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STRENGTHENING SOCIAL SECURITY: WHAT CAN WE LEARN FROM OTHER NATIONS?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

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WASHINGTON, DC

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STRENGTHENING SOCIAL SECURITY: WHAT CAN WE LEARN FROM OTHER NATIONS?

TUESDAY, MAY 18, 2004

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee convened, pursuant to notice, at 10 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Larry Craig (chairman of the committee) presiding.

Present: Senators Craig, Bayh, and Carper.

OPENING STATEMENT OF SENATOR LARRY CRAIG, CHAIRMAN

The CHAIRMAN. Please excuse me. I have been stalling for a few moments. We have some of our folks who will testify today stuck in traffic, but I assume that we are about ready to go so let me convene the Senate Special Committee on Aging. I want to say good morning to all of you. We are here today to learn how other nations are working to strengthen their Social Security systems.

The world is aging. Birth rates are declining. People are living longer. The worker-to-retiree ratio is declining across the globe. The result is that public pension systems around the world are increasingly under pressure. Over the next decades, the world will see a growing share of economic resources transferred from the young to the old. Much of this transfer will occur through public pension systems. The challenge for industrialized nations is how to provide a decent standard of living for the old without overburdening the young.

Japan and Europe are on the leading edge of aging populations compared to the United States. Many nations have undertaken or are in the middle of enacting reform to secure the retirement income of retirees. The pace and approach to reform differs by nation. Many of the largest industrialized economies have generally opted to increase taxes and cut benefits. About 30 nations have chosen, in whole or in part, to increase the rate of return on assets by enacting prefunded personal retirement accounts.

As the United States considers personal retirement accounts to strengthen Social Security, it is important that we learn what other nations are doing. So we are here this morning to improve our understanding and to build a record so we in Congress can move forward with the best available information.

With that, I am very pleased to welcome our witnesses to the Aging Committee today. We have on our first panel two distinguished government officials from the United States and Japan to

help us better understand what is being done to strengthen Social Security around the world.

Our first panel is made up of Jim Lockhart, Deputy Commissioner from the U.S. Social Security Administration; and Mr. Yoshinori Ohno, a member of the Japanese House and chairman of the Liberal Democrat Party Research Commission on the Annuities System.

Joining us on our second panel will be Vince Truglia, managing director of the Sovereign Risk Unit at Moody's Investment Services; Axel Boersch-Supan, director, Institute for Economic Research, University of Mannheim in Germany; David Harris, director, Watson Wyatt Worldwide in London; and Jacobo Rodriguez, financial services analyst at the Cato Institute.

I want to thank all of our witnesses for being with us today and now let me turn to Commissioner Lockhart to begin this morning's testimony. Thank you.

STATEMENT OF JAMES B. LOCKHART, III, DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION, WASHINGTON, DC

Mr. LOCKHART. Thank you, Mr. Chairman, for inviting me today to testify about strengthening Social Security and also the very important lessons we can learn from experiences in other nations.

I also want to thank you, Mr. Chairman, for hosting a series of events last month in Idaho during which we discussed Social Security's future. I think they were very useful and very successful and I thank you for your support.

Achieving sustainable solvency is one of the Social Security Administration's four strategic goals. Although Social Security trust funds exceed $1.5 trillion today, Social Security does face serious long-range financing issues.

In 2018, the trust funds are projected to begin paying out more in benefits than is collected in payroll taxes, which will begin to put significant pressure on government finances. By 2042, just prior to the retirement of my two children, the Social Security trust fund assets are projected to be exhausted. Absent any changes, any reforms to strengthen Social Security, their scheduled benefits will be cut by 27 percent.

The reason Social Security is unsustainable under current law is very simple. As you said, it is the aging of America. People are living longer and the birth rate is low. It is projected by 2030 the ratio of workers to all beneficiaries—and this ratio includes not only retirees but the disabled and the survivors that are covered by the Social Security system—which is currently 3.3-to-one will fall to 2.2-to-one and continue to fall thereafter.

This next chart, or the chart I have up here, as you can see on the easel and is attached to the testimony, excludes the disabled and survivors and tries to show the ratio of workers to retirees throughout some of the developed countries in the world. As you can see, in 1995, the ratio is well over two-to-one in many of these developed countries. In fact, in some like the U.S. and Canada, it was over three-to-one. By 2050, it is projected to fall dramatically to unsustainable levels in most of these countries. Actually, in

Italy, it will sink to below one-to-one, meaning there will be more people receiving retirement benefits than paying taxes.

Fortunately, the United States is somewhat cushioned by higher birth rates and higher immigration levels than some of the other developed countries.

As a result of this global aging, many countries have been actively reforming their Social Security programs. In addition to the traditional reforms of raising taxes, which we have actually done 19 times in the history of Social Security in the United States, or reducing benefits, many have decided to prefund a portion of future retirement payments by investing funds in stocks and bonds to increase returns. Some countries, such as Canada, have chosen to increase returns by direct trust fund investments, while many others, approximately 30, have done so indirectly through personal accounts.

By looking at the experience of other countries, we can make better choices about how to strengthen Social Security.

One of the first lessons we can learn is that Social Security reforms will happen. They will have to happen. As President Kennedy said back in 1961, "The Social Security program cannot remain static. Changes in our population, in our working habits, and in our standard of living require constant revision."

A second lesson is the importance of acting sooner rather than later. The trustees have said this in their annual report for many years in a row. We need to act sooner rather than later. Delay may cause the need for more significant tax increases and benefit reductions, as it is doing now for some continental European countries and Japan. If we act sooner to strengthen our Social Security system, we will be able to select from a broader array of options and phase in changes gradually.

A third lesson, and really it is a whole series of lessons we can learn from these countries, is that they can teach us things about the impacts of increasing taxes, reducing benefits, and also, very importantly, increasing rates of return. In fact, just yesterday, Social Security sponsored with our Retirement Research Consortium a conference on global aging to learn more about the impacts of these changes.

Finally, I think it is very important to continue our efforts to improve financial literacy in the United States and to help people understand the need for reform, as we were doing out in Idaho. Once the need is understood, the experience of many of these countries showed that a bipartisan consensus is achievable to strengthen Social Security.

In conclusion, we share the challenge of the global aging with many countries around the world. It is important to learn as much as we can from their experiences.

Mr. Chairman, I again commend you for holding this hearing and especially for your very strong leadership in the bipartisan effort to strengthen Social Security. I will be happy to answer any questions. Thank you.

The CHAIRMAN. Jim, thank you very much.

[The prepared statement of Mr. Lockhart follows:]

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STRENGTHENING SOCIAL SECURITY: CAN WE LEARN FROM OTHER NATIONS?

SENATE COMMITTEE ON AGING

MAY 18, 2004

TESTIMONY
OF
JAMES B. LOCKHART III
DEPUTY COMMISSIONER
OF SOCIAL SECURITY

Testimony by James B. Lockhart III
Deputy Commissioner, Social Security Administration
Hearing before Senate Committee on Aging
Strengthening Social Security: Can We Learn From Other Nations?"
May 18, 2004

Thank you Mr. Chairman and Members of the Committee for inviting me to testify today about strengthening Social Security and what we can learn from experiences in other nations. Learning from other countries is one of the reasons Social Security is actively involved in three international social security organizations.

I also want to thank you again, Mr. Chairman for hosting a series of events last month in Idaho during which we discussed Social Security's future. Achieving "Sustainable Solvency" is one of the Social Security Administration's four strategic goals.

As President Bush and many of his predecessors have said, Social Security has been one of the most successful government programs. Social Security is the foundation of well being for the elderly, the disabled and their families. This may be why in a poll conducted by the National Archives, the Social Security Act was recently voted one of the ten most important documents in American history, sharing that distinction with the Declaration of Independence and the Constitution among others. The Social Security Act and the Civil Rights Act were the only two pieces of legislation selected.

Social Security continues to be one of the most successful government programs. Last year SSA paid over $470 billion in benefits to 47 million retirees, survivors, and disabled individuals and their dependents. Social Security is much more than a retirement program. Thirty percent of our beneficiaries are disabled or survivors -- widows, widowers and children. Nearly 157 million American workers paid Social Security taxes last year. They, their families, and the millions joining the system every year, are relying on Social Security for a major portion of their future financial security.

Hearings like this, events like those in Idaho and reform lessons learned from other countries will help create a bipartisan consensus for reforms to keep Social Security successful for future generations.

In my testimony I will review the Social Security program's financing and discuss the long-range status of the trust funds, particularly in terms of the changing demographics that will have a major impact on the program. I will also discuss how many other nations face similar demographic issues and how some of those nations implemented reforms in their social insurance programs to address those issues. Finally, I will discuss what lessons can be learned from the foreign experience.

It is important to keep in mind that every country has its own unique circumstances and that what works best in one country may not be the best solution for the United States. However, there is a good deal of valuable information that can be obtained from examining the efforts to reform social insurance programs around the globe.

Social Security Financing

The American Social Security program is financed primarily through payroll taxes. Workers in covered employment, their employers, and self-employed people are taxed on earnings up to an annual maximum amount. The maximum amount, $87,900 for 2004, increases automatically in proportion to increases in average covered wages. The combined employee-employer tax rate is 12.4 percent of earnings.

Social Security is financed on a pay-as-you-go basis, under which most of the Social Security taxes paid by workers are immediately paid out in benefits. Trust fund reserves serve as a contingency when program outgo exceeds income. By law, trust fund assets that are not immediately needed to pay benefits are invested in special securities of the United States Treasury. These securities earn interest which is paid in the form of special issue Treasury bonds.

Status of the Trust Funds

Social Security's trust funds grew by over $150 billion to $1.5 trillion last year. Over half this growth was from interest on the trust funds. But today Social Security faces serious long-range financing issues. Under the 2004 Trustees Report's intermediate assumptions, it is projected that Social Security trust fund assets will be exhausted in 2042. At that point, just prior to my two children's retirements, the incoming payroll taxes would cover only about 73 percent of scheduled benefits.

More importantly, the Trustees point out that pressure on the trust funds will begin in 2008, when the first Baby Boomers reach early retirement age. Beginning in 2018, the trust funds are projected to begin paying out more in benefits than is collected in payroll taxes. At that time, in order to pay benefits, the program will begin to rely on trust fund interest income and redemption of government bonds, which will put pressure on government finances. So as you can see, the financing challenges faced by the program need to be addressed sooner rather than later.

As the Trustees said in their 2004 report, "The projected trust fund deficits should be addressed in a timely way to allow for a gradual phasing in of the necessary changes and to provide advance notice to workers. The sooner adjustments are made the smaller and less abrupt they will have to be." For example, the

changes enacted to increase the retirement age in 1983 started last year -- 20 years later -- and will phase in over several decades. Early action will also allow current workers plenty of time to properly plan for their retirement.

Demographic Factors

The reason Social Security is unsustainable under current law is very simple -- the aging of America. People are living longer, the birth rate is low and the first Baby Boomers will be eligible to retire in 4 years. This combination means that the growth in the number of beneficiaries will begin to greatly exceed the growth of workers. The ratio of workers to beneficiaries which includes retirees, disabled workers, survivors and dependents, has fallen from 8 to 1 in 1955 to 3.3 to 1 today. Most of the Baby Boom generation will be retired by 2030, and the projected ratio of workers to beneficiaries will be only 2.2 to 1 at that time. Thereafter, the number of workers to beneficiaries will slowly decline, and Social Security's projected costs will continue to increase.

