THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT: EXPERIENCES OF OTHER COUNTRIES

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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CONTENTS

THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT

THURSDAY, SEPTEMBER 18, 1997

House of Representatives,
Committee on Ways and Means,
Subcommittee on Social Security,
Washington, DC.

The Subcommittee met, pursuant to call, at 11:10 a.m., in room 1100, Rayburn House Office Building, Hon. Jim Bunning (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE CONTACT: (202) 225–9263
September 8, 1997
No. SS–10

Bunning Announces Sixth Hearing in Series on "The Future of Social Security for this Generation and the Next"

Congressman Jim Bunning (R–KY), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the sixth in a series of hearings on "The Future of Social Security for this Generation and the Next." At this hearing, the Subcommittee will examine the views of experts on the Social Security reform experiences of other countries. The hearing will take place on Thursday, September 18, 1997, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 11:00 a.m.

In view of the limited time available to hear witnesses, oral testimony will be from invited witnesses only. However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Subcommittee's first five hearings in the series have focused on the recommendations of the Advisory Council on Social Security, the fundamental issues to consider when evaluating options for Social Security reform, the findings of the 1997 Social Security Board of Trustees, and the views of policy experts, organizations with different generational perspectives, business and labor representatives, and Members of Congress on Social Security reform.

Forecasts of future insolvency of the Social Security program are largely due to the aging of the population, particularly the coming retirement of the post World War II baby boom. Most industrialized countries are experiencing problems similar to the United States. The effects on each country's retirement system, however, differ, depending on each country's stage of economic development, societal behavior, and cultural attitudes. Many of these countries have implemented reforms of their Social Security systems.

Social Security systems in other countries can be broadly categorized by distinguishing the method of financing between pay-as-you-go, financed mostly from current revenue and run by the government, and those that are funded in advance, which may be run by the government or the private sector. Other variations include degrees of income redistribution, government and private-sector responsibilities, benefits payable based on need or as a matter of right, and choice of alternative plans.

Remedies being enacted by other countries include raising the retirement age, making certain benefit reductions, mandating participation of workers who have remained outside the system, raising contribution rates, and establishing compulsory contributions paid to individual accounts in a national account managed by a public agency. In 1981, Chile fully replaced its public pay-as-you-go plan with privately and competitively managed mandatory personal savings plans. Recently, other Latin

American countries have begun replacing or supplementing their public pension schemes with mandatory or voluntary competitive private savings plans.

In announcing the hearing, Chairman Bunning stated: "The United States is not alone in facing the challenges of an aging population. We can learn a great deal from the experiences of other countries who have tackled needed changes in their Social Security systems."

FOCUS OF THE HEARING:

The Subcommittee will receive the views of experts on the Social Security reform experiences of other countries. Specifically, Members of the Subcommittee would like to hear the views of each individual regarding: (1) prevailing factors contributing to Social Security reform, (2) national budget and macro-economic effects of the reforms, (3) problems faced during the transition to the new Social Security system, including transition costs and how such costs were paid for, (4) the degree of individual risk and reward assumed, (5) the degree to which protections against inflation are contained in the new Social Security system, and (6) the degree to which features of the Social Security system are applicable to the United States situation.

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 at least six (6) single-space legal-size copies of their statement, along with an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format only, with their name, address, and hearing date noted on a label, by the close of business, Thursday, October 2, 1997, 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 Subcommittee on Social Security office, room B–316 Rayburn House Office Building, at least one hour before the hearing begins.

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 typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format. 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, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. 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.

Chairman BUNNING. The Subcommittee will come to order, please.

Today marks our sixth hearing in a series on the future of Social Security for this generation and the next. During this hearing, we will focus on Social Security reform experiences of other countries.

Forecasts of future insolvency of the U.S. Social Security Program are largely due to demographics, including aging baby boomers, declining birth rates and increased life expectancies. The United States is not alone in facing the challenges of an aging population. With few exceptions, life expectancies are increasing throughout the world.

The World Bank estimates the number of people age 60 and over around the world will triple between the year 1990 and the year 2030. However, the strain this places on the retirement systems differs depending on each country's economy, society, and culture. Most industrialized countries are experiencing similar solvency problems with their Social Security Programs.

Today, we will hear about the experiences of four foreign countries who have reformed their Social Security Programs. Each of these countries has implemented or is about to implement, varying degrees of privately managed personal savings accounts.

In 1981, Chile fully replaced its public pay-as-you-go plan with mandatory private accounts. The United Kingdom has allowed workers to partially opt out of the State plan in favor of private accounts. We will hear testimony from representatives of Chile and the United Kingdom today, along with representatives from Australia and Sweden. We can learn a great deal from the experiences of these countries who have tackled needed changes in their Social Security systems.

Each of these countries instituted change during economic and political environments that are not identical to the United States. However, we should listen carefully to their reasons for change, and closely consider the aspects of their reforms that could shed light on possible reforms of our own Social Security Program.

In addition to the representatives from the foreign countries, we will also hear from Social Security experts who will provide their own observations on what we can learn from these and other countries.

In the interest of time, it is our practice to dispense with opening statements, except from the Ranking Democrat Member. All Members are welcomed to submit statements for the record.

I yield to Congresswoman Kennelly for any statement she wishes to make.

Mrs. KENNELLY. Thank you, Mr. Chairman. Today, we review the Social Security reform experiences of several countries. Some of those countries face demographic and economic situations much like the United States. Others, like Chile, are developing social insurance systems along with new economic systems.

There are some important lessons to be learned from each of these countries. Those lessons are both positive and cautionary. Some of the countries we will hear from today have experienced significant economic growth and project long term increased national saving from their revised systems. But those same countries also provide cautionary lessons about the effects of privatizing some or all of our national retirement system.

Most countries that have adopted this approach have experienced excessively high administrative costs. Moreover, one country, Great Britain, has experienced significant consumer fraud and investor unhappiness with investment outcomes. No system has survived without revisions. We must review these lessons carefully and exercise care in implementing changes in our own retirement system.

I want to thank today's witnesses for appearing before us, and I look forward to hearing what they have to say. Thank you for coming.

Chairman BUNNING. We have a very distinguished panel of witnesses and I am going to introduce them, or try to. Some of the pronunciations might suffer a little bit, but I will try. Karl Scherman is president of the International Social Security Association in Sweden; Daniel Finkelstein is director of the Conservative Research Department for the Conservative Party of Britain's Policy Development and Briefing Unit in London; Dr. Teresa Ghilarducci, professor of economics at the University of Notre Dame; Dr. José Piñera, president of the International Center for Pension Reform in Santiago, Chile, and cochairman of the CATO Institute Project on Social Security Privatization; Stephen Kay, a doctoral candidate at UCLA; Paul O'Sullivan, Deputy Chief of Mission at the Australian Embassy, who will present the testimony of Anthony Blunn, Secretary of the Australian Commonwealth Department of Social Security; and Lou Enoff, an old friend, of Enoff Associates Limited, former Acting Commissioner of Social Security.

Mr. Scherman, if you would begin, please.

STATEMENT OF KARL GUSTAF SCHERMAN, PRESIDENT, INTERNATIONAL SOCIAL SECURITY ASSOCIATION, BROMMA, SWEDEN; AND FORMER DIRECTOR GENERAL, NATIONAL SOCIAL INSURANCE BOARD

Mr. SCHERMAN. Mr. Chairman, I am grateful for having been given the opportunity to address the Social Security Subcommittee of the Ways and Means Committee. This is the first time a president of the International Social Security Association has been invited to testify before this Subcommittee. This fact makes this event especially significant for me.

Sweden is at present considering a major public pension reform. Like today's system, the new one will be a compulsory national scheme. In addition to an earnings-related part, there will be a fairly high guarantee level for those who have not earned enough pension credits.

The earnings-related part of the scheme will contain a fully funded supplement. Two percentage points, out of a total contribution of 18.5 percent, will be set aside for this purpose.

To summarize, the reform will be designed to reduce the increase in pension spending; to more closely link contributions and benefits; to make pension spending as a percentage of GDP, gross domestic product, less sensitive to the rate of growth of the economy; and to make it possible to have a stable contribution rate in the future.

The reduction of the pension spending will be obtained primarily by three measures: The first one is a new benefit formula that will take all lifetime earnings into account. This will mean that everyone who does not work full time all his adult life, will get a lower pension than in the current system. For many persons, this will mean a fairly substantial reduction.

The second measure is a new indexation method, according to which the pensioners will be fully compensated for inflation only if the growth in the economy exceeds a certain level. Thus, the pensioners will be made to share with the active population the problems following a weak economic growth.

The third cost containment measure is that the amount of the old-age pension will depend on life expectancy. Thus, when life expectancy increases, there will be a built-in incentive to work longer, or to save more prior to retirement, or both, or to accept a lower yearly pension.

Another feature of the reform that will contribute to a stable contribution rate in the future is the use of a reserve fund in the pay-as-you-go system as a buffer for demographic fluctuations. These will be dealt with by letting the size of the fund fluctuate, instead of changing the contribution rate from time to time. There is presently a reserve in the current pay-as-you-go system that corresponds to 5½ years of pension payments. This reserve will slowly fall to about 1 year of payments around the year 2040, and then increase again.

In the new system, the fall in the current reserve fund will be compensated by accumulation of reserves in the premium reserve supplement to the earnings-related pension. There is today a heated debate in Sweden about this part of the new pension system.

Mr. Chairman, by way of concluding, I venture to share with you a few thoughts about our reform that I think might be of interest to you in your own reform process.

First, we might say that we face similar problems. Sweden is a mature postindustrial State with important social commitments, and we have realized that we have major problems. Our social insurance programs are neither financially stable nor adapted for encouraging continued work force participation for older workers.

Second, I want to say that an economically sound pension reform can be brought about without a total switch to a fully funded system by changing the benefit formula, indexing pensions to wages instead of prices, introducing demographic reserve funds, and adapting benefits to average life expectancy.

Last, although not absolutely necessary, it might also be worthwhile to switch a share of the earnings-related pension system into a fully funded scheme, thereby spreading the risks as much as possible.

Mr. Chairman, distinguished Members of the Subcommittee, I appreciate very much to have had this opportunity to share with you some thoughts about the Social Security reform efforts in my home country. Thank you for listening. I am prepared to answer any questions that you want to put to me.

[The prepared statement follows:]

Statement of Karl Gustaf Scherman, President, International Social Security Association, Bromma, Sweden; and Former Director General, National Social Insurance Board

I am grateful for having been given the opportunity to address the Social Security Subcommittee of the distinguished Ways and Means Committee. This is the first time a President of the International Social Security Association has been invited to testify before this important Subcommittee. This fact makes this event especially significant for me.

1. Introduction

Sweden is at present considering a major social security pension reform designed to: curtail rising pension spending; adjust pension benefits automatically for lengthening life expectancy;

1. more closely link contributions and benefits;
2. make pension spending as a percentage of GDP less sensitive to the rate of growth of the economy.

Pension reform is a major political challenge. The Swedish experience is that a condition for a successful reform is that it be designed in a non-political setting in a process in which all major political parties are participants and in which both practical politicians and technical experts can work together.

The reform process takes a long time and should be started without delay, once the need for reform is observed. Also, simply coming up with a new set of principles for handling retirement benefits is not likely to be sufficient. One needs also to have worked out how to make complementary changes in survivor and disability benefits before one can expect reform of retirement benefits to be finally adopted.

I am pleased to be able to share with you, distinguished Committee members, the Swedish experience from an arduous and complex reform process.

2. Prevailing factors contributing to Social Insurance reform in Sweden

2.1 An overview of the current system

All persons residing in Sweden are covered for certain benefits, the most important of which are: medical care, basic pension, child-allowance and parental benefit at a flat rate level. These are available on the sole basis of residing in Sweden and do not depend on the payment of any contributions. Persons with income from gainful employment (whether as employed or self-employed) are also covered for sickness cash benefit, supplementary pension, work injury and unemployment benefits and parental benefit at an income-related level. All schemes, apart from the medical care and child allowance, are in principle contributory.

To summarize, basic features are that the Swedish system is statutory, universal and based on residence, and that it is generally not means-tested but income-related.

Administration

The Social Insurance system in Sweden is administered by a Government agency, the National Social Insurance Board, through its regional and local agencies. The Ministry of Health and Social Affairs is responsible for legislative questions and policy questions at the political level. Unemployment benefits are under the Ministry of Labor administered by the Labor Market Board and Unemployment Insurance Funds. Medical care in general is a responsibility for the regional County Councils, while medical care for the elderly is provided by the local municipalities.

Costs and financing

The scope of the Swedish social insurance system as well as the insurance costs have increased markedly during the last three decades. The main reasons behind this development have been the implementation of new schemes, improvement of the benefits, and the maturing of the pension system that was introduced in 1960. An increasing unemployment has lately added to the rise in costs.

The total social insurance outlays (exclusive of unemployment benefits and administrative costs and expressed as a percentage of GDP) increased from about 7% of GDP in 1965 to a maximum of more than 20% in 1993. Since then the costs have decreased, and are expected to amount to around 18% of GDP in 1997. In addition to this public health care costs are estimated to correspond to about 8% of GDP.

Social insurance is financed mainly through employers' contributions and to some extent also through contributions from the insured persons themselves. Other sources of finance are allocations from the state budget and yields from accumulated capital in a reserve fund linked to the supplementary pension system. Public health care is financed mainly by local income taxes, levied by the County Councils and the municipalities. For 1997 the total employer's contribution to the social security is around 30% of the wage bill, and the employee's contribution is close to 6% of the wage up to a ceiling.

Costs for old-age, disability and survivors' benefits amount to about 28% of the wages. Contributions cover about 18.85 percentage points of this.

2.2 Problems in the economy

During the last few years the social insurance systems have been under debate in most parts of the world. A stagnating economy, high unemployment and a recent monetary crisis are phenomena that Sweden has in common with numerous industrialized countries. In the case of Sweden, the country entered a deep crisis in the beginning of the 1990's, both in the economy and in the society as a whole.

In this situation the social insurance system has come into focus. The size of the National Swedish Social Insurance System—around 20 per cent of the GDP—means that it is of greatest significance not only to the well-being of the individuals, but also to the economy as a whole.

Major changes and adaptations of some of the most important social insurance schemes have already been implemented and other changes are under consideration, the most essential one being a reform of the pension system after a decision in the parliament in 1994.

The Swedish economy now seems to recover, but still the fight against the effects of the crisis dominates the Government's policy.

2.3 Structural problems

The main structural problem with social insurance in Sweden is that there are no direct links between the state of the economy and the paying of benefits from the various schemes. The ability to pay is dependent upon the growth in the economy. With a low growth in the GDP, as Sweden has experienced lately, the burden on the working population gets heavier than if growth is high.

The pension system is the biggest part of social insurance and, there, the problems resulting from the lack of correspondence between growth in the economy and expenditures of the system are the most conspicuous. The current pension formula implies that the pension is raised in accordance with inflation, regardless of growth in the economy. Thus, when there is a low growth in the economy, then the pension cost as a percentage of GDP gets higher than when there is a high growth. To come to grips with these problems a completely new pension system has been designed. The principles were passed by the parliament in 1994. Five of the seven major political parties today representing about 80% of the electorate are committed to this change.

3. Pensions

3.1 The current pension system

3.1.1 Basic features

The current public pension system consists primarily of two parts, the flat rate basic pension and the earnings related supplementary pension. Included in the public pension system are also additional pension benefits, as well as housing supplements and partial retirement pensions.

Everyone who has lived in Sweden for at least 40 years, or has worked for at least 30 years, is entitled to an unreduced basic pension. The basic pension provides a single person with 96% of a base amount. Married persons receive 78.5% of the base amount. The base amount corresponds currently to about 5,000 USD. This basic pension is fairly high, taking into account the fact that those who have no other pension income get special supplements.

A person who has worked for at least 30 years is entitled to an unreduced supplementary pension. The pension is calculated on the basis of the average covered income during the 15 best years. The covered income is subject to a ceiling of about 35,000 USD at current exchange rates. Both pension credits earned and pensions paid out are increased with inflation.

The basic pension is financed partly out of general revenue and partly out of employers' contributions. The supplementary pension is financed by employers' contributions, based on the wage bill, without any ceiling. The supplementary pensions are based on the pay-as-you-go (PAYG) financial principle with a fairly large reserve fund.

3.1.2 Key problems in the current system

One problem is that there is an imbalance between the trends in revenues and in outlays. Pension payments are financed out of contributions, based on wages. Pension payments are indexed according to the consumer price index. If real wages increase, the burden of financing the pensions will be lower than if they do not. The increase in real wages has significantly slackened since the 1950's and the 1960's. As a consequence, the burden on the active population to finance the pension system is now heavier than in earlier decades.

Another problem concerns the portion of peoples' incomes that is covered. If real wages increase, the ceiling for pensionable income is successively lowered, relative to wages, since the ceiling is indexed according to prices.

A third problem is that pensioners live longer. In the year 2000 there will be 30 old-age pensioners for every 100 economically active persons. 25 years later this number will have increased to 41.

Other problems include unemployment. During the period 1990–1993 the cost of old-age, disability and survivors' pensions rose dramatically, from 24.5% to about 30% of the contribution base, to a large part due to unemployment eroding the contribution base.

The link between an individual's income, contributions and benefits is weak. The national supplementary pension scheme favors those who have had an uneven flow of income, or who have worked a limited period during their active years.

Many people receive only a small pension in proportion to their work in comparison to those who have not worked at all or for very short periods, due to various basic pension supplements to those who have not accrued pension credits for an income related pension.

Savings: The national supplementary pension scheme no longer contributes to savings to any significant extent.

The first three problems mentioned above are the most important ones. I will discuss them below. First, however, let me describe the new pension system.

3.2 The new system for public pensions in Sweden

Main differences between the current pension system and the new one are that the old system bases benefits on only the years of highest earnings, whereas the new bases benefits on the full career, that the old is indexed to prices and the new to wages, that the old system does not adjusts benefits for changes in life expectancy, whereas the new one does. The current basic pensions will be abolished. In the new system they will be replaced by a fairly high minimum guaranteed level for low-income earners.

3.2.1 Basic Features

Like today's system, the new one is a compulsory national scheme. In addition to an earnings related part there will be a guarantee level for those who have not earned enough pension credits. For an old-age pensioner who is not entitled to an earnings-related pension, the guarantee level will be approximately equal to the amount required for a minimum standard of living. The guarantee-level will be price-indexed.

Child care, military service and studies after a certain age will count toward pension rights in a similar way as gainful employment.

The ceiling for pensionable income will be indexed according to wages, not as today according to prices. The same ceiling will be introduced for contributions payable by the employees.

The earnings related part of the scheme will contain a fully funded supplement. This new premium reserve pension scheme will be administered separately from the pay-as-you-go system and insurance alternatives will be offered to the public. Pensions from this part of the system will be based on financial investments and their return.

The pay-as-you-go part of the earnings-related pension will have the following characteristics:

- The coverage will be related to all lifetime earnings.
- Acquired pension credits will be indexed according to wages.
- The pension amount will be dependent upon the cohort's average life expectancy upon retirement after age 61.
- Pension benefits will be indexed in relation to wages.
- The retirement age for an individual will be flexible after age 61.
- There will continue to be a reserve fund in the PAYG system, serving as a cushion for demographic fluctuations.

3.2.2 Specific aspects of the new system

Contributions to the new system

The reform will link the benefits more closely to the workers' contributions, both in the calculations and in the optics of how the contributions are collected. In the future system a fixed contribution of 18.5 per cent of the individual's yearly earnings are to be paid into the pension system. Contrary to the present situation, where the employer pays the entire contribution, half of the future contribution will be paid by the insured persons themselves and the other half by their employers. The former part of the contribution will be subject to a ceiling.

Out of the total contribution 2 percentage points will be set aside for the fully funded pension system.

Contributions will be credited to individual notional accounts and indexed to wage growth

Earnings, hence contributions, over the lifetime of work starting at age 16, will be used for calculating the pension. Instead of recording earnings as today and index them to prices, contributions will be credited to individual notional accounts, and indexed in accordance with the growth of wages. The contribution total will be continuously updated each year to reflect wage increases (just as a savings account balance rises to reflect interest earnings).

This indexation can be regarded as a kind of "interest" on the contributions paid. If there is an increase in the real wages in society, the value of the pension credits will increase as well, and if there is a decline in the level of real wages, the pension credits will decrease accordingly.

The coverage will be related to lifetime earnings

All lifetime earnings (measured by the contributions paid) will be taken into account. This is a radical shift from the current system, in which only 30 years with pensionable income are needed for a full pension, which is then calculated on the basis of the 15 best. To earn a pension with a 60% replacement rate in the new system, 42 years of participation with a wage that increases with the average for the economy will be required. Earnings used as a basis for calculating the pension amount are subject to the same ceiling as the contributions paid by the employees. The ceiling is approximately 50% above the average wage level for an industrial worker in full-time employment.

In this context it might be well worth pointing out that the fact that the size of the pensions is based on lifetime earnings comprises a radical change of focus for what is considered socially acceptable. The risk for an inadequate benefit level stemming from an uneven flow of incomes over a lifetime will be switched from the state to the individual.

The amount of the old-age pension will depend on life expectancy

At retirement, accrued pension capital (the contributions indexed to the rate of growth of wages) will be divided by a figure, based primarily on average life expectancy at the time of retirement and a "norm" real rate of return.

This rule means that as life expectancy increases, there is a built in incentive to work longer or to save more prior to retirement or both or to accept a lower yearly pension.

Pension benefits will reflect wage growth

The "norm" real rate of return used to compute the annuity will be 1.5%. If real wages increase as much as the norm, the outgoing pensions will be adjusted exactly by the inflation rate. If, however, the growth in real wages turns out to be less than the norm, full compensation for inflation will not be paid. If, on the other hand, wages increase more than the norm, the pensioners will share in the rising standard of living.

The result of the method used for indexing outgoing pension is that there will be no guarantee that the pensioners will be fully compensated for inflation. This is one of the key features of the reform, whereby the pensioners are made to share with the active population the problems following a weak economic growth.

Flexible retirement age

Starting in the year 2001, the regulations concerning flexibility in retirement age will be changed significantly. Everyone will, as today, be entitled to draw an old-age pension at age 61. The method for computing the pension will, however, be different. The later the pension is drawn, the higher the annual pension will be, in the new system due to more pension credits earned and a lower remaining life expectancy at the time of retirement. There will not be any upper age limit for this recalculation.

Reserve fund

A reserve in the PAYG-system will play a vital role as a cushion for demographic fluctuations. In times when the number of pensioners is high compared to the size of the working population, contributions for a strict PAYG-system must be increased, compared to times when there are fewer pensioners. These variations are dealt with by letting the size of the fund fluctuate.

There is presently a reserve in the current PAYG-system, that corresponds to five-and-a-half years of pension payments with the new system. This reserve will slowly fall to about one year around 2040 and then increase again as the ratio of workers to pensioners increases

3.2.3 The Transition

The new system is planned to start operating 2001. Changes in basic principles for old age pensions as radical as the ones described here cannot be introduced without a very long transition period. People have planned for their retirement on the assumption that pension promises will be fulfilled. And pension reform depends on general public support. Therefore, the new pension system will be introduced successively over a 20 year-period for persons born up to 1954. Persons born 1954 and later will be entirely in the new system.

4. National budget and macro-economic effects of the reform

4.1 Financial dependence on a high level of economic growth

This table shows that the contributions that the active part of the Swedish population has to pay to cover the pension costs in the current Swedish pension scheme vary strongly according to economic growth. Future old-age, disability and survivors' pension costs [1] (current scheme) as a percentage of the contribution base with different GDP growth levels.

	0%	1%	2%	3%
1990	22.5	22.5	22.5	22.5
2005	34.3	29.1	25.7	26.9
2025	49.2	33.6	23.8	17.4

With stable 1% growth in GDP, a contribution rate of roughly 34% will be necessary in 2025 to totally finance all old-age, disability and survivors' benefits. In the case with a stable growth of 2%, the contribution rate can be maintained at approximately its 1990 level, i.e. 23%.

We can not know for sure today what growth rate we will have in the future. What we know, however, is that we can afford the evolution of costs if we reach around 2% growth, since the cost profile at 2% growth, as just mentioned, does not rise above today's contribution level in the long run. This observation is the reason for the new indexation method for outgoing pensions described above. That indexation method will be applied even for existing pensions. This method has been called "flexible indexation."

[1] These are gross costs. Pension income is taxable income in Sweden. The average top rate for pensioners is about 30% of total income.

4.2 The ceiling

With continued economic growth, the earnings of most people will eventually be above today's ceiling in the pension system. This follows from the fact that the ceiling currently is price-indexed. With a yearly growth of 2%, a man born in 1980 will have reached an income level, equivalent to 12.7 base amounts during his 15 best years before retirement. A woman born in 1980 can expect to reach an income level of 9.1 base amounts with a continuous 2% growth. Thus, if the ceiling of the system continues to be indexed to prices and not to the real growth of wages, a normal supplementary pension will be a fixed amount, based on an income of 7.5 base amounts (approximately 35,000 USD at current exchange rate).

The ceiling strongly affects the financial pattern in the future. With the current ceiling, the contribution rate, needed to cover the expenses for pension purposes diminishes in the long run with a yearly growth in the economy of 2% or more. The diminution is due to the fact that an increasing part of the income of the working population does not give pension credits, while the contribution, according to the present regulations, is still being paid on their entire income, i.e. including the part of the income that is above the ceiling.

When, as the intention is in the new system, the ceiling will be indexed to the growth of average earnings, the system will provide the same relative benefit for tomorrow's generation as for today's.

4.3 Dependence on demographic fluctuations

The third key problem is that of the aging population and demographic fluctuatis. Contributions must be raised if average life expectancy increases, but also when the cohorts of new pensioners are growing for other reasons, for instance as a consequence of fluctuations around a general trend. This is the "baby-boom-problem."

The remedy for the first problem, a general trend to higher life expectancy figures, is quite simple; either higher contributions or an increase in the retirement age. The new system "solves" this problem by taking increased life expectancy into account in the benefit calculation. In practice, this could be expressed as an indexation of the retirement age to life expectancy.

In order to handle the fluctuations around a general trend it is proposed that resources from the pension funds should be used as a demographic cushion, which could be accomplished by letting the funds fluctuate. The fluctuations in the size of the funds will, consequently, be quite important. This is, however, unavoidable in a system in which one tries to stabilize contributions.

