow workers to put the full 5.3 percent FICA tax that goes to old age in what President Clinton calls the USA accounts. And you will immediately have the next month workers accumulating real money in their account, with 5.3 percent of wage. Keep the other 5.3 as employer contribution to pay the transition cost, and keep the disability system exactly like it is until you decide to reform it later.

Ms. THURMAN. I have one more question. I need to know what happens to those self-employeds, that their businesses fail when they are reaching older age. I mean, does the government pick up a pension plan for them? Do they become kind of wards to your country? I mean I don't understand what happens to this group of folks out there.

Mr. PIÑERA. Well, as I said before, the self-employed were not covered by the old system precisely because of an enforcement problem, and therefore they were not covered by the new system. So that is not the difference in Chile. But it is here they are covered by the old system, you should cover it in the new system. So really, for America, it's not very relevant because really I would suggest this strongly that you keep exactly what you're doing today. The self-employed in America must pay the total 12.4 percent. So you simply keep the self-employed paying the 12.4 percent, but with a difference that now a fraction of that, 5.3, would go to an individual or to a USA account.

Ms. THURMAN. Thank you.

Chairman ARCHER. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Dr. Piñera, I appreciate your testimony today. It's been very informative.

Who were the major opponents of your Social Security reform? And what were they saying? And where are they today? Can you give me a little list?

Mr. PIÑERA. Yes, sir. I would say definitely that there were two groups. One basically of people disinformed, people who wanted explanation. And I believe that is a very legitimate thing. So as I said before, I did an extraordinary effort of education and communication. And even though at the beginning some trade union leaders were worried, when I visited them and I went for a full year explaining them, at the end of the day they were all in favor. And they are all in the passbook system. Because if you have 93 percent of people there, by definition, all the workers and the trade unions carry a passbook.

The second group that I never was able to convince, because you cannot convince them, are the vested interests. And who has a vested interest? Basically, the bureaucracy that manages these billions or trillions of money in a way that does not respond to the direct interests of the people. The bureaucracy, you can have no argument, because at the end of the day it is true that you are taking their job away.

Now I do believe that they can find a job in the private sector, but some people prefer to keep their job in the old institution forever. So I must confess that the—not everyone, huh, not everyone, I want to be clear—but I would say that the people who had the power of taxing the worker for one-eighth of its wage, one-eighth, 12.4 percent, is a huge taxing power, is a huge power to control.

Well, those people didn't want to give it away. So it was not a matter of argument; it was not a matter of the technical point of disability or whatever it is. But why I am so optimistic, sir, is that a representative of the people, the Congressmen, in the last 8 years have approved completely the system. There is not one party in Chile, represented in the Chilean Congress, that is advocating dismantling the system.

So the representatives of the people have adopted the system, have confirmed the system—of course are always debating how to improve it. I do believe, sir, that every system can be improved. My system is not perfect. It would be incredible arrogance to believe that you cannot improve it. It can be improved.

So the real, sir, sirs, force against this is those who do not want to lose the bureaucratic power because at the end of the day, this is a process of decentralizing power from the bureaucracy to the people.

Mr. LEWIS. I think you really hit the nail on the head. We've had testimony here before us that, from those who feel like that the American people just wouldn't use their hard-earned dollars wisely if it was left up to them to make individual choices. And I disagree with that. I think the American people are really capable of using their money in wise ways.

Thank you.

Mr. PIÑERA. Thank you, sir.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman. Mr. Piñera, it is an honor to have you before our Committee. I had the privilege of listening to you twice now in Chile and now it's nice to see you here in our Ways and Means room.

In looking over some of the figures and statistics that are out there, both from the Congressional Budget Office and also from your statement, I draw from your statement that the mandatory minimum savings level of 10 percent was calculated on the assumption of a 4 percent average net yield during the whole working life so that the typical worker would have sufficient money in his USA to fund benefits equal to 70 percent of his final salary.

Now, of course, you've exceeded that. You talked about 11 percent. In looking at our own stock market, the Standard & Poor Index, if you had invested in that over the last 5 years, you'd be looking at 18 percent, which means that the opportunities are absolutely tremendous out there.

I also want to compare our system, in which we have 12.4 percent being paid in, shared by the worker and the employer, in contrast to your 10 percent, I believe. And I understand that's split between the employer and the employee also.

Mr. PIÑERA. No, it is paid by the worker because as I explained, it's just a matter of how you label the contribution.

Mr. SHAW. OK. But we've got 12.4 percent and you've got 10 percent, and where your worker is receiving 70 percent on the average of what he or she has paid?

Mr. PIÑERA. Yes.

Mr. SHAW. Ours receive 42 percent. So how in the world can we stick with our existing system knowing that it's headed down the tubes, knowing that our grandkids are going to be paying about 40 percent of what they earn just to take care of their parents. And when you look at the great opportunity we have to get so far ahead of the curve so that we can actually compete with the results that you have produced for your country of Chile—I say that just as an opening statement to you and how much we appreciate your bringing your experience to the table.

I have two questions. One is, what is the qualification of somebody to become a manager of a fund? And the second is, what would you change about the Chilean system if you were the architect of the American system?

Mr. PIÑERA. As I said, the principal of a private individual account with a safety net, and with some degree of prudent American regulation is a universal idea that can be applied in the United States, can be applied in Chile, has been applied in seven other Latin American countries already that have followed Chile: Argentina, Peru, Colombia, Bolivia, Salvador, Mexico and Uruguay.

So this proves the point this is a universal idea. It will be applied in March of this year in Poland—Poland, the former Communist country only 8 or 9 years ago—in March of this year it is beginning a partial system of individual private accounts.

A system like this was presented by the U.K. Government precisely by my friend Peter Lilley some years ago as the basic pension plan, a very good plan that Peter, of course, would explain to you. So this is a universal idea.

What I would change, sir, in each country is, as I said, the degree of regulation. I believe that your capital markets are so much ahead of what they were in Chile that you can provide workers more, maybe much more, choice. You can provide them—you see, today you can even invest by the Internet. I have seen, you see, programs that allow workers to choose their portfolio in the Internet. There is a company, Financial Engines, with a Nobel Prize winner devising portfolios adequate to every person's preference about old age.

So regulation, sir, is something that I believe should be studied, definitely according to what is the American sophistication of capital markets. But the basic principle, I want to emphasize once and again, that it's exactly the same. A USA account with FICA taxes, not a voluntary one because that is not universal by definition. In order to be universal, it has to be with FICA taxes so that the poorer worker in America, the person who is making the minimum wage and who is contributing 12.4 percent to Social Security can also have a USA account.

So that would be, sir, my respectful suggestion for the United States.

Mr. SHAW. Very briefly stated, what is the qualification of your managers?

Mr. PIÑERA. Oh no, the qualifications are prudent-man qualifications, a given amount of capital, some track record of never having any fraud. They are the same types of qualifications probably you put in America for anyone who wants to enter the financial industry.

I discussed this issue with Arthur Levy, Securities and Exchange Commissioner, and we agreed very easily on the kind of qualifications that should apply in a case like this. It's not rocket science.

It's just prudent-man qualifications for someone who will manage financial resources of workers.

Mr. SHAW. Thank you.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman. I want to join, Dr. Piñera, in thanking you from the bottom of my heart, and I know I speak for a number of Americans, for what you've done, for the leadership you have done, and for the leadership that the great country of Chile has done in moving forward on this incredible problem that is facing so many of us, really throughout the world, and certainly is coming to a head here in the United States. So I thank you.

Some of the critics have brought up the concern of administrative costs. Some critics have indicated they are fearful if we were to switch over to a system such as you have in Chile that perhaps administrative costs could be as high as 15 or 20 percent. Now I'm quoting them. This isn't what I'm thinking. Yet I notice, I believe in your testimony you mentioned that your administrative costs were running between 1 and 2 percent—1.2 percent——

Mr. PIÑERA. The figure is 1.2 percent of assets managed.

Mr. HERGER. Of assets managed.

Mr. PIÑERA. It's so very important to define very clearly with what you are comparing. You see, the critics try to compare it with the total contribution as it is done in a pay-as-you-go system. But I believe they are comparing apples with oranges there. The real way to compare costs in an industry that is investing money is with regard to assets managed, and I repeat once and again, it is around 1.2, maybe 1.3 1 year, but around 1.2, 1.3 percent of assets managed.

Mr. HERGER. Of assets managed. I think it is interesting to note that back in 1940 our own Social Security Administration's administrative costs were equal to 74 percent of the benefit outlays at that time, which is interesting. I see they've fallen here recently to 9.8 percent. So even in the system that we're using, currently using, in our current Social Security system, our administrative costs are very high—just responding to some of the critics in this area.

Would you have any estimate of what it is that people are contributing? You mention 1.2 percent of the assets managed, and I really think that is the proper way to look at it, but would you have any idea what, if we were to try to switch from apples and oranges to apples and apples, what the administrative costs would be approximately?

Mr. PIÑERA. In America, much, much lower, sir. There are different studies that mention that it could be so low, maybe one-half percent of assets managed when the system is mature. Not at the beginning. Remember that at the beginning, the assets managed are very low. The first month is just the month's contribution. But in a steady state, that is when the system matures, I have seen some studies mentioning one-half of 1 percent.

But anyway, sir, I want to be, if I can make a point, I believe it's completely wrong to look at this on the perspective of administrative costs only. Let me tell you that many, many years ago I had an encounter with a car that was produced by East Germany. It is called the Trabant. You may not even know it. It didn't run very often, but was called a car, this Trabant. Now the Trabant cost very, cost very much money. You could not compare a Mercedes-Benz of West Germany with the Trabant of East Germany. Of course the Trabant is cheaper. The problem is it doesn't run. [Laughter.]

So people prefer a Mercedes-Benz even though it is a little expensive. So I prefer my money to be fully invested in the market, getting a rate of return of 5, 6, 7, 8, 9, 10 percent. I'm paying whoever is providing the service 1.2 percent. I have no problem of paying someone a price if it is voluntary. That is absolutely America. You pay a price if it is voluntary. So why this focusing on the price, on the cost? And not on the product?

It should be discussed in the context of the product. If you get 11 percent—let me be frank, I would be willing to pay 5 percent commission to someone who gives me 11 percent a year. And still I would be much, much better than with a 2-percent rate of return that is the Social Security rate of return in America. And zero percent for the young man who is entering today.

So the whole debate about administrative costs, sir, is a complete diversion. The important thing is the comparison between the benefits and the costs, as in everything. So that's my answer, sir. And finally, if anyone in America didn't like to pay 1 or 1.2 percent to a mutual fund, that person should stay with the Social Security Administration and pay a fraction of 1 percent because really the cost is very low, but the return is very low. In other words, if you want to buy a Trabant, you can do it, but why are you willing to prohibit all the rest of the workers of your country from buying a Mercedes? So that is my answer to those people about administrative costs, whenever they say, OK, stay in the old system: But why are you willing to constrain the freedom of Americans to invest what is their own money? We're talking about their wages; we're talking about one-eighth of their wages that you took away from them and put it in this pay-as-you-go, Bismarckian, 19th-century system.

Mr. HERGER. Thank you very much, Mr. Piñera. You have convinced me, and I might mention in my younger days I had a couple cars like you described. [Laughter.]

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Dr. Piñera, is it fair to say that when you transitioned from your old system to the new system, there was a slight tax increase for workers overall?

Mr. PIÑERA. No. Tax increase zero, sir. No, no, no. No tax increase whatsoever.

Mr. MCCRERY. Well, for example, when the former employer contribution was switched—labeled—again to salary for the employee, didn't he have to pay income taxes on that salary?

Mr. PIÑERA. No, because the money you put in the passbook is tax free. So it was tax free before; it is tax free afterward. So the 10 percent, you take it from your salary before paying income taxes. You make it harmless. And you put 10 percent here, your income tax base is 90. So it was tax free before, it was paid by the employer. When you relabel it, it goes on being tax free. So there is no tax increase whatsoever.

On the contrary, as we have already financed most of the transition, the former transition tax that was part of the payroll tax has been eliminated. That is the 5.3 percent that I am suggesting in America, that you should keep inside the system in order to pay the elderly, but after 10, 20, 30, 40, 50 years, you will have an extraordinary opportunity of beginning the reduction of that tax until the day will come when the last person who stayed in the old system fades away, when you will be able to eliminate that tax. And that will be something very good for the economy because it will have all kinds of growth effect because you are eliminating a distortion in the labor market.

Mr. MCCRERY. Would the 5.3 percent be paid by the employer or the employee or both.

Mr. PIÑERA. Excuse me.

Mr. MCCRERY. Would the 5.3-percent tax be paid by the employer or the employee or both? Transition tax?

Mr. PIÑERA. Today you have 5.3 paid by the worker, 5.3 by the employer. OK?

Mr. MCCRERY. Right.

Mr. PIÑERA. What I will do in order to make it simple, the 5.3 of the worker should go into the passbook—5.3 into the passbook immediately. The 5.3 of the employer is paying anyway to the Social Security Administration. He should keep paying it, for another 10, 20, 30, 40 years—paying the cost of the transition. And when the cost of the transition goes to zero, because some day it will go to zero in a system like this, if you ask the young people to go into the new system, at that moment, you can have a huge payroll tax reduction. In Chile, we already had that payroll tax reduction to zero. In Chile, the payroll tax is zero.

What we are debating now, is that since in the next years we will begin to have a budget surplus as elderly people go away, we are beginning to debate the elimination of the income tax, paid as a dividend of the Social Security reform. Because the day when the government does not have to pay benefits to the elderly except the safety net, that will be a very small amount, there will emerge a huge budget surplus. And there is beginning a debate there, and we are following Chairman Archer's leadership on that, and we are debating the eventual—the eventual—elimination of the income tax with extraordinary growth effect, and not only growth, also respect for the privacy of the individuals.

Mr. MCCRERY. Mr. Chairman, that's a good idea, I think, for us to follow. We ought not exact income taxes on payroll taxes, which our system currently does. So I hope we follow that example.

One more question. You talk about, in your paper, benefits being taxed when they are withdrawn.

Mr. PIÑERA. Oh yes.

Mr. MCCRERY. How are they taxed? Just at the ordinary rate at the time.

Mr. PIÑERA. At normal rate. You do not pay tax when you put the money in, you pay tax when you take it out.

Mr. MCCRERY. When you take it out—OK.

Mr. PIÑERA. You pay taxes as if you were getting the money from other sources. It is very simple. You don't pay when it's in, you pay when it's out.

Mr. MCCRERY. Are there private pensions as well in Chile?

Mr. PIÑERA. No. Basically none, sir, because 20 years ago, of course, there were very few people who could get private pensions. And therefore most of the population was covered by the Social Security system. I do know that in America you also have private pension, and that is another very interesting challenge to be resolved in America, but I have not studied it, but some of my colleagues are studying, how to combine, eventually, USA accounts filled with FICA taxes with 401(k)s, IRAs and so on because eventually if you were to combine all these accounts, the administrative costs of the whole system will go down very much. So that an individual, instead of having one 401(k), one IRA, one USA account, maybe he should have only one account with different provisions for taking out the money. Part of the money cannot be taken until retirement; part of the money can be taken for some and specific things, and so forth, and so forth. That is a challenge for your country to eventually, not in the first reform, I would say that is a second or a third reform, to eventually combine everything and make it very simple and very clear to the most common worker because something that has been, sir, a great help to the workers in Chile is the extreme simplicity of this system. The system is simple; it's a passbook. And you accumulate money, and that's it.

There is no small—there is no, you see, hundreds of difficult provisions for the worker to understand. The worker understands so easily. Saving in a passbook, and you can get the money when you reach retirement age or when you accumulate enough money to have an early retirement.

Chairman ARCHER. The gentleman's time has expired.

Mr. Collins.

That completes inquiry by all Members currently present. Dr. Piñera, thank you so much for taking your time to come and share with us your experiences in Chile. We have to learn from what has happened all over the world, and you've given us a good start. We are very grateful for your appearance today.

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

Chairman ARCHER. Buenos suerte.

Mr. PIÑERA. Buenos suerte, gracias. Thank you very much to all of you, sirs.

Chairman ARCHER. The Chair would like to take a recess for lunch and return at 1 o'clock for our next witnesses. So we will stand in recess until 1 o'clock.

[Whereupon, at 11:44 a.m., the Committee recessed, to reconvene at 1 p.m., the same day.]

Chairman ARCHER [presiding]. The Chair would invite Hon. Peter Lilley, Member of Parliament of the United Kingdom, to take the witness chair. And we're really happy to have you here with us. Thank you for bearing with us. I hope you got some lunch. I apologize for detaining you for an extra period of time.

M.P. Lilley is also Deputy Leader of the Conservative Party, I believe, is that correct?

Mr. LILLEY. That's correct.

Chairman ARCHER. And former Secretary of State for Social Security in the United Kingdom. We're happy to have you here today, and I think you understand the context of the hearings by listening to some of the former witnesses' testimony and questioning. So we'd be happy to receive your testimony with the encouragement that you limit as much as possible your verbal presentation. And if you have a written statement, without objection, the entire statement will be printed in the record. We're not going to keep a time limit on you on your verbal presentation, but there will be, hopefully, adequate time during the inquiry period to expand on whatever you would like to say. So, welcome, and we'd be pleased to hear your testimony.

**STATEMENT OF RT. HON. PETER LILLEY, MEMBER OF PARLIAMENT, UNITED KINGDOM; DEPUTY LEADER, CONSERVATIVE PARTY; AND FORMER SECRETARY OF STATE FOR SOCIAL SECURITY**

Mr. LILLEY. Mr. Chairman, it's a great honor to be asked to give testimony on this very important subject. In the context of a mature economy like Great Britain, which I think may well complement the evidence you've just heard from Chile and demonstrate that in a mature economy it is also possible to extend the benefits of personal ownership of savings and investment to millions of people to the advantage of the public finances.

Basically, there are only two ways of financing pensions. One is to tax in work and use the taxes and charges to pay for the pension of people who are already retired, with nothing being saved or invested for the future. And that's the process that is operated in most European countries. So that as they have an increasing number of retired people and a declining number of people of working age, the nightmare they face is the increasing burden of tax on their economy and their working population.

By contrast, in Great Britain, we put more emphasis on the second method of financing pensions, encouraging people to save and invest during their working life for their future pensions. We've done that by enabling people to opt out of one component of the Social Security pension—it's in two parts in the United Kingdom, a flat-rate basic pension, which is the same for everybody, and an earnings-related pension, which is related to the amount they earn and therefore pay in payroll taxes during their life—we allow people to opt out of that earnings-related pension into company pension schemes—and that's been allowed for a long time—and more recently into personal pension funds, which are a bit like your individual retirement accounts.

About 60 percent of people who are eligible to opt out of the state earnings-related pension do take advantage of that, some 8 million into company schemes and over 5.5 million, that's 10 times what we anticipated when we introduced the scheme into personal pensions. Those who do opt out of the state system, receive a rebate of their payroll tax, their national insurance contribution as we call it, to finance a private pension. And it's calculated as being sufficient to provide at least an equivalent pension to that which they would have obtained had they remained in the state system. And that rebate is paid directly into their private fund. So it is saved;

it is invested; it goes into industry; it generates the profits to pay for their pensions in 10, 20, 30 years time, when they will retire, without imposing a burden of tax on the economy, and meanwhile strengthening the economy through a huge accumulation of investment funds.

The United Kingdom has now accumulated British-owned pension funds amounting to $1.3 trillion. And that's not just more than any other country in Europe, it's more than all the other countries in the European Union put together have managed to save and invest to meet their future pension needs. So it puts us in a very advantageous position.

Now as a Member of Parliament, I often find myself on your side of the table, Mr. Chairman. When I do, I get rather restless about hearing people describe their successes, want to hear them talk a bit more about the problems that they had to go through. So I'll address straight away two problems which have affected our pensions system in the United Kingdom, the problem of misselling and the problem of the Maxwell theft of pension funds.

Both were major scandals. But it is very important to recognize that neither had any direct connection with our decision to let people opt out of the state earnings-related pension scheme into personal pensions.

Misselling was about unscrupulous salesmen persuading gullible investors to transfer funds from one kind of private pension provision, mainly their company scheme, the company fund, into a personal pension, not about opting out of the state system into personal pensions. Therefore, it is something which could, I think, happen in principle in other countries where there is no right to opt out of or receive an opt-out rebate from the state system.

That abuse only became possible because we changed the law which previously had permitted companies to make it a condition of employment that their employees pay a certain sum into the company pension scheme. And we liberated them so that they were free not to do that if they didn't want to. And it was at that stage that some people were persuaded to opt out of their rather good company schemes into less good personal pensions.

They may still have been better off than if they had opted back into the state scheme. But all of them are being compensated, and not one of those investors will lose a penny as a result of it.

The Maxwell scandal had even less to do with our system of allowing people to opt out of the state scheme, when Robert Maxwell, a former Labor MP, a millionaire, stole £450 million from the pension funds of the companies he controlled. They were set up long before our present arrangements and had nothing to do with it. But it did reveal that there was a weakness in our regulatory system of how such company funds were regulated and protected. We since addressed that and made them more secure.

What is remarkable is that the Labor Party, who traditionally believe in a pay-as-you-go state Social Security provision and used the two scandals I have just referred to to try and denigrate the system that we put in operation of encouraging private provision, were forced to change their mind because the system of private pension provision, allowing people to build up private funds, were so popular and the system has so many clear advantages for the public finances, that there is now a consensus between the major parties in Britain that we should go further in encouraging to opt out of the state system and, where it is beneficial for them, into personal or private provisions of one kind or another.

Indeed, the new government has just proposed that in about 5 years time, anyone with an income above £9,000 a year, that's about $15,000 a year, is likely to find themselves excluded from the state system. They would have to have a private-funded pension. So it shows that is a system which has broad acceptance in the United Kingdom.

I regret that they haven't gone further than that and taken up the plan I announced when I was Secretary of State for Social Security. And that was that all young people newly entering the labor market should automatically be required to have their own individual savings account, a bit like that described by my friend José Piñera. They would receive a rebate payable into their—sufficient to pay, not just for their earnings-related pension but the basic state pension as well.

So that over a generation, as the young people displaced older people who had retained the present system, we'd move from a system of financing pensions partly out of taxation to one where it was all funded by savings and investment. And that would bring about the largest extension of personal ownership of wealth that we've ever seen—greater even than that resulting from the spread of home ownership. It would mean that in the future, pensioners would participate directly in the wealth and prosperity of the economy. It would give a massive boost to the economy by boosting savings and investment. We calculate that if that extra savings, which would be huge, were to increase the rate of growth of the economy from its estimated 2.25 percent by one-twentieth of 1 percent, to 2.3 percent a year, the whole system would be self-financing because the extra growth would generate extra tax revenues to make good any shortfall due to the rebates from the state system.

So in short, we believe Social Security reform is about much more than saving money for improving the public finances. It should be about spreading independence, wealth and security to everyone, including to those individuals who in the past have not enjoyed that. And Britain has, I think, shown that that can be done, even in a mature economy.

Thank you.

[The prepared statement follows:]

**Statement of Rt. Hon. Peter Lilley, Member of Parliament, United Kingdom; Deputy Leader, Conservative Party; and Former Secretary of State for Social Security**

"There are only two ways to finance the pensions of future generations of retired people.

The first is to rely on taxing those who will be in work to pay the pensions of those in retirement.

The second is to encourage people to save and invest during their working life to pay for their future pensions.

Most European countries rely largely on the first method.

Almost all their pensions are paid out of taxes and charges on those in work. This year's taxes are used to pay the pensions of people already retired. Nothing is saved or invested for the future. It is pay as you go.

So as the number of retired people rises and the number of people of working age falls they face an increasingly onerous burden of tax on their economies. That is the nightmare facing most finance ministers in Europe and elsewhere.

By contrast the UK has persuaded the bulk of people to build up pension funds for retirement. It allows and encourages them to opt out of the State Earnings Related Pension Scheme. Over 60 per cent of those eligible do opt out. They receive a rebate of their payroll tax which is payable into an occupational or personal pension. So their money is genuinely saved. It is invested. It goes into industry to earn the dividends which will pay their pensions in ten, twenty, thirty years time when they retire—without imposing a burden of tax on the economy and meanwhile strengthening it through a massive build up of investment.

The total value of British owned pensions funds is now some £830 billion. That is $1.3 trillion.

That is not just more than any other country in Europe. It is more than all the other countries in Europe put together have saved and invested for their own pension needs. As a result, the IMF calculated that if countries maintain their present systems—by 2050 France and Germany would have accumulated government debts nearly twice their national income. By contrast the UK would have paid off its entire national debt and accumulated a surplus.

Let me explain how the UK system works to bring this about.

The Social Security System provides for a two tier pension. The first tier is a flat rate basic pension. Every employee earning above the minimal threshold at which payroll tax (known as National Insurance Contributions) becomes payable earns entitlement to this basic pension. It is currently worth £64.70 per week for a single person and £103.40 for a married couple and is uprated each year in line with inflation.

On top of that employees also earn entitlement to a State Earnings Related Pension. As its name suggests, the pension entitlement is proportionate to earnings.

SERPS pension rights accruing each year are proportionate to eligible earnings. Eligible earnings are those between the Lower and Upper Earnings Limits. The Lower Earnings Limit is currently £64 per week, while the Upper Earnings Limit is £485 per week. (People pay a National Insurance Contribution on their earnings between those limits.) Employees with earnings between those limits for 40 or more years will receive a State Earnings Related Pension (on top of the Basic State Pension) equivalent to some 20 per cent of their average eligible earnings.

Since SERPS was established (in 1978) provision has been made for some employees to be opted out of the scheme. Employees who are opted out are entitled to a rebate of their payroll taxes (which we call National Insurance Contributions). This rebate is payable only into an approved pension scheme. It is paid direct into the pension scheme and cannot be spent on anything else by the employee.

The rebate is set at a level which is calculated to be sufficient to ensure fund mangers can invest to provide for an at least comparable pension. The rebate is currently set at 4.6 per cent of eligible earnings. The Government Actuary calculates that this will be sufficient to generate a fund sufficient to buy an annuity on retirement equal to the SERPS pension. He assumes investments will yield 4.25 per cent per annum in real terms.

Initially, the possibility of opting out existed only for members of occupational pension schemes provided by employers. Employers take the decision as to whether their scheme and all its members should opt out of the state scheme. Most did choose to opt out.

Typically employers running such schemes paid contributions into their scheme and usually required employees to do so as well (on top of the rebate from payroll taxes/national insurance contributions).

In 1986 the Conservative government gave employees who were not opted out of SERPS through membership of an occupational scheme the right to opt out of SERPS into an approved Personal Pension scheme. These were something like Individual Retirement Accounts in the USA.

Anyone opting for a Personal Pension is entitled to a rebate from their National Insurance Contributions. This is payable direct into their Personal Pension. So it can only be used to fund a pension not spent on *personal* consumption.

Five and a half million people have taken out approved personal pensions. These are in addition to more than 8 million who are members of opted out occupational pension funds.

People are of course free to put more into their private pensions than just the rebate.

*Problems.*

I imagine the Committee will be at least as interested in the problems we have had to tackle as in the success of this approach.

The first problem was the problem of 'misselling': pension salesmen selling personal pensions to people who had a better alternative. This was *not* the result of giving people freedom to opt out of the State Scheme into personal pensions. The initial rebate was set at a level sufficient to ensure that it could fund a personal pension which was better than the State scheme.

The problem arose from a separate change introduced at the same time. This was the decision to give employees the right to opt out of company pension schemes. Prior to 1986, employers who ran occupational pension schemes could make membership of their scheme a condition of employment and deduct from employees' pay at source a premium payable into the fund. Most employers with such schemes did make membership obligatory for those eligible to join. Typically, they made employees pay pension contributions of up to 10 percent of salary and many added a similar sum themselves.

From 1986 employers could no longer force employees to join their scheme. If employees wished they could leave the company scheme and take out a personal pension. If they did, their rebate of National Insurance would be automatically transferred to the personal pension fund. They could also pay into their personal pension the premium previously deducted from their own salary. But most employers would not pay into the personal pension the matching amount they had been paying into a company scheme.

So anyone foolish enough to move from a generous company scheme to a personal pension fund was almost bound to lose out. Nonetheless, many were persuaded by unscrupulous salesmen, paid on commission, to make this change.

Many employees were allegedly confused by government advertising extolling the virtues of opting out of the State scheme into personal pensions. They assumed that the government was also recommending them to opt out of company pension funds into private pensions.

In fact from the start legislation required salesmen to make sure their product was appropriate to their customer's circumstances. Consequently it was invariably illegal to missell in this way. The Regulator has therefore required companies to go through their files and reimburse any customer who was missold a pension in this way.

This is a massive exercise. However, the Regulator has given an assurance that no-one who was missold will lose out at the end of the day. They will either be reinstated in their original scheme or compensated.

The second problem was a massive theft from a company scheme. In 1991 Robert Maxwell (a former Labour MP and head of a complex business empire) was found dead leaving up to £450 million missing from the pension funds of his companies. The pensions of 30,000 people seemed to be at risk. In the event, sufficient monies were recovered to ensure all pension entitlements will be paid in full. Nonetheless the theft revealed apparent weaknesses in pension fund security. A new framework was therefore established to ensure that adequate funds are in place and that they would be safe in future. In the last resort, a compensation fund would make good any shortfall due to fraud.

*Public Acceptability.*

In the UK the Labour Party has traditionally favoured state funded, pay-as-you-go pension provision. It was grudgingly prepared to allow company schemes to opt out of the State Earnings Related Pension scheme. But it was critical both of the principle and the practice of allowing individuals to opt out of the state scheme into personal pensions.

The emergence of the misselling problem and the Maxwell scandal gave them ammunition to fire at private funded pension provision. Despite that, the growing public popularity of private pension provision, coupled with increasing awareness of its long-term benefit to the public finances brought a gradual change of heart. Labour now plans to encourage more people to build up private funded pensions.

Consequently, there is now more of a political consensus in Britain that private pension provision is a success; and that where possible more people should be enabled to opt out of the state system.

*Proposals to Extend Private Provision of Pensions.*

Before the last election Conservatives were seeking ways to extend private pension provision.

In the late 1980s we gave members of company schemes the right to save more than the standard amounts required by the company. Employees could make Additional Voluntary Contributions into their fund up to a certain amount out of income tax free.

The then government also consulted on the idea of closing the State Earnings Related Pension Scheme. That would have meant everyone would in future be opted out and pay obligatory premiums (rebated from National Insurance Contributions) into personal or company schemes.

However, the government was persuaded that this would damage the position of the low paid and those with variable patterns of employment (as well as putting an increased burden on businesses).

Because the SERPS scheme is earnings related, anyone on low earnings who opted out would receive a small rebate. This would be inadequate to cover the fixed costs of setting up and running a personal pension. The government therefore kept the State Earnings Related Scheme for people on low and intermittent earnings.

Within that framework the only way to enable more people to benefit from opting out is to reduce the costs and charges of running a personal pension scheme.

The government therefore encouraged transparency—requiring companies to publish their charges and costs in a standardised form. This would enable competition to drive down costs. In addition, regulations were streamlined especially for simple standard schemes. And new and small companies who are typically reluctant to set up company schemes (which have low costs) were encouraged to set up Group Personal Pensions. These are a form of personal pension, but the company can negotiate low charges for its employees by arranging personal pensions for them.

The Labour government is essentially going down the same route with what it calls Stakeholder Pensions. These will have fairly standardised terms and a ceiling on costs.

However, there is a limit to how far costs can be reduced. So such developments, welcome though they are, can only extend the attractions of opting out of SERPS a little wider. Many low paid would continue to find their rebates too small to set up a personal pension.

*Basic Pension Plus.*

Before the May 1997 General Election, I published a proposal which involved a radical step forward to enable all new entrants to the labour market to opt out of SERPS.

This would involve extending funded provision to cover the basic state pension as well as the earnings related pension.

Our Basic State Pension is flat rate. So if people are allowed to opt out of it and enabled to save for an equivalent private pension they must be given a flat rate rebate.

Such a flat rate rebate would enable everyone—even low earners—to cover the fixed costs of setting up a pension fund. So even low earners could then also opt out of SERPS and put their earnings related rebate, however small, into the same fund.

This could only come in gradually with the new generation of young people entering the labour market We therefore proposed a scheme called Basic Pension Plus.

It had three key elements.

First, *the personal fund*. Everyone in the new generation would have their own pension fund to finance their basic pension and more. They would choose an approved firm to manage it. They would own their fund. And any amount not used to pay for their pension could be passed on to their heirs.

Second, the *rebate*. They would receive a rebate from their National Insurance contributions. Over their working lives it would be sufficient to build up a fund big enough to pay their basic pension. The Government Actuary calculated that £9 a week would be needed. So people would receive a rebate of £9 a week (rising in line with inflation) paid into their fund.

The third element was the *Basic Pension Guarantee*. The State would guarantee that everyone would receive a pension at least equal to their basic state pension (increased at least in line with inflation). We called the scheme Basic Pension Plus because it would have been the Basic Pension, plus a fund, plus a rebate, plus a State Guarantee. Each fund should grow to provide the basic pension. If for any reason a person's fund was insufficient, the state would top up the pension it provides. So they would still get their basic pension. Everyone would be protected by the Basic pension Guarantee. No-one would do less well than under the present state scheme.

And everyone would stand to do better, if as we hoped, the economy and their investments did well. If returns are one per cent higher than assumed they would get a pension nearly 30 per cent above the basic pension. If the yield is 2 per cent higher, the pension could be over 70 per cent better.

So a person on average wages would build up a fund which should be worth £130,000 when they retire. That would be sufficient to provide a pension of £175 a week at today's prices. That is based on making the minimum contributions over most of a working life. But once everyone in work has their own fund they and their employers would be able and encouraged to save more in their fund.

We would phase in the new system of funded pensions gradually over a generation. Existing pensioners would not be affected by the new scheme and would continue to receive their state pensions (rising at least with inflation). Likewise the current working generation would continue to build entitlements to the basic state pension and be free to remain in or opt out of SERPS during the rest of their working lives. The new Basic Pension Plus system would apply to the rising generation—all young people newly entering work plus those initially aged up to their early twenties. They would receive rebates to build up their pension funds over their working lives. So it would take a generation to replace the present system. That means the impact on public revenues of the rebates needed to fund investment would grow very gradually over forty years.

In addition, we could halve that impact by reversing the timing of tax relief on pensions for the new generation. Under the current system contributions to pension funds attract tax relief but pension income is taxable. That system would have continued for the present generation. For the new generation covered by Basic Pension Plus, I proposed that pension contributions (including voluntary pension savings) be paid from net income and all pension income be *entirely tax free*. As far as the saver is concerned the new tax treatment was equivalent to the old one (except for the lump sum) if the saver's tax rate was the same in work and retirement. For the pension providers it should have been possible to make the new PEP style tax treatment far simpler and less onerous than the current regime.

This proposed change in tax timing, combined with the gradual phasing in of the new system, would make the impact on public finances quite manageable. The net value of extra investment would mount at only about £160 million a year. And eventually, it would produce massive savings in public expenditure reaching £40 billion a year. At its peak the net revenue forgone would be less than the peak cost of SERPS rebates, which we had already taken in our stride. It would be a fraction of the savings resulting from the UK's recent Pension Act which will ease the burden of state pensions by some £13 billion a year. And the extra rebates would be small relative to normal growth of tax revenues. Moreover, if the huge extra funds available for investment which would be generated by the scheme boosted economic growth by just a twentieth of one per cent the scheme would be entirely self-financing—though we did not take account of this in costing the scheme.

To summarise:

- Basic Pension Plus would come in gradually over a generation
- Everyone covered by the new system would have their own pension fund
- They would receive a rebate of £9 a week to fund their basic pension.
- They would be guaranteed to receive at least their basic state pension (protected against inflation).
- Employees would be opted out of SERPS and get a second rebate worth five per cent of their earnings to fund their second earnings related pension. Because everyone would have a fund they would be able and encouraged to save more on top.
- Anyone on average earnings paying in just the minimum contributions should accumulate a fund worth £130,000 by retirement, paying a pension of £175 a week in today's money.
- Everyone would stand to benefit from good economic and investment growth. An extra one per cent investment yield would generate a pension 30 per cent higher. The economy would be strengthened by a massive increase in long-term investment funds.

Ultimately the taxpayer and the economy would be relieved of the largest single item of public spending—some £40 billion a year. In short—British people would have been able to look forward to secure pensions, higher investment and low tax.

Chairman ARCHER. Thank you very much. That certainly gives us another perspective, which is very helpful. I'm going to recognize Mr. Shaw, the Chairman of the Social Security Subcommittee for inquiry.

Mr. SHAW. Thank you, and I'd like to echo the Chairman's appreciation for your presence here today.

Could you talk to us a little bit about your transitional period, going from the old system to the new system? And how long ago did you do that?

Mr. LILLEY. The system was made easier by the fact that we only introduced comprehensively an earnings-related element into the pension system at the end of the seventies and simultaneously allowed company schemes to opt out of that. We then moved forward and allowed individuals, who perhaps didn't work for a company which had a company pension fund, to opt out of the state system into personal pensions in about—we passed the law in 1986 and I think it became effective in 1988.

So it's over the last 10 years that we've seen the massive growth of personal pension provision by people opting out of the state system. And that obviously involved a transitional period, but it was one that was easily accommodated in the public finances and seems not to have been a issue really.

Mr. SHAW. Do you know, off the top of your head, what the average retiree receives as a percentage of his salary that he had when he retired?

Mr. LILLEY. Well the state earnings-related pension is designed that someone paying into it over their life will from that portion of their Social Security pension alone get a pension equal to 20 percent of the earnings that they've had during their life, uprated by the growth of earnings throughout the economy. And the basic pension actually doubles that on average. So the state system provides a pension worth about 40 percent of earnings when people worked.

That's obviously when people opt out into private pensions, by and large, they've done much better. So they get better pensions than they would do if they had remained in that basic state system.

Mr. SHAW. OK. Is that the individual savings accounts we are talking about?

Mr. LILLEY. Well, you have the option of remaining in the state scheme, with its two components.

Mr. SHAW. And that's 40 percent.

Mr. LILLEY. And that would give you about 40 percent.

Mr. SHAW. That's about what ours is. I think ours may be 42 percent, but it's close. What's the withholding rate on percentage of salary?

Mr. LILLEY. The——

Mr. SHAW. Paid into by the combined employer-employee contribution.

Mr. LILLEY. The earnings-related element, the bit that you're to allowed to opt out of into private IRA-type account, you get a rebate which is currently set at 4.6 percent of your earnings. And that amount is set by the government actuary as what he believes is necessary to provide you with a pension at least as good as you would have got if you had remained in the state scheme. And it assumes that the return on assets that you will get in the private sector is 4.25 percent more than inflation.

In fact, over the whole time this system has operated, the average return on assets has been nearly 10 percent more than the rate of inflation. And the average the last 50 years, since the war, in private company schemes has been over 7 percent more than inflation. So it's a very modest——

Mr. SHAW. So that the pension the retiree receives is greatly more than the state system, which is around 40 percent. So it's substantially higher than that.

Mr. LILLEY. They should be better. Yes.

Mr. SHAW. The previous witness testified to us that the Chilean model—it's about 70 percent as opposed to our 42 percent. And it sounds like your experience is somewhat similar.

Mr. LILLEY. Yes, it is in that direction. And of course, once people have a private pension fund, the equivalent of an IRA, then they can put in not just the rebate they get from the state, but any additional money they want to, if they want to have a higher pension still, and in increasing proportion. And people do that.

Mr. SHAW. And it sounds like the Labor Party supports what you're doing. They are going to actually expand it, not to the extent you want to, but they are expanding it.

Mr. LILLEY. That's correct. They have had to change their opinion because it's popular with the public.

Mr. SHAW. Perhaps that will happen here. Thank you.

Mr. LILLEY. In a democracy, the public often does influence politicians.

Chairman ARCHER. The Chair now recognizes the Ranking Minority Member on the Social Security Subcommittee, Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Welcome Mr. Lilley.

I just want to understand the system. There are two tiers. One tier is government financed, and the amount is $105 per week when one retires, and that's automatically guaranteed. And then there is the second tier, and one can opt a government plan, employer plan or an individual plan. I guess the individual plan is appropriate personal pensions. That's very British.

What I want to know is—and help me with these numbers because I'm just not quite sure whether these numbers are accurate or not. About 20 percent of a worker's APP, appropriate personal pension account, is consumed by administrative costs? Is that still a correct figure or has there been some improvement in that?

Mr. LILLEY. Nobody knows what the average figure is, but a figure of that amount has been suggested, about 20 percent. But that includes three types of costs. The costs of managing investments, much the same as you would experience here for managing a mutual fund, less than one-half of 1 percent usually of assets.

Then there is the cost of shilling, persuading someone to save more than the minimum, which the government lays down. And it is costly to persuade people to do things. We say in my country, pensions are not bought, they are sold. The figures you would get would be averaging that selling cost to people who have been persuaded to do more than the government requires.

And third, there is the cost of meeting the regulatory burdens, which we have imposed, which are quite heavy, and which we are not seeking to simplify to minimize those costs.

The government is proposing to put a ceiling equivalent to 1 percent of the assets invested. We tend, like Mr. Piñera, to think in those terms. So it would be a lower cost than the Chilean model.

Mr. MATSUI. But that isn't agreed to yet? That's a proposal being discussed? Is that right?

Mr. LILLEY. That's correct.

Mr. MATSUI. Approximately 40 percent of the workers in the APP at one time or another switch, I understand, into a different area, of mutual funds or whatever it might be. And there is a transfer fee there, I understand. But approximately every 4 years there is that transfer that occurs. What is the cost on that? Do we happen to know?

And that's a separate cost from the administrative cost?

Mr. LILLEY. Are you talking about transferring from a company fund into a personal pension fund or——

Mr. MATSUI. No. This would be within the APP itself. Apparently, participants would transfer into another asset area, whether it's equities or perhaps mutual funds. I understand there is a cost to that, but perhaps——

Mr. LILLEY. But all that sort of cost is included in the number you first quoted.

Mr. MATSUI. Oh. I wasn't aware of that because we have it separate here. So in other words, that would be administrative costs.

Mr. LILLEY. It's part of the administrative costs.

Mr. MATSUI. And then when one completes his work or her work, then you annuitize the account, and, I understand that it's an additional 10 to 15, up to perhaps 20 percent of the cost of the assets in that situation? Is that a correct number?

Mr. LILLEY. It's not a number I'm aware of or familiar with. There is a cost; I would doubt very much it is remotely as large as that.

Mr. MATSUI. Did you know what the number might be because, you see, one of the concerns, obviously, besides the issue of fraud, and I want to get into that if I have a moment, is the issue of what is the cost. In other words you have a maintenance cost, a transfer cost, and a cost to annuitize. I would just like to kind of get an idea of these costs. Let's say there's $100 in this account on retirement, what percentage of that has been used for all three of these particular areas?

Mr. LILLEY. Yes. You're right. It is an important issue. And clearly one wants to keep those costs to the minimum.

Mr. MATSUI. Oh, I understand that.

Mr. LILLEY. What we've tried to is say it doesn't matter particularly what the breakdown is as long as the total is assessed. We have moved to what we call transparency, requiring the companies——

Mr. MATSUI. Right.

Mr. LILLEY [continuing]. To report all their costs, all those you've mentioned——

Mr. MATSUI. I understand that.

Mr. LILLEY [continuing]. In a standardized form so that you could see in a personal pension what proportion was being absorbed by these costs if you kept it for a standard period of time and it behaved in a standard fashion.

Mr. MATSUI. I'm not suggesting anybody is trying to hide it. I know there's transparency; there has to be transparency. But I just wanted an idea of what the total cost would be. And you do not seem to be able to provide that total.

Mr. LILLEY. I can't give you the breakdown, but for example, the government actuary, when he's calculating what the rebate system should be in order to provide an equivalent pension, takes into account what he considers a fairly standard and typical level of costs, which I think is of the order of 1⅛ or 1¼ percent of return on assets, fairly similar therefore to what Mr. Piñera was talking about. And all those costs average out at different schemes over the life of——

Mr. MATSUI. My time has run out. I——

Chairman ARCHER. If you need to, we can come back on a second round.

Mr. MATSUI. Thank you.

Chairman ARCHER. The Chair will recognize Mr. Nussle, and you'll be the last to inquire before we recess to go vote.

Mr. NUSSLE. Thank you, Mr. Chairman. And I appreciate your coming to testify before us today. My curiosity is in the area of your country's savings rate. Do you calculate the personal accounts in the overall savings rate for your country? And the other part of that question is, have you seen over the period of time that you have instituted this more personal system, an increase in the personal savings rate for your country? As I understand it, that's one of our challenges here in the United States. I believe Chairman Greenspan testified that we are almost statistically at a zero for our savings rate for our country, which is alarming. And what I'm wondering is whether this has helped in the overall savings rate for Great Britain?

Mr. LILLEY. There certainly has been a recovery in the savings rate since we introduced it. But it would be very hard to say whether that is cause and effect or just something that happened at the same time. But the presumption must be that it certainly helped and didn't hinder the recovery of savings in Britain. I think they are better than America but still below some other countries. And we believe if we could persuade more of the population to save and invest in this way, that would be beneficial further to improving our savings and investment ratio.

Mr. NUSSLE. Do you have any statistics or figures to describe the amount of people that have supplemented the system, and have you been successful in persuading your citizens to invest or contribute in addition to the amount which is rebated from your government?

Mr. LILLEY. I think, from memory, something like 30 percent, but is a rising proportion save more than the minimum through appropriate personal pensions. And a substantially higher proportion, the vast majority, of those saving through company pension funds, save more than the minimum that the government lays down.

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

Chairman ARCHER. Mr. Lilley, if you will indulge us, we must go vote and then we'll come back immediately. And if it's not imposing too much on you, we ask you to remain and we will be back in a very short time.

The Committee will stand in recess until we can vote and return.
[Recess.]

Chairman ARCHER. We had two votes instead of one, and so it took longer than I had anticipated. Now Mr. Shaw, would you like to continue your discussion with Mr. Lilley so it can be part of the record?

Mr. SHAW. I learned as much as I need to, sir. So I'll just keep it to myself. [Laughter.]

Great testimony. I was talking to Mr. Lilley about the Chilean model, and whether—and he said they were sort of going along the same path without really realizing it. As he expressed, they developed theirs before the Chilean model became famous. I'm think I'm accurately ——

Mr. LILLEY. Yes. We didn't specifically model ourselves on Chile, and obviously the United Kingdom has a very different economy, starting from very different circumstances, and adopted a different, more gradualist route. I'm by temperament a gradualist. I prefer to do things step by step and buildup. In Chile, given the circumstances in which the Chileans found themselves, it was probably better to go for a big bang approach. That we were able to build up a growing proportion of people opting out of the state system, building up private pensions, the system became more and more popular and more and more people have done so, and eventually it's captured the political high ground and is now the consensus for both parties.

Mr. SHAW. The Chileans had a different form of government when they put this in place, didn't they, than the United Kingdom?

Mr. LILLEY. That's true, but it shows that it's not something that has to be done against the grain of public opinion. What it amounts to is giving people ownership of the wealth which they are creating and spreading out wealth more widely and harnessing the power of capitalism and compound interest to enable people, who otherwise would have mediocre pensions to have better pensions. Those things are rather popular in a democracy.

Mr. SHAW. You mentioned to me that it took 5 years in order to put this in place. You worked on it 5 years. Could you just give us a little bit of a briefing as to the steps you went through, the thought process, what happened, what we might expect, how we could manage to do this in less than 5 years?

Mr. LILLEY. I'm not sure that I mentioned 5 years. Perhaps I said something that was misinterpreted. We started the earnings-related scheme in 1978, and very early on gave people the right to opt out of that scheme into private-company schemes if they had them. And then in 1988, we introduced the right to opt into appropriate personal pensions, and then that's built up over a 5-year period or more to become a popular and established part of our pension provision in this country.

The next step that I was talking about would have been to basic pension plus, where people could opt out of the whole state provision and receive a much larger rebate and have a much larger fund for something we only came up with at the end of my 5-year period as the Social Security Secretary. We will have to get back to power, I think, to implement it.

Mr. SHAW. Thank you.

Chairman ARCHER. Mr. Lilley, if I might inquire on a couple of specific points. How do you pay for your basic pension system?

Mr. LILLEY. It's paid for through a payroll tax deduction, called national insurance contributions. And they're now roughly 10 percent paid by the employee, 10 percent paid by the employer—20 percent in all. But that covers much more than pension provision, it covers unemployment play, sickness pay, and some of it is used to finance health care. So it is only a portion of that that is used by the pension system and therefore rebated to——

Chairman ARCHER. Are you able to roughly isolate how much of it is required for the basic pension system?

Mr. LILLEY. For the basic flat-rate pension, we estimated that—in order to opt out, if you opted out and took a rebate, we calculated, the government actuary recalculated, a rebate of £9 a week would pay over a working life for a pension equivalent of a basic pension. But of course that has the advantage of compound interest and investment building up. It would be more than £9 a week that are currently being used to pay for the basic pension of people who have opted out.

Chairman ARCHER. But of the 20 percent, 10 on employer, 10 on employee, do you have any rough percentage that is required to fund the basic pension amount that you talked about?

Mr. LILLEY. It would be best part of half of it, I think.

Chairman ARCHER. The rest of it would be for sick pay and for health and other items?

Mr. LILLEY. And for the second pension for those who haven't opted out.

Chairman ARCHER. All right. And after you have let people opt out and you have also given them a refund, as it were, of what they have paid in, as I understand it, you are creating a void in the necessary stream of revenue to pay the current retirees. Now how did you handle that? How did you handle the transition?

Mr. LILLEY. We just accepted that there would be less revenue coming into the Treasury in respect to the people who opted out. And that led to the shortfall, the government got less revenues for a period, but in the long run, we all make far greater savings on the expenditures it will have to make on pensions. And that was possible within the government financings at the time.

Effectively, it was a tax cut, specifically going to pensions.

Chairman ARCHER. But for the short-term revenue gap, as it were, you simply drew on other revenues coming into the Treasury and used those to defray that shortfall. Is that a fair——

Mr. LILLEY. Yes. At the time when we introduced it, we were in a position not dissimilar to you, I understand, where you have a surplus on your national insurance funds. We had a surplus on government finances. And the government was in surplus overall, and therefore was able to do this with no great difficulty in the second half of the eighties.

Chairman ARCHER. And then how does the next layer of retirement benefits, which you mentioned, work? How much is required out of payroll? And were there any transition costs in that?

Mr. LILLEY. We haven't implemented that at all. If they move to a much more radical system, which I was talking about at the end—all we've done is allowed people to opt out of the earnings-related pension, and they receive a 5-percent rebate from their national insurance contributions.

Chairman ARCHER. So the next layer to increase retirement above that is paid for strictly by the worker on an independent basis? Is that fair to say?

Mr. LILLEY. Yes.

Chairman ARCHER. OK. Thank you very much. Mr. Collins, do you have any questions to ask?

Mr. COLLINS. Yes, sir. Just a couple, Mr. Chairman.

I might have missed this, Mr. Lilley, in your comments. The rebate for those who opt out, is it based on a percentage of the contributions that have been made over the years?

Mr. LILLEY. Yes, effectively, they are given a rebate equal to just less than 5 percent of their earnings, which would otherwise be being paid into the national insurance fund, instead is paid direct into their pension funds.

Mr. COLLINS. What I'm speaking of, though, is previous years contributions to the national insurance fund. When they opt out of that, is there any rebate there?

Mr. LILLEY. No. It's not retrospective. So that if for 10 years they've been in the state system, they would keep the accrued rights that they built up in the state system, and when they retire they will get modest pension for those 10 years contributions, but only from the point that they opt out that they get the rebate and get a personal pension instead of future accrued rights in the state system.

Mr. COLLINS. OK. I better understand now.

You mentioned some of the things you haven't implemented because you're out of power. Have there been any changes or proposals in the national insurance since you lost that power to the new power?

Mr. LILLEY. Yes. The Labor government has tried to echo some of our rhetoric about moving in the direction of more funded private provision and less reliance on the state. They haven't gone as far as I would have liked, but they have recently published a document called "Partnership in Pensions," which is encouraging. They see it as a partnership between private and state systems. The most radical proposal in it is that anyone earning more than £9,000 a year, $15,000 a year, will, from about 5 years time, pull it, effectively have to opt for a personal or company pension and won't have the option of a full earnings-related Social Security—they will have the basic flat-rate pension, but they will no longer be able to remain opted into the earnings-related element of Social Security.

Mr. COLLINS. They haven't reversed the trend that you started?

Mr. LILLEY. No, no. They have continued in the direction which we initiated and which they used to criticize vigorously. But they found it was both popular and clearly on closer inspection the right thing to do in the light of the public finances.

Mr. COLLINS. Very good. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Is there any further inquiry.

Mr. Shaw.

If not, Mr. Lilley, thank you so much for taking the time to be with us today. I think you've made a significant contribution to our learning process. And we hope to welcome you back to the United

States in the very near future or perhaps we might be able to see you over in London.

Mr. LILLEY. I welcome this either way.

Chairman ARCHER. We wish you well. Thank you.

Mr. LILLEY. Thank you.

Chairman ARCHER. Our next witness is David Harris, a research associate of Watson Wyatt Worldwide, Bethesda, Maryland. Mr. Harris, welcome. We will be happy to hear your testimony. We would—the Chair would strongly encourage you to make your verbal testimony as concise as possible, hopefully within 5 minutes, and your entire statement will be printed in the record, without objection. So you may proceed.

**STATEMENT OF DAVID O. HARRIS, RESEARCH ASSOCIATE, WATSON WYATT WORLDWIDE, BETHESDA, MARYLAND**

Mr. HARRIS. Thank you, Mr. Chairman, Committee Members. Thank you for the invitation. It is indeed an honor today to discuss the Australian retirement system, with particular reference to individual superannuation retirement accounts.

Before joining Watson Wyatt Worldwide to examine with my vice president and director, Dr. Sylvester Schieber, a number of countries' approaches to Social Security reform, I was a consumer protection and financial services regulator in Australia. The expertise I, thus, bring to you today is drawn not only from the Australian retirement savings experience, but also from our examination of retirement systems in Asia, Africa, Europe and the Americas.

What is striking about the Australian system is that the political pressures are the reverse of those in the United States. There is a Federal Labor government, a largely liberal leaning administration, who has established and extended individual retirement accounts in 1987 and again in 1992. This policy is not only supported by organized labor but also is actively encouraged by the leadership of Australian Council of Trade Unions. Businesses and consumer groups also back the changes.

Such a unified approach to reforming Australia's superannuation system, or pension system, was due to possible fiscal concerns about the impact of an aging population on Australia's economy in the future. Moreover, organized labor argued that the coverage of superannuation, which had been narrowly confined to a relatively affluent 40 percent of the work force, should also cover all workers through compulsory employer contributions.

The consensus was to create a retirement system with three distinct pillars. The first pillar is a means-tested, pay-as-you-go, unfunded, old-age pension. The full pension payments equate to 25 percent of male total average weekly earnings, with revenues being generated from Federal taxation and provided out of consolidated revenue. In recent years, this benefit has been means tested by strong income and assets tests, detailed in my written testimony.

The second pillar is a mandated individual account-based system which received 7 percent of the employee's salary today in excess of A$450 per month. The contribution level will eventually rise to 9 percent by 2002. Additionally, workers voluntarily can contribute an average of 4 percent on top of the 7 percent currently.