Looking just at retirees, the attached chart shows that in 1995 the ratio of workers to pensioners was well over 2 to 1 in most of the developed countries. By 2050, this ratio is projected to fall dramatically to unsustainable levels in most of these countries. And in one country -- Italy -- it will sink beneath 1 to 1, meaning that more people will be collecting benefits than paying taxes.

As these data show, the world stands on the threshold of a great demographic sea change -- global aging. Just yesterday, the Social Security Administration sponsored a conference on global aging with some of the leading experts on the subject. We are also now publishing a monthly newsletter of happenings in the international social security world.

There are two forces behind global aging. The first force is falling fertility rates -- people are having fewer babies, decreasing the relative number of younger people in the population. The second force behind global aging is rising life expectancy. People are living longer, thus enlarging the relative number of older people in the population.

Global aging is at different stages in different countries. As shown in the chart, the issue for Europe and Japan is more advanced than the United States. We are cushioned by higher birth rates and higher immigration levels than those countries but we still face the challenge of an aging population. Also, due to the 1983 reforms, Social Security has one of the highest retirement ages, as we move the full benefit retirement age to 67.

For these reasons, the United States is in a somewhat better position to begin to deal with the challenges presented by our changing population than are many other nations. It is sometimes difficult to make direct comparisons with what other countries are doing or have already done because other countries have different income support and private sector pension programs. Nonetheless,

examination of the experience of foreign countries provides interesting and valuable insights, and there is much we can learn.

Reforms in Selected Countries

Although Social Security reforms throughout the world have been complex and ever evolving, there are basically three major categories of reform:

- increasing taxes
- decreasing scheduled benefits
- increasing investment returns

The first two are the traditional reforms. The Social Security payroll tax rate has been raised 19 times and the 1983 increase in the retirement age was a reduction in scheduled lifetime benefits. As a country gets closer to a crisis, raising taxes or reducing benefits are the only choices.

Many countries have decided to plan ahead by prefunding future social security payments and investing those funds in private sector securities to increase returns. In some countries, such as Canada, that has meant direct investment by the trust funds in private sector securities. In others, it has meant establishing personal accounts.

President Bush, in his State of the Union address this year, once again called for personal accounts for younger generations when he said, "Younger workers should have the opportunity to build a nest egg by saving part of their Social Security taxes in a personal retirement account. We should make the Social Security system a source of ownership for the American people."

About 30 countries have implemented some type of personal account system as a component of their mandatory retirement insurance program. In addition, several other countries have recently passed legislation or are considering reforms that include personal accounts.

Now I would like to talk briefly now about the experiences of six specific countries that have implemented reforms to their systems. These countries are the United Kingdom, Chile, Australia, Sweden, Japan, and Germany.

UNITED KINGDOM

Let me begin with the United Kingdom as they began reforms in 1980, which I remember well as I was working there at the time. The United Kingdom offers a system comprised of two compulsory tiers. The first tier provides a flat-rate benefit prorated according to years of contributions. The second tier is an earnings-related benefit in the form of a public, occupational, or personal pension. Workers may opt out of the public pension by participating in either an occupational pension provided by the employer or in a personal pension plan financed by rebates of the employee and employer contributions to the public

system. These last two options use investments in private sector markets to fund retirement.

The late 1980s saw an expansion of approved options for personal account plans and the government actively encouraged workers to opt out of the public system. However, a series of scandals in the "mis-selling" of these pension products and the abuse of a prominent company's pension plan led to legislation to increase government regulation and oversight. In addition, other reforms were enacted to restructure the second tier and tighten regulations and oversight of the pension industry. These reforms have increased participation in personal pensions by low wage workers by providing greater investment options while capping administrative fees. This year, the United Kingdom is continuing its reform effort with significant new legislation to modify and strengthen its social security and pension plans.

CHILE

In 1981, Chile was the first country to totally replace a pay-as-you-go system with a personal account approach. Under the Chilean model, each worker contributes 10 percent of their wages each month to a personal account in a pension fund management company plus an additional 2.6 percent for administrative fees and disability and survivors insurance. The employer makes no contributions. The plan is based on personal retirement accounts administered by private pension fund management companies, licensed and regulated by the Chilean government. At retirement, the benefit is equal to the insured's contributions plus investment returns, less administrative fees. The government guarantees a minimum pension to those with 20 years of contributions whose account balance is insufficient to fund a minimum benefit, which could create a financial burden for the Chilean government.

As the first country to transition from a pay-as-you-go system to a system based upon a personal account approach, Chile has had to resolve many new issues with regard to social insurance policy. The government was able to fund much of the transition investment by selling off a vast array of nationalized companies and issuing "recognition" bonds. Over the past two decades a number of changes have been made in the Chilean system in an effort to address these issues and develop a viable and sustainable retirement income program. Improvements have been made in the number of workers enrolled in the system, the number and type of investment choices, and in the regulation of the annuities market. Overall the reforms have been successful, but concerns remain about relatively high administrative costs, participation rates and improving worker's knowledge of the system.

AUSTRALIA

In 1993, in recognition of the demographic changes, the Australian retirement system was reformed. Australia provides a two-pillar system. The first pillar is a means-tested program known as the Age Pension which is financed by general revenues. The second pillar, called the Superannuation Guarantee, requires employers to contribute on behalf of their employees to privately managed funds. Employers make contributions to these funds at the rate of nine percent of employee earnings and some employers make contributions that are above what is required. Benefits may be paid out as early as age 55, either as an annuity or as a lump sum.

Thus, Australia has approached the problem of improving retirement income not by expanding public programs, but by imposing a mandate on all employers to offer at least one contributory retirement plan to all employees. The accounts are intended to be portable and are managed by the private sector. However, because the accounts are provided on an individual employer basis with the fund selected by the employer, there are over 277,600 different funds, 99 percent of which are very small.

SWEDEN

Sweden began seeing the need for pension reform in the mid-1980s. Yet, 15 years passed from the time a commission was formed to study their pension system to the time reforms were implemented. The new system, begun in 1999, included the creation of a mandatory, fiscally sustainable, public system tied to economic growth. The Swedish model consists of their traditional social security program which will gradually be replaced by notional defined contribution (NDC) accounts as the first pillar. These non-funded accounts are a variant of a traditional earnings-related pension in which a hypothetical account is created for each insured person, with the account containing all the contributions during his or her working life. A pension is calculated based on average life expectancy and various economic factors. The annual contributions to the NDC are used to finance current pension obligations on a pay-as-you-go basis, but the account balances grow with annual contributions and the rate of return credited.

The second pillar is a mandatory personal account called the Premium Pension plan. Both employers and employees contribute equally to the NDC account and Premium Pension. The combined contribution rate is 18.5 percent of earnings (16 percent for the NDC and 2.5 percent for the Premium Pension).

The Premium Pension accounts are privately managed, under public supervision, and can be invested in almost 700 domestic and foreign mutual funds. Earnings are reported on an annual basis. Recordkeeping and investing on behalf of licensed pension funds is carried out by the Premium Pension Agency, a

regulatory authority. Participants may choose to have the government manage their premium account balances instead of a private manager. For those who fail to make any selection, there is a government managed default fund.

Relatively low administrative costs are mandated. Initial surveys indicate that many participants find the system to be complicated and feel that they are inadequately informed about the basics of the new system.

JAPAN

Japan has a two-tiered system. The first tier is a flat-rate benefit for all working age residents and citizens living abroad. The second tier is an earnings-related benefit. Employees and employers contribute to both tiers but the employers can reduce their contribution to the second tier by contracting out part of that pension. The first tier full benefit is payable at age 65 (with an actuarially reduced benefit payable at age 60), but a full benefit under the second tier may be payable at age 60.

The finances of the public pension system have rapidly deteriorated since 1999. The government is now considering a package of reforms to the pension system that would significantly increase the tax contributions incrementally through 2017. Simultaneously, benefits as a percentage of average salary would be gradually reduced. The government is also proposing to increase its share of the national pension program expenditures. At the same time, public skepticism in the viability of the pension system is growing and, as recent news reports indicate, many workers are not paying the required mandatory premiums into the system.

GERMANY

In Germany, retirement income comes from a variety of sources. The public pension system operates on a pay-as-you-go basis and is financed by a 19.1 percent contribution rate split evenly between employers and employees. There are also employer-sponsored pensions which offer earnings-related benefits, but only to a relatively small portion of retirees. A system of voluntary individual accounts, known as *Reister* pensions, was introduced in 2001 to provide additional retirement income. These savings accounts can be arranged either individually or through an employer. Available evidence indicates that demand for them has remained low and the government is considering steps to encourage participation.

Fiscal pressures resulting from an aging population, combined with relatively early effective retirement ages and high replacement rates, prompted a series of pension reforms in 1992, 1999, and, most recently, in 2004. This year, the government enacted two reform packages designed to address an estimated $10 billion shortfall in 2004. The first of these reduced benefits by freezing the usual annual benefit increase and delayed the payment schedule of benefits from April

2004. The second reform involved changing the way that pensions are calculated. Effective January 1, 2005, a "sustainability factor" will be introduced into the pension benefit formula that will link the level of retirement benefits to the size of the workforce relative to the number of retirees. As the "dependency ratio" rises, benefits are expected to fall from 53 percent of pre-retirement income to 46 percent by 2020. Additional changes enacted in the March 2004 reform package include an increase in the statutory age for early retirement from 60 to 63 by 2008 and the elimination of credit years for time spent in school.

Lessons Learned

This brief review illustrates the diversity of responses to the challenge presented by global aging. We can learn valuable lessons from international experience. And I believe the American people want us to learn these lessons. A recent poll by the Opinion Research Corporation reported that 60 percent of working age adults are not confident that Social Security will still exist when they retire. The 25 to 44 year old group was the most pessimistic with 73 percent doubters. Even 36 percent of near-retirees (those 55 to 64) were not confident that Social Security will be there when they retire.

By looking at other countries that have made or are making reforms to their retirement systems, we can use their experience to improve decisions and avoid some of those same problems.

The first lesson to learn is that Social Security reforms are inevitable. Because of global aging, reforming social security systems is being discussed throughout the world. As President Kennedy said in 1961, "The Social Security program plays an important part in providing for families, children, and older persons in times of stress. But it cannot remain static. Changes in our population, in our working habits, and in our standard of living require constant revision."

The second lesson is the importance of acting sooner, rather than later, in beginning to implement reforms. The experience of other countries shows us that strengthening social security programs takes a long time.

The importance of early action is also highlighted by the experience of continental Europe and Japan. Rising life expectancy, falling birthrates, and a decline in the worker to retiree ratio have led to the need for drastic action to achieve sustainable public retirement systems, including significant tax increases and benefit reductions. By choosing to act sooner to strengthen our Social Security system, we will be able to select from a broader array of options and phase in any changes more gradually.