By the measures described here, i.e. linking the pensions to the growth of income, indexing the ceiling for pension carrying incomes, linking the pensionable age to life expectancy for each cohort and using the reserve fund as a demographic cushion, it will be possible to achieve a constant contribution rate for the Swedish pension system, in a fairly broad interval of different growth rates and various demographic fluctuation patterns, while retaining the basic PAYG-principle.

5. The reform process

The National Social Insurance Board is under the present law requested to submit to the Government every fifth year an analysis of the financial situation for the public pension system. Based on such analyses the Board suggests a contribution rate for the following seven years. In earlier years the Board restricted its work to a long term analysis of the development of the pension system as such. The scope of the analysis was, however, gradually broadened. The interconnection between the public pension system and the public economy in general was highlighted. It became clear that the pension system was financially unstable, as I have discussed above. This was pointed out by the Board already in the early 1980's. Only after a fairly prolonged timelag, the politicians and the general public came successively to realize that something must be done to counter this problem.

A special governmental commission was set up in the mid-eighties to study the pension system, its problems and possible remedies. The commission's conclusion was that as the problems would become acute only ten to fifteen years after the year 2000, nothing needed to be done for the time being.

The conclusion from the governmental commission was not correct. Namely, when financial problems in pension systems become acute, it is too late to cure them! This was realized by a new Government, and a new commission was appointed under the responsibility of the cabinet minister for social security at that time, Mr. Bo Könberg. Much of the analysis leading to the final proposal was produced by the National Social Insurance Board. This commission put forward its proposals early 1994 and they were accepted by a broad majority in the parliament in 1994.

The Swedish experience illustrates the need for interaction between experts and politicians. It has been essential for the result that the analysis has been performed and presented by a non-political authority. The questions are so technically complicated that the demand for expertise is great if there is to be a comprehensive basis for a well-prepared decision. It has given opportunities for debate on a technical and scientific level, and it has given opportunities to accustom people to the need to reform the pension system.

An important observation is that the complexity of the issues makes them hard to understand and, hence, accept by the ordinary citizen. In Sweden the Social Democratic Party, the party that is now in power, have given an extra year for consideration to get acceptance for the new reform by their members. Recently the parties behind the agreement once again agreed to fulfill what had been settled in the agreement of 1994.

New problems now seems to mount for the political process. There are many issues remaining, some of them of great political significance. It is not yet clear if they can be solved within the political alliance behind the 1994 decision. If this proves not to be the case, the whole reform might very well collapse. The danger for this is aggravated by the fact that the final decision must be made by the parliament next spring to avoid that this politically sensitive issue remains open over the election campaign before the September 1998 General Election.

6. Remaining issues to be solved

Disability and survivors' benefits still need to be changed

The new pension system comprises only the old-age pension system. Neither a new disability pension system, nor a new survivors' pensions system are yet decided upon. The consequence is that the politicians do not know of the overall financial framework for the new old-age pension system. Furthermore, this means that we still do not know how much will remain of the existing reserve fund for the new old-age system. Hence, the basis for calculations on the future of the new old-age pension system is weak.

There has been a strong criticism in the political debate against the fact that the whole new pension system has not been decided upon at the same occasion. Final decisions by the parliament on the remaining issues concerning the old-age pension system must now await the proposals regarding disability and survivors' pensions.

Indexation

The exact form for indexation has not yet been decided. Neither the growth norm, nor the exact formula that will be the basis for this indexation is constructed. As those who are experienced in actuarial analysis very well know, this means that a basic feature for the financial stability of the new system is not established.

Employee contributions

In the current system the employers pay all the contributions. The plan is to share the contribution between employers and employees equally. This has caused great political trouble, and there is yet no decision on how and when (and if) the change will be done.

The funded part of the new system

How the funded part of the new system will be constructed is not yet decided upon, it is not even investigated. There again substantial practical and political problems remain to be resolved.

Changes in the current system

The norm to be used to create financial stability vis & vis benefits earned under the old system remains to be decided. The same observation applies to the question of the retirement age in the current system.

The basic theory of the new system

The new Swedish model is neither a defined benefit system nor a defined contribution system. It is a completely new concept, which borrows features both from a traditional funded defined contribution system and from defined benefit systems.

The new Swedish model may, theoretically speaking, be constructed so as to be financially stable in all circumstances. In practice, taking political and social consequences into account, it will be stable within certain limits when it comes to levels of economic growth, demographic fluctuations, rates of inflation and so forth. A problem is that the flexibility of a traditional PAYG pension system is abolished. In the traditional PAYG systems it is possible to reduce benefits, increase contributions or raise the pensionable age in order to meet changes. In the new Swedish model these adjustments are meant either not to be made, or they are made automatically. Therefore, the system is more inflexible than the current one, when it comes to meet substantial changes in the environment. It is a weakness of the model that the basic features have not been analyzed, we do not know in what intervals for economic growth, inflation and demographic fluctuations the new model is really stable.

7. Problems faced during the transition, and how to cover transition costs

The transition to the new pension system has in reality not yet begun. Still, there are some observations to make on the subject.

7.1 The prolonged process

The reform process is arduous. Decision-makers themselves must understand the problem and then create acceptance for the necessary changes. There might be no alternative to a process of successive steps to "educate" the people. All the same, such a prolonged process tends to influence peoples' feelings and their trust in the public pension system as such, more than to open up for a constructive debate on how to change the system to make it reliable and sustainable. This seems to have been the effect in Sweden and in many other countries too.

7.2 Enactment

Due to the way in which the decision making process has been designed, i.e. beginning with decisions in principle, and then coupled to a tight implementation schedule, has created substantial difficulties. The risk that this kind of difficulties are under-estimated in the political process is evident.

7.3 Administrative implementation

Administrative implementation of the new system is the responsibility of the National Social Insurance Board. The Board has experienced considerable difficulties in trying to meet the tight schedule for the new system. In that process the Board has had to try to figure out the new system in concrete details, without knowing what will be the ultimate legislation. The result of this has been an inefficient use of resources.

The Board has also faced difficulties in designing a computer system with the ability to meet the need for complicated calculations that will follow from the detailed regulations in various fields.

The costs for the administrative implementation are covered by special "loans" granted to the National Social Insurance Board by the Government. Ultimately, these costs will be charged as interest and amortization to the future administrative costs for the pension system.

8. The degree to which the Swedish experience might be applicable to the situation in the United States

I do not think that I am in the position to give any recommendations to this great nation, when it comes to solving your own problems. All the same, I venture to share with you, distinguished members of this Committee, a few thoughts about some of the particulars of our reform and of our problems that I think might be of interest to you.

We might say, that we face similar problems. Sweden is a mature post-industrial state with important social commitments, and we have realized that we have problems. Our Social Insurance programs are neither financially stable nor adapted for encouraging continued work force participation for older workers. I think that the same situation prevails in many other countries.

The social insurance system must be kept in balance with the size of the economy, i.e. the size of the social expenditures must in the long run respond to (the changes in the growth of) the economy.

An economically sound pension reform can be brought about without a switch to a fully funded system by introduction of:

- so called Notional Accounts,
- indexation of pensions to (contribution-related) wages,
- demographic reserve funds,
- adaptation of benefits to average life expectancy.

The US system contains two strong redistributive features, redistribution from high to low income earners, and from two career couples to one career couples.

It will be impossible to replicate these redistributional effects in a Notional Account system. The question is, how can we create security for low-income pensioners? In Sweden a fairly high guarantee level will be introduced. This takes care of the redistribution between high- and low-income earners. This part of the total system will be financed solely out of general revenue.

9. ISSA AND THE STOCKHOLM INITIATIVE

As President of the International Social Security Association I would like to mention something about the ISSA, its tasks and the very special challenge we have named the Stockholm Initiative an activity strongly connected to the discussion here today.

9.1 ISSA, THE INTERNATIONAL SOCIAL SECURITY ASSOCIATION

ISSA is a member of the UN family, but is different from other UN organizations by not being a governmental organization. The ISSA is financed by contributions from social security organizations which belong to the Association. At the present time the ISSA has a total of 350 member organizations in 135 countries.

ISSA activities include:

- Information dissemination (publications, information center, on line data bank)
- Research
- Organization of exchange of information and experience between members (conferences, seminars)
- Training

9.2 THE STOCKHOLM INITIATIVE

In recent years the structural adjustment plans of many economies have for various reasons led to questioning social protection systems. ISSA members throughout the world have urged the Association to support them in the internal and international debates on the issues. ISSA has taken up the challenge.

The Stockholm initiative: The Social Security reform debate; In search of a new consensus is an extrabudgetary effort to facilitate a dialogue on the most important social protection issues and to promote a debate and subsequently a new consensus about acceptable approaches to social security. This project will assist policy makers and social security organizations throughout the world to understand the arguments and to choose reform alternatives best suited to their circumstances.

This Initiative is now well under way in a first step. That step concerns analytical questions in the area of pensions. Mr. Lawrence H. Thompson, Senior Fellow of The Urban Institute, Washington, D.C., has prepared papers addressing a wide range of issues in the pension reform debate. Those papers will soon be published, and will be used in the world-wide debate. The Initiative will explore other issues in close co-operation with sponsors and experts.

This Initiative is in its entirety financed by ISSA member institutions in all parts of the world, such as social security institutions, governments and private sector companies. We hope that the Initiative will bring into focus the broad concept in which social security is a part and create a better balance between the different options in the reform process, and we invite all concerned to join us in this vital undertaking!

There are many organizations now engaged in trying to broaden the debate in order to cope with the tremendous task to reform social security systems, among those the pension systems. The World Bank, IMF, EU, ILO and OECD can be mentioned alongside with ISSA. All these bodies realize that public confidence in the reform process and a reconciliation of economic and social policy are key elements in this process.

10. CONCLUSIONS

The reforms implemented in Sweden were partly forced by the economic situation. We are still in a process of realizing that resources are not endless and that politicians will have to deal with promises for the future in a more cautious way than was the case before. There is still a need for efforts to strengthen the economy and thus create a basis for sustainable growth in the future. Still, nearly everyone in Sweden agrees that a general welfare policy, with stable social security rules concerning sickness, parenthood, unemployment and old-age is an important part of economic and social policy in Sweden.

My concluding opinion on the situation in my home country is that the Swedish politicians and the public administration are working concretely with the challenge to take into account new knowledge in this field; knowledge about the interaction between the economy and social security and a deeper understanding of peoples behavior. Sweden is now, and this is my feeling and sincere hope, in the process of building a new Swedish model, based on the best in the old model while trying to avoid earlier mistakes!

11. ACKNOWLEDGMENTS

This report is based on official documents from the Swedish parliament and Government and from the National Social Insurance Board. It also draws on reports from various international conferences made by myself, by Mr. Göran Smedmark, Director and Head of the International Secretariat of National Social Insurance Board and by Ms. Lena Malmberg, Principal Administrative Officer at the National Social Insurance Board. We have together written this report, and I thank both of them for their support. I also thank Professor Edward Palmer, head of the Research Division of the National Social Insurance Board for his valuable comments on a draft to this report.

Mr Chairman, distinguished Members of the Committee, I appreciate very much to have had this opportunity to share with you some experience from the social security reform efforts in my home country. Thank you for listening. I am prepared to answer any questions occasioned by my presentation.

Chairman BUNNING. Mr. Finkelstein.

STATEMENT OF DANIEL FINKELSTEIN, DIRECTOR OF CONSERVATIVE RESEARCH DEPARTMENT, CONSERVATIVE PARTY OF BRITAIN'S POLICY DEVELOPMENT AND BRIEFING UNIT, LONDON, ENGLAND

Mr. FINKELSTEIN. Mr. Chairman, Members of the Subcommittee. First, may I thank you for your invitation to address the Subcommittee about the changes that have been made to the British pension system over the last 10 years.

As director of the Conservative Research Department, I work closely with the Prime Minister and ministers of the Department of Social Security to develop plans for Social Security reform and it is this experience that forms the observations I will make this morning.

Let me start with three facts. First, although the ratio of pensioners to the population of working age in the United Kingdom is forecast to rise from 30 percent in 1995, to 38 percent in 2030, the ratio of public expenditure on pensions to GDP is expected to fall over the same period from 4.2 percent to 3.3 percent.

Second, United Kingdom private sector pension funds have more than 600 billion pounds worth of investments, which is more than the rest of the European Union put together.

Third, over the past decade, pensioner incomes have risen by 50 percent. There have been increases at all points in the pensioner income distribution, and pensioners are no longer concentrated right at the bottom of the population income distribution.

How has this been achieved? What more needs to be done and what lessons can be learned by countries with different systems? I intend to touch on each of these points briefly. It might be helpful if I begin with a brief description of the pension system inherited by the conservative government when it came to power in 1979.

Since the National Insurance Act, passed by the 1945 labor government, Britain has had a nonmeans-tested basic State pension. Those who paid national insurance contributions as part of their tax bill during their working life are eligible for this benefit, and it has always been done on a pay-as-you-go system.

When the system was originally proposed by the social reformer, William Beveridge, during the war, he intended that the pension should be phased in over 20 years, but it was decided to pay them in full from the outset.

In 1975, another labor government added a second tier to the United Kingdom State pension system. They introduced a State earnings-related pension, SERP, in an attempt to narrow the differentials between pensioners with a private occupational pension and those without.

SERPs provided a pension based on 25 percent of the average of the best 20 years of earnings. The crucial second reading of the bill to introduce SERPs was unopposed. When conservatives came to power under Margaret Thatcher in 1979, they inherited an ailing economy, a fast-rising Social Security budget, and commitments far in excess of our ability to pay for them.

In addition, as Nigel Lawson put it, our Chancellor of Exchequer at the time, it is clear to anybody who took the trouble to analyze SERPs that it was a doomsday machine, so clearly reform was necessary.

Let me describe our three-stage reform program. First, we removed the link between pensions and wage increases and linked the basic State pension to prices instead. The decision was controversial, but it was accepted because of the obvious crisis in the United Kingdom economy in 1980, and because there were no losers in real terms.

Second, in 1985, the government turned its attention to the long-term problem of SERPs. The government didn't just want to abolish SERPs, since the arguments for the creation remained good ones. Instead, it decided to offer taxpayers two alternatives. One option was to remain in a somewhat less generous SERPs. For example, the percentage of your income that you would be paid would be reduced from 25 percent to 20 percent.

The other alternative was to contract out of the scheme and have the State pay a part of your national insurance contributions into a private fund. Takeup of this second alternative was encouraged by a number of measures. For example, those who decided to contract out would receive an extra 2-percent rebate above that strictly necessary to make their pension the equivalent of SERPs for the first 5 years. The government also created a new private portable pension providing tax relief on contributions, and companies were forbidden from bringing employees to their own scheme.

I shan't detain you with the detailed description of all the financial details, but suffice it to say they greatly exceeded expectations in terms of takeup. The Department of Social Security's working assumption was that about 500,000 would take out personal pensions and the number might ultimately reach 1.75 million. In the event, the takeup reached 4 million by the end of 1990, and by 1993–94 had risen to 5.7 million.

This success didn't, of course, end the debate. Some wanted a much larger compulsory private pension. Margaret Thatcher was one and told her chancellor they had such a pension in Switzerland. "Yes, Prime Minister," he replied, "but in Switzerland everything that is not forbidden is compulsory."

The most important debate of all concerned the basic State pension. It remained a large item of government expenditure, yet current and future recipients believed it was inadequate. So a third stage of reform was proposed. A basic pension-plus plan published in the new year would involve replacing the basic State pension and SERPs with a State guarantee.

New entrants into the work force would be given a rebate from their taxes paid into their choice of private plans. If, when they reached retirement age, their private plan was not large enough to replace the basic State pension, the State guaranteed to make up the difference.

In reality, this would not happen very often, if at all, and the advantages of a funded scheme would yield the average pensioner a much more generous pension than they would otherwise get.

How was such a radical reform plan possible? Because in Britain, like in America, pensions are an extraordinarily sensitive subject, and no government could survive unscathed if it made a gross mistake in this area. I think the program's success teaches a number of political lessons.

First, the reforms were the result of a debate about the long term, the security of young people, and the country's finances. Budgetary problems were often the ally of reformers, but they would not seem to be the main reason for reform. Indeed, in the short run it was all cost.

Second, victory in the debate about long-term reform would have been useless if pensioners feared their income was under threat. At every stage it was necessary to ensure that there were no losers among current recipients and that as far as possible future recipients felt, they were making a one-way bet. The sacrifices this involved that were there could be no short-term savings and the reforms would have to be phased in over very long periods.

Third, the reforms were not introduced all at once. Voters were more inclined to support the next stage of reform because they could see the previous changes had not left them worse off. It was also less easy to attach the proposals as unworkable, or to defeat the entire package by concentrating on its weakest point.

Finally, the provision of choice was vital. The reforms of the mideighties were not imposed on future pensioners. They were given a choice and a financial incentive to choose the private option. The popularity of the scheme depended on the feeling that the government was providing the opportunity to get a better deal. If voters thought instead that they were being forced into a scheme to save money, they would have been much more resistant.

In conclusion, your natural political instincts will, I am sure, make you suspicious of the idea that in the United Kingdom we found the perfect formula for painless reform, and natural political instincts would, of course, be right. Pensions remain a controversial topic and throughout the 18 years we spent in government, Conservatives had to face criticism of the scheme we were developing. Yet there is now remarkable consensus that the basic decisions were the right ones, that in general they have helped rather than hindered the Conservative Party at the polls, and that the new labor government is far more likely to extend the program than it is to reverse it.

[The prepared statement follows:]

Statement of Daniel Finkelstein, Director of Conservative Research Department, Conservative Party of Britain's Policy Development and Briefing Unit, London, England

Mr. Chairman and Members of the Committee, first, may I thank you for your invitation to address the committee about the changes that have been made to the British pension system over the last ten years. The experience and advice of American policy analysts and law makers has been of great value to the British people over the many years of friendship between our countries. I hope that you will find some of the things we discuss today of similar use.

As Director of the Conservative Research Department, the British Conservative Party's policy development and briefing unit, I worked closely with the Prime Minister and Ministers at the Department of Social Security to develop plans for social security reform. This experience and my work as Director of one of Britain's leading welfare reform think tanks, the Social Market Foundation, informs the observations I will make this morning.

Let me start with three facts. First, although the ratio of pensioners to the population of working age in the United Kingdom is forecast to rise from 30% in 1995 to 38% in 2030, the ratio of public expenditure on pensions to GDP is expected to fall over the same period from 4.2% to 3.3%. Second, UK private sector pension funds have 600 billion worth of investments , more than the rest of the European Union put together. Third, over the past decade pensioner incomes have risen by 50%, there have been increases at all points in the pensioner income distribution and pensioners are no longer concentrated right at the bottom of the population income distribution.

How has this been achieved? What more needs to be done? And what lessons can be learnt by countries with different systems? I intend to touch on each of these points briefly and would then be happy to answer any questions that you may have.

It might be helpful if I begin with a brief description of the pension system inherited by the Conservative Government when it came to power in 1979. Since the National Insurance Act passed by the 1945 Labour Government, Britain has had a non means tested basic state pension. Those who have paid national insurance contributions as part of their tax bill during their working life are eligible for this benefit. It has always been paid for by Government out of current revenues, rather than out of investment funds. In other words, each generation pays for the pensions of its elders. When the system was originally proposed by the social reformer William Beveridge during the war, he intended that the pensions should be phased in over 20 years. Labour decided to pay in full from the outset. The judgement of Britain's foremost welfare state historian Nicholas Timmins is that "although it was a mighty expensive decision, almost certainly nothing else would have been politically tenable."

Beveridge's aim was to eliminate means testing as far possible. As in other areas of benefit provision, however, both the problem of providing housing for the less well off and the difficulty of setting means tested rates below non means tested ones frustrated him. Around a third of pensioners in the UK receive means tested benefits in addition to their basic state pension.

In 1975 another Labour Government added a second tier to the UK state pension system. They introduced a State Earnings Related Pension (SERPs) in an attempt to narrow the differentials between pensioners with a private occupational pension and those without. SERPs provided a pension based on 25% of the average of the best 20 years of earnings. The crucial second reading of the Bill to introduce SERPs was unopposed. According to Lord Lawson, later as Chancellor an important player in the design of the reform programme, the Conservatives were "clearly wrong to do this" but believed "that pensions ought not to be a political football."

When the Conservatives came to power under Margaret Thatcher in 1979, they inherited an ailing economy, a fast rising social security budget and commitments far in excess of our ability to pay for them. In 1950 social security spending represented 5.1% of national income, by 1980 it represented 8.4%. By far the largest group of beneficiaries were elderly people and by 1965 the cost of pensions was twice that which Beveridge predicted. In addition, as Lord Lawson puts it, "it was clear to anyone who took the trouble to analyse SERPs that it was a doomsday machine." Clearly, reform was necessary.

The best description of the welfare reform strategy of Conservative Governments between 1979 and 1997 was given by its last and longest serving Social Security Secretary, the Rt Hon Peter Lilley MP in his 1993 Mais Lecture. In the lecture he explained the principles behind the reforms across the welfare field. He set out ten propositions. First "there are no easy solutions. That should be self evident, since if there were, I or my predecessors would have adopted them." With this he dismissed such pet solutions of right and left as merging the tax and benefits system or using tax credits to save money.

He went on to say "My second proposition is that any effective structural reform must involve either better targeting, or more self provision, or both." Yet he did not accept that targeting need lead him to an exclusively means tested approach. His third proposition was that "disincentives are inherent in statutory benefits. When there is a choice between universal and means tested benefits there is a trade-off between imposing disincentives on the claimants or on taxpayers." He continued by saying: "My fourth proposition is that means testing is not the only way of targeting benefits more closely on need." Alternatives included changing the categories of people eligible for benefit (for example, changing the pension age), defining need differently by tightening the rules of receipt for certain benefits), tighter enforcement, imposing new conditions for receipt or using the contributions test. He claimed as his fifth proposition that "the existing array of benefits—contributory, universal and income related—are rather more targeted than some comments suggest."

Next, Lilley entered the debate about allowing people to opt out of the system and make their own provision. A particular target has been the basic state pension. The Secretary of State's sixth proposition was that "no one has the right to opt out of contributing to help those who cannot provide for their own needs. But there is no reason in principle why people should not (in addition to contributing to others) opt to make provision for themselves privately rather than through the state system." His seventh proposition was connected—he pointed out "that contracting out inevitably involves a switch from pay-as-you-go to fully funded provision" and that, particularly in the case of pensions, this would leave a gap in the public finances until the policies mature.

His final two propositions were first that "the more the provision for needs and risks is monopolised by the state the less the incentive to work and save to provide for them" and second that "reform of something as vast as the social security system is best carried out sector by sector rather than by the 'big bang' approach. Comprehensive big bang reforms invariably result in imposing elegant intellectual and bureaucratic structures on the inconvenient diversity of the real world."

This is an admirable description of the principles behind the Conservative Government's three stage reform programme:

First, it removed the link between pensions and wage increases and linked the basic state pension to prices instead. The decision was controversial, but was accepted because of the obvious crisis in the UK economy in 1980 and because there were no losers in real terms.

Second, in 1985 the Government turned its attention to the long term problem of SERPs. The Government didn't just want to abolish SERPs since the arguments for its creation remained good ones. Instead it decided to offer taxpayers two alternatives. One option was to remain in a somewhat less generous SERPs. The percentage of your income that you would be paid, for instance, would be reduced from 25% to 20%. The other alternative was to contract out of the scheme and have the state pay a part of your National Insurance contributions into a private fund. Take up of this second alternative was encouraged by a number of measures. Those who decided to contract out would receive an extra 2% rebate above that strictly necessary to make their pension the equivalent of SERPs. The Government also created a new private portable pension, provided tax relief on contributions, and companies were forbidden from binding employees to their own schemes.

I shall not detain you with a detailed description of all the financial details and safeguards that were put in place to ensure the scheme was popular and secure. These are set out in the Heritage Foundation's admirable paper on Social Security Privatisation in Britain. Suffice it to say that take up greatly exceeded expectations. The Department of Social Security's working assumption was that about 500,000 would take out personal pensions and the number might ultimately reach 1.75 million. In the event, take up reached 4 million by the end of April 1990 and by 1993–4 it had risen to 5.7 million.

This success did not, of course end the debate. Some wanted a much larger compulsory private pension. Margaret Thatcher was one and told her Chancellor that they had such a pension in Switzerland. "Yes Prime Minister," he replied "but in Switzerland everything that is not forbidden is compulsory." Others were concerned about the security of private pensions and after the newspaper owner Robert Maxwell was found to have stolen from the Mirror Newspaper pension fund the Government introduced safeguards to prevent swindles and incompetence depriving pensioners of their income. Still others believed SERPs remained too expensive and pressed for its abolition. Once again this option was rejected, partly because some pensioner's contributions to SERPs were too small to pay the administrative costs in the private sector. Instead the Government once again reduced long term SERPs entitlements but compensated with reforms to make it more worthwhile for older people to opt out.

Yet the most important debate of all concerned the basic state pension. It remained a large item of Government expenditure, yet current and future recipients believed it was inadequate. So the third stage of reform began. Over the summer of 1996 Peter Lilley began to work on new proposals to deal with the problem. His Basic Pension Plus plans were published in the New Year. Under these proposals, the basic state pension and SERPs would be replaced with a state guarantee. New entrants to the workforce would be given a rebate from their taxes paid into their choice of private plans. If, when they reached retirement age, their private plan was not large enough to replace the basic state pension, the state guaranteed to make up the difference. In reality, this wouldn't happen very often and the advantages of a funded scheme would yield the average pensioner a much more generous pension than they would otherwise get. Of course, the scheme would cost money during the long transitional period. Because young people would be funding their own pension they wouldn't be paying for the pensions of their elders. However, by the time this cost peaked it would be offset by savings from an earlier reform to raise the retirement age for women to the same as that for men. Another critical change was to switch tax relief from the time of saving to the time of receiving the benefit. This halved the transition cost.

Lilley's proposals received a rapturous reception in the press. The left wing Guardian newspaper, for instance, said that "like the concept of a share holding democracy, it could also be empowering a new generation, which will have much more control over its retirement arrangements." The defeat of the Government in the General Election in May mean that Lilley's plans have not become law, but it is widely anticipated that the new Government will conclude that some sort of funded basic pension system is necessary.

How was such a radical programme of reform possible? In Britain, like in America, pensions are an extraordinarily sensitive subject. No Government could survive unscathed if it made a gross mistake in this area. I think that the programme's success teaches a number of political lessons.