Largely these accounts exist on an employer-sponsored defined contribution basis. Workers can choose professionally managed equity or bond funds, fixed income securities, or a mix.

The third pillar, which sees again individual retirement accounts created on a voluntary basis with contributions largely received through savings rebates and taxation credits.

The superannuation model does not involve government control to any great extent, with regard to investing moneys on behalf of the individual accountholders. Except for the normal standards of regulation associated with disclosure and prudential solvency, effective competition between industry participants has effectively driven down fees and increased returns.

So that administrative costs today as a percentage of assets under management have fallen into the range of 69 to 83 basis points in 1997.

Contrary to what is often argued in the United States, even the small account holders in Australia can minimize charges and maximize returns. For women and disadvantaged groups, especially, regulation on superannuation or pension accounts have developed to take account of seasonal or broken career patterns. To reach these groups, the government had a rigorous program of public education, which began with those who need to be made aware of how to plan effectively for their retirement through individual responsibility. This point is noted in attachments 1 and 2, which are the public education material that I worked on as a regulator and in past life.

One of the other issues that is important to note in my address, is that effective regulation, modeled in part on SEC regulations here in the United States, has meant that Australia has immunized itself against large-scale misselling and inappropriate selling practices relating to superannuation accounts, which are noted in some other international models.

In effect, the long-term retirement outlook for Australians living on Main Street is promising. Favorable returns, comparatively low charges, and effective regulation have generated public confidence in the existing system.

Today, Mr. Chairman, the Australian work force of just over 9 million people have established 18.7 million individual accounts to help ensure their retirement prosperity. These accounts already hold assets of A$364 billion, roughly US$203 billion. And this figure will grow rapidly in the next century. Around 16 percent of these assets are invested abroad in countries like the United States, and over 36 percent are invested in equities and trusts.

An average worker in Australia today, Mr. Chairman, is a shareholder, a shareholder in a company, a shareholder in his or her own retirement future. And a shareholder in the economic prosperity of the country that decided individual accounts with investment choices was the most appropriate course to follow.

I would add that being part of generation X, I don't believe in UFOs. I believe in individual retirement accounts, so much so that I've decided to live in the United States because I believe, that like Australia, the United States will eventually follow a similar path.

Thank you.

[The prepared statement and attachments follow:]

**Statement of David O. Harris, Research Associate, Watson Wyatt Worldwide, Bethesda, Maryland**

Mr Chairman, I am pleased to appear before the House Ways and Means Committee to discuss the structure, success and ongoing improvements to the Australian retirement model. I would like to begin by sharing with you today how an industrialized nation like Australia moved its retirement system from a reliance on an unfunded pay-as-you-go (PAYG) system towards a more fully funded, defined contribution approach. I will then discuss the structure of the superannuation (pension) industry, paying particular attention to the issues surrounding asset allocation and administrative costs. These details I am confident will add further clarity to the debate on reforming social security which President Clinton highlighted in his recent proposal. After that, I will look briefly at some of the issues that surround maintaining the integrity of the superannuation system, with particular reference towards regulation, consumer protection and meeting the special needs of women and minority groups. Finally, I will conclude by linking the main features and aspects of the Australian superannuation system with some of the arguments associated with individual retirement accounts.

DEVELOPING AND NURTURING AN INDIVIDUAL RETIREMENT SYSTEM

For Australia, a country that at the beginning of the twentieth century had one of the highest standards of living in the world, the Old Age Pension, introduced in 1909, appeared to be both a stable and viable approach to meeting an individual's retirement needs in the future. Under the system a flat rate benefit is provided which equates to a maximum of 25 percent of male total average weekly earnings (MTAWE). Before the 1980s a common mentality among retirees was that after paying taxes over their working lives, they were entitled to an Old Age Pension from the Federal Government.

In the early 1980s both politicians and bureaucrats alike began to realize that the current Old Age Pension could not be sustained with the rapid aging of the population. Simply put, Australia could no longer afford a 'non-earmarked PAYG Old Age Pension' with its associated generous qualification requirements.

Australia's demographics are similar to those in the United States. Today, roughly 15 percent of the population is age 65 or over. Their share in the population is expected to rise to 23 percent by 2030. The percentage age 85 and over is expected to more than double from around 2 percent today to more than 5 percent by 2030. Australia's aging population poses a threat to the nation.

It may be surprising for some in the United States, but it was the Australian Labor Party, a social democratic political party, working with organized labor that generated the momentum for change of Australia's retirement system. Elected in 1983, Prime Minister, Bob Hawke, a former Australian Council of Trade Unions President (the Australian equivalent of your AFL–CIO), and his Cabinet began the task of restructuring Australia's national retirement system. They began by ensuring the long-term viability of the Old Age Pension, at its current level was maintained. To this end, maximum payments per fortnight by the mid 1980s would now be determined through the interaction of a comparatively stringent income and asset tests. These income and asset tests, as they stand today, are outlined in Table 1 and Table 2. At the current time, maximum payments per fortnight are $347.80 ($US225.65) for a single pensioner and $290.10 ($188.22) each for a pensioner couple.

Table 1: Summary of the Income Test Provisions of the First Pillar

| Income Test | Maximum Payment if Your Fortnightly Income is Equal to or Less Than | No Payment if Your Fortnightly Income is Equal to or More Than |
|---|---|---|
| Single | $100.00 | $806.40 |
| Couple (combined) | $176.00 | $1,347.20 |
| For each child | $24.00 | add $24.00 |

Source: Department of Social Security

Table 2: Summary of the Asset Test Provisions of the First Pillar

| Assets Test | Maximum Payment if Your Assets are Equal to or Less Than | No Payment if Your Assets are Equal to or More Than |
|---|---|---|
| Single, homeowner | $125,750 | $243,500 |
| Single, non-homeowner | $215,750 | $333,500 |
| Couple, homeowner | $178,500 | $374,000 |
| Couple, non-homeowner | $268,500 | $464,000 |

Source: Department of Social Security

In Australia's case, the Federal Government, with full trade union support was able to convey to the nation effectively the impending problems Australia would confront, if it did nothing about addressing its pension system in the face of its aging population. This theme of the realization and an acceptance of a future retirement hurdle was best summarized in the Better Incomes: Retirement into the Next Century statement which expressed a commitment to:

> "'Maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce." [1]

For trade unions, which had strongly supported the election of a Federal Labor government in 1983, increasing superannuation coverage was seen as a major priority. Before the introduction of a mandated, second pillar, superannuation accounts, the extent of coverage was limited to roughly 40 percent of the workforce. Typically employees who were covered by superannuation were employed in middle class, 'white collar' jobs where usually women and people from minority groups were under-represented. By 1986 circumstances were ideal for the introduction of a widespread employment based retirement incomes policy. The situation was facilitated by the role played by the Conciliation and Arbitration Commission in setting wage increases for workers in the union sector. Continuing pressure for wage increases and demands by the union movement on the government for a comprehensive superannuation policy combined to result in the introduction of award superannuation. The Conciliation and Arbitration Commission set a wage increase of 6 percent for the year, but provided that half the increased wage was to be paid into individual superannuation accounts.

By its action, the Conciliation and Arbitration Commission in requiring compulsory contributions of 3 percent to be made into individual superannuation accounts, award superannuation was born. The trade union movement and the Federal Government worked together in refining and improving the delivery and regulation of superannuation products to employees. Moreover trade unions did not simply advocate a policy of increased superannuation coverage for their members but would become specifically involved in the day to day operations of superannuation funds. These funds were generally organized around an occupation or industry and were sponsored by employer and employee organizations. Fundamentally they were established to receive the 3 percent mandated award contribution.

Most experts and politicians agreed that 3 percent was not a sufficient level to generate adequate retirement income for employees once leaving the workforce. On this basis the Federal Government would again intervene in 1992 to reposition Australia's long term retirement income strategy.

## Structure of the Australian Superannuation Industry—Second Pillar

With a delay to the 1990–1991 wage case (centralized wage fixing) occurring, where the ACTU and the Government supported a further 3 percent round of award superannuation, the then government realized that compulsory superannuation contributions needed to be separate from wage setting mechanisms. Some employees for example were not covered by federal and state award wage setting guidelines which meant that compulsory contributions, often did not apply to certain professional and occupational groups.

In August 1991 the Government's Treasurer, the Hon. John Dawkins MP, foreshadowed the Government's intention of introducing a Superannuation Guarantee

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

Levy that would commence on July 1, 1992. In issuing a paper on the levy the Treasurer indicated that such a scheme would facilitate:

- a major extension of superannuation coverage to employees not currently covered by award superannuation;
- an efficient method of encouraging employers to comply with their obligation to provide superannuation to employees; and
- an orderly mechanism by which the level of employer superannuation support can be increased over time, consistent with retirement income policy objectives and the economy's capacity to pay.[2]

Additionally in a statement Security in Retirement, Planning for Tomorrow Today given on 30 June 1992, the Treasurer reaffirmed the government's position and direction on the aging of Australia's population and the need for compulsory savings for retirement:

> "Australia—unlike most other developed countries meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments. And, like most other people, Australians generally undervalue savings for their own future retirement. Private voluntary savings cannot be relied upon to provide an adequate retirement security for most Australians. This is so even with the very generous taxation concessions, which are available for private superannuation savings. . . . . In the face of these factors, changes are required to the current reliance on the pay-as-you-go approach to funding widely available retirement incomes. This means that we need now to start saving more for our future retirement. It also means that saving for retirement will have to be compulsory. It means that these savings will increasingly have to be 'preserved' for retirement purposes. Lastly, the rate of saving will have to ensure retirement incomes, which are higher than that provided today through the age pension system. There seems to be a general awareness in the community that something has to be done now to meet our future retirement needs."[3]

The Superannuation Guarantee Charge Act 1992 encompassed these views of the Treasurer and required that all employees contribute to a complying superannuation fund at a level, gradually phasing in from 3 percent in 1992 to 9 percent by 2002. It should be noted that some relief was provided for small business in how the levy was introduced, based on the size of the annual payroll. If an employer chooses not to pay the levy he or she will have a superannuation guarantee charge (SGC) imposed on their business operations by the Australian Taxation Office (ATO). By deciding not to meet the obligations under the Act, an employer will not receive favorable taxation treatment in regard to contributions made on the employees' behalf.

At the present time the levy is currently at 7 percent which will increase progressively to 9 percent by 2002. The threshold for paying this levy was based initially on the individual earning a minimum of A-$450 (US-$294) per month. More recently employees may decide to opt out of the system and take the contribution in cash up to a level of A-$900 (US-$587) per month.

Table 3: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar

| Period | Employer's Prescribed Rate of Employee Support (%) |
|---|---|
| July 1 1997–June 30 1998 | 6 |
| July 1 1998–June 30 1999 | 7 |
| July 1 1999–June 30 2000 | 7 |
| July 1 2000–June 30 2001 | 8 |
| July 1 2001–June 30 2002 | 8 |
| July 1 2002–03 and subsequent years | 9 |

Source: Australian Taxation Office

[2] Senate Select Committee on Superannuation: 'Safeguarding Super,' June 1992, p.13, Canberra, Australia

[3] The Hon John Dawkins, MP, Treasurer: 'Security in Retirement, Planning for Tomorrow Today,' 30 June 1992, pp1–2, Canberra, Australia

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

With regard to the taxation of superannuation, Australia has pursued a course which is quite unique and which on the whole I cannot agree with, in terms of design and the overall rate of taxation applied. Contributions to the funds are taxed at a rate of 15 percent, along with possible additional taxation of 15 percent for members' contributions who earn over $73,220. A tax of 15 percent is levied on the investment income of the superannuation fund. Finally, the benefits can be subjected to varying tax treatment of between 0 and 30% percent at distribution.

Superannuation funds are managed in a highly efficient and effective manner for members through a trustee structure. Life insurance companies and fund managers, like those in the United States play an active role in the management and investment of superannuation fund assets. Additionally specialized administration companies have developed services that allow superannuation fund trustees to outsource much of their investment and administrative functions. Intense competition has led to an environment of high returns being maximized and relatively low administrative fees.

Varying measurements exist for evaluating the success of how Australia has contained administrative costs, compared with other international models. Keep in mind, that this is a system that is still being phased in. As it matures, it is becoming increasingly efficient. In a recent paper presented at the National Bureau of Economic Research Conference, on the administrative costs of individual accounts systems, Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide and John B. Shoven, Charles R. Schwab, Professor of Economics, Stanford University made the following conclusions about Australia's cost structure:

> "The Association of Superannuation Funds of Australia estimates that the average administration costs of their system equal A-$4.40—i.e., U.S.-$2.85—per member per week. In U.S. currency terms, administrative costs at this rate for a system that held average balances of $1,000 would be nearly 15 percent of assets per year. For a system that held average balances of $5,000, it would drop to 3 percent per year. For one that held average balances of $10,000, administrative costs would be 1.5 percent per year. By the time average account balances got to be $30,000, administrative costs would be under 0.5 percent per year.[4]

Further evidence of the relatively low cost structure associated with superannuation accounts in Australia is highlighted in Table 4 prepared by the Financial Section of the Australian Bureau of Statistics, on behalf of Watson Wyatt Worldwide.

Table 4: Administrative Costs as a Percent of Assets under Management in Australian Individual Account Superannuation Funds during 1996 and 1997 [5]

| Number of members in the plan | 1996 (percent) | 1997 (percent) |
|---|---|---|
| 1 to 99 | 0.689 | 0.619 |
| 100 to 499 | 0.849 | 0.673 |
| 500 to 2,499 | 0.803 | 0.797 |
| 2500 to 9,999 | 0.854 | 0.837 |
| 10,000 or more | 0.922 | 0.846 |
| Total | 0.900 | 0.835 |

Source: Australian Bureau of Statistics, Belconnen, Australia Capital Territory, tabulations of a joint quarterly survey done by the Australian Bureau of Statistics and the Australian Prudential Regulation Authority (APRA).

[4] Schieber SJ & Shoven JB: 'Administering a Cost Effective National Program of Personal Security Accounts' (Draft), NBER, Cambridge MA, December 4, 1998, p.16

[5] Ibid., p.17

I would like to mention briefly that investment decisions and strategies are developed solely between the investment managers and the trustees of each superannuation fund. The Australian Government plays no role in shaping directly or indirectly the investment decisions of the individual superannuation fund but rather through regulation, stresses the need for a sensible and sustainable investment strategy. Regulations refer to this approach as the prudent man test. Further, the September issue of the APRA Bulletin highlights that 36.2 percent and 15.7 percent of the total superannuation assets of the A-$364.6 billion or US-$234.07 in superannuation assets are invested in equities & units in trust and overseas assets. Clearly this level is deemed acceptable by government, trustees and superannuation fund members alike. A concise overview and asset allocation of the Australian superannuation industry and as at September 1998, is provided in Table 5 and Table 6.

Table 5: Overview of the Australian Superannuation Industry—September 1998

| Type of Fund | Total Assets ($billion) | Number of Funds (June 1997) | Number of Accounts (million) |
|---|---|---|---|
| Corporate | 65.6 | 4,510 | 1.41 |
| Industry | 24.8 | 108 | 5.67 |
| Public Sector | 78.5 | 86 | 2.69 |
| Retail (including RSAs)—RSAs | 95.7 | 363 | 8.62 |
| Excluded | 43.8 | 145,761 | 0.34 |
| Balance of Statutory Funds | 56.0 | ............................. | ............................. |
| Total Assets | 364.6 | 150,816 | 18.7 |
| Directly Invested | 98.7 | ............................. | ............................. |
| Placed with Managers | 142.5 | ............................. | ............................. |
| Invested in Life Office Statutory Funds | 123.3 | ............................. | ............................. |
| Total Assets | 364.6 | ............................. | ............................. |

Source: APRA Bulletin, Australian Government Publishing Service, September 1998

Table 6: Asset Allocation of the Australian Superannuation System

| Asset Class | Amount ($billion) | % of Total |
|---|---|---|
| Australian Assets | ............................. | ............................. |
| Cash & Deposits | 26.3 | 7.2 |
| Loans & Placements | 17.9 | 4.9 |
| Interest bearing Securities | 90.8 | 24.9 |
| Equities & Units in Trust | 131.9 | 36.2 |
| Land & Buildings | 32.2 | 8.8 |
| Other Assets | 8.1 | 2.2 |
| Overseas Assets | 57.3 | 15.7 |
| Total Assets | 364.6 | 100 |

Source: APRA Bulletin, Australian Government Publishing Service, September 1998

The third pillar of Australia's retirement income system is characterized by individual retirement accounts generated on a voluntary basis through the private annuity, retail funds management, and life insurance markets. Government taxation and concessional rebates provided to certain taxpayers have seen this segment of the retirement system grow in recent years. With regard to final benefits, Australia allows these to be taken in the form of a lump sum or an annuity. Past experience has seen lump sums, favored by many retirees but with changes in recent tax laws, annuity and allocated pension vehicles are increasing in popularity.

I would like to now turn briefly to the mechanics associated with selling, distribution, and withdrawal of benefits from superannuation accounts. One of the reasons why Australia has been so successful in keeping administrative costs low and also avoiding the problems associated with misselling is through effective and cost efficient regulation. Strict rules govern how superannuation policies are sold and switched. Moreover consumers are required to receive minimum levels of information about the superannuation products at the time of sale and also on a regular basis. Clearly it is felt that, as this is the largest financial transaction that a consumer will enter into in their life, effective disclosure should be provided to encourage transparency in the transaction. Increasingly, superannuation account holders are being provided with greater investment choices. Some retail funds for example offer between 5–7 investment choices and proposed legislation by the Federal Government will force employers to offer choice of funds. Consequently, effective consumer protection strategies will provide an important deterrent for any forms of mis-selling from occurring.

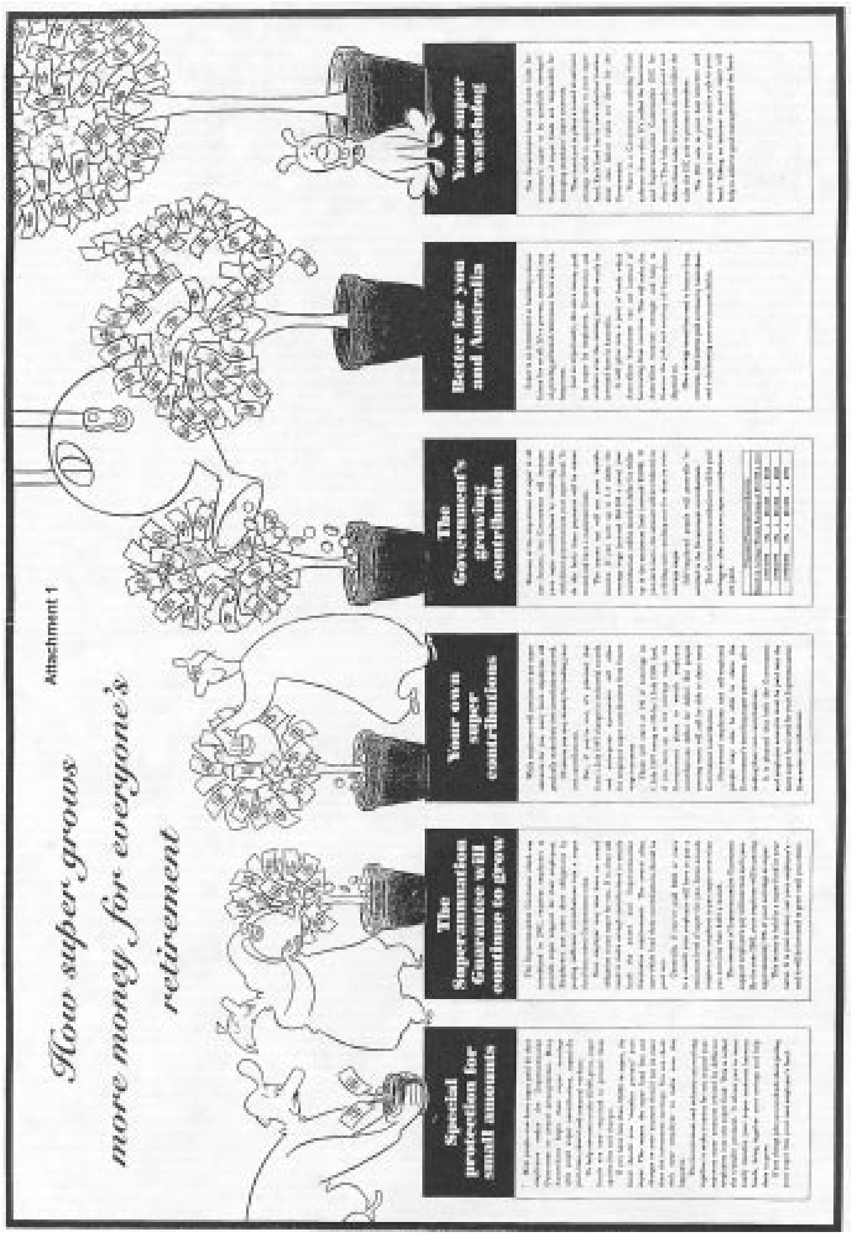
I would now like to refer to Attachment 1 that depicts part of the public education campaign that was initiated in 1994 and implemented between 1995–1996 by various government departments. To build a better understanding and stress the value of superannuation to individual workers, the Federal Government initiated a comprehensive public education campaign. This campaign harnessed both electronic and print media to convey several main themes including the future benefits of superannuation for the nation and the individual, information on how the new mandated superannuation system functioned and how a regulatory body was active in safeguarding superannuation assets. The estimated cost of this campaign was approximately A-$11 million in 1995 or A-$0.60 cents for every man, woman and child in Australia. When devising this elaborate and integral public education campaign, the Federal Government was committed to directing part of the campaign towards women and ethnic minorities. An example of this specific element of the campaign is presented in Attachment 2. For many years government agencies like the Office of the Status of Women (OSW) had highlighted genuine concerns that women were disadvantaged by the retirement system, largely prior to compulsion. Although compulsion had increased the overall superannuation coverage level of the workforce to 91 percent it was argued, many issues still remained in terms of education, product structure and aspects surrounding divorce.

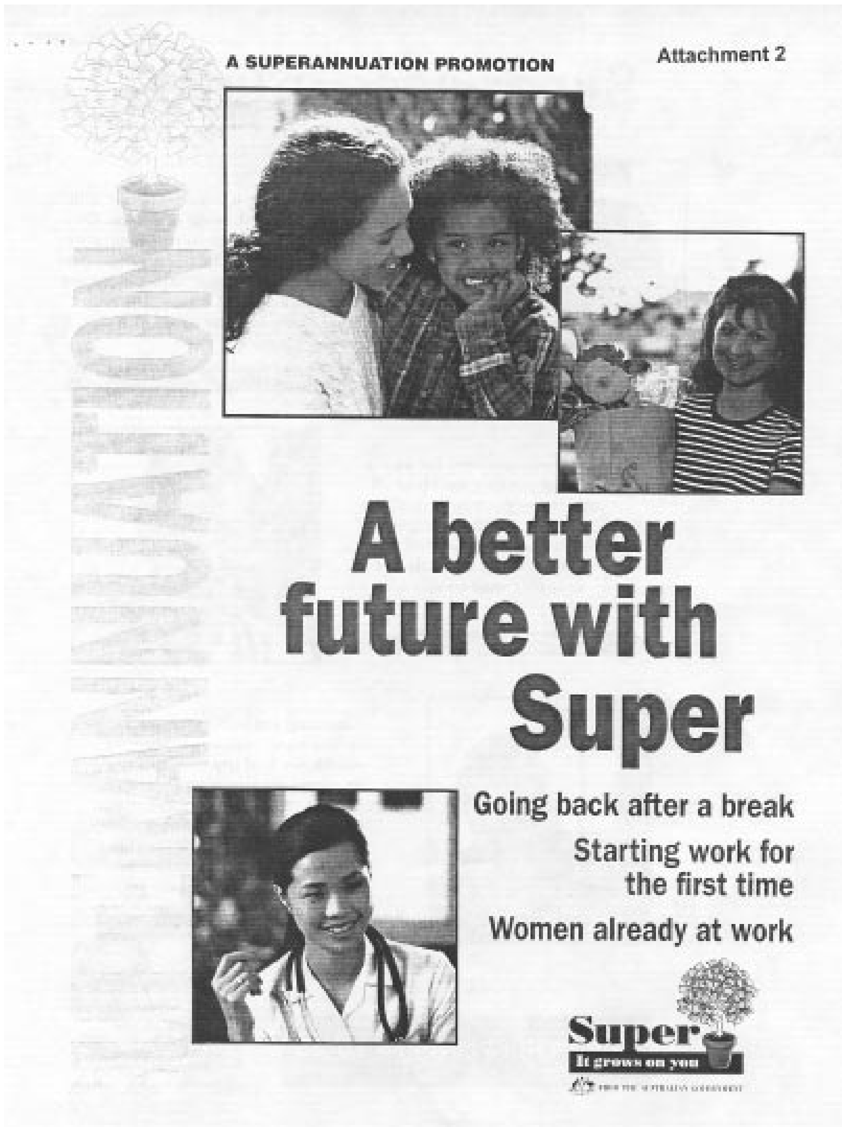
## CONCLUSIONS

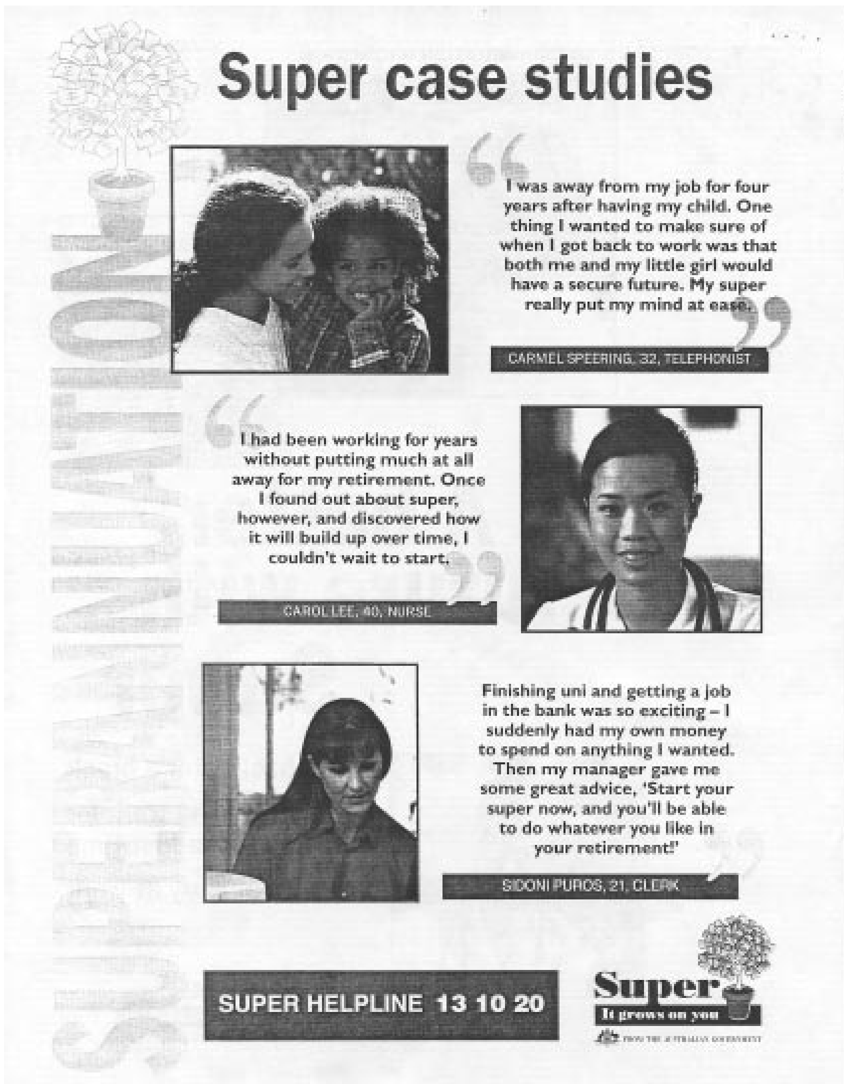
Australia, as a nation with close cultural, industrial, and historical links with the United States has addressed already many of the issues that are being discussed with regard to the future of social security in the United States. Aspects of choice of investment, the role of the government and the private sector in the management of retirement and administrative costs linked with individual accounts, have largely been resolved. Today individual Australians wake up knowing that they are contributing effectively to a retirement vehicle that they own and control. Moreover these superannuation accounts do not generate excessive fees and pay poor returns. Rather superannuation and individual participation in the system is seen to be the only option where effectively Australians can shape and mould their future retirement outlook into the next century. What is also important to consider is that government, while establishing a mandated individual retirement accounts system has not infringed on the efficiency of the financial markets in Australia, for generating the necessary returns of individual accounts. Finally Senator Sherry, the former Chairman of the Senate Select Committee on Superannuation in Australia commented recently in Washington DC, that "the government in directly controlling Australian superannuation was not, an option."[6]

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

[6] Consultations with leading Government and Industry Representatives, January 20–22 1999


Attachment 1
How super grows more money for everyone's retirement
Special protection for small amounts
The Superannuation Guarantee will continue to grow
Your own super contributions
The Government's growing contribution
Better for you and Australia
Your super watchdog


A SUPERANNUATION PROMOTION
Attachment 2
A better future with Super
Going back after a break
Starting work for the first time
Women already at work
Super
It grows on you




Chairman ARCHER. Mr. Harris, why did not Australia decide to invest in government funds out of a government pension plan in the private sector in order to be able to take advantage of these benefits of compound earnings?

Mr. HARRIS. What's important to remember, Mr. Chairman, is that the government had a first pillar old-age pension, and when the government introduced the compulsory requirements, first in 1987 and 1992, the government's view is quite clear, and Senator Nick Sherry from the Senate Select Committee echoed this several weeks ago when he was here in Washington, DC. He said, and I agree with him, that there is no role for government to decide on the investments of the individual. The funds that are apparently being accrued in the superannuation accounts today are controlled by fund managers and life insurance companies. And the Australian view, as a former bureaucrat, was that they are the best people, men and women in Australia, who can generate the highest returns for our individual retirees in the future, not the government.

Chairman ARCHER. Thank you very much.

Mr. Shaw.

Mr. SHAW. Generally, what is the extent of the regulations that are involved as far as the investment limitations?

Mr. HARRIS. In Australia, unlike Chile, we don't have any real barriers to investments. We adopt the prudent-man test, and as a regulator we argued that the individual superannuation funds should adopt an investment strategy, but there's no role for government in telling them where to invest the money. What we'd argue with superannuation accounts was that they had to have suitable investment options or an investment strategy which if you like minimized risk.

But we didn't want to see, for example, 100 percent of a superannuation fund investing in fine art. What we wanted was their investments to be diversified. So if you look on my testimony, you'll see the overall superannuation assets of Australia are well diversified, 16 percent into international equities, and we argue in Australia that it is not in the interest of the regulator to tell superannuation funds where to invest money. The argument among my fellow regulators is this, find investments that generate returns for the individual retiree in the future.

Mr. SHAW. I'm trying to find the language as to qualifications of investment managers. We've all had good experiences with brokers and bad experience with brokers. And there are some brokers who are good at selling, but I wouldn't take their advice on where to put any money. Is there any type of guideline or any type of certification of investment advisers that you have, qualifications as to education, background experience?

Mr. HARRIS. That's a very good point. One thing I'd like to mention is that often we hear in the debate here in the United States, how the individual retiree will be basically by themselves or making these investments on their own. In Australia, it's quite the contrary. We have 8,500 financial planners, certified financial planners who actually get trained at university now, university courses offered in financial planning. These people work hand in hand with the individual superannuant to develop and craft a retirement policy, a retirement strategy in the long term for their needs.

Today, specifically, to the individual brokers, we have a comprehensive licensing regime, which is currently being developed in Australia and implemented, that exists in the system. What we have is that we feel there has to be minimum educational standards, generally of your high school level. That's been increasing significantly to certifications based on aptitude, mathematical ability, and general educational standards.

I think what's important for Australia is that we have avoided a large amount of misselling that other countries have experienced on this basis. That is where we got, for example, the know-your-client rules from the SEC, and we've modified them accordingly.

Mr. SHAW. What concerns me the most is that we've got some wage earners who are darned good workers, but they've never lived in a house where anybody invested, and they know absolutely nothing about it. They don't know the language of it. The only thing they have invested in is the lottery. And we want to be sure that they get good investment advice and that there be some restraints on the type of things that they can invest in. That's what's of concern to me.

Mr. HARRIS. Just to follow on that point. I think I agree with your comments, Congressman. I think it is a concern. And when initially our system was introduced, our investment choices were limited or narrow, more narrow in the startup phase. The balances were low, generally two to three investment options are offered to individual retirees or planned retirees in the future.

But what's happened as the balances have increased, the financial knowledge and experience of the individual worker has also increased. And what we're seeing—I come from a town like Pittsburgh, I come from a town called Newcastle, steelworking, hardworking community. What's been very interesting to note is organized labor, the trade union people have come to the party and provided educational seminars, come and assisted their individual members in doing that.

Mr. SHAW. Do you find that organized labor is very supportive of the plan?

Mr. HARRIS. Totally and absolutely 100 percent behind it. Senator Nick Sherry, who visited here and talked to the Public Pension Reform Caucus, is a former casino worker, a former trade union official, and a former Trustee of the superannuation plan, and is a current senator. That's a typical example of where trade unions fully back the system. The reason being was quite nicely put by Senator Sherry: Trade unions feel that their members should have the same ability to have retirement vehicles as their bosses, the senior employees. And they are craving for financial responsibility.

All that regulators like myself did, Congressman, was build the infrastructure of the vehicle. They are driving the vehicle or the bus, and they are doing very well at it.

Mr. SHAW. Thank you very much.

Chairman ARCHER Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. Mr. Harris, are there general revenues in the pension fund?

Mr. HARRIS. This may be to do a brief overview again——

Mr. MATSUI. You'll have to forgive me. I came in——

Mr. HARRIS. Yes, certainly. Just to explain again, Australia for many years—an example is my mother. My mother worked for 35 years, and the view was simply this, if she worked for 35 years, paid her taxes into general revenue, or consolidated revenue, she would be entitled to an old-age pension. But when she came to retirement, the system changed because we brought in a means test on income and assets, and that meant that my mother, unfortunately, got a reduced pension. And so, what we have seen now, increasingly, is the burden shifting toward more responsibility.

The former government proposed a contribution of 15 percent—not just 9 percent by 2002—15 percent; 9 percent by the employer, 3 percent by the employee and 3 percent by the government. That's very important to note. Currently, the legislation only stands at 9, but I foreshadow that will increase to 12 within 5 years.

Mr. MATSUI. So right now, the contribution is 3 by the——

Mr. HARRIS. Currently 7 by the employer, and 4 percent on a voluntary basis by the employee.

Mr. MATSUI. Now it's my understanding that 2002——

Mr. HARRIS. That the 7 percent is being progressively ratcheted up. Back in 1992, when the legislation came in, we initially introduced it at a level of 3 percent, and this is very important for small business. And I know maybe some of your constituency would be very interested in this.

Small business is a particular concern to the government because an impact of bringing in compulsion and compulsory contribution would be a cost. So we gave a little bit of a holiday for 1 to 2 years for small business under $1 million in payroll. The level would be increased at a slower rate.

So since 1992, the rates, Congressman, have been progressively increasing from 3 percent. Currently, it's 7. By 2002, it will hit 9 percent. But what's important to stress here is that public confidence is being generated in the system. Australians are very much like Americans culturally, philosophically and savings base. We don't generally save like Americans. We enjoy a good time. And what's important to note here is that there is a cocontribution developing on a volunteer basis.

Mr. MATSUI. But the 9 percent after 2002, would that remain constant in perpetuity?

Mr. HARRIS. It is. It's foreshadowed that the employer will have to obviously pay the 9 percent in perpetuity. There is some argument, though, by the—your colleagues in the Australian Labor Party that there should be an employee contribution, a cocontribution, something like Singapore and Malaysia. Where the employer's paying 9 percent, employees should pay 3 percent contribution. And although it hasn't been spoken of, they're currently in opposition. I think that Australia will come back to that idea.

Mr. MATSUI. Were you saying my colleagues in the Labor Party?

Mr. HARRIS. Oh, colleagues, I apologize Congressman, ideological colleagues. The Australian Labor Party has a close affinity with the Democrats, I was told by Senator Sherry, an Australian Labor Party politician.

Mr. MATSUI. Thank you. I have no further questions.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Mr. Harris, these are employer contributions, but what is the income tax structure in Australia?

Mr. HARRIS. Income tax structure in Australia is a progressive tax system based on income. We have generally a higher level of taxation than in the United States. We don't have indirect taxation of any form. We're talking about a goods and services tax.

Our highest marginal tax rate is 47 cents on the dollar. With regard to the taxation of retirement, we adopt a very unique policy.

We tax the contribution. We tax the income generated on the fund. And then we tax the benefit. Now the argument and the rationale was this.

Generally 15 percent contribution, 15 percent income, 15 percent benefit. If the people of a retiree or a Super Washington plan to put money into a bank account, they'd be getting taxed at 47 percent or 47 cents on the dollar. So when they put their money in the Super account, it's perceived or argued that it's at a concessional rate of taxation.

Mr. COLLINS. You mentioned that there's talk of going back and having an employee deduction of possibly 3 percent.

Mr. HARRIS. Yes.

Mr. COLLINS. Is that due to the fact you see the fund having trouble down the road? Do you see a shortage of funds?

Mr. HARRIS. Quite the contrary. I think the rationale within Labor Party circles is that the employee should explicitly make a contribution for their futures. As Dr. Piñera stressed, whoever pays the contribution, it really doesn't matter. It's salary sacrificed. But the argument in Australia was that we were trying to generate individual accounts ownership. And if it's perceived that only the employer is contributing, it takes a little bit of the tarnish off if we could get the cocontribution working together.

And what we're stressing now, public education campaigns and you'll see it on attachment one and two is this person watering a tree, and the tree is sprouting leaves which are money. And it suggests that if the employee can be encouraged to contribute to the individual accounts, he'll be a lot better off in the future. But already on a voluntary basis, people are making 4-percent contributions at the moment.

Mr. COLLINS. One last question. Does Australia have a national debt?

Mr. HARRIS. We have a national debt which at this stage quite off the top of my head, I think it's increasing at something like A$176 billion. But that's off the top of my head. Our external debt, just to give some brief historical trends, Australia has always been a net importer of capital. We're a large nation like the United States. We've only got 19 million people roughly in our tax base. So obviously we're now considering a goods and services tax, an indirect form of taxation.

But we have increasingly been relying on overseas capital sources to modernize our economy.

Mr. COLLINS. Very good. Thank you, and thank you, Mr. Chairman.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman. It's good to have you with us, Mr. Harris. I just had a great opportunity to visit your country a few weeks ago, and I was very impressed.

Just getting back again, you did mention earlier, and I find it very ironic that the labor unions were actually one of your very prime supporters when you were setting this up. And it's ironic because here in our country, labor unions are probably some of our strongest critics. Would you like to comment on that why you think there might be a difference?

Mr. HARRIS. Ah, I've looked at these responses by the AFL–CIO, and I've been puzzled by this reaction as well, Congressman. I came to the United States in September 1997, with a view that certainly organized labor would be very active like Australia in pursuing the individual nurturing their own retirement responsibility and building up their overall savings.

I think the mentality amongst Australians was that we have to ensure that the individual workers would not be exposed to a demographic time bomb. That was their primary concern. Second, it was the risk—the political risk of their counterparts in Australia changing the laws related to old-age pensions and seeing workers retiring largely like my mother with limited savings because of her thinking that they would have an old-age pension for life.

And so the unions stressed, I suppose, a responsibility. This trend in unionism and organized labor is a trend that's growing in Denmark. You can cite examples in the United Kingdom. I think the third point is very interesting and the distinction here is quite strongly put, organized labor unlike in the United States, saw women union leaders who were actively pushing this because it was the women and the minority groups who are disadvantaged groups who are largely locked out of the then voluntary system.

It was women leaders who had the foresight to say we have to go down this path. We have to give people individual responsibility. And sadly, no offensive criticism to the AFL–CIO, but I generally don't get those sounds of responsibility in most of their statements.

Mr. HERGER. Well, thank you. And, again, I think this is a very important point to emphasize. And I would hope that our good friends in the labor movement hopefully would reconsider. But as we look at it, when you look at the benefits that your citizens have seen, we look around at Chile. We've heard from them earlier today and others. It sounds like those in the labor movement, the workers, really it's almost a win-win in a major way for them.

And, again, I would be hopeful that they'll learn from the great example that you and some of our other good allies have set. So——

Mr. HARRIS. I think as a former organized labor official myself, I'd be more than happy to talk to my organized labor colleagues at any stage. Unfortunately, they seem not to return my calls.

Mr. HERGER. Well, thank you very much.

Chairman ARCHER. Does any other Member wish to inquire? If not, thank you, Mr. Harris. We appreciate your input, and we, again, learned a lot. And that will all be factored in when we make our ultimate decision.

Mr. HARRIS. Thank you, Mr. Chairman.

Chairman ARCHER. I wish you well.

Mr. HARRIS. Thank you.

Chairman ARCHER. Our next witness is the new Director of the Congressional Budget Office, Dan Crippen, who will be making his first appearance before our Committee, and we welcome you, and we'll be pleased to receive your testimony.

## STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. CRIPPEN. I was aware, Mr. Chairman, of your admonition to the last witness on being brief, and I will certainly try to do that. I was actually quite attracted by Dr. Piñera's rule this morning, the 3-minute rule. I'm not quite sure I'll make that, but I will try to make your 5-minute rule.

Mr. Chairman and the rest of the Committee, thank you for inviting the Congressional Budget Office to offer testimony today on the important issue of Social Security reform, especially as it's experienced in other countries.

In the interest of full disclosure, as you suggested, Mr. Chairman, today is my fifth day on the job, and this is my second appearance before a congressional committee despite the fact that it's only 5 days. So I don't know exactly what it says about my mental state, but I'm certainly pleased to be here.

One of the reasons I returned to Congress, frankly, was the prospect of reforming Social Security and Medicare, and I'm very interested in working on those subjects. This is the first time I've had a chance to present any of our results.

Our report on the experiences with Social Security privatization abroad, which is the basis for my testimony today, was written by Jan Walliser, a staff member who's now at the International Monetary Fund. The report was released by CBO before I arrived last week.

Obviously, many of your other witnesses today know a great deal more about the reforms in their countries than even our longer report reflects. However, I think a number of lessons seem to apply when you look across countries.

One of those lessons, I believe, is quite simple—that is, keep your eye on the ball. And the ball, Mr. Chairman, may not be the trust fund. The establishment of and accounting for trust funds have important implications. But the maintenance of a trust fund has nothing to do with the ability to meet obligations. In the countries that we examined that established trust funds, as in the United States, there is no trust fund in the commonsense meaning of the word—that is, no stash of assets to be sold to meet obligations for retirees.

Let me give you just one example before I move on to our report. In the Social Security Trustees' most recent report, they estimate that the OASDI, Old-Age, Survivors, and Disability Insurance Trust Fund will be exhausted roughly in 2032. However, the report also includes the fact that starting in 2013, Social Security revenues from the payroll tax will not be sufficient to meet the program's obligations.

If this was a trust fund in the traditional sense of the nongovernmental world, assets in the trust fund could be sold to cover the shortfall. However, the surpluses in the trust fund have been loaned, as you well know, to the Federal Government. And although special bonds have been issued to indemnify the fund, there are no assets to be sold in the classic sense of the word. Starting in 2013, the program's expenditures will exceed revenues, and the government will eventually have to go further into debt, raise taxes, or cut spending to be able to send out Social Security checks. If this was a funded program, those actions wouldn't be necessary.

So if trust funds, as I have suggested for our purposes here today at least, are not reliable indicators of economic effects, what role should we follow? Judging the desirability of reform—indeed, judging the results of reform in these other countries—depends critically on at least two related questions. One I would suggest is: Can the reform help economic growth? And second: Can the reform reasonably be expected to work?

The first question is critical and, in many ways, is the only ball worth watching in this game. It is ultimately the size of the economy that determines our ability to support a growing elderly population with fewer workers. The mechanism by which resources are transferred from the working population to retirees matters little in the macrosense. What matters most is how much the working population creates, how big the economy is, how big the pie is relative to the piece devoted to retirees.

How does that translate in the context of Social Security reform? One thing—perhaps one of the few things many economists involved in this debate agree on—is that increasing national savings should enhance productivity and, thereby, economic growth. Increased savings can result from funding a heretofore unfunded system. Increased savings can also result in reduction of Federal debt held by the public.

The second question—Can we reasonably expect these programs or reforms to work?—includes considerations of practicality, cost and ease of administration, protection against severe losses, fraud, the extent of regulation, and the like.

Now finally to the punchline, Mr. Chairman. What do the five countries we studied suggest as answers to the questions I have posed? Can privatization help economic growth, and can it be expected to work?

First, these countries had difficulty in funding a retirement system controlled by the National Governments. They had intended to fund their systems over time. However, their good intentions were overcome by the ease with which trust funds can be deployed for other government programs or to expand retirement benefits.

One motivating force, indeed, for privatization in several of these countries was the inability of the National Governments to establish and maintain a true trust fund. Second, the initial evidence, which is certainly based on less than perfect information, suggests that privatization can help increase net national savings by as much as to 2 to 3 percent of GDP, gross domestic product, in the case of Chile and perhaps 1.5 percent of GDP in Australia. The result depends critically on the ongoing financing of the individual accounts from future actions we can't yet foresee. If the government pays for those accounts by issuing debt in the future, there would be no increase in net national savings. However, if the countries continue to build assets as they have in the recent past, economic growth will continue to be improved.

Finally, administrative concerns, including costs, do not appear to be insurmountable. Clearly, the structure and regulation of the program are important factors. But after the initial startup costs, it seems costs should not be much higher than those currently experienced by managed mutual funds in the United States—say, in the neighborhood of 100 basis points—and could be as low as index funds, around 35 basis points, which has been closer to the experience in Australia.

Mr. Chairman, the details of any reform are important, and the United States is vastly different from any of the other countries examined in our report. But we're all bound by one truth: The larger the economy, the easier it will be to meet our obligations to future retirees. The experience of other countries suggests that privatization can help with that goal. Thank you. Which rule did I abide by?

Chairman ARCHER. I think you did very well. You may have established your own rule, but it's an acceptable rule.

Mr. CRIPPEN. Thank you.

[The prepared statement follows:]

**Statement of Dan L. Crippen, Director, Congressional Budget Office**

Mr. Chairman and Members of the Committee, I am pleased to be with you this morning to discuss the lessons from the experience of other countries that have reformed their Social Security system at least in part through privatization.

The retirement of the baby-boom generation in the United States will put our Social Security program under financial pressure, and a debate is now proceeding about how to pay for retirement in a financially sound way. Many recent proposals would allow workers to invest some portion of their earnings in personal retirement accounts. The amounts accumulated in those accounts would replace some of Social Security's benefits. Because some of a worker's retirement income would come from savings in his or her account rather than from a government program, such plans would partly privatize Social Security.

Other countries face the same demographic and financial pressures as the United States. In fact, for many countries, the pressures are much more severe and immediate. Some have already responded to those pressures by privatizing their public pension systems to some extent, and their experience can offer some lessons for the design of privatized pension systems. The economies and pension systems of those countries differ considerably from those of the United States, however, and comparisons should therefore be made cautiously.

The Congressional Budget Office (CBO) recently released a paper that reviews the experience of five countries—Chile, the United Kingdom, Australia, Argentina, and Mexico—that have introduced individual accounts to fully or partly replace their public retirement system.[1] Such plans are defined contribution plans—that is, retirement income depends in part on the uncertain returns on contributions to the accounts. Other countries have relied on more traditional measures to close the financing gap, such as changing benefit rules and retirement ages or increasing payroll taxes, but those countries were not included in our analysis.

All five countries started out with some type of old-age income support system. Those systems relied on "pay-as-you-go" financing, in which taxes collected each year mainly or entirely finance the benefits paid to retirees in the same year. For example, in the United Kingdom (U.K.), a payroll tax finances the government's expenditure for pensions (and other benefits) in the same year. Three of the other countries also generated most of the revenue for their pension systems by earmarked taxes on wages before they reformed the system.

By contrast, systems with personal retirement accounts prefund retirement income by requiring people to accumulate savings during their working years. For example, Chile's system requires workers to invest in personal retirement accounts from which workers may withdraw money only after they retire. Moving from a pay-as-you-go system to a prefunded private system, however, imposes a financial burden on transitional generations.

All five countries encountered the same set of issues in privatizing their systems, and those issues are also relevant to efforts to privatize the U.S. Social Security system.

• Policymakers have to decide who would pay for the transition between the pay-as-you-go system and a prefunded system. The transitional generation must continue to support retirees under the old system while saving for their own retire-

[1] See Congressional Budget Office, Social Security Privatization: Experiences Abroad, CBO Paper (January 1999).

ment. That issue is obviously not unique to privatization and must be faced in any reform of Social Security that moves toward a prefunded system.

• Some countries have required workers to shift to a new system of private accounts, and others have allowed workers to choose whether to join the new system or stay in the old pay-as-you-go system. Allowing choice can mean that the pay-as-you-go system lingers on and may (as in the United Kingdom) entail some additional administrative problems. But it can also help workers accept the change, particularly older workers who have substantial accrued benefits.

• Policymakers must decide whether to offer minimum benefit guarantees and how generous the guarantees should be. Without such guarantees, some people risk not having adequate retirement income. Making such guarantees, however, imposes a contingent liability on future taxpayers.

• Countries must decide how to regulate investment choices in the retirement system and how the retirement funds may be used. Regulation may be needed to limit fraud and risk—both the risk to retirees if investments turn sour and the risk to taxpayers if the plan guarantees minimum benefits. Regulations about how the retirement funds may be used, such as conditions for withdrawal and whether annuities would be mandatory, are also important. However, regulations also limit an individual's choice about investment and retirement.

## Types of Privatization Plans

The countries we examined followed one of three major models in privatizing their pension systems. Chile, Mexico, and Argentina used a model in which workers establish private retirement accounts. The United Kingdom allowed its workers to choose between the old pension system and the new system. Australia based its system on employers' contributing to retirement accounts for workers.

### *The Chilean Model*

Chile, a pioneer in privatization, replaced its pay-as-you-go system with a system based on private retirement accounts in 1981. New workers had to establish private accounts. Workers already in the old system could choose to remain there or switch to the new system and earn a more attractive return. To encourage switching, the government compensated workers who did so with "recognition bonds" that would be paid into a worker's account at retirement. Workers with sufficient years in the system were guaranteed a minimum retirement income of about 25 percent of the average wage. Obligations to existing workers were financed with general revenue and debt (the recognition bonds).

Mexico and Argentina generally followed the same model as Chile, with some modifications. In Mexico, for example, all workers have been required since 1997 to join the new system and save in private accounts. At retirement, however, workers who have contributed to both systems may choose to receive benefits from either system (but not both). Argentina has both benefits that are financed on a pay-as-you-go-basis (similar to those in Social Security) and private retirement accounts. People who choose to contribute to private accounts receive an additional pension that reflects their contributions to the old system (like the recognition bonds in Chile).

### *The U.K. Model*

The United Kingdom, when it began its reforms in 1986, followed a different model. Its existing retirement system already had a privatizing option; that is, people whose employer offered a pension were allowed to opt out of part of the government's pay-as-you-go system. Those who did so received a rebate on their payroll taxes. The reform simply extended that option by allowing workers who set up a personal pension plan to opt out as well. Transition costs are financed out of general revenue (possibly including debt) and by reduced benefits in the government system.

### *The Australian Model*

The third model is that of Australia, which chose to base its reformed system on employers by requiring most of them to contribute to workers' retirement funds. Unlike the other four countries, Australia never had a Social Security-like system funded by earmarked contributions. Instead, the government used general revenues to pay for a means-tested pension that was not regarded as an entitlement. Because the old system lacked a specific entitlement, it did not require the government to compensate workers for any benefits accrued under the old system. However, if the reform succeeds in replacing the government pension, it will be true in Australia, as in the other countries, that one generation will pay for their parents' as well as their own retirement.

## Design Issues

The experiences of the countries that have already begun their reforms highlight the importance of the design of the new pension systems. Our analysis revealed three issues: the need for additional information if a complex system is to work; the need to regulate investment choices; and the need to regulate withdrawals from the accounts.

### *Information Requirements of a Complex System*

The reform in the United Kingdom demonstrates the difficulties that can arise if the new system offers workers a large array of choices and decisions to make but does not ensure that the worker has sufficient knowledge to make informed decisions. In the U.K. case, figuring out whether they should stay in their employer-based plans or switch to the newly available private accounts was difficult for many workers. If they switched, they would lose accrued benefits in the employer plans but would gain a more attractive return in the private accounts. Under pressure from sellers of the private accounts—including, apparently, some fraud—some workers made poor decisions. The United Kingdom responded to that problem with more careful regulation. Sellers of private accounts now have to provide enough information to enable workers to make a reasonable decision.

### *Regulation and Risk*

Regulation of investment choices within the private accounts differs among the five countries. Such regulation could be important to protect either retirees or taxpayers, who in many cases are on the hook to finance a minimum benefit guarantee if investments in the accounts prove to have been unwise. One would expect, therefore, that systems that guarantee a minimum benefit would tend to have more regulation, though that is not always the case.

Neither the United Kingdom nor Argentina has a contingent minimum benefit. A worker whose investments went sour (and who has worked long enough to qualify) would have to rely on a basic pension that is not means-tested. The basic pension therefore does not depend on how successful the worker's investments are. The possibility of poor returns in the private accounts does not explicitly impose any risks on taxpayers. Of course, taxpayers still have to pay for the basic pension.

By contrast, the basic pension is means-tested in Chile and Mexico. Workers in those countries can choose their investment portfolio. (Australia also has a means-tested pension, but employers choose the portfolio.) Consequently, workers in Mexico and Chile have an incentive to invest in risky assets offering high expected returns—the worker reaps all the benefits if the gamble pays off and can rely on the basic means-tested pension if it does not. Taxpayers in those countries thus have a greater interest in ensuring that returns on the private accounts do not fall too low. (Means-tested pensions can also have other disadvantages: for example, they can reduce incentives to work and save.)

The taxpayer thus bears part of the risk of poor investment choices in Chile, Mexico, and Australia but not in the United Kingdom or Argentina. One would therefore expect the United Kingdom and Argentina to have little regulation and the others to regulate investment choices more closely. As expected, regulation of investment choices in the United Kingdom is minimal, consisting mainly of the ordinary "prudent man" fiduciary standard. Chile and Mexico, however—as expected—regulate investment choices quite heavily. The odd couple are Australia and Argentina. In Australia, taxpayers bear some of the risk of the accounts, but regulation is as light as in the United Kingdom. In Argentina, by contrast, taxpayers do not bear that risk, but regulation is as heavy as in Chile, which has in other respects also been a model for Argentina.