A third lesson is that, if personal accounts are established as part of a plan to strengthen Social Security, it is important to keep administrative costs in check. Some countries, such as the United Kingdom and Chile, have experienced

relatively high costs in administering the accounts, whereas Sweden's process appears to have been more successful in limiting administrative costs.

In the United States, we have probably the world's best example of a government sponsored personal account system, the federal government's Thrift Savings Plan. It offers five diversified investment choices with fees that are lower than 1/10 of one percent of assets.

Another lesson we have learned from looking at the experience of other countries is the need to improve the public's general financial literacy. Legislation passed by the Congress and signed by President Bush last December created the Financial Literacy and Education Commission, of which Commissioner Barnhart is a member. The Social Security Administration has been active in promoting savings and financial literacy. We have sponsored the "Save for Your Future" campaign with American Savings Educational Council to promote savings.

A final lesson is that it is very important to help people understand the need for reform. In many countries that I have discussed, reforms have been bipartisan and ongoing, no matter what political party is in power.

Conclusion

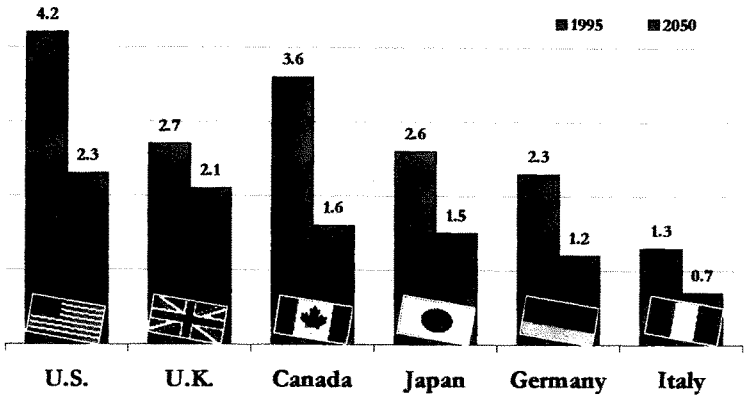
We live in an era defined by many challenges, but few are as certain as global aging and as likely to have such a large and enduring effect on the shape of national economies and the world order.

The developed and developing worlds must work together to engage this challenge constructively. Putting off strengthening of our Social Security system will limit the possible choices available to us. By taking action sooner, the changes to the program can be smaller and less abrupt. Further, the sooner action is taken, the sooner confidence can be restored to the Social Security program.

In conclusion, let me say we have much in common with many countries around the world as we face similar demographic challenges. It is important to learn as much as we can from their experiences.

Mr. Chairman, I again commend you for holding this hearing and for your efforts in keeping this issue before the public and, especially, for your very strong leadership in the bipartisan effort to strengthen Social Security. I will be happy to answer any questions you or the other Members have.

Ratio Of Workers To Retirees Is Falling Rapidly



Source: IMF (1998)

The CHAIRMAN. Now let me turn to Mr. Ohno, who, as I said earlier, is a member of the Japanese House and Chairman of the LDP's Research Commission on the Annuities System. Mr. Ohno, it is a great pleasure to have you travel the distance you have to be with us today.

STATEMENT OF YOSHINORI OHNO, MEMBER OF JAPANESE HOUSE, AND CHAIRMAN, RESEARCH COMMISSION ON THE ANNUITIES SYSTEM, LIBERAL DEMOCRATIC PARTY OF JAPAN, KAGAWA, JAPAN

Mr. OHNO. Thank you, Mr. Chairman. I am extremely honored to be here to testify before the Senate Special Committee on Aging regarding the Japanese pension reform now under deliberation in the Diet. In Japan, the pension reform is badly needed because our society is dramatically aging with fewer children.

The Japanese people are living longer. This is one of the greatest achievements of our society. Page six of my written testimony shows how dramatically the Japanese society is aging. This also shows that the discrepancy of life expectancy between men and women is getting wider and wider. Why? That is another story. Living longer is a great pleasure and we should not turn this pleasure into anxiety.

A more serious problem than living long is extremely low birth rates. Currently, the birth rate is 1.32 per woman. It was 2.14 in 1965. Thus, the Japanese population would halve by the end of the 21st century.

As you see at page eight, the average age of first marriage is going up now. At their 20's, unmarried women occupy two-thirds of the total.

Thus, the age dependency ratio is, as you see at page nine, worsening. Under such circumstances, it is necessary to raise contributions and lower benefits every 5 years when the pension system is to be reviewed and people are losing trust on their pension system. The most important task, therefore, is to restore confidence in the pension system and make it sustainable for at least 100 years to come. This is, in my analysis, the fundamental purpose of the current reform, because the DNA of the Japanese people is security.

The gist of our pension reform plan is as follows. First, sustainability. In order to make the Japanese pension system sustainable for the coming 100 years, we decided to restructure the level of benefits and contributions, as you see at page ten. On the point of the level of benefits, we decided that the minimum level of pension benefits should be about 50 percent of the average income of working people. It is now almost 60 percent.

The level of contributions of the employees' pension, currently 13.58 percent, will be gradually raised to 18.3 percent over 14 years, each year by 0.354 percent. We also decided to raise the tax-financed part of the basic pension from one-third to one-half within 5 years.

In addition to the above, for example, the government proposed that in case of a working husband and non-working wife, working husband's income-related benefits be divided half and half when both of the couple reach the age of 65. But we thought that dividing half and half of the husband's income-related benefits might be

a stimulus to divorce of the loved couple, so we made the system in which the benefits will be half only when they are divorced.

The opposition party, the Democratic Party of Japan, proposed its draft law against ours. The main points of the proposal are the integration of the three categories of pension system, that is to say, the national pension, the employees' pension, and the mutual aid pension, as you see at page three.

Final agreement was reached between government parties and the opposition party that we will discuss the matter of integration later on. The draft law of the pension reform passed the House of Representatives, but now the political climate of Japan is rather chaotic because it is revealed that some leading politicians did not pay into the pension program. We will do our best, we try our best so that the law may pass the House of Counselors by the end of this Diet session.

It is said in Japan that the pension is a gift from young generation to parents and grandparents. However, because of the rapidly aging society with fewer children, the Japanese pension system is becoming unfair between generations. People of my age are to receive benefits eight times of the paid contributions in case of employees' pension, but people born in 1985 and after will receive benefits only 2.3 times of the paid contributions. However, in the framework of the pension system we see not only the remittance of money, but also we see a gift of warm heart, which is most important in our human society.

Yet, the most important is to produce more babies. If we are successful in making the Japanese society more favorable for the youngsters to produce more babies, it is not necessary at all to discuss the level of contributions and benefits and all the serious problems will immediately be solved. I am sure that producing more babies is the most fundamental reform of the pension system in Japan.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, thank you very much.

[The prepared statement of Mr. Ohno follows:]

Testimony by Representative Yoshinori Ohno
Hearing "Strengthening Social Security:
Can We Learn from Other Nations?"
Senate Special Committee on Aging

May 18, 2004

Thank you, Mr. Chairman:

I am extremely honored to be here to testify before the Senate Special Committee on Aging the Japanese pension reform now under deliberation in the Diet. In Japan, the pension reform is badly needed because our society is rapidly aging with fewer children.

The Japanese people are living longer. This is one of the greatest achievements of our society. As you see at page 5 of my written testimony, the life expectancy of the Japanese people was 68 for men and 73 for women back in 1965. Now, 78 for men and 85 for women. In 2050, 81 for men and 89 for women. This shows how rapidly the Japanese society if aging. This also shows that the discrepancy of life expectancy between men and women is getting wider and wider. Why? But that is another story. Living longer is a great pleasure, and we should not turn this pleasure into anxiety.

More serious problem than living long is extremely low birth rates. Currently, the birth rate is 1.32 per woman. It was 2.14 in 1965. Thus the Japanese population would halve by the end of the 21st century.

As you see at page 7, the average age of the first marriage is going up now. At their 20s, unmarried women occupies 2/3 of the total.

Thus, age dependency ratio is as you see at page 8. 9.1 working persons paid into the pension system to support one retiree back in 1965. Now 3.4 persons support one retiree. 1.4 is estimated to support one in 2050.

Under such circumstances, it is necessary to raise contributions and lower benefits every five years when the pension system is reviewed, and people are losing trust on their pension system. The most important task is to restore confidence in the pension system and make it sustainable for at least 100 years to come. This is, in my analysis, the fundamental purpose of the current reform because the DNA of the Japanese people is security.

The gist of our pension reform plan is as follows:

First, sustainability. In order to make the Japanese pension system sustainable for the coming 100 years, we decided to restructure the level of benefits and contributions, as you see at page 9. On the point of the level of benefits, we decided that the minimum level of pension benefits should be above 50% of the average income of working people; it is now almost 60%.

The level of contributions of the Employees' Pension currently 13.58%, will be gradually raised to 18.3% over 14 years, each year by 0.354%.

We also decided to raise the tax-financed part of the Basic Pension from 1/3 to ½ within five years.

In addition to the above, first, we are going to cut down benefits for working people over the age of 70 and with high income.

Second, government proposed that, in case of a working husband and non-working wife, working husband's income-related benefits be divided half and half when both of the couple reach the age of 65. But we thought that dividing half and half of the husband's income-related benefits might be a stimulus to divorce of the loved couple. So we made the system in which the benefits will be half only when they are divorced.

The opposition party, the Democratic Party of Japan, proposed its draft law against ours.

Main points of the proposal are:

First, integration of the three categories of pension systems, that is to say, the National Pension, the Employees' Pension, and the Mutual Aid Pension, as you see at page 2.

Second, the rise in consumption tax instead of raising contribution level, and others.

Final agreement was reached, between government parties and opposition parties, that we will discuss the matters of integration later on. The draft law of the pension reform passed the House of Representatives and will pass the House of Councillors by the end of this diet session.

It is said in Japan that the pension is a gift from young generation to parents and grand parents. However, because of the rapidly aging society with fewer children, the Japanese pension system is becoming unfair between generations. People of my age are to receive benefits eight times of the paid contributions in case of Employees' Pension. But people born in 1985 and after will receive benefits only 2.3 times of the paid contributions. However, in the framework of the pension system, we will see not only the remittance of money but also we will see the gift of warm heart, which is most important in our human society.

And yet, the most important is to produce more babies. If we are successful in making the Japanese society more favorable for the youngsters to produce more babies, it is not necessary at all to discuss the level of contributions and benefits, and all the serious problems will be solved. I am sure that producing more babies is the most fundamental reform of the pension system in Japan.

Thank you, Mr. Chairman.

Overview of the Japanese Public Pension System and the Pension Reform in 2004

Prepared by Yoshinori Ohno

President of the Research Commission

on Pension System

Liberal Democratic Party of Japan

May 2004

Part 1 Overview of the Japanese Public Pension System

1. History of the Japanese Public Pension System

1942 Public pension system was initiated in Japan. (Law Concerning the Workers' Pension Insurance was enacted.)

1961 Universal pension coverage (Self-employed, employed, and government officials) was achieved by the Law Concerning the National Pension.