First, the reforms were the result of a debate about the long term, the security of young people and the country's finances. Budgetary problems were often the ally of reformers, but they were not seen to be the main reason for reform. Indeed, almost all the reform involved spending money in the short term and a recognition that without this, long term change was impossible.

Victory in this debate was not inevitable. As late as 1992 Labour made large increases in the basic pension its central election promise and it also promised to restore the wages link. Yet when they were defeated in this election Labour realised that the voters didn't believe their promise could be delivered and didn't, in any case, want to pay for it. They dropped the pledge and quickly began to join in considering long term reform and the control of costs.

The result of winning the debate was that when a Labour spokesman weighed in against Peter Lilley's new pension plan, press reaction made the Party backpedal very quickly. The next day Tony Blair welcomed the way Lilley had widened the debate. It is thought by some press analysts that the unsuccessful attempt by some Labour members to raise scares about Lilley's plan lost the Party the endorsement of The Times newspaper.

Second, victory in the debate about long term reform would have been useless if pensioners feared their income was under threat. At every stage it was necessary to ensure that there were no losers among current recipients and that, as far as possible, future recipients felt they were making a one way bet. The sacrifices this involved were that there could be no short term saving and that the reforms would have to be phased in over very long periods. Basic Pension Plus would have yielded only costs until nearly half way through the next century. Where savings had to be made to offset these costs, they too were phased in over a long period and did not leave any current recipients worse off. To ensure that fears were not allowed to take hold, the Government was always very clear about the costs of its schemes and the nature of the guarantees it was giving.

Third, the reforms were not all introduced at once. Voters were more inclined to support the next stage of reform, because they could see that the previous changes had not left them worse off. It was also less easy to attack the proposals as unworkable or to defeat the entire package by concentrating on its weakest point. The temptation to demonstrate how radical the Government was and its farsightedness, by announcing the entire programme in advance was also eschewed. Each part of the programme was advanced on its merits and given time to work before further innovations were considered.

Finally, the provision of choice was vital. The reforms of the mid 1980s were not imposed on future pensioners, they were given a choice and a financial incentive to choose the private option. Much of the popularity of the scheme depended on the feeling that the Government was providing the opportunity to get a better deal. If voters thought, instead, that they were being forced into a scheme to save money, they would have been much more resistant.

Your natural political instincts will, I am sure, make you suspicious of the idea that in the UK we have found the perfect formula for painless reform. You instincts would be right. Pensions remain a controversial topic and throughout the 18 years we spent in Government Conservatives had to face criticism of the system we were developing. Yet there is now a remarkable consensus that the decisions were the right ones, that in general they have helped rather than hindered the Party at the polls and that the new Government is far more likely to extend the programme than to reverse it.

Chairman BUNNING. Thank you, Mr. Finkelstein.
Dr. Ghilarducci.

STATEMENT OF TERESA GHILARDUCCI, PH.D., ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF NOTRE DAME, NOTRE DAME, INDIANA

Ms. GHILARDUCCI. If you use your hands, it goes better. Ghilarducci.

As you heard, during the last 20 years in the United Kingdom and in Latin America, and especially Chile, cut the government's role in providing retirement income security has drastically changed. They have done it in favor of a model of individual pensions. Australia's Government and the employees in the unions there agreed also to reduce the State control of a very regulated—it is very different than these other models—labor and employer-controlled pension system.

And it is true, most Organization for Economic Cooperation and Development, OECD, nations like the World Bank report that you just quoted from indicates, are looking to cut benefits by raising retirement ages and by reducing pensions in various ways.

Emerging democracies, notably in Eastern Europe and in China, are struggling with new models for providing for retirement. The old communist model wasn't working so what do they adopt? And U.S. policymakers want to know what lessons from abroad can inspire Social Security reform here.

You have asked me, and I am really glad to be here, to comment on what factors have inspired these reforms; what macroeconomic goals were hoped for; what governments paid in transition costs; the benefits and cost to workers; and what an international overview can teach us.

And I want to look at some other factors that you did overlook in your list because these factors have become starkly clear in my scholarship and, in my travels in the last 3 years. And I have been everywhere. I have been in Madrid, London, Paris, Geneva, Rome, Palermo, Amsterdam, Bonn, Buenos Aires, Santiago, Mexico City, Kiev and last I was in Beijing. I also went to Ft. Worth and Mishawaka, Indiana. In all of those places I either worked for the governments, the labor unions, for the State Department, or for the United Nations to examine their pension systems.

Six months ago, my 100-page report on China went to the United Nations. Therefore, I speak with some conviction that what you need to look at, and what policymakers need to look at when we consider pension reform, is the effect on work effort. The effect on employers—employers have really been written off in this pension reform—and therefore what effect it will have on economic productivity.

I have seven findings for the Subcommittee. Let me summarize: First, if the United States supplanted our Social Security for individual pensions, and there are lots of suggestions out there how to do that, retirement income and adequacy and equity goals would be weakened. Maybe it would be for a good reason, but we have to recognize that there would be losses there.

For instance, in the United Kingdom and Chile, workers with low incomes and frequent breaks in employment, pay large administrative costs and they also have a reasonable bias toward investing conservatively. We see Americans do that in their 401(k) plans, especially for those with lower income.

Workers in personal pensions face what we call the longevity risk, the risk of living too long. Buying an annuity is very expensive for insurance and market failure reasons. And women especially have a much higher longevity risk. It is an odd way to talk about living too long, but it is a risk when you are dependent on a fixed income.

In the United Kingdom women were found to be particularly vulnerable to their choice, because their choice involved being convinced by salespersons in advertising campaigns and they were found to be choosing plans of extremely poor value. They found that their company plan, what they opted out, was actually much better because of their up front administrative costs.

Second on these labor force effects, in the United Kingdom and Chile workers are entitled to a minimum pension. In Chile, this could mean that you could work for just a short period of time, be entitled to a minimum pension, and then really have no financial incentives to stay in the system. So evasion is a big problem. Fifty percent of people with an account in Chile who, at any one point are not contributing—they are not active members—but they are still paying administrative costs.

This subtle long-term effect of having individual based pensions on tax evasion affects me quite a bit. I am chilled to the bone by the cynical evasion that I found in the Ukraine and in Chile. That because employers were not involved in the system like they were in the past, there began a kind of social norm to game the system. Spain's Social Security director just spoke in Argentina 3 weeks ago and said, look, the Chilean model will never work in Spain, but we do have to focus more on tax evasion.

Third, a lot of you, Mrs. Kennelly, you especially, emphasize the effect of savings growth on these private pensions. But mind you that you could have demographically driven financial markets that are very unstable. Just think about the United States. We have a baby boom generation pouring money into the mutual funds, into the stock market, driving asset values up.

John Shoven from Stanford and Sylvester Schieber, from Watson Wyatt published a paper that showed what drove the asset values up will also drive them down in 2020 or 2030. So we are looking forward to asset fall off by 25 percent, the value of financial assets and houses, just because of the demographics. We have to look at these long-term consequences of these demographically driven financial markets.

Fourth, what an individual pension does is break the link between what you get and what you contributed. This is something that Sweden really wants to reconnect. Right now we have a system where people who live side by side and have the same employment history, get the same thing out of Social Security. It is not a welfare program. You get what you get because of your work history.

If you have an individual pension, you get what you get because of luck, good advice, or other vagaries so that you have this real break between your work effort and what you finally get from your pension.

In fact, the Office of Fair Trading in the United Kingdom has been very critical of the system, not as laudable as my colleague from the Conservative Party, and actually characterized the process in the United Kingdom as when you select a pension fund, it is almost like selecting a lottery ticket. It is almost like playing the lottery.

Fifth, the international experience shows that if the United States moved toward mandated individual accounts, it will really have one clear group of winners and those winners, of course, will be financial institutions and actually advertising firms. Wall Street will gain a lot from privatization here.

You will hear a lot today about the fees that these for-profit companies in the United Kingdom and Chile are charging workers for maintaining their accounts. There are lots of inefficiencies in those markets. There is name brand, if you are the first entrant, because of exaggerated dependence on advertising, and because workers do not know they made a bad choice until later. There are lots of reasons why market forces do not work well when you are selling pensions.

Sixth, a lot of people say that transparency is one of the most important aspects of cutting back the State system and introducing individual pensions. Transparency, the Spanish word even sounds better, the idea that workers should know what they are being promised and should see through their benefit promise.

Well, in the United Kingdom in 1997, over 570,000 workers are being investigated—or rather, the pension plans they bought are being investigated—because they might not have had that transparency. They couldn't see through the sales practices and they might have made a bad choice. One-third of workers in the United Kingdom don't even know if they have opted out or not. So if you ask average worker in the United Kingdom what plan they are in, they don't even know.

The macroeconomic effects were really overexaggerated. In Chile they are practically nil. In the United Kingdom savings rates were not the kind of problem that they are here. The United States low savings rate could be due to this very unique situation that we are in. We do not mandate retirement.

All OECD countries, Latin American countries, require that 65-year-olds leave the labor force. We do not allow that. Now, that is good for freedom, but it might have a perverse effect on savings because one out of four Americans when asked, "Are you saving?" says, "No, I will just work until I die." So we may need to look at these institutional factors affecting savings. Thank you.

[The prepared statement follows:]

Statement of Teresa Ghilarducci, Ph.D, Associate Professor of Economics, University of Notre Dame, Notre Dame, Indiana

The United Kingdom, in 1976 and in the mid 1980s, and many Latin America nations, following the lead of Chile's 1981 privatization, drastically cut their government's role in retirement security in favor of individual pensions. Australia's government, employers, and unions also agreed to reduce state central control for a highly regulated, labor and employer controlled, compulsory system of individual pensions. Most OECD nations have cut benefits and emerging democracies, notably Eastern Europe and China, are struggling with new models in the face of maturing populations. U.S. policy makers want to know what lessons from abroad can inspire Social Security reform in the U.S.

An international survey shows the U.S. system has superior features. We have a mixed employer, personal, and state system. Social Security works well because it is based on work not welfare. The tax rates are relatively low so coverage is large—92% of all workers. Social Security is also portable. The U.S. stands apart from most other nations because we outlaw age discrimination and forced retirement. This could lower the savings rate by reducing retirement planning as some employees anticipate working past 65 (Farkas, 1995).

I am complying with the committee's request by addressing the following factors in international pension reform: the factors that led up to the reforms;

- the macro-economic goals and effects (primarily savings);
- the transition costs;
- the benefits and costs to workers; and,
- what lessons and counter lessons can be gleaned from the experience for the U.S.

I add three other important factors:

- How pension reform can promote or diminish evasion—workers not keeping up with their contributions;
- How pension reform can promote or diminish productivity through its effect on labor management relationships;
- How world wide accumulation of capital may cause sharp increases and falls in asset values.

1. The Promises of Mandated Pay-Go Systems and Their Retrenchment

A nations' pension system can help shape its economic development. Pensions and other social insurance contributes to political stability in market economies where people can lose their ability to support themselves through no fault of their own. Pensions can promote productivity in three ways: pensions can enable workers to move between jobs to find their best use of skills; pensions can ease the retirement of older workers, and pension systems can help tie employers and workers to employment that is regulated, scrutinized, and upon which taxes are paid. So-called formal employment helps prevent substandard working conditions and helps foster skill development, as well as, a national tax base.

Pension systems also have to protect people against their persistent optimism about their long-term personal health, ability to work, and the generosity and ability of their adult children to provide for them in old age. Mandatory systems overcome workers short sightedness, optimism, and risk averseness. Universal and mandatory pension systems also correct the insurance markets failure to overcome adverse selection problems—the people with the most risk buy the insurance. Gaps appear because for profit insurance companies avoid the social insurance markets or charge prohibitively high premiums. Universal mandatory coverage solves this problem by spreading the cost of the premiums across high and low-risk groups.

There are seven goals in a nation's social insurance system. A good national social insurance system provides adequate benefits; helps promote economic growth and stability; is equitable—it treats people in similar situations in similar ways; is efficiently run; redistributes to those who need benefits the most; and provides social stability. Mandatory social security schemes, like the U.S. system, meet most of these goals.

Reasons for Change: UK and Chile

Universal government systems succeed in meeting many goals. They provide mobility between jobs and industries and spread the risk of retirement and superannuation across industries, firms and workers. They overcome private market failures and provide social insurance efficiently. Then why did some nations dramatically reform their mandatory systems? For example, UK and Chile moved to dismantle their systems in the last twenty years.

The Chilean and UK changes were due, in part, to the increasing costs of their systems and also adherence to political goals for a smaller economic role for the state. Issues of savings rates, productivity, equity, and retirement security were secondary. Therefore, to understand the reforms one must understand the imperatives—reduce state's costs and manage the political opposition from labor and old age groups while doing so This motive, coupled with eager private sector insurance companies and financial institutions to sell personal pensions, helps explain the individual-account approach in both nations.

In 1976, UK workers could opt out of the pension system if the replacement was as good as or better than the state system. In 1986, in an effort to promote the dismantling of the state system, the Thatcher government dropped the guarantee and boosted the reward for leaving the system. (The national insurance fund would pay 2% of earnings (within limits) and had some guarantees of a fixed payment for 5 years.) Prime Minister's Thatcher's government had originally proposed to abolish the system; but, the financial institutions wanted the lowest paid workers to stay in the government system since their potential individual accounts were not profitable (Ward, 1996).

The aggressive marketing and the lump sum incentive prompted many more, 5.5 million to leave the system than had been expected. The government also boosted the demand for individual, personal pensions by forbidding employers to mandate that their workers belong to the employer's plan. Studies reveal that over 570,000 workers, predominantly lower paid and female, made the wrong choice when they opted out of their employers' systems (Office of Fair Trading, 1997). The insurance companies are now having to change their advertising practices.

The circumstances surrounding Chile's abolishment of the Social Security system was much more dramatic. Eight years after the military coup, the Pinochet government introduced a mandatory individual plan in 1981. The government praised the new system because workers could clearly see their benefits and that it promoted the idea of individual destiny and interests. The Chilean Labor Secretary under the Pinochet dictatorship, José Piñera reflected on the 1981 reform in 1988, "We do not harbor a single doubt that this capitalization system will benefit the silent majorities, which were systematically fooled by the PAYGO system." He described the political goal. The new system will provide "a dramatic increase in individual freedom, which with the participation in social life and economic progress will constitute an insurmountable barrier against communism." (Piñera, 1988)

2. The Long Term Macro-Economic Effects

Recent studies in Chile show that, though the growth in private pensions was large, the growth in foreign investment and profits was larger and contributed far more to national savings (Uthoff 1994). Chilean pensions accounted for 2% of the increase in national savings.

The long run savings effects of privatization may not be always positive either. Contrary to the proponents' claims, Social Security privatization may reduce national savings. Once people are compelled to have an individual account they may likely cut back other saving and give up on retiring at all.

Another concern is the long run effects of advanced funded pension systems on global financial stability. U.S. baby boomers will start retiring in 12 years and by 2030, 100 workers will support 36 retirees, up from 21 in 1995. However, just as their demand for financial assets lifts stock and bond prices, their sell-off starting in the year 2020 will lower asset values. The de-accumulation period will start at about 2025 (Shoven and Schieber, 1994). This de-accumulation could cause asset values to fall. The hope for the source of demand to buy the surplus assets in 2020–2035 is the young populations of Mexico, Brazil, and China and India. This works if these nations have private pension systems that invest in foreign assets. This may explain why the World Bank's effort to privatize pension systems spans the globe.

3. How Do Workers Do Under Individual Accounts

Who are the winners and losers in pension reform that make individual pensions dominant? The winners when the private sector takes over a government function are, first and obviously, the vendors—the pension administration industry.

Employers gain in the short term because they are exempted from paying pensions. However, employers lose because they lose the commitment of a long term relationship with workers who would otherwise be encouraged to stay longer to accrue pension benefits.

Certain workers gain—those who do not live long, and are savvy or lucky in investing and do not have drop out years when they are not contributing regularly in the formal sector. Disabled workers, workers working outside the formal markets, long livers or cohorts who contribute through a financial market bust lose. In the UK, the state system was cut drastically (mainly by linking pensions with prices rather than earnings growth) and now only provides 15%–20% of pre-retirement earnings and by 2030, 9%). The lowest earners are encouraged to try to do better but when they have personal pensions they invest very conservatively. An OECD (1997) report by analyst E. Phillip Davies concludes, "Evidence suggests that individuals are myopic in accumulating wealth for their retirement and the low paid particularly so...personal pensions may by their nature be unsuitable for the low paid." (Davies 1997, 4). Women receive smaller annuities because they are presumed to live longer.

Women and low income workers with sporadic employment also do poorly under the Chilean system. The Chilean government guarantees 25% of the average real wages to anyone who contributed twenty years by supplementing a puny pension. This rule means that a women contributing all her life, with a five-year break for child rearing and retiring at the mandatory age of sixty would have to earn an estimated 7% on her pension account with real wages only growing at 1% annually to earn just as much as the minimum pension guarantees. In the absence of high returns and low growth rates low paid workers will fall back on the government (Barrientos and Firinguetti 1996).

The principle of horizontal equity loses. Two workers with the same employment circumstances may get widely different pensions because of investment strategies.

Workers gained transparency—they can see what is in their accounts. However, there is concern in Chile about the hidden sources of power and influence represented by personal pensions. Some of the largest AFPs, (for example, the president of largest and oldest AFP, Provida, and his brothers who own textile and metallurgy firms) have interlocking financial interests and a heavy investment of workers money in their own stock. Jorge Bustamonte, the Superintendent of Pensions, ordered greater transparency—a reporting of cross ownership in 1995. (Just four funds own approximately 55% of all corporate bonds (in the US the same percentage is spread out across thousands of managers.)) Yet, no report has been issued.

In the UK, confusion about the state system may have been replaced by expensive confusion about the private system. In the UK one-third of workers did not know if they had a personal pension (Office of Fair Trading, 88) and most only depended on one source for advice—the seller of a investment product.

In sum, workers with personal pensions in a market economy face longevity risks—the risks of living long after the ability to earn a living;

- market risks—the regular risks of financial market cycles;
- timing risks—being retirement when asset values are low;
- inflation risks, the risk of asset values falling due to price increases.

Personal pension are said to help workers because of the reduction in political risks and the gains in transparency.

4. Transition Costs

The UK government state lost in the short run. The transition costs in UK were high—the state spent 9.3 billion pounds and saved only 3.4 billion pounds.

In Chile, the transition costs were paid for by a cut in the national health insurance and the federal surplus the state was running at the time. Unlike gaps in coverage the potential liability to the government is not admitted. The government guarantees a minimum pension and if returns low and growth rates are low, low paid workers will fall back on welfare. This projected liability is not booked and it is likely to be larger if workers avoid working in the formal economy after twenty years because they will get no return from the contributions—they are guaranteed the same pensions without the extra contributions.

5. The Winners: The Professional Management Industry

Efficiency is lost. Marketing and administrative fees in UK are 20% and in Chile the estimates are 15 −30%. In contrast, the administrative costs in the U.S. Social Security system are largely borne by the firm who must collect and redeem the payments and the state. The costs to the state are less than .01%. Chilean and UK workers lost the economies of scale in administration and the zero marketing costs when they opted out of the state system.

The pension industry in the UK is concentrated—ten companies have 80% of the business. Prudential is the largest with a ten percent market share.

The profits of the private companies that administer the AFPs were over 22% since 1995. Strict competition, theoretically, is the only regulating influence designed to keep these fees low, but the five largest AFP's control 80% of the market and have formed an implicit cartel. Instead of forcing fees to fall, competition has increased costs as AFP's hire more sales staff to lure workers from fund to fund. In the last 4 years, the number of sales persons leaped from 4,000 to 12,000. Solomon Brothers, notices that this hefty turnover is taking place "in an industry in which it is very difficult to differentiate among companies. If AFP's under-perform the average they pay a penalty. Therefore, the portfolios are similar and the returns are similar. These are classic monopolistic competitive inefficiencies—barrier to entry is high, the product is nearly the same, but competitors still must advertise. It is also a market that encourages advertising because people do not know if the product is defective until many years after choosing the AFP.

6. Private Pension can Distort Labor Markets

The World Bank is continually assessing the labor market effects, such as tax evasion. This is a real threat in Chile where 50% of workers with pension accounts do not currently contribute. Pension reforms have a dramatic effect on labor markets and incentives to evade taxes and formal employment. A high degree of evasion undermines democratic governments and well-functioning high skilled labor markets. The evasion stems from a two tiered system. If minimum service and contributions will garner a pension then extra work in the sector that pays taxes—the formal sector—is unrewarded as far as more pensions are concerned.

Of very serious concern but very little study is the effect on national productivity effects of an eroded employer pension system. Although defined benefit pension plans "penalize short stayers" they reward workers for loyalty and skill acquisition. These effects on productivity and stability have been long recognized by labor economists and have been little studied by pension reform analysts (Dorsey and McPhearson, 1996).

7. Lessons From the International Experience For The U.S.

If the U.S. reduced Social Security in favor of more personal pensions we could face an erosion in adequacy and equity as lower income workers, and those with frequent breaks in employment, end up with small pensions, that pay large administrative costs and were conservatively invested.

If there is a welfare tier, a significant number of workers may work in the underground economy after getting the minimum number of years of credit. The government may face big welfare outlays in a few decades, and more aged poverty. More importantly, tax evasion takes away from social stability.

If the U.S. encourages more accumulation of assets by reducing Social Security in favor of advanced funded pensions, then demographically-driven financial markets will soar as the population bulge reaches middle age and crash when the bulge sells to finance retirement. The link between pensions and work will be further broken as demographic position and luck predominately determine a worker's retirement income. Economists now speculate that demographic aging will cause a 20% decrease in asset values in the U.S. in 2020.

The international experience shows that a U.S. move toward mandated individual accounts would clearly benefit financial institutions and advertising firms. Personal pension administrative costs are large in the U.K. and Chile as much as 29% of contributions.

The U.S. non-means tested Social Security program meets the horizontal equity test. U.S. workers in like employment situations now have similar pensions. Under a two tiered plan the "pension/-work" link is broken and those in need (perhaps because they were spendthrifts) pensions and those who got better investment advice and were lucky get a better pension. In the UK reported performance of the funds differs from survey to survey, so that according to the Office of Fair Trading, "selecting a fund is something of a lottery" (p.71).

Workers in personal pensions face increased longevity risks, because annuities are so expensive in UK and Chile, that people may opt to live on their funds. Women have a higher longevity risk. In the UK, women were found to be particularly vulnerable to sales practices and choosing personal plans of extremely poor value. Their company plan was often better and they pay huge fees because administrative costs are paid at first and bear heavily on those who leave the labor force early and do not amortize the costs.

In Chile, the political risk of not having political clout to obtain improved pensions or that the government would default was perceived to be high (the government had been taken over by the military). (Diamond, 1991). The conservative government in UK cut benefits drastically. Political risk is low in the U.S.. The Social Security system—not Medicare—is financed until 2030 and then can pay 75% of benefits if nothing is done.

Transparency is said to be better under the private pension system. However, in the UK in 1997 over 570,000 pension plans are being investigated for being missold—workers would have likely done better had they stayed in their employers' pensions (Office of Fair Trading, p. 32). One-third of works do not know if they opted out of the employer plan for a personal pension (Office of Fair Trading, 88). Most only depended on a commercial, non neutral, source for pension advice.

In Chile, the AFPs increased sales staff and the Superintendent of Pensions announced his intention in require AFP's to reveal interlocking directorates in 1995 but no report has been issued Former Chilean Labor Secretary Rene Cortazar conceded that new concentrations of power may forming "in the shadows" of the privatization of capital (Cortazar, 1995).

Last, some hope that the U.S. low savings rate might be boosted by an advanced funded pension scheme displacing Social Security. First, the transition costs are high—rough estimates for some proposals are 2% of national income for 75 years. Net savings will not be increased we will replace private savings for government spending. The evidence that the Chilean plan increased savings is dubious; though it seems to have boosted personal savings in U.K., but government losses were 5.9 billion pounds. The U.S. low savings rate could be due to the easy access to debt and a weak retirement motive because the U.S. outlaws mandatory retirement.

In sum, much of the world wide reforms are attempts to limit the state presence in favor of a mixed system of retirement income support. My experience and reading is that many OECD nations and emerging nations, China and Poland, in particular, are interested in the U.S. model.

A 1997 three volume report from the UK Government consumer affairs office, the Office of Fair Trading (dedicated to act directly on the activities of industry and commerce by investigating and remedying anti-competitive practices and abuses of market power, and bringing about market structures which encourage competitive behavior) recommended a major overhaul of the UK system for a system that is passively managed, nearly universal, fully indexed, with low fixed and open fees, provides unbiased advice, and maintains fully portable pensions (1997). In other words, the suggested reform of the current UK model looks a lot like the U.S. Social Security system. At this point in time the U.S. system is an export, though there are many ways to improve coverage, equity and efficiency along the margins. There is no compelling international model to import.

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Chairman BUNNING. Thank you. Let me remind the panel that we have a reasonable amount of time set aside for each person, and I don't want to have to gavel you silent, but I will if you continue to run over.

And that is not a threat, Doctor. Doctor Piñera.

STATEMENT OF JOSÉ PIÑERA, PRESIDENT, INTERNATIONAL CENTER FOR PENSION REFORM, SANTIAGO, CHILE; COCHAIRMAN, CATO INSTITUTE PROJECT ON SOCIAL SECURITY PRIVATIZATION; AND FORMER MINISTER OF LABOR AND SOCIAL SECURITY

Mr. PIÑERA. Mr. Chairman and distinguished Members of the Subcommittee. I am very honored to be here. I am a Chilean citizen, but I spent many years in your country and my eldest son has been born in this country so if our experience in Chile can be of any help to your country, I will be very proud and very happy.

As you know, 17 years ago in Chile we faced a very difficult dilemma. Our pay-as-you-go Social Security system that began in 1925, 10 years before the United States signed the Social Security Act, was going bankrupt. It was like the Titanic ship going directly toward the iceberg of an aging population. There was no way of saving that system. But we do believe in the noble idea of Social Security, so in order to save Social Security, we decided to radically change the way it is provided.

The basic idea in Chile was to allow workers to put their full payroll taxes into individual retirement accounts. The basic idea is that for a long time investors have known the extraordinary power of compounded interest. The fact that money saved during a long period of time gets interest over interest, and therefore you are able to build a huge amount of wealth. But generally workers have not been able to benefit from this extraordinary force because they do not have enough money to make additional savings.

So the basic idea of the Chilean system is to allow all workers of the country to benefit from the magic of compound interest and, therefore, to save during their lives and build wealth so that when they reach the retirement age they have a huge capital of their own.