### *Regulation of Withdrawals*

In Australia, workers can "game" the system by withdrawing all their money from the accounts at retirement and spending it, for instance, by paying down their mortgage or buying a new house. Housing receives special treatment under the rules for the means-tested pension. Currently, most people qualify for the pension. If that practice continues, the reform will have made almost no difference to the government's costs for retirement. Australia's experience suggests the importance of establishing rules that govern when, how, and for what purpose funds may be withdrawn from the accounts. Many proposals for reform in the United States, for example, prohibit lump-sum withdrawals and require workers to purchase an annuity at retirement. Having such rules would avoid the problem Australia encountered.

## ADMINISTRATIVE COSTS

Most analyses of the administrative costs associated with proposals to privatize pension systems examine the cost of managing private accounts. That is, of course, only one part of the cost of a proposal; both the current social security system and any reformed system also impose administrative and accounting costs on employers and workers. CBO is now conducting a more detailed study of administrative costs in a privatized system.

Comparing the administrative costs of managing private accounts for the five countries is quite difficult. Some plans take out administrative costs as an initial payment at the time of investment, and other plans charge an annual fee. The different fee mechanisms preclude any direct comparison, particularly since most of the reforms are recent and the plans have not matured. Nevertheless, a couple of lessons have emerged.

First, fees and commissions of individual accounts appear to be close to what managed mutual funds charge for individual accounts in the United States. In Chile, account fees and commissions are about 1 percent of the assets held in Chilean pension accounts. A 1 percent charge is quite common for managed mutual funds in the United States. The large accounts in Australia that give limited choices to workers seem even less costly, with fees approaching those that index funds charge in the United States (about percent of assets). In addition to managing investments, systems with individual accounts need to collect and maintain data in more detail and collect it more frequently than a large-scale public system without individual accounts. Such systems therefore tend to be more expensive than, for example, the U.S. Social Security system.

The second lesson is that design choices seem to affect management costs. In Chile and the United Kingdom, for example, funds are marketed directly to individuals, which leads to relatively high sales costs and little bargaining power for purchasers. In addition, workers in Chile can switch funds several times a year, and workers in the United Kingdom can contribute sporadically and to several small accounts. All those factors increase total administrative costs. In Australia, by contrast, companies representing many individuals and contracting on a more stable basis face much lower fees.

## NATIONAL SAVING

All of the reform plans hoped to reduce strains on the government's financing of retirement and, by encouraging private saving, increase the national saving rate. That is an important goal because the only way that real resources can be put aside for retirement is through saving and capital investment in plant and equipment and human capital (education and training).

Because of limited information on what the governments and workers would have done had the pension systems not been reformed, estimating the reforms' exact impact on national saving is difficult. In Chile and the United Kingdom, the fiscal tightening associated with pension reform indicates that the government offset little if any of the additional private saving in personal retirement accounts. As a result, Chile's national saving rate may have increased by 2 percent to 3 percent of gross domestic product (GDP). In Australia, estimates indicate that under certain behavioral assumptions, the reform might increase national saving by about 1.5 percent of GDP in the long run. The saving effect of reforms in Mexico and Argentina cannot yet be ascertained; however, the gains to national saving are probably less in Mexico and Argentina than in Chile.

A second important lesson from the countries we studied is the difficulty of funding a retirement system controlled by a national government. Several of the countries intended to fund their systems over time. However, in each case the good intentions were overcome by the ease with which trust funds can be deployed for other government programs or to expand retirement benefits. A motivating force for privatization, again in all five countries studied, was the inability of the national governments to establish and maintain a cache of assets in a trust fund as we commonly understand it.

## CONCLUSION

The aging of the population is not unique to the United States—many countries are experiencing growing retirement populations supported by fewer workers. Those facts mean, in part, that the traditional pay-as-you-go pension and health care programs for retirees will be strained. Other countries have undertaken, and the United States is considering, reforms to those programs to help ensure future benefits.

Judging the desirability of reform, indeed judging the results of other countries' reforms, depends critically on at least two related questions: Can the reform help economic growth? And can the reform reasonably be expected to work?

The first question is critical. It is ultimately the size of the economy that determines our ability to support a growing elderly population with fewer workers. Increasing national saving should enhance productivity and thereby economic growth. Increased saving results from funding a heretofore unfunded system with real assets, not increases in government debt.

The second question addresses considerations of practicality, ease and cost of administration, protection against severe losses, and the extent of regulation.

Our comparisons of the five countries suggest that:

• Efforts by national governments to prefund programs for retirement have not succeeded.

• Prefunding through privatization offers an opportunity to increase national saving and economic growth.

• Administrative concerns, including cost, do not appear to be insurmountable, but the details are important. Suffice it to say, the United States is vastly different from any of the countries examined here.

Chairman ARCHER. Thank you very much. As the Director of CBO, you are challenged with the obligation to do an awful lot of estimating and to have a completely clear crystal ball for the future which makes your job a very difficult job.

But insofar as whether we have or have not saved Social Security by whatever reform program we enact, would you do the estimating of that, or will SSA do the estimating of that?

Mr. CRIPPEN. Well, currently, Mr. Chairman, we rely quite heavily on SSA, Social Security Administration, actuaries to give us data like those they produce in their annual reports and for the Trustees. We have some capability of our own, although we're relatively new to the long-term projections. Only in the past couple of years has CBO gone beyond the 5- or 10-year budget window to the more relevant, in this case, longer term 15- and 75-year projections.

We aren't yet able to do completely independent analysis, however, akin to what the Trustees do. One thing that I'm interested in looking at, after I've had a few more than 5 days on the job, is whether we want to—and before your Committee in particular, the Committee with Social Security jurisdiction—have a little more capability in the area of Social Security estimations. I think both as a matter of economics as well as a matter of trust fund accounting that the Congress may not want to be in the position of relying solely on the Social Security Administration.

Chairman ARCHER. Let me thank you. Let me inquire briefly on some of the things that you said. You said there were no assets to sell after the year 2032 based on the current projections for the Social Security Trust Fund. And, of course, that is a sine qua non because it is a pay-as-you-go system. And in contrast—and correct me if what I'm saying in your opinion is wrong, in contrast to the countries that you examined where you say they intended to ultimately fund the system, but politics got in the way of it—well, you didn't say politics. I'll say politics got in the way of it. We never intended to fund our Social Security Program in the United States.

As I understand the history of it—Mr. Roosevelt will be up shortly, and his grandfather designed the program—but as I understand the program, it was never designed to be prefunded but was designed to be a pay-as-you-go program with the fund containing only enough to pay the benefits for 1 year. And if there was money above the necessary benefits for 1 year, then that money was available to basically do whatever we wanted to with it, not to pay General Treasury obligations, but to increase benefits or to give tax reduction on the payroll tax.

And our government also succumbed to the political pressures. And as the money came in far in excess of the benefit requirements annually, the Congress said, Oh, well, this is a pay-as-you-go system, but we now have a lot more money, we can increase the benefits. And that's what Congress did over and over and over again.

And from the years 1968 to 1973, the Congress on an ad hoc basis increased the benefit levels by 70 percent in that 5-year period while inflation was running 4 percent per year so that at the end of that 5-year period, real benefits were 50-percent higher than they were in 1968. If you died in 1968 with the same earnings record of someone who began to draw benefits in 1973, you would have witnessed one-third less in your benefits than a worker with the same earnings record that retired in 1973.

So I just only point that out to support what you said that politics is really something when it gets into the issue of what you do and how it prevents the funding of a system provided that it is based on the pay-as-you-go concept.

Fortunately, we finally decided that we better not do that any more, and we've decided to let some surpluses buildup in the fund. Now if in fact, and I take as a thesis of your testimony that we would be far better advised in the future to try to fund what will ultimately be our retirement plan than to use a pay-as-you-go system. Is that a fair analysis of your statement?

Mr. CRIPPEN. Yes, Mr. Chairman. I think that to the extent there's a consensus on Social Security reform, funding is something everybody agrees we ought to be doing.

Chairman ARCHER. Do you have any concern about the Federal Government investing Social Security Trust Funds in the private sector as a government-owned and government-managed investment program as a means of trying to prefund because if we're going to prefund within the current so-called trust fund and make it a real trust fund by prefunding it, then we're going to have to find extra revenues to put into that fund, and then they're going to have to be invested in the productivity of the private sector if we're going to take advantage of this compounded earnings which we've heard expressed so many times today.

Do you have any view as to whether that is a desirable thing for whatever reason for the United States to do?

Mr. CRIPPEN. I share some of the concerns that Chairman Greenspan has expressed to this Committee and to others as well about the ability of the government to make decisions that are nonpolitical or without some kind of influence. Even in the case of a large index fund—say, an S&P 500 fund—the investment itself may not become a matter of congressional interest or concern. But which companies are in the 500 index is a matter of great concern. And if you're in the index, your stock would probably perform much better than if you weren't in the index. Even when we talk about broad indexes, it is certainly possible for the government to make decisions based on something other than pure economics. So I share Mr. Greenspan's concerns with that.

If, however, as you suggest, we need to find a means to save this money—something we haven't been able to do in the United States or anywhere else thus far—we need to find a means to be able to increase net national savings. We can't continue to do what we're doing now, which is not increasing net national savings.

Chairman ARCHER. Have you done any study at all of what might be reasonably expected in the way of percentage return from government-owned, government-managed funds?

Mr. CRIPPEN. We have not that I'm aware of, Mr. Chairman. I will ask my colleagues here as well. We have a couple of other studies underway on Social Security, including one on administrative costs in the United States. However, I'm aware of some research along the lines you suggest, particularly by Estelle James at the World Bank. She concludes that in countries that have tried to run investment portfolios for retirees, the more government control over those funds, the lower the return.

Chairman ARCHER. Because Chairman Greenspan alluded to that in his testimony. And whatever data you can give us in that regard would be helpful to him, too. But if we do not do that, if we do not make the trust fund operated by the Federal Government, managed by the Federal Government and a true trust fund by putting assets into it in advance and presaving, then the only other option for prefunding is by having personal savings accounts in it.

Is that a fair statement?

Mr. CRIPPEN. Absolutely, Mr. Chairman. In fact, a number of us who deal in the arcana of budget accounting tried to figure out a way to do it short of actually sending the money back out to retirees. And we haven't figured out a good way yet to design one. I think equally important, the report we present here today shows quite clearly that the countries that tried to do it otherwise failed and indeed turned to privatization because of precisely the reason you cited.

Chairman ARCHER. OK. Thank you very much. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman. Mr. Crippen, I want to walk back through some of your testimony because I think that this is a concept that's somewhat hard to grasp. But once you grasp it, it's very obvious.

And that is what happens with putting surplus back into the trust fund. Now the only financing of the existing system that we have is that meager 2 percent interest that we pay ourselves and the payroll taxes.

At some point, you start paying out more than you are taking in. Right now it's 2013—that point can be extended out a little bit by pumping some more money into it. But when you pump more money into it, all you do is go out and buy more IOUs. Then that money goes back into the Treasury, and it either pays off the accumulated debt or the Congress spends it or gives it on a tax break or something like that.

So the net effect is that you've really done very little to delay the day of reckoning when the government is going to be required to come up with general revenue to pay the benefit or cut benefit.

Mr. CRIPPEN. I think you've broken the code.

Mr. SHAW. Yes. Now that's something that people are not understanding because people feel that if you put several billions of dollars in there, you've increased the trust fund. But the problem is it's like Old Mother Hubbard's cupboard. It's bare because that money is flushed out, and how do you pay the benefits? You have to go out and get general revenue so you can pay yourself off so that you can continue to exist.

That curve that we keep looking at goes up slowly and comes down rather quickly. As soon as you hit the top point of that curve and start coming down, that is when really the only thing that is going to contribute to paying off the benefits is the little bit of interest that the trust fund is going to draw, because everything else is going to have to come from general revenue.

Mr. CRIPPEN. Right.

Mr. SHAW. So this is a problem. This is a mentality, and this is a mindset that we've got to get away from. And this is why I feel that it is so important that we come up with some type of a program where we can actually invest in some real assets or let the people invest in some real assets so there is something out there that they own. And it's not a question of the government owing itself so that it can have a call on taxpayers further down the line so that these taxpayers will have to come in and pay off the debt of the unfunded liabilities of Social Security. So it would certainly appear, then, that that is the question. However, the President having put that money in his plan hasn't really nudged that date by very much, has he? Have you done calculations on that?

Mr. CRIPPEN. We haven't, Mr. Shaw, finished yet. We're in the process of trying to analyze the President's budget, which we just received, as you did, a couple weeks ago. So we don't have all of the data that we'll need. In fact, I saw yesterday that the administration mentioned it was going to send legislation, maybe by tomorrow, on how this transfer mechanism will work. So we don't know exactly.

Mr. SHAW. The administration is going to send you legislation?

Mr. CRIPPEN. The administration mentioned yesterday that it was going to send legislation—I thought they said Friday—to make clear how the transfer mechanism would work. We can infer from some of the tables how it works, but we're not sure.

Mr. SHAW. That would be very helpful for us.

Mr. CRIPPEN. We could fill out some details as well. But, again, we're not sure about our analysis. But it doesn't appear that the 2013 date that you and I both referred to would change significantly. The President's budget is not very clear about what he intends to do on the Social Security benefit side. As you know, in the State of the Union and partly in the budget, he made some allusions to changing the benefits for widows and others.

Mr. SHAW. But you're awaiting in the actual legislation so you can score it. Because many have said that actually it will set it back, and it will go down even quicker because of some of the benefits. I don't criticize the benefits. But it does create concern as to how we're going to extend it.

Perhaps if I could ask Mr. Matsui if he knows of the legislation—if he's had a hand in it.

Mr. MATSUI. Well, I'm not really able to discuss this any further. I think you need to talk to others about this. I'll chat with you later.

Mr. SHAW. OK. Thank you, gentlemen. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. Mr. Crippen, welcome to the Committee. Congratulations on the new position. I really don't have much. I just want to get into one area, and it's probably just for the record.

We have this enormous surplus that's building up over the next 15 years both in the budget and in the Social Security account. And it's my understanding there's only four ways to deal with this, and I've talked to a lot of economists and a number of people.

One is doing what we have been doing with the Social Security surplus, that is, using it to pay for government expenditures. Obviously, if Mr. Greenspan is right, that's not quite appropriate to do, it's better to save it for the future. This is—we're talking about at least the Social Security surplus.

Mr. CRIPPEN. Most economists would agree with that.

Mr. MATSUI. And that's exactly right. That's agreed upon almost universally. Within that same category, we can use the surplus for tax cuts, and Mr. Greenspan suggested that's not a good alternative either because a tax cut is similar to an expenditure in terms of the surplus.

After first and second is just putting it in the vault. As the money comes in, put the dollar bills and coins in a vault. That's nonsensical, but that's, I guess, an option. The fourth is that you can go into the equity markets. You could just take that money and throw it in the equity markets. A lot of folks don't like that. The present proposal suggests making up about 4 percent of the market once it's fully phased in. But there's a lot of problems with that, particularly if you throw the whole $2.8 trillion. So those are the four. And the last way, I understand it, is just dedicating the surplus to drawing down the debt, and that's exactly what the President has proposed in his package.

Unless you pick one of those four, and to me that sounds like the most logical way to handle this to preserve the money for the future, frankly I'm perplexed as to why nobody understands or can't understand why this makes a lot of sense.

And at the same time, the savings on buying down the debt can be used for other governmental purposes including Social Security, which the President has proposed in his package. I guess you can use it for further tax cuts down the road, or you could use it for maybe lending money to the Russians or perhaps buying more hardware or whatever the case may be.

But the President has decided to put that additional sum toward buying down the debt and into the Social Security Fund to shore it up, to pick up that 2.19 percent of payroll shortfall.

And I'm not really asking you a question. I just want to raise that and throw that out because the alternative to that is not using the surplus at all or any of the proceeds off the surplus. And that means one has to make cuts in the program and the benefit levels, or increase the payroll taxes, or a combination of both. And it would be my guess, given the way the debate has gone, is that those two options are probably not available at this time unless somebody wants to step out. But I don't really see that as a viable option.

So if we really want to solve this problem without making those cuts or tax increases, I just want to know what other alternatives we might have. And I would just hope that those that are being so critical and kind of vetting the President's program would come up with another way to deal with this because I'm certainly open, and I'm sure the President is, and I'm sure the public is.

But we need to have more than just criticism. And I just make that observation. I don't have any questions. I just welcome you and look forward to working with you, and I certainly appreciate the fact that you're here today.

Mr. CRIPPEN. Thank you. Mr. Chairman, if I could, I have just one remark in response, if that's appropriate.

Mr. MATSUI. Certainly.

Mr. CRIPPEN. It's simply that we have not, as I suggested, completed our analysis of the President's budget. So I don't know what he proposes, and we need some more detail. But I think it's important to note that my predecessor made her final testimony 2 weeks ago in which she presented a baseline report for the upcoming year, as you know.

Mr. MATSUI. Right.

Mr. CRIPPEN. I think it's important to note that if we do nothing, we will pay down the Federal debt.

Mr. MATSUI. Right.

Mr. CRIPPEN. So that is an option as well. I mean, the do-nothing option may pay down Federal debt a lot. And so I just want to make sure that, as part of your list of options, doing nothing may be helpful.

Mr. MATSUI. Right. In fact, some of my colleagues on both sides of the aisles had suggested maybe that's the best thing to do right now, given the fact that there's no consensus. But certainly we want to try to see if we can use some of the assets for the purpose of dealing with the most fundamental issue that we have probably in this Congress.

But you're right. That is certainly an option, and it will obviously aid the economy and aid the savings rate. Thank you.

Chairman ARCHER. Mr. Crippen, let me, if I may, just piggyback for a moment. Many Members of Congress are confused by the way we budget. The public is totally confused by the way we budget up here.

There's no relationship to anything that you find in the private sector that I know of. In order to try to make a little more common sense out of it for understandability, we have two kinds of debt. We have debt that is held by the trust funds of this country, and that is legitimate Treasury bonds with the full faith and credit and obligation of repayment by the Treasury the same as EE bonds.

And we have the privately held debt which is sometimes referred to as publicly owned debt—the debt that's held by the private sector and not held by government. Both of those debts are equally an obligation of the United States, are they not?

Mr. CRIPPEN. Yes.

Chairman ARCHER. Is there any difference between them as to the obligation to the United States?

Mr. CRIPPEN. No, not that I'm aware of.

Chairman ARCHER. All right. Both of them are covered by the debt ceiling, is that correct?

Mr. CRIPPEN. Yes.

Chairman ARCHER. Have you had a chance to look at the President's budget without necessarily knowing the details of this budgetary scheme for Social Security?

Mr. CRIPPEN. Yes and no. I mean, we have——

Chairman ARCHER. Well, I'm going to ask you a question, and either you've seen it or you haven't seen it. But this refers to the President's presentation in his budget.

Mr. CRIPPEN. Right.

Chairman ARCHER. Does the total debt of the country go up under his scheme, or does it go down?

Mr. CRIPPEN. It would appear to go up.

Chairman ARCHER. OK, let's be very clear. Appear to go up—now by his own figures, does it go up or does it go down?

Mr. CRIPPEN. It goes up.

Chairman ARCHER. It goes up. And yet I read today again in a news story by the Associated Press that the White House has said they're paying the debt down by $2 trillion. How are the American people supposed to understand that when you are telling us that the President's own figures show that the total debt of the United States goes up?

Mr. CRIPPEN. Mr. Chairman, I don't know. I don't have a good answer to that. Obviously, we all measure these things relative to what, and we're in a position——

Chairman ARCHER. But under our system of budgeting, Mr. Crippen, we are always judged by the baseline that CBO puts out. We have been judged that way ever since we've been in the majority. If we raise spending above the baseline, we've increased spending. If we reduce spending below the baseline, we've cut spending.

Mr. CRIPPEN. Right.

Chairman ARCHER. The baseline is the determinator for everything that we do here. Now relative to the baseline, does the President's scheme raise the national debt?

Mr. CRIPPEN. Yes.

Chairman ARCHER. It does. Clearly, it does by his own announced document.

Mr. CRIPPEN. Yes.

Chairman ARCHER. And yet they still can say they're reducing the national debt. What does it do to debt service charges in the future? What does his proposal do to debt service charges in the future? Does it raise them or lower them?

Mr. CRIPPEN. On a gross basis, it would raise them.

Chairman ARCHER. It raises them. This is the matter of concern to me and many of my colleagues. And I just think that we've got to be open and use common sense with the American people and not just shift around things within these budgetary concepts.

I don't think we have a lot more time before we have to vote. And so if you'll indulge us, we'll recess and vote and come back as quickly as possible and continue with the hearing. The Committee will stand in recess until we can come back from the vote.

[Recess.]

Chairman ARCHER. What there is of it. Mr. Crippen, you have, I think, made a contribution to the beginning of our process of trying to determine what the best course is for us in Social Security. We'll appreciate your continuing input. And if you can get any data to us as to your evaluation of what public investment—government investment of government funds in the private sector has done in other areas, that would be very helpful to us.

[The following was subsequently received:]

The Congressional Budget Office (CBO) has not prepared an analysis of the performance of publicly managed portfolios of private investments and currently lacks the data for a comprehensive comparison of the performance of those funds with that of privately managed portfolios. However, we have identified several articles by other analysts that address the issue of how political interference can reduce returns in publicly managed portfolios. Most of the articles examine the experience of state and local governments in managing their public employee pensions. Although many state and local governments have managed their pension portfolios prudently, some have used their public pensions to target political and social objectives, which reduced the returns of their portfolios. The effect of such investments on the overall returns of state and local pensions does not appear to be large, but the evidence is somewhat hard to interpret. Another study looked at the experience of other countries in managing investment portfolios and found that publicly managed pension funds in developing countries have not performed well.

Several studies looked at the performance of state and local governments in managing investment portfolios. Munnell (1983) found that 31 states had undertaken some form of targeted or social investment. Her investigation focused on 10 state funds that had invested in privately insured, mortgage-backed pass-through securities between 1980 and 1982 that provided funds for local housing markets. According to her study, those social investments provided rates of return that were 200 basis points less than they should have been, given the risks of the securities. Romano (1993) examined the relationship between the state funds' earnings and the degree of political involvement and concluded that some public pension funds have been subject to political demands that adversely affected their performance. In a 1997 study, Mitchell and Hsin found that state pension funds earned lower returns if they were required to invest part of their portfolio in in-state assets. According to the authors, a 10 percent increase in in-state investments reduced returns by 1 percent. In a 1998 study, Nofsinger found that state pension funds with economically targeted investments earned rates of return that were about 200 basis points less than those from state funds without such investments.

Some analysts argue, however, that such investments have not had a large impact on the overall returns of the state pension portfolios. Several organizations representing state and local governments recently released a letter showing the 10-year median returns of the public pension fund were about 80 basis points less than those of corporate pension funds, but they also pointed out that state and local governments tend to invest fairly conservatively, so lower returns are not unexpected (National Conference of State Legislatures and others, 1999). Deputy Secretary Lawrence Summers recently testified that the Administration's preliminary analysis indicated that the returns of public pension funds from 1990 to 1995 were similar to those of private funds (Summers, 1999). However, the Administration's analysis has not been published yet so CBO cannot evaluate the results. In any case, since neither analysis appears to control for risk, it is difficult to determine whether the state pension plans are receiving returns commensurate with their risks.

One study (James and others, 1994) examined the average annual investment returns for publicly managed pension funds of selected countries. It concluded that public funds earned substantially less than privately managed funds. That analysis, however, focused on developing countries, so the relevance of its results for the United States is uncertain.

Some analysts have argued that pension funds, if set up properly, can be insulated from political interference. Those analysts often point to the federal government's Thrift Savings Plan (TSP) as a successful model (see Angelis, 1998). However, the TSP accounts are fully owned by federal employees. TSP's experience may not apply to a situation in which the government owns the assets.

References

Angelis, Theodore, "Investing Public Money in Private Markets: What Are the Right Questions?" in R. Douglas Arnold, Michael Graetz, Alicia Munnell, eds., *Framing the Social Security Debate: Values, Politics, and Economics* (Washington, D.C.: National Academy of Social Insurance, 1998).

James, Estelle, and others, *Averting the Old-Age Crisis* (Washington, D.C.: World Bank, 1994), pp. 93-96.

Letter from the National Conference of State Legislatures and others to E. Clay Shaw, Jr., Chairman, Subcommittee on Social Security of the House Committee on Ways and Means, February 27, 1999.

Mitchell, Olivia, and Ping-Lung Hsin, "Public Pension Governance and Performance," in Salvador Valdés-Prieto, ed., *The Economics of Pensions: Principles, Policies, and International Experience* (Cambridge: Cambridge University Press, 1997).

Munnell, Alicia, "The Pitfalls of Social Investing by Public Pension Plans," *New England Economic Review* (September/October 1983), pp. 20-37.

Nofsinger, John, "Why Targeted Investing Does Not Make Sense," *Financial Management*, vol. 27, no. 3 (Autumn 1998), pp. 87-96.

Romano, Roberta, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review*, vol. 93, no. 4 (May 1993), pp. 795-853.

Statement of Lawrence Summers, Deputy Secretary of the Treasury, before the Subcommittee on Social Security of the House Committee on Ways and Means, March 3, 1999.

Chairman ARCHER. So I thank you very much, and I wish you Godspeed in your work.

Mr. CRIPPEN. Thank you. We need it. Invite us back again.

Chairman ARCHER. Our next witness is James Roosevelt, Jr., the grandson of Franklin Roosevelt, the founder of Social Security, a system that on a bipartisan basis there is unified support to save and to continue to make available for future generations.

And since you are one of those future generations and perhaps you've got others coming behind you, we'd be pleased to receive your testimony.

**STATEMENT OF JAMES ROOSEVELT, JR., ASSOCIATE COMMISSIONER, RETIREMENT POLICY, SOCIAL SECURITY ADMINISTRATION**

Mr. ROOSEVELT. Thank you, Mr. Chairman. I appreciate the opportunity to discuss the issue of insuring retirement security for future generations, and what the United States can learn from the experiences of other countries.

As you've said, my name is James Roosevelt, Jr., and I'm Associate Commissioner for Retirement Policy at the Social Security Administration. Our Social Security Program is the most successful program in the Nation's history, and its financial health is now sound.

But if we do not address the long-range financing issues, the trust funds which today have a balance of about $730 billion and are growing, would be exhausted in 2032. At that time, payroll taxes would generate enough income to cover only about three-fourths of benefit obligations.

As you know, the reason for the future strain on the financing of our social insurance system is largely demographic. When benefits were first paid in 1940, a 65-year-old on average lived about 12½ more years. Today, that life expectancy is about 17½ years and rising.

Further, the number of older Americans is expected to double by the year 2030. Comparisons to other countries must be done carefully. The life expectancy in the United States has grown, but not as fast as in other countries. The fertility rate in the United States has fallen, but not as much as in many other developed countries.

So just as our demographics are not identical to those of other countries——

Chairman ARCHER. Mr. Roosevelt, that's some of the best news we've heard so far.

Mr. ROOSEVELT. That's true. And there are in my written testimony some numbers to lay this out in more detail. Just as our demographics are not identical to those of other countries, our economies and our social institutions are not identical.

We also differ from other countries because we have already taken some precautionary measures to buttress our Social Security system. The National Commission on Social Security Reform on which you served, Mr. Chairman, proposed reforms to begin to prepare our Nation for the retirement of our baby boom generation.

For these and other reasons, we are in a better position to deal with our demographic challenges than many other nations. Nonetheless, examination of the experience of other countries can provide valuable insights. Let me mention just two examples at this time.

Of special interest to the United States is the Canadian decision to invest new funds in a diversified portfolio of securities. That is, a combination of stocks and bonds. An investment board for the Canadian pension plan will operate at arm's length from government influence. Its private investments reflecting a diversified portfolio will mirror broad market indexes.

In Chile, as we've heard discussed earlier today, fundamental social insurance reforms were made in 1981 when the old Chilean system was close to bankruptcy. The current plan is based on private retirement pension funds. No employer contributions are made. Workers are required to make monthly contributions equal to 10 percent of their wages plus 3 percent for administrative fees and disability and survivor's insurance.

Overall, the rate of return under the privatized Chilean system from 1981 through 1998 has been 11 percent. But if you factor in all costs, the real rate of return is 7.4 percent through 1995, but it has declined since then.

The recent annual rates of return in Chile were negative in 2 of the last 4 years. In fact, the situation has deteriorated to such a degree that the Deputy Secretary of Social Security in Chile is encouraging workers who are eligible to retire to postpone their decision until such time as losses in the individual accounts may be reversed. I think it is safe to say that no one here today would ever want to make such a pronouncement to the American public.

Let me now turn to the administration's framework for ensuring retirement security for future generations of Americans that will help us reach a comprehensive solution for extending Social Security solvency for at least the next 75 years.

The President has proposed steps that can be taken to extend solvency through 2055. Specifically, the President proposed first to transfer 62 percent of budget surpluses over the next 15 years to Social Security and pay down the publicly held debt which would strengthen our economy for the future.

Second, the President has also proposed that we invest a portion of the 62 percent in the private sector to achieve higher returns for Social Security. Funds would be invested in broad market indexes by private managers, not the government.

Because such a small portion, never exceeding 15 percent of the trust funds, would be invested in the private sector, the risk to the trust funds would be minimal, and that risk would be borne by the government, not by private citizens.

Finally, the President has called for the bipartisan effort that will be needed to make the hard choices to ensure long-range solvency. And I would note that this bipartisan cooperation on long-range actions is what you have called for, Mr. Chairman.

The President has also said that reducing poverty among elderly women must be a priority as part of the solution. And he has proposed eliminating the annual retirement earnings test.

In conclusion, we can learn much from other countries around the world in dealing with retirement security issues. At the same time, we must chart our own course based on our own experience and our own situation. The administration and the Congress must work together to achieve a bipartisan package to ensure the solvency of Social Security for at least the next 75 years.

We must use the window of opportunity provided by the historic budget surpluses to strengthen the Social Security system. We look forward to working with you and this Committee in that effort. Thank you very much.

[The prepared statement follows:]

**Statement of James Roosevelt, Jr., Associate Commissioner, Retirement Policy, Social Security Administration**

Good morning, Mr. Chairman and Members of the Committee. My name is James Roosevelt, Jr., and I am the Associate Commissioner for Retirement Policy at the Social Security Administration. I appreciate the opportunity to appear before you today to discuss Social Security reform lessons learned in other countries. I am glad to be a part of the ongoing discussions to save Social Security for the 21st century. There is valuable information that can be gleaned from examining the efforts to reform social insurance programs around the world.

In my testimony today I will briefly review for you Social Security's long-range solvency situation in terms of the status of the trust funds as well as changing demographics. I will also discuss the demographics facing other nations, and a broad range of reforms that have been implemented in other countries to address those changes. This topic is quite relevant; as I will discuss later, the Administration considered foreign experience carefully in the process of developing our framework to protect Social Security.

It is important to keep in mind that every country has its own unique circumstances and that what is best in one country may not be the best solution for our country. Each country faces a different set of demographics and has a different set of programs to support retirees, survivors and the disabled. For example, merely comparing cash benefits without considering health and housing supplements may provide a distorted picture. Also, the social insurance tradition and the status of the social insurance programs in different countries vary greatly. We face a problem in this country, but we are fortunate in that we do not face a crisis. Some countries have made radical changes because their situations were more dramatic and immediate.

### STATUS OF THE SOCIAL SECURITY TRUST FUNDS

I'd like to take a moment to share with you the current status of the Social Security Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds. The OASDI Trustees monitor the financial health of Social Security—our Nation's most successful family protection program.

According to the 1998 Trustees Report, the assets of the combined funds increased by $88.6 billion, from $567.0 billion at the end of December 1996 to $655.5 billion at the end of December 1997. At the end of fiscal year 1998, the combined funds had a combined balance of $730 billion. In 1997, the Social Security trust funds took in $457.7 billion and paid out $369.1 billion. Thus, over 80 percent of income was returned in benefit payments. Administrative expenses in 1997 were $3.4 billion, or about 0.9 percent of benefits paid during the year.

Under the 1998 Trustees Report's intermediate assumptions, the annual combined tax income of the OASDI program will continue to exceed annual expenditures from the funds until 2013. However, because of interest income, total income is projected to continue to exceed expenditures until 2021. The funds would begin to decline in 2021 and would be exhausted in 2032.

In 2032, when the trust funds are projected to become exhausted, continuing payroll taxes and income from taxes on benefits are expected to generate more than $650 billion in revenues (in constant 1998 dollars) for the Trust Funds in 2032. This is enough income to cover about three-fourths of benefit obligations. And I want to stress that the President is committed to seeing to it that this scenario never develops.

## Changing Demographics

I have mentioned "demographics" in a general way, but I have some specific facts to share with you that may be helpful to our discussion today:

• In the U.S. in 1995, the elderly population (aged 65 and over) was about 34 million, making up about 12% of the population. In contrast, there were about 9 million aged people in the U.S. in 1940, and then they accounted for less than 7 percent of the population.

• And Americans are living longer. When benefits were first paid in 1940, a 65-year old on average lived about 12 more years. Today, a 65-year old could expect to live about 17 more years and by 2070, life expectancy at age 65 is projected to be an additional 20 years.

• The elderly population growth rate is expected to be modest from now through 2010, but it will increase dramatically between 2010 and 2030 as the baby-boom generation ages into the 65-or-older age group. For every 100 working age people, there will be more than 35 people aged 65 and over by 2030.

• In 1994, 60% of the elderly were women and 40% were men. Among the oldest of these (85 or older), over 70% were women and fewer than 30% were men.

Clearly, many millions of people are depending on us for strong and decisive action to preserve and protect the multi-tiered structure of retirement income security. President Clinton stated that we must act now to tackle this tough, long-term challenge.

## Foreign Demographics

Certainly it is no secret that other countries are facing similar demographic issues, some far more serious than ours. In the U.S., we will have 21 people aged 65 and over for every 100 American workers next year. But in Japan, for every 100 workers, there will be more than 24 people aged 65 and over. Belgium, France, Greece, Sweden and Italy will likely have higher ratios of aged persons to workers than we will. Our elderly person to worker ratio would be higher today if not for the baby boom.

Life expectancy is also increasing around the world and is expected to continue to do so. In the United States and the United Kingdom, life expectancy at birth has increased by about 6 years from the early 1950's to the late 1980's. Over the same period, life expectancy at birth has increased by about 10 years in France, Italy and Greece, 13 years in Spain, 8 years in Switzerland and 7 years in Germany.

Further, the fertility rate in developed countries needs to be about 2.1 to maintain a stable population, and only Ireland is at that level or projected to be there. The impact of increasing longevity and decreasing fertility is indicated by the percent of population over 65. When compared with some other developed nations, the percent of the U.S. population over 65 is relatively low and the relative position of the U.S. is not projected to change in the next twenty years. In Italy, for example, elderly residents represented 14.1 percent of the total population in 1990, with projected growth to 20.9 percent in 2020. 11.7 percent of the population was over 65 in Japan in 1990, and is projected to grow to 24.2 percent in 2020. Here in the U.S., 12.6 percent of us were over 65 in 1990; we are projected to reach just 16.3 percent in 2020.

## Differences in Social Policy

Just as our demographic picture is not identical to that of other developed countries, we differ in other important ways as well. For example, our Social Security program is a relatively small piece of this country's Gross Domestic Product (GDP)—in 1998, Social Security expenditures were 4.6 percent of GDP. In many countries, social insurance represents a far larger proportion of GDP.

We also differ from other countries in our approach to changing demographics because we were foresighted enough to begin to prepare our Nation for the retirement of our baby boomers with the 1983 Social Security Amendments. The 1983 amendments paved the way to move from a pay-as-you-go approach to partial advance funding.

For all of these reasons, we in the U.S. are in a somewhat better relative position to begin to deal with the challenges presented by our changing population than are many other nations. In addition, other countries have different income support and social service programs. Therefore it is sometimes difficult to make direct comparisons with what other countries are doing or have already done. Nonetheless, examination of the experience of foreign countries provides interesting and valuable insights, and there is much we can learn.

INTERNATIONAL APPROACHES TO REFORM

Let me turn now to a discussion of how other countries are dealing with these demographic changes. Sweden and the United Kingdom have made recent changes in their old-age pension programs. Canada is also making changes. Of course, Chile is another, oft-cited model for retirement income reform and Australia has added a new element to their very different and interesting social insurance structure. I would like to talk about each of these countries, beginning with what is going on in Canada.

Our neighbors to the north have recently enacted legislation to deal with their changing population. When the Canada Pension Plan was introduced in 1966, the face of Canada's population was entirely different than it is today. A quickly growing senior population, a generation soon to retire, and a rapidly shifting economy resulted in the Canadian government's adoption of a number of reforms to strengthen Canada's retirement income system.

Of special interest to us in the United States is the Canadian decision to invest new funds in a diversified portfolio of securities—that is, a combination of stocks and bonds. This recent legislation allows the fund to build an eventual reserve of 4–5 years of benefits and moves the Canada Pension Plan system away from a pay-as-you-go plan toward a more fully funded system.

The new investment board for the Canada Pension Plan is to operate at arm's length from government influence, with the stock investments reflecting a diversified portfolio, which will be selected passively, mirroring broad market indexes. We will be watching Canada carefully as it deals with questions concerning corporate governance. For example, regulations have not yet been issued on whether or how shares owned by the Canada Pension Plan will be voted.

Another country that invests part of its government pension fund in stocks is Sweden, which has been making such investments since 1974. About 13 percent of the surplus funds were invested in stocks in 1996, the latest data available. These investments represent about 4 percent of total Stockholm Exchange market capitalization. The funds are directed by large boards that represent government, business, and labor.

Let me talk a little more about Sweden's program. Under the new Swedish system (now being implemented), basic and supplementary pensions will be phased out and replaced by a single, earnings-related pension. In addition, 2 percent of earnings will be invested in individual "premium accounts." These premium accounts will be privately managed, under public supervision, and permit a wide range of investments. Payroll contributions will be held in a conservatively invested account until the administrative process is completed and they are credited (with interim returns) to each worker's chosen account. Since this program is brand new, we will be watching its implementation with great interest.

The United Kingdom has about 10 years of experience with individual retirement accounts. Starting in 1988, the British system allowed workers to "contract out" the earnings related portion of their two-tier pension program in order to set up tax-deferred "personal pensions." Thus, under this system, privatization is voluntary. However, there are weaknesses to their system. The British system has diverted funds away from occupational or government defined benefit plans to defined contribution plans, shifting risk to the individual. In addition, workers with low wages or sporadic work histories do not seem to be well protected. The British government has recently proposed substantially revising their system to address this issue. We will be watching with interest to see what steps the United Kingdom takes to improve their retirement income protection program.

In addition, the British government has had difficulty regulating the sale of private pensions; misleading and sometimes fraudulent sales tactics may have adversely affected as many as 20 percent of those who opted for personal pensions. Also yet to be resolved is how best to set up an effective regulatory mechanism whereby investors can seek redress and compensation.

It would appear that social insurance reform plans that involve direct selling of investment instruments raise many difficult issues. Arthur Levitt, Chairman of the Securities and Exchange Commission, recently cautioned that under a mandatory individual accounts program, uninformed investors won't be able to capture the potential for greater returns because "they risk making poor decisions, perhaps through ignorance or because they fall prey to misleading sales practices."

And let me say a couple of things about the fundamental reform of the Chilean social insurance system. It is worth pointing out that the situation in Chile prior to reform looked nothing like the situation we are facing today. Chile's demography was vastly different in that it had, and still has, a relatively young population, a fertility rate substantially above ours, and a 9-to-1 ratio of workers to retirees when the change was made. Further, as you know, the old Chilean program was close to bankruptcy when it was overhauled in 1981.

The plan is based on private retirement pension funds administered by private pension fund management companies. There are no employer contributions under the new plan, but workers are required to make monthly contributions equal to 10 percent of their wages into individual savings accounts. There is an additional 3 percent contribution for administrative fees and disability and survivors insurance. Transition costs were funded in part by selling off a vast array of nationalized companies.

This is not to say, however, that the experience of Chile does not hold some lessons for the United States. While the Chilean reforms did respond to some of the problems inherent in the old system, some serious concerns remain. Some of the difficulties are:

- about 40 percent of workers are not contributing regularly;
- 80 percent of the self employed are not participating;
- administrative fees are high but choice in investments is limited due to regulation;
- and rates of return in recent years are too small to cover administrative fees.

The overall real rate of return under the privatized Chilean system from its inception in 1981 through the end of 1998 is 11 percent. However, the overall real rate of return is not what every worker is getting. After considering administrative costs, including withdrawal fees and costs of annuitization, the real rate of return through 1995 was 7.4 percent and is still declining.

In the last 4 years, annual rates of return in Chile have been low or negative. In fact, the situation has deteriorated to such a degree that in October the Deputy Secretary of Social Security in Chile, Patricio Tombolini, encouraged workers who are eligible to retire to postpone their decision until such time as the market losses could be reversed. I think it is safe to say that no one here today ever wants to have to make such a pronouncement to the American public.

Another country that has made recent changes to its pension system is Australia. Australia's system is quite different from the United States'. Australia has approached the problem of improving retirement income not by expanding public programs, but by imposing a mandate on all employers to offer at least one contributory retirement plan to all employees. Employers are required to make contributions to these funds at the rate of seven percent of employee earnings in 1999, rising to 9 percent in 2002–2003. Many employers make contributions that are above and beyond what is required. The plans are fully portable and managed by the private sector. They are paid out at age 55, some as pensions but the majority as lump sums which can be annuitized. This supplements a very generous, wealth-tested retirement benefit funded through general revenues payable at age 65. The Australian approach to individual accounts was implemented in 1992 and is scheduled to be complete in 2002.

This brief review has illustrated the great diversity of the retirement income protection plans around the world. While I do not want to over-generalize about what we can learn from international experience, one observation I can make is that when countries have individual accounts as part of their national retirement system, lower earners, intermittent workers, and women tend to have less favorable outcomes than others. However, in many nations, this problem is offset by the provision of a great variety of income support and social service programs offered to the elderly. Where such programs do not exist, or are very limited such as in Chile, the affected workers may be severely disadvantaged.

## President's Response Reflects Foreign Experience

Three weeks ago, in his State of the Union address, President Clinton proposed historic steps to ensure the solvency of Social Security. When putting together his framework for a solution to the long-range Social Security solvency problem facing our country, President Clinton wanted to increase national savings to reduce burdens on future generations and reduce publicly held debt. His plan, therefore, draws on the approach taken by Canada and other countries and State and local pension systems in this country to diversify the fund portfolio. Through the provision of Universal Savings Accounts (USA accounts), the President's framework draws on the experience of countries that have added individual retirement accounts as a voluntary supplement to social insurance protection.

Specifically, the President proposed the following three actions to solve the Social Security program financing problem:

- Transfer 62 percent of projected federal budget surpluses over the next 15 years—about $2.8 trillion—to the Social Security system and use the money to pay down the publicly held debt, which would strengthen our economy for the future. Thus the President's plan provides for debt reduction while giving Social Security the benefit of the gains from reducing publicly held debt.

• Invest a portion of the trust funds, which would never exceed about 15 percent, in the private sector to achieve higher returns for Social Security. Funds would be invested in broad market indexes by private managers, not the government.

• A bipartisan effort to take further action to ensure the system's solvency until at least 2075. There are hard choices that we must face. To assure confidence in Social Security it is important to bring the program into 75-year actuarial balance.

The President's first two steps will keep Social Security solvent until 2055, and bipartisan agreement on the hard choices could extend that solvency at least through 2075.

President Clinton also said that reducing poverty among elderly women must be a priority as part of this comprehensive solution. While the poverty rate for the elderly population is approximately 11 percent, for elderly widows it's 18 percent. In addition, he proposed eliminating the retirement earnings test, and strengthening Medicare. These proposed actions constitute a solid framework for ensuring retirement security for current and future generations of Americans, and I would like to review them now in some detail.

First, the President's plan would require that transfers be made from the U.S. Treasury to the Social Security trust fund each year for 15 years. The annual funds transferred would be specified in law, so that by 2015, about $2.8 trillion would be allocated to save Social Security. A portion of these funds would be invested in the private sector each year, from 2000 through 2014, until such time as 14.6 percent of the Trust Funds are in private investments. The remainder, 85.4 percent, would continue to be held in government securities. Thus, for example, in 2032, 94 percent of benefit payments will come from tax revenue and interest on government securities with only six percent from private investments.

Stocks over time have returned about 7 percent annually after inflation, while bonds have yielded about half as much. Diversifying the trust fund investment to include stocks would produce more investment income and reduce the projected shortfall. It would provide a higher rate of return with no risk to the individual and minimum risk to the trust funds.

Under the President's proposal, total investment in the private sector would account for around 4 percent or less of the U.S. stock market over the next 30 to 40 years. This share of the market is equivalent to the share that Fidelity manages today. State and local pension funds now represent more than twice that figure—about 10 percent—of total stock market investments. If State and local pensions had not, years ago, gone in the direction of a diversified portfolio, then States and localities would have had to increase taxes or curtail pensions significantly. State and local government pension plans now hold roughly 60 percent of their total investment portfolios in the private sector.

The Administration understands the importance of providing appropriate safeguards to avoid politicizing the investment process; under the President's proposal, the Administration and Congress together would craft a plan that ensures independent management without political interference. We believe that this can be done, especially if the Federal Reserve Board and the Thrift Savings Plan Board serve as models.

The President's framework does not merely protect Social Security—it reduces publicly held debt and increases the savings rate. Paying down publicly held debt would cause new capital formation to occur; it will reduce debt servicing costs as well. As Alan Greenspan recently asserted, "reducing the national debt—the publicly held debtis a very important element in sustaining economic growth." He added, "as the debt goes down, so do long-term interest rates, so do mortgage rates, and indeed economic growth would be materially enhanced as a consequence." Finally, paying down publicly held debt provides Government with flexibility to respond to future conditions. That is, if the government later decides to finance some obligations by issuing new publicly held debt—for example, redeeming Social Security assets—it would be possible to do so without threatening future economic performance.

Second, in addition to strengthening Social Security and Medicare, the President has proposed Universal Savings Accounts, separate from Social Security, to help every American build the wealth they will need to finance longer lifespans. Under the President's framework, we will reserve 12 percent of the projected surpluses over the next 15 years—averaging about $33 billion per year, so that every worker can have a nest egg for retirement. These accounts, proposed by the President, would be matched on a progressive basis. Today, the vast majority of pensions and savings go to the top one half of the population by income, leaving only a small percentage for the lower 50 percent by income. USA accounts, separate from Social Security, will mean hundreds of dollars in targeted tax cuts for working Americans, with more help for lower-income workers.

CONCLUSION

In conclusion, let me say we have much in common with many countries around the world as we face the demographic challenges we are discussing today. It is important to learn as much as we can from their experiences. It seems clear that many foreign nations are looking to strengthen their savings rates and provide for advance funding. The President's proposals for protecting Social Security are consistent with these goals. The President's proposals represent a solid framework for ensuring retirement security.

The President's plan is a sound approach for protecting Social Security. It uses the budget surpluses—the first the nation has enjoyed in more than a generation—to help preserve a program that is of overriding importance to the American public. The Social Security program in the United States has been a resounding success. It has lifted the elderly out of poverty. Today without Social Security about half of the elderly would be living in poverty. With Social Security that number has been reduced to 11 percent. This is a program worth protecting and must be protected.

The Administration and the Congress worked together successfully to achieve a robust economy. The Administration and the Congress must now work together to achieve a bipartisan package to ensure the solvency of Social Security for at least the next 75 years. We must use the window of opportunity provided by the budget surpluses to move us closer to a financially secure system. We look forward to working with this Committee to strengthen the Social Security system for the future.

Chairman ARCHER. Thank you, Mr. Roosevelt.

Mr. Shaw.

Mr. SHAW. Mr. Roosevelt, you mentioned that the President's plan would keep the trust funds solvent for 75 years. What is your definition of solvency?

Mr. ROOSEVELT. Well, the steps that the President has proposed would keep the Social Security Trust Funds solvent until 2055, Congressman. He has said that there is a need for a bipartisan effort to reach agreements on steps that would bring it all the way to 75 years.

Mr. SHAW. Well, I understand that. But what's your definition of solvency? That's what I'm concerned about.

Mr. ROOSEVELT. Solvency, as I've used it as a working definition, is to continue to pay current benefit levels as promised under the law.

Mr. SHAW. And where will we get the money to make those payments in cash?

Mr. ROOSEVELT. Since 1983, we have been in a program where we combine a pay-as-you-go method and some degree of prefunding.

Mr. SHAW. What type of prefunding?

Mr. ROOSEVELT. Well, the prefunding involved in the credits to the trust fund that are represented by government securities.

Mr. SHAW. So it's your testimony that solvency includes paying the Federal Government paying off the Treasury bills that are in the trust fund, is that correct?

Mr. ROOSEVELT. It includes the steps that the President has suggested with the use of the surplus so that there will be funds to continue to pay benefits through 2055 and then additional steps so that we will have the funds to pay the benefits for the next 75 years.

Mr. SHAW. How is it going to pay those Treasury bills off?

Mr. ROOSEVELT. Well, if we follow the plan that the President has put forward, we will be paying down the publicly held debt so that there will be more capital available in the economy and more income to the Social Security Trust Fund.

Mr. SHAW. More capital in the economy. But it's going to require an infusion of tax dollars into the trust fund to retire the Treasury bills, is that correct? I mean, that's a simple yes or no. The answer is yes because when payroll taxes no longer can take care of the obligations of the trust fund, then the trust fund starts to liquidate the Treasury bills. And the only way it can liquidate the Treasury bills is to get tax dollars, is that correct? I just want to be sure that we've got some truth in accounting here. I mean, we——

Mr. ROOSEVELT. As we know, at the point where there is not sufficient income from the pay-as-you-go method, it will be necessary to use the interest from the trust funds and then to redeem the Treasury bills.

Mr. SHAW. So it will be necessary to start using tax dollars at a future date, is that not correct?

Mr. ROOSEVELT. It would be necessary if we reach that point, depending on the other decisions that we make, to redeem those bonds for Treasury funds. And those bonds, of course, are backed by the full faith and credit of the U.S. Government.

Mr. SHAW. Which is the taxpayer?

Mr. ROOSEVELT. Which is the U.S. Treasury funded by the taxpayer.

Mr. SHAW. Which is the taxpayer. Each one of us who pays taxes are backing the full faith and credit of the Federal Government. There's no question about that.

Mr. ROOSEVELT. Absolutely, Congressman.

Mr. SHAW. Good. Are you in the loop on this legislation that the last witness talked about?

Mr. ROOSEVELT. I am not aware of any legislation that's to be filed imminently. No, I'm not.

Mr. SHAW. Well, this Committee would be very interested in seeing this legislation. And, hopefully, we would be interested in supporting it.

Mr. ROOSEVELT. I will pass that word along to the administration.

Mr. SHAW. OK. Thank you, Mr. Roosevelt.

Chairman ARCHER. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. I thank you for being here, Mr. Roosevelt. I want to get to the Chilean issue, if I may. And you did speak on it, and I was not here. I was coming in the room when you were speaking in your opening remarks on it.

But could you tell me what the overall cost of the Chilean individual account might be in terms of percentage of the asset itself taking into consideration transfer cost, the cost of maintenance, and setting up an annuity from the Chilean fund. Do you happen to have those statistics? I know that some other people who will follow you do. But if you happen to have them, I——

Mr. ROOSEVELT. Congressman, are you talking about the administrative costs of running that system?

Mr. MATSUI. Right, exactly, and maybe just those two, the administrative costs and the costs of setting up an annuity account beyond that because I wasn't able to really get that from you.

Mr. ROOSEVELT. The figures that I have seen indicate that the rate of return is reduced from 11 percent to about 7.4 percent by the administrative costs. So that would take about 3.6 percent of the rate of return for administrative costs.

Mr. MATSUI. OK. Let me ask you about the President's plan here. The administration is buying down debt with a sizable portion of the surplus, and it also is not using any of the general revenues in this portion for government spending. But they will in fact have additional moneys coming in through the savings on the reduction of the debt service. Is that my understanding?

Mr. ROOSEVELT. Yes, that is my understanding.

Mr. MATSUI. And what does that come to in dollar terms, do you recall, $2.1 trillion or $2.7 trillion?

Mr. ROOSEVELT. Of the money to be transferred to the OASDI Trust Funds, about $2.1 trillion would reduce the publicly held debt.

Mr. MATSUI. I guess what I was asking, maybe I didn't state that right—but the total amount of the additional funds going into the Social Security system would be about $5.1 or $5.2 trillion over that period up to 2055. Is that correct, or am I wrong about that? It would be $2.7 trillion plus the debt service savings going into it. Could you give me that number?

Mr. ROOSEVELT. The number I have is that the amount transferred to the OASDI Trust Funds through 2014 would be about $2.7 trillion. Of course, additional interest and dividend income would come to the trust funds as a result of this transfer.

Mr. MATSUI. See, this is where I'm confused because Mr. Aaron, who is with the Brookings Institution, has suggested that you have $2.7 trillion of the surplus, and I just want to get this because there's a lot of confusion out there even among my colleagues on our side of the aisle. The figure is $2.7 billion of the surplus that will be used to buy down the debt.

And go ahead. I'm asking you to help me frame the question.

Mr. ROOSEVELT. All right. I think what we're doing here is that $2.1 trillion of the amount transferred to the OASDI Trust Funds would be used to buy down the debt.

Mr. MATSUI. Mr. Aaron uses a figure of about $2.5 trillion over the period of 2055. Does that number mean anything?

Mr. ROOSEVELT. He is an economist which I am not, so I think that that number probably does mean something. But I'm not in a position to validate it one way or another.

Mr. MATSUI. Well, I'm sorry. I probably shouldn't even have raised that. I probably was asking the wrong individual. So I apologize to you for that. I just wanted to try to clarify it, and obviously I haven't been able to, but not through your fault.

Mr. ROOSEVELT. Well, thank you. I think perhaps one of the other witnesses who is an economist will be able to.

Mr. MATSUI. I have no further questions. Thank you. I yield back.

Mr. ARCHER. The gentleman yields back the balance of his time. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman. Mr. Roosevelt, let me just ask you one or two questions, and then I'll yield back my time. Dr. Piñera in his testimony earlier today mentioned that the President's proposed universal savings accounts were not really universal, or at least he made that statement that they weren't really universal. And one of those reasons was that you couldn't use the money for whatever purpose you chose. They weren't really private accounts with private decisionmaking vested in the individual.

Can you explain to me if there is a universal character or give me your comment on whether or not there's a universal character to the USA accounts that the President has proposed?

Mr. ROOSEVELT. The USA accounts, as the President has suggested them, are intended to be for retirement security as I'm sure you're aware, Congressman. It has always been intended in the planning of the Social Security system that there be three parts to retirement security with Social Security as a foundation, private pensions for those who have access to them, and private savings for retirement as opposed to other things that it's perfectly worthwhile to have private savings for.

So the universal savings accounts that the President has suggested are for retirement security. They're separate from Social Security, but they're still intended for retirement security.

There are in other models around the world—Australia, for example, which I discuss in my statement, has accounts that can be used for any purpose, and they meet a more pure private account approach. But they don't necessarily meet the retirement security test. In Australia, the majority of people retire at 55 and spend down their entire account by the time they're 65, at which time they become eligible for a generous means-tested age pension. That's not what we're aiming for in this country. We're aiming for dealing with people's longevity.