1982 Compulsory coverage of foreigners living in Japan started.

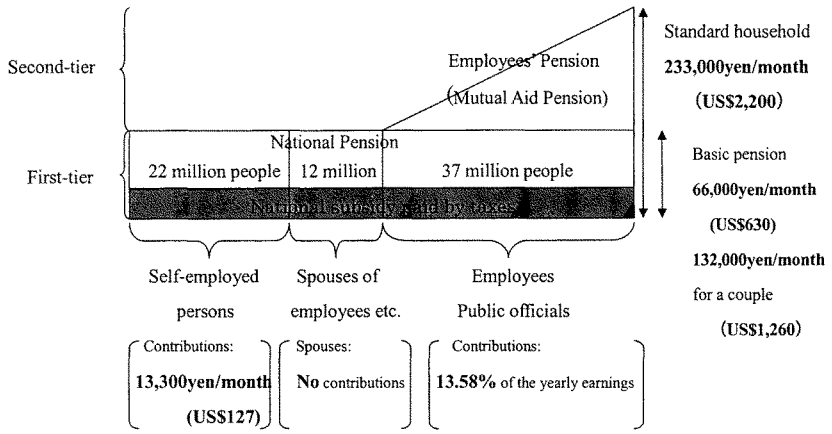
2. Framework of the Japanese Public Pension System

(1) Contributions

- Income-related contributions
  - ---Employees
    - Employees' Pension ------- Employees in private sector
    - Mutual Aid Pension -------- National public officials / Local public officials / Private school personnel
- Fixed-sum contributions
  - ---Self-employed persons・・・National Pension

(2) Benefits --- Two-tier System

- Self-employed persons, including farmers, students, and others over 20 years old, are covered only by the National Pension.
- Employees are covered by the National Pension and income-related system (Employees' Pension or Mutual Aid Pension).
- Mutual Aid Pension has the third-tier, which pays almost 20% of the benefits of the second-tier, in addition to the first- and the second-tier.



(Note 1) The above-mentioned is the pension for old-age persons. In addition to old-age pension, we have the disability pension and the survivors' pension.

(Note 2) Persons covered by the Employees' Pension are entitled to receive benefits beginning in the first-half of the sixties. The age is now gradually being raised

from 60 to 65, and persons who were born on or after April 2, 1961 (April 2, 1966 for women) will receive benefits starting at the age of 65.

Part 2 Pension Reform in 2004

1. Serious Problems Japan Faces – More Old People and Fewer Children (Special Japanese Phrase "Sho-shi-ka")

(1) Aging Society

Living longer is one of the greatest achievements of the Japanese society. Life expectancy of Japan is record-high in the world. However, pleasure of longer life should not be turned into anxiety.

--- Thus, immediate pension reform is necessary.

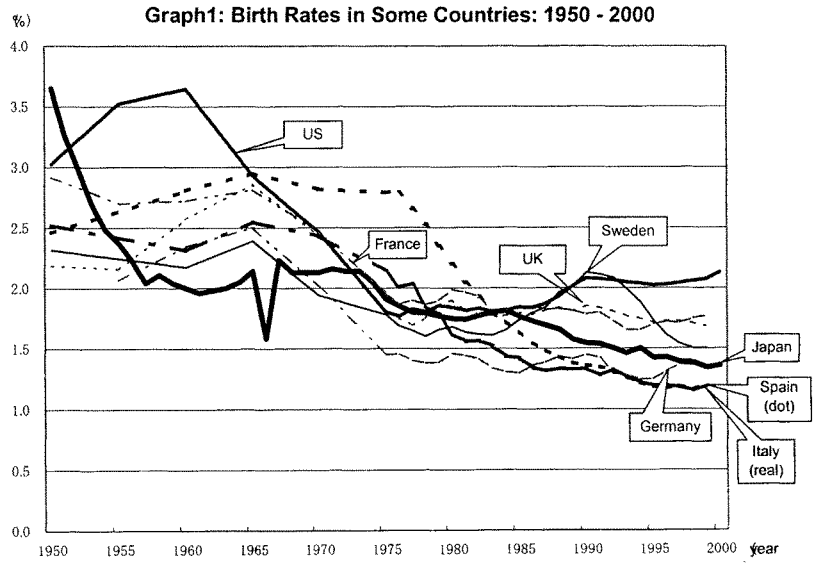
Table1: Life expectancy in Japan (years old)

Year	1965	2001	2050(estimates)
Men	67.74	78.07	80.95
Women	72.92	84.93	89.22
Difference between men and women	5.18	6.86	8.27

(2) Fewer Children

Japan is one of the few countries (Germany, Italy, etc.) that have extremely low birth rates. The birth rate of Japan is now 1.32, and we estimate that the Japanese population (now 127 million) will halve by the end of the 21st century.

--- Decrease in contributions and increase in benefits are due to the aging population with fewer children.

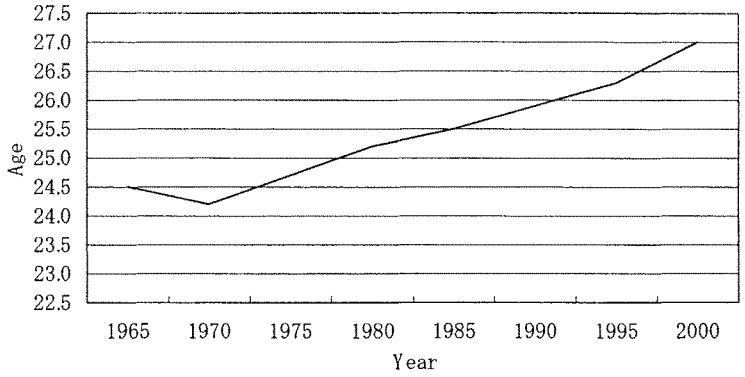


Source :UN,Demographic Yearbook, and Council of Europe,Recent demographic developments in Europe and North America Before 1991, Germany means West Germany.

(*) Causes of Fewer Children

(a) Average age of first marriage of women in Japan is rising

Graph2: Average age of first marriage of women in Japan



(b) Long working hours

40% of all the labor force is women. It is a sort of Japanese customary practice that workers stay in office even after the fixed office hours. Therefore, working men and women come back home very late and do not have much time to care children.

(c) Men do not share the housekeeping

Japanese husbands share less than 5% of total of housekeeping time.
In Norway, husbands share 40% of the family affairs.

(d) Educational expenses of children are very high

Children go to supplementary private school or cram school (in Japanese phrase "Juku") to prepare for the entrance examinations.

Average expenses for supplementary private school are 160,000 yen (US$1,520) /year for students of public junior high schools.

(3) Age Dependency

Age dependency in Japan is just unbelievable. The number of working generations between the age of 20 and 64 as against retirees over the age of 65 will be 1.4 in 2050.

Table 2: Age dependency

Year	1965	2001	2050
People between 20 and 64 / People over 65	9.1	3.4	1.4

(4) Summary

In Japan, it is provided for in the law that contributions and benefits are reviewed and revised every five years on the basis of demographic projection and economic forecast. So far, we were forced to revise the level of contributions and benefits every five years, that is to say, contributions are to be raised and benefits are to be decreased. Under such circumstances, the retirees and the near-retirees are losing reliability on the pension system, and younger people, joining the retirees and near-retirees, are suspicious if the pension system is sustainable. Therefore, the most important task for the pension reform is to restore confidence in the Japanese pension system on the part of Japanese people.

3. Content of the Pension Reform

(1) Sustainability

First, we must make the pension system sustainable for 100 years to come. The pension reform bill, now under deliberation in the Diet, makes it sustainable through raising the level of contributions, lowering the level of benefits, and pouring more tax money into the pension system.

(a) Level of Benefits

The level of benefits (*1) compared to average income of working people is currently 59.3% in standard household (*2). It will be lowered to 50%. However, more than 50% is secured by the reform bill.

(*1) Model case of benefits of a husband and a wife together (Retiree from company and non-working wife)

(*2) A household consisting of a husband who worked for 40 years and now retired, and a wife who has not worked at all

(b) Level of Contributions

- Contributions of the Employees' Pension (currently 13.58% as against income) will be gradually raised in 14 years (each year by 0.354%) to 18.3%, half paid by employers and half by employees, in 2017.
- Contributions of the National Pension (currently 13,300yen (US$127) /month) will be raised gradually in 13 years (each year 280yen (US$2.7)) to 16,900yen (US$161) /month in 2017.

(c) National Subsidy

At present, 1/3 of the benefits of the Basic Pension is from national treasury. It will be raised to 1/2 by 2009.

(d) Pension Reserve Fund

- Pension reserve fund, which comes from contributions of the National Pension and the Employees' Pension and amounts to 141 trillion yen (US$1.3 trillion), will be used to supplement the payment of benefits after 2050, the year when the age dependency rate will peak out in Japan.
- The size of pension reserve fund will be equal to the amount of one-year benefit payments around 2100.

(2) Other Aspects of Pension Reform – Responding to the Various Ways of Life in Japan

Pension system will become suitable for various ways of life.

(Continue to next page.)

Items	Problems in the Current System	Content of Reform
Pension system for people still working, yet already entitled to pensions	Present system has less incentive for retirees to work more. Benefits for retirees between 60 and 64 years old are reduced by 20% under the current system.	The reduction will be abolished. (Effective in April 2005)
	People between 65 and 69 pay contributions and if their total amount of income and benefits are larger than the certain level, benefits will be cut off to a certain degree. However, people over 70 do not pay contributions and their benefits are not reduced.	Cut-off rule will apply to retirees over 70; yet not necessary to pay contributions. (Effective in April 2007)
Pension in case of divorce	Non-working wives are not entitled to receive benefits income-related benefits of their former husbands after they are divorced. It is unfair.	Divorced wives are entitled to a half of the benefits coming from income-related pensions of their former husbands. (Effective in April 2007)
Pension for people who have raised children	More support should be given to families with small children.	Currently, people who have children of less than one year old are exempted from paying

		contributions. This measure will be expanded to those who have children of less than three years old. (Effective in April 2005)
Disability pension	The amount of Disability Basic Pension does not change even if disabled people work. Such work should be reflected to the amount of benefits.	Disability Basic Pension and Old-age Employees' Pension will be received simultaneously. (Effective in April 2006)

(3) Stopping the Wasteful Usage of Pension Contributions

Pension Contributions should not be used for purposes other than payment of benefits.

(a) Abolishment of Welfare Facilities

Welfare facilities, which include hospitals and hotels constructed by using the contributions, will be abolished and sold.

(b) Change in the Scheme of Pension Fund Management

Financial specialists, instead of bureaucrats, should manage pension fund on a sound and effective basis.

(c) Fundamental Reform of Pension System for Members of Diet

We are pledged that we will pursue fundamental reform on Pension System for Members of Diet.

4. Future Issues

There will be further issues to solve in the near future.

(a) Pension System Responding to the Changing Way of Life

(Part-timers, Pension and women, etc.)

(b) Integration of Public Pension Systems and the Scheme of Basic Pension

(National subsidy to the Basic Pension, Comparison to public assistance to the poor, etc.)

