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SOCIAL SECURITY REFORM

Preliminary Lessons from Other Countries' Experiences

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Highlights

Highlights of GAO-05-810T, a report to Subcommittee on Social Security, Committee on Ways and Means, House of Representatives

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Why GAO Did This Study

Many countries, including the United States, are grappling with demographic change and its effect on their national pension systems. The number of workers for each retiree is falling in most developed countries, straining the finances of national pension programs, particularly where contributions from current workers fund payments to current beneficiaries—known as a "pay-as-you-go" (PAYG) system. Although demographic and economic challenges are less severe in the U.S. than in many other developed countries, projections show that the Social Security program faces a long-term financing problem. Because some countries have already undertaken national pension reform efforts to address demographic changes similar to those occurring in the U.S., we may draw lessons from their experiences.

The Chairman of the Subcommittee on Social Security of the House Committee on Ways and Means asked GAO to testify on preliminary results of ongoing work on lessons learned from other countries' experiences reforming national pension systems. GAO focuses on (1) adjustments to existing PAYG national pension programs, (2) the creation or reform of national pension reserve funds to partially pre-fund PAYG pension programs, and (3) reforms involving the creation of individual accounts.

www.gao.gov/cgi-bin/getrpt?GAO-05-810T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

Based on preliminary work, all countries in the Organisation for Economic Co-operation and Development (OECD), as well as Chile, have, to some extent, reformed their national pension systems, consistent with their different economic and political conditions. While reforms in one country may not be easily replicated in another, their experiences may nonetheless offer lessons for the U.S. Countries' experiences adjusting PAYG national pension programs highlight the importance of considering how modifications will affect the program's financial sustainability, its distribution of benefits, the incentives it creates, and public understanding of the new provisions. Nearly all of the countries we are studying reduced benefits, and most have also increased contributions, often by increasing statutory retirement ages. Countries included provisions to ensure adequate benefits for lower-income groups, though these can lessen incentives to work and save for retirement. Also, how well new provisions are implemented, administered, and explained to the public may affect the outcome of the reform.

Countries with national pension reserve funds designed to partially pre-fund PAYG pension programs provide lessons about the importance of early action and sound governance. Funds that have been in place for a long time provide significant reserves to strengthen the finances of national pension programs. Countries that insulate national reserve funds from being directed to meet other social and political objectives are better equipped to fulfill future pension commitments. In addition, regular disclosure of fund performance supports sound management and administration, and contributes to public education and oversight.

Countries that have adopted individual account programs—which may also help pre-fund future retirement income—offer lessons about financing the existing PAYG pension program as the accounts are established. Countries that have funded individual accounts by directing revenue away from the PAYG program while continuing to pay benefits to PAYG program retirees have expanded public debt, built up budget surpluses in advance, cut back or eliminated the PAYG programs, or some combination of these. Because no individual account program can entirely protect against investment risk, some countries have adopted individual accounts as a relatively small portion of their national pension system. Others set minimum rates of return or provide a minimum benefit, which may, however, limit investment diversification and individuals' returns. To mitigate high fees, which can erode small account balances, countries have capped fees, centralized the processing of transactions, or encouraged price competition. Although countries have attempted to educate individuals about reforms and how their choices may affect them, some studies indicate that many workers have limited knowledge about their retirement prospects.

Mr. Chairman and Members of the Subcommittee:

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

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

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

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

and interest group representatives. We conducted our review in accordance with generally accepted government auditing standards.

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

Background

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

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

- **Adjustments to existing pay-as-you-go systems**. Typically, these are designed to create a more sustainable program by increasing contributions or decreasing benefits, or both, while preserving the basic structure of the system. Measures include phasing in higher retirement ages, equalizing retirement ages across genders, and increasing the earnings period over which initial benefits are calculated. Some countries have created notional defined contribution (NDC) accounts for each worker, which tie benefits more closely to each worker's contributions and to factors such as the growth rate of the economy.

- **National pension reserve funds**. These are set up to partially pre-fund PAYG national pension programs. Governments commit to make regular transfers to these investment funds from, for example, budgetary surpluses. To the extent that these contribute to national saving, they reduce the need for future borrowing or large increases in contribution

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

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

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

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

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

Because each country is introducing reforms in a unique demographic, economic, and political context these factors will likely affect reform choices and outcomes. For instance, several European countries we are reviewing have strong occupation-based pension programs that contribute

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

to retirement income security. In addition, some countries had more generous national pensions and other programs supporting the elderly than others. All countries also provide benefits for survivors and the disabled; often these are funded separately from old age benefit programs. Some countries are carrying out reforms against a backdrop of broader national change. For example, Hungary and Poland were undergoing large political and economic transformations as they reformed their national pension systems. All of these issues should be considered when drawing lessons.