Mr. BECERRA. A final question. The situation in Chile last year evidently there were statements made by high-level government officials and those who ran the private accounts or the investment funds that some individuals should hold off in retiring until a later date until the market recovered a bit. Give me a little bit more detail on that because I know Mr. Piñera seemed to indicate that he wasn't—when Mr. Matsui asked him about that, he didn't at least indicate that he was in agreement with what Mr. Matsui was saying with regard to that.

Mr. ROOSEVELT. Yes. Well, of course, Mr. Piñera has been here in Washington in recent years. Patricio Tambolini who is the Deputy Secretary of Social Security who actually runs the system now in Chile has made the suggestion publicly and in the press in Chile that people not retire in the near future because the accounts have declined, and that they should wait and hope that they recover.

Mr. BECERRA. What's the effect of that? What do you mean by they declined?

Mr. ROOSEVELT. The actual value of the accounts in 2 of the last 4 years has had a negative rate of return so that some workers will have suffered from their accounts actually going down rather than building up for their retirement.

Mr. BECERRA. Would it cause a situation where if you have two similar individuals, two twin brothers who have worked the same amount of years, same type of employment, same amount of investment. One chooses to retire on *x* date when the fund, the market is still doing fairly well, then another chooses to retire at a later point in time when the market has gone down.

Even though they have similar records that they would be receiving different types of retirement pensions?

Mr. ROOSEVELT. That is the problem that they would face if one retired in 1995 when there had been a number of good years, he would have done much better than his twin brother who retired in 1998 when there had been 2 out of 3 bad years and had not regained the losses.

Mr. BACERRA. Thank you. Thank you, Mr. Chairman. I yield back.

Mr. SHAW. Mr. Chairman.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. I'd like to go back to some of the earlier questioning because there's some other testimony that's been received that would really conflict with the testimony of this particular witness. I want to see if I can try to get it straightened out.

Earlier, the witness right before you, Mr. Crippen, testified that the debt ceiling was actually going to increase under the President's program. I believe you were in the room and heard him testify to that. I have here the testimony of David Walker before the Senate Finance Committee on February 9, just a few days ago.

And he not only testifies as to the increase of the debt, but he shows a graph where the increase is far above the baseline. Now how do you reconcile that with your response that you just had to Mr. Matsui's question with regard to how you were going to finance that, I think that you said savings on the servicing the debt. Do you stick with that testimony despite the fact that clearly—according to these—we're going to see increased debt under the President's program?

Mr. ROOSEVELT. I do, Congressman, because what the President's framework would do is pay down the publicly held debt. The increase in the overall debt including government obligations to the trust fund simply acknowledges the debt that we already have to meet our obligations.

And actually, Mr. Walker did speak to that on February 9, and he said that debt held by the public and debt held by the trust funds represent very different concepts. Debt held by the public approximates the Federal Government's competition with other sectors in the credit markets, and this affects interest rates and private capital accumulation and further interest on the debt held by the public is a current burden on the taxpayers.

In contrast, debt held by the trust funds performs an accounting function. It does not compete with private sector funds in the credit markets.

Mr. SHAW. Let me respectfully disagree with you. I think you were talking about obligations of the Federal Government to the trust fund. It has the full faith and credit of the Federal Government.

Now how do you differentiate that from what's owed the public? It's money that's owed. Isn't that correct?

Mr. ROOSEVELT. They certainly are obligations, and there's no suggestion here that we would ever renege on that. It's a question of whether this——

Mr. SHAW. We're talking about total debt. And whether it's due to the trust fund or due to the public as a whole, it's still debt of the Federal Government which has to be accounted for. And it does go above the baseline, and it does increase the debt.

Mr. ROOSEVELT. There's no question but that it does do that. On the other hand, as Mr. Walker pointed out, the President's proposal reduces debt held by the public which reduces net interest cost, raises national saving and contributes to future economic growth.

Mr. SHAW. Well, I would suggest that the statement that you have made in the context that you made it in reply to Mr. Matsui is simply false. It's simply not true that this is all going to be all paid off and taken care of, because of the fact that you've reduced the public debt, and that you're not going to have the expense of this debt when this debt is still due to the trust fund.

Mr. ROOSEVELT. It's certainly true, Congressman, that compared to current law, the debt ceiling would have to increase. On the other hand, any way in which we spend the surplus would bring about the same result. So the only way that would not happen is if we used the surplus only to reduce debt.

Mr. SHAW. You know, it's very curious. One thing you talk about as far as putting that money into the trust fund in the first place or putting that surplus because we pump it out the other end and take in Treasury bills. So that money's sitting out there again.

You could pump it through several more times, couldn't you?

Mr. ROOSEVELT. I don't—that's not my understanding. Now I'm not a budget expert. I believe that's my colleagues at OMB or Treasury.

Mr. SHAW. I mean, from an accounting standpoint, if you do it again, I mean, the money's back. So you can either pay down the debt, or you can run it through the trust fund again and create more IOUs.

Mr. ROOSEVELT. Once it's used to spend down public debt——

Mr. SHAW. This is the problem with the system that we have, and it shows how it is subject to gimmicks—and it's nothing but a gimmick. What we need to look at and concentrate on on our whole discussion with regard to this is cash flow. And that means we have to concentrate on that point in time when there is not enough money coming into the Social Security Trust Fund to pay its obligations. And that's what we've got to look at because beyond that point, it's just a question of the obligation of the taxpayers of this country, and it changes a whole nature of the system that your grandfather created.

Mr. ROOSEVELT. I think we can agree that that's why we need to work toward a bipartisan solution.

Mr. SHAW. Good way to end. Yes, sir.

Chairman ARCHER. Thank you very much, Mr. Roosevelt.

Mr. ROOSEVELT. Thank you for the opportunity, Mr. Chairman, Members of the Committee.

Chairman ARCHER. We will continue to be working with you in your capacity over at SSA in trying to resolve this on a bipartisan basis.

Mr. ROOSEVELT. I'm very much looking forward to it, and I appreciate the opportunity to have had a discussion with you earlier this afternoon as well.

Chairman ARCHER. Thanks. Mr. Shaw will preside over the hearings for the rest of the afternoon.

Mr. SHAW [presiding]. We have three more witnesses. Would there be any objection to hearing them as a panel? I would like then to invite the three remaining witnesses to the witness tables as a panel. Dr. Peter Orszag who's president of Sebago Associates from Belmont, California.

We have Professor Eric Kingson who is from the School of Social Work at Syracuse University, Syracuse, New York. And Stephen Kay, economic analyst, Latin America Research Group, Federal Reserve Bank of Atlanta, Georgia.

We have the testimony of each of you which will be made a part of the record without objection. And we would invite you to summarize as you might see fit.

Dr. Orszag.

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

Mr. ORSZAG. Thank you. Mr. Chairman and Members of the Committee, my name is Peter Orszag. In addition to running an economics consulting firm, I teach economics at the University of California at Berkeley.

It is an honor to appear before this Committee to discuss Social Security reform and the lessons that we may be able to draw from other countries' experiences. My testimony will focus on the United Kingdom which is the only G–7 economy with direct experience in individual accounts, and a country that has adopted partial privatization. So unlike Chile, the United Kingdom has moved partially to privatization. It, therefore, provides a unique environment for us to study the operation of such accounts.

The key point of my testimony is that a decentralized approach to individual accounts has proven to be quite expensive in the United Kingdom, significantly more expensive than previous estimates have suggested and significantly more than anyone would have predicted based on the costs of similar financial products in Britain.

As my written testimony notes, there are three sources of cost in any system of individual accounts. I want to focus briefly on the component I call transfer costs since that is the one most frequently overlooked.

Transfer costs measure the costs from switching financial providers during a working career. Most previous analyses have ignored the cost of transferring funds. The evidence, however, suggests that they are significant.

In the United Kingdom, annual management fees are often frontloaded, and individuals charge more for the first year or two in the account than for subsequent years. Such frontloading is at least partly due to the cost of acquiring and advising new customers which itself is the result of the complexity and decentralized nature of the system.

To see how such frontloading could affect total costs over a working life, consider the following example. Assume, again, just as an example, that a firm charges $300 for the first year that an individual is in an account and $50 for each additional year. Then an account held for 40 years with a single provider would cost an average of $56.25 per year.

But an account held for 20 years with one provider and then 20 years with another provider would cost an average of $62.50 per year. More frequent switching would produce higher average costs per year.

If one ignored the fact that workers transferred accounts as previous estimates have, costs would appear to average $56.25 per year, but that would underestimate the charges that were actually paid by the worker who transferred the account.

As the example illustrates, transfer costs are only relevant if workers actually switch accounts. The evidence from the United Kingdom suggest that they do so relatively frequently. Of all the individual accounts held in 1993, 40 percent were transferred by 1997. So very frequent transfers.

As part of a World Bank project, two colleagues and I have constructed a detailed database of firm level costs on individual accounts in Britain. This project is documenting the transfer costs I have mentioned along with other sources of costs in the U.S. system.

While our results are not yet final, our bottom line is that a decentralized approach to individual accounts like the one in the United Kingdom is expensive. Again, much more so than previous estimates have suggested, much more so than the 20-percent figure that was mentioned this morning, and much more so than we would have predicted based on other similar financial products in Britain.

Therefore, in addition to evaluating the fundamental issue of whether individual accounts should be adopted, it is critical to evaluate what type of individual accounts should be created if the Nation decides that such accounts are a good idea in general.

In making such decisions, I hope the U.K. experience with decentralized accounts proves helpful to you. Finally, I would like to note two other lessons from the United Kingdom. First, costs can be imposed on consumers in a wide variety of ways, and consumers often don't understand all of the charges that are imposed.

As one market analyst in the United Kingdom has argued, "Pension plans have a blithering array of charges including bid offer spreads, reduced allocations of premiums, capital units and levies, annual fund charges, policy fees and penalties on transfers, early retirement and other events. In examining the administrative costs of individual accounts, we must, therefore, be careful to include all such costs." That is the purpose of our World Bank project.

Second, investor protection and investor education are very important, as the so-called misselling schedule illustrates. In that scandal, financial providers gave misleading advice to thousands and thousands of U.K. holders of individual accounts and are now being forced to provide an estimated $18 billion in compensation to the individuals who were misled.

Thank you, Mr. Chairman, and I would welcome your questions following other remarks.

[The prepared statement follows:]

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

Mr. Chairman and members of the Committee, my name is Peter Orszag. In addition to running an economics consulting firm, I teach economics at the University of California, Berkeley.[2] It is an honor to appear before this committee to discuss Social Security reform and the lessons that we may be able to draw from experiences in other countries. My testimony will focus on the United Kingdom, which is the only G–7 economy with direct experience in individual accounts. It therefore provides a unique environment in which to study such accounts, which are perhaps the most contentious issue in the Social Security debate here.

My testimony this morning has two purposes:

- To describe the U.K. system of individual accounts, and
- To discuss a World Bank study that I am conducting with two colleagues on administrative costs in the U.K., and examine why previous studies have underestimated those costs

One of the key points of my testimony is the importance of comprehensively measuring the administrative costs associated with individual accounts. These administrative costs are important because, all else equal, they reduce the net return investors receive on their contributions. A comprehensive approach to measuring costs is particularly important in situations, such as in the U.K., in which costs are imposed in a baffling variety of ways.

As part of a World Bank project on administrative costs in the United Kingdom, Dr. Mamta Murthi (of the World Bank), Dr. Michael Orszag (of Birkbeck College in London), and I are completing a detailed study applying this comprehensive approach to U.K. data. In particular, we have constructed a detailed database of firm-level charges on individual accounts, which is an important step forward in understanding both the level and causes of such costs. We hope to release a summary of our results in several weeks. Our preliminary estimates indicate that the administrative costs on individual accounts in the U.K. are significantly higher than previous estimates have suggested.

The evidence from the U.K. suggests that, in the debate over individual accounts in the United States, it is particularly important to consider the structure of any such accounts. The U.K. has adopted a decentralized approach to individual accounts, in which workers hold individual accounts with private financial firms, with no regulations on fees. That approach has generated high administrative costs. Other approaches to individual accounts—such as a centralized approach modeled after the Thrift Savings Plan—would likely involve lower administrative costs.

My testimony concludes with a brief discussion of the lessons that American policy-makers could draw learn from the British experience.

## I. Overview of the U.K. Social Security system

Since 1988, the British government has allowed individuals to opt out of the state-run Social Security system and into individual accounts. The state-run system consists of two tiers: a flat-rate basic state pension and an earnings-related pension. The first tier is provided through the government to all workers who have contributed to the system for a sufficient number of years. The second tier, which can be managed by an individual, his or her employer, or the government, depends on an individual's earnings history.

[1] Peter Orszag is the President of Sebago Associates, Inc., and a lecturer in economics at the University of California, Berkeley. He served as Special Assistant to the President for Economic Policy at the National Economic Council, and as a Senior Economist and Senior Advisor on the Council of Economic Advisers, from 1995 to 1998. He holds a Ph.D. in economics from the London School of Economics.

[2] During the current or preceding two fiscal years (the period covered by the Rules of the House), Sebago Associates, Inc., has held two contracts with the Federal government. One contract, which is no longer active, was to assist the Office of Policy Development in technical preparations for the White House conference on Social Security. Another contract, which remains active, is to provide economic analysis on Social Security to the Securities and Exchange Commission. Neither contract has provided funding for the detailed analysis of administrative costs in the U.K. individual account system that forms the basis of this testimony. The project on U.K. administrative costs is funded through a contract held by Sebago Associates, Inc., with the World Bank.

*Tier I benefits*

The first tier of the U.K. Social Security program is called the Basic State Retirement Pension (BSP). Under the BSP, a portion of the National Insurance Contribution (NIC) payroll tax finances a flat-rate benefit for retirees. In other words, this basic benefit is the same for all qualified retirees, rather than varying with an individual's earnings history. The full benefit payments amount to about $105 per week per person. The BSP is similar to the "flat benefit" that was proposed as part of the Personal Security Account plan, one of the three plans put forward by the Gramlich Commission in 1997. (Under that plan, the flat benefit would have been initially set at $410 monthly in 1996, roughly the same amount as the BSP in Britain.)

*Tier II benefits*

The second tier of the U.K. system offers three different alternatives to workers: the government-run system (SERPS), individual accounts, or employer-provided accounts.[3] Those who choose either of the latter two options receive a rebate on their payroll taxes that is then deposited into either an individual account or employer-provided pension. In this sense, the system is similar to some of the voluntary opt-out proposals for individual accounts in the United States (e.g., the Moynihan-Kerrey bill). The options for the second tier are:

• *SERPS*. Roughly one-quarter of British workers currently choose the most basic option, the state-run State Earnings-Related Pension Scheme (SERPS). SERPS is similar to the U.S. Social Security system: it is a publicly funded pay-as-you-go system, with benefits based on earnings history and funding provided by the NIC payroll tax.

When it was first introduced in 1978, SERPS was relatively generous. Over time, however, reforms have made the program less attractive, especially to middle- and upper-income workers. The maximum SERPS benefit is currently about $200 per week, and the average benefit is under $30 per week. The majority of Britons who remain enrolled in SERPS today earn less than $15,000 annually.

• *Individual accounts*. Individuals can opt out of the SERPS system by opening an Appropriate Personal Pension (APP), which is an individual account held with a private financial firm. About 25 percent of workers in the U.K. currently hold such individual accounts.

• *Employer-based pensions*. Individuals can also opt out of the SERPS system by participating in an employer-sponsored pension plan. About half of all workers participate in such plans plan (often referred to as "occupational pensions"). Roughly 85 percent of all employer pension plans in the U.K. are defined-benefit plans—a higher percentage than in the United States.

The U.K. system thus allows workers to choose among the state-run pay-as-you-go system, individual accounts, and employer-provided pensions.

*Individual accounts in the U.K. and the mis-selling controversy*

Since it provides the only example of individual accounts among the G–7, and since it is very similar in culture and general outlook to the U.S., the U.K. may offer particularly trenchant lessons for the debate here. This section therefore explores the British individual account system in more detail.

About one-quarter of workers in the U.K. opt out of the state-run system and into individual accounts. The government's payroll tax rebate finances contributions into individual accounts equivalent to roughly 3 percent of average (mean) annual earnings for workers covered by the U.S. Social Security system. Roughly half of account holders contribute an additional amount on top of the government rebate. Thus, the contributions being deposited into individual accounts in the U.K. are at least as large as those being considered for individual account plans in the United States.

British workers can hold individual accounts with a variety of financial firms. The system is thus decentralized, with significant marketing and advertising costs. It lacks the economies of scale in administrative costs that a more centralized system could offer.

The market in the U.K. is dominated by insurance firms, largely because insurers can offer certain related products (e.g., annuities). It is also very competitive, a fact underscored by the withdrawal of several high-profile firms from the market because of keen competition. For example, in the face of intense competition, Fidelity withdrew from the personal pension market in 1993 and transferred its existing ac-

[3] The self-employed are not required to participate in the second tier (earnings-related) component.

counts to another provider. But it is worth noting that strong competition has not resulted in low administrative costs, as discussed below.

Competition has sometimes been taken to extremes, however. Perhaps most notably, misleading sales practices created the so-called mis-selling controversy. When individual accounts were introduced in 1988, few analysts thought that they would present regulatory difficulties. After all, the British financial services industry was, by and large, a reasonably safe place to invest, and the 1986 Financial Services Act had established a system of self-regulation combined with heavy penalties for conducting unauthorized investment business.

As it turned out, however, the U.K. experienced substantial difficulties with the movement to individual accounts. In what has become known as the mis-selling controversy, high-pressure sales tactics were used to persuade members of good occupational pension schemes (especially older, long-serving members) to switch into unsuitable individual accounts. Many of these people switched from a good occupational scheme into an individual account less favorable to them. Sales agents had often sought too little information from potential clients, and then provided misleading information to those clients. Their firms did not keep adequate records to defend themselves against subsequent mis-selling claims. Miners, teachers, and nurses with relatively generous occupational pensions were among the main targets of sales agents.

In reaction to the controversy, the U.K. government has imposed stricter rules for providing advice on the transfer of funds from occupational to individual accounts, required providers to disclose their fees and commissions, and insisted that the firms compensate investors who had been given bad advice. Total compensation is projected to amount to 11 billion ($18 billion) or more. Despite these steps, there is some evidence of continuing problems. For example, an undercover investigation by the Guardian newspaper in London recently discovered that, "Britain's biggest life assurer, the Prudential, was at the centre of a new controversy last night after a Guardian investigation revealed it is continuing to attempt to mis-sell pensions." Prudential agents engaged in a variety of prohibited activities, such as quoting future growth figures banned by the Financial Services Act and showing deliberately misleading statistics to reporters from the Guardian.[4]

## II. ADMINISTRATIVE AND OTHER COSTS IN A SYSTEM OF INDIVIDUAL

Individual accounts are perhaps the most controversial issue in the current debate over Social Security reform in the United States. And the administrative costs associated with such accounts are particularly contentious, with proponents claiming that costs will be relatively low and opponents claiming that costs will be high.

Costs can be imposed on consumers in multiple ways, and therefore measuring them accurately is complicated. This problem is particularly acute in the U.K. The Congressional Budget Office, in a recent report, noted that in Britain, "Given the variety of plans and portfolios, clearly assessing the overall cost of fees and commissions is difficult."[5] Another market analyst has argued that, "Pension plans have a bewildering array of charges, including bid/offer spreads, reduced allocations of premiums, capital units and levies, annual fund charges, policy fees and penalties on transfers, early retirement, and other events."[6]

Our approach to the myriad variety of costs in an individual account system is to compute a summary charge ratio. The charge ratio reflects all the various costs imposed on account holders and expresses them on a comparable basis. It does this by measuring how much of an individual account's value is dissipated by costs over an entire working life—regardless of the source of the cost. A charge ratio of 20 percent, for example, indicates that administrative and other costs reduce the value of an account by 20 percent over a typical career, relative to an account with zero administrative costs.

It is important to note that charges can be high because profits are high or because underlying costs are high. The competitiveness of the individual account market and the exit of some providers suggest that the market is not excessively profitable. It is thus likely that the charge ratio primarily reflects underlying costs, rather than unusually high profits for providers. Some examples of the underlying costs affecting the charge ratio include sales and marketing; fund management charges; regulatory and compliance costs; record-keeping; and adverse selection effects.

[4] The Guardian, August 10, 1998.

[5] Congressional Budget Office, Social Security Privatization: Experiences Abroad, January 1999, page 92.

[6] John Chapman, "Pension plans made easy," Money Management, November 1998, page 88.

A decentralized approach to individual accounts, like the one in the U.K., is expensive. And all the costs are reflected in the charge ratio.

*Decomposing the Charge Ratio*

The charge ratio can be broken down into three components, corresponding to the costs charged by a single financial provider during a working life (accumulation ratio); additional costs from switching financial providers during one's working life (transfer ratio); and costs upon retirement from converting the account into an annuity (annuity ratio).

1. The accumulation ratio captures fund management and administrative costs for a worker contributing funds to a single financial provider throughout her career. It does not include any costs from switching providers (which are instead captured by the transfer ratio).

2. The transfer ratio measures the costs from switching funds during a working career. It is computed as the ratio of funds received at retirement by an individual switching providers during a working career, to the funds that would have been received at retirement by the same individual if she had not switched providers at all. It does not include the ongoing costs of holding an account with a specific provider (which are captured by the accumulation ratio). Most previous analyses have ignored the costs of transferring funds. The evidence, however, suggests that such costs are significant.

3. The annuity ratio reflects the losses from annuitizing an account upon retirement. It measures the ratio of private annuity yields to theoretical yields from population mortality tables. Annuity costs reflect both adverse selection (that those choosing to purchase annuities tend to have longer life expectancies than the general population) and cost loadings (administrative costs of providing annuities, which are over and above the administrative costs captured by the accumulation ratio).

Previous cost estimates—both for the U.K. and other countries with individual accounts—have not included all these components. They have therefore underestimated charges. For example, it is often noted that accumulation costs in the U.K. and elsewhere average about 100 basis points per year, and they reduce the value of an individual account by 20 or 25 percent over a typical career. This figure, however, does not incorporate the effects of transfer costs and annuitization costs.

*A comprehensive approach to measuring costs—as well as benefits—is essential to evaluating properly the pros and cons of individual accounts, and the various ways of structuring such accounts*. And a comprehensive approach to costs must include all three components of the charge ratio: accumulation, transfer, and annuitization costs. Only by including all the relevant factors can we make an informed choice about different approaches to Social Security reform.

I want to focus briefly on the transfer cost, since it is the component most frequently overlooked. The experience in Chile has indicated that transfers across Administradora de Fondos de Pensiones (AFPs), the individual account providers in Chile, occur relatively frequently. But in Chile, the fee structure is regulated. And under the typical method of charging fees, transfers do not impose additional costs on consumers: Deposits in the AFPs are charged a one-time contribution fee when the initial deposit is made, but are not subject to subsequent fees even if the account is transferred to another provider. That fee structure obviates the need to worry about transfer costs, since costs do not depend on whether the account is held with a single AFP or switched many times over a career.

In the U.K., by contrast, costs often do depend on whether accounts are transferred. In particular, management fees are often front-loaded: an individual is charged more for the first year or two in an account than for subsequent years. The front-loading is at least partially the result of the complexity and decentralized nature of the system, which raises the costs of customer acquisition (through marketing costs, commissions to advisers and salespeople, and the cost of providing accurate and disinterested information to those interested in switching).

Financial providers in the U.K. impose transfer costs in a variety of ways. For example, some (albeit only a small number) charge an explicit fee on those leaving a fund. Some impose a "capital levy," in which contributions for the first year or two are termed "capital units" that have substantially higher costs than subsequent "accumulation units." Although this practice is becoming less common, it is still used by several insurance companies. The FT Personal Pensions 1998 handbook recently argued that "the ONLY reason for having capital or initial units is so that the planholder will not realise exactly what the charges are."[7] These types of fee

[7] Financial Times, Personal Pensions (Pearson Professional, 1997), page 9.

structures impose additional costs on those transferring accounts, despite the claim by many financial providers in the U.K. that they impose no such additional charges.

To see how front-loading could affect total costs over a working life, consider the following example. Assume, merely as an example, that financial firms charge $300 for the first year of an account, and $50 for each additional year. Then an account held for 40 years with the same provider will cost an average of $56.25 per year, but an account held for 20 years with one provider and then 20 years with another provider will cost an average of $62.50 per year. More frequent switching would produce even higher average costs. For example, switching three times would generate an average cost of $75.00. If one ignored the fact that the worker switched providers, costs would appear to average $56.25 per year, which would underestimate the charges for the worker who transferred accounts.

As the example illustrates, transfer costs only raise costs if individuals switch providers—and raise costs more the more frequently individuals switch. The evidence suggests that they do so relatively frequently. According to data from the 4th Personal Investment Authority's Persistency Survey, of all the regular premium personal pensions sold by company representatives and held with financial companies in 1993, 14.5 percent were transferred within one year, 25.4 percent were transferred within two years, 33.8 percent were transferred within three years, and 39.4 percent were transferred within four years. In other words, roughly 40 percent of the individual accounts held in 1993 were transferred within four years.

The impact of such transfers on costs, moreover, can be significant. A recent Money Management survey published in the U.K. concluded that—including the costs of transferring accounts—the annual cost would be roughly 250 basis points.[8] Over the course of a working career, an annual fee of 250 basis points would consume substantially more of the funds in an account than the 20 or 25 percent figure often cited for privately managed individual accounts. (That 20 or 25 percent figure is predicated on an annual cost of 100 to 125 basis points. It reflects only accumulation costs, and excludes both transfer costs and annuitization costs. The Money Management article finds a much higher figure merely by including transfer costs. It excludes annuitization costs, which would raise the total cost even further.)

In the paper we expect to release by early March, my co-authors and I will document these transfer costs, along with the other two sources of costs (accumulation and annuitization costs) in the U.K. system. Again, our preliminary results indicate that costs are significantly higher than previous estimates have suggested.

## III. CONCLUSION

Accurately measuring the costs associated with individual accounts is crucial to a full and fair evaluation of whether to create such accounts, and, if so, how to structure them. A comprehensive measure of costs in the U.K. suggests that these costs are high, and significantly higher than previous estimates have suggested.

Costs depend on the structure of individual accounts. For example, some proposals for individual accounts in the United States would aggressively take advantage of potential economies of scale through centralized provision (as in a Thrift Savings Plan approach, under which workers would hold their accounts with a single or limited number of providers). Others would allow individuals more choice through decentralized provision (as in an Individual Retirement Account approach, under which individuals would be allowed to choose their own financial provider). Furthermore, the individual accounts could be mandatory or voluntary, and fee structures could be regulated or unregulated. It is therefore worth emphasizing that:

- *The U.K. system involves decentralized, privately managed accounts and annuities*. Most analysts agree that such a system is substantially more expensive than a centralized system (such as the Thrift Savings Plan for Federal government employees in the United States).[9] A centralized system would obviate the transfer costs highlighted in my testimony, as well as the incentives to mislead consumers that created the mis-selling controversy in the U.K. Such benefits, however, may come at the potential cost of reduced choice for consumers.
- *The U.K. system of individual accounts and annuities is voluntary*. In the U.K., individuals can choose whether to participate in the system of individual accounts

[8] John Chapman, "Pension plans made easy," Money Management, November 1998, page 88.

[9] See, for example, Estelle James, Gary Ferrier, James Smalhout, and Dimitri Vittas, "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in a Social Security System?" presented at NBER Conference on Social Security, December 4, 1998; and National Academy of Social Insurance, "Evaluating Issues in Privatizing Social Security, Report of the Panel on Privatization of Social Security," Washington 1998, available at www.nasi.org.

and annuities. Mandatory accounts and annuities might lead to reduced adverse selection effects and less complexity. The effect of a mandatory approach in reducing costs, however, is difficult to assess. It is likely to be most significant in reducing the adverse selection costs associated with annuities—which is not a substantial component of the total charge ratio in the U.K. It is thus relatively unlikely that a mandatory approach (as long as it remains decentralized) would have dramatically different costs from the U.K.

• *The U.K. system does not regulate fees*. In Chile, AFP fee structures are regulated: AFPs can impose only certain types of fees on customers. The U.K. system does not have such regulations (although it does have new disclosure requirements on fees). The lack of fee regulation in the U.K. has produced a wide variety of fees, many of which consumers do not fully understand, and has also facilitated front-loaded costs that impose additional costs on individuals switching accounts. Regulating the fee structure may address some of these concerns, albeit at the potential cost of reduced supply (if the fee regulations are too restrictive, providers may be unwilling to offer accounts to customers). In considering whether to regulate fees, it is important to remember that fees are high fundamentally because a decentralized, privately managed system is expensive to run. Fee regulations cannot change that. If costs are high, but fee regulations do not allow financial firms a reasonable return on their activities, we are unlikely to see many financial firms participating in the market. Fee regulations thus offer a temporary palliative, not a full long-term solution, to high underlying costs.

It is perhaps instructive that because of the mis-selling controversy and the high administrative costs of individual accounts, the system of privately managed individual accounts may be losing favor even in Britain. The U.K. government recently released a Green Paper that advocates reducing the incentives for low earners to opt out of SERPS and into individual accounts, while also creating a new type of employer-provided pension with regulated fees that is designed for middle-income workers.

The U.K. experience thus vividly warns us that if individual accounts were adopted in the United States, we would have to pay careful attention to their design to ensure that administrative and other costs are not unduly high, and to avoid the regulatory failures associated with misleading sales practices. The study that I am completing with my colleagues from the World Bank and Birkbeck College will provide a more detailed examination of the administrative costs. But one lesson is already clear: A privately managed approach is likely to produce high administrative costs, and unless it is overseen by a strong and effective regulatory body, could result in abuses similar to the mis-selling controversy. In addition to evaluating the more fundamental issue of whether individual accounts should be adopted, it is therefore critical to evaluate what type of individual accounts should be created if the nation decides that such accounts are a good idea in general. In making such decisions, I hope the U.K. experience proves helpful to you.

Thank you, Mr. Chairman. I would welcome questions from you or other members of the Committee.

Mr. SHAW. Dr. Kingson.

**STATEMENT OF ERIC KINGSON, PROFESSOR, SCHOOL OF SOCIAL WORK, SYRACUSE UNIVERSITY, SYRACUSE, NEW YORK**

Mr. KINGSON. Thank you, Mr. Chairman. It's a pleasure to appear before this distinguished panel.

My name is Eric Kingson. I'm a professor at the Syracuse University School of Social Work. I've previously served as staff to two commissions that have looked at Social Security reform issues. With your permission, I will enter my written testimony for the record, and summarize key points in the verbal testimony.

I think you've wisely chosen to look at the foreign experience. I will do my best to offer a few suggestions.

One lesson that comes from the foreign experience is that we're really not alone, and we're really not that bad off either. Most industrialized nations are experiencing population aging, as tables 1 and 2 suggest, and in fact, their rates of population aging are much greater than our own. They anticipate higher rates of so-called age dependency rates in 2030.

Second, that more people are reaching old age and living longer once getting to old age is a success. It's not a crisis. It's a challenge. It's not a defeat.

I have to say that some of the presentations today, almost sound as if we had done something horrible by spawning the largest healthiest group of old people in the world—that population aging worldwide is a disaster, that it doesn't represent the best of what nations have done in terms of investing in public education, biomedical research in terms of opening up opportunities for life with a future, that somehow it has created a crisis that we have to manage. In my judgment, this emphasis on crisis is often used to argue for radical reform to Social Security rather than calling for more realistic assessments of how to address population aging and the real pressures it creates on pension systems.

There's another lesson. I don't think we're doing so bad as a country. When we look at our statistics relative to other industrial nations, our per capita GDP are considerably higher. In 1996, per capita GDP in the United States was $28,000 compared to $21,000 in Germany, and $19,000 in the United Kingdom.

Our population is generally younger. Government expends considerably less of the GDP—all sources of government—than is true in the great majority of other highly industrialized nations. And we've entered a period of relatively favorable budget circumstances and relatively favorable economic growth.

In short, we're well positioned to address some of these challenges, and we ought to think about how much we have done positively and not overstate the worries associated with population aging.

Third, this is fundamentally a discussion of values, and that hasn't been well acknowledged. There are competing views of the extent to which retirement income protection for Americans should be based on shared responsibility through a social insurance mechanism, or on a more privatized approach in which individuals are entirely responsible for their retirement, disability and survivorship.

Part of the discussion and part of the framing of the issue relates to that. We've heard from Mr. Piñera this morning. As he makes clear, application of the Chilean model would create a very different system. He describes the need for reform. Mr. Piñera says a specter is haunting the world. It is, he says, a "specter of bankrupted, state-run pension systems. The pay-as-you-go pension system has reigned supreme through most of the century, but it has a fundamental flaw, one rooted in false conceptions of how human beings behave. It destroys at the individual level."

Well, that's a point of view, and it has its merits. But it's a very different point of view from those who would suggest that we ought to have a mixed retirement income system as we do today as opposed to substantially individual responsibility at its base.

Now I think if I believed all that I had heard this morning, I would be very inclined to not give my testimony today. We've heard wonderful things about the virtues of privatization. But we haven't looked at any of the downsides, and we haven't looked at any of the costs. What are we willing to give up to move to private accounts? Are we willing to give up the mild redistribution that exists within Social Security that protects low-income workers? We don't have a lot of experience worldwide with these private approaches—only 10, 15, 20 years, and in short, we have a paucity of data on how they would work if applied to this large country of ours.

We do, however, have an interesting experiment going on in the State of Texas in three counties which gives some idea of some of the problems that might result from any kind of privatization.

In January 1981, three counties withdrew their public employees from Social Security—Galveston, Matagorda and Brazoria counties. The Galveston plan covers roughly 3,500 current employees and 5,000 former employees. Contribution rates are set slightly above the combined payroll tax contribution rates for Social Security. The funds are invested conservatively, and they've yielded a rate of return roughly the same as the Social Security system over this period of time, a little bit less.

The virtues of the Galveston plan—as are the virtues of all these privatizations around the world—have been talked about by those who would encourage a full privatization and a shrinking from some of the traditional commitments in Social Security.

The Cato Institute mentions that retirees are receiving far greater benefits under this plan than they would have gotten under Social Security. Another think tank, the National Center of Policy Analysis, suggests the Galveston plan provides a much larger post-retirement income for Social Security.

Well, it sounds too good to be true. And in fact, it is too good to be true. A more sober analysis by SSA's Office of Policy as well as a draft GAO report discussed in USA Today points to some of the flaws in the system.

Women and low-income workers are not well served by the plan. This is true of many privatizations. Low-wage workers would give up the benefit tilt that they receive in Social Security and would receive considerably less in an asset-accumulation system.

Spouses and divorced spouses are not covered. There are no guaranteed benefits for widows as well. High-income single long-term employees win in this system, and they win big perhaps. Analysis by Social Security's Office of Policy which we have on tables 9 and 10 of the formal testimony shows that the distribution of benefits in the Galveston plan runs counter to our social insurance system.

On that table, if you look at it, you'll see initially that certain workers do much better under the Galveston system. High-income workers who are single and very high-income workers who are married do well initially under this plan.

But over time, their income erodes because this plan does not provide inflation protection for workers. So that over 15 years, benefits of middle-income married workers shrink from being 82 percent of what Social Security would provide to 52 percent. The benefits for very high-income married people shrink from 108 percent to 69 percent.

In addition to this inflation risk, you have very substantial longevity risks in this type of plan. You can outlive your asset. There is no requirement that you accept an annuity in the plan.

One of the dangers of this plan is that we could undermine the entire notion of retirement savings. All of us like and wish to promote savings. But to base a Social Security system first and foremost on an asset accumulation system poses huge dangers for the concept of retirement savings. Any one of us could have a child who's ill faced with that kind of situation, we would naturally want to go into our retirement savings. No Member of Congress would consider it unreasonable to open up the retirement savings system once developed for that kind of an emergency. As well intentioned as that would be, we would shortly be losing the notion of a retirement income system altogether or risking that notion. So there are both downsides and upsides to the various privatization approaches.

What we haven't looked at today also are some of the more moderate reforms that might be considered in other nations, and we haven't considered the great success of Social Security and what it does do for the 44 million Americans, including 3 million children, who receive benefits each month.

We've also really not talked about what those Members who I've heard advocate for privatization are willing to give up in Social Security. As a citizen, I'd be curious to know who would win and who would lose. Are we willing to give up benefits for women—for married women or for spouses in order to move toward an idealized private system?

Finally, I'd suggest we shouldn't lose sight of the moral dimension of Social Security. A public Social Security Program, to paraphrase former Senator Bill Bradley, is one of the best expressions of America's community.

Indeed, much more is at stake in this discussion than bend points, percents of taxable payrolls, years of exhaustion. There's something at stake about the notion of what we owe each other as a society, as a national community which ought be brought into the discussion. It's important that in the process of addressing long-term reform that we not lose sight of the moral dimension of the program. Thank you.

[The prepared statement follows:]

**Statement of Eric Kingson,[1] Professor, School of Social Work, Syracuse University, Syracuse, New York**

Mr. Chairman and other distinguished members of the House Ways and Means Committee, it is an honor to appear before your panel.

My name is Eric Kingson. I am a professor at the Syracuse University School of Social Work. My scholarship and research address the political and economic consequences of population aging, including examinations of Social Security policy, the aging of the baby boom cohorts and cross-generational obligations. Previously, I directed a study for the Gerontological Society of America in 1984–5 which examined various ways of framing policy discussion about the aging of America, and I served as an advisor to the 1982–3 National Commission on Social Security Reform and to the 1994 Bipartisan Commission on Entitlement and Tax Reform.

Many lessons can be drawn from the experience of other countries with population aging and reform of their public pension systems. I would like to bring the following

[1] Eric Kingson, Professor, School of Social Work, Syracuse University, Sims Hall, Syracuse, New York 13244 315–443–1838 kingson@social.syr.edu

to your attention as you explore ways of addressing the financing problems of Social Security:

• Lesson: We are not alone. And we're not so bad off, either.

Examining the foreign experience, as your Committee has appropriately chosen to do, places our nation's concerns about the future of Social Security in an important context. It suggests that the population aging and pension reform challenges our nation faces are, comparatively speaking, quite manageable.

Industrial democracies are aging and projected to continue to do so, but generally at a faster rate than the United States. Comparative data published by the Organization for Economic Co-operation and Development (OECD) indicate that today there are approximately 19 persons aged 65 and over in the United States per hundred persons of working ages, compared to 18 in Canada, 24 in Germany, 24 in France, 26 in Italy, 24 in Japan and 24, in the United Kingdom. By 2030, when the youngest of the U.S. baby boomers will reach age 65, the elderly dependency ratio will grow to 37 in the United States, 39 in Canada, 39 in France, 49 in Germany, 48 in Japan, and 39 in the United Kingdom (see table 1). In other words, while the elderly dependency ratio trends show increases across all OECD countries, compared to the United States, most European OECD countries and Japan already have a substantially larger proportion of their population aged 65 and over. Moreover, they anticipate further significant growth—generally at a rate that is faster than our own—in the relative size of the elderly population during the next 30 years (Kalish and Tetsuya, 1999).[2]

• Lesson: That more people are reaching old age, and living longer, once getting there, is a success, not a crisis; is a challenge, not a defeat.

Elsewhere and in the United States, population aging is an indication of successful outcomes of century-long investments in the growth of economies, education, pensions and bio-medical and public health advances. These changes have resulted in declines in childhood diseases and deaths earlier in the century and in higher standards of living throughout the course of life. Changes accompanying industrialization also contribute to declines in fertility and to population aging. Obviously, the expected increases in the proportion of the population that is considered old, and in life expectancies at age 65 (see tables 2 and 3), bring challenges. But it should not be overlooked that they also bring new opportunities for enriched life, continued learning and engagement through employment and community service in the growth of economies and communities. This is not to suggest that we do not face a significant financing problems, needing to be addressed through prudent policymaking. But the politics of Social Security reform is not well-served by exaggerated claims of impending disaster brought on by population aging.

• Lesson: As a prosperous society we are well-positioned as we cross the threshold of Social Security reform.

Our per capita income is among the highest, $27,821 in 1996 U.S. dollars, as compared to the equivalent of $20,533 in France, $21,200 in Germany, and $18,636 in the United Kingdom (see table 4). As noted, our population is generally younger than that of other fully industrialized societies. Importantly, government expends considerably less of the GDP than the great majority of other highly industrialized societies (see tables 4 and 5) and, due in large measure to the prudence exercised by this Committee, we have entered a period of relatively favorable growth and government budgeting. Other nations carry much higher tax burdens than the United States (see tables 5 and 6). Our federal expenditures, as a percent of GDP, are generally much lower than other OECD nations—21.6 percent in 1996, compared to 44.7 percent in France, 32.1 percent in Germany, 47.9 percent in Italy, 45.2 percent in Sweden, and 39.9 percent in the United Kingdom. In short, compared to our major trading partners, our economy is large and it will be yet larger in the future.

[2] The total dependency ratio—the ratio in the OECD table of the population aged 0–14 and 65 and over as a percent of working aged persons—is perhaps a better measure of the economic pressures associated on future workers attending to caring for non-working persons. These data suggest that some of the cost of a growing elderly population may be offset by the relative decline in the proportion of the population aged 14 or under. However, much of the cost of raising children occurs in the context of the family and government expenditures on the old are substantially larger on a per capita basis. Moreover, the elderly and the total dependency ratios both fail to acknowledge changing patterns in labor force participation (e.g., increased participation by married women), the contributions—real and potential—of the old to the workforce. But regardless, the same point stands when OECD data on the total dependency ratio is examined. The overall burden for U.S. workers is projected to increase between 2000 and 2030 at a slower rate than that of the major industrial nations and to be equal to or lower than the dependency ratios projected for 2030. Interestingly, our overall dependency ratio in 2030 (68) is projected to be roughly the same as it was in 1960, when our per capita GDP and standard of living was less than it is today and still less than what we project for 2030.

Moreover, we have considerably more room to respond to the challenges of an aging society—if we so choose—through application of the budget surplus in the Social Security reform process and, if desired in the future, through additional tax revenues.

• Lesson: It is important to acknowledge explicitly that values and choice of primary policy goals matter in the reform of public pension systems.

Approaches to the financial reform of retirement income systems reflect value preferences and differences with regard to the primacy of achieving retirement income security for the citizenry versus other important goals, such as increasing national savings and rewarding work effort. They can reflect deep divisions in the philosophy of the extent to which the individual versus the national community should bear the risks of preparing for their retirement, disability or survivorship. Nowhere is this seen better than in the differing views of those supporting social insurance approaches as the foundation of retirement, disability and survivorship income security, as opposed to those who would seek to replace Social Security with various privatization plans.

Shared responsibility and securing protection against what President Franklin D. Roosevelt termed the "hazards and vicissitudes of life" inform the traditional view of Social Security program (Heclo, 1998). Providing widespread protection to individuals and their families is, within this framework, the fundamental purpose of any social insurance program. Promoting financial security—with associated values of maintaining dignity and strengthening families and community—has primacy over other policy goals. From this perspective, stabilizing financing and assuring benefits that are adequate and can be counted upon regardless of inflation, business cycles and market fluctuations are central objectives for reform. Strong commitment exists here for maintaining the moderate redistribution that seeks to provide a minimally adequate floor of protection for those who have worked for many years at relatively low wages. This commitment to widespread protection provided rationale for decisions made earlier in the life of the program to enable workers nearing retirement age to receive full benefits even though they had made relatively small contributions. This was also done each time benefits were increased, so that those nearing retirement age became eligible for the new benefits. But because the basic structure and major benefit liberalizations in Social Security have generally been in place for a number of years, future retirees will not reap such large returns. However, had Social Security failed to blanket-in workers approaching retirement—the system's adequacy goal would have been compromised. And to have done so would not have been fair in another sense since the economic welfare of workers retiring earlier in the history of the program was generally far worse than that of future retirees.

Strong belief in the primacy of individual responsibility and freedom of choice as the preeminent organizing values of society underlie the views of those who advocate the privatization of retirement income systems based on social insurance principles. Where the advocates of social insurance programs see greater market risks as an accompaniment of privatization, the advocates of privatization see higher returns, greater control over retirement resources and less political risk (e.g., legislative decisions to reduce benefits). The emphasis, here, is on maximizing rates of return and reducing the role of government in a market economy. While safeguards may be built in for the most disadvantaged, these systems in their design provide substantially greater reward to those with higher earnings. At heart, there is a belief that the market is an entirely efficient and fair way of distributing goods and services and that social insurance programs are undermining of free markets. José Piñera, former Minister of Labor and Social Security in Chile from 1978 to 1980 and Co-Chairman of the Cato Project on Social Security Privatization, advocates for the extension of the Chilean model with the following assertion:

> A specter is haunting the world. It is the specter of bankrupt state-run pension systems. The pay-as-you-go pension system that has reigned supreme through most of this century has a fundamental flaw, one rooted in false conceptions of how human beings behave: it destroys, at the individual level, the essential link between effort and reward—in other words, between personal responsibility and personal rights. Whenever that happens on a massive scale and for a long period of time, the result is disaster. (Piñera, 1995/96)

Piñera advocates that privatization of public Social Security programs will empower workers and "mean a massive redistribution of power from the state to individuals, thus enhancing personal freedom, promoting faster economic growth, and alleviating poverty, especially in old age" (Piñera, 1995/96).

As Piñera makes clear, application of the Chilean model or a parallel system of private accounts would undermine of the central purposes of the current program and would represent a decision to implement a very different set of values and policy goals.

• Lesson: Things aren't always what the most committed advocates of privatizing Social Security claim.

Advocates of the Chilean and other private models no doubt believe them to be superior. It is not my intention in this testimony to discuss the Chilean or other such models in detail. Instead, I would suggest that in giving serious attention to these plans, it is important to assess their strengths but also carefully explore their downside—including expanded market risks, increased risk for women, high administrative costs, longevity risks, inflation risks, political risk to the maintenance of a retirement income program, and structured regressivity and political risks for low income workers. Some examples:

• Greater market risk. While long run returns on equities have generally been quite good, a privatized system shifts risks from government to the individual, exposing individuals and their families to substantial market risk—especially those who are not sophisticated investors. No doubt, in the long run, many workers—especially those who never marry and always earn high incomes—may do better in various private plans. But "no promises can be made about what will happen to an individual's nest egg in the few years, months or even days before retirement" (Williamson and Kingson, 1997). In the short run, returns have been known to stagnate or to be negative. I doubt that we would like to have at the foundation of the nation's retirement income system, an approach requiring people to time their retirements to bull markets. This point is also made by economist Lester Thurow's observation in a February 1, 1999, *USA Today* column. Thurow writes about the tradition of Japanese employers to provide retirees with a lump sum distribution when they retire and the investment risk this tradition poses for retirees:

> Individuals are not given monthly pensions from their company pension funds but a lump-sum cash distribution when they retire. They could, if they wished, put all of that money into the stock market. But think of what happened to those who did exactly that before 1990. In 1990, the Japanese stock market went down from 39,000 to 13,000. and it is still near 13,000 eight years later. Two-thirds of their prospective pension disappeared for at least a decade, and maybe forever. (Thurow, 1999)

• Increased Risks and Inequity for Women. On average, women live longer, earn less than men,[3] experience discontinuities in their labor force participation as a result of caring for children, and are more likely to work part-time. Shifting from Social Security—a defined benefit plan which incorporates benefits for divorced and married spouses, benefits for widows (and widowers), annual cost-of-living adjustments and a benefit formula favorable to low-income persons—to a plan where benefit amounts more nearly reflect prior contributions is, on balance, disadvantageous to women (Rix and Williamson, 1998). For example, under some privatization proposals, lump sum distributions may be allowed at retirement age. Under the Chilean plan, on reaching retirement age, workers have the option of withdrawing funds on a regular basis or purchasing an inflation-indexed life annuity. Lump sum distributions and the Chilean withdrawal option pose greatly increased risk for women of outliving their resources. Alternatively, such inflation indexed annuities, while addressing of inflation, disadvantage women relative to men because women's monthly annuity amounts are actuarially reduced to account for their longer life expectancies (Kay, 1997).

• High administrative costs. Privatization plans have been criticized for having high administrative costs relative to Social Security. (The cost of administering Social Security is about 0.9 percent of program expenditures.) Stephen Kay (1997) testified before your Subcommittee on Social Security that "if you count the amount workers contributed and deduct commission charges, an individuals real average rate of return over the" 1982 to 1995 period in the Chilean system was 7.4 percent, not the 12.7 percent figure that advocates of the plan like to use. Teresa Ghilarducci (1997) similarly testified that marketing and administrative fees are an estimated 15 to 30 percent in the Chilean system and an estimated 20% in the privately administered defined contribution plans that workers were encouraged to join in the United Kingdom in lieu of continued participation in the State Earnings-Related Pension Scheme (SERPS) or alternative occupational plans. The big winners here seem to be the companies that administer these programs, for example, a 22 percent

[3] The earnings of full-time year round female employees was roughly 74% of comparable male earnings in 1996. Moreover, women are more likely to be out-of-the labor force or employed part-time as compared to men (Rix & Williamson, 1998).

profit in 1995 alone for the companies (AFPs)[4] administering the accounts of Chile's covered workers (Ghilarducci, 1997).

• Longevity and Inflation Risks. In planning for retirement, individuals must deal with two important uncertainties—they do not know how long they will live; they do not know the extent to which inflation may eat into their assets. Social Security addresses these risks by assuring a stream of monthly income that maintains their purchasing power from year to year, no matter how long someone lives. As noted, privatization plans that allow for lump-sum distributions or other non-inflation indexed distributions undercut the economic security and adequacy goals driving a system such as Social Security. They do not and cannot provide adequate protection against such risks.

• Retirement Security Risks. Privatization plans inevitably pose a political risk to the retirement income security of individuals and the societal goal of underwriting an adequate retirement for the citizenry. A private plan based on defined contribution principles creates huge temptations for individuals and members of Congress and other political leaders. Though intended as retirement income savings, it is only a matter of time when the distribution rules will be liberalized to allow for medical or other emergencies; perhaps for the laudable goal of making a down-payment on a home. Few individuals with a critically ill child needing expensive medical care would question the value of cashing in their retirement savings to give their child a chance for a healthy life. Few members of Congress would consider such a change to be unreasonable. Yet, once such an exception is made, the goal of maintaining a retirement program would be seriously compromised.

• Regressivity and Political Risks for Low Income Workers. The principles of a privatized system which place individually-owned accounts as the foundation of a retirement income system. By doing so, privatization would "place low- and moderate-income workers at significant political risk. As Social Security is currently structured"—with its emphasis on providing widespread and adequate protection to the entire population—"low-income workers get a better return than high wage workers on their contributions, a factor that keeps millions of the elderly out of poverty during their retirement years. But in separating out the interests of higher-income workers from the public portion of the program, privatization schemes ensure erosion of political support for the program's redistributive role—an outcome which would further increase the economic and social distance between rich and poor...Privatization may be a bad idea for most Americans, but not necessarily for everyone—at least if we assume that the winners in the "privatization lottery" do not have a stake in promoting the well-being of the rest of society. Though trading off some surety of protection, [on average] the most affluent workers would likely do better under privatization plans—at least in so far as they do not experience serious declines in their earning capacities during middle age" (Williamson and Kingson, 1997).

• Data Risk. With the exception of Chile and the United Kingdom, most experiments with moving from public pensions to privatized alternatives (i.e., defined contribution approaches) are quite recent. Even Chile and the United Kingdom have only 10 years experience; hardly enough time to tell whether these systems will work for their citizens. Hence we do not have a basis, as yet, for determining their long-term success or their ability to meet the needs of retirees once these systems mature, when many more retirees will depend on them.

• Lesson: A home-grown alternative to Social Security provides an excellent example of the false claims of its advocates and the risks of adopting the Chilean and other privatization models.

We do not need to search far and wide to see the effects of privatizing Social Security. Privatization has taken root in three Texas counties—Galveston, Matagorda, and Brazoria.

In January 1981,[5] these counties withdrew from the Social Security program, implementing, instead, a defined benefit plan for county employees. The Galveston Plan covers roughly 3,500 current employees and 5,000 former employees (persons who receive or are eligible to receive benefits). Contribution rates are slightly higher under the Galveston Plan—a combined employee/employer pre-tax contribution of 13.2 percent (6.1 percent for workers and 7.8 percent for the county) on earnings up to $82,160 compared to the 12.4 Social Security payroll tax contribution on earnings up to $68,400 in 1999. (Additional contributions can be made by workers to their retirement accounts.) The Counties make investment decisions and utilize the same investment company. Having chosen to pursue a conservative investment

[4] Administradora de Fondos de Pensiones.

[5] The 1983 Amendments to the Social Security Act foreclosed the option for public employee pension systems to withdraw from the program.

strategy, the rates of returns from 1981 to 1997 are comparable to those received by the Social Security OASDI, a 4.62 percent real rate of return on average, compared to 4.88 percent for Social Security (Social Security Administration, January 28, 1999).

The virtues of the Galveston Plan are being loudly proclaimed by organizations advocating for privatization. An announcement on the CATO Institute's website notes:

> In 1981 employees of Galveston and two other counties in Texas voted to opt out of the federal Social Security system in favor of a private alternative. At a [Cato Institute] Policy Forum on "Opting Out of Social Security: How Galveston County Did It," Donald Kebodeaux and E. J. Myers, who helped to design the private system, reported that retirees are receiving far greater benefits than they would have gotten under Social Security and maintained that Galveston County's plan could serve as a model for the entire United States. (Cato website, 1999)

A similarly pro-privatization think-tank, the National Center for Policy Analysis, issued a report that claims:

> Employees of three Texas counties are enjoying rapid growth in their retirement incomes, better benefits than those offered by Social Security and the satisfaction of knowing that the money deposited in their accounts belongs to them and will be there when they retire. Privatizing Social Security is not a distant dream; for some Americans it is a present reality. Fairness and true social security demand that all Americans have the same opportunity. (National Center for Policy Analysis, 1996).

In short, as the policy brief suggests the Galveston Plan "provides a much larger postretirement income than does Social Security."

Sounds too good to be true. And it is! The Galveston Plan has advantages for certain workers—for some disabled workers and especially for high-income single workers without any dependent children. It also allows for the accumulation and passing on of an asset. But, it also has very significant drawbacks common to many other privatization plans.

- Women and low-income workers are not well served by the plan. Since the Galveston Plan's retirement benefits are based on what workers accumulate in their accounts during their term of county employment, low wage workers have lost the benefit of the tilt in the Social Security benefit formula which provides proportionately larger benefits to those working for many years at low wages. Women and others who are likely to be intermittent or short-term employees, earn less and lose important Social Security coverage, which, unlike the Galveston plan, stays with them as they move from job to job. Moreover, the plan does not require spouses to select a joint survivor annuity. And, unlike Social Security, there are no spouse benefits and there are no guaranteed benefits for divorced spouses.
- High-income, single, long-term employees win. Analysis by Social Security's Office of Policy (see table 9) shows that the distribution of benefits in the Galveston Plan runs counter to a social insurance program designed to provide widespread and adequate protection to the entire population. The potentially big winners in Galveston are long-term employees with high salaries; but there potential good fortune comes at a price—considerably less security for most of their co-workers. Interestingly, *USA Today* (Welch, February 3, 1999) discusses the preliminary findings of a GAO report that seems to confirm the SSA findings—"The GAO study did credit the alternative investment plans with producing better long-term retirement benefits in many cases for higher income workers, those earning more than $51,263 a year. But it said low income workers generally fare better under Social Security. And it said its calculations showed mixed results for the middle income workers: Though many may receive higher initial benefits under the Alternative Plans, the inflation adjustment built into Social Security benefits each year may erode that advantage over time and make Social Security a better deal." Certainly, it is if the goal is to provide a floor of protection for the entire population.
- Substantial longevity and inflation risks exist. Workers and eligible survivors can outlive their retirement benefits because they can take benefits in the form of a lump-sum distribution or fixed annuity. Equally concerning, inflation can erode their benefits since the plan does not include annuities that are indexed to inflation. A Social Security Administration memo notes that Galveston plan benefits would lose 46 percent of their purchasing power in 20 years with yearly inflation averaging three percent. While the SSA table of illustrative benefits for workers at different earnings levels indicates that "initial benefits offered under the Galveston Plan are higher than under Social Security for single workers at the middle, high and very

high earnings levels," after "20 years of inflation all of Galveston's benefits are lower relative to Social Security" (January 28, 1999; also see tables 9 and 10).