(c) Collection of National Pension Contributions

(*) Draft Law on the Promotion of Pension System Reform by the Democratic Party of Japan (DPJ)

(1) Gist of the Draft Law of DPJ

(a) New public pension system, which consists of income-related pension and guaranteed pension, will be established.

- In their so-called "income-related pension", a person will receive benefits, the amount of which is as same as the total of paid contributions. (Contribution rate will be expected as same as present (13.58%).)
- Guaranteed pension will be paid by tax money in case the amount of benefits of income-related pension is less than a certain level.

(b) New category of consumption tax will be introduced to finance guaranteed pension and transitional benefits from the current system.

(c) The pension reform will be discussed during the coming five years. Pension reform will be in force in 2008.

(2) Our Comments on the DPJ Proposal

- No clear figures are indicated in the draft law, such as level of benefits and contributions, proportion of contributions paid by employers, or rate of rise in consumption tax rate.

- What is clear is the sizable increase in consumption tax rate. DPJ hinted that the rate of consumption tax will rise by 3%. However, according to our calculation, it is estimated that the rate should be raised by 6 or 7%.

- Income-related pension has no element of mutual assistance in and between the

generations.

---It is not necessarily managed by the government.

- The financial structure of the new system is based on pay-as-you-go system. However, method of calculation of benefits is based on the funded system.

  ---Expenditure and revenue of the system are not sustainable because aging society with fewer children in the Japanese demography will further be aggravated.

- The opposition party claims that the integration of the three categories of public pension systems is necessary and fundamental to establish new system.

  ---However, in our analysis, the most fundamental is sustainability of the pension system for the coming 100 years. We think that the integration is desirable, but there are some difficulties involved in it; for example, the most difficult is how to take hold the income of those self-employed persons.

The CHAIRMAN. Let me ask both of you some questions that will help bring out several of the points involved. Commissioner Lockhart, you provided some lessons to be learned from the foreign experience. What do you believe, based on what you know now, would be the most important lesson to date?

Mr. LOCKHART. I think we can learn an awful lot from the foreign experiences, but I think the most important lesson really is to act sooner rather than later. If we act sooner, we will have more of a range of opportunities, more choices to make. Any changes will be less drastic, less abrupt to the people.

As you remember, in the 1983 reforms, they increased the retirement age from 65 to 67, and just 2 years ago, it started to actually move up. If we can make those kinds of gradual changes, that will allow people to compensate.

It will also allow us to look at more options, not just the traditional increase taxes or decrease or slow down the growth of benefits. We can start looking at some of those related to increasing investment returns and prefunding.

We can learn also from the experience of those countries—how they reformed their programs and some of the lessons they learned, if they didn't do it as well as they should have, if they made them too expensive, and some other things. So there are a lot of lessons out there that we can learn.

The CHAIRMAN. What activities is the Social Security Administration currently undertaking that would begin to explore all of these kinds of options that could be presented to Congress?

Mr. LOCKHART. First of all, we have been very active internationally. We belong to three international Social Security groups. We actively meet with them. We have various working committees on things related to policy, in particular.

Social Security itself has been really strengthening our ability to respond to Congress and the administration on reforms. We have developed a whole series of models, papers, that really look at all aspects of reform, and on top of that, our actuarial shop led by Steve Goss has been very active at looking at plans, helping members to structure them, and helping to score them. There has been a lot of activity there. I mean, that is the good news, that he has been very active in looking at plans, not just Republican plans but also Democratic plans.

So what we have tried to do is put in place all the infrastructure to help Congress and the administration make reforms.

The CHAIRMAN. You mentioned your presence in Idaho last month, and I greatly appreciate that presentation. It got good play in our State. It was the rolling out of a communications effort and an information effort on the part of the Social Security Administration.

You and I visited earlier before the hearing today about the difficulty of getting public attention at this moment on this issue because of all the other issues that are out there and a Presidential political year probably on top of all of that. But having said that, I think that both you and Mr. Ohno have spoken to the value of information and the value of public knowledge about what is reality and their willingness to adjust and change based on that reality.

Would you visit with us for a few moments about that particular information piece that you offered in Idaho, the work that has been done on it, and what your plans are to use it effectively over the next couple of years?

Mr. LOCKHART. Yes. As I said early in my testimony, one of the four strategic goals of Social Security is achieving sustainable solvency, and that means not just solvency for the 75-year period but for the very long term. I think a key aspect of that is to help educate the American people about the future of Social Security. Social Security has been one of the most successful, if not the most successful program. Certainly President Bush has said that several times. But he and many others have said we need to strengthen Social Security for future generations. He has actually asked the Social Security Administration to work with members and interested parties in a bipartisan educational effort, and that is really what we have been trying to do.

As you know, those events in Idaho were designed, first of all, to lay out the issue to the people and then look at the various alternatives for strengthening Social Security. We tried to do it very much in a very level, evenhanded manner. We looked at reforms, various reforms related to increasing taxes, various reforms related to slowing the growth in benefits, and then looked at the increased investment return alternatives. Again, we looked at three different kinds of alternatives there. As you know, we also had a simulator that we had launched in Idaho which allowed people to actually make choices and see what would happen to the system, but also more importantly to their benefits and to their taxes.

We are hoping that this tool and these series of events, which we hope to get more sponsors for, could be a very useful component in helping the American people understand the issue here, because it is an extremely serious long-term issue for American people, for the American economy, and the sooner we start moving on it, the better off we will be.

The CHAIRMAN. We thank you very much for being here this morning, and I do believe that presentation was extremely valuable and I would agree with you. The simulator is really a hands-on opportunity for the average recipient or beneficiary. I think once those kinds of pieces of knowledge are out there and they can actually see how it would impact them individually, that change is doable. It is very sellable to the American people if the educational process goes forward.

What I don't want to create is the very experience I had and that every member of this Congress has had that has served here for any length of time, and that is the flood of mail that continually comes because somebody got notched, the old notch act, as we know. The problem is people don't understand that the notch was one of those adjustments in the system out there that was made and then later was allowed to be effectively misrepresented, in part because there was not an informational base out there. You and I had nothing to do with it, but we have wrestled with it over the years.

Mr. LOCKHART. I think it is an important point, and President Bush makes it many times, that any reforms will not touch today's retirees and near-retirees.

The CHAIRMAN. Yes.

Mr. LOCKHART. Their benefits are safe and secure. As we saw out there in Idaho in these events, once you talk to the elderly about that, they really start to understand that these are really reforms for their children and grandchildren and they actually get into thinking about how best to do it and I think that is extremely important.

The CHAIRMAN. Thank you very much, and speaking of reforms for children and grandchildren is a great sequel to you, Mr. Ohno, and again, we are very pleased that you are with us this morning.

My first question to you would be, you have clearly given a lot of thought on how to reform your public pension system. You mentioned sustainability as the first goal of the proposed reforms. How well do the proposed reforms achieve their intended goal of sustainability in that 100-year window that you speak of?

Mr. OHNO. Thank you very much, Mr. Chairman. As I told you in my first statement, every 5 years, the Japanese pension program is to be reviewed, and every 5 years when we review the Japanese pension program, we have to change the structure of the pension program. That is to say, we have to raise the level of contributions and we have to lower the level of benefits. That is the reason why the Japanese people at large are losing the confidence, as I told you, in the Japanese pension program.

So in order to make the pension system sustainable for the 100 years to come, the actuarial calculation of the current pension reform is based on the following figures. First, birth rates. There is in 2050 1.39. It is now 1.32. Life expectancy in 2050, men 80.95, women 89.22. Rising consumer price, 1.0 percent per year. Rising wage, 2.1 percent every year. Interest rate, 3.2 percent, et cetera. This is the actuarial calculation basis.

If the birth rates in 2050 is 1.1, very, very low level, or as I told you, 1.32 or 1.39 is the actuarial calculation basis, but if the birth rate goes down to 1.1, the pension system will be, I am terribly sorry to say this, but insolvent—insolvent, exhausted in 2066.

Well, if we do not strengthen our pension program, the employees' pension will be insolvent within 17 years—within 17 years—and the national pension will be insolvent in 13 years. If we maintain the current level of benefits, we must raise the contributions of the employees' pension to almost 26 percent. Well, on the contrary, if we maintain the current level of contributions, we must lower the level of benefits by 40 percent.

Anyway, we have right now 150 trillion yen for the accumulated fund from the contributions and that will be used after around 2050 and we can see this, if, as I told you before, every actuarial calculation basis keeps as it is. It continues for around 100 years to come. Thank you.

The CHAIRMAN. Mr. Ohno, you have spoken, of course, in your testimony to the importance of the increase in Japan of the birth rate as a matter of good pension policy. Not only is birth rate an issue in your country, it is becoming an issue in our country as it relates to the long-term actuarial soundness of the pension fund, but also the dynamics of the economy itself, a strong vibrant economy, people at work, contribution into the system.

Would you speak to me or speak to the committee for a few moments about policies that you have considered that would actually promote an increase in birth rate, how you would make it more desirable for the Japanese family to have more children, and your present look at the economy long term and changes that you might produce there to keep it vibrant.

Mr. OHNO. Mr. Chairman, before I speak about the policy problem, how to increase the birth rates, let me make an analysis why the Japanese women are not producing more babies. First of all, well, about 40 years ago, there was a pressure on Japanese girls to get married before the age of 25. If they were not married before the age of 25, they were called "leftover Christmas cakes" or something like that—— [Laughter.]

Mr. OHNO [continuing]. They look, of course, beautiful, still edible, but no one would buy them.

Senator BAYH. What did they call the boys, Mr. Ohno? [Laughter.]

Mr. OHNO. I don't know. [Laughter.]

So then there is no pressure like that in Japan of today. Girls work and stay with their parents, relying everything, including meals and room and everything on their parents. They enjoy their lives, relying everything on parents, well, say earn money and enjoy their lives, going abroad for sightseeing, et cetera. In Japan, they are called "parasite singles," if you call that in the United States or not, I am not quite sure, but this may be the Japanese inventive English.

The CHAIRMAN. It is very descriptive, I will say that. [Laughter.]

Mr. OHNO. So as I told you before, the average age of first marriage of the Japanese girls, women, is rising, and so, how to educate them, how to let them know about the human contact, warmness of human relations. This is very important for the Japanese society. This is the first one.

As I told you, the average age of first marriage is getting up. It is right now 27. About 30, 40 years ago it is 24 years, and right now, 27 years old. So this is the average of the first marriage for Japanese women.

Maybe in the second place, I have to say long working hours for the Japanese workers, including women. So maybe we have to—and, of course, Japanese women occupy almost 40 percent of the total workforce, so we have to ask the business circle to establish some sort of new working habit or practice. This is one of the points.

Third, in Japan, a man does not share the housekeeping business. Japanese husbands share only 5 percent of the total working household keeping business, while in Norway, for example, as I understand it, husbands' share of housekeeping is 40 percent, as I understand it. Well, I don't know how much percentage in America.

Fourth, then very high cost of education in Japan—very high cost of education in Japan. Children go to cram school in order to pass the entrance examination at the university, et cetera. So education cost is very, very expensive. That is the reason why they do not like to produce more babies.

One more thing, if I may say so, the average size of Japanese houses is very, very small, so they have to give up the hope of having one more baby. This is the reality.