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

Table 1: Countries' National Pension Reforms

Groups of countries undertaking different types of reform[a]			
Only adjustments to PAYG	**Adjustments to PAYG and National Pension Fund**	**Adjustments to PAYG and Individual Accounts**	**All Three Types**
Austria	Belgium	Australia	Denmark
Czech Republic[b]	Canada	Chile[d]	Sweden
Italy	Finland	Hungary	Switzerland[g]
Germany[c]	France	Iceland[e]	
Turkey	Greece	Mexico	
	Ireland	Poland	
	Japan	Slovak Republic	
	Korea	UK[f]	
	Luxembourg		
	Netherlands		
	New Zealand		
	Portugal		
	Norway		
	Spain		
	U.S.		

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

[a]Member nations of the OECD and Chile.

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

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

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

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

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

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

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

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

PAYG Adjustments Prove Important to Financial Sustainability

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

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

- Increased years of earnings. To reduce initial benefits several countries increased the number of years of earnings they consider in calculating an average lifetime earnings level. France previously based its calculation on 10 years, but increased this to 25 years for its basic public program.

- Increased minimum years of contributions. Another approach is to increase the minimum number of years of contributions required to receive a full benefit. France increased the required number of years from 37.5 to 40 years. Belgium is increasing its minimum requirement for early retirement from 20 to 35 years.

- Changed formula for calculating benefits. Another approach to decreasing the initial benefit is to change the formula for adjusting prior years' earnings. Countries with traditional PAYG programs all make some adjustment to the nominal amount of wages earned previously to reflect changes in prices or wages over the intervening years. Although most of the countries we are studying use some kind of average wage index, others, including Belgium and France, have adopted the use of price indices. The choice of a wage or price index can have quite different effects depending on the rate at which wages increase in comparison to prices. We see variation in the extent to which wages outpace prices over time and among countries.

- Changed basis for determining year-to-year increases in benefits. In many of the countries we are studying, the rate at which monthly retirement benefits increase from year-to-year during retirement is based on increases in prices, which generally rise more slowly than earnings. Others, including Denmark, Ireland, Luxembourg, and the Netherlands, use increases in earnings or a combination of wage and price indices. Hungary, for example, changed from the use of a wage index to the Swiss method—an index weighted 50 percent on price changes and 50 percent on changes in earnings.

- Implemented provisions that provide a closer link between pension contributions and benefits. Countries that have adopted this approach stop promising a defined level of benefits and instead keep track of notional contributions into workers' NDC accounts. Unlike individual accounts, these notional defined accounts are not funded. Current contributions to the program continue to be used largely to pay benefits to current workers, while at the same time they are credited to individuals' notional accounts. When these programs include adjustments that link benefits to factors such as economic growth, longevity, and/or the ratio of workers to retirees, they may contribute to the financial sustainability of national pension systems.

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

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

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

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

In selecting between the many reform options, policy makers need to strike a careful balance among the following objectives: provide a safety net, contain costs, and maintain incentives to work and save. Costs can be high if a generous basic pension is provided to all eligible retirees regardless of their income. On the other hand, means-tested benefits can diminish incentives to work and save. The UK provides both a basic state pension and a means-tested pension credit. Concerned about the decline in the proportion of preretirement earnings provided by the basic state pension, some have advocated making it more generous. Others argue that focusing safety-net spending on those in need enables the government to alleviate pensioner poverty in a cost effective manner. However, a guaranteed minimum income could reduce some peoples' incentive to save. In view of this disincentive, the UK adopted an additional means-tested benefit that provides higher benefits for retirees near the minimum income level. This benefit, called the savings credit, allows low-income retirees near the minimum pension level to retain a portion of their additional income. However, any loss of income due to means-testing still diminishes incentives to save. Without changes to pension rules, the proportion of pensioners eligible for means-tested income is expected to increase to include almost 65 percent of retiree households by 2050.

Implementation, Administration, and Public Education Are Important

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

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

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

Early Action Matters

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

Effective Management Can Contribute to Financial Sustainability

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

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

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

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

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

Approach to Funding Individual Accounts Affects Sustainability of National Pension System

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

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

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

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

It is sometimes difficult for countries to predict their transition costs. In particular, countries that allow workers to opt in or out of individual account programs have had difficulty estimating costs. For example, Hungary and Poland experienced higher than anticipated enrollment from current workers in their individual account programs, leaving the existing PAYG program with less funding than planned. As a result, both countries had to make subsequent changes to their individual account and PAYG programs.

Balancing Opportunities to Realize High Returns and Benefit Adequacy Is Important

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

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

decisions, minimize voluntary contributions, or, as in the case of Australia where the minimum guarantee is means-tested, may spend down their retirement assets quickly.

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

Effective Regulation, Implementation, and Education Can Protect Individuals

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

Some countries' experiences highlighted weaknesses in regulations on how pension funds can market to individuals. The UK's and Poland's

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

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

Countries' individual account experiences reveal pitfalls to be avoided during implementation. For example, Hungary, Poland, and Sweden had difficulty getting their data management systems to run properly and continue to experience a substantial lag time in recording contributions to individuals' accounts. In addition, Hungary and Poland did not have an annuities market that offered the type of annuity required by legislation.

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

Concluding Observations

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

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

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

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

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

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

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