Every Chilean worker carries a passbook like this. I always carry a set of them. There are many of them. It is a pension passbook where every month the 10-percent payroll tax goes into their account. They cannot take it during their working life. This money is protected by the constitution and the law. The workers are empowered because they know that they can decide which company can manage their money. They can even move from one to the other whenever they want. So when they reach retirement age, they do not look for the government to provide them a retirement check, but rather they get an annuity out of the capital accumulated in this account.

The system gives government two very important roles. First, of regulation. That is, we have created a very technical supervisory body in order to assure that this money is invested in a very safe portfolio of bonds and shares. And second, the government provides a safety net. If after 20 years of contributions you reach 65 and you have not accumulated enough wealth to provide a minimum annuity, then the government fills the account of the worker out of general tax revenues.

We place three basic rules for the transition to this system. The first one is we guarantee the elderly their benefits. That is, we protected our grandmothers' retirement checks. The elderly shouldn't be harmed because of this pension reform and they were not in Chile.

Second, we gave every worker the free choice that if they liked the government-run Social Security system, they can stay there. But we allowed them the free choice of moving out to this new system of individual retirement accounts. And when they did, we gave every one of them a recognition bond recognizing their past contributions. And the third rule was that new entrants into the labor force enter into the system so that we know then that in time the new system will be the only system in place in Chile.

The results have been extraordinary, first, for the workers. When I explained the system, because I was Secretary of Labor at that time and I did a huge education effort, I told workers that only with a 4-percent real rate of interest they will be better than the old system. During 16 years, the average real rate of return, real, above inflation, has been 12 percent a year.

If you take the administrative cost of 1.3 percent of assets on average, that means the real rate of return of 10.5 percent a year for 16 years. That is incredibly good for the workers. So this has meant a big benefit to every worker in the country and especially the very poor who are able to benefit from the power of compound interest.

Second, on macroeconomic grounds, the results have been extraordinary. Chile has been growing at 3.5 percent during all this century. Now we are growing at a rate of 7 percent a year during the last 12 years. That means if we go another 8 years growing at 7 percent, in 20 years Chile will have multiplied, GNP, gross national product, by 4. When you multiply your GNP by 4 it is a new country, it is an economic, social, even a political revolution.

And finally, and maybe the most important thing this has given workers is more personal freedom, has empowered them and allowed them to participate in the benefits of the economy. In Chile when share prices go up, every worker benefits because they know they have their money in the market.

In a system rewarding in the world the accumulation of wealth, we have allowed workers to also benefit from owning wealth and not only having income. This has created also a sense of belonging of the workers, have given them more dignity because they can confront employers owning wealth, and it has led to a very successful economic and political system in Chile. Thank you very much.

[The prepared statement follows:]

Statement of José Piñera, President, International Center for Pension Reform, Santiago, Chile; Cochairman, CATO Institute Project on Social Security Privatization; and Former Minister of Labor Social Security

Mr. Chairman, distinguished members of the subcommittee:

My name is José Piñera and I am a Chilean citizen. I spent several years of my life at Harvard University, earning a Master in Arts and a Ph.D. in economics, and my eldest son was born during those years in Boston. Today, I am president of the International Center for Pension Reform in Santiago, Chile, 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 privatization of the Chilean pension system.

I want to thank Chairman Bunning for his invitation to me to testify. 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.

THE WORLDWIDE PENSION CRISIS

The real specter haunting the world these days 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 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.

For example, the OECD projects that government retirement benefits alone will exceed 16 percent of GDP annually in Germany, France, and Italy by 2030. According to the OECD, the current unfunded liabilities of the public pension systems in France, Germany, and Japan are well over 100 percent of their respective GDPs. In the United States, your Social Security system will begin running a deficit in just 15 years.

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 and 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.

When I was secretary of labor and social security in Chile, we faced similar problems with our social security system. In 1981, we decided to replace our U.S.-style pay-as-you-go system with a new system based on individually-owned, privately invested accounts, details of which I will provide in a few minutes. This system has been an overwhelming success for 16 years and is now being copied throughout the world.

The success of the Chilean private pension system has led three other South American countries to follow suit. In recent years, Argentina (1994), Peru (1993), and Colombia (1994) undertook a similar reform. Mexico, Bolivia, and El Salvador have already approved laws that will reform their state-run pension systems following the Chilean model. The new system in those countries will begin operation in the next few months (for example, July 1 in Mexico).

As an indication of the power of ideas, even officials from the People's Republic of China have come to Chile to study the private pension system. Indeed, I have just returned from a conference in Shanghai, where I met with top government officials who demonstrated a clear interest in Chilean-style pension reform.

THE CHILEAN PSA SYSTEM [1]

Let me tell you a little more about the Chilean model. In 1980, Chile approved a law (D.L. 3500) to fully replace a government-run pension system with a privately administered, national system of Pension Savings Accounts.

The new system began to operate on May 1, 1981 (Labor Day in Chile). After 16 years of operation, the results speak for themselves. Pensions in the new private system already are 50 to 100 percent higher—depending on whether they are old-age, disability, or survivor pensions—than they were in the pay-as-you-go system. The resources administered by the private pension funds amount to around 42 percent of Chile's GNP. By improving the functioning of both the capital and the labor markets, pension privatization has been one of the key initiatives that, in conjunction with other free-market oriented structural reforms, has pushed the growth rate of the economy upwards from the historical 3 percent a year to 7.0 percent on average during the last 12 years.

In a recent work, has stated that, "The [Chilean] pension reform has had important effects on the overall functioning of the economy. Perhaps one of the most important effects is that it has contributed to the phenomenal increase in the country's saving rate, from less than 10% in 1986 to almost 29% in 1996. 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 social security contributions it has reduced the cost of labor. Second, by relying on a capitalization system it has eliminated the labor tax component of the retirement system."

Under Chile's Pension Savings Account (PSA) system, what determines a worker's pension level 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 a government-funded pension. Instead, during his working life, he automatically has 10 percent of his wages deposited by his employer each month in his own, individual PSA. 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," AFPs) to manage his PSA. 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," 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 PSA passbook and every three 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 pension (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 retirement age for powerful political constituencies. It is a one-size-fits-all scheme that exacts a price in human happiness.

The PSA 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 pension, based on the money in his account, and the year in which he wishes to retire. Alternatively, the worker can specify the pension amount 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

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

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 pension fund or the changes in the life expectancy of his age group. The bottom line is that a worker can determine his desired pension 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 PSA is tax free. Upon retirement, when funds are withdrawn, taxes are paid according to the income tax bracket at that moment.

The Chilean PSA system includes both private and public sector employees. The only ones excluded are members of the police and armed forces, whose pension 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 a PSA). All other employed workers must have a PSA. 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 pension fund, upon reaching retirement age, is below the legally defined "minimum pension" receives that pension from the state once his PSA 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 PSA has been depleted, does a poor pensioner receive a government subsidy. (Those without 20 years of contributions can apply for a welfare-type pension at a lower level).

The PSA 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 2.9 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 PSA to fund a pension 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 PSA 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 PSA 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 PSA 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 PSA 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 pension liabilities—does not exist under the PSA system.

In contrast to company-based private pension systems that generally impose costs on workers who leave before a given number of years and that sometimes result in bankruptcy of the workers' pension funds—thus depriving workers of both their jobs and their pension rights—the PSA system is completely independent of the company employing the worker. Since the PSA is tied to the worker, not the company, the account is fully portable. Given that the pension funds must be invested in tradable securities, the PSA has a daily value and therefore is easy to transfer from one AFP to another. The problem of "job lock" is entirely avoided. By not impinging on labor mobility, both inside a country and internationally, the PSA system helps create labor market flexibility and neither subsidizes nor penalizes immigrants.

A PSA system is also much more efficient in promoting a 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 a PSA scheme where stop-and-go contributions are no problem whatsoever.

The Transition

One challenge is to define the permanent PSA system. Another, in countries that already have a pay-as-you-go system, is to manage the transition to a PSA 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 a pension that their pensions would be unaffected by the reform. This rule was important because the social security authority would obviously cease to receive the contributions from the workers who moved to the new system. Therefore the authority would be unable to continue paying pensioners with its own resources. Moreover, 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 PSA system. Those who left the old system were given a "recognition bond" that was deposited in their new PSAs. (The bond was indexed and carried a 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 pension 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 PSA 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 pensions to retirees of the old system).

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 a recent World Bank study [2] at around 80 percent of GDP. (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.) That 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 a PSA system:

1. Since the contribution needed in a capitalization system to finance adequate pension 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).

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 pensioners 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 PSA system promoted substantially increased tax revenues. Only 15 years after the pension reform, Chile is running fiscal budget surpluses of around 2 percent of GNP.

5. In a theoretical state's balance sheet (where each government should show its assets and liabilities), state pension obligations may be offset to some extent by the value of state-owned enterprises and other types of assets. Privatizations in Chile were not only one way to contribute, although marginally, to finance the transition, but had several additional benefits such as increasing efficiency, spreading ownership, and depoliticizing the economy.

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

THE RESULTS

The PSAs have already accumulated an investment fund of $30 billion, an unusually large pool of internally generated capital for a developing country of 14 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.

Since the system began to operate on May 1, 1981, the average real return on investment has been 12 percent per year (more than three times higher than the anticipated yield of 4 percent). Of course, the annual yield has shown the oscillations that are intrinsic to the free market—ranging from minus 3 percent to plus 30 percent in real terms—but the important yield is the average one over the long term.

Pensions 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 a pension 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 pension, the total value would come close to 84 percent of working income. Recipients of disability pensions also receive, on average, 70 percent of their working income.

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

For Chileans, pension savings accounts now represent real and visible property rights—they are the primary sources of security for retirement. After 16 years of operation of the new system, in fact, 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 PSA.

Finally, the private pension system has had a very important political and cultural consequence. Indeed, the new pension 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.

Mr. Chairman, I will not try to spell out in detail exactly how a Chilean-style system can be established in the United States. Let me simply say that I believe it is possible for the United States to move to a social security system based on individual accounts and private investment. The transition to such a system will be technically tricky but can be done. Several of your country's top experts are now at work designing such transition proposals. I do not pretend that Chile's system can be imported to the United States without any changes. But, I do believe that you can learn from our successful experiment.

Thank you very much.

Chairman BUNNING. Thank you, Doctor.

Mr. Kay, please.

STATEMENT OF STEPHEN KAY, PH.D. CANDIDATE, UNIVERSITY OF CALIFORNIA AT LOS ANGELES, LOS ANGELES, CALIFORNIA

Mr. KAY. Mr. Chairman, thank you for this opportunity. I spent the past 4 years researching Social Security reform in Argentina, Brazil, Chile and Uruguay and I spent a total of 2 years in those 4 countries. Some people have suggested that Chile's privatized pension system provides a model for the United States. However, the Chilean system is not a compelling model because, one, it would entail massive transition costs and potentially high administrative costs; two, it would introduce risk and uncertainty regarding the adequacy of future benefits; and three, it would create distributional inequalities.

The costs of transition 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 4 percent of GDP. To finance the cost of moving to a funded system, governments must raise taxes, incur debt and/or cut other areas of public spending. In other words, privatization would exacerbate the problems of financing Social Security rather than solving them.

The pension fund market in Chile is dominated by a few funds and competition has not driven down costs. Marketing and operations expenses are very high as firms seek to capture the 25 percent of workers who switch funds every year. These costs are translated into high commissions for workers. Approximately 17 to 20 percent of worker contributions go toward commissions.

Furthermore, pension funds that charge fixed commissions take proportionately higher fees from lower income workers. Once commission costs are considered, the system's highly touted 12.7-percent average annual return was actually 7.4 percent.

Exposing individuals future Social Security benefits to market forces creates unnecessary risks. Predictions for future annual returns in Chile range between 3 percent and 5 percent. However, these are only averages. Through chance or skill some workers will do very well while others who make unwise investments or suffer bad luck will be poor. Even if a Chilean-style system did raise aggregate returns, a system that created winners and losers would run counter to the goal of providing basic retirement security for all citizens.

In Chile, the high evasion rates raise concern about the number of workers that will be able to enjoy secure retirement. Only 56 percent of workers affiliated with the system make regular contributions. Most of the uninsured come from the poorer sectors of the population.

By December, 1995, over a third of the contributors to the new private system had accumulated less than $500 in their accounts and half had less than $1,230. Chile's private pension system also treats women differently than men. Because women tend to earn less than men, spend more of their years outside the labor force and live longer, they systematically receive lower benefits than men.

In a sense, the Chilean system punishes maternity because interrupted earnings inevitably lead to lower pensions. Even if we assume identical wages during their working years, a woman retiring at age 65 and purchasing an annuity would be paid a monthly benefit equivalent to 90 percent of what a man would receive.

Finally, current pensions under the new Chilean system are not an indicator of future returns. These pensions were largely funded by special bonds issued to compensate for contributions made to the old pay-as-you-go system. The true test will come in the future when workers who have contributed for most or all of their lives begin to retire.

The Chilean case teaches us to ask the following questions: How would the massive transition costs be distributed? Would cuts come in education and health as in Chile? Would Social Security continue to have an effective antipoverty component? Would the risks of the marketplace, including the risk of inflation, be placed entirely on the shoulders of individuals?

Would membership in a private system be optional as in Argentina and Uruguay, or mandatory as it is for all workers who have entered the work force since 1981 in Chile? Would women systematically receive lower benefits? And finally, how would administrative costs and commissions be minimized?

We should ask all of these questions when considering the implications of privatization, thank you.

[The prepared statement follows:]

Statement of Stephen Kay, Ph.D. Candidate, University of California at Los Angeles, Los Angeles, California

Mr. Chairman, distinguished members of the subcommittee:

My name is Stephen Kay. I am a doctoral candidate in political science at UCLA and a political science instructor at California State University, Fullerton. I have spent the past four years conducting research and writing on politics and social security reform in Argentina, Brazil, Chile, and Uruguay. I spent a total of two years in these four countries.

Chile's 1981 pension privatization has garnered a great deal of international attention, and some have gone so far as to argue that it provides a case study in how to "save" the U.S. Social Security system. The Chilean system has received much praise for its simplicity, its important role in promoting the development of capital markets, its high returns, and the fact that it is well-regulated. However its weaknesses have received less attention. The new private system deserves criticism for its less than universal coverage, its high marketing expenses, operations expenses, and commission charges, and its gender inequity. Chile's new private system does not provide us with a model that would justify dismantling Social Security and adopting a system of individual capitalization.

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]

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 ranged from partial privatizations in Argentina (1993) and Uruguay (1995), to an aborted privatization drive in Brazil (the Brazilian reform is still underway).

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 are used to fund Social Security benefits. In Chile's private 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. 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 while the military and police kept their relatively generous PAYG systems. 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. The minimum pension is approximately 25% of the average salary, and is currently around $120 a month for those under 70.

The Argentine and Uruguayan reforms, which were implemented by democratically-elected governments, are partial privatizations which differ from

[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.

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 either a public or private 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 1981.

RETURNS AND COMMISSIONS

Since its founding, Chile's private system achieved impressive average annual returns on investment. However once commissions are factored in, the real average return is considerably lower. While advocates of privatization like to point out that the annual return on invested pension funds between 1982 and 1995 averaged 12.7%, this figure does not incorporate the commission charges that workers pay on contributions. If you count the amount workers contributed and deduct commission charges, an individual's real average rate of return over this period was 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 over the first four to five years (imagine a mutual fund with a 17% "load").[2] The 7.4% figure provides a more realistic assessment of the returns of the system because it represents what workers actually received on their entire investment. Furthermore, fixed commissions have been a source of regressivity in the new system because the charge consumes a proportionately greater percentage of the contributions of low-income workers (fixed commissions are becoming less common.)[3]

Although market competition should keep costs low, expenses generated by marketing have helped keep costs high. 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.[4] Furthermore, the pensions industry is oligopolistic,[5] as three firms controlled 68% of all insured persons in 1994. Chilean regulators have sought to lower commissions, which have come down from their peak of 8.69% of taxable salary in 1984 to around 3.1% today (these include a disability insurance premium of 1%); however commissions still represent a sizable portion of a workers' overall social security contributions.

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 firm's 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. Since these options are complex, workers often hire independent consultants, who charge a fee of between 3% and 5% of the total value of the individual's account.[6]

Chilean pension funds are often criticized for their high marketing and operations costs. Private pension funds engage in expensive sales campaigns to capture workers from competitors, as 30% of affiliates in Chile switched pension funds in 1994.

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[2] Shah, Hemant. 1997. "Toward Better Regulation of Private Pension Funds." Paper presented at the World Bank, LAC Division, 1–16–97.

[3] See Arenas de Mesa, Alberto. 1997. *Learning from the Privatization of the Social Security Pension System in Chile: Macroeconomcs Effects, Lessons and Challenges.* Dissertation. University of Pittsburgh, Pittsburgh (March) 1997. Arenas de Mesa quantifies how commission charges affect low and high income earners due to commission charges.

[4] 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.

[5] 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.

[6] Gillon, 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.

These marketing costs absorb betweRoughly a third of these administrative costs are generated by salespersons seeking to persuade workers to switch funds.[7]

RETURNS AND PENSIONS

Pensions granted in the next few years are not necessarily 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%.[8] The true test will come in the future, when workers who have contributed to the new system for most or all of their lives begin to retire.

While the system has achieved high annual returns thus far, whether or not they can be sustained is uncertain. Chile's high returns resulted from specific macroeconomic circumstances in the 1980s. The economy had hit a low point in 1982 when 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.[9]

Pension benefits depend upon worker-investor savvy and/or luck, as well as the overall performance of the economy. 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.[10] One study estimated that for Chile to achieve the system's goal of a 70% replacement rate, the system would have to have annual returns of around 4.5% (leading some analysts to suggest that the 10% worker contribution might not be sufficient to generate a 70% replacement rate).[11] This demonstrates how sensitive pensions are to market returns. Of course these are only averages. Except where government subsidies raise worker benefits to the minimum pension, each individual worker-investor bears the risks of the marketplace, and may do better or worse than the average.

GENDER EQUITY

While PAYG systems in Latin America generally reproduced market inequalities, privatization marks the abandonment of some equity-enhancing measures that were present in the public PAYG systems. The most striking change concerns the treatment of women. In the old PAYG system, women received more generous benefits with fewer requirements, and the disparity in benefits between men and women was smaller. The private social security systems in South America favor men by 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 (benefits are even lower if women opt for early retirement).

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 former salary, while a man retiring at age 65 would receive 86%. Arenas de Mesa and Montecinos argue that Chile's new private system punishes maternity because interrupted earnings inevitably lead to lower pensions. This is a consfits with earnings, rather than providing both redis-

[7] Fidler, Stephen. 1997. "Lure of the Latin Model," *Financial Times*, 4–9–97.

[8] 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*.

[9] See Vittas, Dimitri. 1995. "Strengths and Weaknesses of the Chilean Pension Reform." Mimeo. Financial Sector Development Department, World Bank.

[10] The figures on the rate of return and benefits are from Gillon and Bonilla (1992). Cheyre predicts a 5% annual return (see Cheyre, Hernan 1991. *La Previsión en Chile, Ayer y Hoy. Santiago: Centro de Estudios Públicos).*

[11] See Gillon and Bonilla (1992 p. 186) and Barr (1994 p. 213).

tribution and earnings replacement, as is the case in the United States Social Security system.

Non-Compliance

While 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, evasion persists. Only 60 to 62% of workers are covered by the new system, figures that are similar to the old system.[12] In the early 1990s, 54% of affiliates were active contributors (defined as those making a contribution in December of each year).[13] In June of 1995, 43.4% of those affiliated with the new system made no contribution[14] (evasion levels have remained high in Uruguay and Argentina's new private systems as well). The compliance rate also varied by income level. Funds which catered to lower-paid workers received contributions from 45–55% of their affiliates, while those serving higher paid workers had a compliance rate of 80–90%.[15] To further illustrate the problem of evasion, 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.[16]

Capital Markets and Savings

Although economists have had a difficult time quantifying it, 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.[17] In a country like the U.S., with its well-developed capital markets, the same process may not occur. As UCLA economist Sebastian Edwards put it, "It is not clear that these mechanisms that have benefited Chile will be there in other, more developed countries."[18]

According to economist Nicholas Barr, the effect of a funded pension system on economic growth is "arguably the most controversial area" of this debate, and the "experience of countries in the West is inconclusive both theoretically and empirically."[19] 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), there does not seem to be a lot evidence to support this claim. A recent study argues 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.[20]

Transition Costs

The enormous transition costs of privatization, and how they would be distributed, is perhaps one of the most overlooked issues in the privatization debate. In a privatized system, workers stop paying social security contributions to the government, but the government will continue to owe benefits to individuals belonging to the old system. This shortfall in revenue can only be financed through cutting other areas of government spending, raising taxes, or debt. Prior to privatizing, the Chilean government raised the retirement age to 65 for men and 60 for women and eliminated privileged retirement programs based upon years of service. The govern-

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[12] See Fidler (1997).

[13] See Vittas (1995).

[14] Ruiz-Tagle, Jaime. 1996. *El Nuevo Sistema De Pensiones En Chile. Una evaluación provisoria (1981–1995). Carmelo Mesa-Lago reported that in 1991, 52% of those in private pension schemes contributed regularly. See Mesa-Lago, Carmelo. 1994. Changing Social Security in Latin America.* Boulder: Lynne Reiner.

[15] These figures are from 1990. See Barr (1994 p. 212).

[16] See Shah (1997).

[17] See Holzman, 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."

[18] See Fidler (1997).

[19] See Barr (1994).

[20] See Arrau, Patricio 1996. *Nota Sobre El Aumento del Ahorro en Chile.* CEPAL: Santiago. The 1% figure is from 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.

ment ran budget surpluses, privatized state-owned industries, and issued bonds that were purchased by the new pension funds. Since recognition bonds were not issued until retirement, some of the transition costs could be postponed. In the 1980s, transition costs were around 3% of GDP, and are expected to range between 3% and 4% of GDP over the next five years.[21] As the transition costs grew in the 1980s, they consumed relatively greater percentages of social spending, while expenditures on health and education were cut.[22]

INFLATION

The biggest risk to any investment portfolio is inflation, which is less threatening in a PAYG system, where most of social security revenue is paid out as benefits. Only government is capable of insuring against inflation through prudent fiscal policy and the issuing of inflation-indexed bonds, the only inflation-proof financial instruments.[23] The risk of inflation is uninsurable (it is not an independent risk that can be pooled), providing an efficiency argument for government guarantees.[24] 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 a market downturn or inflation could diminish their capital.

POLITICAL RISK VS. MARKET RISK

One of the arguments for privatization is that it replaces political risk with market risk. In Latin America, social security benefits were constantly subject to political risk, because unlike the United States, governments often failed to index benefits against inflation, failed to take prudent steps to finance the system, promised unrealistic benefits, or did not pay what they legally owed. For example, until recently, Argentine workers were legally entitled to social security benefits equivalent to 70–82% of their former salary. In practice, few people ever received such a generous pension. By 1994, underpayment of benefits led to the filing of 335,000 lawsuits against the Argentine government for failing to fulfill its obligations.

In contrast, our Social Security system has always paid its benefits on time, it is fiscally solvent, and it has never been subject to the episodes of fraud and mismanagement that have occurred in South America. Unlike their Latin American counterparts, advocates of privatization in the US cannot substantiate rhetoric about government inefficiency ruining Social Security.

CONCLUSIONS

The social security systems in the Southern Cone of Latin America suffered from financial and administrative problems that we in the United States can scarcely imagine, and their debates over privatization were informed by fundamentally different political and economic realities. By most measures, governments in Latin America had failed to provide adequate social security coverage, and privatization offered an alternative strategy. In contrast, our Social Security system does not suffer the maladies that plagued South America's social security systems. Several eminent scholars of Social Security, including Henry J. Aaron, Robert Ball, Robert J. Myers, and C. Eugene Steuerle, have suggested a range of measures which would reform Social Security rather than dismantle it. If economist Herbert Stein is correct that "privatizing the Social Security funds would not add to national saving, private investment or the national income and would not allow the system to earn more income without anyone earning less," we might ask whether privatization is worth the risk and cost for resolving what is essentially a tractable actuarial shortfall.

What do the Latin American cases teach us about privatization? First and foremost, we need to consider how the transition costs of privatization would be distributed. Would they be paid for by new taxes, government borrowing, or cuts in other areas of public spending? Would cuts come in health and education, as in Chile?

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[21] See Asociación Internacional de Organismos Supervisores de Fondos de Pensiones, 1996. *Reformas a los Sistemas de Pensiones*. Buenos Aires: SAFJP. See p. 85.

[22] 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 Gillon and Bonilla (1992 p. 192–195).

[23] 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.

[24] Barr, Nicholas. 1987. *The Economics of the Welfare State*. Stanford: Stanford University Press.

Would Social Security continue to have an effective anti-poverty component? How much of the market risks of privatization would be shoule government? Would membership in a private system be optional as in Argentina and Uruguay, or mandatory, as in Chile? How would pension fund investments be regulated? By strictly linking paid employment and pensions, would women consistently receive lower pensions because of time spent outside the labor force? Would men and women be placed into separate actuarial categories, with women receiving lower benefits? And finally, how would administrative costs and commissions be kept down? We should ask all of these questions when considering the implications of privatizing the United States Social Security system.

The debate over privatization is not merely technical, but forces us to confront a fundamentally different vision of the role of Social Security. A private system simply mandates savings and investment for retirement, while each individual's retirement fate is determined by the market. Our Social Security system provides both earnings replacement and income redistribution that keeps about half of our nation's elderly out of poverty. Without some redistributive mechanism, millions of retired workers would end up on welfare despite having contributed to Social Security. It is a form of social insurance where each of us knows that no matter how life turns out for us, we (and our survivors) will be provided with an adequate benefit. Even if a private system did raise aggregate returns, it would not serve the purposes of Social Security to create a system where some investors fared well and others foundered. We are better off with a system that will continue to provide a secure retirement for everyone.

Chairman BUNNING. Thank you, Mr. Kay.

Mr. O'Sullivan, please.

STATEMENT OF ANTHONY BLUNN, SECRETARY, COMMONWEALTH, DEPARTMENT OF SOCIAL SECURITY, AUSTRALIA; AS PRESENTED BY PAUL O'SULLIVAN, DEPUTY CHIEF OF MISSION, AUSTRALIAN EMBASSY

Mr. O'SULLIVAN. Thank you, Mr. Chairman. Mr. Chairman, the Secretary of the Department of Social Security unfortunately couldn't be here today, but he has submitted a statement for the record.