Then on the point of the policy, while there are some policy measures we have established and are following, name some, for example, improvement of work environment, for example, extension of the period of child rearing leave, promotion of shorter working hours and securing various types of employment, fulfillment of child allowance, et cetera.

But the most important point I have to say, have to point out here, is that government expenditure for the aged people, if it is ten, level ten, then the government expenditures for children is only two or something like that. As I understand it, in Scandinavian countries, if the ten expenditures, government expenditures for the aged is the same level for the children, or more than that. So from now on, we have to consider the increase of the expenditure so that we survive this low birth rate world. Thank you.

The CHAIRMAN. Thank you very much. What you say is phenomenally important when we look long-term at programs like a Social Security or pension program, and that is the cultural changes that go on in a country, social adjustments and changes that may not be predictable in the long term as trends develop that are substantially different from when these programs were initially created.

Let me turn to one of our colleagues that has joined us, Senator Evan Bayh of Indiana. Senator, welcome.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman. I apologize for being a little bit late. As you understand and our witnesses may or may not, traffic delays are an occupational risk here in Washington, so I am sorry to have missed the testimony, but I want to thank you for your appearance, and Mr. Chairman, I want to thank you for holding this hearing. It is not often that Congress tries to get out in front of the curve and anticipate the solution to problems before they have reached the critical point. I think the more we can focus our nation's attention upon this looming problem, the better off we will be.

I was looking at some briefing materials. In the year 2018, 14 years from now, I think—is that right, Mr. Lockhart—the system tips over and we begin to pay out more in benefits than we take in in revenues. My guess is it is at that moment when the crowding-out effect will begin and other programs will begin to receive less funding because of the needs to meet our entitlement obligations, that this will come in stark relief. But if we wait that long, then obviously the potential solutions are much more difficult to implement. These actuarial problems tend to take on a momentum all of their own.

So in any event, thank you, gentlemen. Mr. Chairman, thank you for calling the hearing. Are we in the question time now, Mr. Chairman?

The CHAIRMAN. Please. Go right ahead.

Senator BAYH. Just a couple things, and Mr. Ohno, please don't think I am ignoring you, but I would like to at least direct my first couple questions to Mr. Lockhart.

Is my understanding correct that the magnitude of the challenge in Social Security is significant, but Medicare is in all likelihood going to be a more sizable problem? Is that correct? If we did nothing and just sort of let the situation run, we would still have in the out years about 73 percent of the money coming in to fund Social Security, so we are looking at a 27 percent problem or thereabouts, is that correct?

Mr. LOCKHART. Both are very, very serious problems to the American people and both long term. The numbers on Medicare are larger, but the numbers on Social Security are still very, very large. If you look, for instance, at the shortfall over the next 75 years and say, we need that money today, to invest it today to cover the benefits that are scheduled for today and without increasing taxes, that is $3.7 trillion. That is equal to the U.S. debt to the public today.

Senator BAYH. So it is a $3.7 trillion problem?

Mr. LOCKHART. Over the 75-year period, and as Chairman Greenspan says, after the 75-year period, which is an arbitrary number, you just fall off the cliff and you keep falling and the number grows to the——

Senator BAYH. Three-point-seven—that is in today's dollars?

Mr. LOCKHART. Today's dollars, earning interest, you need it.

Senator BAYH. That is about 27, 25 percent?

Mr. LOCKHART. Well, another way to look at it is——

Senator BAYH. In other words, if we did nothing, we would still have enough money coming in to cover about three-quarters of our obligations?

Mr. LOCKHART. That is correct. For instance, if we did nothing, no tax increases, no change in benefits, no change in investment policy, in 2042 when the trust fund is exhausted, the benefits would be cut 27 percent, and then every year thereafter, they continue to fall.

Senator BAYH. Just to make it clear on the record, I am in the camp of hoping that we don't do nothing, but I am just trying to identify the size of the problem.

I am also interested, Mr. Chairman, in our use—and we all do it, we refer to the trust fund. But am I right in saying, Mr. Lockhart, just for the record, there really is no pot of money. These are just obligations against the ongoing revenues of the government, correct, and so it is money we are taking out of either education or health care or other things that we would like to do as a society. There is no bank account with assets sitting in it.

Mr. LOCKHART. The trust fund consists of special issue Treasury bonds that have been issued to Social Security over the years in every year in which there has been an excess of taxes over benefits paid. In addition, every year, we get new Treasury bonds for the interest owed on the trust fund. So, for instance, last year, the increase was about $138 billion, but over half of that was actually interest. It wasn't even excess taxes.

Senator BAYH. I guess my point is, in 2018 when we tip over and we start paying out more in benefits than we take in tax revenues, these are not actually—the money is going to have to come from somewhere, correct, and there is not some magical trust fund sitting there we can just take the money out of and say, "Well, we

will plug the gap by doing that." We are either going to have to raise taxes or cut other parts of the budget——

Mr. LOCKHART. That is very correct, Senator. At that point, Social Security comes knocking on the door of the Treasury and Treasury will have to start paying the interest in cash and/or redeeming the bonds. Obviously, where that money comes from is increasing taxes, cutting government spending somewhere else, or borrowing it somewhere else.

But it even happens before 2018. Pressure really starts about 2008, 2009 when us baby boomers start to retire and——

Senator BAYH. Believe me, it is going to come as a revelation, I think, Mr. Chairman, to folks up here on Capitol Hill whenever the date arrives when they say, "What do you mean, we have to appropriate money for Social Security?" This has never happened. We thought there was a trust fund. It is going to come as—you mean we have to have less for the other things we want? It is going to, I think, be a real eye opener for people who haven't followed this problem, probably a shock to the system.

Just a couple of other questions. Our country has experienced a renaissance in productivity growth over the last few years and it seemed to hang in there pretty well even during the most recent economic downturn. I would like to ask you, if we are fortunate enough to see—I imagine it will taper off, but hopefully will taper off at a higher plateau than was the case over the last couple of decades—if we are fortunate enough to experience higher productivity growth, can that play some role in helping to close this gap or not?

Mr. LOCKHART. Certainly, higher productivity will help. We are projecting reasonably high productivity in our 75-year numbers. But if it goes beyond that, it will certainly help, but it can't solve the problem.

Senator BAYH. Forgive my ignorance. What are you forecasting over the——

Mr. LOCKHART. About 1.6 percent.

Senator BAYH. You are a brave man to try and forecast anything over 75 years.

Mr. LOCKHART. Well, it is not me. It is our independent actuaries at Social Security. But the trustees get very involved in those discussions. In fact, there have been some very significant discussions over the years about productivity numbers.

But if you do sensitivity analysis over productivity, it still won't grow your way out of the problem, and the real issue goes back to what Chairman Ohno was saying, is that there is just not enough population growth. If you have very few workers, even if you have relatively high productivity, you are not going to be able to pay for all of today's retirees or tomorrow's retirees.

Senator BAYH. So you have factored in some of—forgive me, I was thinking you said—what is your average estimate of productivity growth?

Mr. LOCKHART. About 1.6 percent, but, I mean, it has been higher and it has historically been lower, and we can send you some numbers around what that will do to the numbers, but if you increased it, you would almost have to get to about a 3-percent pro-

ductivity level continually for the 75-year period to actually solve this issue and that would be pretty unheard of.

Under the intermediate assumptions of the 2004 Trustees Report, the annual change in productivity is assumed to decrease from 3.4 percent for 2003 to the ultimate assumed level of 1.6 percent by 2012.

If the assumed ultimate level of annual productivity were increased from 1.6 percent to 2.1 percent (an extra 0.5 percent increase in the ultimate annual productivity assumption) and all other assumptions were equal to those under the intermediate assumptions, this would lead to an improvement in the financial status of the Social Security program. The maximum improvement on the 75-year actuarial deficit is about 0.5 percent of taxable payroll). The word maximum is used because it is assumed that all the extra increase in productivity falls through to average real earnings. That is, the assumptions for the other linkages to average real earnings (hours worked per week, compensation to GDP, etc.) remain as assumed under the intermediate assumptions.

Senator BAYH. Can I just, in knocking this around just in my own mind, I didn't anticipate that this would solve the problem, but if we are a little on the upside on productivity, that can make a contribution to helping hopefully close the gap.

Mr. LOCKHART. Yes, I think that is right. Economic growth will help us, too. Anything we can do to stimulate economic growth will be helpful, as well. Yes, that will close the gap somewhat. But the key issue, as you were saying earlier, is if we can make these changes earlier, we have a lot of time and we can make them smaller and we have a lot of time to have them have an impact. Frankly, some of these changes might actually increase productivity, I mean, might increase growth of the economy, so you would have a dual benefit.

Senator BAYH. Well, the good news, if there is any, over a 75-year period, these things go up and down. Mr. Chairman, I never cease to be amazed. We try and estimate, as you know, Mr. Lockhart, and Mr. Ohno, you may be aware, too, our budget is on a 10-year basis. When I was Governor of my State, we had biennial budgets. The estimates were never right for 2-year periods, let alone 10 or 75 years. So again, I tip my hat to you and the actuaries for attempting this.

But the good news, if there is any, may be, Mr. Chairman, it seems to be that the pace of innovation, if anything, is accelerating. If you look at our economies—and it ebbs and flows over long periods of time, but if you try and anticipate what our economy's long-term comparative advantage is going to be, it is probably going to be structuring our activities more around high innovation, value-added parts of the economy. So perhaps if that is true and we can make the most of those opportunities, maybe we can bump up that productivity number a little bit, not solve the problem, but at least make a modest contribution, which leads me to my next question.

I don't want to hog the microphone here, Mr. Chairman. I had a couple of other questions.

The CHAIRMAN. You can proceed.

Senator BAYH. The GDP price deflator, did you discuss that in your testimony?

Mr. LOCKHART. No, I didn't. I think we are assuming a 2.8 percent inflation rate over the 75-year period.

Senator BAYH. The annual cost-of-living adjustment, that is what I wanted to get to. I gather that on a technical basis, some experts feel that that overstates the true rate of inflation. If that were to be adjusted to what the technical analysts feel is a more accurate number, what kind of contribution would that make to solving the problem?

Mr. LOCKHART. Well, I am not an expert on various CPIs with all the little letters after them, but it is my understanding that it would have, again, a marginally beneficial impact to the system. Obviously, there are issues, and as I said to the chairman, President Bush has made it clear that he wants to protect the benefits of today's retirees and near-retirees.

Senator BAYH. That is just one item that some people, I remember former Senator Moynihan and others had put out there to say——

Mr. LOCKHART. Right, and Chairman Greenspan recently——

Senator BAYH [continuing]. Absolutely nobody wants to tinker around, or nobody wants to—it is just a technical matter. I mean, is this, the current way it is being calculated, is that an accurate expression or——

Mr. LOCKHART. I think there are experts on both sides and I am really not an expert, so I will not comment on it.

Senator BAYH. That never stops people in our positions from commenting, but I thank you for your reticence.

Two more quick questions. It seems to me that the real challenge we are trying to arrive at here is how do we—and I want to get to the rate of return issue. Is there a way we can harvest greater rates of return while still maintaining the safety net mechanism? There are different ways to go about that.