• Undermining of goals of retirement income security. The Galveston Plan allows employees to withdraw all their savings when they leave their county jobs. That is, these funds do not have to be rolled over into another retirement account. The plan also specifics a number of unforeseen emergencies (e.g., illness, casualty loss) under which the employee may go into some or all of the accumulated funds. This flexibility places employees under increased risk of inadequate retirement income.

• Arguably better disability protection for some and worse for others. Initial benefits for single individuals without dependent children and very high income persons with two dependent children are higher and there is no disability waiting period. But, again, the redistributive benefit tilt doesn't apply to low-income workers and benefits for all persons with disabilities are not protected against inflation. And workers are not covered during periods of unemployment or for more than 12 months if their disability is a result of mental illness.

• A mixed story on survivors benefits. Life insurance benefit triples the worker's salary (with a maximum benefit of $150,000 and a minimum benefit of $50,000), and the balance of a worker's retirement account can be passed on, without regard to whether the worker has children, is married or has other dependents. Again, single workers, without dependents, who die do well (at least from the point of view of an economist's moneysworth analysis). But lost is the surety of family protection for families with very young children, especially those with low and moderate incomes.

In sum, this home-grown privatization plan illustrates some of the potentially deleterious outcomes that would follow from large-scale privatizing of Social Security.

• Lesson: We would do better to set our sights on examining some of the more moderate reform approaches implemented or under consideration by nations choosing to maintain their commitment to social insurance as the foundation of their retirement income systems.

Some nations are pursuing modest reductions in the long-term generosity of their pension systems through changes in their benefit formula requiring more years of earnings to calculate the basic benefit (e.g., Spain, France); in slight adjustments to their inflation indexing procedures (Finland, Japan and Germany). Some countries have introduced increases in contribution rates (Canada, Finland, France) (Kalisch and Aman, 1999). Canada, having recently decided against privatizing its social insurance program (Canadian Pension Plan), is seeking to expand the funded portion of its contributory, earnings-related social insurance program and is diversifying its investments to gain advantage from higher rates of return in its equity market (Kalisch and Aman, 1999; also see Ycas, 1997).

• Lesson: Many OECD nations are responding in incremental ways to changes in family structure and the labor force.

Most OECD pension systems are contributory, with eligibility and benefit amounts linked to previous work. Hence, the increased labor force participation of women, the early retirement trend of older men, the growth of part-time and intermittent work and the decline in long-term employment and job security all have implications for pension outcomes. Women in OECD nations are more likely to have gained rights to benefits from past work, than as a spouse. Partial pensions are being used by some nations (e.g., Denmark, Japan, Luxembourg, Germany) to ease the transitions from work to retirement. As we do through the Social Security Delayed Retirement Credit, some nations reward continued work with permanent benefit increments for delaying acceptance of a benefit past normal retirement. Finland, Sweden, and the United Kingdom do not limit the number of years that workers may receive pension adjustments for delaying their retirements. In terms of retirement age policies, most often it is directed at bringing the early and normal retirement ages of women in line with (e.g., Australia, Belgium, Germany, Hungary, Japan, Portugal and U.K.) or closer to (Switzerland, Czech Republic, Italy) the ages of early and normal retirement for men, something that parallels what the United States did with the enactment of the 1961 Amendments to the Social Security Act, which gave men the same right women were afforded in 1956, to retire with an actuarially reduced benefit as early as age 62. Indeed:

> There are relatively few examples of policy changes to increase the statutory retirement age for both men and women in OECD countries. Where this is planned, it is usually to bring the retirement age above the current age of 60 (as in the case of Japan, Hungary and the Czech Republic). Italy will increase the male retirement age from 63 to 65 by the year 2000 at the same time as the female age is increasing from 58 to 60 years. Only

> the United States has a firm policy to increase the pensionable age beyond 65... (Kalisch and Aman, 1999)

Divorce rates have increased and with this trend the adequacy of public pensions for divorced women has emerged as a policy concern. Belgium has responded by guaranteeing that divorced spouses will receive an old-age pension at age 60 that is at least equivalent to 37.5% of the former spouse's earnings during their marriage. Some nations (e.g., Belgium, Switzerland) provide credits that partially offset losses in pension benefits as a result of time spent out of the labor force caring for young children or disabled relatives (Kalisch and Aman, 1999). Australia actually has a separate benefit payment for persons giving care to functionally disabled persons under age 16 or to functionally disabled social security pensioners (Ycas, 1997).

- Lesson: There is much that is sound about Social Security.

In our search for solutions to current financing problems,[6] we should bear in mind the great success and popularity of our nation's universal and public Social Security program. It provides widespread and basic protection to America's families and employees, covering 149 million workers and their families and paying benefits to 44 million persons. Included among its 44 million beneficiaries are three million children under 18 who receive benefits each month. It is the main source of disability and survivors protections for America's families. For a 27 year old couple with two children under age 2 and with earnings equal to average wages, Social Security is the equivalent of a life insurance policy in excess of $300,000; a disability policy in excess of $200,000. It provides Americans with the equivalent of $12.1 trillion dollars in life insurance protection, more than the entire value ($10.8 trillion) of all the private life insurance protection in force. It is the only pension protection available to six out of ten working persons in the private sector.

Social Security has transformed old age in America. For the middle class, it provides the foundation of a secure retirement, ideally to be built upon by other pension coverage, private savings, sound investments, accumulated equity in their homes and, for some, work in their later years. But even for those who are relatively well off, say the roughly 4.9 million elderly households with incomes between $20,001 and $33,777 in 1996, Social Security provides nearly half of the total income (see table 4) going to their homes. For the bottom 60 percent of the elderly income distribution—those 14.7 million households with incomes under $20,000 in 1996, Social Security provides over 70 percent of all household income (see table 7). Indeed, absent Social Security, the poverty rate among the old would increase to roughly 50 percent (see table 8). And importantly, the security of beneficiaries is protected by annual cost-of-living protection which assures that benefits, once received, maintain their purchasing power into advanced old age—the point in time when elderly persons, especially widows, are often at greatest economic risk. Indeed, it is the adequacy features—the desire to provide widespread protection and do a bit more for those who have worked many years but at low wages—of Social Security which have driven the program's success.

- Lesson: We should not lose sight of the moral dimension of Social Security.

A public Social Security program is, to paraphrase former Senator Bill Bradley, the best expression of community in America today. Indeed, more is at stake in this discussion than the technical aspects of how to address the financing problems of Social Security. Behind all the discussion of "bend points," "year of exhaustion," "dependency ratios," and "percents of taxable payroll," this debate is fundamentally about our sense of responsibility to each other; about the basic protection that each working American should be assured of for themselves and their families in old age, disability or on the death of a loved one; about the mix of public and private efforts we should encourage to assure that security. In a very fundamental way it is an expression of the moral commitment of our nation to serve as our brothers' and sisters' keepers; to honor thy mothers and fathers. In the process of addressing long-

[6] As the Committee knows, under intermediate assumptions as reported in the 1997 trustees report, the combined OASDI trust fund is estimated to be able to meet its commitments until 2029. However, it is not in actuarial balance for the 75 year period over which long-range estimates are made. Tax returns (payroll tax receipts and receipts from taxation of benefits) will be exceeded by outlays in 2013. Total income, including interest earnings, is expected to exceed expenditures through about 2021 and the combined OASDI trust fund is able to meet all its commitments until 2031. Under the most commonly-accepted intermediate assumptions there is a projected 2.19 percent of payroll short-fall (–5.42 percent of payroll shortfall under the high cost assumptions and a +0.25 percent of payroll surplus under the low cost assumptions.) This deficit represents a roughly 14 percent shortfall over the 75-year estimating period; a 25% shortfall after 2031. Since the deficit years fall in the middle and end of the estimating period, the short-falls in the out years are substantially larger than suggested by the overall 2.19 percent of payroll estimate (i.e., −5.62 percent of payroll from 2048–2072).

term financing problems, it is important that we not lose sight of this moral dimension of the program which is one of the joining institutions of our society.

## References


Board of Trustees (April 30, 1998), *1998 Annual Report of the Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*.

Congressional Budget Office (January 1999), "Social Security Privatization: Experiences Abroad.

Ghilarducci, Teresa (September 18, 1997), Statement before the Subcommittee on Social Security of the House Ways and Means Committee "Hearing on the Future of Social Security for this Generation and the Next—Experiences of Other Countries."

Kay, Stephen (September 18, 1997), Statement before the Subcommittee on Social Security of the House Ways and Means Committee "Hearing on the Future of Social Security for this Generation and the Next—Experiences of Other Countries."

Heclo, Hugh (September 1998), "Political Risk and Social Security Reform," *Social Security Brief*, National Academy of Social Insurance.

Kalisch, David W. and Tetsuya Aman (1999 off website), "Retirement Income Systems: The Reform Process Across OECD Countries," OECD.

National Academy of Social Insurance (1998), *Evaluating Issues in Privatizing Social Security*.

National Center for Policy Analysis (1999), Policy Brief 215.

Piñera, José (Fall/Winter 1995/1996), "Empowering Workers: The Privatization of Social Security in Chile," *Cato Journal*.

Rix, Sara E. and John B. Williamson (1998), "Social Security Reform: How Might Women Fare?," *Issue Brief*, Public Policy Institute of AARP.

Social Security Administration, Office of Policy (January 28, 1999), *The Galveston Plan*.

Thurow, Lester (February 1, 1999), "Clinton snookers Republicans at their own economic game," *USA Today*, p. 15A.

US Department of Health and Human Services (Washington, D.C: January 1996), *Income of the Population 55 and Over*, Social Security Administration, Office of Research and Statistics.

US Department of Health and Human Services (Washington, D.C: January 1998), *Income of the Population 55 and Over*, Social Security Administration, Office of Research and Statistics.

Ycas, Martynas (1997), "International Updates," *Social Security Bulletin*, Vol. 60, No. 3, pp. 53–60.

Welch, William M. (February 3, 1999), "Study may show pitfalls of investing Social Security," *USA Today*.

Williamson, John B. and Eric R. Kingson (January 10, 1997), "The Pitfalls of Privatization," *Boston Globe*.


Table 1. Elderly and Total Dependency Ratios

| | Elderly dependency ratio [1] | | | Total dependency ratio [2] | | |
|---|---|---|---|---|---|---|
| | 1960 | 2000 | 2030 | 1960 | 2000 | 2030 |
| United States | 15.4 | 19.0 | 36.8 | 67.4 | 52.0 | 68.0 |
| Australia | 13.9 | 16.7 | 33.0 | 63.2 | 48.0 | 62.6 |
| Austria | 18.6 | 23.3 | 44.0 | 52.1 | 49.3 | 71.4 |
| Canada | 13.0 | 18.2 | 39.1 | 70.5 | 48.3 | 69.0 |
| Denmark | 16.5 | 21.6 | 37.7 | 55.8 | 49.1 | 67.0 |
| France | 18.8 | 23.6 | 39.1 | 61.3 | 52.8 | 67.9 |
| Germany | 16.9 | 23.8 | 49.3 | 47.4 | 46.7 | 75.1 |
| Greece | 12.3 | 25.5 | 40.9 | 52.0 | 48.8 | 66.3 |
| Italy | 13.3 | 26.5 | 48.3 | 47.9 | 47.8 | 72.7 |
| Japan | 9.5 | 24.3 | 44.5 | 56.6 | 47.2 | 70.5 |
| Mexico | ——— | 7.0 | 14.8 | ——— | 61.5 | 48.1 |
| Portugal | 12.7 | 23.5 | 38.7 | 59.1 | 46.4 | 59.8 |
| Spain | 12.7 | 23.5 | 41.0 | 55.1 | 45.3 | 64.8 |
| Sweden | 17.8 | 26.9 | 39.4 | 51.8 | 57.9 | 70.4 |
| Switzerland | 15.5 | 23.6 | 48.6 | 51.5 | 49.6 | 77.0 |
| Turkey | 6.7 | 8.9 | 16.2 | 81.4 | 57.9 | 48.6 |
| United Kingdom | 17.9 | 24.4 | 38.7 | 53.7 | 54.0 | 68.0 |

[1] Population aged 65 and over as a percent of working age population.
[2] Population aged 0–14 and 65 and over as a percent of working age population.
Source: OECD.

Table 2. Percentage of the Population Aged 60 and Over.

| | 2000 | 2030 |
|---|---|---|
| OECD Countries[1] | | |
| United States | 16.5 | 28.2 |
| Australia | 15.3 | 27.7 |
| Austria | 21.5 | 34.5 |
| Belgium | 22.5 | 32.2 |
| Canada | 16.8 | 30.2 |
| Denmark | 20.4 | 32.1 |
| Finland | 19.8 | 30.9 |
| France | 20.2 | 30.1 |
| Germany | 23.7 | 35.3 |
| Greece | 24.2 | 32.5 |
| Iceland | 14.9 | 26.0 |
| Ireland | 15.7 | 22.9 |
| Italy | 24.2 | 35.9 |
| Japan | 22.7 | 33.0 |
| Luxembourg | 21.2 | 29.5 |
| Netherlands | 19.0 | 33.4 |
| New Zealand | 15.9 | 26.8 |
| Norway | 20.2 | 29.6 |
| Portugal | 19.8 | 29.7 |
| Spain | 20.6 | 30.9 |
| Sweden | 21.9 | 30.0 |
| Switzerland | 21.9 | 31.0 |
| United Kingdom | 20.7 | 29.6 |
| Other Countries | | |
| Argentina | 13.7 | 19.3 |
| Brazil | 7.7 | 16.9 |
| Chile | 9.8 | 20.8 |
| China | 10.2 | 21.9 |
| Columbia | 6.7 | 18.0 |
| Mexico | 6.6 | 15.7 |
| Russia | 18.7 | 24.9 |
| Venezuela | 6.4 | 15.5 |

[1] Excluding Czech Republic, Hungary, Poland and South Korea
Source: OECD National Accounts, Main Aggregates, Volume 1, January 1998.

Table 3. Life Expectancy at Age 60 by Gender[1]

| | Female | | Male | |
|---|---|---|---|---|
| | 1960 | 1995 | 1960 | 1995 |
| United States | 19.5 | 22.9 | 15.8 | 18.9 |
| Australia | 19.4 | 23.7 | 15.6 | 19.5 |
| Austria | 18.6 | 22.9 | 15.0 | 18.7 |
| Canada | 19.9 | 24.3 | 16.8 | 19.9 |
| Denmark | 19.1 | 21.4 | 17.2 | 17.6 |
| France | 19.5 | 24.9 | 15.6 | 19.7 |
| Germany | 18.5 | 22.5 | 15.5 | 18.1 |
| Greece | 18.9 | 22.8 | 17.0 | 19.9 |
| Italy | 19.3 | 23.5 | 16.7 | 19.0 |
| Japan | 17.8 | 25.3 | 14.8 | 20.3 |
| Mexico | 18.1 | 22.4 | 16.8 | 18.9 |
| Portugal | 18.6 | 22.0 | 15.9 | 18.0 |
| Spain | 19.2 | 24.1 | 16.5 | 19.5 |
| Sweden | 19.3 | 23.9 | 17.3 | 19.8 |
| South Korea | ——— | 20.1 | ——— | 15.5 |
| Switzerland | 19.2 | 24.5 | 16.2 | 20.0 |
| Turkey | 15.9 | 18.1 | 14.7 | 15.8 |
| United Kingdom | 19.3 | 22.9 | 15.8 | 18.9 |

[1] Data refer to given year or closest available year.
Source: OECD, Health Data, 1997.

Table 4. GDP Per Capita in 1996 U.S. Dollars [1]

| | |
|---|---|
| United States | 27,821 |
| Australia | 20,376 |
| Austria | 21,395 |
| Belgium | 21,856 |
| Canada | 21,529 |
| Denmark | 22,418 |
| Finland | 18,871 |
| France | 20,533 |
| Germany | 21,200 |
| Greece | 12,743 |
| Iceland | 23,242 |
| Ireland | 23,242 |
| Italy | 19,974 |
| Japan | 23,235 |
| Luxembourg | 32,416 |
| Netherlands | 20,905 |
| Norway | 24,364 |
| Mexico | 7,776 |
| New Zealand | 17,473 |
| Portugal | 13,100 |
| Spain | 14,954 |
| Sweden | 19,258 |
| South Korea | 13,580 |
| Switzerland | 25,402 |
| Turkey | 18,636 |
| United Kingdom | 18,636 |
| OECD—Total [2] | 20,289 |
| OECD—Europe [3] | 17,630 |
| European Union | 19,333 |

[1] Based on purchasing power
[2] Excluding Czech Republic, Hungary, Poland and South Korea
[3] Excluding Czech Republic and Hungary
Source: OECD National Accounts, Main Aggregates, Volume 1, January 1998.

Table 5. Central Government Expenditures

| | Expenditures as a percent of GDP | | Health, Education & Income Security as a percent of total expenditures [1] | |
|---|---|---|---|---|
| | 1980 | 1996 | 1980 | 1996 |
| United States | 20.7 | 21.6 | 50.8 | 53.1 |
| Australia | 33.3 | 39.1 | 71.6 | 70.0 |
| Canada | 21.0 | — | 45.6 | 48.6 |
| Denmark | 31.3 | 35.3 | 57.1 | 54.9 |
| France | 37.4 | 44.7 | 70.2 | — |
| Germany | — | 32.1 | 69.4 | — |
| Greece | 24.7 | 29.1 | 51.5 | 35.4 |
| Italy | 39.1 | 47.9 | 50.7 | — |
| Japan | 14.8 | — | — | — |
| Mexico | 10.7 | 14.0 | 44.3 | 50.2 |
| Portugal | 28.7 | 38.8 | 48.4 | — |
| Spain | 23.7 | 36.2 | 69.1 | 49.5 |
| Sweden | 37.6 | 45.2 | 63.9 | 60.5 |
| Switzerland | 18.7 | 25.4 | 64.4 | 71.7 |
| Turkey | 15.5 | 24.6 | 23.8 | 19.0 |
| United Kingdom | 36.4 | 39.9 | 45.8 | 51.7 |

[1] Refers to education, health, social security, welfare, housing, and community amenities.
Source: World Development Report 1998/99, World Bank

Table 6. General Government Total Outlays as a Percentage of Nominal GDP

| | 1970 | 1980 | 1990 | 2000 [1] |
|---|---|---|---|---|
| United States | 30.0 | 31.4 | 32.8 | 31.1 |
| Australia | ——— | 31.4 | 34.8 | 33.3 |
| Canada | 34.1 | 39.2 | 46.7 | 41.2 |
| Denmark | ——— | 55.0 | 56.0 | 52.5 |
| France | 38.5 | 46.1 | 49.8 | 53.5 |
| Germany | 38.3 | 47.9 | 45.1 | 46.3 |
| Greece | ——— | 30.4 | 48.2 | 41.1 |
| Italy | 32.8 | 41.9 | 53.6 | 48.8 |
| Japan | 19.0 | 32.0 | 31.3 | 39.0 |
| Mexico | ——— | ——— | 17.2 | 13.5 |
| Portugal | 19.5 | 23.2 | 40.6 | 44.1 |
| Spain | 21.6 | 32.2 | 42.5 | 40.3 |
| Sweden | 42.8 | 60.1 | 59.1 | 58.1 |
| Switzerland | ——— | ——— | 41.0 | 49.3 |
| Turkey | ——— | ——— | 27.9 | 25.2 |
| United Kingdom | 37.2 | 43.4 | 41.8 | 40.0 |

[1] Estimates and projections.
Source: OECD, Economic Outlook, December 1998, OECD.

Table 7. Importance of Various Sources of Income to Elderly Households, 1996*

(All members over age 65)

| | All Aged Units | QUINTILES | | | | |
|---|---|---|---|---|---|---|
| | | Units Under $8.156 (Q1) | $8,157–$13,007 (Q2) | $13,008–$20,000 (Q3) | $20,001–$33,777 (Q4) | $33,778 and over (Q5)— |
| Number of Units (in millions) | 24.6 | 4.9 | 4.9 | 4.9 | 4.9 | 4.9 |
| Percent of Total Income From:** | | | | | | |
| Social Security | 40.3 | 80.7 | 80.4 | 65.8 | 47.3 | 20.6 |
| Railroad Retirement | 0.5 | 0.1 | 0.6 | 0.8 | 0.9 | 0. |
| Government employee pension | 8.1 | 0.9 | 1.9 | 4.9 | 9.5 | 10.0 |
| Private pension/annuity | 9.9 | 1.6 | 4.0 | 8.9 | 13.4 | 10.4 |
| Income from assets | 18.0 | 2.7 | 5.7 | 9.5 | 14.8 | 25.0 |
| Earnings | 20.0 | 1.2 | 3.0 | 6.6 | 11.7 | 31.5 |
| Public Cash Assistance | 0.7 | 11.4 | 2.1 | 0.7 | 0.2 | 0.0 |
| Other | 2.1 | 1.3 | 2.3 | 2.8 | 2.4 | 2.2 |

*All members of households are 65 or over. Aged units are married couple living together—at least one of whom is 65—and non-married persons 65 or older.
**Details may not sum to totals due to rounding error.
Source: US Department of Health and Human Services, Social Security Administration, Office of Research, Evaluation and Statistics, Income of the Population 55 and Over (Washington, D.C: 1998, pp. 123).

Table 8. Elderly Households* Below Poverty Line in 1994, With and Without Social Security Benefits, Among Households Receiving Social Security Benefit

| | All Aged Units | African-American Elderly Units | Hispanic Elderly Units | White Elderly Units | Women not Married |
|---|---|---|---|---|---|
| 65 and Over | | | | | |
| Number of Units* with SS Benefits (in millions) | 23.9 | 1.9 | 0.9 | 19.6 | 9.9 |
| PERCENT ** | | | | | |
| Below Poverty Line | 14 | 29 | 21 | 10 | 20 |
| Kept Out of Poverty by Social Security | 42 | 39 | 40 | 42 | 44 |
| Total Below Poverty Without Social Security | 54 | 69 | 61 | 53 | 64 |
| 85 and Over | | | | | |
| Number of Units* with SS Benefits (in millions) | 2.5 | 0.2 | 0.1 | 2.2 | 1.7 |
| PERCENT** | | | | | |
| Below Poverty Line | 17 | 30 | 25 | 15 | 20 |
| Kept Out of Poverty by Social Security | 49 | 47 | 46 | 50 | 48 |
| Total Below Poverty Without Social Security | 66 | 76 | 71 | 65 | 68 |

Source: US Department of Health and Human Services, Social Security Administration, Office of Research and Statistics, Income of the Population 55 and Over (Washington, D.C: January 1996), p. 123

*Aged units are married couple living together—at least one of whom is 55—and non-married persons 65 or older.

**Details may not sum to totals due to rounding error.

Table 9. Initial Monthly Retirement Benefits in 1998 Dollars*

| Family/Earner Type | Galveston Plan [1] | Social Security |
|---|---|---|
| Single | | |
| Low | $ 733 | $ 763 |
| Middle | *1,700* | 1,267 |
| High | *2,402* | 1,689 |
| Very-high | *3,489* | 1,974 |
| Married | | |
| Low | $ 670 | $1,139 |
| Middle | 1,555 | 1,895 |
| High | 2,197 | 2,522 |
| Very-high | *3,192* | 2,948 |

Indirect source: Social Security Administration, Office of Policy; American United Life Insurance Company Annuity Table for the Galveston PLan 1/25/99.

*Italic numbers indicate the Galveston Plan offers a benefit that is higher than Social Security's.

[1] It is assumed that retirement benefits under the Galveston Plan are paid in the form of a life annuity, and in the case of a married couple, through joint-contingent annuity with rights of survivorship with its equivalent to ⅔ of a single-life annuity. Galveston and Social Security retirement estimates assume that all workers retire in the year 2045 at age 65. Low and Middle earning workers begin employment at age 20 and work 45 years under each system. High and Very-high earning workers begin employment at age 22 and work 43 years under each system. In the year 2045, the normal retirement age for Social Security is 67, and therefore, the Social Security benefits presented in this report reflect the benefit reduction due to early retirement. The categories for this table represent earnings at the following percentiles in the year 2045: Low = 10th, Middle = 50th, High = 75th, Very-high = 90th.

Direct Source: The Galveston Plan, Social Security, Office of Policy, January 28, 1999.

Table 10. Galveston's Monthly Retirement Benefit as % of Social Security's Over Time (assuming 3% inflation) * [1]

| Family/Earner Type | Initial Benefit | After 15 years | After 15 years |
|---|---|---|---|
| Single | | | |
| Low | 96 % | 61 % | 52 % |
| Middle | *139 %* | 88 % | 76 % |
| High | *142 %* | 90 % | 77 % |
| Very-high | *177 %* | *112 %* | 96 % |
| Married | | | |
| Low | 59 % | 37 % | 32 % |
| Middle | 82 % | 52 % | 45 % |
| High | 87 % | 55 % | 47 % |
| Very-high | *108 %* | 69 % | 59 % |

* Italic numbers indicate where the Galveston Plan offers a benefit that is higher than Social Security's.
[1] See footnote 1 in table 9.
Source: The Galveston Plan, Social Security, Office of Policy, January 28, 1999.

## STATEMENT OF STEPHEN J. KAY, ECONOMIC ANALYST, LATIN AMERICA RESEARCH GROUP, FEDERAL RESERVE BANK OF ATLANTA, ATLANTA, GEORGIA

Mr. KAY. Thank you, Mr. Chairman, and distinguished Members of this Committee. Thank you for this opportunity to testify.

My name is Stephen Kay, and I'm an economic analyst in the Latin America Research Group at the Federal Reserve Bank of Atlanta. I spent 5 years researching and writing about the process of Social Security reform in Argentina, Brazil, Chile and Uruguay. I'm here as a private citizen, and the views that I will express are my own and do not reflect the views of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

Chile's system of defined contribution individual investment accounts has received international acclaim and has served as a model for the rest of Latin America. Other countries in the region, including Argentina and Uruguay, have also implemented systems with individual accounts. However, unlike Chile, these plans include a universal pay-as-you-go benefit and joining the private system remains optional.

Chile's reform has been praised for its relative transparency and simplicity and its role in promoting the development of Chile's capital markets. However, Chile's new private system has experienced its share of problems, and we can benefit by studying both its strengths and weaknesses. There are three elements of this reform that deserve particular attention.

One, the system's high transition and administrative costs. Two, its risk and uncertainty regarding future benefits. And three, its distributional consequences. First, let's look at the transition and administrative costs. The transition costs to a private system are enormous because governments must continue to pay benefits while contributions are diverted to private accounts.

Transition costs in Chile are currently almost 3.8 percent of GDP annually. By any measure, Chile's new pension system has been expensive to run and expensive to join. High administrative costs are translated into high commission charges. In 1997, 18 percent of an average Chilean's pension fund contributions went toward the administrative fee, and flat-rate commissions made these fees proportionately more burdensome for low-income groups.

Chile's Government is currently debating a number of measures that could lead to lower commission charges. But even if these charges were cut in half, they would still represent a significant burden.

The secondary concern is market risk. Pension benefits bear the risk of poor investment returns. Projections for future returns which will determine pension benefit range between 3 and 5 percent. Pension benefits will vary dramatically depending on which, if any, of these forecasts hold true.

For example, a 3-, 4-, or 5-percent annual return on retirement savings in Chile would lead to benefits representing 44, 62, or 84 percent of preretirement earnings for men. One city estimated that in order to achieve the goal of the 70 percent earnings replacement rate, the system would have to have returns of around 4.5 percent.

Finally, there are distributional consequences of the system. Perhaps the most striking change concerns the treatment of women. In the old pay-as-you-go system, the disparity in benefits between men and women was smaller. Because women tend to earn less and spend more years of their lives in unpaid labor, women spent fewer years accumulating capital in their accounts.

When they purchase an annuity upon retirement, men and women are placed in separate actuarial categories. So women receive lower benefits because of their greater longevity. Therefore, even if a man and woman have identical earnings and contribution histories, a woman purchasing an annuity will receive 90 percent of what a man would receive.

I want to conclude by saying that while we can learn a lot by studying pension reform in Chile and other Latin American countries, we're not yet in a position where we can evaluate the long-term performance of these programs. These new systems are still in the early and relatively easy phase of capital accumulation.

Current pensions under the new Chilean system are not an indicator of future retirement benefits because current benefits are largely funded by special government bonds issued to compensate for contributions made to the old pay-as-you-go system.

The true test will begin 30 years in the future when the first generation of workers who have spent their entire careers contributing to the new private system begins to retire. Thank you.

[The prepared statement follows:]

**Statement of Stephen J. Kay, Economic Analyst, Latin America Research Group, Federal Reserve Bank of Atlanta, Atlanta, Georgia**

My name is Stephen Kay. I am an economic analyst in the Latin America Research Group at the Federal Reserve Bank of Atlanta. Prior to joining the Federal Reserve Bank of Atlanta last year, I spent several years conducting research on social security reform in Argentina, Brazil, Chile, and Uruguay. I am here as a private citizen, and the views outlined below are my own, and do not reflect the views of the Federal Reserve Bank of Atlanta, or the Federal Reserve System.

Chile's 1981 pension privatization has garnered a great deal of international attention, receiving praise for its relative transparency and simplicity, and its role in promoting the development of Chile's capital markets. However Chile's new system of individual savings accounts has experienced its share of difficulties, which also merit our attention. The new system has been criticized for its high operating expenses, commission charges, and transition costs, as well as its low rates of compliance and its distributional impact on women. By studying the strengths and weaknesses of Chile's new private system, we are better able to understand the potential risks and rewards of defined contribution social security systems that are based upon individual savings accounts.

## BACKGROUND

Prior to recent reforms, South America's social security systems were in varying degrees of disarray: aging populations and massive evasion by both employers and workers meant that fewer contributors were supporting more pensioners, surpluses had been wasted on bad investments, benefits were highly inegalitarian and financed regressively, deficits were mounting, administrative performance was poor, and payroll taxes were among the highest in the world.[1] Social security systems were also organized into multiple sub-systems, each with its own administration and benefits structure.

By the end of the 1980s (Latin America's "lost decade" of economic development) there was consensus in the region that reform was necessary; however intense political conflict arose over the direction of reform. Reforms in the Southern Cone of South America ranged from partial privatizations in Argentina (1993) and Uruguay (1995), to a short-lived privatization effort in Brazil.

Chile became the pioneer of privatization when the Pinochet dictatorship implemented the world's first-ever social security privatization in 1981. Under the tripartite "pay-as-you-go" (PAYG) model used in most of the world (including the United States), a combination of payroll taxes on workers and employers, and government contributions (when necessary) are used to fund social security benefits. In Chile's new defined-contribution system, workers are required to contribute 10% of their salaries to individual investment accounts, where funds are invested by private pension fund companies in closely regulated portfolios. An additional 3 percent of a worker's salary goes toward commission fees and a disability and survivors' insurance premium. Pension fund companies must guarantee profitability relative to the average profitability in the pension fund industry. The self-employed are not required to join a pension plan (only about 10% do), and the military and police have kept their relatively generous defined-benefit PAYG systems.

In Argentina and Uruguay, democratically-elected governments found little popular support for a Chilean-style reform, and consequently both reforms differ from Chile's privatization in two significant respects. First, both systems maintain a universal public pay-as-you-go benefit, while Chile's PAYG system is being gradually phased-out. Second, membership in the private system is optional for Argentine and Uruguayan workers (although workers in Uruguay must make contributions to a pension fund on earnings between $800 and $2500). In Chile the new private system was optional when it was introduced (there was a financial inducement to join), and it has been mandatory for all workers entering the labor force since the reform.

## ADMINISTRATIVE COSTS

Chile's new private system is plagued by high administrative costs, which are in part passed on to workers in the form of high commissions. Commissions have come down from their peak of 8.69% of taxable salary in 1984 to around 2.96% in 1997 (these include a disability and survivors' insurance premium of around 0.7%). High costs are expected during the start-up phase of a new pension fund industry. However in 1997, commission charges alone still accounted for around 18% of a worker's total contribution. Although its founders expected that competition would lead to lower commission costs, this has not occurred, and expenses generated by marketing have helped keep costs high. The recent trend in the industry is toward greater concentration, as three firms (out of a total of eight), controlled 73% of all affiliates in 1998.

Marketing and operations costs have been high as Chilean pension funds have engaged in expensive sales campaigns to capture workers from competitors. 28% of affiliates in Chile switched pension funds in 1996. Marketing costs absorb between 30% and 40% of all operating costs. Roughly a third of these administrative costs are generated by salespersons seeking to persuade workers to switch funds.[2] The government has recently enacted measures aimed at reducing the number of transfers by making the process of switching pension funds more complicated. Chilean regulators are also considering a number of steps to lower commissions, including a plan to allow lower group-rate commissions (which are currently prohibited), and a proposed rating system where pension funds would be ranked according to charges and service provided. In 1998, commission fees as a percentage of contributions dropped an average of 8%.

Upon retirement, workers face a number of options. The accumulated funds may be used to purchase an annuity indexed against inflation, or pensioners can elect to receive a "programmed pension," paid directly by the pension fund company, based on the accumulated funds in an amount that is reassessed every year based upon the fund's investment performance. Workers may also elect to withdraw funds in a lump sum, as long as they leave enough capital to purchase an annuity in the amount of 110% of the minimum pension. These options give workers greater control over their funds, but they pose the risk that workers may outlive their income (in the case of a programmed withdrawal), or spend a large portion of their retirement income at once and be left with a pension just slightly above the minimum. The annuities market in Chile has not functioned well, with no provision in place for group contracts. Since these options are complex, workers are exposed to intense selling pressure by insurance agents who may charge as much as 4% of the value of the contracts.[3] In the Chilean system, government guarantees against inflation are provided for life annuities which can be purchased upon retirement (until workers purchase annuities they are exposed to the risk that inflation could diminish their capital).[4]

Retirement pensions granted in the next few years are not indicative of future benefits because between 60% to 75% of the funds accumulated in these individual accounts will come from government "recognition bonds." These bonds are paid to pensioners upon retirement in recognition of past contributions made to the old public system, and carry a real interest rate of 4%.[5] The true test will come in another thirty years, when workers who have contributed exclusively to the new system begin to retire.

## Returns and Pensions

Since its founding, Chile's private system claims to have achieved an impressive average annual return on investment. The figure usually cited shows that the pension funds have produced a real average annual return of 11% since 1981, but these are gross returns, without consideration of investor-paid commission expenses. Once commissions are factored in, the real average return is considerably lower. For example, while the simple real average annual return on invested pension funds between 1982 and 1995 was 12.7%, this figure does not incorporate the commission charges that workers pay on contributions. If you consider the amount workers contributed and deduct commission charges, an individual's real average annual rate of return over this period would be 7.4%. The disparity between these two figures illustrates how commissions affect the rate of return. Over shorter periods of time, the impact on the rate of return is even greater since contributors may earn negative or very low returns for several years (imagine the impact of an 18% load).[6] Furthermore, fixed commissions are a source of regressivity in the new system because these fees consume a proportionately greater percentage of the contributions of low-income workers.[7] The high cost of pension fund accounts for poor people led the World Bank to suggest that poor people might be better served by saving for retirement in bank savings accounts.[8]

Each pension fund company offers just one investment fund, and these funds are required to deliver returns comparable to their competitors over a twelve-month period, or make up the difference from their reserves. Funds are required by law to deliver a real return that is no less than 50% of the industry average, or 2% below the industry average, whichever figure is lower. As a result, there is little divergence among returns as each fund seeks to emulate the returns of its competitors. In order to encourage pension funds to take a longer term view and avoid the "herd effect" of uniform returns, the government is considering extending the time period over which relative fund pension fund performance is measured. However any movement away from uniform portfolios has to be weighed against the risk of workers receiving lower returns by choosing poorly-managed funds.[9]

While the system has achieved high annual returns thus far, their sustainability is uncertain. Chile's high returns resulted from specific macroeconomic circumstances in the 1980s. The economy had hit a low point in 1982 when real GDP fell by 14%. After the banking crisis in 1981–83, real interest rates were very high. Pension funds invested heavily in government debt instruments, and when real rates fell, they realized large capital gains. Pension funds increased investment in equities in the 1990s, and high real returns came mostly from the impressive performance of the stock market.[10] Stock prices increased in part because of pension fund demand,[11] and conversely, were adversely affected in 1998 by the decision of pension funds to cut their holdings of Chilean shares in half (from 28% at the end of 1997 to 14% at the end of 1998). Pension fund returns over the past four years have averaged under 2% before commissions.

Regulations on minimal profitability and requirements that each pension fund company can only administer one fund have restricted diversity among fund portfolios as pension funds have largely produced similar returns.[12] Until now, pension fund companies have been limited to offering just one investment portfolio, even though individuals have different tolerances for risk according to their ages. For example, an individual close to retirement might want to have a portfolio largely composed of bonds, while a younger worker's asset mix would be invested heavily in stocks. In July, a World Bank report criticized Chile's pension fund managers for not offering a wide enough asset mix. The danger of this was brought home last fall, when the average pension fund had lost 9.9% between January and September (the year-end rally in financial markets cut the average loss to 1.1%), a development that no doubt caused hardship for individuals planning to retire last fall. The government now plans to allow pension funds to offer a fixed-income fund that will only be open to workers with ten or fewer years left until retirement. This fund will not be available to all workers, reportedly because of fears that this would generate an exodus from existing pension funds.[13] The government is also considering permitting the introduction of other investment portfolios aimed at younger workers.

Predictions for future returns, which will determine pension benefits, range between 3% and 5%. Pension benefits will vary dramatically depending on which, if any, of these predictions hold true. For example, a 3%, 4%, or 5% annual return on retirement savings in Chile would lead to benefits representing 44%, 62%, and 84% of pre-retirement earnings for men.[14] One study estimated that for Chile to achieve the system's goal of a 70% earnings-replacement rate, the system would have to have annual returns of around 4.5% (leading numerous analysts to suggest that the 10% workers contribution might not be sufficient to generate a 70% earnings-replacement rate [15]).

### Impact on Women

Perhaps the most striking distributional consequence of moving to a system of individual accounts concerns the treatment of women. In the old PAYG system, the disparity in benefits between men and women was smaller. When compared to PAYG systems, the private social security systems in South America disadvantage women by strictly linking benefits with earnings, and placing men and women in separate actuarial categories. Because they tend to earn less, spend more years of their lives in unpaid labor, and have greater longevity, women purchasing annuities upon retirement will systematically receive lower benefits than men.

In a forthcoming study, economist Alberto Arenas de Mesa and sociologist Veronica Montecinos project the rates of return that women would need in order to achieve the same pensions as men. For example, assuming identical wages and years of contribution, a woman retiring at age 65 and purchasing an annuity would receive approximately 90% of what a man would receive. When we consider the actual disparities in income profiles and years of contribution, the differences are even more striking. The authors cite a 1992 study that found that a typical woman retiring at age 60 and purchasing an annuity after earning a 5% annual rate of return would receive a replacement rate of 57% of her former salary, while a man retiring at age 65 would receive 86%.[16]

### Non-Compliance

Many believed that the private system would reduce evasion because workers have a greater incentive to contribute to their own personal retirement accounts than to a PAYG system. However, evasion persists. Only 60 to 62% of workers are covered by the new system, figures that are similar to the old system.[17] In August of 1998, just over half of workers covered by the new system (55.3%) made contributions to their accounts.[18] The compliance rate also varied by income level. Funds which catered to lower-paid workers received contributions from 45–55% of their worker-contributors, while those serving higher paid workers had a compliance rate of 80–90%.[19] To further illustrate the problem of non-compliance, as of December 1995 over 35% of the 5.4 million contributors to the private system had accumulated less than $500 in their accounts, while more than half had less than $1228 in their accounts.[20]

Part of the compliance problem may be related to a moral hazard incentive in the program for workers not to comply. The government provides a subsidy to workers who contribute for at least twenty years but do not accumulate enough capital to earn a minimum pension. This provides an incentive for individuals to evade by contributing just enough to qualify for a minimum pension, but no more, thereby shifting the funding burden to the taxpayers. The minimum pension is approximately 30% of the average salary, and is currently around $120 a month for those under the age of 70. Government subsidies for the minimum pension will rise dramatically in the future, as some estimate that the number of affiliates who will not save enough to receive a minimum pension could be as high as 70%.[21]

### Capital Markets, Growth, and Savings

According to economist Nicholas Barr, the effects of a funded pension system on national savings, and hence economic growth is "arguably the most controversial area" of this debate, and he suggests that the "experience of countries in the West is inconclusive both theoretically and empirically."[22] Increased pension fund savings are likely to be offset by a decline in government savings as payroll taxes are diverted to private accounts. Individuals expecting a larger retirement benefit may also elect to save less in other ways.

Although some have claimed that privatization explains the meteoric rise of Chile's national savings rate (which climbed from around 15% of GDP in the 1980s to 27% in 1995), recent studies negate this claim.[23] One study argues that Chile's rapid economic growth is the primary reason for the increased savings rate, with the pension reform contributing to growth in the savings rate equivalent to 3% of GDP.[24] Arrau argued that increased corporate savings resulting from Chile's 1984 tax reform played a large role in boosting Chile's savings rate, and that the private pension system's direct contribution to the increase was around 1% of GDP.[25] Another study concurred, concluding that "A very popular perception in Chile and in international circles is that the introduction of a privately-administered pension system based on individual capitalization has been the driving force behind the growth in national savings. However the principal sources of increased savings in Chile are elsewhere: in private enterprise and the government."[26]

There is agreement that shifting to a funded pension system has contributed to the deepening of Chile's domestic capital markets, which in turn has had a positive impact on economic growth.[27] In a country like the U.S., with its well-developed capital markets, the same process may not occur. As economist Sebastian Edwards put it, "It is not clear that these mechanisms that have benefited Chile will be there in other, more developed countries."[28]

### Transition Costs

In a defined contributions system with individual accounts, workers stop paying social security contributions to the government, but the government will continue to owe benefits to individuals belonging to the old PAYG system. This shortfall in revenue can only be financed through cutting other areas of government spending, raising taxes, cutting benefits, extending the retirement age, and/or by issuing debt. The Chilean reform did many of these things. Prior to privatizing, the Chilean government raised the retirement age to 65 for men and 60 for women and eliminated special early retirement programs. The government ran budget surpluses, privatized state-owned industries, and issued bonds that were purchased by the new pension funds. Since "recognition bonds" (recognizing past contributions to the old PAYG system) are not issued to workers until retirement, the transition costs are incurred over an extended period of time. In 1996, the transition costs were 3.7% of GDP, and are expected to range between 3% and 4% of GDP over the next five years.[29] If welfare pensions, minimum pensions, and the deficit in military and police pension funds are included, the 1997 figure would be 5.5% of GDP.[30] As the transition costs grew in the 1980s, they consumed relatively greater percentages of social spending, while expenditures on health and education were cut (social spending has increased since Chile's return to democracy).[31]

### Conclusions

Prior to their recent reforms, social security systems in the Southern Cone of Latin America suffered from financial and administrative problems that we in the United States have not encountered, and debates over reform were informed by fundamentally different political and economic realities. By most measures, governments in Latin America had failed to provide adequate social security coverage. Privatization has offered an alternative strategy that has been pursued, to varying degrees, throughout most of the region. This statement has outlined some of the costs, risks, and distributional consequences associated with the Chilean reform. Continued study of the pension reforms in Chile and the rest of Latin America would contain valuable lessons for all of us as we proceed along the path of reform.

ENDNOTES

1. For a description of the ills of Latin America's social security systems see Mesa-Lago, Carmelo. 1994. *Changing Social Security in Latin America*. Boulder: Westview.
2. Fidler, Stephen. 1997. "Lure of the Latin Model," *Financial Times*, 4–9–97.
3. Gillion, Colin, and Alejandro Bonilla. 1992 "Analysis of a National Private Pension Scheme: The Case of Chile," in *International Labour Review*. Vol. 131, No.2, 1992, p.171–195. Also see Vittas, Dimitri. 1995. "Strengths and Weaknesses of the Chilean Pension Reform." Mimeo. Financial Sector Development Department, World Bank.
4. On the risk of inflation and defined-contribution savings accounts, see Barr, Nicholas. 1992. "Economic Theory and the Welfare State: A Survey and Interpretation" in *Journal of Economic Literature*. Vol. 30 (June 1992), p.741–803 and Barr, Nicholas. 1987. *The Economics of the Welfare State*. Stanford: Stanford University Press.
5. Arenas de Mesa, Alberto, and Veronica Montecinos. Forthcoming (1998). "The Privatization of Social Security and Women's Welfare: Gender Effects of the Chilean Reform." Forthcoming in *Latin American Research Review*.
6. Shah, Hemant. 1997. "Toward Better Regulation of Private Pension Funds." Paper presented at the World Bank, LAC Division, 1–16–97.
7. See Arenas de Mesa, Alberto. 1997. *Learning from the Privatization of the Social Security Pension System in Chile: Macroeconomc Effects, Lessons and Challenges.* Dissertation. University of Pittsburgh, Pittsburgh (March) 1997. Arenas de Mesa quantifies how commission charges affect low and high income earners.
8. Bridge News, 1998. "Chile Press: World Bank Study Says Asset Mix in AFPs Lacking." Story #14616, 7–23–98.
9. Queisser, Monika. 1998. "The Second-Generation Pension Reforms in Latin America" in OECD, in Maintaining Prosperity in an Ageing Society, OECD Ageing Working Papers 5.4. P.58.
10. See Vittas (1995).
11. On the impact of pension fund demand on stock prices, see Uthoff, Andras. 1997. "Reformas de los Sistemas de Pensiones y Ahorro: Ilustraciones a Partir de la Experiencia Chilena," in *Ahorro Nacional: La Clave Para Un Desarollo Sostenible En America Latina*. Madrid: Instituto de Relaciones Europeo-Latinoamericanas (IRELA).
12. Diamond, Peter, and Salvador Valdés-Prieto. 1994. "Social Security Reforms," in Barry P. Bosworth, Rudiger Dornbusch, and Raúl Labán eds., *The Chilean Economy: Policy Lessons and Challenges* Washington D.C.: Brookings Institute.
13. Ruiz-Tagle, Jaime. 1998. "Jubilo o Tristeza? El Futuro del Nuevo Sistema de Pensiones en Chile," in *Problemas Actuales y Futuros del Nuevo Sistema de Pensiones en Chile*. Santiago: Fundación Friedrich Ebert.
14. The figures on the rate of return and benefits are from Gillion and Bonilla (1992). Cheyre predicts a 5% annual return (see Cheyre, Hernan 1991. *La Previsión en Chile, Ayer y Hoy*. Santiago: Centro de Estudios Publicos).
15. See Gillion and Bonilla (1992 p.186) and Barr (1994 p.213).
16. Arenas de Mesa, Alberto, and Ver≤nica Montecinos. 1999. "The Privatization of Social Security and Women's Welfare: Gender Effects of the Chilean Reform," forthcoming in *Latin American Research Review*, volume 34, No. 3. Arenas de Mesa and Montecinos project that a woman working 70% of a "normal" 45-year career (having remained outside the labor force due to family responsibilities), would receive 32% to 46% of her working salary (assuming 5% annual returns). In order to receive a 70% replacement rate, she would have to have an average annual return between 7.7% and 10%.
17. See Fidler (1997).
18. Salomon Smith Barney. 1998. "Private Pension Funds in Latin America–1998 Update." Salomon Smith Barney Industry Report, December, 1998.
19. These figures are from 1990. See Barr (1994 p.212).
20. See Shah (1997).
21. See Ruiz-Tagle (1998).
22. Barr, Nicholas, 1994. "Income Transfers: Social Insurance" in Barr, Nicholas, ed., *Labor Markets and Social Policy in Eastern Europe: The Transition and Beyond*. New York: Oxford. See page 214.
23. For an analysis and summary of recent work on the relationship between pensions and the savings rate in Chile, see Uthoff (1997).
24. Gavin, Michael, Ricardo Hausmann, y Ernesto Talvi. 1997. "El Comportamiento del Ahorro en América Latina: Panorama y Consideraciones Globales," in *Ahorro Nacional: La Clave Para Un Desarollo Sostenible En America Latina*. Madrid: Instituto de Relaciones Europeo-Latinoamericanas (IRELA).
25. See Arrau, Patricio 1996. *Nota Sobre El Aumento del Ahorro en Chile.* CEPAL: Santiago. The 1% figure is cited in Titelman, Daniel. 1997. "Impacto De Los Fondos De Pensión En El Proceso De Ahorro Interno" in *1er Seminario Internacional Sobre Fondos De Pensiones*. Buenos Aires: Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones.
26. Agosin, Manuel R., Gustavo Crespi T. y Leonard Letelier S. 1997. *Análisis sobre el aumento de ahorro en Chile*. Office of the Chief Economist, Inter-American Development Bank, Red de Centros de Investigación, R–309. My translation.
27. See Holzmann, Robert 1997. *On Economic Benefits and Fiscal Requirements of Moving from Unfunded to Funded Pensions.* Santiago: ECLAC. Also see Barr (1994 p.214). Barr reports that according to some commentators, "this is the only substantial benefit of the pension reform which could not have been achieved by redesigning the old PAYG system."
28. See Fidler (1997).
29. See Asociación Internacional de Organismos Supervisores de Fondos de Pensiones, 1996. *Reformas a los Sistemas de Pensiones*. Buenos Aires: SAFJP. See p.85.
30. Interview, 2–3–99, Alberto Arenas de Mesa, Ministry of Finance, Chile.

31. Vergara, Pilar. 1994. "Market Economy, Social Welfare, and Democratic Consolidation in Chile," in Smith, William et al eds., *Democracy, Markets, and Structural Reforms in Latin America*. New Jersey: Transaction—North/South Center. See page 254. Also see Gillion and Bonilla (1992 p.192–195).

Mr. SHAW. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. I appreciate the testimony of all three of you.

Mr. Kay, you are right; I asked the gentleman who spoke on behalf of the Chilean system from the Cato Institute about this as the system is only 19 years old. It hasn't even gone through one generation yet. And it is great that he is enthusiastic about the program in representing the Cato Institute throughout the United States as well. But the fact of the matter is that it is untested. We had high growth in the first 10 years of the new system, and now we are starting to see staggered growth or unstable growth in Chile and some of the Latin countries. As a result of that, the true test is probably going to be over the next 30 or 40 years, as you suggest, and I appreciate that.

When do you think that we will be able to get a definitive feeling on whether the Chilean system is actually working and we can evaluate it fairly?

Mr. KAY. As I said, there is a lot of uncertainty. No one knows, of course, what returns are going to be. We will have to wait 30 years, until people begin to retire and successive generations begin to retire, draw down their accounts, and purchase annuities. If the Chilean markets continue to do well in the way they have in the past, then nobody will have anything to worry about—for those who have contributed, because there is a compliance problem as well. But Chilean markets benefited from some very unusual circumstances over the past 15 years that may or may not be repeated.

The system was developed with the idea that a 4-percent return or a 4.5-percent return would be enough to get a 70-percent earnings replacement rate. So, I don't think anybody expects the kinds of returns that have happened in the eighties to be sustained, so 4 percent would be good. This is where the experts disagree. Some say that 5 percent is a realistic expectation; others say 3 percent.

Mr. MATSUI. Right. I appreciate that.

Dr. Kingson, you were saying that we ought not to be so down on the system that we have here in this country, if I am not mistaken. I was kind of back and forth. I apologize. Our system now has been in place for about 65 years. Obviously, it was more of a widows and orphans fund at the beginning, but it has matured, obviously, into kind of a safety net income security program for seniors and the disabled and for survivor purposes.

How would you rate our system, again, for the record?

Mr. KINGSON. I would rate it as a tremendous American success——

Mr. MATSUI. I appreciate that.

Mr. KINGSON [continuing]. And one that remains quite popular, across all ages, in fact, although we acknowledge that there is concern about its future and that there is work to be done. It is very important.

Mr. MATSUI. I appreciate that, because I think all of us are aware of the fact that we do have a demographic problem, and we need to address that issue in a good-faith way. I know all of you feel the same way, and all of us do as well.

Mr. Orszag, in terms of the—and I couldn't get this out of—perhaps maybe I didn't try hard enough, but out of the witnesses prior to you. What is really the cost of maintenance of the Chilean system? We have got, basically, three issues of cost. One is the cost of maintenance of the system; that is, the cost of financial advisors and the cost of fees. The second is, when a transfer occurs, I guess that is an additional fee. Then, three, when you annuitize the program, particularly if you give CPI or at least an inflationary increase, that does add to the cost.

Then perhaps you could also discuss whether there is a differential between men and women. Since women live longer in Chile and the United States, are women penalized? Do they get a lower rate, even though they have the same dollars fund at the end of the retirement period? Perhaps you can respond to those two or three questions I asked.

Mr. ORSZAG. Sure. My research has focused mostly on the United Kingdom, but the apparatus for analyzing individual accounts will apply to any system.

Mr. MATSUI. Right.

Mr. ORSZAG. So it can just as well apply to Chile. Again, you have an annual management fee, which is the one that is referred to effectively as adding up to about 18 or 20 percent. In Chile, there are regulations on the fee structure. There are only certain types of fees that are allowed. It turns out that the way that the fees are typically imposed, which is a one-time fee of, say, 18 percent, regardless of whether you then switch AFPs or financial providers. This structure means that transfer costs are effectively zero in Chile, despite relatively rapid transferring across AFPs. That, again, just to emphasize, is not true in the United Kingdom——

Mr. MATSUI. Right.

Mr. ORSZAG [continuing]. Where people are hit for those transfers.

Mr. MATSUI. Could you just tell us what that number is—and I know my time has run—but could you tell me that number?

Mr. ORSZAG. In the United Kingdom?

Mr. MATSUI. United Kingdom, yes.

Mr. ORSZAG. In the United Kingdom, again, our estimates are very preliminary, but it is looking like that may well double the figures that were discussed this morning.

Mr. MATSUI. OK. Then if you can finish?

Mr. ORSZAG. Sure. Then, on Chile, again, the transfer costs are zero. The annuitization cost we have to be somewhat careful about. There are two different costs that are associated with annuities. One is an administrative cost, and the evidence I have seen from Chile is probably on the order of magnitude of 2, 3, 4, 5 percent, that kind of range, although the estimates vary.