Chairman BUNNING. Without objection. You are going to read it, or shall we just enter the whole statement into the record or are you going to summarize it?

Mr. O'SULLIVAN. No, I would rather do something else if that is convenient to you and the Subcommittee. Rather than summarize or read out of his statement, I thought it might be more interesting if I made some comments about the political and economic context.

Chairman BUNNING. That is fine. We will enter his full statement in the record without objection.

[The prepared statement follows:]

Statement of Anthony Blunn, Secretary, Commonwealth Department of Social Security, Australia

INTRODUCTION

Australia, like other OECD countries, is facing a steady ageing of its population. The Australian Bureau of Statistics has estimated that between 1994 and 2015 the proportion of Australians aged 65 years and over will increase from 11.9 per cent to about 23 per cent of the population. Like other countries, this projected demographic change has highlighted the need to develop a retirement income policy that is fiscally sustainable.

The Australian Government is committed to a retirement income policy that provides encouragement for individuals to achieve a higher standard of living in retirement than would be possible from the Age Pension alone, but also ensures that all Australians have security and dignity in retirement. This will be achieved by:

• encouraging people who are able to save for their retirement to do so, particularly through superannuation;
• ensuring the provision of an adequate public safety net in the form of an age pension for Australians who are unable to support themselves in their retirement years;
• ensuring the system is predictable, but facilitates choice and is equitable; and
• ensuring the system is fiscally sustainable and delivers an increase in national saving.

In the first section of this statement for the Sub Committee we will briefly outline Australia's social security system; and Australia's three pillar model of retirement income provision and factors contributing to its evolution; before turning in detail to describe the features of the superannuation pillar.

The second section analyses the major issues arising, including demographic and fiscal issues recent initiatives which are foreshadowing some possible future directions for Australian attention.

In conclusion, we outline the major advantages of the Australian system, with reference to our own institutional, political and economic context.

1. Australia's system—general features and context

The Social Security System

Unlike the United States, a national, general revenue funded system of social assistance is the principal means of providing social security payments in Australia. The historical focus of Australian social security has tended towards adequacy and income redistribution objectives rather than providing earnings-related pensions. Income support payments are flat rate, that is, the same rate of pension or benefit is paid to everyone regardless of their previous earnings, but has regard to current capacity for self support.

In Australia social security covers diverse target groups including the aged, people with disabilities, the unemployed, young people and families. Payments for families include sole parent pension, maternity allowance and child support. The Australian social protection system is financed from general taxation revenue. Welfare expenditure in Australia comprises 37% of total government outlays, including payments to veterans and child care. This represents 10% of GDP, or A$47 billion per annum currently.

Australia's system provides means-tested income security payments to over 4.6 million adults out of our total population of 18.2 million. Categorical income support payments are provided according to principles of "need" rather than previous income. Need is assessed by an income and assets test.

Social protection mechanisms are also evident in a range of Australian institutions and programs, including the recently introduced family tax initiative for low to middle income earners; superannuation; universal health insurance (Medicare); subsidised child care; high levels of home ownership; and award-based sickness benefits.

Australia's Retirement Income System

The Australian retirement income system can be described as a three pillar model. The first pillar provides a flat-rate, means-tested pension known as "age-pension." The rate of payment is not related to prior earnings. Rather, it is set at 25 per cent of Male Total Average Weekly Earnings (MTAWE) for a single person. The married rate of pension paid to each partner of a couple is currently 83% of the single rate. Eighty-four per cent of all aged Australians receive this pension (including Service Pensions). of the Age Pension recipients, 65 per cent receive the maximum amount and 35 per cent get a partial pension.

The second pillar mandates compulsory concessionally taxed saving for retirement through an employment-based system known as the Superannuation Guarantee (SG).

The third pillar encourages individuals to supplement the first two pillars, particularly through voluntary superannuation assisted by tax concessions and other saving.

Age Pension

The first elements of a national social security system began in l909, with the introduction of an Australia-wide, non-contributory and means tested age pension scheme. There were unsuccessful attempts to introduce a contributory social security scheme in 1928, 1938 and 1975. In the 1980s a brief trend towards a universal age pension was reversed when income and asset tests were reintroduced.

Policy trends in recent years have encouraged self provision, particularly through superannuation and private saving, so that those who have the capacity to support themselves without recourse to public assistance do so. This has also been reflected in the modifications that have been made to social security legislation and the income and asset test in particular.

The Age Pension is one of the largest Commonwealth government expenditure programs, with some 1.6 million customers and program outlays of A$12.1 billion in l995–96, or around 33 per cent of total DSS program outlays.

The Age Pension is paid to Australians who have been a resident for a total of 10 years (unless modified under shared responsibility social security agreements). It is payable to men at age 65 and women at age 61 years. However, the age for women is being slowly increased to 65 over the next 16 years (reaching 65 years in July 2013).

Payment is targeted at those in financial need through the application of income and assets tests. Under the income test pension is reduced by 50c for each dollar of income over a specified "free area" of income. Some pension can be received until other income reaches $A806.40 a fortnight for single people and $A1,347.20 a fortnight for couples. Under the assets test, pension is reduced proportionally for assets over specified limits. The test which results in the lower pension rate is the one which applies.

The rate of age pension paid is indexed every March and September, according to movements in the Consumer Price Index. The single rate of pension is also benchmarked to 25 per cent of MTAWE. As at 20 September 1997, the single rate of pension will be $A347.80 a fortnight (25.3 per cent of MTAWE) and the married rate of pension will be $A290.l0 a fortnight for each member of a couple.

SUPERANNUATION (Private Retirement Provision)

The role played by superannuation in Australia's retirement income policy has grown considerably in importance since 1983 and is expected to have considerably greater influence in the future. It is important to have some knowledge of the way in which occupational superannuation has evolved as it is unique to Australia and other countries might not experience the same circumstances.

Superannuation in Australia is a long term savings arrangement that operates primarily to provide income for retirement from paid employment. Since contributions are made usually in the form of a percentage of earnings, superannuation tends to provide end benefits that are related to pre-retirement income.

Superannuation differs from social insurance in that it is privately managed (albeit publicly regulated) and occupationally based.

Australia expects that its superannuation arrangements will lead to increased household and national savings in the long run. The superannuation arrangements can be viewed in part as a move by the Government from an unfunded age pension to a partly Government partly private, funded retirement income scheme.

In 1983 less than 40 per cent of employees had some form of superannuation coverage. These employees were concentrated in the public sector and in higher income private sector employment.

There was little regulation to ensure that superannuation savings were preserved to deliver income in retirement. There was limited opportunity for portability of benefits between schemes, consequently, superannuation mainly served to provide higher income earners with concessionally taxed windfalls on change of employment.

- only 5 per cent of such benefits taken as a lump sum were included in a person's taxable income and taxed at marginal tax rates.

A process of reform commenced in 1983. Firstly, the tax on that component of lump sum benefits relating to employment after June 1983 was increased to reduce the bias against people taking benefits as annuities and pensions. A higher tax was also imposed on benefits taken before age 55 to encourage superannuation savings to be preserved until retirement after that age. Also, rollover vehicles, namely approved deposit funds and deferred annuities, were created in 1983 to provide people with the opportunity to preserve their superannuation benefits within the concessionally taxed environment until retirement, and to facilitate the portability of superannuation benefits when people changed jobs.

In 1986, the then Government sought to encourage the spread of superannuation through the workforce by agreeing to support the peak employee body, the Australian Council of Trade Unions (ACTU), in seeking through industrial awards a universal 3 per cent employer provided superannuation benefit in lieu of an equivalent productivity based general wage rise. Award superannuation was to be fully vested in the member and subject to preservation until retirement after age 55. Endorsed by the Industrial Relations Commission, industrial award superannuation became the principal vehicle for increasing the superannuation coverage of wage and salary earners.

Award superannuation played a principal role in extending access to superannuation to some 72 per cent of employees by July 1991. However, it suffered a number of problems, including:

- non-compliance by employers and the costs associated with employers who did not fulfil their obligations;
- the fact that not all wage and salary earners were covered by awards and difficulties in ensuring award superannuation provisions were reflected in all State and Federal award jurisdictions; and
- the difficulty of facilitating increased superannuation contributions through the award system.

In an effort to overcome these problems and in recognition of the fact that a voluntary tax assisted private savings system could not of itself be relied upon to deliver a secure retirement other than for the wealthy, Australia moved to formally adopt a three pillar retirement income policy with the introduction of the Superannuation Guarantee (SG) in 1992.

The SG is a compulsory, occupational based, defined contribution superannuation system. Under the SG employers are required to make on behalf of their employees prescribed minimum contributions to complying superannuation funds. The required minimum contribution was set at 3% of employee earnings in 1992 rising to 9% of employee earnings in 2002–03.

- Under the SG, assuming a 9 per cent contribution rate, it is estimated that a person earning ordinary time earnings can be expected to achieve a replacement rate of pre retirement final net expenditure of 72%.
- Superannuation coverage of employed people was around 81 per cent at November l995.

Administration and Investment.

Superannuation funds operate as trusts with trustees being solely responsible for the prudential operation of their funds and in formulating and implementing an investment strategy. Duties and obligations are codified and trustees are liable under both civil and criminal law for breaches of obligations. Superannuation funds face few investment restrictions. There are no asset requirements or floors, no minimum rate of return requirements, nor a Government guarantee of benefits.

As a result, superannuation funds tend to invest in a wide variety of assets with a mix of duration and risk/return characteristics. The recent investment performance of superannuation funds compares reasonably with alternative assets such as ten year bonds.

As at March 1997 there were 151,311 superannuation funds with assets totalling around A$279.5 billion. However, some 98% of all member accounts are held in approximately 8,000 funds.

Superannuation Industry Regulatory Framework.

The prudential regulation of the superannuation system is currently the responsibility of the Insurance and Superannuation Commission. Concurrent with the introduction of the SG, a number of reforms were made to the superannuation regulatory framework to enhance the security of retirement savings. The new prudential regulatory regime is embodied in the Superannuation Industry (Supervision) Act 1993 and provides, in particular, for:

- a significant strengthening in the role and responsibilities of trustees;
- an increase in the role and responsibilities of key services providers, including actuaries, auditors and fund managers;
- greater participation by members in the management of their fund, including through equal member representation on trustee boards;
- full and proper disclosure of relevant information by superannuation funds to their members and a requirement on funds to make available appropriate internal and external procedures for resolving member complaints; and
- increased enforcement powers for the Insurance and Superannuation Commission.

Superannuation taxation arrangements and voluntary contributions.

The income of complying superannuation (and approved deposit funds) is generally subject to concessional taxation under the Income Tax Assessment Act 1936 at a rate of 15%. Superannuation pensions and lump sums (within specified thresholds) are also subject to concessional taxation. Additional voluntary contributions (up to a prescribed reasonable benefit limit) also receive concessional treatment.

Forecast impact of social security reform

Currently around 84 per cent of Australians of Age Pension age draw on the Age (or equivalent veterans' Service Pension), with some two-thirds of pensioners being paid the full rate pension. It is projected that expenditure on Age and Service Pensions will rise from 3.2 per cent of GDP in 1994–95 to 4.7 per cent in 2050 taking into account the reduction in pension outlays resulting from the superannuation savings accumulated under the compulsory SG arrangements. Without the SG, pension outlays would increase by a further 0.3 per cent of GDP by 2050.

Fiscal pressures and saving

The continued high levels of Australia's current account deficit (CAD) are of major concern. Unemployment cannot be reduced on a sustainable basis without adequate investment. Therefore, unless additional savings are available, including from the public sector, the CAD will not be reduced over time.

Increasing dependence on foreign savings, as reflected in growing net foreign liabilities, exposes the economy to sudden shifts in market confidence, leads to higher borrowing costs for Australian business and makes the economy more vulnerable to external shocks. Inevitably, the effect of these risks is to place an external "speed limit" on the pace at which economic growth can be sustained.

The Government's medium term fiscal strategy is to follow, as a guiding principle, the objective of maintaining an underlying balance on average over the course of the economic cycle. This approach will ensure that over time the Commonwealth budget makes no overall call on private sector saving and therefore does not detract from national saving; it will provide the Government with the flexibility to allow fiscal settings to change in response to economic conditions over the course of the cycle and to respond to external shocks.

The Government is committed to introducing legislation to ensure greater fiscal discipline and enhanced reporting arrangements in accordance with its election commitment to a Charter of Budget Honesty.

There is also a need to increase private saving and household saving in particular. Private saving comprises household and corporate saving. After reaching a peak in excess of 14 per cent of GDP in the mid-1970s, the gross household saving rate trended steadily downwards with some small temporary rises reflecting cyclical peaks in economic activity before flattening out over the past five years at around 7.75 per cent of GDP. over the same period, the gross corporate saving rate has risen from around 4.5 per cent to a peak of 6.75 per cent of GDP in 1993–94, with a small fall since then.

Despite six years of recovery since the recession of l990–91, gross private saving remains at around l5 per cent of GDP compared with an average 16 per cent in the 1960s and 18 per cent of GDP in the 1970s.

Recent developments—measures introduced

Australia's retirement income policy faces a number of challenges including to:

- improve the equity, efficiency and flexibility of the retirement income system;
- minimise the incentives and opportunity for retirees to dissipate superannuation savings rather than use them to provide a genuine income in retirement;
- improve the interaction between the age pensions and superannuation aspects of the retirement incomes system; and
- provide for greater competition and choice in the contribution and retirement phases of the system.

Towards this end, the current Government elected in 1996, while generally endorsing Australia's current three pillar retirement incomes policy, has introduced a number of reforms aimed at successfully meeting these challenges.

These reforms have been strongly focused on improving the operation of the retirement incomes framework including incentives, and further enhancing the principles of self provision and capacity to pay—underpinned by a commitment to benchmarking the adequacy of the age pension. A number of initiatives now serve to broaden choice within the third pillar of retirement provision. These recent announcements are likely to set the future direction for retirement policy reform in Australia.

Specific reforms announced in the 1996–97 Budget and in the Government's 1997/98 retirement income policy statement, *Savings: Choice and Incentive*, by the Hon. Peter Costello MP, Treasurer; and Senator, the Hon. Jocelyn Newman, Minister for Social Security, are outlined below.

To improve choice and competition within the superannuation system the Government introduced Retirement Savings Accounts (RSAs) in the 1996/97 Budget to provide a simple, low cost, low risk product especially suited to those with small amounts of superannuation.

Certain institutions including banks, building societies, credit unions, life insurance companies and prescribed financial institutions may apply to the Insurance and Superannuation Commissioner to become an RSA institution, that is to provide superannuation without a trust structure. RSAs are required to be "capital guaranteed." The RSA Bill provides that where an RSA provider undertakes poor investment decisions which result in negative investment returns, these cannot be passed on to the RSA holder to reduce the balance in the holder's account. They are fully portable, owned and controlled by the RSA holder, and are subject to the retirement income standards applying to other superannuation products, including preservation, contributions eligibility and disclosure rules.

To ensure that superannuation savings are directed towards producing an income in retirement the Government has announced a phased increase in the preservation age from 55 to 60 by the year 2025 and tighten preservation rules.

Further, the Government aims to make the Social Security means test treatment of income streams simpler, more consistent and more equitable. From 1 July 1998, income streams will be more effectively classified and means tested on the basis of their characteristics. Consistent with these changes, the superannuation regulations will also be amended to provide superannuants with greater choice as to which income stream products qualify as "complying" pensions or annuities for purposes of gaining access to the higher superannuation pension reasonable benefit limits.

To improve the flexibility of superannuation arrangements for low income employees, from 1 July 1998, people earning from $450 to $900 per month from an employer (or $1,800 over two months where the person is under 18 years of age) will be allowed, with the employer's agreement, to choose to receive wages or salary in lieu of employer SG contributions.

To enhance competition within and between superannuation funds and RSA providers the Government has announced a measure whereby employers will be required to give employees 28 days to make a choice from among five (or more) complying superannuation funds or RSAs nominated by the employer. For existing employees, employers must provide a similar choice within two years of the date of effect of the legislation.

Providing cost effective and equitable assistance to household saving for life cycle needs in a manner which recognises the importance of individual choice, a tax rebate will be available to individuals who make undeducted (ie, already taxed) member superannuation contributions, and/or who earn net personal income from other savings and investments, up to an annual cap of $3,000. The rebate will be phased in at a rate of 7.5 per cent from 1 July (a maximum rebate of $225), rising to l5 per cent (a maximum of $450 per annum) from 1 July 1999.

Finally, the Deferred Pension Bonus Plan offers people of Age or Service Pension age a positive incentive to defer retirement. Under the plan a person who defers retirement and access to the Age or Service Pension will accrue a tax exempt bonus of 9.4 per cent of his or her basic pension entitlement for each year of employment beyond Age or Service Pension age, up to a maximum of 5 years, when the bonus reaches 47 per cent of entitlement for each of the deferral years. The starting date for bonus accrual will be 1 July 1998. The bonus will be paid as a lump sum on pension take-up. At current pension rates, the maximum bonus would be $21,251 for a single person, and $35,450 for a couple who qualify for the maximum rate of pension.

Advantages—an Australian perspective

In recognition of the interests of the United States Sub Committee on Social Security the advantages of the Australian system focus in four main areas.

Firstly, the Australian Social Security system was developed according to Australian needs and history and it works appropriately for this country. Demographic conditions, institutional arrangements and political circumstances have had an impact on the direction that the social security system in Australia has taken. Within this framework Australia has developed its system to ensure that it meets the needs of Australians in a comparatively equitable manner.

The provision of uniform and flat rate benefits result in a high degree of equality and uniformity in pension and benefit rates and the structure of rights is based in legislation with a well established system of rights to appeal.

Secondly, the Australian Social Security system has been historically based on the principles of adequacy and income redistribution and is widely recognised as having one of the most highly progressive tax and transfer systems. As a consequence it is highly successful at directing social benefits to the poorest sector of the community compared to other countries.

Thirdly, Australia has demonstrated that it is possible, under the right circumstances, to add an earnings related scheme onto a non-contributory system. In particular, Australia's experience—although it is clear that the system is not yet fully tuned—demonstrates that major retirement income reform can proceed incrementally according to a country's institutional and other requirements.

The full impact of the use of superannuation in Australia will not be evident until around. However increasingly, aged people have access to more private resources. over time there has been a sustained increase in the percentage of age pensioners receiving a part-rate pension because of the level of their private income. In June 1987, 25.6 per cent of age pensioners received a part-rate pension; by June 1997 this had increased to 32.6 per cent. This is expected to continue to increase as superannuation coverage and benefits increase over time.

Finally, as a consequence of well established legislation, infrastructure and support, Australia has been able to fund its Social Security system from general revenue without adverse effects on the rate of Social Security payments. Australia's efficiency in its administration of the means testing system has assisted in keeping costs down. Recent data indicates that the Australian cost of administering social security as a proportion of total transfers was 3.8 per cent.

A major advantage of a targeted approach (via income and asset testing) combined with general revenue financing is its flexibility in dealing with economic, social and demographic changes. Spending decisions are more likely to be based on current and future priorities and economic conditions. Income and asset testing of social security benefits in Australia has also constrained social expenditure to levels far below those in most other OECD countries.

Mr. O'SULLIVAN. Thank you, Mr. Chairman. The early eighties saw a thorough reexamination of the Social Security system in Australia and essentially there were four findings out of that review which were relevant to subsequent policy choices. The first is that there were too many Australians dependent on Social Security age pensions as a primary source of retirement income. At that time less, than 40 percent of Australian workers participated in funded pension plans, and coverage was essentially limited to government employees, finance sector workers, professionals and senior business executives.

The second point was that although government funds were defined benefit plans that paid out pensions upon retirement, most private sector superannuation funds were simply tax-deferred compensation schemes for high-income employees. Third, dependence on Social Security age pensions reduced national savings and hence depressed economic growth. And finally the population was growing older. Australian age dependence ratio, which is the number of persons age 65 or more divided by the number of persons aged 15 to 64, will rise sharply from a projected 18 percent in 2005 to 30 percent in 2031. So what to do about those problems?

Well, the government at the time decided to implement a new retirement income policy based on three goals. The first was to provide more retirement income for future retirees. The second was to increase national savings, and the third was to reduce long-term budget pressures.

The government took the following steps to try and achieve those goals: The first was to mandate that most workers save 3 percent of their income. Employers were responsible for withholding that money and depositing the funds in a superannuation plan.

In 1992, the government boosted the required level of savings and extended the superannuation scheme to virtually all workers. So by 2002 when this new phase is fully implemented, all workers through their employers will have to save 9 percent of their income.

In addition to those mandatory savings, the government of the eighties made changes to the tax laws to encourage retirees to use superannuation savings to purchase annuities rather than making excessive lump sum withdrawals. The government also implemented means testing. Under that policy, the government's age pension is gradually reduced and eventually eliminated as income from other sources rises.

Moreover, the government also imposed an assets test, meaning that Australians can lose eligibility for age pension if their savings or other assets exceeds a certain limit.

Those essential features have stayed in place, but there were some adjustments when a new government took power in 1996. They did essentially three things. First of all, they gave some tax relief. To encourage additional voluntary retirement savings, individuals would be given a 15-percent tax credit up to an annual limit on savings income or additional contributions to savings accounts.

Second, consumer choice was enhanced. When deciding where their employers will deposit their superannuation savings, private sector workers are given the right to choose amongst at least five options. And third, more retirement income was encouraged, because early hardship withdrawals are now prohibited and the age at which withdrawals can be made will be increased to 60 years of age by 2025.

In view of the time, Mr. Chairman, let me just make some comments about how we have gone so far in achieving those three goals that were specified as objectives of the program of reform in the mideighties.

The first goal was to provide more retirement income for future retirees. Well, private savings will result in significantly higher retirement incomes for Australian workers. Average-wage workers under the new system will be able to retire with more than 75 percent of their preretirement income, which is approximately three times the level they would have received under the old system.

Second, the objective was to increase national savings. As it has turned out, the funds in superannuation accounts have soared from $40 billion in 1988 to more than $280 billion today and projected to reach about $1,500 billion by 2020.

Not only that, voluntary contributions have gone up so that all told, superannuation is projected to increase the national savings rate by 4 percent of Australia's GDP. And finally the objective was to reduce long-term budget pressures. Age pension reform will have a positive long-term effect on Australia's fiscal position. Had the government provided universal benefits, budget outlays would have grown dramatically consuming about 6.7 percent of GDP by 2050.

Under the current projections, outlays will climb to about 4.7 percent of GDP. And to grasp the magnitude of that shift, a similar degree of savings in the United States would require Social Security spending by 2050 to be cut by 320 billion 1997 dollars.

So, Mr. Chairman, the conclusion we reach is that we are on our way to being able, I believe, to control long-run entitlement costs while simultaneously increasing living standards for the elderly. Thank you.

Chairman BUNNING. Thank you, Mr. O'Sullivan.

Mr. Enoff.

STATEMENT OF HON. LOUIS D. ENOFF, ENOFF ASSOCIATES LTD., SYKESVILLE, MARYLAND; AND FORMER ACTING DEPUTY COMMISSIONER OF SOCIAL SECURITY

Mr. ENOFF. Thank you, Mr. Chairman, for the opportunity to be here today. It is an honor and a privilege to be back here. I want to say at the outset that the views I express today are purely my own as a private citizen. Although I have collaborated on a couple of papers in this area recently, these views are mine that I garnered over 30 years with the Social Security Administration and in the past 4 years as a self-employed consultant in over 15 countries where I have consulted on pension and Social Security issues.

I commend you, Mr. Chairman, and Members of the Subcommittee, for holding this hearing and this set of hearings on this vital subject that is so important to Americans of all ages and for laying out a record of what we need to do and some examples. The Social Security Program, which has been so successful in bringing the elderly out of poverty and protecting the income of millions of disabled workers and their families and in keeping families of workers who die prematurely out of poverty is headed for trouble. This problem is no secret and neither is it in dispute. The Advisory Council, the Board of Trustees, and nearly everyone who has looked at demographics and the economic projections agree to the problem and the need for a fix.

There is another major problem, I believe, and it is just as critical and that is the loss of confidence in this program by workers who are contributing to it. We all know that for a national transfer program like Social Security to be successful over the long term, the participants must have confidence that they will receive promised benefits and that there will be a fair return on their taxes paid. The need for reform is evident and the need is for reform that will truly provide for retirement security in the next century. Tinkering with the current system will solve neither of these problems.

I urge you to look at the facts and to make a determination to design and debate reform proposals to fit the needs of the coming generations, as well as to protect those who are retired or nearing retirement, and to design reforms which will restore confidence in this bedrock of protection for American workers.

Around the world, aging populations and maturing pay-as-you-go systems are causing nations to implement or plan reforms. The four countries represented here today display some of the most positive and innovative approaches that are being taken in developed economies. We can certainly learn from the successes and the failures of others in this respect.

In reviewing experiences of other countries, however, I urge you to be sure that the results are conclusive, that you have the facts and not just someone's observations, and that the principles are applicable to the United States.

In looking at the four experiences described here today, specifically, my view is that there are several lessons that we can learn.

One overriding lesson of which I am sure you are all aware is that Social Security reform takes time and courage, as well as the ability to sell and implement politically difficult decisions.

More directly, in Sweden we see the beginning of an effort to fund a formerly pure pay-as-you-go system with a unique method of funding being proposed and a series of benefit cuts to control future liabilities. Outside the lessons of bold leadership and careful planning, there are as yet no programmatic lessons to be learned here.

The success of the reforms in Chile is nothing short of remarkable, despite some of the comments you heard today. However, I believe that the economic, political and programmatic differences make direct application of the Chile model unfeasible in the United States.

Nevertheless, there are very valuable lessons to be learned from the creation of privately managed pension funds and the regulatory and administrative processes that are needed. Although the results in Australia are rather early, I believe that we can see there the need to gain broad bipartisan support for any Social Security changes and to carefully design and test models of proposed reforms so that we are not back here every 2 years looking at Social Security financing.

I believe that the United Kingdom experience provides several lessons for us. First, there is the popularity of choices in the second-tier mandatory savings approach. Also, on the positive side are the tremendous reductions in future government unfunded liabilities and the lack of negative impact on private savings, which is about twice the level of that in the United States.

On the negative side, we see the need to provide protections against unscrupulous fund managers and uninformed investors. Finally, we need to see how the changes in tax incentives affect the worker's choices to opt out of SERPs and to determine if a reform in the U.S. system should include options to move back and forth between private and government pensions. As a result of these and other experiences, I would suggest 11 principles for following in reforming the U.S. system.