Have you looked at all at the experience of some State pension funds, where they invest in stocks and other higher rate of return instruments, but they do it by, rather than the individual accounts—and I am not expressing an opinion one way or the other, but they pool their resources, invest them and generate a higher rate of return over longer periods of time and yet maintain the safety net by guaranteeing a certain pension. Have you looked at that option and do you have an opinion about that?

Mr. LOCKHART. Certainly, I know that world very well. I spent probably a 30-year career in the world of pensions, meaning the corporate side and international side, for that matter. So I am very familiar with all forms of pensions. Certainly, the State systems have some pluses and minuses to them.

I think actually you can—and some of the proposals out there are creating a safety net within Social Security but also allowing personal accounts to individuals. That way, the individual has a little more choice and control of their assets and it does give them a nest egg.

Senator BAYH. Let me follow up on that. How would you go about guaranteeing a minimum rate of return, in other words, the safety net, within the individual account approach?

Mr. LOCKHART. There are a whole series of different kinds of personal account approaches. There are all sorts of bills that have

been introduced. There was the President's commission. I think the key issue is to keep a defined benefit portion in any type of reform to have that safety net under there that is a defined guarantee, a defined benefit plan, and then layer on top of that the personal account—as is done in some of the reforms we are looking at. So you have, like many corporations do today, a defined benefit plan with a personal account, in that case a 401(k) on top of it.

Senator BAYH. The advantage of that over the State pension model in your mind would be——

Mr. LOCKHART. Well, what we are talking about here is much more money than any State pension plan has. We are talking trillions of dollars, and I think that could lead to some real political issues if a government agency owned a major portion of many American companies. The CBO, I think probably last June or thereabouts, wrote a paper on this and really started to talk about some of these issues. What happens if a factory is being shut down in someone's district? Wouldn't there be pressure on the Social Security trustees to put pressure on that company not to do it?

Senator BAYH. Has that been the experience with State pension funds?

Mr. LOCKHART. That is a good question and I really don't want to make many comments about State pension plans, but there have been some things about social investing and other issues in State pension plans. There has been, you know, certainly some pressure from time to time. Most of them don't succumb to it, but there has certainly been pressure.

Senator BAYH. My final question has to do with the transition costs to a private account system. Have we been able to estimate what the transition costs would be?

Mr. LOCKHART. I like to call it a transition investment because that is what it really is. It is actually reducing the long-term cost by putting some money up a little sooner rather than later.

Various plans have transition investments in the range of, again, in today's dollars, present value, what you would need today, of $1 to $2 trillion versus that $3.7 trillion I talked about earlier. Really, because some of these plans actually produce sustainable solvency which means the program is fixed forever, if you will, you can compare it to that $10 trillion number. So at a cost——

Senator BAYH. I am sorry, what was the $10 trillion number?

Mr. LOCKHART. The $10 trillion——

Senator BAYH. That is to fix it forever?

Mr. LOCKHART. Yes, basically——

Senator BAYH. The $3.7 trillion is for what, 75 years?

Mr. LOCKHART. A 75-year period, but then the 76th year it just falls off the cliff again. It is a new number we introduced in the Trustees' Report last year and it is really trying to look at the very long-term issue. Obviously, those numbers, there is variability around them, but it is an indication of the potential we might need to fill. If you look at the transition investment of $1.5 trillion, that can be very small compared to the long-term costs if we don't fix the system.

Senator BAYH. In a private account approach, as I understand it, the Social Security recipients of most modest means are actually subsidized somewhat, is that correct?

Mr. LOCKHART. Well——

Senator BAYH. They actually receive more in benefits than they paid in? Could you still maintain that——

Mr. LOCKHART. Most of the private account proposals I have seen have actually increased the safety net for the lower-income workers. In fact, they consciously have done that.

Senator BAYH. So there would still be a subsidy——

Mr. LOCKHART. Well, I wouldn't call it a subsidy because everybody contributes to this program. I mean, that is one of the great things about Social Security.

Senator BAYH. But the people at the higher end would be, in fact, having some of the money they pay in, as is currently the case, go to help people at the lower end.

Mr. LOCKHART. Yes. The people at the lower end get a higher replacement rate, get a higher return on their investment.

Senator BAYH. That is currently the case, isn't it?

Mr. LOCKHART. Yes, and some of the proposals are even raising that safety net higher than that, just again to protect the longer-working, lower-wage workers.

Senator BAYH. Good. I am interested in exploring all these options and am merely in favor of what works.

Mr. Chairman, again, I want to thank you. It is refreshing for us to take a look at a problem that, gee, 75 years, that is not too often we look that far over the horizon. Our children and grandchildren will thank us if we do that, and I thank you for holding the hearing today, and thank you, gentlemen, for your time.

The CHAIRMAN. Senator, thank you for being here and asking those questions this morning. It is important that we begin this dialog and that the Congress of the United States become increasingly aware of the urgency of it in relation to long-term stability. You and I both know with our experience here that we usually tend to wait until the last minute. This is an issue in which we cannot wait until the last minute to make those changes. Oh, we could, but you and I might not survive them politically. It is to our political advantage and to our economic advantage and to the advantage of our children and grandchildren that we make them long-term and that we get out in front of this issue. I think that is good business and good politics and that is what we are trying to accomplish.

Chairman Ohno, thank you very much for coming and sharing with us this morning the challenges, and I view them as challenges, you have in your country. In many respects, there are challenges similar to ours, different countries, different cultures, but there are some similarities. As we look across the world to other countries that are making these adjustments, yours will be one that we will watch very closely. So we thank you for being with us this morning.

Mr. OHNO. Mr. Chairman.

The CHAIRMAN. Yes?

Mr. OHNO. Could I say something?

The CHAIRMAN. Please.

Mr. OHNO. In my opinion, the pension reform should be considered not only from the viewpoint of the level of contributions and benefits, but also from a viewpoint of macro economy, corporate

profitability, fiscal stability, working and lifestyle. Everything should be taken into account when we consider the pension reform. Thank you very much.

The CHAIRMAN. Thank you very much. Commissioner, thank you for being with us this morning.

Mr. LOCKHART. Thank you, Mr. Chairman.

The CHAIRMAN. We will ask you to step down and we will introduce our next and last panel.

While they are coming, I was visiting with the Commissioner earlier this morning and I will never forget, oh, a year ago, I guess, we had Alan Greenspan before us and we were questioning him then, you and I, and others were contemplating how we adjust Medicare, get prescription drugs into it, and I asked the question, in measurements of difficulty, how much more difficult is it, one over the other, to make the reform.

I think the Chairman was very clear in saying, oh, Social Security just takes political will. It is relatively easy to fix because you are dealing with predictable numbers that you can control and manage, whereas with Medicare or health care, you are dealing with a very dynamic economy. He said, one major change in health care delivery and/or a breakthrough in science could throw all of your actuarials or all of your variables off by a considerable amount simply by cost factors.

I had not thought of it in that context. I looked at them as trust funds and social programs and benefit relationships, but not with the idea of how they apply to the dynamics of a set number versus a non-set number.

Senator BAYH. All of that is true. If history is any guide, my guess is it would throw them off on the up side, not on the down side.

The CHAIRMAN. Oh, very much so. Very much so.

Let me introduce our next panel. We have with us this morning Vincent Truglia, managing director of the Sovereign Risk Unit at Moody's Investor Services. We also have with us Axel Boersch-Supan, director, Institute of Economic Research, University of Mannheim in Germany; David Harris, director of Watson Wyatt Worldwide in London; and Jacobo Rodriguez, financial services analyst at the Cato Institute.

Mr. Truglia, we will turn to you first for your testimony.

STATEMENT OF VINCENT J. TRUGLIA, MANAGING DIRECTOR, SOVEREIGN RISK UNIT, MOODY'S INVESTORS SERVICE, NEW YORK, NY

Mr. TRUGLIA. Thank you very much, Mr. Chairman. Let me first start by pointing out that my perspective in this is looking at pensions and health care benefits truly from a credit risk point of view. There are obviously many other different perspectives you could have, but it does produce a somewhat different view than other perspectives.

Given that, it is our expectation that every industrialized nation will, "default" on its pension and health care claims, and what do I mean by that? A default simply means that you don't meet the terms of the original contract, and in this case, if a government did that on a bond obligation, that would simply be considered a finan-

cial default. But simply changing the rules on pension and health care reforms also represents the equivalent of a default.

The only reason society seems to care less about a default on a pension or health care claim is that it is a societal convention. We just happen to place greater importance on a contract if it happens to be a truly financial obligation.

If we take a look around the world, and we have looked at lots of different countries and we have taken a look at endless estimates of their net present value of their pension obligations, it becomes pretty clear that, as I mentioned, every country will have to change its pension and health care claims. When we start looking at the individual analysis, what you have to start with as a credit analyst is the amount of debt outstanding.

I have on this table here, and it just is trying to look at the major industrialized countries and put them into small groups, you have the U.S. and France and Germany and the U.K. approximately at the same area. The mean for AAA and AA rated countries of debt to GDP is about 58 percent and the median 56 percent. The U.S. has a slightly higher debt-to-GDP ratio than others and so we are probably in the middle range. But every country on this list cannot afford to suddenly add the equivalent of $3.5 trillion or $5 trillion worth of debt to the overall total.

Now, this is one measure of what countries look like, and you can see, given the earlier presentation, that there are two outliers. One is Italy, but the other one is really Japan and Japan is really in a class all by itself, starting out with a ratio of 170 percent of government debt to GDP at this time.

There is another ratio, however, that probably gives you a better idea of how much governments can actually afford given their existing levels of debt and that is to take a look at the general government debt-to-revenue ratio. Here, you can see the U.S. is significantly worse than certainly the mean or the median and especially for most continental European countries, and the reason for that is that we have a smaller government. We take less revenue in, in general. You can see Italy doesn't look that much worse than the U.S. simply because the Italian government is so large and takes so much revenue relative to GDP.

Once again, though, the outlier is here Japan, and this is unprecedented for an industrialized country. Their existing debt is already over five times their total revenue. Now, what you see here is that the Japanese, because of their economic situation for the last 10 years, have not been able to raise revenues, and that is why it is going to be fascinating to see what actually happens when they start to increase these pension contributions, which as you know is the same as a tax, what happens to the economy when you do that. They have been very reluctant to do that and they have been financing all their deficits, very large deficits, through debt creation.

Now, the question is, how much can you do of that? What is the upper limit? Well, if you look historically, when governments in the pre-World War II period, where we actually had defaults, when they reached about 170 to 180 percent of national income, that put great stress on financial systems.

The problem we have today, even though Japan is already there, is that when you make a comparison with those earlier periods, you also had countries functioning under a gold standard and we think that that actually has created greater limitations because you had balance of payments considerations and constraints much sooner then than you would have today. So we think that countries can probably absorb more debt than they did under that old system.

But when looking at the individual pension and especially the health care estimates, we obviously have to use net present values and I think the Senator alluded to some of the problems regarding actuarial calculations for pensions in general. But when you look at these net present value estimates, they are through the roof in most instances.