There is another kind of annuitization cost—I haven't seen estimates for Chile—which is quite prominent both in the United

States and in the United Kingdom, which is people who purchase annuities tend, on average, to live longer than the rest of the population. So if you were a typical person and you went to buy an annuity, you would effectively be penalized because the annuity provider would say, oh, no, the people who normally buy annuities live longer than you do, and we are not going to give you as much. So there is an additional cost. I haven't seen those figures for Chile. In the United Kingdom and in the United States, that can often be 10 or 15 percent.

Mr. MATSUI. Of the entire asset?

Mr. ORSZAG. Of the entire value of the asset.

In terms of the men versus women, while it is true that the value per year is lower for women, again, the reason that it is lower is that, on average, they are expected to live longer. So if you look at lifetime benefits, there shouldn't really be a difference. What it does mean is that, if a woman dies prematurely, she will not get as much as she would have otherwise. I would note in the United Kingdom, if you annuitize an appropriate personal pension, the annuity value has to be the same for a man and a woman. So that doesn't occur. But, again, that kind of differentiation by gender is intended to equate lifetime benefits, and that means, because of different life expectancies, that the annual benefit has to be different for men and women.

Mr. MATSUI. Thank you. My time is up. Thank you.

Mr. SHAW. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman, and thank you to the panelists for staying and being so patient with us.

Let me ask a couple of quick questions, so I can get to the heart of one final question that I would like to ask. First, in regards to Chile and the fact that the annuities that you are eligible to take out or to draw down works against women, is there anything that the Chilean system does to try to compensate for the fact that the treatment of women will be worse than that for men? Does anyone know?

Mr. KAY. As Mr. Orszag was saying, by saying it is better or worse, I was pointing out it was different. In a pay-as-you-go system you didn't have this differential that you get when you place men and women in separate actuarial groups. But if you draw down—for anyone who draws down—you can purchase an annuity or you can draw down your pension based on your life expectancy. So, since women tend to live longer, they would also get a lower benefit. But anybody who survives drawing down their benefit is eligible for a minimum pension in Chile.

Mr. BECERRA. Which, unfortunately, probably a lot of women in Chile qualify for, the minimum pension, since they probably don't have high salaries.

Mr. ORSZAG. If I could just comment briefly on annuitization, if a similar system is created in the United States, there is a very difficult sort of issue that will have to be addressed, which you are touching upon, involving whether or not men and women should have different annuity rights; whether annuitization should be mandatory, which would be one way of dealing with, what is called, the adverse selection or the issue I mentioned regarding different life expectancies, and a whole set of very difficult tradeoffs. For example, by making annuities mandatory, you might solve this adverse selection problem of people with different life expectancies choosing to purchase annuities, but you would be forcing someone who knew, say, that they had cancer to convert their accumulated $500,000 account balance into a portion of that for a year, and then have it be gone.

Mr. KINGSON. When we talk about Chile or other countries, I think it is very important to recognize we are in a very different context and our Social Security system is quite different. We are not facing a system which hasn't been able to maintain its payments; it has never missed a payment. We are not facing the kinds of problems the Chilean system faced.

Mr. BECERRA. In fact, it was interesting, because that was the point I tried to make when Dr. Piñera was here. They started their pension system, the PAY–GO system, before we started ours, about 10 or so years before we did. They had tremendous problems, such that, by the time 1980 rolled around, they had no more money. In fact, they were broke.

We have been operating under a sort of PAY–GO and now a prefunded. Yet, we have a surplus. So they started before us having sort of the same system. Yet, theirs didn't go well; ours has gone fairly well. At least we are in surplus, and we are now trying to deal with the problem that is still 30 years out. So there is a difference between what Chile experienced and what we are experiencing now.

Mr. KINGSON. The Chilean system also is far less than perfect. I think Dr. Kay would know the precise numbers, but roughly half the work force, maybe 60 percent, is covered in Chile. The military is still in their own defined benefit plan. They have chosen not to go into this privatized plan.

Mr. BECERRA. Mr. Kay, you have mentioned something about the administrative costs—actually, Mr. Orszag did as well. But Mr. Piñera seemed to think that they were insignificant, the administrative costs, and you are saying that they are a percent of the contributions that people make into these accounts.

Mr. KAY. Mr. Piñera was measuring costs as a percentage of assets under management, a management fee on assets managed. But the commission costs are charged to individuals as a basis of their contributions to the system. So that is why workers have been paying roughly—it came down slightly this year and I used the 1997 figure—18 percent of their total contributions to pension funds as administrative charges. It is often expressed as 10 percent going to their accounts. The whole 10 percent goes into their accounts, and then an additional, for 1997, 2.2 percent went to a management fee. So it is a significant cost for workers who are seeing that money disappear, and that is why you have the difference that Mr. Roosevelt cited with respect to returns between 1982 and 1995. Average annual returns, if you average a simple average, not a weighted average, of each year's annual return, were 12.4 percent. But if you take into consideration the commission charges, it brought returns down to 7.4 percent.

Mr. BECERRA. What are the administrative fees that Social Security incurs right now?

Mr. ORSZAG. Relative to that 18 percent, on a comparable figure, it is about 0.8 percent.

Mr. BECERRA. So less than 1 percent versus 18 percent cost?

Mr. ORSZAG. Right.

Mr. BECERRA. OK. Significant.

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

Mr. SHAW. It seems that, from this panel, we are not even talking about the same plans that we have been talking about earlier today. Mr. Lilley and Mr. Piñera had testified to us that the workers retiring in both the United Kingdom and in Chile, through these personal savings accounts, end up maintaining their income at about 70 percent of what it was when they were working. Do you dispute that?

Mr. ORSZAG. If I could actually comment on that, for example, looking at the appropriate personal pensions, which is the individual account component, in the United Kingdom, we don't know. It has only been operating for 10 years. Basically, no one has retired under that system yet. Disproportionately young people opted out of the existing system and into individual accounts. They still have 20, 30 years for that.

Mr. SHAW. All right. Let me ask you this then: Is that account building up faster than the Social Security Trust Fund, which yields 2 percent here in this country?

Mr. ORSZAG. The rate of return on that account has been roughly the rate of return on the equity market, which has been about 10 percent per year.

Mr. SHAW. Now that is opposed to 2 percent here.

Mr. ORSZAG. Well, however, the Social Security system in the United Kingdom is still in its very early years. As in any early year of a pay-as-you-go system, the rates of return are very high, just as they were at the very beginning of the——

Mr. SHAW. But you were just telling us that the charges of putting the money in are very high. So how could you come to that conclusion?

Mr. ORSZAG. I'm sorry?

Mr. SHAW. The initiation cost for putting the money, you have been critical of the plans for having some frontloaded expenses that are very high.

Mr. ORSZAG. That is right.

Mr. SHAW. So if you follow that through, it would seem that, the older the plan is, the better the return.

Mr. ORSZAG. It is not clear that—the reason I am emphasizing this—it is not clear that individuals will wind up better off under the individual accounts than they would have under the state-run system.

Mr. SHAW. How long do you suggest we watch it before we decide whether it is a good thing?

Mr. ORSZAG. Well, if I could just——

Mr. SHAW. Whether we decide 10 percent is better than 2 percent?

Mr. ORSZAG. No, if I could just add as to why that is, first of all, there is the misselling cost, $18 billion that firms will have to make up to individuals. It is only because the government stepped in and insisted that the firms make that up to individuals that it is even possible they will be better off.

Second, the government has provided additional incentives to workers to opt out of the existing system. There is a recent paper by the Social Security Administration that looks in detail at how much benefits are saved by having people move out of the system versus how much the tax rebates are. The net cost to the U.K. Government is about £16 billion, or roughly $22 billion. It is not surprising that, if you get $22 billion from the U.K. Government through additional tax incentives, and then you are made whole through $18 billion from private providers, which the government insists on, those things combined could make you slightly better off. But, again, these are all projections of how much compensation will ultimately be paid——

Mr. SHAW. Let me switch over to Mr. Kay, and ask you how you would react to his testimony, which says—and it is being critical, actually, to the Chilean model by saying that women only get 56 percent, where under our plan they only get 43 percent. How do you respond to that? Which is better? That is 19 years old.

Mr. ORSZAG. I understand. A higher replacement rate, all else equal, is better, but one has to worry about, in Chile, for example, those figures don't include—Mr. Kay also mentioned the high cost of the transition, the bonds that were issued to recognize benefits accrued under the previous system.

In doing a full accounting of whether a movement to an individual account system makes sense or not, one would want to include the cost of those bonds, or else you are comparing apples and oranges. If you included the cost of financing those bonds, at least the academic supposition is——

Mr. SHAW. Those are transitional costs that show up——

Mr. ORSZAG. That is correct.

Mr. SHAW. And it is something that we are going to have to face here, too, one way or the other. If we are going to maintain the level of benefits, which everyone that I know of and everyone that I talk to wants to do, then I think there is going to be a certain amount of pain in the transition that we are going to have to face.

Mr. ORSZAG. I think that that is exactly right, Congressman. There is a tradeoff to be made. Basically, under any pay-as-you-go system, by giving very high rates of return early in the system, all subsequent generations are made worse off. We don't escape that tradeoff by moving to individual accounts. What you do is you tilt it between one future generation and another in different ways.

Mr. KINGSON. Congressman, our first——

Mr. SHAW. Let me give the next question to Dr. Kingson because I do have a question here for you. You say you staffed one of the commissions, so you are familiar with the lifeline and with the life of the Social Security system as we know it now. You testified that you have looked at some of the European models, and we are better off than a lot of them. Well, a lot of them are a disaster. I understand that in Italy, for instance, that they are just a few years from having a horrible problem because of decreasing birth rates.

With regard to where this thing is going to break down, in 30 years my children will retire, and they will be looking for some type of pension plan. Their children, my grandchildren, will have to contribute to some system, unless there is a radical departure from where we are. We all agree that the Social Security system is one of the wonderful things about America, and we can certainly support that.

Now if we were to stick with the existing system, what percentage of their pay would my grandchildren have to pay to be sure that my children's pension is adequate, or if I am lucky enough to still be a burden to them and be hanging around, also to take care of me?

Mr. KINGSON. It depends on the choices the Congress makes.

Mr. SHAW. I am talking about under the existing system.

Mr. KINGSON. Well, it depends. We have the choice—respectfully, the Congress has the choice between——

Mr. SHAW. As it is today. As it is today, without any change in legislation.

Mr. KINGSON. Well, the current payroll tax is 6.20 percent on employer and employee.

Mr. SHAW. Right, 12.4.

Mr. KINGSON. If the current system—and I would just put this background to answer your question: As you know, the current system is projected to have sufficient funds to meet all obligations through 2031 and about three-quarters thereafter, Congressman.

Mr. SHAW. Let me interrupt you just 1 minute.

Mr. KINGSON. So, clearly, some——

Mr. SHAW. I am not asking you another question. I am just interrupting. I have just been told that Dr. Orszag has a commitment over at the Capitol at 4. So if no one has any additional questions for him, I would like to excuse him——

Mr. ORSZAG. Thank you very much.

Mr. SHAW [continuing]. So that we don't inconvenience him any further. Thank you for taking the time to be with us.

Go ahead, Doctor.

Mr. KINGSON. Thank you, sir.

Clearly, we need to do something. I have faith that the Congress will do something, some combination of changes. The President has put a proposal forward that has some merit, considerable merit. There are other possible ways of doing this. If one wanted to use cuts in benefits, moderate cuts in benefits, they are available through retirement age changes or through changes in the benefit formula. I am not suggesting that is what we should do. They are there, if we wanted to——

Mr. SHAW. Back up and answer my question. What percentage of their earnings would my grandchildren have to be paying 30 years from now to take care of their parents and their grandparents, if their grandparents are still alive?

Mr. KINGSON. I cannot tell you precisely, sir. I can tell you that I have two children who will retire in 2045 and 2049, and we share the concern that it be there, but we certainly need——

Mr. SHAW. I have heard the figure 30 to 40 percent. Is that correct?

Mr. KINGSON. That is absolutely wrong.

Mr. SHAW. Well, what would you say then? Throw a figure out for us.

Mr. KINGSON. We are looking at a system which is running right now at about 4.6 percent of GDP; furthest out on the problem, it would go up to somewhere in the neighborhood of 6.9 percent, if we made no other changes in benefits.

Mr. SHAW. You are talking about GDP. I am talking about their earnings. Right now it is 12.4 percent. What would it have to be to be a fully funded system? That is a simple question. If you don't know the answer, I can understand. I don't know the answer.

Mr. KINGSON. Well, I can say I don't know precisely. I think it would be somewhere in the neighborhood—we are looking at 25-percent shortfall, 33 percent out in the year 2070. So we would probably need, if one only chose to do it through payroll taxes, which would not be terribly wise, I would probably need at the far end—you would need nothing until 2030; we would need something in—we would need clearly payroll taxes after then. And at the farthest end, out in 2070, it would probably be about 18 percent.

Mr. SHAW. You are saying it would only go up less than 6 percent, 5.5 to 6 percent?

Mr. KINGSON. I believe in 2070—roughly out there—we are looking at about a 6 percent of payroll shortfall. I think it is 5.81, if I remember correctly.

Mr. SHAW. That is interesting.

I would like to make this observation with regard to the testimony we heard, and particularly yours, Dr. Kingson. I look at today's testimony as a bright light of opportunity, that we do have an opportunity to do better. The fact that these programs are popular in these other countries I think is a very good thing. It is something that we should be somewhat hopeful for.

I don't know of any Member of Congress that wants to increase the payroll taxes, nor do they want to decrease the benefits. The President has said as much; I just said as much. So we need to look at what other countries are doing and try to get some of the things that we think are working.

Obviously, I know of no pension that invests only in the type of investments which our government invests in. It is pitifully low. It is criminally low. The Social Security system that we have today is still well; it is viable, and it is going to take care of my mother, but it is not going to be around to take care of people beyond that without an awful lot of pain for those who are in the work force. That is what we have got to do. That is what we have to search—for better investment opportunities. Because I know of nothing we can do—if we are unwilling, which we are, to increase the taxes, if we are unwilling, as we are, to decrease the benefits, then we have got to look at the investments structure. That is the only thing left. If you have a rabbit to pull out of the hat that you want to tell us about, we will be glad to listen to you for the rest of the afternoon.

Mr. KINGSON. I won't pull a rabbit out of a hat, but I would suggest that the new Director of CBO noted that there is no escaping the fact that current generations of workers support nonworking people. It doesn't matter whether we prefund a Social Security system or we go pay-as-you-go; the burden falls on current workers to care for their children and for nonworking adults. Therefore, it becomes critical to invest in the economy. We have some choice with respect to the mechanisms we use, but we still have current workers having to pay for them, whether we have a prefunded system or not.

Mr. SHAW. And I think our job, our mission, here is to be sure that our grandchildren are cared for in such a way that they are not overburdened with this, so that we could end up with an intergenerational problem in this country. If we do nothing, our children will turn our pictures to the wall and say, "Shame, shame, shame." So I think we are going to do something, and I have great hope that we will.

I appreciate you all waiting so long. I appreciate your testimony and your willingness to come before this Committee.

We are now adjourned.

[Whereupon, at 4:26 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

**Statement of Joseph G. Green, Toronto, Ontario, Canada**

WEP MODIFICATION PROPOSAL

BACKGROUND

Historically, years ago, government employees in the US, (local, state and federal) could not belong to the Social Security System and also be part of a government pension plan. Since government pensions then were higher, most employees elected to join the appropriate government plan and not social security. As of 1984, Congress mandated that ALL workers must belong to the Social Security System.

However, Congress realized that these civil servants would retire, having paid in only the minimum of 40 quarters or a little more, but at a much higher social security rate than those pensioners who had joined the system 20 or more years before (but contributed when the rate was much less). Therefore, beginning in 1984 and thereafter, the pensioners with a non-covered pension would in effect get their full non-covered pensions plus much higher social security benefits than would those workers who had contributed to social security for many more years before 1984, when maximum was less than half of today's $1,326 (as of January 1997).

Thus, pensioners retiring in the 1990s and thereafter, with a full non-covered pension, would enjoy a proportionately larger social security benefit than those who had contributed for many more years but had contributed less.

To adjust this situation, when Congress amended the Social Security Act in 1983, it wrote into the statue a provision to offset this unintentional oversight for those with a SUBSTANTIAL non-covered pension. This provision is known as The Windfall Elimination Provision (WEP).

THE STATUTE

Provision 113–WEP—of the 1983 Social Security Amendments PL98–21, stipulates that a pensioner entitled to social security benefits and also having a non-covered pension (all foreign pensions are obviously non-covered by social security) will have $50 deducted from his/her monthly social security benefit for every $100 he/she receives from the non-covered pension. The law further states that those whose social security computation falls under the WEP cannot lose more than half of their entitled social security benefit. This law went into effect as of January, 1986. Anyone drawing social security benefits prior to that date is not affected.

THE PRACTICAL APPLICATION FOR OVERSEAS PENSIONERS

Congress never even considered American pensioners and how WEP would affect them if they are living overseas and are entitled to social security and get also a small or partial foreign pension. We abroad are adversely affected TWICE!

In the first place, our social security was frozen when we elected to leave the United States and relocated abroad at a time when social security monthly benefits were less than half of what they became in the 1990s. For example, in 1973, maximum social security benefits were only $550 per month. As of January, 1997, the maximum Social Security benefit is $1,326. American pensioners abroad entitled to a small or partial foreign pension, have their already frozen social security benefit of $550 or less further reduced up to half as a result of applying the WEP. Thus, anyone falling under the WEP in the United States enjoys a full non-covered pension of a $1,000 or more monthly, and even at maximum, can only lose up to half of today's maximum of $1,326 when applying the WEP formula. However, the overseas pensioner who winds up with a modest foreign pension of as little as $200–400 monthly has his/her frozen social security benefit of 20 or more years ago further reduced, up to half, netting him or her only a few hundred dollars per month.

This is a gross inequity and needs modification. In the first place, many overseas pensioners have paid into the Social Security system for many years. When they relocated abroad, they were certain that upon retirement their full social security due them would be guaranteed. Secondly, the Windfall Elimination Provision was only intended for those with a SUBSTANTIAL, non-covered pension. In today's economy. getting $400–600 of a monthly non-covered pension cannot be considered as being substantial. For many, their meagre foreign pension, together with their low, frozen social security is their only means of income. Having their entitled social security cut in half because they also are entitled to a modest, or partial non-covered pension causes an unfair hardship. This also places the overseas pensioner in an unequal situation relative to his fellow pensioner residing within the United States, falling under the WEP.

MODIFICATION SOUGHT

To correct this inequity, Congress is petitioned to modify the Windfall Elimination Provision as follows:

l) Anyone whose non-covered pension is $600 or less shall be exempt from the Windfall Elimination Provision.

2) Anyone whose non-covered pension is between $600–$1,200 shall have his/her first $400 exempt before applying the WEP formula.

3) Anyone whose non-covered pension is $1,200 or above shall have his/her monthly social security benefits fully computed in accordance with the WEP provision.

This proposal would greatly ease the inequity that now exists between pensioners residing at home or abroad. At the same time it would retain the spirit of the law; namely reducing the social security benefits of only those who have a SUBSTANTIAL non-covered pension, in addition to a substantial benefit from social security.

## Information from the Heritage Foundation: Australia's Privatized Retirement System: Lessons for The United States by Daniel J. Mitchell, McKenna Senior Fellow in Political Economy and Robert P. O'Quinn, Policy Analyst

Like the United States, Australia has been confronted by a dual crisis in its government-run old-age pension system. Benefits payments to an aging population threatened to consume ever larger amounts of Australia's budget according to projections in the 1980s, yet the Australian Social Security system clearly was unable to provide an adequate income for retirees.

In 1986, in an effort to address these serious problems, a left-of-center Labor government began to implement an innovative retirement system based primarily on mandatory private savings in plans called "superannuation[1] funds." This system, which in 1992 became known as the Superannuation Guarantee, continued to be modified and expanded and now features three key elements. First, workers contribute a set percentage of their income through their employer to private savings plans. By 2002, when the system is fully implemented, all workers will be required to set aside 9 percent of their income in a superannuation fund of their choice (see Appendix 1). This mandatory savings can be augmented by tax-favored voluntary contributions. Second, upon retirement, workers will have accumulated a large nest egg from which to draw a secure and comfortable annual income. Third, a safety-net program guarantees that all retirees will receive an income that at least matches the income they would receive under the original government-run program.

Even though Australia's private retirement savings plan is still very young, it is quite popular. The benefits which have begun to materialize herald a significant long-term improvement in the Australian economy. For example:

• More income for retirees. In the future, average-wage workers should be able to retire with two to three times the income they would have had under the original government-run system, depending on the level of additional voluntary savings and the earnings performance of the superannuation funds.

• Increased national savings. The overall savings rate could climb by more than 3 percent of gross domestic product (GDP) by 2020. Already, private savings in superannuation funds have skyrocketed, rising from Au$40 billion [2] (US$28 billion) in 1985 to Au$304 billion (US$240 billion) as of June 1997.

• Reduced pressures on the budget. Because eligibility for taxpayer-financed age pensions is now means-tested,[3] the higher incomes made possible by privatization will lead to substantial budget savings. Government spending on age pensions will reach only 4.72 percent of GDP in 2050, one-third less than would have been needed had the government chosen to provide an American-style universal Social Security retirement benefit. (In the United States, Social Security retirement outlays are expected to consume 5.59 percent of GDP by 2050.)

The United States faces many of the same challenges that Australia confronted in trying to ensure an adequate retirement income for its aging population.[4] The U.S. Social Security system is expected to begin running a deficit by 2012. As the baby-boom population approaches retirement, policymakers grapple with a serious dilemma: How can they reform Social Security to give American workers a comfortable and secure retirement while addressing the system's massive long-term deficit?

As a model for reform, Australia's transition from a government-run benefits program to a system based on private savings was a resourceful answer to the challenges the Australian government faced. Like similar privatization efforts in Chile and Great Britain, Australia's system offers legislators in the United States several key lessons for reforming the troubled Social Security system.[5]

## WHY AUSTRALIA HAD TO REFORM ITS PENSION SYSTEM

The government-run old-age pension system in Australia was created in 1909 to help lower-income retirees. The government progressively began relaxing means-testing and moving toward a universal age pension after World War II.[6] By 1983, all Australians over the age of 69 received a full age pension regardless of income, and the rules for men 65 to 69 years old and women from 60 to 69 years old were so lax that almost all of them qualified for a full age pension as well.

This Social Security system was just one part of a massive expansion of government's role in the Australian economy between 1901 and 1983. Among other things, policymakers tried to promote industrial development through high tariffs and subsidies to manufacturers. The government nationalized most energy, telecommunications, and transportation companies. It also created a highly centralized system of wage bargaining, known as the Award System, in which employer organizations, labor unions, and the government jointly established wages and working conditions across entire industries based on concepts of "social justice" rather than on market conditions. The economic impact of these policies, not surprisingly, turned out to be negative. Australia's per capita GDP went from the highest in the world in 1900 to 14th by 1980.[7]

This long-term decline, as well as fears of a more immediate economic crisis, drove the newly elected Labor government in 1983 to implement fundamental changes in Australia's economic policies. Then-Treasurer Paul Keating best summarized the challenges facing Australia:

> We must let Australians know truthfully, honestly, earnestly, just what sort of international hole Australia is in.... If this government cannot get...a sensible economic policy, then Australia is basically done for. We will end up being just a third rate economy.... Then you are gone. You are a banana republic.[8]

As part of the new Labor government's comprehensive economic reform program, the Social Security system was given a thorough re-examination. Prime Minister Bob Hawke and Treasurer Paul Keating found that government policy discouraged private savings and left too many Australians dependent on Social Security age pensions as their primary source of retirement income. Moreover, these policies were causing adverse consequences for the nation's economy. The dire problems confronting Australian policymakers included the following:

• Less than 40 percent of all workers participated in public or private pension plans (superannuation funds) before 1983, and coverage was limited to government employees, financial sector workers, professionals, and senior business executives.[9]

• Accumulated retirement savings generally could not be transferred from one employer's superannuation fund to another when an Australian changed employment.

• This lack of portability, along with the preferential tax treatment of lump-sum distributions—95 percent of lump-sum distributions from superannuation funds were tax exempt—often meant that superannuation merely provided high-income Australians with a way to acquire virtually tax-free income upon changing employment.

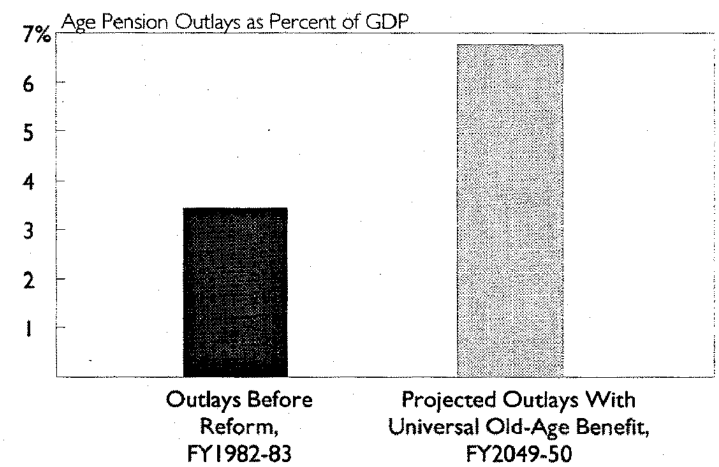
• Dependence on Social Security age pensions contributed to reduced national savings and depressed economic growth. Indeed, Australia's national savings rate had declined from an average of more than 25 percent in the early 1970s to 16.1 percent in fiscal year 1991–1992.[10]

• The population was growing older. From 1994 to 2051, the number of Australians 65 or older will climb from 11.9 percent to about 23 percent of the total population.

• The growth in the aging population also means that dependence on Social Security age pensions would threaten long-term fiscal stability. Age pension payments consumed 3.44 percent of GDP in FY 1982–1983 and were projected to rise dramatically as the population aged, potentially reaching 6.8 percent of GDP by FY 2049–2050 if Australia continued on the path to a universal age pension like the U.S. Social Security program.[11]

Chart 1

**Under the Old System, Government Old-Age Pension Outlays as a Share of GDP Were Expected to Double**




**Source:** Retirement Income Modeling Unit, Australian Treasury.

## THE PRIVATE SAVINGS SOLUTION

To address these serious problems, the Labor government decided to restructure Australia's retirement policy. Policymakers decided that a new system should satisfy three goals:

1. Provide more retirement income for future retirees,
2. Increase national savings, and
3. Reduce long-term pressures on the budget.

The government concluded that the best way to achieve these goals was to reduce the scope of government tax-and-transfer schemes and instead promote greater individual reliance through a system of mandatory private savings. As a result, the Labor government took the following steps during its 13 years in power:

• Means-testing of age pensions. In 1983, the Labor government reversed the trend toward a universal old-age pension and strengthened means-testing for age pensions. The existing income-based means test was extended to Australians age 70 or over. A new asset-based means test also was imposed (see Appendix 2).

• Superannuation portability and penalties for pre-retirement withdrawals. To encourage Australians to preserve their superannuation savings until retirement, two new rollover vehicles were created in 1983—approved deposit funds and deferred annuities. These vehicles allowed Australians to keep their superannuation savings when they changed jobs. In addition, a 30 percent tax was imposed on lump-sum withdrawals from superannuation funds before age 55.

- Award Superannuation. In 1985, the Labor government reached an agreement with Australia's chief labor organization, the Australian Council of Trade Unions, to seek a universal 3 percent contribution for each employee to a superannuation fund in lieu of a general wage increase through the Award System. In 1986, the Industrial Relations Commission endorsed this agreement and incorporated this employer mandate into all future labor contracts. As of July 1991, 72 percent of all employees were covered by Award Superannuation.
- Superannuation Guarantee. In 1992, the government introduced the Superannuation Guarantee (SG) to expand Award Superannuation to cover virtually all workers.[12] Under SG, every employer is required to contribute a prescribed minimum on behalf of each employee to a superannuation fund. The required minimum contribution was set at 3 percent of an employee's earnings in FY 1992–1993 and will rise gradually to 9 percent by 2002–2003.[13] Savings in superannuation funds are fully vested and portable between employers. Under current law, savings in superannuation funds must be preserved until retirement after age 55.[14]

In March 1996, Australians elected a Liberal Party-National Party coalition government which made further reforms in the system in May 1997. These included:

- Tax relief. To promote additional non-compulsory private savings, the tax burden was lowered on savings. During the 1998–1999 fiscal year period, individuals will be allowed a 7.5 percent tax credit of up to Au$225 (about US$177) and a 15 percent tax credit in 1999–2000 and beyond of up to Au$450 (US$355). These credits will apply to savings income and/or additional voluntary contributions to superannuation accounts.[15]
- Consumer choice. Private-sector workers were given the right to choose a fund from at least five options into which their employers would deposit their superannuation savings. As of July 1, 1998, these options must include (1) any relevant industry superannuation fund, (2) any corporate superannuation fund, (3) at least one retail superannuation fund, and (4) a new kind of superannuation fund—the Retirement Savings Account (RSA)—provided by the bank or financial institution receiving an employee's pay. RSAs are low risk/low return capital guaranteed funds offered by banks, building societies, credit unions, and life insurance companies.[16]
- More retirement income. To maximize the amount of savings in each superannuation account (and therefore the size of the annuity that could be purchased), early hardship withdrawals are prohibited, and the preservation age before which no withdrawals could be made will be raised from 55 in 2015 to 60 by 2025.[17]
- Gender neutrality. The government age pension program was modified to ensure equal treatment for men and women. Currently, women may receive age pensions at age 61 while men must wait until age 65. As of 2013, neither sex will be able to qualify for the government safety-net program until age 65.[18]

## Retaining the Safety Net

Although there is a strong consensus in Australia that individuals should be responsible for saving for their own retirement, a safety net will remain in place to ensure that no one will be worse off under the privatized system. In effect, every retiree is guaranteed an age pension equal to 25 percent of the average worker's wage—exactly what was available before privatization.[19]

Moreover, the means-testing provisions for the government age pension are extremely generous. Even though almost all retirees will have some income from their superannuation savings, more than 33 percent of senior citizens in 2050 will get a full age pension from the government.[20] All told, a full 75 percent of the elderly population in 2050 will have their private savings income supplemented by full or partial government benefit payments.[21]

These generous payments reflect Australia's primary goals in adopting mandatory superannuation: boosting retirement incomes and increasing national savings. Reducing government spending was a lower priority. And while there will be significant long-term budget savings, they will not be nearly as large as they could have been with a stricter means-testing policy, a more rapid implementation of the SG savings mandate, and elimination of the gap between the SG preservation age and the qualification age for age pension payments.

THE RESULTS OF SUCCESSFUL REFORM

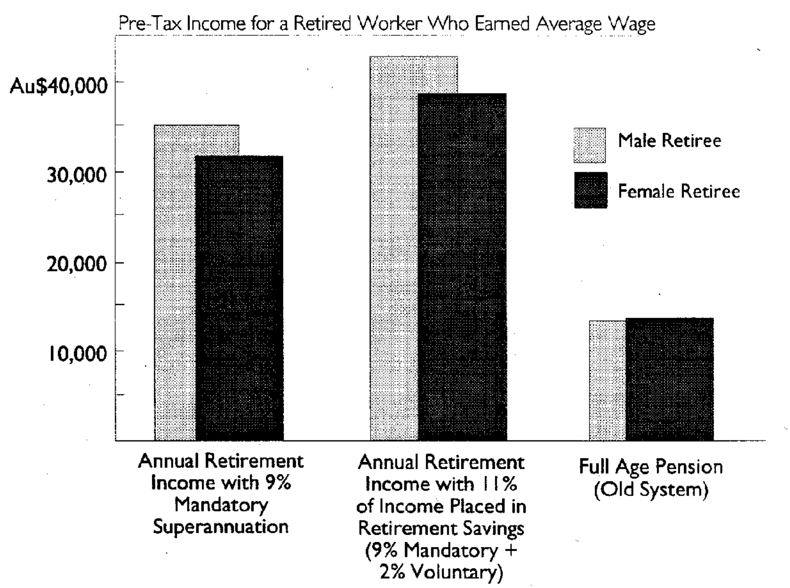
By every possible measure, the Australian move to privatization thus far must be considered a success. The Labor Government had committed itself to establishing a system that would satisfy three major goals: providing more income for retirement, increasing savings, and reducing long-term pressures on the budget. As the following information illustrates, Australia is well on its way toward achieving those goals.

*More Income for Future Retirees*

Increasing the level of private savings will result in significantly higher retirement income for Australian workers. Predicting exactly how much higher is, of course, difficult because retirement income under the private system will depend on the earnings performance of the superannuation funds as well as the level of additional voluntary contributions. Yet even pessimistic scenarios show that privatization will boost old-age income substantially.

Chart 2

**Average Annual Real Retirement Income from Australia's Privatized System is Significantly Higher Than Previous System**



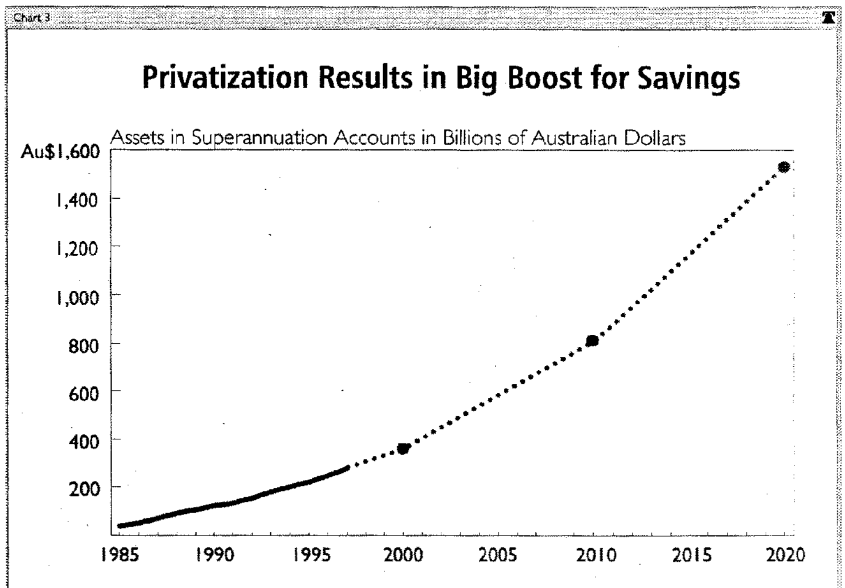

**Notes:** One Australian dollar= U.S.$ 0.788. Income levels based on a 40-year working life with retirement at age 65, 5 percent annual real return on superannuation investments, 3 percent real return on annuity, all calculations are on a pre-tax basis. Difference between male and female workers is based on differences in longevity, not pre-retirement income.
**Source:** Retirement Income Modeling Unit, Australian Treasury.

The Australian Treasury's Retirement Income Modeling Task Force, for instance, computed that average-wage workers who made no voluntary contributions and earned only 4 percent in real returns each year (a modest figure, since the average over the last 10 years has been 5.5 percent) will be able to retire with nearly twice as much income as they would have had under the old government-run system.[22] More realistic assumptions, such as higher average returns and some degree of voluntary savings, have demonstrated that privatization easily could mean more than twice as much, and perhaps about three times as much, retirement income for the average Australian worker. As Appendix 3 illustrates, the benefits for different demographic examples are similarly startling.

*Increasing National Savings*

The amount of funds in superannuation accounts has soared from 17 percent of GDP in 1985 (Au$40 billion) to more than 55 percent of GDP in 1997 (Au$304 billion). By 2020, superannuation assets are projected to reach more than 100 percent of GDP (Au$1,525 billion, or US$1,202 billion).[23]

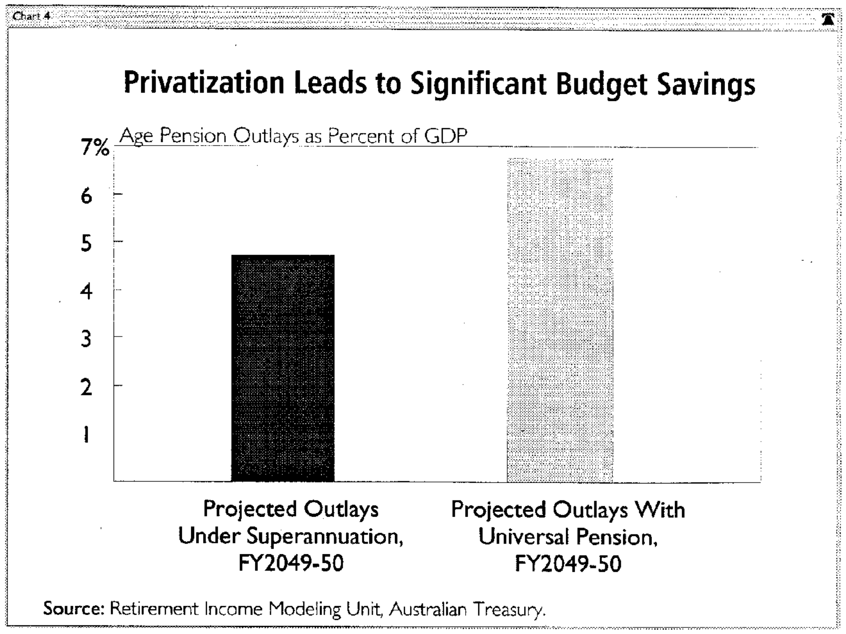
Policies to boost the level of voluntary savings also seem to be highly successful. One-third of superannuation deposits in the most recent reporting period, for instance, came from unforced employee contributions.[24] All told, superannuation is projected to increase Australia's national savings rate by at least 3 percent of GDP.[25]




**Source:** Retirement Income Modeling Unit, Australian Treasury. For more information, see official RIM website, *http://www.treasury.gov.au/organisations/rimtf/*

*A Reduction in Long-Term Budget Pressures*

Age pension reform and the growth of superannuation funds will have a long-term positive impact on Australia's fiscal position. Before reform, Australia had an almost universal age pension. The Australian Treasury's Retirement Income Modeling Task Force estimates that outlays for a universal age pension would have consumed 6.76 percent of GDP in FY 2049–FY 2050.[26] Because the Labor government strengthened means testing for age pensions and initiated the Superannuation Guarantee, however, age pension outlays will be only 4.72 percent of GDP in FY 2049–FY 2050.




POTENTIAL FUTURE CHANGES

Australian policymakers are largely satisfied with the core components of their newly privatized retirement system. Across the political spectrum, legislators understand the flaws of the old government tax-and-transfer scheme and recognize that private savings can provide a more comfortable and secure retirement for the nation's senior citizens. Nonetheless, some features of the new system continue to provoke debate, and it is certainly possible that changes may be made in the near future. The issues that are most likely to attract reform are:

• The tax treatment of superannuation. The coalition government announced that it will conduct a complete review of Australia's tax code. Many lawmakers believe the tax laws are needlessly complex and impose unnecessarily harsh penalties on work, savings, and investment. It is therefore possible that, as part of comprehensive reform, Australia might choose to follow the lead of other nations with private retirement systems and abolish taxes on superannuation contributions and annual fund earnings, taxing withdrawals upon retirement instead.[27] In other words, rather than impose the 15 percent tax on workers' contributions made by employers as well as the high income surcharge, it might make contributions to superannuation funds tax deductible. Moreover, both the 15 percent tax on interest and dividend income in superannuation funds and the 15 percent tax credit on withdrawals after retirement would be repealed. These changes would accelerate the accumulation of assets within members' superannuation funds during their working years and reduce their dependence on the age pension after retirement. This approach would also ensure that the Australian tax code does not put a disproportionately heavy burden on income that is saved.

• A mandate that superannuation assets be used to finance retirement income. Australians can manipulate the current system in two ways to increase their age pension payments from the government. First, the gap between age 55, when SG benefits can be withdrawn, and age 65 (age 61 for women), when age pension payments commence, could tempt some Australians to use their superannuation funds to finance early retirement and then rely on taxpayer-financed age pensions after age 65. The coalition government previously agreed to raise the SG preservation age from 55 in 2015 to 60 in 2025, but this leaves a gap of five years. Pension experts advocate eliminating this gap to prevent citizens from "double-dipping." In addition, current law allows retirees to make large lump-sum withdrawals from their superannuation funds. This may tempt some workers, even those who work until age 65, to dissipate their retirement funds by purchasing “big ticket” consumption items immediately and then relying more heavily on taxpayer-financed age pensions. In order to ensure that retirement savings are used for retirement income, the government may decide to require that at least a portion of superannuation funds be used to purchase an annuity which would provide a minimum level of income in regular increments over time.

## Parallels to Privatized Retirement Systems in Chile and Britain

As various nations around the world rush to privatize their retirement systems and secure retirement income for their senior citizens, Americans continue to fear for the future of their Social Security system. Reformers can learn much from studying what other countries are doing. And though an exhaustive comparison of the systems is beyond the scope of this paper, it is worth noting how Australia’s system compares with those of Chile and Great Britain, two other countries whose privatization efforts have attracted considerable attention.

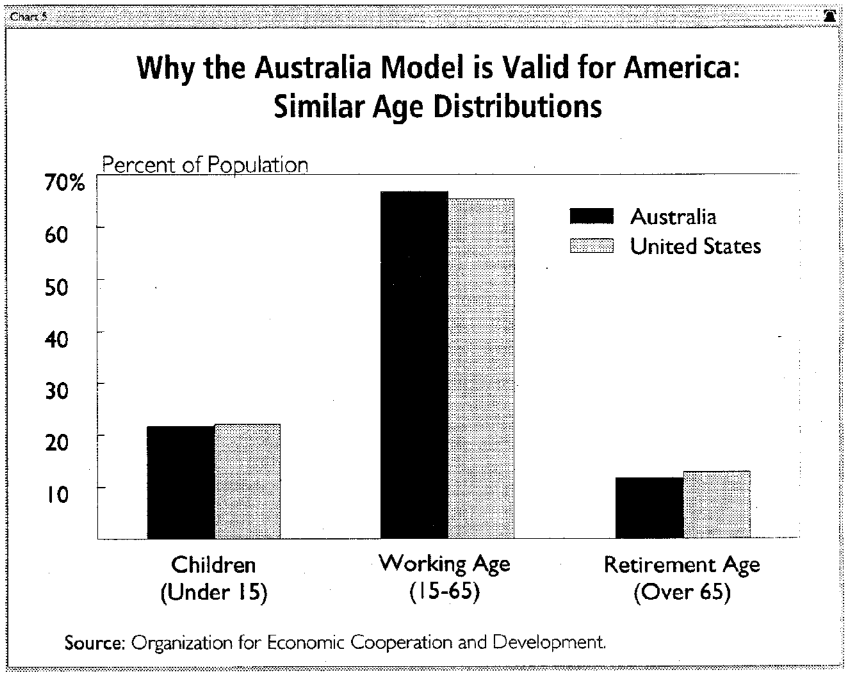
Chile privatized its old-age system in the early 1980s, replacing a tax-funded income-transfer scheme with a system based on mandatory individual savings. The amount of savings mandated for retirement accounts in Chile is 10 percent, which is quite similar to Australia’s 9 percent superannuation charge. Chile’s system, however, has advantages and disadvantages. On the positive side, Chile imposes a simple and neutral tax treatment on retirement savings. Moreover, it imposes the savings mandate directly on the worker instead of using the employer as a middleman. Since labor economists are virtually unanimous in recognizing that employer-financed benefits (such as payments into pension funds) come out of worker compensation, the Chilean approach deserves applause for its honesty. However, Chile’s pension funds are subject to excessive regulation, a drawback which has the effect of limiting diversity and creating higher than necessary administrative costs as funds compete for customers on the basis on non-performance criteria.

Britain has a two-tiered retirement system. The first tier is an almost universal flat-rate benefit provided by the government. The second tier depends on earnings, and workers can choose to use the government system or select a private pension alternative. Only 17 percent of workers have elected to stay in the government-run program thus far, while 73 percent have decided to divert 4.6 percentage points of their payroll tax into a private fund. Two differences between Australia’s system and Britain’s are worth highlighting. First, the system in Great Britain is best categorized as partial privatization (though the Labor government may propose more complete privatization sometime next year), while Australia’s has been more sweeping. However, Australia’s privatized system, like Chile’s, does not compare favorably in terms of tax treatment. The British government does not tax contributions to the accounts or the annual earnings of the accounts. Instead, it imposes one layer of tax at the time of withdrawal.

## Lessons for American Social Security Reformers

The United States and Australia are similar in many respects. In Australia, 11.9 percent of the population is 65 or older, compared with 12.7 percent in the United States. Both are high-income, developed countries with stable democratic governments. The overall size and structure of their governments are also similar: General government outlays in 1996 were 36.9 percent of GDP in Australia and 35.8 percent of GDP in the United States. It is therefore reasonable to surmise that reformers in the United States would draw lessons from the Australian experience in reforming Social Security. Indeed, when Australia’s Labor government first embarked on this policy, it faced obstacles that are not unlike those that exist in the U.S. It had, for instance:

- 1.6 million retirees receiving government age pensions, a large majority of whom were apprehensive about any change in the existing system, and
- A highly skeptical working-age population of 8.4 million employees, many of whom doubted that politicians would make changes that would enhance their retirement.




Nevertheless, Australia overcame these challenges through an innovative privatization program combining mandatory contributions to private pension plans with means-testing of Social Security age pension benefits.

Some of the steps Australian policymakers took are applicable to the United States as well. To reform the Social Security system successfully, U.S. policymakers should:

1. Be honest about the shortcomings of the current system. The Labor government issued a series of reports, culminating in Security in Retirement—Planning for Tomorrow Today in 1992, which stressed that working-age Australians could not expect the federal government to provide them with adequate retirement incomes in the future.[28]

2. Appeal to self-interest. Australian leaders Bob Hawke and Paul Keating stressed that superannuation was the key to obtaining higher retirement incomes. In other words, working-age Australians needed to accumulate far greater private savings than they had in the past if they were to be secure in their retirement years.

3. Appeal to national interest. The Labor government reminded Australians about their country's low national saving rate compared to other developed countries, informing them that age pension reform and the Superannuation Guarantee, along with other macro-economic and micro-economic reforms, would accelerate Australia's economic growth and create new job opportunities.

4. Protect existing beneficiaries. Policymakers realized that benefit reductions for existing retirees or those near retirement would be a major political liability for reform. Even though benefit reductions would generate immediate budget savings, such outlay reductions would jeopardize the immense long-term benefits to citizens and the nation from privatization.

5. Avoid relying on appeals that the reform is needed to balance the government's books. The fiscal benefits from introduction of the Superannuation Guarantee were presented almost as an afterthought in Australia. Unlike in the United States, where politicians focus on the need for individuals to sacrifice through higher payroll taxes and lower benefits to solve the federal government's fiscal problems, discussions in Australia stressed how comprehensive reform would benefit individuals by accelerating economic growth now and increasing retirement incomes later.

There are many other features of the Australian system that offer valuable lessons to Social Security reformers because the two countries are so similar. But it is also worth noting the differences between the United States and Australia. One big difference is that it is easier to change government policy in a parliamentary system, in which one party generally controls all the levers of power, than in a presidential system of checks and balances. Australia has a unique mixture of British parliamentary and American constitutional traditions,[29] so it is not as easy for Australia to change policies as it is for other parliamentary nations such as Great Britain. Nonetheless, it is still easier to make policy changes than it would be for policymakers in the United States with its presidential system of checks and balances.

Pension reform in Australia was facilitated as well by the Award System of highly centralized collective bargaining. Indeed, the unions were one of the biggest advocates of using private savings to boost retirement income. Although this system of collective labor negotiations has been partially deregulated since 1996,[30] it helped the Labor government to introduce mandatory private retirement savings to the workforce. Needless to say, such a system does not exist in the United States.

Finally, the U.S. and Australian governments fund their Social Security retirement benefits through different methods. Australia funded its old system, and pays for the safety net portion of the new system, out of general tax revenues. In the United States, Social Security benefits are financed through payroll taxes. This significant difference actually could prove to be an advantage for reformers in the United States since policymakers could privatize the system by diverting some or all of current payroll taxes into private accounts, rather than by trying to impose a new savings mandate on American workers.

## Conclusion

Privatization has been a huge success in Australia: Workers will be able to retire with higher incomes, the government has significantly reduced long-term budget pressures, and the economy will benefit by a dramatic increase in savings. Like other nations around the world, Australia recognized in the 1980s that replacing the government's tax-and-transfer old-age retirement scheme with a private retirement system based on mandatory savings was a win-win proposition. Because Australia is in many ways politically and demographically similar to the United States, American policymakers would be well advised to learn the lessons of Australia's successful reforms.

## APPENDIX 1.

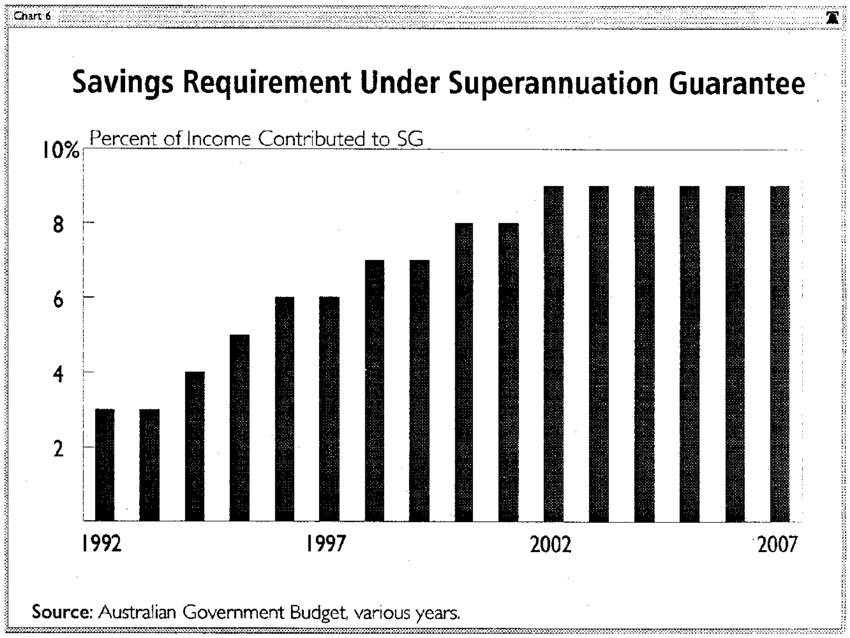
### How Australia's Superannuation Guarantee (SG) Works

#### Annual Savings Requirement.

Currently, 6 percent of income must be saved in a superannuation fund. This rate will rise to 7 percent on July 1, 1998; 8 percent on July 1, 2000; and 9 percent on July 1, 2002. The charge is imposed on the first Au$90,360 (US$71,273) of pre-tax cash employment compensation; it is adjusted annually to keep pace with inflation (see Chart 6).

#### Collection of SG charge.

Employers are responsible for withholding superannuation charges and depositing them in a fund selected by the worker. The burden of the charge clearly falls on the worker since it is part of total employee compensation, much as the individual income tax in the United States is a burden on workers even though it normally is withheld and sent to the Internal Revenue Service by employers.




TYPES OF SG FUNDS.

According to the March 1997 Insurance and Superannuation Commission Bulletin, there are 137,808 superannuation funds in Australia.

• Excluded funds. The majority of all superannuation funds are small self-managed pension plans, known as excluded funds, containing fewer than five members. Taken together, excluded funds have 228,000 members and control 10.5 percent of all superannuation assets.

• Trustee-managed funds. In contrast, 16.1 million Australians are members of larger, trustee-managed superannuation funds. There are four types of trustee-managed funds: corporate, industry, public-sector, and retail.

1. Corporate funds typically are set up by large private-sector employers. These funds have 1.4 million members and control 20.9 percent of all superannuation assets. The number of corporate funds is declining as more employers are meeting the SG mandate through retail funds.

2. Industry funds are sponsored jointly by multiple employers and labor unions in an industrial sector. These funds, originally set up to receive the 3 percent Award Superannuation contributions, now have 5.7 million members and control 6.3 percent of all superannuation assets.

3. Public-sector funds are established for employees of federal, state, and local government. They have 2.55 million members and control 23.2 percent of all superannuation assets. Some public-sector funds are not fully funded.

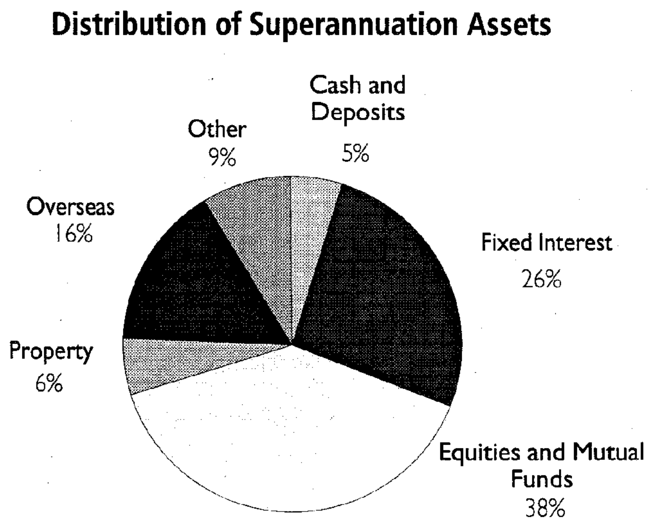
4. Retail funds, or public offer funds, are provided by financial institutions such as banks, insurers, and securities firms. Sold through intermediaries to those eligible to contribute to superannuation funds or holding superannuation savings for retirement, they typically are organized as master trusts, allowing members to direct their contributions among a number of mutual fund investment options. Currently, the 402 retail funds have more than 6.5 million members and control 24.2 percent of all superannuation assets.

ANNUITIES.

About 15 percent of superannuation assets are held by life insurance companies, usually on behalf of retirees.

Today, most corporate funds as well as almost all excluded, industry, and retail funds are defined contribution plans in which the member bears the investment risk. Many public-sector funds remain defined benefit plans in which the sponsoring employer is liable for pension payments to retirees regardless of whether accumulated contributions and earnings in the fund are sufficient to cover the pension payment liabilities. In March 1997, only 16 percent of all member accounts were in defined benefit funds. However, because most public-sector funds are defined benefit plans, 52 percent of all assets held by non-excluded funds were in defined benefit funds.[31]

Chart 7




**Source:** Insurance and Superannuation Commission, March 1997.

SG ASSET ALLOCATION AND RETURN.

Overall, SG assets are allocated under management as shown in Chart 7. The Insurance and Superannuation Commission (ISC) reports that the average real rate of return for all superannuation funds was 5.5 percent for the 10 years ending on June 30, 1996.[32]

SG REGULATION.

Superannuation funds fall under the supervision of the Insurance and Superannuation Commission to ensure that fund managers do not engage in self-dealing or other forms of imprudent behavior. The ISC takes a light-handed approach, relying primarily on a high degree of disclosure of funds' policies and performance to members. Other than a 5 percent ceiling on in-house investments, the government imposes virtually no regulations or restrictions on the investment decisions of superannuation funds.

SG TAXATION.