One, give priority to long-range security and long-range goals. Be prepared to deal with some short-range costs, but give the priority to the long term. Two, protect current beneficiaries and those near retirement. You will have to work the exact details out as a plan is developed.

Three, admit that there will be a short-term cost to move to a funded program, but recognize that there is a cost to fix the current program as well.

Four, work at simplifying the program. It is far too complex. We could use much more transparency in the U.S. system. Five, take extra care to protect long-term low-income workers. There needs to be careful debate at the level of any flat benefit and who would be entitled. Six, design any reform to try and increase the overall savings rate. I think we need to fully explore giving income credits to low-income workers and also to fully explore earnings sharing for couples.

Seven, give workers some say in the level and investment of their retirement funds. I believe that is the only way to gain worker confidence in the system. Eight, design a comprehensive, but reasonable regulatory framework to protect the retirement investments of workers. Here, I think we have the Federal Employee Retirement System, FERS, and the Federal Employee Health Benefit Program to look at as successful startup models that offer all kinds of protections.

Nine, educate the public about the principles and projected outcomes of the reform program compared to the current program. I wish that this was already done for the current program. It hasn't been done, but I think an educational effort needs to be taken with the participation of the Congress.

Ten, proceed expeditiously to design and carefully to implement. We know and others have told us, that gradual implementation works best, and we also know that while we have time, each day of delay is costing us.

Finally, design reform for the retirement program, but consider separately the reforms needed for the disability and survivors program.

I would like to close by paraphrasing one of the remarks made by one of our United Kingdom colleagues who said something like, no one has the right to shirk the responsibility of contributing to the welfare of low-income workers to keep them out of poverty in old age, but neither should the government deter individuals from providing what they can do better for themselves.

Mr. Chairman, and Members of the Subcommittee, I urge you to think boldly, to plan carefully, and to speak truthfully in this endeavor. Thank you.

[The prepared statement follows:]

Statement of Hon. Louis D. Enoff, Enoff Associates Ltd., Sykesville, Maryland; and Former Acting Deputy Commissioner of Social Security

INTRODUCTION

Thank you for the opportunity to come before you today. It is an honor and a privilege to be here. I want to clarify for the record that the views I express are strictly my own. Although I have collaborated on two papers surrounding this subject, these views are mine as a private citizen, shaped by 30 years of service in the US Social Security Administration and the past four years as a self-employed consultant looking at social security programs in over fifteen countries.

Mr. Chairman and members of the Subcommittee I commend you for holding this hearing and the series of hearings dealing with this vital subject. The US Social Security program which has been so beneficial to so many Americans over the past 60 years is in need of reform. This program which has been so successful in bringing the elderly of this country out of poverty; in sustaining a modest lifestyle for millions of disabled workers and their families; and in providing an adequate income for millions of surviving families of workers who have died prior to retirement; needs to be reformed in order to meet these same needs during the next century.

This need for reform is not a secret, neither is the need in dispute. The Social Security Advisory Council, the Board of Trustees and just about everyone else who has looked at the demographics and economic forecasts (optimistic and pessimistic) agree that something needs to be done. The demographics cannot be changed. Those who will be retiring in the next 50 years have already been born. Except for the possibility of a small change in immigration, the only reasonable expectation would be an increase in longevity which would only exacerbate the financial plight of the program.

The other major problem facing the Social Security program is the tremendous loss of confidence with this program among workers, particularly young workers. We all know that for a major transfer program like social security to succeed in the long term, those paying into the system must have confidence that they will receive promised benefits and some kind of fair return for the FICA taxes paid. Public opinion surveys show a continuing loss of confidence in the program. One often cited survey showed that most respondents believed they were more likely to see a flying saucer than to collect promised Social Security benefits. While this loss of confidence may be somewhat attributed to the general loss of confidence in our government, we must recognize that workers are becoming more concerned about getting a return for their FICA taxes. The current program will mean returns of only a fraction of the returns received by previous generations of workers and will actually produce negative returns for several cohorts of workers.

FOREIGN EXPERIENCE WITH SOCIAL SECURITY REFORM

Around the world the aging of populations and the maturing of pay-as-you-go retirement systems are causing developed nations to review the economic viability of existing programs. In developing and transition economies there is a trend toward providing old age security through defined contribution schemes rather than the traditional defined benefit model developed in western Europe. Our neighbors to the North in Canada are developing a proposal for investing accrued retirement funds in the market rather than their traditional restricted government investments. They are also considering ways to curb the future unfunded liabilities of their pension system. Efforts to reform the system in Mexico are in progress as they are in several Latin American countries. In addition to Chile, the Argentines have implemented a comprehensive set of reforms and several other countries are in the design or implementation phase.

There are lessons to be learned from the experience of other countries. However, we must be sure that the results are conclusive from these other country reforms and also be sure that successful changes in other countries are applicable to the situation in the US. The experiences of the four countries you have heard from today represent a broad range of changes that are generally viewed as some of the most positive and innovative changes developed around the world. The presentations by this distinguished panel has certainly given much food for thought. I would like to be so bold as to suggest some lessons to be learned from these experiences based on my understanding of the current problems with the US system and some view of what is desirable in a new program. One overriding lesson to be drawn from the experiences of these countries is that social security reform takes time and courage as well as the ability to implement politically difficult decisions.

Looking at the experience of these countries individually we must recognize that Australia is in the early stages of realizing any results from their recent changes. As described earlier, their social security retirement program previously consisted of a strictly means tested benefit that was amended in 1991 to create a tier of employer financed non means tested benefits to be phased in over several years. As we have heard from our Australian colleague these amendments have already been revised because of the newly elected government's economic forecasts and plans. These kinds of frequent changes tend to work against building confidence in the retirement program. It demonstrates the need for reforms in the US to include a broad bi-partisan consensus and carefully tested models. With broad consensus and sound forecasts, reforms to our pension system can be relatively free from the need for amendments for many years. This constancy will help in building confidence.

The success of the reforms in Chile are indeed remarkable and deserve to be looked at. I believe that the economic, social, and political situation and the status of the social security program during the time of the reform in Chile differ so radically from the current situation in the states that it is unrealistic to look at the overall reform in Chile as a model for the US. Having said that, I do believe that there are several lessons to be learned. The creation and success of the special pension funds known as AFPs can give us great insight into structuring vehicles for investment of retirement funds by individual workers. Also, the rules concerning workers switching among the various funds and the protections provided by the regulatory framework can be helpful to us in designing the format for investment of individual funds.

In Sweden we see the beginning of an effort to fund what was a pure pay-as-you-go system as a trend that is becoming more popular around the world. Yet the method of implementing this change and for using the accrued funds made it unique. As you have heard, the changes are still under consideration and have not been fully implemented. It would appear that Sweden has taken a lead in showing how the social economies in western Europe may deal with the looming fiscal problems of their retirement systems. However, outside the general lessons of leadership and planning I do not believe there are programmatic models that can be adopted in the US.

As you know, I believe that the experience with reforms in the UK over the last fifteen years offer significant lessons for us. First, the UK experience shows that a mandated second tier defined contribution plan can become very popular with workers and can substantially reduce future unfunded government liabilities. The British experience with unscrupulous or fraudulent investment funds can also give some insight for the need to carefully build protections into any privately managed funds that are designated to provide security in old age. Protection of current beneficiaries seems to have helped the UK government convince the general population of the need for and desirability of the reforms. The growth of several new and innovative instruments for investing retirement funds should be a signal that while protections must be carefully designed there should be room for creativity and that market forces will design viable programs to meet the needs and desire of investors. Proposed changes by the new government may have the affect of causing many of those workers who have invested in their own plans to return to the government administered SERPS program. While broad bi-partisan support may pre-empt the rapid change of US pension reforms should a President of a different party be elected, this does raise a question about the structuring of a workers ability to move back and forth between privately run or government run pension programs. Argentina has a similar provision to their new pension system which allows workers to move back and forth between private or government run second tiers. While this ability to move between different options in the second tier may be a good incentive, it works against the goal of controlling future government liability. Finally, from a macroeconomic standpoint, the UK experience shows that this mandated second tier of pension savings did not have a negative effect on overall private savings which is about twice that of the US.

Principles for Reforming the US System

With the benefit of applying the experience of these four countries to the US situation, I would like to suggest a set of principles for consideration in your effort to reform the US Social Security program.

1. Give priority to the long range retirement security of American workers. Short term budget considerations are obviously important. However, it is time to look at the retirement needs of workers over the long term. Tinkering around the edges will not fix the current program and certainly will not restore confidence to the workers. We need to develop the most desirable retirement program from an economic, political, and social perspective. Even the most ardent supporters of the current program agree that if we were starting afresh, they would not design the current program. The transition plan and cost should only be tackled after a bi-partisan agreement at least to the principles of the selected approach.

2. Protect current beneficiaries and those near retirement age. Assurances should be given up front that current beneficiaries will not be harmed. The precise age of those to be guaranteed these rights might vary with an option for some age groups to join the new program or remain in the old. This can be done obviously only after the full particulars and projected effects of the new program are known. The nagging question of the correct measure to be used for indexation of benefits for the current program should be resolved on its merits and costs or savings considered in the projection of transition costs.

3. Admit that there will be a cost to transition from an underfunded pay-as-you-go program to one that is adequately funded or to any kind of funded program. There is general agreement that returns on accrued funds can be improved by investing them in some instruments other than government bonds. This increase in returns will not be sufficient to offset the transition costs in the short term. Therefore some funding mechanism will have to be developed. This could take many forms including notional accounts, increased contributions, increased government borrowing. The actual cost developed here should be recognized as only the net difference between the cost of the new program and the realistic cost of really fixing the current program.

4. Work at simplifying the program. The current program started out with a rather complex benefit formula and has become more complex over time. The average worker has a hard time understanding how to compute a benefit even if all of the necessary information is available. An easier to understand program would help in restoring confidence.

5. Take extra care to protect long term low income workers from poverty in old age. The current Social Security program has always provided for a transfer of funds from higher income workers to lower income workers. This transfer has been accomplished through weighting of the benefit formula. Although this transfer or welfare aspect of the Social Security program has not often been well understood, the principle is generally accepted and should be retained. A flat rate basic benefit paid to all who work and contribute to the program for a required minimum of years would accomplish this type transfer.

The level of any basic benefit should be carefully determined considering the number of beneficiaries, the funding source, and benefit amounts likely to be generated. Minimum requirements for this basic benefit may determine whether the level should be at or near the poverty level or higher in order to recognize the work effort and contributions of the workers.

6. Design any new program so as to try and increase the overall savings rate in the US. The savings rate in the US is about half of that in the UK. There is general agreement on the need to increase this rate if we are to remain competitive in the next century. A social security retirement system consisting of a first tier flat rate basic benefit and a second tier defined contribution element could enhance the overall savings rate in the country while meeting the social objectives and creating a fiscally sound retirement program for workers in the next century. One of the crucial elements for increasing savings is to increase savings by lower income workers. Favorable tax incentives alone have not proven successful in encouraging low income workers to invest in retirement funds based on our experience with IRAs. By mandating savings for retirement and providing incentives and perhaps subsidies to low income workers we would have an opportunity to increase overall savings and provide greater security for these workers while decreasing the need for needs based payments to the poor elderly. An EITC type transfer directly to a retirement account could ensure adequate retirement for low income workers while relieving some financial strain during their working life. This provides a type of transfer in an easily understood and fair way. Adequate retirement benefits for long term low income workers should reduce some of the need for SSI benefits for the aged. There will still be a need to develop special programs to meet the needs of part-time and intermittent workers. Earnings sharing between married couples should also be carefully explored as a means of providing adequate benefits for one earner couples and especially to help provide equity to divorced spouses.

7. Give workers some say in the level and investment of their retirement funds. Many of the proposals to fix the current program call for an increase in the normal retirement age. Despite the current requirement raising the normal retirement age from 65 to 67, there has not been a perceptible increase in the age at which most workers retire. Continuing to increase the retirement age could prove especially difficult for some low-skilled or fairly manual occupations. A somewhat personally controlled second tier of mandatory savings can have the flexibility to allow workers to save above mandated levels and thereby have some choice in the age or gradualness of retirement. Ideally we as a nation must look at ways to encourage older workers to remain productively in the workforce. That effort will include programs and incentives beyond this pension scheme. But the idea of a somewhat flexible second tier (with a minimum base) should eliminate the need for the cumbersome unpopular retirement earnings test. Tax treatment of benefits and contributions obviously are critical elements in making these decisions. Providing some individual worker choices about the investment of their retirement contributions is in my view the only way to really develop worker confidence in the program. While this is a major departure from the current program, times have changed since the initial program was designed in the 30's. The bond market, equities market, mutual funds, and other investment vehicles have matured tremendously over the last 60 years and average workers are much more familiar and comfortable with them. There are areas that will need to be strengthened (such as annuities), but I am confident that market forces will rise to the occasion and meet the needs when the demand is seen. However, even with this maturing of the markets and optimism, I do not believe we are prepared to simply let the market forces work.

8. Develop a comprehensive but reasonable regulatory framework to protect retirement investments of workers. While any person should have the right to invest their own money as they see fit, this is a government program designed to protect the security of workers in old age. A mandated savings program requires a higher degree of protection to ensure workers against fraudulent and unscrupulous activities and perhaps even some protections against the potential fluctuations of the market. While American workers have become more comfortable with investment vehicles, many of us, perhaps a majority would benefit from some extra protections at least in the initial stages of a new program of this magnitude. The FERS and the FEHBP programs offer some hands on experience with market oriented programs with an extra degree of regulatory protection. The framework of these programs could be used as a model for designing the initial retirement investment approach. I want to emphasize initial , because I would hope that the regulatory framework would allow for expanded freedom as more experience is gained.

9. Educate the public about the principles and projected outcomes of the reformed program compared to the principles and projected outcomes of the current program. Accurate education of the public about the current program is sorely lacking. Too many workers still think that they have an individual account which they pay into during their working life and draw benefits from during their retirement. Many other myths about the program persist and as mentioned earlier very few people are able to calculate their own benefit amount or understand why their benefit differs from that of a friend or neighbor. It is probably too late to complete a valid comprehensive public education effort before beginning serious efforts to design reform options. However, it is not too late to mandate that the implementation of the new program be preceded by an objective education effort to all age groups in the country. I would urge you to make this an integral part of your proceedings and to participate in the design and evaluation of the education vehicle.

10. Proceed expeditiously to design and carefully to implement. While we are not in a crisis, time is of the essence. Each delay in correcting current problems in the program will mean additional costs. Yet we and other countries have learned that changes implemented incrementally are much more readily accepted and more efficiently implemented. We have not talked about potential administrative difficulties in implementing any proposed changes or administrative difficulties in the transition. With adequate lead times all of the proposals offered in this testimony are administratively feasible and indeed might well simplify some of the current difficulties. The administration is just at the beginning of implementation of the comprehensive effort to inform workers about their contribution records and potential future benefits. This effort (PEBES) may indeed show that recordkeeping for the current program will require additional attention.

11. Design a reform of the retirement program but consider separately reforms to the disability and survivors programs. The current social security disability program has a number of substantial problems. However, these problems have more to do with administration of the program than with benefit levels now or in the future. These administrative problems are complex and have been around for years. I am speaking mainly of the length and complexity of the appeals process, the dismal rate of return to work by disabled workers, and the process problems of initial adjudication and continuing disability reviews. While these are substantial problems and need attention, because of the amount of the cost and the adequate structure of benefits in the disability program, it would be unwise to try to include this program with reform proposals for the retirement program. Fix the processes mentioned above and the cost of the disability program should be maintainable for some time in the future. The changes made to fix the existing process problems may indeed lead to some suggestions for changes in financing if any are needed. In the meantime, American workers should be protected from loss of income due to a disability.

Likewise, the Survivors portion of the Social Security program for families of workers who die prior to retirement is relatively small compared to the Retirement portion of the program. The retirement program should be reformed before attempting to redesign benefits for survivors. While some countries have opted to purchase group insurance from the private sector to meet these needs, it is often inadequate to meet the needs especially of young families. Once the retirement program has been reformed, the best method for protecting survivors in an adequate way should become clearer. This vulnerable group should not be put at risk.

Conclusion

In summary, I would like to close by paraphrasing a quote from our British colleague. One of the designers of the UK reform effort said something like "No one has the right to shirk the responsibility of contributing to the welfare of the low income worker to keep him from poverty in old age. Neither should anyone give up the right to provide for themselves if they can do it better." That statement should be a reminder of the need to allow greater freedom in planning for retirement for American workers. If that thought is kept before us, I believe that we can design, model, and implement a program that will increase security in retirement for workers at all wage levels. This should be a program which will endure through the next century and which will have the enthusiastic confidence of the workers and employers who participate. At the same time we can reduce unfunded government liabilities and increase our overall savings rate. While this sometimes sounds like it is too good to be true, who can question the remarkable productivity and ingenuity of American workers and the performance of the American economy? There will be a cost for the transition to such a program. The potential benefits far outweigh the costs and the alternative is not acceptable. Let us be bold in our thinking, careful in our planning, and truthful in our speaking.

Chairman BUNNING. Thank you, Mr. Enoff. Thank you all for your testimony and we will proceed. Put me on the time clock also so we will have 5 minutes of questioning by Members.

Let me ask a general question of the total panel. Has anyone here read the report of the Advisory Council on Social Security that was done in the United States? You all have? Or some of you have? OK. They had problems coming to conclusions. They came to three separate conclusions and said, take your choice of A, B, or C.

There seem to be mixed views among this panel also on whether private, personal accounts raise or lower national savings, since once individuals are compelled to have an individual account, they may likely cut back on other types of savings that they might use in retirement.

What has happened to your level of national savings since you have implemented your pension reforms in the countries that are implementing them? To what portion of any increase in national savings do you attribute your pension reforms as opposed to changes in the economy or any other things? So I am asking those who have—go right ahead, Mr. Sherman.

Mr. SCHERMAN. When it comes to the impact on the total savings rate of these mandatory savings plans, I should say that current knowledge in the scientific community tells us that we really do not know what is the effect. I could tell you that ISSA, the International Social Security Association, of which I am the president, has launched an initiative in order to try to find out better about what is the scientific state of knowledge today. And our experts advise us that although you can see on the surface certain effects of various arrangements when it comes to the pension systems, in the long run we cannot answer the question.

Specifically in Sweden, we have tried to find out what our pay-as-you-go system and the implementation of that system meant for the overall savings rate in the economy. We cannot answer the question because there are so many complexities and there are so many effects and countereffects that cannot be measured.

Chairman BUNNING. Mr. Finkelstein, do you have an opinion on that?

Mr. FINKELSTEIN. Similarly, the effect of measures are quite complicated, but neither the introduction nor the reform of SERPs significantly affected other savings. But the funding, the placement of government rebates into a funding system has significantly increased the amount of private sector savings, although obviously there is a transition cost.

Mr. PIÑERA. In Chile, the rate of savings went from 10 percent of GNP to around 27 percent of GNP after the reform was implemented. But it is true that there were also very important reforms helping that movement. So it is very difficult to say exactly the contribution of the pension reform.

Chairman BUNNING. In other words, there were incentives that were built in?

Mr. PIÑERA. Exactly, sir. There were incentives for additional savings. There were a lot of technical measures to increase savings, but it is difficult to know exactly the result.

Now, the best papers on this, sir, the general case that a reform like this would increase savings made in the United States, is by Professors Martin Feldstein and Larry Kotlikoff. And a professor at UCLA, Sebastian Edwards, has written a very good paper called, "The Chilean Pension Reform: A Pioneering Program," presented at the National Bureau of Economic Research conference in 1996, and his conclusion is that the pension reform has clearly increased the rate of savings in Chile.

Chairman BUNNING. Australia?

Mr. O'SULLIVAN. Mr. Chairman, I said in my testimony that part of the incentive for the reforms in the first part of the eighties was that dependency on Social Security age pensions had reduced national savings and depressed economic growth.

In fact, what had happened, to be more specific, is that Australia's national savings rate had declined from an average of more than 25 percent in the early seventies to about 16.1 percent in the 1991–92 period. So there is obviously an incentive to reform the pension schemes and national savings schemes to reverse that.

And as I mentioned, the effect so far, although it is not yet fully implemented, but the effect so far of the reform of pensions has been to boost superannuation accounts very significantly, and to boost not only those accounts, but to boost voluntary contributions as well. So that all told, superannuation is projected to increase national savings rate by 3.6 to 4 percent of GDP. At least initially the answer to your question is that our experience has been a positive one.

Chairman BUNNING. Thank you. The gentleman from California.

Mr. BECERRA. Thank you, Mr. Chairman. If I could begin, Professor Ghilarducci, you mentioned in your presentation the fees that are charged workers for these private investments. Can you give us a sense of how much those fees typically are, as a percentage of the investment, compared to regular investment vehicles?

Ms. GHILARDUCCI. Yes, they are high. And they vary. But on average, in Chile, they could be up to 17 percent. So this is 17 cents on the dollar that is contributed. Also, if there is a fixed fee structure, it means that people who have dropped out of the labor force for a while, like women, are still paying on their accounts, eroding itself even further. In the United Kingdom, the fees are even a little bit higher. The estimates have been 20 percent. They may be different, but they are also not very transparent.

Mr. BECERRA. What about the issue of transition costs, and this I open up to anyone on the panel. We spoke a bit about the Chilean model, and how the British also underwent a transition to a private investment model. We are nowhere near where the British were in getting to a more privatized system for Social Security. Certainly the Chileans underwent a change at a point when their entire economy and society was undergoing change.

What type of transition costs did those two countries undergo, and what type of transition costs might we undergo if we were to try to do something similar to either the Chilean or the British model? I leave it open to anybody.

Chairman BUNNING. Don't all jump up. Go right ahead.

Mr. BECERRA. Anyone who wishes to answer.

Mr. PIÑERA. Yes, can I answer? There are no economic transition costs, sir, in the sense that a movement to a system like this improves the present value of your economy in a way. There are cash flow costs, but the cost is already incurred because you have an unfunded liability, in the United States some put it at 7 trillion U.S. dollars. What the transition does is recognize the unfunded liability that the pay-as-you-go system already has, and, of course, there is a cash flow problem that should be financed adequately. But over the long term, the movement to the new system reduces the cost to the economy of keeping with the old system going on.

Mr. BECERRA. And in the case, let's talk about the transition—you say they are not transitional costs, but cost flow, or what did you call them?

Ms. GHILARDUCCI. Cash flow.

Mr. PIÑERA. Yes, it is cash flow. Teresa is right. It was around 4 percent of GNP in the first 10 years. And the good news in Chile is that we are running a budget surplus of 2.5 percent of GNP during the last 4 years. So after 16 years of the reform, the results have been so extraordinarily good for budget and finances that we now have a budget surplus.

Mr. BECERRA. So in the United States if we diverted our current payroll tax structure into a private system, we would probably run a deficit of $1 to $2 trillion. How would you address that for the U.S., how we would make up that $1 to $2 trillion deficit in the Social Security Fund?

Mr. PIÑERA. It depends how you define your transition. I don't believe that you should define your transition the same way we did it in Chile. You can do it in a much more gradual way. It would depend on how——

Mr. BECERRA. Doctor, Doctor, help me. If we let money come out of the Social Security System so that people can individually invest it, we have people who are already retired who must be paid. Over the next 10 years, the estimate is $1 to $2 trillion. How do we fund the system for those who are retired or retiring during that period of time?

Mr. SCHERMAN. Might I say that in Sweden——

Mr. BECERRA. If I could ask Dr. Piñera first, and then of course you, Mr. Scherman, you are welcome to answer as well.

Mr. PIÑERA. There are many ways to fund the transition. Professor Martin Feldstein proposed using debt. Basically recognizing the unfunded liability, that is not new debt.

Mr. BECERRA. If I could stop you there. Using debt; in other words, have the government run a deficit?

Mr. PIÑERA. Yes, of course, but you are recognizing the unfunded liability——

Mr. BECERRA. Let me stop you there. Let me stop you there. Have the government run a deficit; that means that at some point, we either had to cut spending in other programs or raise taxes; correct? Is that correct?

Mr. PIÑERA. To whom are you talking?

Chairman BUNNING. Let me relieve my good friend from California. We have a vote on. But I want to ask the panel if they will stay, because I have pages and pages of questions I want to make sure that I get to ask.

I just want you to think about one question that I want to ask. I want you to think of this question while we are away.

Did any of the countries have budget surpluses at the time of your reform? And did any of you use the surplus to help finance the transition? And if so, how did you do it? Maybe none of you had surpluses.

Mr. BECERRA. Mr. Chairman, when we come back, if anyone on the panel could just conclude with the remarks in answering that last question that I had, I would appreciate it.

Chairman BUNNING. We will recess for a few votes.

[Recess.]

Chairman BUNNING. The Subcommittee will return to order, please.

Let me reask the question I asked before I left. Did any of the countries that did a transition and/or a reform have a budget surplus at the time of those reforms, and did they use the surplus to help in that transition?

Mr. SCHERMAN. No, we hadn't any surplus in the economy, so we had nothing to use. And might I add that in Sweden it was no way to fund the system and find any big financial flows from anywhere. And that was one of the reasons why we are not switching to such a funded system, taking only a slice of the whole thing into a funded part.

We have no financial surpluses and we do not think that the Swedish population will be prepared to pay both for the savings for their own pensions and for the old pensions. So in a mature economy I do not think it is possible.

Mr. FINKELSTEIN. The United Kingdom was certainly assisted when it started its SERPs Program by the fact that the budget situation was good at the time and we had a surplus. But that only helped one part of the problem, and that is because we were encouraging so many more people to put their money into private pensions, they were not paying tax on that income. And so we did have a short-term cost, and we were able to fund it by a short-term budget surplus. But most of the transition costs are long term.

And for the program we put forward the last general election, we had to think how to meet costs that were not going to peak until 2020 or 2030, and so the way we addressed that was by putting forward changes that would not happen until 2020 or 2030, one of which was the equalization of the State retirement age; another of which were changes to entitlements to SERPs; and the third of which, which I think was the most important, was that the new entrants to the work force, we changed the date of your tax relief. Previously, you got tax relief before you paid into your pension. You paid your pension out of pretax income, and when you got it back, it was taxed. We changed that for new entrants and said that when you paid into your scheme, you paid out of posttax income, and that held the transition costs, and that was an important way of being able to answer questions about transition.

Chairman BUNNING. Mr. O'Sullivan, how about Australia?