The tax treatment of superannuation is needlessly complex and excessive. Employees must pay a 15 percent income tax on employer contributions to their superannuation accounts. Workers earning more than Au$70,000 (approximately US$55,216) must pay an additional surcharge of up to 15 percent on employer contributions to their superannuation accounts.[33] Workers also must pay a 15 percent income tax on any interest or dividend earnings in their accounts. Withdrawals from superannuation accounts upon retirement are subject to Australia's income tax less a 15 percent credit. This credit is designed to partially offset the taxation imposed on both the original contributions and fund earnings.[34]

## APPENDIX 2.

### AUSTRALIA'S GOVERNMENT BENEFITS PAYMENTS AND MEANS-TESTING PROVISIONS

#### AGE PENSION BENEFITS

| | Maximum Biweekly Payment |
|---|---|
| Single | Au$347.80 (US$274.34) |
| Couple (each) | Au$290.10 (US$228.83) |

- Age pensioners may also receive rent or residential care assistance, a pharmaceutical allowance, a telephone allowance, or a remote area allowance.

#### INCOME AND ASSETS TESTS

- The pension rate is calculated under both income and assets tests. The test which results in the lower rate is applied.
- Social Security payments are not counted as a part of income.

| Income Test | Full Age Pension if biweekly income is equal to or less than | No Age Pension if biweekly income is equal to or more than |
|---|---|---|
| Single | Au$100.00 (US$78.88) | Au$806.40 (US$636.09) |
| Couple (combined) | Au$176.00 (US$138.83) | Au$1,347.20 (US$1,062.67) |

- The effective marginal tax rate on income over the amount for the maximum payment is 50 percent (single) and 25 percent (each for a couple).

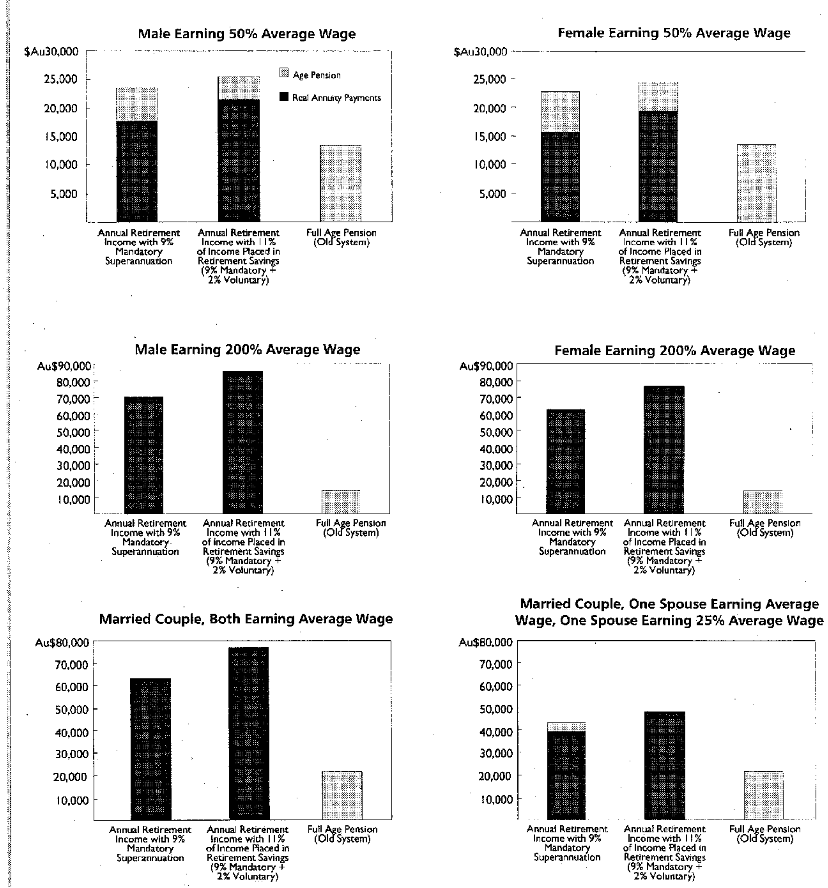
| Assets Test | Full Age Pension if assets are equal to or less than | No Age Pension if assets are equal to or greater than |
|---|---|---|
| Single, homeowner | Au$125,750 (US$99,192) | Au$243,500 (US$192,073) |
| Single, non-homeowner. | Au$215,750 (US$170,184) | Au$333,500 (US$263,065) |
| Couple, homeowner (combined). | Au$178,500 (US$140,801) | Au$374,000 (US$295,011) |
| Couple, non-homeowner (combined). | Au$268,500 (US$211,793) | Au$464,000 (US$366,003) |

- The effective marginal tax rate on assets over the amounts for the maximum payment is 7.8 percent.

APPENDIX 3

Appendix 3

## Case Studies: Average Annual Retirement Income for Selected Income Groups




**Notes:** One Australian dollar= U.S.$ 0.788. Income levels based on a 40-year working life with retirement at age 65, 5 percent annual real return on superannuation investments, 3 percent real return on annuity, all calculations are on a pre-tax basis. Difference between male and female workers is based on differences in longevity, not pre-retirement income.

**Source:** Retirement Income Modeling Unit, Australian Treasury.

## Endnotes

1. In Australia, the term superannuation refers to funded retirement income plans.
2. For the purposes of this discussion, all amounts will be given in Australian (Au) dollars first, with their equivalent value in U.S. dollars following, at the average exchange rate in March 1997 of Au$1.00 = US$0.7888.
3. Means-testing refers to policies that restrict government benefits to those with lower incomes.
4. Daniel J. Mitchell, "Creating a Better Social Security System for America," Heritage Foundation Backgrounder No. 1109, April 23, 1997.
5. For more information on reform in other nations, see Louis D. Enoff and Robert E. Moffit, "Social Security Privatization in Britain: Key Lessons for America's Reformers, Heritage Foundation Backgrounder No. 1133, August 6, 1997; Daniel Finkelstein, "The Policy and Political Lessons of Britain's Success in Privatizing Social Security," Heritage Foundation Committee Brief No. 30, September 29, 1997; and Jose Piñera, "Empowering Workers: The Privatization of Social Security in Chile," Cato Institute Cato's Letters No. 10, 1995.
6. Over time, Australia incorporated age pensions into a broader system that also provided income support payments to the disabled, the unemployed, and low-income families. Unlike Social Security in the United States, which is funded through dedicated employer-employee payroll taxes, the Australian Social Security system is funded from general federal revenue primarily through an individual income tax, a company income tax, and a wholesale sales tax. Although Australian states levy payroll taxes on employers, state payroll taxes are unrelated to the Australian Social Security system. In addition, age pension payments are not related to earnings, as they are in the U.S. Instead, the payments are a flat amount equal to approximately 25 percent of the average earnings for male workers. Married couples receive a flat rate benefit equal to approximately 40 percent of the average wage.
7. Paul Kelly, End Of Certainty: The Story of the 1990s (St. Leonard's, New South Wales: Allen-Unwin, 1994).
8. The "banana republic" comment was made during a radio interview with John Laws on May 14, 1986.
9. Saving for Our Future, statement by Ralph Willis, M.P., Treasurer of the Commonwealth of Australia, May 9, 1995, p. 1.
10. The Australian government's fiscal year runs from July 1 through June 30. See V. W. FitzGerald, National Savings: A Report to the Treasurer, June 1993, p. 2.
11. Ibid.
12. The few remaining exclusions include workers under age 18 and over age 65, temporary foreign workers, and those with very low incomes.
13. The superannuation requirement applies only to the first Au$90,360 of income. For income above that level, the decision to save is voluntary.
14. The Labor government also had plans for additional mandatory savings. It decided in 1995, for instance, that all employees would begin making mandatory co-contributions of 1 percent of earnings in FY 1997–1998, rising to 3 percent of earnings in FY 1999–2000, to their superannuation accounts. The government simultaneously proposed matching this contribution with a government contribution of up to 1 percent of an employee's FY 1998–1999 earnings, rising to 3 percent of earnings in FY 2000–2001. These projected changes were repealed by the coalition government elected in 1996.
15. Budget Measures, 1997–1998, Australian Treasury, May 13, 1997, pp. 186–187.
16. Ibid., pp. 189–191.
17. Ibid., pp. 192–194.
18. Budget Measures, 1996–1997, Australian Treasury, May 1996.
19. Married couples under the old system received an age pension equal to 40 percent of the average worker's wage.
20. Preliminary projections by the Retirement Income Modeling Unit of the Australian Treasury, by facsimile to authors.
21. Ibid.
22. Ibid.
23. George P. Rothman, "Aggregate Analysis of Policies for Accessing Superannuation Accumulations," available at the Retirement Income Modeling Task Force Web site: www.treasury.gov.au/organisations/rimtf.
24. Media release, Insurance and Superannuation Commission, July 6, 1997.
25. Data supplied to authors by Vince FitzGerald. See also Phil Gallagher, "Assessing the National Saving Effects of the Government's Superannuation Policies," available at the Retirement Income Modeling Task Force Web site: www.treasury.gov.au/organisations/rimtf.
26. Data supplied to authors by the Treasury's Retirement Income Modeling Task Force.
27. This tax treatment (deductible contributions and taxable withdrawals) is known as the "IRA approach" to savings. Another simple and neutral tax regime for long-term savings is to tax superannuation contributions, but then to impose no tax on earnings and eventual withdrawals. This "municipal bond approach" is economically equivalent to the "IRA approach." Neither approach, of course, makes the mistake of taxing the annual earnings of the fund.
28. Statement delivered by John Dawkins, M.P., Treasurer of the Commonwealth of Australia, June 30, 1992.
29. Like the United States, Australia has a written constitution, a federal system in which states delegate specific and limited powers to Canberra, and courts with the power to rule specific acts of the federal or state parliaments unconstitutional. Like Great Britain, Australia has a responsible government under which the Prime Minister and state Premiers must command majority support in the lower houses of their respective parliaments. Australia has a Senate elected by the people through a proportional system. Because Australian governments seldom command a majority in the Senate, Prime Ministers—like U.S. Presidents—are forced to bar-

gain with independent minor party and opposition Senators to secure enactment of their programs.

30. Australia's competitiveness is still hampered by the remnants of centralized labor markets, which helps to explain why unemployment remains over 8 percent. Along with high marginal tax rates, further deregulation of Labor markets continues to be a challenge for Australian policymakers.

31. David M. Knox, unpublished manuscript, University of Melbourne, July 1997.

32. "Superannuation Investment Performance," Insurance and Superannuation Bulletin, Insurance and Superannuation Commission, Canberra, September 1996, p. 19.

33. The surcharge is 1 percent for each $1,000 of taxable income exceeding $70,000, up to a maximum of 15 percent for taxable incomes exceeding $85,000.

34. For lump-sum withdrawals under a reasonable benefit limit of Au$434,720 (US$342,907), a tax rate of 16.7 percent (30 percent income tax plus a 1.7 percent Medicare levy less a 15 percent tax credit) is applied. For lump sums exceeding the reasonable benefit limit, the marginal income rate (including the Medicare levy of 1.7 percent) is applied. For annuity purchases under a reasonable benefit limit of Au$869,440 (approximately US$685,814), annuity payments are taxed at the marginal income rate less a tax credit of 15 percent. The 15 percent tax credit does not apply to the portion of annuity payments attributable to the amount exceeding the reasonable benefit limit or to lump-sum withdrawals exceeding the reasonable benefit limit.

## Social Security Privatization in Britain: Key Lessons for America's Reformers

### INTRODUCTION [1]

Many young Americans are becoming increasingly anxious about the future of their Social Security benefits. Their fears are not misguided. Based on the latest official estimates,[2] Social Security benefit costs will exceed contributions within 15 years. Assuming the Social Security Trust Fund assets in government bonds are fully paid, the system will be unable to pay promised benefits by the year 2029. Clearly, it is a system badly in need of reform.

At the same time, workers in Britain, traditionally the closest ally of the United States, enjoy a veritable treasure trove of private pension funds. Britain's pension pool—already worth over £650 billion (over $1 trillion U.S. dollars)—is rapidly approaching the value of the country's annual economic output. In fact, it is larger than the pension funds of all other European countries combined.[3]

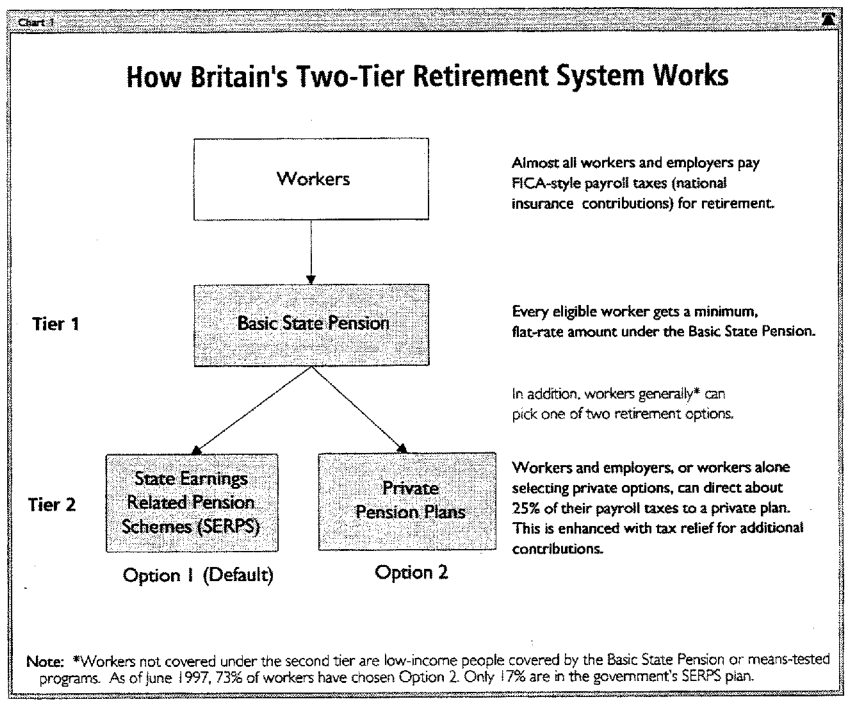
The reason? Instead of being locked into a rigid, financially troubled government-run system, millions of British workers can take advantage of a law that permits them to invest a portion of their payroll taxes in private retirement plans. Consequently, at a time in which young workers in the United States can expect only lower—even negative—returns on the taxes they pay into the current Social Security system,[4] workers in Britain enjoy solid returns from a substantially privatized pension system that allows them to invest a portion of their payroll taxes in private stocks and equities. In Britain today, about three-quarters of all workers are enrolled in private pension plans.[5] In the United States, however, private-sector workers are not allowed to invest any portion of their 12.4 percent Social Security payroll tax in private stocks and equities or private retirement plans for their future retirement; all of their payroll taxes must go into the U.S. government's Social Security system with little guarantee that this "investment" will pay off down the retirement road.

*Britain's Quiet Pension Revolution*

The British social security reform effort tackled many of the problems that plague the U.S. Social Security system. Before Members of Parliament and other leaders could suggest solutions, however, they had to recognize that the government system had serious problems. Their solution was to enact a two-tiered system that offered security, flexibility, and a positive return on the investment of mandatory payroll tax money.

Under the British system of social security, a first tier pays a flat-rate basic pension, and a second tier pays pension benefits based on earnings while in the workforce.[6] All eligible employees are entitled to a safety net Basic State Pension, but they also have a choice: remain in an American-style government pension program called the State Earnings Related Pension Scheme (SERPS) or divert a specified portion of their payroll taxes (known as "national insurance contributions") into a private company-based plan or personal pension plan. In this second tier, British employees must be enrolled either in SERPS or an approved private pension plan. If they opt out ("contract out") of SERPS, they give up that portion of their government benefit when they retire, but they also can receive a bigger and better pension with higher returns on their private investments. Workers may contract back into SERPS, with certain restrictions, if they are unhappy with the private option.

By restructuring their state pension system and allowing consumer choice and competition among private pension plans, the British have managed to amass huge retirement savings while controlling entitlement spending. According to Roderick Nye, director of the London-based Social Market Foundation, the Organization for Economic Cooperation and Development (OECD) "estimates that by 2030 the UK will have paid off its entire national debt; in France and Germany, where earnings related pensions are paid out of contributions from those currently in work, the national debt will have doubled to exceed national income if current pension policies are maintained." [7] John Blundell, general director of London's Institute for Economic Affairs, reports that "Every European Union state except Britain has a huge overhang of debt, driven by the political bribe of offering something for nothing. We are probably no more virtuous as a people, but we have a far happier financial horizon." [8]




*The U.S. Advisory Council Report* [9]

In the United States, by contrast, members of the Social Security Advisory Council were tasked in 1994 with studying ways to ensure the long-term solvency of the Social Security system.[10] The council's report, released in January 1997, proposed several solutions, including a partial privatization of the 62-year-old U.S. system, routinely dubbed the deadly "third rail" of American politics because of its politically sacrosanct character. Even though the report's major proposals differed in crucial details, the Advisory Council urged unanimously that Social Security funds be invested in private stocks and equities to help ensure solvency and generate a higher rate of return on Americans' tax dollars.

One of the proposals endorsed by five of the 13 members of the Advisory Council contains elements that closely resemble the key components of the reformed British system. Under this proposal, 5 percent of the existing Social Security payroll tax would be used to foster the creation of private pension accounts.[11] Although the Advisory Council report outlines a broad proposal for reform, the British experience offers a more detailed guide that can help Congress expand private pension opportunities in the United States and avoid pitfalls on the path to Social Security reform.

To help them prepare their report, members of the Advisory Council had been briefed on the experiences of other countries, and several economists and scholars had suggested that Congress and the Clinton Administration use Chile's successful reforms of 1981 as a model for reform in the United States.[12] But even though the Chilean effort is impressive and valuable as a design, the political and economic conditions in Chile at the time of its reforms were very different from those in the United States today. Thus, Chile's usefulness as a relevant model for reform in the United States is limited.

In terms of culture, Britain is closer to the United States than is Chile. The British and American people have similar demographic and economic problems, a common language, and deep historical ties. Thanks to these similarities, Congress and the Administration can rely on the lessons learned from the successful British experiment to assure a solid and prosperous retirement for future generations of Americans.[13] But there is little time to waste. The longer policymakers delay in making the necessary changes, the more likely American taxpayers will have to make up for current unfunded liabilities within a shorter period of time.

BRITAIN'S BRIGHTER FINANCIAL FUTURE

The failure to tackle entitlement spending, especially public pensions, threatens several countries in Western Europe with the associated mountainous and unsustainable levels of public debt. In 1995 and 1996, for example, the governments of Italy, France, and Germany tried, but failed, to reform their state pension systems. The British are a bright exception.

Today, Britain ranks behind only the United States and Japan in the sheer size of its financial assets. Frank Field, cabinet minister for welfare reform in the Labor government and former chairman of the Social Security Committee of the House of Commons, recently observed that the "pension industry is one of Britain's most successful corporate sectors, alone accounting for much of the country's financial power. Unlike our European counterparts, who often hold pension assets in the book reserves of company accounts, Britain's fund assets are released into the world's capital and currency markets."[14]

In January 1996, then-Social Security secretary Peter Lilley explained how well Britain's position on pensions fared when compared with those of other developed countries:

> The OECD forecast each country's national debt assuming they continue with their present pensions systems and levels in taxes and charges. By 2030 in France and Germany, the national debt will have about doubled and will exceed national income. In Japan, which is ageing particularly fast, debt will reach three times national income. By contrast, Britain's second tier funded pensions place us in a unique position. The OECD forecasts that we will have paid off our entire national debt and started to build up assets.[15]

Table 1

**1993 Pension Fund Assets as Share of Gross Government Debt**

| | General Government Gross Debt in Billions of U.S. Dollars | Pension Funds Assets in Billions of U.S. Dollars | Pension Funds Assets as a Share of Government Debt |
|---|---|---|---|
| U.K. | $428.08 | $717.25 | 167.55% |
| Japan | 1,910.74 | 1,800.00 | 93.71 |
| U.S. | 3,858.20 | 3,546.00 | 91.91 |
| Germany | 944.84 | 105.95 | 11.21 |
| France | 631.99 | 41.10 | 6.50 |
| Italy | 1,138.63 | 11.65 | 1.02 |

**Sources:** Koen Dr Ryck, *European Pension Funds: Their Impact on European Capital Markets and Competitiveness*, European Federation for Retirement Provision, 1996; Japanese Embassy.

Britain's promotion of private pensions has been combined with a careful but decisive reduction in the growth of the state pension system. The present value of the country's "net public pension liabilities" is estimated at 5 percent of gross domestic product (GDP), which is noticeably below comparable figures for the United States and such other economic giants as Germany and Japan.[16] The lesson for the United States is clear: Carefully planned and executed policies governing entitlements can have a positive impact on the overall financial health of the country, particularly its public debt.

This partially privatized pension system has made substantial gains for British workers and retirees over the past decade. From 1986 to 1995, the gross rate of return for median private pension funds was 13.3 percent per annum.[17] Data supplied by 1,500 pension funds in 1996 for company based retirement plans showed that 50 of Britain's largest occupational funds registered returns of 10.5 percent overall and 16.4 percent in British equities. A large sample of smaller firms registered returns of 11 percent overall and 17.1 percent in British equities.[18]

Table 2

**1993 Pension Funds Assets as Percentage of GDP**

| | GDP in Billions of U.S. Dollars | Pension Fund Assets in Billions of U.S. Dollars | Assets as a Share of GDP |
|---|---|---|---|
| U.K. | $903.12 | $717.25 | 79.42% |
| U.S. | 6,000.31 | 3,546.00 | 59.10 |
| Japan | 4,025.47 | 1,800.00 | 44.72 |
| Germany | 1,824.02 | 105.95 | 5.81 |
| France | 1,194.69 | 41.10 | 3.44 |
| Italy | 947.27 | 11.65 | 1.23 |

**Sources:** Koen Dr Ryck, *European Pension Funds: Their Impact on European Capital Markets and Competitiveness*, European Federation for Retirement Provision, 1996; Eurostat.

*The Crucial Lessons*

Britain's experiment in social security reform has accomplished several major goals. It has helped control entitlement spending; it has raised the standard of living for elderly persons; and it has given young people broad personal choice in deciding how best to invest their own money and control their own futures. The British experience, therefore, offers many valuable lessons for the U.S. Congress:

- Offering the choice of enrolling in private pension plans is likely to be very popular. Today, about 73 percent of British workers are in private plans; only 17 percent are left in SERPS.[19] Of the private pension holders in Britain today, 5.6 million have opted out since 1988 to open appropriate personal pension plans (the British version of tax-favored individual retirement accounts).[20]
- Structural reform can mean a substantial increase in the standard of living of retirees. From 1979 to 1993, the average incomes of British pensioners (before housing costs) rose by 60 percent—more than for any other segment of the British population. The largest increase in retirees' income during this period came from private pensions and investment income.
- Social Security reform involves providing acceptable tradeoffs for younger workers. Moving from a financially troubled pay-as-you-go system to a funded system that relies heavily on private stocks and equities involves a price for younger workers: They will have to pay not only for their own benefits, but for those of the older generation of retirees as well. The British experience shows that younger workers are prepared to accept that tradeoff. They believe they would be better off in a portable system of personal pension plans with solid rates of return on investment than in a system plagued by political manipulation, politicians' broken promises, and incessant threats of higher taxes or reduced benefits.
- Effective rules must be put in place to protect consumers and prevent fraud and abuse during any transition period. Even the British experience has not been trouble-free. Without effective consumer protection, too many British workers moved from more generous employer-based plans, diverting a portion of their payroll taxes to less generous personal pension plans. The transition to personal pension plans initially was marred by instances of fraud and abuse, misrepresentation of private plan options, and inadequate disclosure of administrative costs and risks. To their credit, British officials recognized these problems and acted to correct them.

• It is important to focus on structural reform, not short-term budgetary savings. Reforms should make significant structural changes in the Social Security system, but their implementation should be timed so that current beneficiaries and workers will not be harmed. The British success in carefully crafted pension reform has been reinforced by solid guarantees to workers and retirees. With rising pension incomes and strong returns on private investment, the British reforms have proven to be a good deal for ordinary people. Congress should structure Social Security reform so that, on balance, as many Americans as possible will be better off with reform than without it.[21]

• Major structural reform can win bipartisan support. One of the most remarkable lessons of the British experience is that structural reform is possible in a Western democracy long committed to social insurance. Outside the normal inter-party sniping typical in a democracy, there has been a remarkable degree of bipartisan support in recent years for Britain's opting-out system, and the new Labor government under Prime Minister Tony Blair is likely to consolidate and extend these reforms. The Labor Party has long supported private occupational pension plans and has published no plans to dismantle the privatized program now in place. "Labour is not going to change that," notes Paul Johnson of the London-based Institute for Fiscal Studies. "All it is committed to is continuing to raise the basic pension in line with prices."[22] Labor's leadership has been considering how, not whether, to expand private pension options for British workers and their families.[23]

• Certain technical considerations must be addressed to make reform successful, and the British experience can provide solid guidance in these areas. Specifically, policymakers will have to decide such issues as how to pay the inevitable transition costs, how to calibrate the degree of income transfer from younger workers to retirees, how to clarify the economic value of a basic government pension, and how to integrate part-time or low-income workers into a newly privatized system.

### How the British Pension System Works

Britain's state pension program represents a complex accretion of policies and programs enacted and implemented by Conservative and Labor governments since the end of World War II.[24] Today's system is grounded statutorily in the National Insurance Act of 1946, a major initiative of the postwar Labor government of Prime Minister Clement Attlee, which replaced Prime Minister Winston Churchill's Conservative government in 1945.[25]

Table 3

**British National Insurance Contributions (Payroll Taxes), 1997-1998**

| Weekly Earnings in British Pounds | Tax Rate for Employees | Tax Rate for Employers |
|---|---|---|
| Below £62 | 0% | 0% |
| 62 to 109.99 | 10% of earnings above 62 pounds, +2% of 62 pounds | 3 |
| 110 to 154.99 | 10% of earnings above 62 pounds, +2% of 62 pounds | 5 |
| 155 to 209.99 | 10% of earnings above 62 pounds, +2% of 62 pounds | 7 |
| 210 to 465 | 10% of earnings above 62 pounds, +2% of 62 pounds | 10 |
| Above 465 | no additional taxes levied | 10 |

**Note:** One pound = $1.60.
**Source:** British Embassy, Washington D.C., March 1997.

Under the National Insurance Act and subsequent legislation, all British workers with earnings above a "lower earnings limit" (LEL) and their employers contribute to a National Insurance Fund. These contributions are roughly equivalent to the payroll taxes used to finance Social Security and Medicare in the United States.[26] Combined employer and employee payments range from 15 percent to 22 percent of earnings, with the proportion of the employer contribution rising as a worker's income increases. Employees contribute if their earnings fall between a lower earnings limit of £62 ($99.20) per week and an upper earnings limit, or UEL, of £465 ($744) per week. An employee's contribution is 2 percent of earnings up to the LEL and 10 percent of earnings in excess of the LEL. Employers at this LEL pay 3 percent of all earnings. At the upper earnings limit, the employee contributes 2 percent of all earnings up to the LEL and 10 percent of all earnings up to £465 ($744) per week (the UEL). The employer, however, contributes 10 percent of all earnings for these high-income employees. The employee pays no additional payroll tax on earnings above the UEL, and the employer continues to pay 10 percent of the employee's earnings with no upper limit.

The National Insurance Fund is managed by the Department of Social Security, which administers a variety of social programs as well as the state (national) pension system. The fund pays out pension benefits as well as unemployment benefits, and both depend on the employee's record of contributions.[27] Like the U.S. Social Security system, it is run on a pay-as-you-go basis: Current "contributions" (taxes) pay for current "expenditures" (benefits). The National Insurance Fund's accounts are held at the Bank of England, but it has no borrowing authority; by law, the fund must maintain a positive balance for the payment of pensions and other government benefits, and its money may be invested only in government and "local authority" municipal stocks.[28]

*A Two-Tiered System*

Over 10 million retirees are enrolled in Britain's pension system. This system has two distinct levels, or tiers: (1) the Basic State Pension and (2) the State Earnings Related Pension Scheme (SERPS) or private pension options. Workers may opt out of the second tier of the state pension system, but not the first.

*Tier #1: The Basic State Pension.*

All British workers, subject to age and eligibility requirements, are entitled to the Basic State Pension, often referred to as the Old Age Pension. Today, the Basic State Pension pays single retirees £62.45 ($99.92) and couples £99.80 ($159.68) per week.

Beyond the Basic State Pension, the elderly also may be entitled to Income Support, a means-tested welfare program based on income and financed separately through general revenue. In addition, the elderly poor are eligible for the Council Tax Benefit, a form of assistance to offset property tax payments, and a housing subsidy called a Housing Benefit that is available to the poor on a sliding scale. Those officially designated as elderly poor, for example, are entitled to a subsidy equal to 100 percent of their housing costs. For older pensioners, the level of Income Support is likely to exceed the Basic State Pension, and the older the pensioner, the wider the disparity. Of the more than 10 million retirees in Britain, approximately 1.5 million receive some Income Support and another 2 million receive means-tested assistance with their housing costs.[29]

Traditionally, increases in the state pension were tied to wage increases. In the 1960s, the Basic State Pension was equivalent to 20 percent of average earnings. In the 1980s, however, in an effort to control soaring costs, the British government broke the link between pension and wage increases and substituted price increases as the basis for future pension increases. Such price increases, similar to adjustments in the Consumer Price Index in the U.S. Social Security system and Civil Service Retirement System, are generally slower than wage increases. Thus, even though the purchasing power of the Basic State Pension has not changed, it is now the equivalent of 14 percent of average earnings.[30] Because of the changes made in 1989, however, British retirees—unlike retirees in the United States—no longer are penalized by the "earnings rule," which reduces the state pension if a worker chooses to work past the age of retirement.[31]

*Tier #2: The State Earnings Related Pension Scheme or Private Pension Options.*

Workers may enroll in SERPS, often referred to as the "additional" state pension, or invest part of their payroll tax in an approved pension plan. It is mandatory that employees enroll in one of these options.

Established by the Labor government in 1978, the SERPS component of the state pension system was designed to give retirees more generous benefits related to the real value of employees' earnings. Because of the disparity in future retirement prospects between British workers with occupational pensions and those without, SERPS was, in effect, an attempt to level the playing field for British retirees who were not enrolled in private occupational pension plans.

Only British workers employed by a company and with earnings above the LEL are eligible for retirement benefits under SERPS. Self employed workers and the unemployed are not. Like the Basic State Pension, SERPS is financed by payroll taxes on a pay-as-you-go basis.[32] It was designed to provide for a pension based on 25 percent of the average of the best 20 years of earnings (later amended to 20 percent) in addition to the basic flat-rate pension funded out of the National Insurance Fund.

*How British Workers May Opt Out of SERPS*

British workers may contract out of SERPS (but not the Basic State Pension) and enroll in an approved occupational pension plan or certain types of personal pension plans.[33] According to the Department of Social Security, "The Government's view is that where people are able to provide for themselves they should be encouraged to do so."[34] Two private options are available for workers who opt out of SERPS: an occupational pension plan based on employment and a personal pension plan similar to an individual retirement account.

Occupational plans. In consultation with employers, workers may substitute an occupational pension plan for the second tier of coverage, with a portion of their payroll taxes (national insurance contributions) used as a rebate to offset the cost of a private "occupational pension scheme." The value of this tax rebate of payroll taxes (national insurance contributions) varies over the years and is determined periodically by the secretary of state for social security based on the recommendation of the British Government Actuary. Today, employers receive a rebate of 3 percentage points on their payroll taxes, and employees receive a rebate of 1.6 percentage points of earnings for money paid into an employer-sponsored pension plan.

Beyond the tax rebate, employers may contribute an amount above the basic contribution required to contract out of the government pension system and receive tax relief. An employee may contribute up to 15 percent of his regular earnings to such a plan tax-free.[35] The tax-free limit for employer and employee contributions combined is 17.5 percent of employee earnings. Today, the average contribution rate for such occupational plans (or schemes in British parlance)[36] is 5 percent of earnings by the employee and 10 percent by the employer. These contributions receive tax relief at the highest marginal rate of income tax for both the employee and the employer. Additionally, the investment returns are free of both income and capital gains taxes.

Occupational plans must be approved by the government, but they are managed privately. They may be defined benefit plans based on years of service and final salary or defined contribution plans based on contributions to a fund and a return on investment. All, however, must provide—in the judgment of the British government—benefits at least as good as those available under SERPS.

When private companies contract out of SERPS, usually in consultation with employees or their representatives, their managers and workers give up their state pension benefits under the program. In contracting out, however, the company must provide a "guaranteed minimum pension" for each worker that is roughly equal to the benefits he would have had under SERPS. If private companies and their workers wish to buy back into SERPS at a future date, they may do so. This requires that the private-sector trustees pay a special "state scheme premium" to the Department of Social Security, after which the department restores the SERPS benefits to the employees.[37]

Most private company plans set up after consultations with employees or trade union representatives are defined benefit plans in which workers' pensions are calculated on the basis of years of work and a final salary amount based on an average of earnings over a certain period of years before retirement. Employers also may offer an extra ("top-up") pension plan above the standard occupational plan, but neither the contribution nor the investment income from such an additional plan receives any tax advantage. Today, industry-wide and company-wide occupational pension plans that combine tax advantages with an employer's contribution typically provide the best pensions for British workers and make British retirees among the most financially comfortable in the world.[38]

Occupational pension plans existed long before the modern state pension system. In Britain, they can be traced as far back as 1375.[39] By the 1960s, approximately half of all British workers were covered by such plans,[40] which are governed by a rich body of law.

Under the Pensions Act of 1995, the British government requires indexation of occupational pension payments, with benefits increased according to inflation or up to a maximum of 5 percent annually, whichever is the lesser amount.[41] The government also imposes a minimum funding requirement to guarantee coverage of the value of the benefits and a system to compensate employees if the sponsoring employer becomes insolvent or employees lose pension funds because of illegal actions on the part of employers.

Men and women enrolled in such plans must be treated equally. In addition, they have a legal right to transfer their pension rights either from one company plan to another or to a personal pension plan. Occupational plans may invest no more than

5 percent of their assets in the employer's company, are to be actuarially re-evaluated every three years, and must permit persons to pay tax-free "additional voluntary contributions" into their pension funds. These funds are managed, subject to trust law, by a board of trustees that may invest the funds or appoint a fund manager to make the investments. To receive favorable tax treatment, these plans must receive contributions from employers; must meet certain benefit levels; must be set up as irrevocable trusts separate from employers; and must spell out clearly the rights and obligations of workers, trustees, and employers.[42] For example, British employers today may not force employees to join company-based pension plans.

As noted, these private pension plans must satisfy a legal "requisite benefits test" by providing benefits roughly equal to those provided by SERPS. Plans also are certified by the Pension Schemes Office, an agency of the Inland Revenue (Britain's equivalent of the U.S. Internal Revenue Service). In the case of an employer-sponsored "money purchase scheme" (a defined contribution plan), the total contribution must be at least at the level of the contracted-out rebate, currently set at 4.6 percent of earnings. Typically, the employer will fund a pension on a matching basis with the employee, and a typical scheme will have a 5 percent employee and a 5 percent employer contribution. Today, 62 percent of all British pensioners and 70 percent of pensioner couples have an occupational pension. During the 1979 to 1994 period, the incomes from such pension plans rose by 60 percent.[43]

Personal pension plans. The second option available to British workers, both employees and the self-employed, is to contract out of SERPS and enroll in an appropriate personal pension (APP) plan. These "money purchase" plans are sponsored by various organizations, including banks and building societies (mortgage companies), insurance companies, unit and investment trusts (mutual funds), and mutual associations or "friendly societies." Under current law, if a worker is already enrolled in an occupational plan and getting a rebate, he may not enroll in an APP also.

Workers who want to participate in an APP must continue to pay the national insurance contributions, but the Department of Social Security then pays a tax rebate from these payroll taxes (currently 4.6 percent of earnings) into an APP of the worker's choice.[44] This rebate is the minimum permissible level of contribution to such a personal pension plan, although workers may make additional contributions as well.

From 1988 to 1992, to encourage contracting out to private pension plans, the government offered workers not only the standard rebate, but also an additional 2 percent "incentive tax rebate." In 1993 and 1994, the government reduced the standard tax rebate from 5.8 percent to 4.8 percent of earnings and replaced the generous additional 2 percent incentive rebate with a 1 percent incentive rebate for persons over 30. In 1994, for example, this enabled these workers to receive a total annual tax rebate of 5.8 percent of earnings. Today, the standard tax rebate is 4.6 percent. This combination of tax rebates, incentive rebates, and tax relief for contributions to personal pension plans has made these plans especially attractive to younger British workers.

Moreover, workers who contract out of SERPS to open up their own APPs do not give up their SERPS benefits from previous working years; their future pension is simply recalculated on the basis of their earnings during the period of SERPS membership.[45] At the same time, to qualify for government approval and tax relief, a personal pension plan must (1) be government-certified; (2) meet minimum contribution standards; (3) use accumulated funds to purchase an annuity at a specified retirement age; and (4) provide an annuity for widows, widowers, and children.[46] Annuities may be purchased from approved insurance companies or friendly societies of the worker's choice.

Personal pension plans have some strong advantages:

• Popularity and portability. As noted previously, personal pension plans—fully portable and characterized by a variety of investment options in stocks and equities—appeal strongly to young working people (both male and female), the self-employed, and workers not enrolled in occupational pension plans. Studies show that, on the basis of the tax rebates alone, younger workers, especially those in their 20s and 30s, can expect a pension that is twice that provided by SERPS.[47]

Based on 1994–1995 estimates, the Department of Social Security reports that personal pension plans have appealed generally to workers with modest incomes, that 60 percent of persons enrolled in these plans were under 30 years of age, and that 37 percent were women.[48] It is estimated that about a quarter of all British workers now have personal pension plans.[49]

Contracting out of the state pension system to enroll in a personal pension plan is not good for everyone, however. For older workers, the Department of Social Security warns that opting out of SERPS in favor of personal pension plans normally is not wise: "At present, when people come within 15 to 20 years of retirement, they will nearly always do better in SERPS than in an appropriate personal pension scheme...because the rebate of national insurance contributions is paid at a flat rate and does not take into account the age of the person contracting out."[50]

Table 4

**Tax Relief for Contributions to Britain's Personal Pension Plans Rises With Enrollee's Age**

| Enrollee's Age | Tax Free Contribution Limits: Maximum Percentage of Pensionable Earnings |
|---|---|
| 35 and under | 17.5% |
| Age 36 - 45 | 20 |
| Age 46 - 50 | 25 |
| Age 51 - 55 | 30 |
| Age 56 - 60 | 35 |
| Age 61 and Over | 40 |

**Note:** "Pensionable Earnings" = income on which benefits and contributions are calculated.
**Source:** National Association of Pension Funds Ltd., March 1997.

The attraction of personal pensions is not difficult to explain. Under current law, the amount a person may contribute each year to his personal pension tax-free depends on his age. A person 35 or younger can deposit up to 17.5 percent of his annual "pensionable" earnings tax-free; the older a person is, as Table 4 shows, the more he can contribute with tax advantages on a progressive scale. Employers also may contribute to personal pensions and receive a tax break. This option has become increasingly popular: As of 1993, 75 percent of all new private pension plans were personal pension schemes.[51]

• Flexibility. A worker does not have to contract out of SERPS to open a personal pension. A worker can remain in SERPS ("contract in"), forego the payroll tax rebate, and still take out a tax-free personal pension plan, subject to certain limitations, to supplement his retirement earnings. Persons enrolled in occupational pensions also can use personal pension plans as a way to receive "transfer payments" from a private plan from previous employment.[52] Under current law, income from a personal pension can be paid to a worker at any time from age 50 to age 75, at which time a worker must purchase an annuity. These rules give workers flexibility in retirement and an opportunity to increase the returns on their investments. Pensions normally are taxable, but there are exceptions. Up to 25 percent of the money in a worker's personal pension fund can be taken as a tax-free lump sum upon retirement, and that lump sum can be left tax-free to his spouse and children upon his death.

Although the Department of Social Security is responsible for the regulation of occupational pensions, the Personal Investment Authority, a special agency that reports to the British Treasury, exercises regulatory responsibility for personal pensions.[53]

## BRITAIN'S TAX POLICY TOWARD PENSIONS

Pensions in Britain are taxable, but the government encourages workers and employers—particularly in plans that are contracted out of the state pension system—to make contributions to private pension plans with significant tax relief. A worker can receive tax relief for personal contributions to an occupational pension plan of up to 15 percent of earnings, and both capital gains and investment income from the plan are tax-free. Likewise, a worker who contributes to an APP receives full tax relief on his contributions of 17.5 percent of earnings, or more, depending on age, and any investment income and capital gains are also exempt from income and capital gains taxes. Again, subject to certain limits, lump-sum pension benefits paid on retirement or death are tax-free.

The British government encourages personal savings in other ways as well. A worker can make additional voluntary contributions to an employer's occupational pension plan, or "free standing" additional voluntary contributions outside of an employer's plan, and receive tax relief for such contributions, subject to certain rules, as long as they do not exceed 15 percent of annual earnings.[54] People can open up Personal Equity Plans (PEPs) and deposit up to £6,000 ($9,600) per year, with the interest and capital gains on these investments tax-free, subject to certain restrictions. Britons also can deposit up to £3,000 ($4,800) in a Tax Exempt Special Savings Account (TESSA) in the first year, and more limited amounts over a period of two to five years, and receive tax-free interest. Not surprisingly, the British savings rate is roughly twice that of the United States.

The new Labor government, according to its election platform, will continue to support tax policies that encourage savings and investment. In 1995, Labor leader Tony Blair declared that there could be "more private funding" of pensions while the government would continue "to provide a minimum guarantee for all."[55] This year, Frank Field, the new cabinet minister for welfare reform, called for expanded private pensions based on compulsory contributions for employers and employees and a phasing out of a component of the existing state pension program.[56] Field has said that

> Labour should agree to the winding up of SERPS (the second tier of the state pension system) so that every taxpayer will be paying into a funded pension scheme. These new individually owned schemes should run alongside a state pay-as-you-go scheme, the bill for which, thanks to Mr. Lilley [then Conservative cabinet minister for social security], is reasonable for taxpayers.[57]

According to its party platform, Labor "will introduce a new individual savings account and extend the principle of TESSAs and PEPs to promote long term saving. We will review corporate and capital gains tax regimes to see how the tax system can promote greater long term investment."[58]

## How the British Improved their Pension System

Pension reform, a staple of British politics since World War II, in recent years has been driven by growing demographic and fiscal pressures.[59] Today, just as in the United States, the ratio of people working to the number of people retiring is declining. This deterioration is not as serious as it is in other West European countries,[60] but British officials also realize that it will accelerate when today's baby boomers are well into retirement. Therefore, they are drafting comprehensive proposals to cope with this eventuality now.

Today, spending on the elderly (estimated at over £40 billion, or $64 billion, in 1996–1997) is the largest item in the British social security budget.[61] The level would have been even higher, however, and the resultant financial pressures on the British taxpayers more severe if Parliament had not acted to improve and open up the system, thereby ensuring, as David Willetts, M.P., has observed, "that we avoid the more melodramatic scenarios of a crisis in public finance for older people."[62]

The key steps in Britain's social security reform have included:

1. Improving the living standards of the elderly;
2. Expanding personal choice;
3. Slowing the growth of the state pension system;
4. Curtailing future tax increases;
5. Establishing equity; and
6. Protecting consumers.

### *Improving the Living Standards of the Elderly*

State pension benefits provided about 60 percent of pensioners' income in the early 1980s, but this level had fallen to about 50 percent in the early 1990s.[63] In the meantime, generous private pension options more than filled the gap. Today, largely as a result of government policy, almost 90 percent of British pensioners have private incomes over and above the Basic State Pension.[64]

Table 5

## Average Income of British Pensioners by Source: 1979-1993

| Income Source | Average Pensioners Income in Pounds per Week* 1979 | 1993 | Change in Income |
|---|---|---|---|
| **Earnings** | £13.10 | £9.50 | -27% |
| **Benefit Income** | 69.20 | 90.50 | 31 |
| **Investment Income** | 12.30 | 27.40 | 123 |
| **Occupational Pensions** | 18.20 | 42.30 | 133 |
| **Other Income** | 0.70 | 0.50 | -24 |
| **Total Gross Income** | 113.40 | 170.20 | 50 |
| **Total Net Income** | 98.20 | 148.50 | 51 |
| **Total Net Income After Housing** | 84.20 | 131.90 | 57 |

**Note:** *Income in July 1993 prices: estimates are derived from the 1979 and 1993 Family Expenditure Surveys.
**Source:** The Department of Social Security,United Kingdom, March 1996

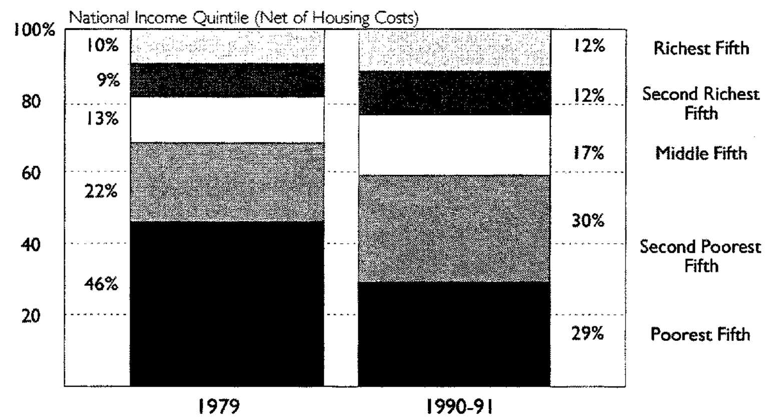
Between 1979 and 1995, the income of British pensioners increased in real terms by 60 percent—the largest increase among any group in Britain.[65] Not surprisingly, as a proportion of the population, the percentage of pensioners who are among the poorest citizens shrank dramatically.[66] From 1982 to 1992, home ownership among British pensioners jumped from 47 percent to 60 percent.[67] On the basis of a comparative analysis conducted in 1993 by actuaries on behalf of the Department of Social Security, British pensioners, given the combination of state and tax-favored private pension options, generally were better off than their counterparts in Germany, the leading economic power in Europe.[68] From 1979 to 1993, as noted in Table 5, the biggest jumps in the income of British pensioners came from occupational pensions (133 percent) and investment income (123 percent). Thus, the available evidence "suggests that the income position of UK pensioners to the rest of society has been gradually improving"[69] and that this improvement is largely attributable to growth in the "private provision" of pensions.[70]

*Expanding Personal Choice*

Parliament's single most important reform in the Social Security Act of 1986 was to expand the private tier of the British pension system, further encouraging British citizens to provide for their own retirement by enrolling in government-certified appropriate personal pension plans.

Chart 2

**British Elderly Moving up the Economic Ladder: In 12 Years, the Share of Elderly in the Poorest Quintile Dropped 37%**




**Note:** Figures are for income level after housing costs are taken out.
**Sources:** Andrew Dilnot et al., *Pensions Policy in the UK*, Institute for Fiscal Studies, 1994; Department of Social Security, 1993.

As noted, APPs have been extraordinarily popular, especially with younger British workers.[71] Before this option was introduced, workers had to join an occupational pension plan in order to secure a retirement income higher than that provided by the state pension system. As of 1992, most of the participants in occupational pension plans had been males with consistent work histories.[72] With new personal pension options, younger workers, especially women, could contract out of SERPS into a personal plan and receive a substantial tax rebate, an initial incentive rebate of 2 percent, and tax relief for contributions. The number of persons with personal pensions jumped dramatically from approximately 1.9 million in 1988 to 5.5 million in 1993,[73] thereby reducing the long-term liabilities of the British state pension system.

*Slowing the Growth of the State Pension System*

During the high inflation periods of the 1970s, state pension increases had been indexed to wage increases, which normally outpaced price increases and thus generated tremendous costs. In 1981—in the middle of a recession—Parliament broke the link between wage increases and pension increases by deciding to index pension increases to prices, which were rising faster than earnings. In addition to ensuring that government pensions at least would keep up with general inflation, substituting price indexation for wage indexation has had a profound and continuing impact on controlling costs. Since 1980, this change alone has saved British taxpayers nearly £9 billion ($14.4 billion).

The future savings from this adjustment, according to Paul Johnson, will prove to be even more dramatic:

> Starting from where we are the Government Actuary (1995) estimates that spending on the basic pension will reach £47 billion [$75.2 billion] in 2030 and remain about constant thereafter. With earnings indexation from the present spending would rise to £80 billion [$128 billion] in 2030 and £107 billion [$171.2 billion] in 2050. With price indexation National Insurance Contribution rates would need to be barely changed by 2030, but with earnings indexation they might have to rise by nearly ten percentage points.[74]

*Curtailing Future Tax Increases*

In a move to ease the future burden on British taxpayers, Parliament enacted the Social Security Amendments of 1986, which took effect in 1988 and lowered the SERPS replacement rate from 25 percent to 20 percent of the best 20 years of earnings. Although this reduction in the base calculation for the state pension was structurally significant, the impact was lessened because it did not affect any British worker retiring before the year 2000. Nonetheless, from the standpoint of future costs, the 1986 changes were significant. As Paul Johnson reports, "The Government Actuary estimated that the reforms to SERPS would cut future spending such that by 2033 the National Insurance Contribution rate could be three percentage points lower than it would otherwise have been." [75]

*Establishing Equity*

Under the original British state pension system, the official age of retirement was 65 for males and 60 for females. The Pensions Act of 1995, however, equalized the age of retirement at 65 for both men and women.[76] Women became eligible for a state pension at age 60 in 1940, a time in which most women were married and dependent, and when few had any independent opportunity to become eligible under British law for a government pension.[77] Today, however, British women account for almost half the workforce, and—just as in the United States—changing conditions in the workplace, growing equality in the private sector, and the fact that women live longer than men have encouraged a change in the law.[78]

This simple change will ease demographic pressures on the pension system, reduce costs, and discourage both age and sex discrimination. Like other British reforms, the age equalization provisions are to be implemented gradually, with age of retirement increases in six-month increments to be phased in between 2010 and 2020. The government estimates that this change alone will save taxpayers £15 billion ($24 billion) by 2025.[79]

*Protecting Consumers*

The Pensions Act of 1995 also strengthened previous legislation and established a more comprehensive system of consumer protection for persons enrolled in occupational schemes, including:

- More rigorous disclosure of funds and assets;
- Greater accountability of fund managers to employees;
- A requirement that professional advisers report to plan trustees rather than to employers;
- A new solvency requirement for pension plans; and
- A compensation system to cover losses from fraud.[80]

The Pensions Compensation Board, a panel appointed by the secretary of state for social security, finances the compensation fund with a small levy on pension plans.[81] Oversight and enforcement of these rules is vested in the Occupational Pensions Regulatory Authority (OPRA), a government agency accountable to Parliament. OPRA can investigate problems in occupational pension plans, maintain a register of personal and occupational plans, secure information from pension plans, appoint or suspend trustees in troubled plans, institute proceedings, and impose civil monetary penalties for breaches of pension law.[82] Disputes between occupational pension fund trustees and employers and trustees of other pension plans can be settled by the pensions ombudsman, an independent agent created by Parliament in 1990, giving both employers and private pension plans an alternative to costly litigation.[83]

In the 1980s and early 1990s, there was insufficient protection of British consumers against fraud in private plans. Much of the impetus for recent regulatory reform was occasioned by the 1992 Maxwell Affair in which officers of a prominent publishing firm had misappropriated employees' pension funds.[84] There also was misrepresentation ("mis-selling") of personal pension plans. Too many British workers made bad investment decisions as a result of bad advice from unscrupulous salesmen.

The problem was not so acute for workers who opted out of SERPS and opened up a personal pension plan.[85] The major difficulties centered on those who switched from occupational pension plans, in which employers were making a substantial contribution to their employees' plans, to personal pension options without such employer contributions. Too many workers made these decisions without a full explanation of the financial consequences of moving from a company plan to a personal defined contribution plan.

## The Future of Pension Reform in Britain

The largely successful pension reforms of the 1980s have established the groundwork for the next stage of pension reform: more expansive private options for the next generation of British workers. Members of Parliament—whether Labor or Conservative, and despite partisan differences—are committed to more extensive pension reform.

### *The New Labor Government's Reform Agenda*

During the 1980s, Labor opposed the Conservative government's reforms in state pension system benefits, particularly those affecting SERPS, and criticized its regulation of personal pensions as inept. Although the new government has not unveiled a comprehensive reform agenda yet, the Labor Party is committed in principle to preserving the Basic State Pension as the foundation of the retirement system; it also opposes a means test for the basic pension and favors a sustainable second level of funded pensions, compatible with the demographic changes facing the country and based on a "high level of contributions." [86] Labor is not committed, however, to restoring SERPS to its original form.[87]

Most important, the new government has voiced no opposition to workers' contracting out of the state pension system and receiving a tax rebate on their national insurance contributions for doing so.

Broadly, Labor envisions a new system of funded pensions for people without occupational pensions based on competition among pension providers. According to Labor Party literature, funded pensions "are capable over time of producing the best returns each individual can achieve from their hard earned savings. They have the potential to give people a real sense of ownership—an identifiable stake in their own pension—which will generate the contribution needed for retirement security." [88] Labor has given the name "stakeholder pensions" to the second tier of pensions. Although formally committed to occupational pensions, it wants to make pension arrangements more understandable while promoting a variety of pension plans outside the standard financial services industry, including multi-employer plans and plans sponsored by employer and employee organizations, local Chambers of Commerce, and friendly societies.[89]

Labor is expected to retain personal pensions but also to regulate them more closely: "We want to make sure that the six million people who are currently in so-called appropriate personal pensions do not see so much of their hard-earned savings being eaten up in excessive costs and charges."[90] Pension policies also should promote long-term savings: "That is why we are developing plans for Individual Savings Accounts that would enable people to save for the medium and the long term."[91] Labor also is encouraging pension plans to offer life insurance to their members at competitive rates and promises to develop a "Citizenship Pension" for persons with low wages and uneven work experience.[92]

### *Conservative Pre-Election Proposals*

In March 1997, just before the general election, Secretary of State for Social Security Peter Lilley outlined the Conservatives' comprehensive plan for further restructuring the British state pension system.[93] According to reporters at the Financial Times, "The move would represent the most radical reform of the welfare state since world war two." [94] Significantly, noted Woodrow Wyatt of The Times, Labor's new minister of state for welfare reform was impressed with the basic idea: "Frank Field immediately recognized the virtues of Peter Lilley's plan for a gradual move into compulsory and properly funded private pension schemes." [95]

The Conservative proposal, targeting new workers in 2001, contains three elements:

- A new privatized basic pension to replace the government earnings-related pension. Every young person entering the workforce would be guaranteed a Basic State Pension. This pension would be funded out of the existing national insurance contributions (payroll tax), just as the current system is today, but would be run as a private plan, not as a government program. In value, it would be at least equal to the current Basic State Pension and indexed to prices, as the basic pension is today. The current SERPS component of the British pension system would be phased out.
- A tax rebate. Every young person entering the workforce would receive rebates. The size of the first—a rebate from national insurance contributions—would be determined by the calculations of the Government Actuary, an agency of the Department of Social Security, and indexed to inflation. Under the government's calculations, an initial rebate of £9 ($14.40) per week would be required to establish a basic pension. In addition, young people entering the workforce would receive a tax rebate

of 5 percent of their wages, which would go into the new privatized pension system. These rebates could be put into an occupational pension plan or a personal pension plan.