Mr. O'SULLIVAN. The answer to the first question is, yes. In a number of years in the eighties and nineties, the Federal budget was in surplus, and it is now in structural surplus.

The answer to the second question is no, because there was no transition in the sense that you are using the word, Mr. Chairman, because essentially what happened is that a previous safety net had added to it a privately funded compulsory superannuation system.

Chairman BUNNING. Private vendors have often been described as winners in Social Security privatization. I am trying to think of the numbers that I have heard some of you use, 17 percent and 20 percent for management fees related to certain types of privatization.

Many of you have had wide and varied experience with private vendors as you have moved to the privatization portion of all of your pension schemes. Many of our constituents are skeptical about the privatization and the costs associated with privatization.

I was in the brokerage business for 25 years, so I am a little familiar with costs involved in private investments. In the United States, we have an awful lot of mutual funds that are nonload, in other words, that are not—they do not have any costs associated, except management fees, and usually, if they are fairly large mutuals, the management fee is 0.6 of 1 percent, or 0.7, or 1 percent max.

I am wondering why there is skepticism of our ability to move into some type of privatization, not totally, but a portion of the system into privatization, without a huge cost associated with it.

So if you would like to address that, Lou, go ahead.

Mr. ENOFF. Yes, Mr. Chairman, I think because of some of the high costs that were experienced in Chile and because there were some unfortunate situations in the United Kingdom with overselling those plans, I think people are skeptical for that reason.

But I think if we look at what we do have here, like the Thrift Savings Plan, the cost, we have an experience. We are talking about a large volume of funds, I agree with you. And maybe I would argue on the side of perhaps very careful regulation at the beginning to ensure that we do not allow some of those practices into the retirement system. I would like to think it would not happen, but it could, and so maybe we need to be extra careful in regulating that at the beginning, and we are not prepared at this point.

Ms. GHILARDUCCI. One of the reasons why our Social Security costs are so low is because employers pay a lot of it. They are responsible for collecting the money and sending it to the government. So a lot of cost of Social Security is actually spread out amongst all of the employers.

So part of the increase in cost of a private system is that workers would have to pay for the collection and also for the distribution of the money. So it is not just the management fees; it is also the administrative fees.

Chairman BUNNING. Let me ask the question, since you have been Commissioner and I have never been the Commissioner. I have to find these things out for the record anyway. Why would there be any associated cost if the individuals made the investment on their own?

Ms. GHILARDUCCI. Because what we saw in Chile and the United Kingdom, because the individual has to make choices about where to go, advertisement——

Chairman BUNNING. What if the government gave them 10 choices and said, these things are available, and you can do like I do in my 401(k), and say I choose A or B or C?

Ms. GHILARDUCCI. Because there will be a lot of advertising, a lot of coldcalling at dinner time. And also if we have a choice to move from plan to plan, even the advertising costs will accelerate. That happened in the United Kingdom and in Chile.

Chairman BUNNING. We can learn from their experiences.

Mr. SCHERMAN. I said in my opening statement, that there is a heated debate in Sweden today about the funded part. One of the issues discussed are the administrative costs. And I think, as has been said, that there will be competition between funds with marketing costs and such things that are very high.

This is a big political issue in Sweden, and I think that we are not going for a totally free competition between Administradoras de Fondos de Pensiones, AFPs, as in Chile and other South American countries. We will offer, I think, a couple of options and then try to streamline the administration of those funds.

Mr. FINKELSTEIN. It is easy to eliminate the cost of marketing if you eliminate markets. If you only give someone one choice, then you don't have the problem of advertising to them or having them pay any costs.

The costs are, indeed, reasonably high, but so are the returns. And I think people would rather have a system which institutes in Britain suggested might produce three times as great a rate of return, even if they do pay a higher administration cost.

Chairman BUNNING. I don't argue that fact, but the fact of the matter is, the 401(k) Federal retirement account has very little cost associated with it because there are limited choices. The more choices you give someone, obviously, the more cost there could be involved in it. But if the individual is making the investment choices, they ought to know what the costs are before they do it.

Mr. FINKELSTEIN. It is certainly true that the less choice you have, the less there are costs of choice, but also the less there are benefits of choice.

Chairman BUNNING. There could be a combination to begin with, and then expanding as you go down the road to more and varied accounts, private investment accounts.

Anyone else on the subject?

Mr. ENOFF. If I might, I think you are absolutely right, and I think that the market adjusts. One of the things when you look at the U.S. situation now, there are not a lot of annuities available. And we would say, well, you would want to have a more efficient annuity market.

Well, if these funds were there, the market would work, and I think you would bring down the cost of annuities, and that would happen. And I think you are right that we should start carefully. We have experience with FERS and with Federal employees health benefits, and those are real examples in the U.S. economy, so we do not have to speculate about what could happen on those.

Chairman BUNNING. As we debate the possible Social Security reforms and whether to adopt some degree of privately held accounts, questions are raised about the payout of the accounts. I would like to hear your experiences, if you have some, regarding any restrictions you have placed on the account before payout is allowed. For example, are individuals allowed to access these accounts to buy a home or to pay for anything else? In other words, anyone that has the experience with private accounts now.

Mr. FINKELSTEIN. You are not allowed to access those accounts.

Chairman BUNNING. You are allowed to?

Mr. FINKELSTEIN. No, no, you are not, because you receive tax relief on them.

We originally had a system whereby you had to purchase an annuity when you retired in order to get the money out of your account. The problem that we found was that sometimes people were forced to buy an annuity at a point when the market was low. So we changed the regulations to allow people to buy the annuity at any time up to the age of 75, and between retirement and 75 they can draw down on that account. They tend to prefer not to do so, because drawing down is actually quite expensive in terms of management costs. But they do have that choice.

Chairman BUNNING. As you well know, we have individual retirement accounts in the United States, and the Tax Code has allowed various degrees of withdrawal, depending on what you might want to use them for, whether it be for educational purposes, medical purposes, or whatever, without penalty. You have to, obviously, put it back some time between when you access it and when you retire. Otherwise, it is taxable income very quickly.

Go ahead.

Mr. KAY. In Chile, you can withdraw the money when you retire as long as you leave enough to fund 110 percent of a minimum pension.

Chairman BUNNING. Others?

Mr. SCHERMAN. In Sweden, according to the decision taken, there will be no opportunity to use the money for other purposes than retirement income.

Mr. ENOFF. Mr. Chairman, if I might, one country not represented here that I have worked in where they have allowed people to withdraw for various purposes, and it has made what started out as a retirement program become a program that does not leave very much in terms of retirement. People use it for—actually, they borrow the money and invest it in equities.

Chairman BUNNING. Which defeats the very purpose for which it was set up.

Mr. ENOFF. Yes, and I think there have to be some solid protections put up, and there will be temptations to people.

Chairman BUNNING. In Australia, as of March, there were over 150,000 superannuity funds, but 98 percent of all member accounts are held in approximately 8,000 funds. Australia set up a regulatory regime which included a number of regulations aimed at strengthening these funds.

I would like to hear the experience of other panelists regarding the degree to which they established regulations for these funds.

What types of regulations were established, and what was the industry's reaction to them?

Mr. FINKELSTEIN. Well, we have—you cannot, as a private fund, accept rebates from the government unless you are a licensed fund, and in order to be a licensed fund, you are now——

Chairman BUNNING. In other words, a commission of some sort?

Mr. FINKELSTEIN. Yes, a pensions operations board. And there is also quite a large degree of self regulation.

Further regulations have been introduced to ensure that particularly the occupational funds remain solvent and that they do not end up investing all of their money in their own company. That was after the experience we had with the newspaper proprietor, Robert Maxwell, and we introduced a whole variety of regulations to ensure that that didn't happen.

There is one further point, which is that the pension misselling that has been mentioned in Britain certainly did take place, and that is because people were encouraged out of their occupational pension funds into their private pension funds. It didn't have anything to do with the rebate that I have been talking about in terms of the State and the private sector; it is a separate question.

Chairman BUNNING. How many different types of educational programs or information programs did you have before your conversion? In other words, that is going to be a major problem with our transition into anything other than what we have right now in Social Security. It is going to take a reasonable time for our certain age groups to say, oh, by the way, what we pay in Federal Insurance Contributions Act, FICA, tax right now is going to be there, or at least I am going to be able to invest a portion of it, and therefore I don't mind the transition cost that will take a 30-year period.

Mr. FINKELSTEIN. I was delighted to hear that only a third of people didn't know that opted out. Since 42 percent of people opt out through their employer, I would not expect a whole lot of those to know, and there are a lot of statistics as to why that should happen.

We did engage in quite a large program of education, and that included the transition costs. I think you have to be very transparent about the transition cost, and the press in the last general election insisted that we were about our new scheme. I spent most of a good part of a week talking to journalists, just talking them through how we were going to pay——

Chairman BUNNING. You were actually able to get your information correctly into newspapers?

Mr. FINKELSTEIN. I didn't say that. I said I spent most of a week trying to explain it.

Chairman BUNNING. OK. We would have to draw it out very concisely and make sure that there was no mistake and give it to the newspapers, so that there would not be any misinterpretations if we decided to transition from what we have to something else, because I know there would be a lot of misinformation about what we were trying to do.

Does anybody else have anything to say?

Mr. SCHERMAN. I might add that in Sweden we think it is very important to educate people. And I can say that the reason why the reform is not enacted today is that there were some failures in informing the public, and the result was chaos in one of the big political parties, so they had to have another year in order to be able to confirm their support for the reform.

Mr. ENOFF. If I might, Mr. Chairman, I think that along with education about the new system, there needs to be education about the current system in terms of what are we changing from. I think it is a shame that most average college graduates probably couldn't compute their Social Security benefits in the States, assuming they had correct information to use. It is very difficult. I think it is important that if we are changing, we educate what we are changing from and what we are changing to.

Chairman BUNNING. Now that the Social Security system sends out periodic information, whether you want it or not, on your benefits and the amount of money that you have paid in in relationship to the benefit that you would receive at age 65 or 67 or whatever you choose to ask about, they do it now, as you know, Lou. There is access to that information on the Internet.

Mr. ENOFF. Well, the Internet is a bit of a question. I was pleased to see that you objected to that. I think that is the question: What use is the calculation if you do not give the earnings?

Chairman BUNNING. Well, you can devise the earnings from the calculation if you have any——

Ms. GHILARDUCCI. Mr. Bunning, there is a problem here that education, though, will not solve. One is that low-income people are going to reasonably be advised to take a more conservative position in their investments, because if you are saving and you only have enough to be a little bit above the poverty level, you are not going to take risks. So we do not see a lot of low-income people being uneducated about the benefits of diversity. You are seeing a lot of people making rational decisions about investing conservatively.

The other thing that education will not solve is that if we have too much of our retirement income dependent upon the financial markets, then we could have whole demographic groups losing out if the market is low when they retire.

It is a lot like me and the housing market. I was just too young to get in on it when the rates were going up. So we could have a lot of people cheated due to the age group that they are in because their retirement income is so undiversified in the financial markets.

Chairman BUNNING. Well, presently we have that same problem.

Ms. GHILARDUCCI. No; it is more diversified, because we have the Social Security System that yields you a benefit, regardless of the financial markets.

Chairman BUNNING. No, but there is some relationship to what you pay in. It is a replacement of a percentage of income.

Ms. GHILARDUCCI. Yes, and that is based on your rate of return as a worker in terms of your pay. And the other portion of your retirement income is dependent on what you get in the finance markets or your 401(k), and the other portion is dependent on your relationship with your employer.

Chairman BUNNING. But we have the same problem with the low-income worker——

Ms. GHILARDUCCI. Right.

Chairman BUNNING [continuing]. Now, because they do not have any surplus to put away into savings, or if they do, it is very small.

Ms. GHILARDUCCI. And conservatively invested, like I said.

Chairman BUNNING. But the replacement income that we are talking about in Social Security is proportionate to the amount of money that you have put in over a certain amount of quarters.

Ms. GHILARDUCCI. I agree, but if we replace the Social Security System with those more dependent on financial markets, then you have much more financial risk that all the education in the world cannot solve.

Chairman BUNNING. I can put all of my financial risk in a government bond if I so choose right now.

Ms. GHILARDUCCI. Right. Right.

Chairman BUNNING. I call on Mr. Portman. I am glad he joined me.

Mr. PORTMAN. It is a pleasure to be back.

You all ran off poor Dr. Piñera, I see. I had some questions for him, so I will have to direct them to others.

I appreciated your testimony. I was here to hear almost all of the testimony. I had to leave just prior to our last witness. The input is very helpful.

One of the things that has not been discussed yet, I am told, is how you put in place a system that deals with the problem of some of the beneficiaries in a more privatized system choosing more risk-averse investments.

I think that in the Chilean system, as Dr. Piñera described it, there are a number of investment funds that people are allowed to interact with, and those funds have a more diversified portfolio.

What do you recommend?

I direct this more, I guess, at Mr. O'Sullivan and Mr. Scherman and Mr. Finkelstein, who are looking at coming up with a new national system of developing private savings.

How do you deal with that problem?

Mr. O'SULLIVAN. In the case of Australia, the employers are required to offer their employees a choice of at least five different funds to which their money could go. So they could make a judgment about the degree of risk-averse funding or the degree of high-risk-return funding that they wish.

Mr. PORTMAN. Do each of those five then have a diversified set of investments? Is there government regulation of those five?

Mr. O'SULLIVAN. Yes; not just those five. The whole of the insurance and superannuation industry is covered by a set of regulations.

But in respect to the individual choices that people can make, they can make a decision to go into a fund, into an insurance broker who offers a range of choices, and those choices can be more risk-averse or offer a high-risk-return ratio.

Mr. PORTMAN. Any ideas about how to protect individuals, if that is necessary? Is that necessary?

Mr. FINKELSTEIN. The schemes in Britain into which you put your State pension have to be licensed. Ninety percent of people put their money into schemes that are equity based, and a lot have tended to invest in British equities and have tended to perform at about the same rate as the market.

It should be remembered that under our current scheme, people have a safety net of the basic State pension, and there are also various means-tested benefits available to them. So the issue of people managing to bust themselves through risky investment didn't arise with our first stage reform.

With our next stage reform, the one proposed in 1997, it did arise because we were proposing to remove the basic State pension, but we overcame it by offering people the basic pension guarantee. We said if your fund would for some reason have fallen below the basic State pension, the State guarantees to make up the difference. We didn't anticipate that we would ever have to make good that guarantee, because we didn't anticipate that anybody would be able to invest their money so badly that they would invest it as badly as the government.

Mr. SCHERMAN. As I said, we have no details on this part of the new pension system in Sweden today, but I think it is a very safe forecast that the Swedish system will be tightly regulated, tightly supervised, there will be a limited range of options, and high-risk funds will not be available in the system.

Mr. PORTMAN. Let me ask one other question that hasn't been asked. It is really directed to Mr. Enoff, but others may want to jump in. It has to do with political change or time.

In the British system, I know the Conservative Party put in place a lot of these reforms and now the Labor Party is responsible for implementing some of what you put in place and moving forward on some of the next stages of reform.

But in this country, particularly, with a change in leadership, what do you recommend, if anything, in terms of avoiding people beginning to depend on one system and having new leadership and the kind of change that is inevitable in a democracy?

Mr. ENOFF. I think that I said in my testimony, I think any change in Social Security should have broad bipartisan support and should be carefully modeled so that we do not have to be looking at changes so that if the administration changes in 2 years or 4 years, that you are not coming back and trying to redo the whole thing.

Now, it is easier to say that, obviously if there are tax incentives. And I think we should have tax incentives for savings. You might be more likely to change tax policy than Social Security policy, but you have to carefully look at that and get a consensus.

Mr. PORTMAN. We have changed it 4,000 times since 1986. Why would you think that?

Mr. ENOFF. We have not really looked at financing Social Security that often in this country. And I would hope that there could be enough of a consensus that we could make a change that would mean you would not have to go back and look at financing every couple of years, because I think that takes away from the confidence in the program.

Mr. PORTMAN. That is a good point. I think your point is well taken that it should be a substantial majority and therefore bipartisan, and that is something that would direct policymakers even at this point in terms of the options.

Mr. ENOFF. And if I could add to that, Professor Ghilarducci said a couple of times about all of this risk. But if you have a basic benefit as they do in the United Kingdom, you are not taking away anything from everyone; you are guaranteeing what you are getting plus.

Mr. PORTMAN. That is the upside that needs to be taken into account.

Mr. FINKELSTEIN. I have to admit that consensus in Britain is not a natural thing; it had to be won by bashing our opponents over the head with the ballot box in several general elections. In 1992, the Labor Party ran on a platform not of reversing the changes but increasing the State pension, and they lost the election partly because the electorate didn't believe the pensions would be increased. And after that, the leader, who is now the Prime Minister, Tony Blair, decided he should join the process of reform.

So you will not get this consensus naturally. It will probably have to be politically fought, I don't know on what basis. But eventually consensus will come, because I think electorates will go for it and they will see that current recipients are not losing and younger people are gaining.

Mr. SCHERMAN. In Sweden, five out of the seven parties in the Parliament are backing the reform, representing 80 percent of the Members of Parliament. As a matter of fact, it has been decisive for the design of the reform that the big parties wanted to agree, because we have to restore confidence. The only way of doing that is, to have a broad political majority behind it. So the new pension system is a compromise, and that is the good thing with it.

Mr. PORTMAN. Thank you, Mr. Chairman.

Chairman BUNNING. Yes, I would like to follow up with Mr. Kay particularly.

You indicated we would be better off with a system that would continue to provide secure retirement benefits. Yet we all know that by the year 2029, our current Social Security System will only be able to pay out about 75 percent of what is currently being paid out.

What do you suggest doing to restore the solvency of Social Security, except raise taxes, because that is not going to happen.

Mr. KAY. Well, that is the question. I wasn't trying to state that we do not have a problem; I was trying to state that perhaps privatization is not the solution.

Chairman BUNNING. You are speaking about total privatization.

Mr. KAY. Yes, I was talking about the Chilean system.

Chairman BUNNING. Not something that would guarantee people aged 40 and over their benefits for life and those 40 and under half their benefit if they want to opt out into some type of privatization? Something that is a similar to what we have been discussing with the United Kingdom representative?

Mr. KAY. Well, there is certainly a lot of room to discuss things in between the Chilean system and what we have today. But I know even the extent of the problem is, of course, a very controversial issue. I do not have to tell you that, obviously.

Chairman BUNNING. How do we restore public confidence for the youth, our younger workers, it has been said many, many times—believe more in UFOs than they believe that their Social Security System will be there when they retire. How do we restore that?

See, because, obviously, we are transferring in a pay-as-you-go from the younger to the older retiree right now.

Mr. KAY. Well, we have this problem that faces us 35 years from now, and we have time to work on it.

Chairman BUNNING. Each year we wait——

Mr. KAY. I am not saying that we should wait. I think the sooner we deal with it, the better.

I would just refer to some of the studies done by people like Henry J. Aaron and others, where they propose incremental concrete technical steps—small and large—that can keep the basic framework of Social Security intact without dismantling it.

Chairman BUNNING. I don't think anybody wants to dismantle what we have. We know that we have a funding problem in the future, and we have got to make a transition period where we are going to guarantee certain benefits. Right now, we have made a compact with our seniors that are retired and are about to retire. We cannot go back on that.

But what are we going to do to restore the confidence in the system that it will be here for my grandkids and my younger children? We have got to have something that they can put their hope in.

Mr. ENOFF. Mr. Chairman, I think the Advisory Council was unanimous in the fact that these funds should be invested somehow that there was a greater return. No one is arguing that. I don't even know that the two members of the panel who object to the idea of privatization have said that there is not a better return. So why not get a better return for those funds? And some of these little technical fixes are really benefit cuts and we ought to call them that. We are talking about cutting benefits.

Chairman BUNNING. If we move the retirement age from 67 to 70, there is a major change.

Mr. ENOFF. And nobody likes to talk about the fact that we have increased the retirement age to 67, yet people are retiring younger and younger. Given the choice, that is what they would like to do. The average retirement age is still 62 years and 10 months. It has leveled off a little bit.

But having those funds, and having some flexibility in those funds, allows a person some choice in when they decide to retire and how they decide to retire, maybe on a gradual basis. And you could get rid of something like this complex earnings test that we have in our system now.

Chairman BUNNING. We tried for 8 years, as you know, and we finally succeeded after 8 years to get it changed a little bit.

But wouldn't the treatment of Social Security retirement benefits have a great deal of impact on how and when people retire? In other words, now that we are taxing up to 85 percent of Social Security benefits?

Mr. ENOFF. It appears, from looking at Western European countries, that it does have a great effect on when people decide to retire.

Now I am in favor of us encouraging people to work as long as they can in terms of productivity, but a person then has some degree of choice in how much they want to work or when they want to retire, and maybe can put extra funds away through a tax incentive, so that they can have a better retirement, and make some choice in that matter, rather than being mandated.

Chairman BUNNING. There are quite a few other questions that I have, and I would like to be able to submit them to you in writing for your written response. I usually don't carry a hearing over 2 hours; I try not to. I am due on the floor.

[Questions were submitted to the panel from Chairman Bunning. The responses follow:]

THE RESPONSES OF MR. SCHERMAN

Question 1. You mention in your testimony that your pension reforms were decided by Parliament in 1994. Apparently, these reforms are gradually being rolled out over time. You also indicate that now there are many issues arising of political significance, which. if not solved within the political alliance behind the 1994 decision, may result in the collapse of the reform. What, in your view, are the causes of this backlash? Is the public now opposed to certain pension reforms?

I would not call it a "backlash." What I have been talking about is a risk that the political alliance behind the reform will not succeed in carrying it to a successful end. I think that such a complicated reform as this must contain several issues that are potential dangers for the reform, and this will be the case up until the final decisions by parliament has been taken.

You also ask about whether the public is opposed to certain pension reforms. Yes, I would say that there is a hesitation among parts of the population about this reform. There are at present three main fractions: First the members of the previous government, who are opposed to changes in the original reform proposal. Secondly, within the social democratic party some want fairly far-reaching changes in the original proposal. Finally, there are some who want to retain the old system without regarding the consequences. To my mind the interesting thing is that the opposition to this far reaching reform is not stronger than it is.

I sense that you also have another question: What could have been better? It is my opinion that if the internal process in several of the political parties had been more intense, with more open leadership from the party leaders, we would have seen fewer problems in the final process.

Question 2. It appears that most of the changes you have made to your pay-as-you-go earnings related pension result in benefit cuts. How were you able to sell these to the public and what was their reaction?

The overall reaction from the general public has been quite calm, although there has been some fairly vociferous opposition from within the social democratic party opposition. Basically, I have the feeling that people in general do realize that the current system is financially unsustainable in the long run and must be changed. I think that the reason why the general public seems to have accepted this reform is that they had realized that benefit cuts were unavoidable even before the politicians. The general feeling in society seems to be that younger people began to question whether there would be any pensions at all in the public system in the future. So what could be regarded as big benefit cuts, can on the other hand for the general public be regarded as a surprise: There will be a pension after all!

Another reason for the relatively calm reaction from the general public is certainly the fact that there is such broad majority behind the decisions taken so far. That means that the general public can trust that very solemn work is done, and nearly every person can see his or her representative's partaking in the decision process.

Question 3. You recognize that it is impossible to replicate redistributional effects in your Notional Account System. Your answer is to introduce a fairly high guarantee level, financed out of general revenue. How will this work?

Those who have earned a pension or only a low one will receive a guarantee pension. The costs will be borne by the state. In addition to the guarantee pension, there will continue to exist a means-tested housing allowance. The extra tax deduction for low-income pensioners will be abolished for both present and future pensioners, but present pensioners will be compensated through recalculated benefits. The level of the new guarantee will also take this into account.

A single person with no pension credits at all, will receive a guarantee pension of approximately 10.000 USD (at the current exchange rate). A married person will receive at least 9.000 USD.

Low-income earners or persons who have worked for a limited number of years and gained at least some credits will receive a guarantee pension, which will depend on the sum of their pension credits. A single old-age pensioner who has earned an annual pension up to the guarantee level will receive the guarantee level plus 25 per cent for the pension credits earned.

Question 4. You indicate that under your new system, pension benefits will reflect wage growth. The result of the method for indexing outgoing pension is that there is no guarantee that the pensioners will be fully compensated for inflation. You say that this is one of the key features of the reform, whereby pensioners are made to share with the active population the problems following a weak economic growth. The U.S. Congress has discussed adjusting our cost of living increase for Social Security beneficiaries. This is an extremely sensitive issue amongst our seniors. How were you able to get public support for an initiative like this?

The sense of emerging long term financial crisis in the pension system together with a deep economic recession 1991–1993, that resulted in a decrease in the wage base, higher contribution rates to cover existing commitments, a rapidly increasing budget deficit; all contributed to a general feeling of crisis and a general opinion that it was no longer possible to unconditionally guarantee the purchasing power of the pensions. In addition a broad political consensus, mentioned above, made it difficult for any specific group to put its interest before that of any other group.

Here it might be added that this form of indexation was discussed many years before the reform decision was taken in 1994. The National Social Insurance Board had for years highlighted this particular issue. In our proposal on how to reform the system submitted to Government in 1991 this was a central point. In other words, the issue had been public for many years, and people had begun to understand the necessity why unconditional price indexation was no longer possible. Secondly, it is worth pointing out that during the economic crises at the beginning of the 1980's and the beginning of the 1990's the indexation had been manipulated many times, so people were used to this happening. What happened now was that an automatic adjustment mechanism was proposed, that will replace ad hoc political decisions.

Question 5. You say that your reform experience illustrates the need for interaction between experts and politicians, and that it has been essential that the analysis has been performed and presented by a non-political authority. Such an authority was set up in this country, yet even that authority could not reach consensus. How were your experts able to reach consensus on recommendations.

As early as the early 1980's, experts in Sweden were already beginning to question the financial sustainability of the pension system. A government commission was given the mandate in the autumn of 1987 to review the pension system. In their report published in 1990 they identified a number of problems with the current system in addition to the perverse link between economic growth and financial unsustainability.

Another serious problem was the untransparent redistribution. Economists had shown that the system was unfavorable for persons with long and steady contribution careers, i.e. most blue collar workers. In addition there were problems with rapidly increasing life expectancy and a downward trend in the de facto pension age.

Experts more or less agreed on these problems, and saw as a solution a system with stronger links between contributions and benefits, and actuarial adjustment to changes in life expectancy.

The National Social Insurance Board submitted to the Government in 1991 a formal proposal that dealt with these problems. This was the result of at least 6–7 years of work, where experts and management from the National Social Insurance Board together with its political board had worked closely together discussing what was needed and what could be done. Of course the National Social Insurance Board had contacts with other institutions, such as universities, but basically the work was carried out by the Board. The ideas of the Board were discussed on many occasions by the press and other mass media, and in that sense it was done in close contact with the society as a whole.

Question 6. You point out that the complexity of the reform issues is difficult for your country to understand and that the party now in power has provided an extra year for consideration to get acceptance for the new reforms. How are you education the public about changes to your pension system?

The process of education is of course gradual. Part of it has undoubtedly been the discussion of various aspects of the reform in mass media. Another aspect is producing information in the form of brochures with an explanation why the reform was necessary, and the various aspects of the reform that are important for the public to be aware of, including examples with persons of different ages and earning careers. In early 1999 the first statements will be sent to all persons covered by the system, in practice everyone with earnings from the age of 16. This will be preceded in 1998 by a new information campaign run, through mass media channels.

Furthermore, I should mention that the employees of the social insurance organization have been participating in training programs since the proposal went through parliament. Already in 1995 it was possible for them to answer questions about the reform.

In addition many important organizations, such as the major trade unions and the Employer's Federation have published their own information.

Question 7. Ms. Ghilarducci discussed the fact that in a privatized system disabled workers, workers who work outside the formal markets, those who live long, and cohorts who contribute through a financial market bust, women, and low income workers with sporadic employment, lose. In your system, have these types of individuals been "losers" and what protections do you suggest might be built into a system to avoid negative impacts on these populations?

To begin with, the system is not privatized, but a public mandatory system. However, the question what happens to the disabled, low-income workers and persons with sporadic employment is important.

Let us take the disabled first. Persons who have been working for some time and then become disabled will have contributions accredited to their accounts, both in the notional PAYG-system and the mandatory second pillar with privately managed individual financial accounts. The contributions will be based on an imputation of the income up to a given age, at which time the disability benefit will be converted to an old-age pension.

Similarly, for the unemployed, contributions will be paid from the unemployment insurance into the old-age system to provide pension rights for periods covered by these benefits.

For women contributions will be accredited up to four years per child from child birth. Calculations show, in fact, that women in comparable careers to men may even do better than their male counterparts due to this mechanism. Low-income workers, for whatever reason, will be covered by the guarantee, if this becomes necessary.

Older workers will in fact not be disfavored, since the annuity calculated in both the PAYG and second pillar systems will be paid out until death.

It is vital to point out that the guarantee is fairly high and will guarantee everyone a decent standard of living. Also, it is vital to point out that those who will not contribute to the system do not benefit from it, for example those working outside the formal market. It is one of the ideas of the reform to have an incentive to work in the formal market in order to get one's pension.

Finally, when it comes to the mandatory funded part of the system with real financial investments, there will be no financial guarantees, with the exception of bankruptcy. On the other hand, the idea is to diversify the workers' total benefit package between the PAYG-system, the return of which depends on economic growth, and a funded system, that depends on financial market growth.

Question 8. Are workers required to purchase or create life annuities at the time they retire, or are they allowed to withdraw large lump-sum distributions? and if annuitization is optional, what is the government's obligation to persons who exhaust their retirement funds prior to death?

As the proposal now stands, persons will not be allowed to withdraw lump-sum payments. They will be requested to convert to a life annuity upon retirement. Consequently, there is no risk that anyone will "exhaust hers or his retirement funds" prior to death.

THE RESPONSES OF DR. PIÑERA

Question 1. You indicate that the average real return on investment has been 12% a year, ranging from minus 3% to plus 30% in real terms. You mentioned, and I certainly agree, that the important yield is the average one over the long term. Nevertheless, I understand the minus 3% return occurred relatively recently. How did the public react?

1. In 1995 all Latin American stock markets suffered a decline following the Mexican peso crisis. As a result, the Pension Savings Accounts (PSAs) suffered a negative return of 2.5 percent in that year. Some very small groups hostile to the PSA system took advantage of the opportunity to advocate unspecified changes to the private pension system. Defenders of the system went on national television to explain the causes of the decline; namely, the Mexican peso crisis and the oscillations that are intrinsic to the free market. They also reminded workers that the return that matters is the one over the entire working life—of 40 years, for instance—not the

return in any particular year. Once workers understood that, their fears were allayed and the attempts to weaken the private pension system quickly died. Absolutely no change to the law was approved or even attempted in Congress.

Question 2. The private Pension Fund Administration companies (AFPs), who manage the pension savings accounts, have charged high administrative costs. What exactly are these costs? Have these costs increased, decreased, or stayed the same over the life of your new system? Is there anything the government is doing to influence the reduction of these costs?

2. The costs as a percentage of total funds managed have decreased over time to less than 1.2 percent of total assets managed and are projected to go below 1 percent in the near future. Over the years there has been an excessive accumulation of government regulations, among them, some unduly ones that restrict the commission structure. Indeed there is an ongoing debate in Chile advocating the removal of those distortions, but regrettably the government has not yet produced results in this direction.

Question 3. What is the average wage in Chile? What percent of workers contribute to the program regularly? Is this percent consistent for low wage workers as well?

3. The average monthly wage of workers affiliated to the system is $500. About 63 percent of the total labor force contributes to the program regularly, a percentage similar to that of the old system. Two factors to keep in mind: a) Self-employed workers are not required by law to contribute to the system, and many of those choose not to participate in the system to avoid having to disclose their income to the government; and, b) Some older workers have already accumulated enough funds in their PSAs so that they do not have to contribute to them anymore. That does not mean, however, that those workers have retired from the labor force.

Question 4. There seem to be mixed views on whether privately-held personal accounts raise or lower national savings, since once individuals are compelled to have an individual account, they may likely cut back other savings or put off retiring for a longer period of time. What has happened to your level of national savings since you have implemented your pension reforms? To what portion of any increase in national savings do you attribute your pension reforms, as opposed to changes in the economy, etc.?

4. The national savings rate in Chile has increased from 10 percent to around 26 percent of GDP since the reform was implemented. The exact portion that can be attributed to the reform is very difficult to measure since there were many simultaneous reforms being implemented. Prominent economists, both in Chile and around the world, credit the fully funded pension system, and the way the transition has been financed, for a substantial contribution to that increase.

Question 5. Private vendors have often been described as "winners" in Social Security privatization. Many of the witnesses had wide and varied experiences with private vendors when moving to privatize portions or all of their pension schemes. Many U.S. citizens are skeptical about moving to private accounts.

What discussions did your leaders have, and did you address the issue of how to protect an individual from being too risk averse in his or her investment choices, causing his or her returns to be too low to yield an adequate retirement or the individual selecting high risk equities or corporate bonds that provide a lower than expected investment return experience?

5. This was a revolutionary reform executed in a conservative way. There is a government agency, the AFP Superintendency, that oversees the AFP industry and the reform law sets rules on the kind of investments the AFPs can make. In addition, should the return on an investment fall below the lower end of a certain return band, the AFP has to make up the difference and add it to the worker's PSA. In addition, workers can choose AFPs with more conservative portfolios.

Question 6. Ms. Ghilarducci discussed the fact that in a privatized system disabled workers, workers working outside the formal markets, those who live long, and cohorts who contribute through a financial market bust, women and low income workers with sporadic employment, lose. In your system, have these types of individuals been "losers" and what protections do you suggest might be built into a system to avoid negative impacts on these populations?

6. No worker participating in the PSA system can be considered a loser. Under the PSA system, all workers have visible property rights, protected by the Chilean Constitution, over their pension contributions. Furthermore, those workers with at least 20 years of contributions to their PSAs are entitled by law to the legally defined minimum pension. Disabled workers are receiving pension benefits under the new system that are 100 percent higher than they were under the old system. Low-income workers have particularly benefited from the new system. (See, also, Piñera 1996.)

Question 7. As we debate possible Social Security reforms, and whether to adopt some degree of privately-held accounts, questions are also raised about the pay-out of the accounts. What were Chile's experiences regarding the restrictions you have placed on the accounts before you pay-put? For example, are individuals allowed to access these accounts to buy a home or pay for other expenses?

7. No, they are not allowed to withdraw money to buy a house or for other expenses. The money in a PSA can only be used as retirement income.

Question 8. In Australia, as of March 1997, there were over 151,000 superannuation funds, but 98% of all member accounts are held in approximately 8,000 funds. Australia set up a regulatory regime which includes a number of regulations aimed at strengthening these funds To what degree has Chile established regulations of these funds? What types of regulations were established and what was the industry's reaction?

Did you find ways to keep administrative costs of the funds down?

How did you educate the public to avoid confusion or scams?

8. See 2 and 4 above.

Question 9. Are workers required to purchase or create life annuities at the time they retire, or are they allowed to withdraw large lump-sum distributions? And if annuitization is optional, what is the government's obligation to persons who exhaust their retirement funds prior to death?

9. See 6 above and Piñera 1996.

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THE RESPONSES OF MR. BLUNN

Question 1. There seem to be mixed views on whether privately-held personal accounts raise or lower national savings, since once individuals are compelled to have an individual account they may likely cut back other savings or put off retiring for a longer period of time. What has happened to your level of national savings since you have implemented your pension reforms? To what portion of any increase in national savings do you attribute your pension reforms, as opposed to changes in the economy, etc?

Response. There is a number of Australian studies which estimate the reduction in other financial savings because of compulsory superannuation (the private saving offset) at between 30 and 50 per cent. Using offsets of this order, and estimates of effects of the policy on wages growth and taxation revenue, the Retirement Income Modelling (RIM) Unit of the Australian Treasury has projected the effect on national saving[1] (change in net worth) to be 0.9% of GDP in 1996–97 rising to 3.6% of GDP by 2019–20 (see Gallagher, Phil "Assessing the National Saving Effects of the Government's Superannuation Policy" which is available on the internet at www.treasury.gov.au/publications/RIM/).

The actual growth of Australian superannuation fund assets do closely match these RIM projections. However, in the period concerned, changes in household borrowing trends have also affected national savings. That is, the substantial growth in superannuation assets has been virtually matched by an equivalent growth in household borrowing, a trend apparent since financial deregulation in 1986. The following table summarises the changes in financial assets and liabilities and their relationship to GDP.

[1] National financial savings which exclude household dwelling equity.

FINANCIAL ACCOUNTS FOR HOUSEHOLDS
YEAR ENDING JUNE

	1989	1990	1991	1992	1993	1994	1995	1996	March 1997
Technical reserves of Life:									
Offices and Pension funds	145.5	164.4	178.3	203.1	218.2	238.3	254.3	280.6	303.1
Total financial assets	381.9	415.3	436.8	462.1	501.4	564.6	587.9	635.1	690.4
Total financial liabilities	159.4	181.3	187.6	197.8	213.9	232.9	258.7	290.4	307.2
Reserves as % of Assets	38.1%	39.6%	40.8%	44.0%	43.5%	42.2%	43.3%	44.2%	43.9%
GDP (I) $B	339.2	370.0	379.3	387.5	405.4	429.7	457.3	487.6	509.8
Life Office and Superannuation:									
Reserves to GDP	42.9%	44.4%	47.0%	52.4%	53.8%	55.5%	55.6%	57.5%	59.5%
Total Financial Assets to GDP	113%	112%	115%	119%	124%	131%	129%	130%	135%

The reserves of superannuation funds and life offices have grown from 43% of GDP in 1989 to 60% in 1997. The growth in superannuation assets has therefore exceeded growth in the economy.

There is evidence in Australia that the compulsory nature of the Superannuation Guarantee system is adding to national savings. Data published in the "Insurance and Superannuation Commission Bulletin" demonstrate that one third to one half of the growth in superannuation assets is due to net contributions with the remainder being due to increasing fund earnings. This provides evidence of growth in saving from the compulsory contributions policy rather than the effects of improved economic conditions on the valuation of fund investments.

The Australian National Accounts measure of Household Saving Ratio has grown from 4.1% in June 1992 to 4.7% in June 1997. However, it is very difficult to relate this measure to financial stocks or flows, let alone to superannuation.

Household Saving is calculated as the difference between household disposable income and household private final consumption expenditure. This residual reflects methodological differences between the income and expenditure side of the accounts. It is divided by household disposable income to obtain the ratio. The direct use of financial assets data and projections (see above) therefore provides more appropriate means of answering the Committee's questions.

Question 2. Private vendors have often been described as "winners" in Social Security privatisation. Many of the U.S. citizens are sceptical about moving to private accounts. What discussions did your leaders have? Did you address the issue of how to protect an individual from being too risk-adverse in his or her investment choices, causing his or her returns to be too low to yield an adequate retirement or the individual selecting high risk equities or corporate bonds that provide a lower than expected investment return experience?

Response. Primary responsibility for the viability and prudent operation of superannuation funds rests with the funds' trustees who are subject to a range of regulatory controls under the national superannuation legislation, the Superannuation Industry (Supervision) Act 1993 (SIS). Some of the "checks and balances" in the SIS regime include:

- a requirement on trustees to formulate and give effect to an investment strategy (having regard to risk, return, the benefits of diversification, liquidity and current and future liabilities);
- requirements for equal numbers of employer and member representatives on the trustee boards of employer-sponsored funds;
- trustee approval processes for public offer funds;
- extensive information disclosure requirements;
- internal and external complaints handling arrangements for members; and
- strong monitoring and investigation powers for the industry regulator, the Insurance and Superannuation Commission (ISC).

As part of its supervisory role, the ISC conducts an extensive national, strategically targeted audit program to monitor compliance with the prudential standards. These audits focus on confirming that the assets of the fund are securely held and assessing the capacity of the fund's management to maintain the future security of assets. This involves checking the fund's compliance with superannuation standards and monitoring prudential matters such as the quality of investments, management controls and systems.

Although regulated under the SIS prudential framework, the security of superannuation benefits and fund investment performance are not guaranteed by the Government.

Public underwriting of benefits or fund investment perforrnance is undesirable as it may tempt trustees to take excessive risks, in the knowledge that the Government would cover any down side losses. However, losses due to fraud can be compensated if the Government judges this to be in the public interest.

The SIS measures outlined above minimise the likelihood of major fund losses through imprudent or dishonest management and moderate the impact of adverse market movements or poor commercial investment decisions on the part of fund trustees.

While the SIS requires trustees to formally implement an appropriate fund investment strategy(s) largely for prudential reasons, historically, most employees receiving only Superannuation Guarantee contributions have been offered little choice as to where their money is invested. However, some fund trustees have offered their members a choice of investment strategy.

In the 1997–98 Budget, the Government announced that it will be giving employees greater choice as to the fund or Retirement Savings Account into which their compulsory Superannuation Guarantee contributions are paid. Among other things, this will provide greater opportunities for employees to choose between funds offering different investment strategies. However, responsibility for the formulation of those investment strategies will remain with the trustee.

- the Australia Taxation Office, the agency responsible for the choice of fund legislation, has been given additional funding to conduct a public education campaign and provide inquiry services to assist employees and employers about choice of fund.

Question 3. One of the other witnesses discussed the fact that in a privatised system, disabled workers, workers working outside the formal markets, those who live long and cohorts who contribute through a financial market bust, women and low income workers with sporadic employment, lose. In your system, have these types of individuals been "losers" and what protections do you suggest might be built into a system to avoid negative impacts on these populations?

Response. In general these particular groups have not been "losers" in terms of the retirement income system that exists in Australia. This is because, unlike the United States, social assistance is the major pillar in the Australian social security system. Therefore, benefits are not "residual" in the same sense that they are in many countries with a primary system of social insurance.

Specifically, the basis of the Australian retirement income system is a flat-rate, means-tested pension known as "age pension." The rate of payment is not related to prior earnings. Rather, it is set at 25 per cent of Male Total Average Weekly Earnings (MTAWE) for a single person. The married rate of pension paid to each partner of a couple is currently 83 per cent of the single rate. Eighty-four per cent of all aged Australians receive this pension (including war service pensions). Of the Age Pension recipients, sixty-five per cent receive the maximum amount and thirty-five per cent get a partial pension.

The emphasis on poverty alleviation in Australia, together with elements of the social wage (such as public housing, education and health provision) mean that, comparatively, the Australian social protection system has achieved a high level of income redistribution from those better off to the most needy.[2]

In addition to the age pension, the Australian retirement income system consists of compulsory concessionally taxed saving for retirement through an employment-based system known as the Superannuation Guarantee (SG) and retirement income supplementation by individuals, particularly through voluntary superannuation assisted by tax concessions and other saving (More details regarding Australia's retirement income system may be found in the statement submitted to the Social Security Subcommittee at the hearing on 18 September 1997).

In terms of a standard of living that is higher than the maximum provision for age pension (25 per cent of MTAWE), Australia acknowledges that some groups are at greater risk of not having had a sufficient level of labour force participation to build up their personal superannuation or private savings. Groups that tend to fit

[2] This conclusion is supported by a recent OECD study which shows that direct taxes and transfers are more progressive in Australia than in any of the other countries examined: Atkinson, A.B., Rainwater, L. and Smeeding, T., Income Distribution in OECD Countries, OECD, 1995, Paris.

within this category include lone parents (mostly women), people with disabilities, low income earners, women who have their employment record interrupted by caring responsibilities and those facing long term unemployment.

The Australian Government has brought in measures specifically targeted at these groups to assist them to supplement their retirement income. The Government has also developed and enhanced strategies, over the last decade, which focus on increasing labour market participation of people of working age and which should assist those who are less able to build up personal superannuation or private savings. Both of these strategies are outlined below.

A. RECENT MODIFICATIONS TO THE SUPERANNUATION SYSTEM TO INCREASE CHOICE AND BETTER TAILORED ARRANGEMENTS TO INDIVIDUAL NEEDS.

There have been concerns that certain groups, such as low income earners, people with intermittent work patterns, people who have left the workforce to care for others and long term unemployed, many of these being women, find compulsory superannuation contributions a financial burden and that their needs may be better served by meeting their immediate circumstances. There has also been debate as to whether these target groups are able to gain easy access to superannuation (and its benefits).

To improve the flexibility and responsiveness of superannuation arrangements for these groups, the Government has recently introduced a number of reforms to the private pension system. Four specific initiatives are outlined below.

1. The introduction of retirement savings accounts (RSAs), under which banks, credit unions and life insurance companies will be able to offer over-the counter superannuation savings plans. RSA's are designed to be a simple, low cost, low risk product especially suited to those with small amounts of superannuation, such as part time, temporary, casual and seasonal workers, or those nearing retirement and wishing to minimise risk. These accounts will be portable and will be owned and controlled by the customer. These will be of special value to women who traditionally have broken work patterns in accommodating family responsibilities;

2. Since 1 July 1997 the Government has allowed a contributing spouse to receive an 18 per cent income tax rebate for contributions up to A$3,000 to a superannuation fund or Retirement Saving Account of a non-income earning spouse or a spouse earning below A$10,800 per annum. This will improve access to superannuation for low income spouses, particularly those with intermittent work patterns;

3. The Government has recently allowed for low income employees (earning between $450 and $900 per month) to choose between receiving superannuation guarantee contributions or the equivalent in wages and salary under certain conditions. This policy provides greater freedom of choice within the superannuation system and recognises the pressing need of people on very low incomes and interrupted employment patterns to maintain their immediate living standards; and

4. Finally, individuals who leave the workforce, but who do not retire, can generally continue to contribute to superannuation for a further 2 years. More recently, the Government has allowed individuals who temporarily leave the workforce under a bona fide parental leave arrangement with their employer to continue to contribute to superannuation for a further 7 years. In addition, individuals, who are working, can continue to contribute to superannuation up to age 70.

Incentives are also provided to encourage retirees to purchase lifetime income streams where the underlying longevity risk is borne by the income stream provider.

B. STRATEGIES TO INCREASE THE LABOUR MARKET PARTICIPATION OF PARTICULAR GROUPS

A major strategy for ensuring that a wide range of the community gain the supplementary benefits of retirement income involves improving labour market opportunities for vulnerable groups. This strategy includes such programs as the Disability Reform Package, for people with disabilities and the Jobs, Education and Training (JET) program for lone parents, low income partnered parents, widowers and carers.

The Disability Reform Package, introduced in 1991, aims to increase the participation of people with disabilities in employment, education, training and rehabilitation. A key feature in pursuing these outcomes is the use of specialist Disability Support Officers who take an active role in identifying people who were likely to benefit from training, rehabilitation or job search assistance.

The JET program, established in 1989, aims to improve the financial circumstances of lone parents, widowers and carers by facilitating access to educational, vocational training and employment opportunities and, if required, child care.

Emphasis is placed on ensuring sustainable employment outcomes by improving long-term labour market competitiveness and career development through education and training. Low income partnered parents will also become eligible for this program from March 1998.

The JET program is voluntary and in the Australian experience has tended to produce positive results relative to the amount of funding invested.

Older workers are also encouraged to retain their labour market contact or pursue a graduated retirement from the paid workforce through the current retirement incomes system which provides a possible span of retirement ages from 55 to 70 years. A pension bonus payment plan will be introduced from 1 July 1998 whereby workers will get a bonus for continuing to work a maximum number of hours, beyond age pension age (men at age 65 and women at age 61—as at July 1997) or war service pension age (men at age 60 and women at 56—as at July 1997).

Also, measures to encourage labour market participation have also been introduced for other target groups such as young people and unemployed indigenous Australians.

On a structural level, the Australian Government has encouraged labour market participation by developing a more competitive employment assistance arrangement whereby private and community based organisations, as well as a corporatised public provider, will be contracted on a competitive basis to provide a range of Public Employment Service (PES) services.

The new arrangements should boost the effectiveness of employment services because contracted providers of intensive individualised assistance will be paid for placing job seekers in employment.

Question 4. As we in the United States debate possible Social Security reforms, and whether to adopt some degree of privately-held accounts, questions are raised about the pay-out of the accounts. I'd like to hear your experiences regarding the restrictions you have placed on the accounts before pay-out. For example, are individuals allowed to access these accounts to buy a home or pay for other expenses?

Response. The Government considers that superannuation savings which have received concessional tax treatment should generally be preserved for genuine retirement purposes. Currently, superannuation savings are generally required to be preserved until age 55 or until later retirement

Early release of benefits is allowed in the event of the death of a superannuation fund member, permanent incapacity, severe financial hardship, compassionate grounds, and where benefits are taken as a non-commutable life pension on termination of gainful employment.

The Government introduced several reforms to the preservation rules in the 1997–98 Budget to reduce the leakage of benefits from the superannuation system. These include:

- requiring from 1 July 1999 that all future contributions and earnings be preserved until retirement upon reaching the preservation age (except in the limited circumstances discussed above); :currently, certain member (undeducted) contributions and certain employer contributions are not preserved;
- no longer allowing access to benefits prior to preservation age on the grounds of permanent departure from Australia;
- confirming an increase in the preservation age from 55 years to 60 years based on a sliding scale with people born before 1 July 1960 subject to 55 years and those born after 1 July 1964 subject to 60 years;
- a new test for financial hardship based on evidence of specified Commonwealth income support; and
- the introduction of defined criteria as to what constitutes compassionate grounds.

Currently, there is some debate over whether the Government should assist low income earners in buying homes by allowing them early access to some benefits. In response to this, the Government released a discussion paper entitled "Allowing Access to Superannuation for Housing" in May of this year.

The Government is currently considering the comments and submissions from the superannuation, housing and welfare sectors, as well as examining the implications of such schemes, including for national savings.

Question 5. Are workers required to purchase or create life annuities at the time they retire, or are they allowed to withdraw large lump-sum distributions? And if annuitisation is optional, what is the Government's obligation to persons who exhaust their retirement funds prior to death?

Response. Australia's retirement income system does not require retirees to access their superannuation savings in the form of an income stream. Retirees can access their benefits in the form of a lump sum at concessional (ie when compared to marginal tax rates) tax rates up to the lump sum Reasonable Benefit Limit (RBL) threshold, currently $454,718. Lump sum benefits which exceed the lump sum RBL are taxed at the top marginal tax rate.

Australia's retirement income system does, however, provide retirees with incentives to access their benefits in the form of an income stream. For instance, lifetime superannuation pensions are assessed against a higher pension RBL, currently $909,435, and are exempt from the social security age pension assets test. The Government announced in the 1997–98 Budget its intention to extend these concessions to life expectancy income streams which meet certain required characteristics, such as being non-commutable.

Age pension is paid to all Australians aged over 65 years (for men) or 61 years (for women, legislated to rise to age 65 by 2013), subject only to residence qualifications and means testing. There are no limitations placed on eligibility due to prior receipt of superannuation lump sums, pensions or annuities. Many retirees receive a part pension, in addition to income from superannuation, investments or other sources.

The Australian age pension is non-contributory and is financed from general taxation revenue. Eligibility is not related to previous labour force participation.

THE RESPONSES OF MR. ENOFF

Question 1. You stress the importance of educating the public about the principles and projected outcomes of the reformed program compared to those of the current program. Considering your years of SSA experience, how would you see that education taking place? Should or could SSA do it?

It is as usual a very insightful question.

The education should be provided (or at least approved and monitored) by a joint legislative/executive branch effort. I say this not because I fear that SSA would try to "slant" the information, but because there is too much public suspicion and posturing on several issues that should be addressed. SSA should certainly play a major role in this effort and continue to utilize any materials after the initial education phase. I believe this type of joint effort would be a positive step in attempting to prevent future misconceptions about the program.

Since there is now a permanent bi-partisan advisory board, they should be involved along with input from CRS and GAO. I am not a communications expert, but it seems to me that all media forms should be utilized; i.e. written, audio, video, internet, and public forums. While this might sound expensive I believe it would be a far more effective use of funds than the flawed PEBES mandate scheduled to begin soon. A special effort should be geared toward developing materials to be included in appropriate high school and college courses and public service tapes for media and employer/union education activities.

In short, SSA could do it but should not do it alone. I would be happy to work with the committee staff to develop some draft proposals if you wish.

[The responses of Mr. Finkelstein and Dr. Ghilarducci were not available at the time of printing.]

Chairman BUNNING. I would like to thank the witnesses who have shared their individual experiences and insight on Social Security reform with the Subcommittee. I would like to offer special thanks to those who have traveled so far to be here today. We have learned a great deal from those of you who represent other countries. Your reforms serve as a model that we here in the United States can closely study and try to stay away from some of the pitfalls before we jump. And we are going to have to do much needed reform of the solvency problem in our Social Security system.

Again, your input is deeply appreciated. And best wishes for a safe trip home.

The Subcommittee stands adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]