• A portable personal pension. All young people would have privately managed pension funds that they, not the state or their employers, would own. Under the projections of the Government Actuary, the initial rebate of £9 per week would be enough for the average wage earner to build up a fund worth £130,000 ($208,000) upon retirement, which would finance a tax-free pension of £175 ($280) per week at today's prices.[96] In any case, regardless of the performance of these plans, the government would underwrite them so that persons would be guaranteed payments equal to the current Basic State Pension.[97] According to The Times, the expanded provision of personal pensions

> will allow people to own the whole of their pensions, instead of trusting some future government to abide by its predecessors' promises. Everyone will have a visible stake in the economy—and their pensions should rise in line with economic growth instead of merely with inflation. Unless the economy collapses or pension funds are run by crooks, most people will be much better off in retirement. And the government's guarantee limits the risk.[98]

The Conservatives' proposed change in pension policy would bolster private investment, reduce the burdens of the government's own pension system, and stimulate economic growth. In adopting a universal compulsory savings proposal, Conservatives moved closer to Labor.[99]

Although criticizing the specific Conservative reform, Labor also is working on a set of reforms that would expand personal pensions.[100] There is interest within the Labor Party in enabling trade unions to sponsor and manage private pensions plans.

The British system has had its share of problems, and there are ample opportunities to make that system work better. Nevertheless, despite their partisan differences, officials have arrived at a broad consensus on pension policy. Says Dr. Ann Robinson, director general of the National Association of Pension Funds, "There seems to be general agreement that funded pensions are superior to pay as you go and that the benefit of such pensions should be more widely available, particularly to those individuals with lower incomes and less regular work records." [101]

Reality defines this new consensus. Today, British workers have a real choice: They can put all their payroll tax into a government-run pension, or they can use a portion of their payroll tax to earn higher returns on their private investments. Overwhelmingly, they have chosen the second course. Thus, Labor recognizes the popularity of existing private options and the recent legislation governing them. Reports Paul Johnson:

> While there remains disquiet on the left of the party, the leadership appears broadly content with the shape of the pensions legislation as it now stands. Such cross party agreement is of course important for the health of a policy on something as long term as pension provision.[102]

## Social Security: Similar Problems Require Similar Solutions

The 1997 Social Security Advisory Council report is a starting point for the emerging debate in the United States over what is needed to assure the long-term solvency of Social Security. But this not simply a quantitative issue. Congress also must focus on assuring both the quality of the retirement available to older Americans and an adequate income for the aged and for disabled American workers and dependent survivors of deceased workers. Although benefits for current pensioners and those near retirement age should be protected, today's demographic, economic, and political realities demand a full and fair debate on the kind and quality of pension options workers should carry into the next millennium.[103]

Like the British state pension program, Social Security is a system of pay-as-you-go financing in which current benefits are paid from current payroll taxes. Designed in the 1930s and amended over the years, the system has served its purpose but now is showing signs of financial weakness that require a basic review of its structure and method of financing. The British experience offers Congress strong lessons and strategies for success.

### *The Demographic Time Bomb*

The basic problem confronting Social Security is not disputed by anyone: The simple demographic reality is that the ratio of workers to retirees will have fallen from a ratio of 20:1 in 1950 (and 3:1 in 1990) to a ratio of 2:1 by about 2025 or 2030.

Congress should note that the British system also has undergone fiscal and demographic strains. As David Blake of the University of London's Pensions Institute has written, "It had been clear for several years that the financial structure of the national insurance scheme was unsound."[104] Although Britain's demographic pressures are not as heavy as those in other European countries, they have been a major factor in British entitlement reform and have served to drive the debate about overhauling the state pension system and expanding private pension options. Peter Lilley observes,

> When the Welfare State began there were five working people contributing to support one pensioner. By the year 2030, for every five working people there will be three pensioners. The only way to ensure decent pensions without burdening future taxpayers is through saving and investing to pay for pensions.[105]

For the United States, the rapid aging of the population has a relentless logic of its own, overrunning easy solutions and political quick fixes. In 1990, 21 percent of the U.S. population was 55 years old or older. By 2010, when the baby-boom generation begins to retire, that portion of the population will have grown to 25 percent. By 2030, it will have jumped to 30 percent. This problem is manageable, however, and strategies to cope with it can be hammered out over the next few years with time to spare. In effect, this is what the British have started to do, thus making their experience directly relevant to the solution of the difficulties in the United States. But political will is essential.

*The High Costs of Congressional Inaction*

For Americans, it is important to note that political paralysis carries with it an unacceptably high price. Specifically, if Congress and the Administration fail to reform Social Security, the country will face four overriding and continuing problems:

Problem #1: Heavy future tax increases on younger working families or lower benefits for retirees. Taxes are not keeping up with Social Security benefits, and current contribution rates will not—and cannot—sustain promised benefit levels. Based on the latest official estimates, benefit costs will exceed contributions within 15 years. By the year 2029, assuming that Social Security Trust Fund assets in government bonds are fully paid, the system will be unable to pay promised benefits. These estimates are from the middle range of the official trustees' reports, yet the situation could be worse. Based on recent experience, the time frames are likely to be shortened. As noted in Table 6, the trend in official projections of the depletion of the Social Security Trust Fund shows the year of exhaustion now progressively closer since 1983—the last time Congress addressed Social Security financing.

Likewise, the growing tax burden to sustain the entire British social security system,[106] including state pensions, was a driving factor in the enactment of reforms in the 1980s. Britain's state pension program has struggled, however, with ever-higher costs since 1946. By the early 1950s, the national insurance contributions were not enough to cover program costs; and by 1965, the costs of the state pension system were twice what British officials had predicted originally.[107]

The popular backlash during the 1970s against Labor's economic policies—policies that contributed simultaneously to high unemployment and high inflation—propelled the Conservatives, led by Margaret Thatcher, into power in 1979. The Conservatives started fashioning a social policy consistent with their pro-growth economic objectives, including changes in the state pension system and reductions in the tax burden on future generations.[108] Parliament's major initiative in this area, the Social Security Act of 1986, allowed expanded contracting out of the state pension scheme and effected a crucial change in the formula for government pension increases. The result: Britain now "stands almost alone in having no serious increase in future tax burdens predicted as a result of an aging population," in the words of Paul Johnson. "To some extent this reflects a rather less dramatic aging profile than that seen in most countries. But the most important aspect has been the determined way in which the government has bitten the bullet in recognizing possible future problems early on and tackling them in a radical and effective manner."[109]

Table 6

## U.S. Social Security Trust Fund Depletion: Current Estimates Have the System Going Bankrupt in 32 Years

| Year of Estimate | Projected Maximum Trust Fund Balance (Billions of Current Dollars) | Year Trust Fund Projected to Be Depleted | Present Value of Tax Income Plus Current Fund Minus Obligations (Billions of Dollars) |
|---|---|---|---|
| 1983 | $20.75 | 2063 | $148.3 |
| 1984 | 18.393 | 2059 | 37.4 |
| 1985 | 11.955 | 2049 | -268.8 |
| 1986 | 12.739 | 2051 | -342.6 |
| 1987 | 12.411 | 2051 | -377.6 |
| 1988 | 11.838 | 2048 | -664 |
| 1989 | 11.930 | 2046 | -849.5 |
| 1990 | 9.233 | 2045 | -1,242.7 |
| 1991 | 8.02 | 2041 | -1,185.1 |
| 1992 | 5.535 | 2036 | -1,772.6 |
| 1993 | 4.923 | 2036 | -1,863.7 |
| 1994 | 2.976 | 2029 | -2,841.9 |
| 1995 | 3.275 | 2030 | -2,832.7 |
| 1996 | 2.829 | 2029 | -3,094.2 |
| 1997 | 2.834 | 2029 | |

**Note:** Data compiled by Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide, and a member of the Social Security Advisory Council, reprinted with permission.
**Sources:** 1983 to 1997 Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Social Security Administration, and the Office of the Actuary, Social Security Administration.

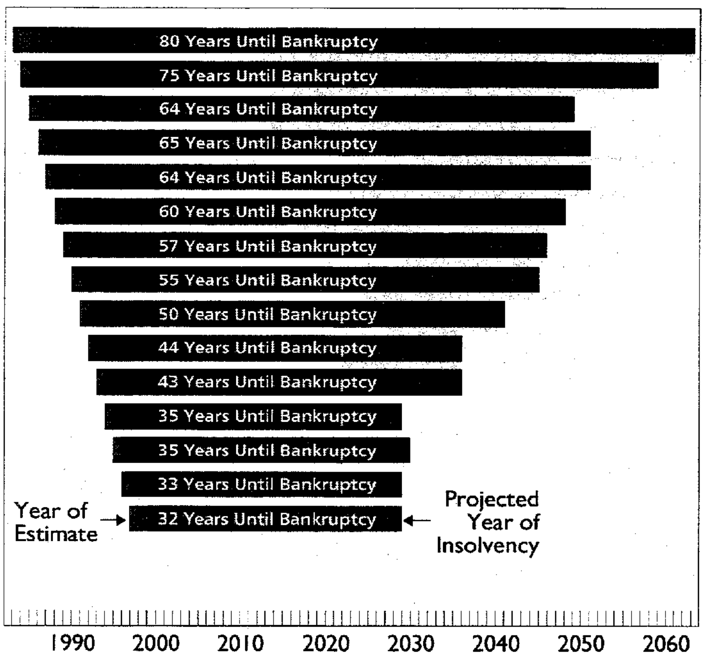
Not surprisingly, fiscal conservatism also guides the new Labor government in its approach to the pensions issue:

> Labour believes that pensions policy can only be secure and sustainable if it takes place within a framework of sound public finances. We are not proposing measures here which place any demands on the public purse that are not already envisaged in the published Public Expenditure Plan; but there is ample scope for making better use of taxpayers' resources already committed.[110]

As noted, the Conservatives have proposed a sweeping privatization of pensions that, if enacted, would save British taxpayers an estimated £40 billion ($64 billion) per year by 2040.[111] Thus far, Labor does not appear ready to reverse course and support big taxes on British citizens to shore up the old state pension system.[112] It remains to be seen exactly how the Labor government will continue the momentum toward private pension expansion.

Chart 3

**Life Expectancy of the U.S. Social Security Trust Fund: In the Past 15 Years, Estimates Have Dropped 34 Years**




**Note:** Data compiled by Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide, and a member of the Social Security Advisory Council, reprinted with permission.

**Sources:** 1983 to 1997 Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Social Security Administration, and the Office of the Actuary, Social Security Administration.

Problem #2: A decreasing rate of return for working families. American workers face a decreasing rate of return on contributions paid by workers as Social Security matures. The average American worker retiring at age 65 in 1950 received a real annual rate of return of about 20 percent on all taxes paid under the Federal Insurance Contributions Act (FICA), while workers retiring at age 65 in 2005 and beyond will receive a real annual rate of return of less than 2 percent.[113]

The situation is different for British workers, who can take a portion of their "payroll taxes" and opt out of SERPS. Well-established British private pension options already increase the rate of return on workers' investments. Annual real returns were nearly 9 percent during the 1980s,[114] and the trend is improving in the 1990s. Dr. Oonagh McDonald, fellow at the Center for Financial Services at the University of Leeds and a former Labor member of Parliament, notes that, between 1984 and 1993, the "real returns on UK pension funds were almost the highest in Europe with an average real return of 10.23 percent...with up to 80 percent invested in equities."[115] In Britain, company plans are not tightly restricted by the government with respect to the kinds of investment options available. In 1993, 27 percent of British pension funds were invested in overseas equities.[116]

The situation could be even better for future workers if the British government succeeds in expanding private investment opportunities. Projecting future income in U.S. dollars, the Conservatives' 1997 pension privatization proposal, as noted, would enable a British worker making average wages and paying in a minimum of contributions to accumulate a personal fund worth $208,000 upon retirement at age 65 and to secure a tax-free pension of $1,120 per month.[117] According to Peter Lilley, "If returns are 1 percent higher than assumed, [British workers] will get a pension nearly 30 percent above the basic pension. If the yield is 2 percent higher, the pension could be over 70 percent better."[118]

Problem #3: A further erosion of public confidence in Social Security. In the United States, there is a growing lack of confidence, especially among younger workers, in the assumption that Social Security will be able to pay promised benefits. A notable survey reveals that young Americans believe they are more likely to encounter alien spaceships than future payments from Social Security.[119] Although this may reflect a more general disillusion with the red tape of inept bureaucracy, it also is understandable that many Americans would like to remove their Social Security funds from the grasp of a politically driven and deficit-plagued Congress and Administration. Moreover, younger Americans increasingly want more control over how and where their pension savings are invested.

Problem #4: A lower standard of living for working and retired Americans. The United States cannot retain its high standard of living without a higher level of savings. There is growing recognition that the overall savings rate in the United States is too low. Failure to secure higher savings will guarantee a lower standard of living for too many of America's 77 million baby boomers and succeeding generations.

Even though Britain's savings rate is higher than that of the United States, and even though—because of its partially privatized pension system—it now has more funds for future retirement than any other European country, senior officials are still not satisfied. "The problem with state schemes is that they are pay as you go," says Peter Lilley. "Nothing is saved or invested for the future. People may think their National Insurance Contributions are being saved in a fund to pay their pensions. In fact, what they put in goes straight out to the taxman."[120] Recent proposals to expand personal pensions, advanced by both Conservative and Labor spokesmen, are designed to promote an even higher rate of savings and investment in the future.

## Twelve Lessons for the United States

The British have grappled successfully with the major problems that now plague the U.S. Social Security system, particularly the fiscal pressures that accompany an aging population. Roderick Nye argues that "Britain is not alone in facing this demographic and fiscal time bomb, but it may have made the greatest strides in addressing the problem."[121] John Blundell of the Institute for Economic Affairs notes that "For a large part, older Britons are not a financial burden on the next generations. They have saved through various market instruments. They are in this sense quite different from their continental counterparts."[122]

Congress and the Administration can learn at least 12 key lessons from Britain's very productive political and economic experience:

Lesson #1: Don't underestimate either the appeal of freedom of choice or the popularity of personal pension investments. When the British government gave workers the chance and the tax relief to opt out of one part of the government pension system in favor of alternative private plans, it was not clear how many would take advantage of the option. It proved to be vastly more popular than anyone—even optimistic proponents of the policy—ever imagined.[123] Congress therefore should not underestimate the popularity of a Social Security reform program that would let individuals and families own and control their own money and their own future retirement. Many Americans, wrestling with an outdated federal tax code that penalizes savings and investment,[124] already are trying to plan safely for retirement. From 1984 to 1993, the number of employment-based 401(k) plans alone jumped from 17,000 to 154,000.[125] Today, 43 percent of adult Americans own stocks; more than 50 percent of investors are below age 50; almost half of these are women; and most have incomes between $40,000 and $100,000 per year.[126]

Lesson #2: Combining a flat pay-as-you-go defined benefits program with a fully funded set of private options can work more effectively for workers and retirees than a one-tier system. The British have a flat-rate Basic State Pension with a mandatory "additional" second tier that includes funded private options. The second tier thus offers the opportunity to opt out of the state pension system into either a funded defined benefit plan or a defined contribution private pension plan. The British experience, especially since 1988, shows that such a system can function more effectively than the standard single-tier, pay-as-you-go system and give workers superior benefits with a lower unfunded government liability. It also presents Congress with a solid basis for developing the proper administrative framework needed to construct a new program that combines defined benefit and defined contribution elements.

By initiating a similar reform of Social Security, Congress can help alleviate the inevitable fiscal pressures caused by the retirement of America's 77 million baby boomers—men and women who will begin to reach retirement age in 2010. By mandating a funded second tier, the British government has partially funded the pension benefits for Britain's baby boomers and is preparing new proposals to fully fund the benefits of the next generation of workers. The Conservatives' 1997 plan not only would increase private pension funding, but also would simplify the process for contracting out for private plans and allow a greater variety of contracted-out private plans as long as they pass a government quality test.

Lesson #3: In any structural reform of Social Security, make sure to protect current beneficiaries, proceed carefully, and frame policies for a more prosperous future. Careful review of the British experience—including the rationale behind the most recent proposals to expand private pension options—will show Congress how to make the proper changes. For example, in making specific adjustments in the existing government pension system in the 1980s and 1990s, such as cutting back on the generosity of SERPS or equalizing the age of retirement, Parliament took pains to make sure that changes would affect future workers and retirees and that current beneficiaries or workers remained largely insulated from their effects.

Although cutting back on the state pension system, Parliament established a superior alternative for British workers, enabling them to receive tax rebates and contract out into private company plans or open personal pension plans with higher rates of return and the likelihood of higher retirement income. Between 1988 and 1992, Parliament further encouraged individuals to open up personal pensions with an incentive rebate of 2 percent and tax relief for contributions to such funds. This made personal pension options a good deal for ordinary workers. As Frank Field has written, "While it would be foolish to idealize private pensions as the answer to all our problems, they have been unique in their ability to provide generous pensions for a lucky and growing proportion of the population."[127] By doing it right—proceeding carefully, protecting current beneficiaries, and establishing guarantees for current workers—Congress also can avoid the need to make extensive revisions several years down the road.

Lesson #4: Don't let the problem of transition costs delay change; be candid about the costs and spell them out. Personal freedom is not without cost, and moving from a government social insurance system to a pension system that is either partially or fully privatized inevitably will incur a transition cost: The younger generation taking advantage of private pension options will pay not only for its own retirement, but also—through taxation—for that of the older generation. If the goal of reform is to move to a superior Social Security system, it is essential that the issue of transition costs be faced honestly.[128] They will have to be paid in any case, and officials should ensure their credibility and enhance the public debate by being clear about the actual costs of change.

Once again, the British example is worth emulating. The movement to personal pension plans, for example, is costing British taxpayers an estimated £3 billion ($4.8 billion) annually, but the transition is projected to reduce the country's future pension liabilities.

The crucial groundwork for even larger future savings was established by the significant pension reforms of the 1980s. In promoting a further expansion of private options in 1997, Peter Lilley has outlined clearly how the full transition to private pension options—phased in over a generation—is to be financed. First, all young people entering the British workforce would continue to pay national insurance contributions to the state pension system, but they also would receive a rebate of £9 ($14.40) per week, indexed to inflation, and a rebate of 5 percent of any earnings paid into the National Insurance Fund that they have allocated to their personal pension funds. Second, the tax treatment of personal pension contributions would be changed; contributions to personal pensions would become taxable income, thus raising an additional £8 billion ($12.8 billion) in revenue per year. Future pension income would be tax-free. According to Lilley, "The proposed changes in tax timing, combined with the gradual phasing in of the new system, will make the impact on public finances quite manageable."[129]

Lesson #5: Explain to taxpayers that there are great public as well as private benefits in moving toward a system based on private savings accounts. As the British experience indicates, there are solid financial opportunities for workers and retirees in moving toward a privatized system. But there are great public benefits as well. For example, the latest Conservative proposal for phasing out SERPS in favor of more private pension plans would result eventually in savings to British taxpayers of £40 billion ($64 billion) per year.[130] Labor's Frank Field argues that a universal system of private pensions would reduce the need for welfare and thus cut welfare costs: "the universal nature of personal private pensions would lift the great majority of pensioners free from dependence on state support."[131] On balance, such public and private opportunities clearly outweigh the costs of staying in an unreformed system financed by higher taxes and plagued by ever lower rates of return on those taxes.

Lesson #6: Clarify the amount of basic pension in a two-tiered system and give careful consideration to the desirable degree of redistribution. The British system, by establishing a funded tier of private pensions, limits the intergenerational transfers from young workers to old retirees in that current workers are required to save ahead for their pension benefits. These benefits will be affected at least somewhat by these savings and the investment income they produce. The current U.S. system provides for redistribution between higher and lower wage earners (based on the weighted benefit formula)[132] and between generations (based on the inflation-indexed pay-as-you-go scheme). If Congress changes Social Security to a two-tiered system, the amount of the basic pension and the method for indexing should be calibrated with great care.

Even though the partial privatization of the British state pension system enjoys broad support, some critics are concerned that the Basic State Pension has become too low. The flat benefit structure allows for the maximum redistribution between high and low wage earners, but if it is set too low, it can become a problem if pensioners receiving only the basic pension fall below the poverty level. Paul Johnson observes,

> The advent of Personal Pensions has provided a new pensions savings instrument for millions of previously uncovered people. If we believe people have the right to make choices then we have to accept that they will sometimes make the wrong choices. With an adequate social safety net they can be protected from the worst of them. But it is important not to lose sight of the importance of providing that safety net."[133]

Another inescapable issue in designing a first tier of government benefits is the eligibility criteria for the basic pension. If earnings over the normal working life are required for eligibility, as in the British system, then it seems that the basic pension should be set to provide a reasonable floor of retirement above the poverty level. If a universal minimum income for the elderly is to be provided regardless of work or contribution history, this floor logically might be set at a lower level, although the formal provision of a second-tier pension or means-tested welfare benefits will still be necessary.

Lesson #7: Realize that covering low-income or part-time workers with a defined contribution system of personal pensions may not be easy. Yet another inevitable difficulty is how to address the problem of an entire class of part-time or low-paid employees who move in and out of the workforce. These persons do not earn enough to invest significantly in private equity funds or stocks. Moreover, according to Andrew Dilnot, director of the Institute for Fiscal Studies, most private-sector fund managers in Britain show little enthusiasm in marketing to these people.[134] Considering the special characteristics of this sector of the workforce, Congress might wish to consider a privately managed defined benefit plan with investments in safer government securities or limited stock options.

Lesson #8: Realize that Social Security represents only one aspect of the current income transfer from young working persons to older retired persons. In any reform of Social Security, the legal relationship between financing and benefits in both Social Security and Medicare must be taken into account.[135] Today, for every $1 paid into the Medicare program by the elderly, young working families pay roughly $5 in payroll taxes and general revenues. If the considerable intergenerational transfer of funds from younger workers to older retirees is to remain through the current Medicare program, this transfer should be a factor in calculating the amount of intergenerational transfer in the Social Security pension benefits system.

Lesson #9: Understand that establishing a tier of mandatory savings in a national pension system can improve the overall savings rate of the economy. In the first quarter of 1997, the personal savings rate in the United States was 5.1 percent.[136] Britain does much better: about twice the rate in the United States. In addition, the personal savings rate in Britain has changed very little during the past 15 years: It was 11.8 percent in March 1982 and 11.7 percent in September 1996, and ranged from a low of 5.4 percent in 1988 to a high of 12.9 percent in 1982.[137] In contrast, the savings rate of Americans has been on a general downward slope over the past 15 years: It was 8.5 percent in March 1982 and 5.2 percent in September 1996, and ranged from a high of 9.3 percent in June 1982 to a low of 2.8 percent in March 1994.[138]

Meanwhile, the relentless amassing of private pension funds has given Britain broader opportunities for economic growth. The buildup has been impressive. In 1970, for example, pension assets in both Britain and the United States amounted to 17 percent of GDP. By 1985, Britain had surpassed the United States with assets at 47 percent of GDP compared with 37 percent for the U.S. By 1990, British pension funds had reached 55 percent of GDP, compared with 43 percent for the United States.[139] Over the past several years, the size of the British pension pool has been growing rapidly. Between 1980 and 1988, real annual growth in pension fund assets averaged 13.3 percent, compared to 8.8 percent for the United States.[140] Today, with a working population of slightly less than 23 million people, Britain has amassed more than $1 trillion in pension reserves—a stunning achievement and more than the rest of the European Union combined. As Field notes, "This gives Britain a head start in terms of personal savings that in turn will pave the way for higher investment." [141]

The size of the British funds represents only a fraction of private pension assets in the United States; the U.S. workforce—producing 25 percent the world's gross national product—is well over 100 million. Yet despite its enormous size and productivity, the overall rate of savings among American workers remains a matter of genuine concern. Over the long term, Americans will have to increase both their personal savings and their domestic investment rates if the United States is to compete favorably in the global economy. Mandatory personal savings plans or funded pension schemes could help increase these ratios. Although broader economic considerations should not be the only factors pension designers weigh, they cannot and should not be ignored.

Lesson #10: Make sure that workers and retirees are protected against fraud, abuse, and the mismanagement of private pension funds, but don't over-regulate. Several problems in Britain could have been avoided or minimized with stronger disclosure rules and an effective oversight body. Frank Field also notes the need for commonsense rules: "Lots of these changes are simple consumer protection measures that place a duty on fund managers to disclose relevant information on fees, capital growth and leaving penalties in an agreed format." [142]

Too many British workers were hurt by unscrupulous salesmen who sold on a commission basis, exaggerated rates of return, promised levels of benefit that could not be realized, or failed to disclose the extent of their commissions or the administrative costs of their plans. The Securities and Investment Board, the senior regulatory agency for Britain's financial services industry, responded by changing its regulatory framework, establishing guidelines for marketing, requiring descriptions of plan offerings and administrative costs and commissions in plain language, and forcing companies to disclose accurate projections based on reasonable assumptions concerning investment yields. Even though effective government action has cleaned up the industry, these scandals initially soured the public on the private pension industry and led more than 500,000 citizens to seek compensation for losses from the British government.[143]

As part of any change in the U.S. Social Security system, Congress must decide on the ultimate goals for reform and then construct the appropriate regulatory and organizational framework to achieve those goals. If Members of Congress are serious about expanding the market in private pensions, they should not authorize federal micromanagement. The current regulatory regime in the United States is not the appropriate mechanism for securing the necessary safeguards for a new nationally mandated system of private savings plans. Even some British analysts fear that, in their well-intentioned effort to protect consumers, British officials may have overshot that objective. British tax policy governing pensions is far too complex, and the regulatory regime governing company pensions and private investments in Britain today is much too cumbersome. As Dr. Ann Robinson recommends,

> The Government must tackle the mass of regulation which surrounds the provision of occupational pensions. Of course, members require security, but does it really take hundreds of often incomprehensible regulations to insure that pensions are paid? The cost to employers is formidable and the complexity confuses employees.[144]

Professor David Simpson, economic adviser to Standard Life Assurance Company of the United Kingdom, argues that British regulatory authority should be more streamlined; that prescriptive regulation of the "selling process" should be replaced by careful monitoring of the industry and tough enforcement of fair trading laws; and that the government should be engaged in disseminating information on comparative plan performance to promote consumer awareness and foster competition.[145]

In this respect, Members of Congress would be wise to review the existing Federal Employees Health Benefits Program (FEHBP) for federal government employees, as well as the rules that govern the private investment options for federal employees in the Federal Employees Retirement System. The FEHBP, in particular, is an excellent example of a program with a high degree of personal choice and market competition that at the same time maintains effective, but not burdensome, rules to guard beneficiaries against fraud or mismanagement.[146] The general success of both these programs can restore public confidence in the federal government's capacity to administer competent, targeted regulation in similar public programs.

As a technical matter, with any move toward a privatized Social Security system, Congress will have to examine how new federal regulatory efforts can be meshed with existing institutions like the Pension Benefit Guaranty Corporation, a federal agency created by the Employee Retirement Income Security Act of 1974 to guarantee payment of basic pension benefits earned by American workers.[147] Finally, Congress should consider what kind of federal re-insurance requirements or government guarantees should accompany any expansion of private or personal pension options under Social Security reform, just as the British government proposed in its 1997 pension reform package.

Lesson #11: Incorporate ways to give young workers the opportunity to set up personalized pension accounts that can rebuild their confidence in Social Security. The erosion of confidence in Social Security among Americans is indisputable. Part of the reason surely is that Americans in general have lost confidence in the federal government.[148] Personalized pension savings accounts, owned and controlled by workers and subject to reasonable regulation and market competition, would help to bridge this confidence gap. It therefore is crucial that Congress take great care in educating the public on the options available to them. Public confidence must be instilled in any government agency that is created to oversee and enforce compliance with regulations to protect the rights of the members of a privatized Social Security program. Otherwise, this regulatory effort will meet similar skepticism.

More important, the pre-funding of pensions obviates the need to depend on politicians' promises to pay future benefits. This becomes especially meaningful when the U.S. Treasury needs to begin paying off bonds to meet the need for Social Security benefits within the next 15 years.

While Congress and the President are working to bring the deficit under control, as promised, they should look for ways to insulate a large portion of Social Security funds from short-term political decisions. Legally protected private pensions that are gaining interest in personal accounts can reduce the anxieties of retirees over the historic inability of Congress and the President to meet their budgetary obligations under politically imposed time constraints.

Lesson #12: Recognize that personal pension options can give workers flexibility in deciding on the age of retirement. Almost all Social Security proposals call for increasing the normal retirement age, but such changes are proposed despite a glaring inconsistency: Even though the retirement age in the U.S. system is scheduled to increase gradually from 65 to 67 as a result of the 1983 Social Security amendments, American workers continue to retire earlier each year. Although this trend has slowed during the past ten years, the age at which retirees take their first Social Security old age pension has been on a downward slope since the 1940s.[149]

Once again, Britain has experienced a similar pattern. Over the past several years, there has been a reduction in the number of men over age 55 in the workforce. The prevalence of defined benefit pension plans, based on final salary, is a contributing factor, for these plans become progressively richer as the years pass. Employers, to ease the company burden, encourage employees to take early retirement.[150] As David Willetts, a member of Parliament, has argued,

> This is a dangerous absurdity. Society might be able to handle the relatively modest and gradual increase in life expectancy. The strains, however, become serious if at the same time as life expectancy is increasing people leave the workforce when they are younger and younger. The de facto retirement age for men is rapidly moving down into the mid–50s. But the right policy is for retirement age to move gradually back upwards into the mid–60s and beyond.[151]

As Willetts points out, in the British case at least, this is a major economic benefit resulting from an expansion of personal pensions based on a defined contribution: "This is one of the most important yet least understood arguments in favor of encouraging personal pension ownership—it immediately creates an incentive for someone to stay on in work for as long as possible."[152]

It is, of course, not entirely clear what would occur if American workers had more control over their own retirement funds. Cultural factors, financial incentives, and behavioral changes all complicate retirement policy. Whether a larger number of older workers would choose to participate in the economy to a greater degree than is now the case because of today's complex retirement earnings test is a question that is not easily answered. But by allowing workers to contribute more to their own retirement accounts, Congress also might enable at least some of them to take early retirement or reduce their hours of work to accommodate their desired lifestyles. Or it might give them a powerful new incentive to change careers and work even longer, harnessing their wealth of experience and enhancing the productivity of the U.S. economy.

## CONCLUSION

The British experience with state pension reform offers Congress and the Clinton Administration useful guidelines for designing changes in the U.S. Social Security system. This is especially true of Britain's Social Security Act of 1986, which broadened the options for British workers to allow them to opt out of the State Earnings Related Pension Scheme and showed that government can move from a traditional social insurance system to a partially funded system of private pensions. Reflecting on their own national experience, the editors of The Times have noted that

> Britain has nothing like the "pensions time bomb" that some other European countries face. Because this country's demographics are more favorable, and the pension age for women is to be raised, we shall have a healthier ratio of workers to pensioners. Because the basic state pension has been linked to prices rather than earnings, it costs the state less. And because the British have saved more for their retirement in occupational and private pensions than the rest of the EU put together, the burden on the taxpayer will be smaller.[153]

Using the 1997 Social Security Advisory Council Report as a starting point for the national debate, Congress and the President have time to consider and model a variety of solutions to the problems currently plaguing the system in the United States. But they have no time to waste. The longer policymakers delay, the more the taxpayers must make up for the current unfunded liabilities in a shorter period of time. Educating the American people on the current Social Security program and honestly discussing its problems in forums and town hall meetings around the country will take some time, not only because of its complexity, but also because several myths surround the issue.

Coming to a national bipartisan consensus on the best approach to retirement in the 21st century, as well as developing a sound plan for transition to a new system, will take time. Any peripheral changes in the system, such as adjustments in the Consumer Price Index, should be based on their own merits, not tied inextricably to an agreement on future changes in the retirement program. Serious reform will tax the political imagination of both Democrats and Republicans. If Congress and the President make a genuine effort, however, systemic change could be in place before the year 2000. Meanwhile, Congress should avoid standard short-term political fixes at least until the overall framework for reform has been developed.

Britain has become a showcase of serious reform. The British have made mistakes and have scored impressive successes in changing their retirement system. Reformers in the United States can learn from both. Considering the strong cultural, linguistic, and historical ties between the United States and Britain, as well as their somewhat comparable demographic, fiscal, and political situations, Parliament's record can provide Congress with important lessons based on valuable insights. Perhaps best of all, Members of Congress and Members of Parliament can discuss these lessons face to face.

## APPENDIX

Further information on Britain's government pension system and private pension plans is available on the following World Wide Web addresses.

### BRITISH GOVERNMENT PENSION AGENCY LINKS

The Benefits Agency, which is responsible for paying state pension benefits: http://www.dss.gov.uk/ba/

The Contributions Agency, which is responsible for payment and recording of national insurance contributions: http://www.dss.gov.uk/ca/index.htm

The Department of Social Security, which administers Britain's social security system, for data and research on pension-related topics: http://www.dss.gov.uk/asd/index.htm

The Employers Charter, a code of conduct for Britain's government pension agency personnel in dealing with employers: http://www.open.gov.uk/charter/employ.htm

General government links to British and international government pension agencies: http://www.econ.bbk.ac.uk:80/pi/vl/govorg.html

The Inland Revenue, Britain's tax collection agency (the equivalent of the IRS), for information on pension topics: http://www.open.gov.uk/inrev/irhome.htm

The Securities and Investments Board, which is responsible for regulation of investment vehicles: http://www.sib.co.uk/

## PRIVATE PENSION PROVIDERS

The Association of Unit Trusts and Investment Plans: http://www.iii.co.uk/autif/facts/pep—pen/

Independent Advice Ltd., a commercial retirement advisory and planning service based in Britain: http://www.independent-advice.co.uk/ia/pensions.htm

Infoseek, a Web site offering a list of British pension firms: http://uk.infoseek.com/infosk/owa/pkg—search.p—cat—search?in—cat—id=474

Moneyworld, a financial magazine, for articles on private pensions and additional links: http://ww.moneyworld.co.uk/

Money Management, a weekly magazine covering Britain's private pension issues: http://www.fee.ifa.co.uk/

The National Association of Pension Funds Limited (NAPF), the main organization for companies involved in designing, operating, investing funds, and advising occupational pension plans in Britain: http://www.napf.co.uk

The Pensions Institute, Britain's most prominent pension research organization, based at Birkbeck College, University of London, for a list of private pension providers: http://www.econ.bbk.ac.uk:80/pi/vl/ppa.html

## POLICY AND RESEARCH INSTITUTES

The Adam Smith Institute, a private, independent economic policy institute that promotes market-based economic reform: http://www.cyberpoint.co.uk/asi/

The Institute for Fiscal Studies, a British think tank that publishes work on the British pension system: http://www1.ifs.org.uk/research/index.htm#Pensions

Pensions Virtual Library, which offers a large collection of links on pensions: http://www.econ.bbk.ac.uk:80/pi/vl/index.html

## ENDNOTES

1. The authors would like to thank several individuals in Britain who provided valuable information and comments, especially Dr. David Blake, The Pensions Institute, Birkbeck College, University of London; Peter Barnes, Department of Social Security; Bill Birmingham, National Association of Pension Funds Limited; Drs. Eamonn Butler and Madsen Pirie, Adam Smith Institute; Andrew Dilnot, Institute for Fiscal Studies; Daniel Finkelstein, Conservative Research Department; Dr. David Green, Institute for Economic Affairs; Bernard Jenkin, M.P.; and Roderick Nye, Social Market Foundation. The views and opinions expressed herein (and any errors) are those of the authors alone.

2. Communication from the Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Fund (Trustees' Report), House Doc. 105–72, 105th Cong., 1st Sess., April 24, 1997, pp. 28–29.

3. Peter Lilley, Secretary of State for Social Security, press statement, March 5, 1997, p. 1.

4. For a discussion of this issue, see Stuart M. Butler, "A Consumer's Checklist for Social Security Reform Plans," Heritage Foundation F.Y.I. No. 141, April 29, 1997; see also Daniel J. Mitchell, "Creating a Better Social Security System for America," Heritage Foundation Backgrounder No. 1109, April 23, 1997.

5. Andrew Dilnot, Richard Disney, Paul Johnson, and Edward Whitehouse, Pensions Policy in the UK: An Economic Analysis (London: Institute for Fiscal Studies, 1994), p. 9.

6. Personal communication from Sharon White, First Secretary of Economic Affairs, British Embassy, April 13, 1997. On the popularity of contracting out, see remarks of Iain Duncan-Smith, M.P., in The Daily Mail, April 13, 1994, p. 8.

7. Roderick Nye, "Pension Reform: Is Britain the Model?" The Financial Times (London), April 15, 1996, p. 16.

8. John Blundell, "The EMU Threat to Our Pensions," The 1996 Annual Newsletter of the European Union of Women, p. 4.

9. For a brief discussion of the Social Security Advisory Council report, see Robert E. Moffit, "Reforming Social Security: Understanding the Council's Proposals," Heritage Foundation F.Y.I. No. 128, January 24, 1997.

10. Although there was some general agreement regarding needed changes, there was not a consensus on any long-term solution.

11. "The best of the three plans proposed in January by a commission that examined Social Security recommended a British-like plan with a safety net of basic benefits and an additional private savings account program." "Retirement: Unthinkable Thoughts," The Florida Times Union (Jacksonville), March 17, 1997, p. A–18. Carolyn Weaver, a member of the Social Security Advisory Council and director of Social Security and Pension Studies at the American Enterprise Institute, dubbed Britain's achievement a "quiet revolution." For her account of the Advisory Council's privatization option, see Carolyn L. Weaver, "Creating a New Kind of Social Security," The American Enterprise, January/February 1997.

12. Chile's experience with privatization inspired the more dramatic 1997 British reform proposals. The most notable work on the success of the Chilean system is that of Dr. José; Piñera,

labor minister of Chile from 1978 to 1980. See José Piñera, "Empowering Workers: The Privatization of Social Security in Chile," Cato's Letters, No. 10 (1996). See also Peter Passel, "How Chile Farms out Nest Eggs; Can Its Private Pension Plan Offer Lessons to the US?" The New York Times, March 21, 1997, p. C 27.

13. Heritage Foundation analysts long have argued that the British experience is a fruitful source of wisdom on Social Security reform. See, for example, Peter Young, "Britain Improves Social Security: A Model for the U.S.," Heritage Foundation International Briefing, December 2, 1985.

14. Frank Field, Private Pensions for All: Squaring the Circle (London: The Fabian Society, 1993), p. 15.

15. Quoted in letter to the author from Roderick Nye, director of the Social Market Foundation, July 10, 1997. According to Nye, these observations were "based on the OECD Economics Department Working Paper No. 156, Ageing Populations, Pensions Systems and Government Budgets: How Do They Affect Saving? Published in 1995."

16. "The outstanding feature of the UK pension system is that, under current policies, public expenditure on pension provision will remain modest, compared with other industrial economies. For example, [International Monetary Fund analysts] Chand and Jaeger (1996) estimate the present value of the difference between the UK's public pension expenditure and revenue up to 2050 is 5 percent of GDP with existing policies and contribution rates. This compares with a ratio of 26 percent for the US and above 100 percent in Japan, Germany and France." Alan Budd and Nigel Campbell, The Roles of the Public and Private Sectors in the UK Pension System, Her Majesty's Treasury, at http://www.hm-treasury.gov.uk/pub/html/docs/misc/pensions.html.

17. The annual increase in the retail price index during that same period was 4.6 percent. Personal communication from Peter Barnes, Department of Social Security, April 2, 1997.

18. The WM Company, 1996 UK Pension Fund Industry Results, 1997.

19. Budd and Campbell, The Roles of the Public and Private Sectors in the UK Pension System.

20. Personal communication from Sharon White, op. cit.

21. Interview with Daniel Finkelstein, director, Conservative Research Department, British Conservative Party, London, March 6, 1997.

22. Paul Johnson, "Brown Is Just Starting, He'll Get Much Tougher," The Evening Standard, May 7, 1997, p. 18.

23. Jill Sherman, "Brown to Stay on Cautious Route," The Times (London), March 6, 1997, p. 9.

24. In 1909, prodded by Liberal Chancellor (later Prime Minister) David Lloyd George, the British government established a limited pension that provided a meager weekly sum for persons aged 70 years and older.

25. The postwar Labor initiative on government pensions was rooted in the work of Sir William Beveridge, a member of the Churchill Ministry whose 1942 report, Social Insurance and Allied Services, became the basis for the modern British state pension system.

26. These figures are for the fiscal year covering April 6, 1997, through April 5, 1998. The dollar equivalent is based on an exchange rate of $1.60 for the British pound, based on February 1997 data. The actual exchange rate on any given date is dependent on supply and demand for currencies in the foreign exchange markets.

27. Disability benefits in Britain are paid out of general revenues.

28. Social Security Department Report: The Government's Expenditure Plans 1997–1999, presented to Parliament by the Secretary of State for Social Security and Chief Secretary to the Treasury by Command of Her Majesty, March 1966, p. 8.

29. Paul Johnson, The Reform of Pensions in the UK, manuscript, Institute for Fiscal Studies, 1996, p. [2].

30. Steve Bee, Prudential Corporation, Presentation to the Committee on Social Security, House of Commons, February 1997, p. 3.

31. David Blake, Pension Schemes and Pension Funds in the United Kingdom (Oxford: Clarendon Press, 1995), p. 66.

32. In practice, SERPS payments are funded not only from payroll taxes, but also from general revenues.

33. Under the National Insurance Act of 1959, which took effect in 1961, private employers and employees were able to contract out of the State Graduated Retirement Pension Scheme, the "additional" state pension program that existed before SERPS was established in 1978. "About 4.5 million employees had been contracted out. These, nearly twice the number expected, included most public service and nationalized industry workers, and about a quarter of the employees who were members of private occupational schemes." Blake, Pension Schemes and Pension Funds, p. 15.

34. Social Security Department Report, p. 41.

35. There are higher tax-free contributions ranging from 20 percent to 27 percent for older workers from 51 to 74 years of age. Blake, Pension Schemes and Pension Funds, pp. 87–88.

36. In the British context, the word "scheme" does not connote anything sinister, as it would in American usage; it merely refers to a program or plan. SERPS is called a "contracted in" scheme.

37. Under the Pensions Act of 1995, effective in 1997, there will be new statutory standards governing the administration of occupational pensions, including pension payments and exchanging pensions for lump sums, and a new statutory standard for private pension plans. For an updated discussion of the process of "contracting out," see Pensions Act 1995: Contracting Out Made Simple (London: National Association of Pension Funds, 1997).

38. Blake, Pension Schemes and Pension Funds, p. 156.

39. Personal communication from Professor David Simpson, economic adviser to Standard Life Assurance Company of the United Kingdom, February 28, 1997. The schemes were devised by

medieval guilds: "The first recorded occupational pension scheme was that of the Guild of St. James of Garlekhithe of London in 1375." Blake, Pension Schemes and Pension Funds, p. 27.

40. Johnson, The Reform of Pensions in the UK, p. [2].

41. Association of Consulting Actuaries, The Changing Face of UK Occupational Pensions in Smaller Companies, September 1996, p. 24.

42. State, Occupational and Personal Pension Arrangements in The United Kingdom (London: National Association of Pension Funds, 1997), pp. 8–9.

43. Reshaping Our Social Security System, Conservative Government Talking Points, March 1997, p. 22.

44. National Insurance Fund Long Term Financial Estimates: Report by the Government Actuary on the Third Quinquennial Review Under Section 137 of the Social Security Act of 1975, ordered by the House of Commons to be printed January 31, 1995, p. 30.

45. Blake, Pension Schemes and Pension Funds, p. 211.

46. Until 1996, a person enrolled in an appropriate personal pension could start using it between the ages of 50 and 75 but had to do so by purchasing an annuity. With the Pensions Act of 1995, new arrangements were set up for these pensions so that persons could "draw down" income from their fund and defer purchase of an annuity up to age 75. By allowing people to defer annuity purchases, current law enables them to get the best returns on their investment and avoid having to retire when annuity rates may be at historic lows.

47. Johnson, The Reform of Pensions in the UK, p. [12]. See also Richard Disney and Edward Whitehouse, The Personal Pensions Stampede (London: Institute for Fiscal Studies, 1992).

48. Department of Social Security, Personal Pension Statistics: 1994/95 (London: Crown Copyright, 1996), pp. 4–6.

49. "Personal pensions are much more attractive than other options for younger workers. SERPS is less generous to them, and contributions to a personal pension are more valuable because there is a longer time to retirement for investment returns to compound." Dilnot et al., Pensions Policy in the UK, p. 28.

50. Social Security Department Report, p. 45.

51. Blake, Pension Schemes and Pension Funds, p. 159.

52. Ibid., p. 162.

53. The Personal Investment Authority currently regulates about 4,000 firms providing personal pensions. David Simpson, Regulating Pensions: Too Many Rules, Too Little Competition (London: Institute of Economic Affairs, 1996), p. 30.

54. Employers are prohibited from contributing to these instruments.

55. "Britain in the USA," The British Media Review, September 28, 1995.

56. "Britain: Tomorrow's Pensioners," The Economist, March 8, 1997, p. 64.

57. Frank Field, "Working for Pensions That People Trust," The Daily Telegraph, March 6, 1997.

58. New Labour: Because Britain Deserves Better (London: Labor Party, 1997), p. 13.

59. Interview with Bernard Jenkin, M.P., Westminster, March 5, 1997.

60. "We in the UK can expect to see the smallest deterioration in our support ratio. We got old first." Peter Lilley, Winning the Welfare Debate (London: Social Market Foundation, 1995), p. 36.

61. Reshaping Our Social Security System, op. cit.

62. David Willetts, The Age of Entitlement (London: Social Market Foundation, 1993), p. 11.

63. Christopher Downs and Rosalind Stevens-Strohmann, Risk, Insurance and Welfare: The Changing Balance Between Public and Private Protection (London: Association of British Insurers, 1995).

64. Reshaping Our Social Security System, p. 3.

65. Ibid., p. 22.

66. Ibid.

67. Paul Johnson, Richard Disney, and Gary Stearns, Pensions 2000 and Beyond, Vol. 2 (London: Institute for Fiscal Studies, 1996), p. 53.

68. Alistair B. Cooke, The Campaign Guide 1994 (London: Conservative Central Office, 1994), p. 27.

69. Downs and Stevens-Strohmann, Risk, Insurance and Welfare, p. 63.

70. Ibid., p. 61.

71. "The success of the personal pensions has surprised the government. In 1988, the government estimated that at most 1.75 million people would leave SERPS and take out personal pensions. By the end of 1990, more than 4.5 million people had taken out personal pensions." Blake, Pension Schemes and Pension Funds, p. 253.

72. For a description of the demographics of Britain's occupational pensions, see ibid., pp. 99–110.

73. Reshaping Our Social Security System, p. 24.

74. Johnson, The Reform of Pensions in the UK, p. [5].

75. Ibid.

76. Another factor in the enactment of the equalization of age provision was a 1990 judgment by the European Court of Justice, a judicial body of the European Union, that males and females should be treated equally with respect to their pensions.

77. Under the state pension system, a married woman is eligible for 60 percent of her husband's basic retirement pension. A 1978 change in British law, the Home Responsibilities Act, reduced the number of years for persons (especially women) whose work opportunities were limited because of the need to care for dependents at home.

78. British women draw pensions, on average, nine years longer than men do.

79. Reshaping Our Social Security System, p. 27.

80. Today, the new compensation system will cover losses up to 90 percent in cases of fraud or bankruptcy. The Compensation Board is required to satisfy itself that there are "reasonable grounds" to believe there has been a "reduction in the scheme's assets due to an offense involv-

ing dishonesty." According to Barnes, "This is a less stringent test than that adopted in criminal cases. Action by the Board should not prejudice any separate criminal proceedings." Personal communication from Peter Barnes, op. cit.

81. For 1997 to 1998, the levy is £0.23 (roughly 37 cents) per plan member.

82. Personal communication from Peter Barnes, op. cit.

83. Ibid.

84. For an excellent summary of the Maxwell scandal, see Blake, Pension Schemes and Pension Funds, pp. 261–279.

85. According to Paul Johnson of the Institute for Fiscal Studies, two major studies of the problem showed that (1) more than 90 percent of workers opting out of the SERPS program to set up personal pensions were making rational economic decisions; and (2) they would "be at least as well off" with a personal pension plan as they would remaining in the government program. The difficulty took place in switching among private-sector plans: "The real problem of ill informed choices leading to undesirable outcomes has been among members of occupational schemes leaving their schemes in order to join personal pensions. The trouble is that in doing so they have lost their employer's contributions to the scheme. Only in rather special circumstances will this sacrifice be worthwhile." Johnson, The Reform of Pensions in the UK, p. [15].

86. "Security in Retirement," in Road to the Manifesto (London: Labor Party, 1996), p. 3.

87. Whatever the final shape of its future pension reform, Labor clearly is not going backward: "We have already suggested that SERPS could not easily or sustainably be rebuilt in its present form. New funded pension schemes could produce better returns for the same contribution level for many people." Ibid., p. 6.

88. Ibid., p. 3.

89. Ibid., p. 5.

90. Ibid., p. 4.

91. Ibid., p. 5.

93. Much of the inspiration for the Conservative proposal comes from the work of the Adam Smith Institute, a prominent free-market British think tank. For a thorough discussion of the privatization of Social Security programs, see Eamonn Butler and Madsen Pirie, The Fortune Account: The Successor to Social Welfare (London: Adam Smith Institute, 1995). See also Eamonn Butler and Matthew Young, A Fund for Life: Pension and Welfare Reform in Practice (London: Adam Smith Institute, 1996).

94. Robert Preston, James Blitz, and William Lewis, "Tories Plan to Privatize Pension Provision," Financial Times (London), March 6, 1997, p. 1.

95 Woodrow Wyatt, "Is Blair's Tory Party Up to It?" The Times (London), May 13, 1997.

96. Lilley press statement, p. 2.

97. Preston et al., "Tories Plan to Privatize Pension Provision," p. 28.

98. "The Pension Plan" (editorial), The Times (London), March 6, 1997, p. 19.

99. "Up until yesterday the Government rejected the idea of universalizing compulsory pension savings, saying that voters would see it as a tax increase. That argument is now truly dead and buried." Field, "Working for Pensions That People Trust," op. cit.

100. Philip Webster and Jill Sherman, "Tory Aim Is One Hundred Seventy Five Pound Tax Free Pension," The Times (London), March 6, 1997, p. 1.

101. Ann Robinson, "Labour Faces an Age Old Problem," The Parliamentary Monitor, May 1997, p. 7.

102. Johnson, The Reform of Pensions in the UK, p. [9].

103. The authors believe that the current focus for revision should be the Old Age Pension scheme. Even though the disability program has some serious problems, these programs should be considered separately; the present disability and survivor benefits and financing mechanisms should not be a part of this review.

104. Blake, Pension Schemes and Pension Funds, p. 13.

105. Lilley press statement, p. 1.

106. According to former secretary Lilley, 1997 British government spending on all social security benefits, including pensions, amounts to £93 billion, or approximately $149 billion in today's U.S. dollars. This costs every working person in Britain £15 ($24) per day. Reshaping Our Social Security System, p. 1.

107. Ibid., p. 3.

108. Daniel Finkelstein, "The System of Social Security in Great Britain," manuscript, September 28, 1995, p. 11.

109. Johnson, The Reform of Pensions in the UK, p. [7].

110. Road to the Manifesto, p. 2.

111. Lilley press statement, p. 3.

112. According to Roderick Nye, director of the Social Market Foundation, "Many of us fear dismantling chunks of the social safety net that we may one day rely on ourselves. But there is a growing disinclination to fund new entitlements or more claimants through increased taxes." Nye, "Why Lilley May Deserve a Statue," The Independent, February 2, 1996.

113. C. Eugene Steurle, Retooling Social Security for the 21st Century (Washington, D.C.: Urban Institute, 1994).

114. Blake, Pension Schemes and Pension Funds, p. 452.

115. Oonagh McDonald, The Future of Continental European Private Pension Funds and Their Impact on the Equity Markets (London: Apax Partners and Company, December 1996), p. 10.

116. Budd and Campbell, The Roles of the Public and Private Sectors, p. 13.

117. Projected in British currency, "An individual on average earnings would, after 44 years, have built up a pension fund from their 9 pounds plus 5 percent rebates amounting to 130,000 pounds at today's prices, using the Government Actuary's Department's assumptions, for example, assuming a four and a quarter percent real rate of return. A 1 percent higher rate of return

would increase the fund by about 30 percent." Basic Pensions Plus: A Technical Note, Conservative Government Talking Points, March 6, 1997, p. 4; see also Lilley press statement, p. 2.

118. Lilley press statement, p. 2.

119. "Social Security: The Credibility Gap," an analysis of a Third Millennium survey conducted by the Luntz Research Companies in conjunction with Mark Siegel and Associates, September 1994. The survey covered young adults from 18 to 34 years of age.

120. Lilley press statement, op. cit.

121. Nye, "Pension Reform: Is Britain the Model?"

122. Blundell, "The EMU Threat to Our Pensions."

123. Finkelstein interview, March 6, 1997; Jenkin interview, March 5, 1997; and interview with Andrew Dilnot, director of the Institute for Fiscal Studies, London, March 6, 1997.

124. For a description of the bias against savings in the complex U.S. federal tax code, see Mitchell, "Creating a Better Social Security System for America," p. 27.

125. "President Clinton Announces Pension Security Steps," press statement, Pension Benefit Guaranty Corporation, March 31, 1997, p. 1.

126. Donald Lambro, "Anemic Personal Savings Rate," The Washington Times, February 27, 1997.

127. Field, Private Pensions for All, p. 7.

128. Jenkin interview, March 5, 1997.

129. Lilley press statement, p. 3.

130. Ibid.

131. Field, Private Pensions for All, p. 14.

132. Under the current Social Security formula, low wage earners receive a 58 percent replacement rate (the percentage of covered pre return earnings); average wage earners receive a 42 percent replacement rate; and high wage earners receive a 28 percent replacement rate.

133. Johnson, The Reform of Pensions in the UK, p. [20].

134. Dilnot interview, March 6, 1997.

135. See Stanford G. Ross, Domestic Reforms: The Importance of Process (Washington, D.C.: Urban Institute, 1996).

136. "U.S. Economic Review," WEFA Econometrics, May 1997.

137. Data extracted from tables compiled by the Office of National Statistics in the United Kingdom and the U.S. Department of Commerce.

138. Ibid.

139. E. P. Davis, Pension Funds (Oxford: Oxford University Press, 1995), p. 55.

140. Ibid.

141. Field, Private Pensions for All, p. 16.

142. Ibid., p. 20.

143. Interview with David Green, Institute for Economic Affairs, London, March 6, 1997.

144. Robinson, "Labour Faces an Age Old Problem," op. cit.

145. Simpson, Regulating Pensions, pp. 81–82.

146. For an account of the Federal Employees Health Benefits Program, see Stuart M. Butler and Robert E. Moffit, "The FEHBP as a Model for a New Medicare Program," Health Affairs, Vol. 14, No. 4 (Winter 1995), pp. 47–61.

147. The Pension Benefit Guaranty Corporation insures the pensions of over 42 million workers in about 50,000 pension plans.

148. "Why Don't Americans Trust the Government?" The Washington Post/Kaiser Family Foundation/Harvard University Survey Project, 1996.

149. U.S. Social Security Administration, Annual Statistical Supplement, 1996, Table 6B5.

150. Willetts, The Age of Entitlement, p. 12.

151. Ibid.

152. Ibid.

153. "The Pension Plan," op. cit.