But I remember in the 1990's when the Italians reforming their pension system under the Dini reforms, all of a sudden, the Italian net present value of their pension reform, which was rather modest—in the long run, it wasn't important, but over the next few decades it was very modest—and suddenly the net present value declined by 200 percent of GDP. Well, the lesson we learned there is ignore these numbers. They are just too susceptible to dramatic shifts in the final outcome.

When looking at what will happen to governments, and again rating governments, what we are very careful about is the what we consider intergenerational resource allocation, and we think that sometimes people misuse that concept. From our point of view, there can never be an intergenerational resource transfer from the present, or from the future to the present or the present to the future. All you ever have is an intergenerational transfer in the present. All fiscal problems are always in the present. So we are actually optimistic in that as long as you expect industrialized democracies to act reasonably at every point in time, then you don't get a default on the government debt.

Now, does that mean that we don't have a problem? No, it doesn't, because fundamentally, the problem is not fiscal. Fundamentally, the problem is standards of living in the future and all you have to then do is what is going to create the highest standard of living going forward. So any pension reform that has a negative effect on increasing standards of living over time are probably a negative.

What do we think is going to happen over the next 50 years? One is I guarantee you that the forecast for the birth rate decline will not happen because the incentives as population shrinks to have children in all likelihood will rise.

Two, one of the biggest changes we have seen in the last 50 years is the decline in working by older people. Again, an extreme example is the Italians after World War II. About 50 percent were still in the workforce above 65 years old. Today, it is down to 4.5 percent. For the industrialized world, we were at, at that time, slightly under one-fourth of all people over 65 were still working. Today, we are down to 9 percent.

So I think what is going to happen, and we are already seeing the beginnings of it, is the normal economic incentives are going to occur for people to work a longer period of time. There will be a

change in the nature of their occupation, perhaps. But that is what is probably going to occur.

Then the final thing that is going to probably happen is that we are going to have and have to maintain more immigration, but that is temporary because as you know so well and have seen all the studies, the whole world is aging. So Mexico will have the same age distribution we have today and China, in fact, will be older than we are today. So what they are going to have to do is the same thing we are going to have to do, is figure out how do we produce more income in the future so when you are fighting over resource allocation in the future and income distribution in the future, that the discussions will be more civil than they otherwise would be.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you for that overview. I think all of that fascinates us as we move down this road.

[The prepared statement of Mr. Truglia follows:]

The Effects of Aging on Public Sector Pensions and Healthcare Systems: A Rating Agency Perspective

Prepared for:
The Senate Special Committee on Aging

By

Vincent J. Truglia
Managing Director
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May 18, 2004

Let me begin by saying that every industrialized nation will "default" on its pension and senior healthcare promises. What do I mean? It will be impossible for any major developed nation to meet presently promised public sector pensions, including promised healthcare benefits for seniors, simply because those promises are too generous compared to future resources. Benefits will have to be scaled back, in some cases, significantly. In others words, future governments will not be able to meet future pension and senior healthcare commitments embedded in law today. Conceptually, what is most intriguing as a credit analyst if that if governments were to handle their bond obligations in the same way, that is, not fulfill the original contract, then those government bonds would be considered in default. Fortunately, pension and healthcare "defaults" tend not to be viewed as seriously by the public as would a breach of promise by a government on its bond obligations. This appears to be simply the result of societal conventions.

It can be argued that the United States has already "defaulted" on its social security obligations once it changed the tax laws on social security payments in the 1980s. As this committee knows so well, payments that were previously exempt from income tax suddenly became taxable income for a large number of upper-income pensioners. The

same result could have been obtained by decreasing benefits to those same pensioners, but the tax route was probably more politically palatable because it better obscured the final outcome -- lower net payments to certain pensioners. This is just one example of how reductions in pension levels can be handled.

The list of pension reforms involving cutbacks in present-day benefits, never mind future benefits, is long indeed. In some countries, such as Canada, the language used to describe these types of benefit reductions is perhaps a little more transparent, and definitely more vivid – such reductions are called "claw-backs", leaving pension recipients in no doubt as to what happened.

In the Sovereign Risk Unit at Moody's, we continually look at the latest academic studies regarding public pension and healthcare benefits. No matter which study you look at, one must come to the same conclusion -- public sector resources needed to fund existing pension and healthcare promises over the long-term will raise serious solvency issues if these systems are not reformed.

At Moody's our interest in pension and healthcare programs for companies and governments, at the national and sub-national level, relates to how these programs will affect the risk of default on financial securities. When looking at pension and healthcare promises, however, there is an important analytical distinction between what national governments can do compared to all other types of borrowers, including local governments. Companies and local governments are obligated to meet existing pension and healthcare promises if they are in the form of a contract, obviously subject to existing law. In other words, companies and local governments cannot unilaterally change these contracts unless allowed to do so by law. National governments, on the other hand, control the legal framework

When looking at a local government or company creditworthiness, our analysts spend quite a bit of time analyzing estimates of unfunded pension and healthcare liabilities. For obvious reasons, emphasis is placed on programs that are contractually or legally binding. Much less weight is placed on unfunded pension and healthcare claims that can be changed at the discretion of the employer.

National governments are quite different because of the very nature of what it means to be "sovereign". All laws are subject to change. Access to legal redress, use of a government's taxing authority, and/or new legislative mandates can all significantly change the nature of any contract agreed to by a national government. Therefore, any pension or healthcare promise undertaken by a national government is a contingent liability at best. The consequences of this distinction for creditworthiness are significant.

The first step in our analysis of the effects of public sector pension and healthcare programs is to start with the existing level of government debt. There are a number of ways to examine relative debt burdens. The most commonly cited is the government debt/GDP ratio.

General Government Debt/GDP Ratio (%) 2004F

USA	66
France	65
Germany	65
Italy	106
Japan	170
UK	40
Mean (Aaa-Aa)	58
Median (Aaa-Aa)	56

Source: Moody's Investors Service

From this sample, you can see that the relative debt burden of the US places it slightly higher than either the median or mean for Aaa or Aa-rated governments. From its initial government debt position, it would appear that the US has much in common with most of the rest of the developed world. Clearly countries like Italy and Japan will face much greater stress if public sector pensions and healthcare programs are to be funded through borrowing rather than current revenues in the future. Both countries will have much less capacity to finance the costs through additional government debt.

Another measure of debt burden is the debt-to-revenue ratio. This is probably a better measure of the ability of a government to finance its debt because it takes into account the existing revenue-generating capacity of the government.

General Government Debt to Revenue Ratio (%) 2004F

USA	208
France	127
Germany	148
Italy	284
Japan	545
UK	103
Mean (Aaa-Aa)	142
Median (Aaa-Aa)	124

Source: Moody's Investors Service

Here we find that the US is significantly more disadvantaged. An important part of the difference is explained because the US has a much smaller government relative to the size of the economy than most European countries. This means that if the US is to fund public sector entitlements through tax increases, the tax increases have to be significantly higher in percentage terms than for France, Germany and the UK. Using this measure, we are not quite as bad as Italy, and it is clear that the problem is acute for Japan. Japan's extremely high debt-to-revenue ratio shows that the Japanese government has been

funding itself through debt creation rather than through higher taxes. An attempt to solve Japan's fiscal problems through higher taxes alone would require a massive increase in taxation and thereby risk a prolonged deflationary spiral. This is a major reason why, despite Japan's enormous strengths, we rate Japanese government bonds A2, lower than any other industrialized country. It is not obvious how the Japanese government extracts itself from this debt bind, especially as the country has already reached its demographic inflection.

Given this background, an important question is, does it make a difference if government pension and healthcare systems are funded through the creation of trust funds as in the US, or through a pay-as-you-go (PAYG) system? From a credit risk perspective, we see no distinction between the two if the trust funds are simply invested in government securities or in non-viable economic projects. The trust funds simply represent the postponement of new debt issuance, really just an illusion of having "invested" funds. For Moody's, the only relevant number is the deficit that has to be funded by the public. In the case of the US, that number is the deficit including social security. The trust funds simply make it easier to run larger non-social security deficits today. Given their more straightforward accounting presentations, one could argue that the PAYG systems are more transparent. Indeed, when we analyze a government's creditworthiness we look at gross debt, not net debt. In the end, when the trust funds are "used-up", the net simply becomes the gross.

In a system where social security trust funds are invested in non-government securities and/or in viable investments (in other words not in government-sponsored white elephants) then these trust funds could be liquidated in the future to finance existing pension and healthcare promises without adding to the stock of government debt. On the other hand, such a scheme also carries risks, say if these alternative investments turned out to have poor rates of return. The government would then have to fill in the financing gaps even under such a system.

How much debt can a government comfortably bear before its solvency is threatened? When looking back through history, we find that as debt approached 170-180% of national income, public finances usually became stressed. The problem with simply looking at the past is that for industrialized countries, prior to the 1970s, public sector debt was normally only built-up because of war or defense-related initiatives. Therefore, resolving public sector problems were usually linked to settling war-related issues. To complicate matters further, since in the past most countries' monetary systems were based on the gold standard, it was hard to separate fiscal problems from balance-of-payments problems. In today's world, where fiat currency is the norm, it is not clear at what point markets would judge local currency-denominated debt to have reached "unacceptable" limits. Nonetheless, we recognize that as debt builds up, by definition, we are approaching that upper limit – Japan represents one such example.

I stated at the outset of my presentation that the cumulative financial obligations represented by existing debt plus future pension and healthcare promises represent an

unsustainable burden for most developed country governments. When examining the scale of the obligations most observers discuss the net present value (NPV) of the existing claims, based on existing claims and contribution levels. Even small changes in either side of these assumptions can produce enormous differences in the final outcome. I remember seeing estimates for the NPV of Italian public sector pensions prior to the Dini reforms of the mid-1990s reaching several hundred percent of GDP. After those reforms, the NPV of such claims was cut by more than 200% of GDP – this for a partial, incomplete pension reform. From that example and others, it became clear to us to use such NPV estimates with great caution.

Although such NPV estimates are helpful in framing the problem, I believe they exaggerate the difficulty facing advanced industrialized democracies. One of the most common concepts discussed in this context is "intergenerational resource allocation". Analyzing fiscal problems using such concepts can exaggerate credit risks, because we are never in the future, but only in the on-going present. No fiscal problem is ever intergenerational in the sense that we are borrowing today to fund consumption to the detriment of future generations. The only intergenerational problems we can have are in the present where we are discussing income distribution among people alive today. All we really ever have is resource allocation questions in the present. If we borrow today, we are simply allowing the beneficiaries of those funds to consume more or control through ownership more resources than others in the society which may not be benefiting from higher consumption or ownership rights. What I mean by this is that once the future becomes the present, the existing level of debt will cause a different distribution of resources than would be true if the debt is not built up.

The problem is that society may find the consequences of such a redistribution of relative income and/or ownership difficult to reconcile within a desired distributional framework. If the problem is acute enough, one possible result is that the society of the day might opt to reschedule or default on its debt which is nothing more than a redistribution of income from creditors to debtors. If it is the government that defaults, then it is the equivalent of a capital levy or wealth tax. From society's point of view, such a default might make very good public policy sense.

This point that all fiscal problems are related to income distribution in the present is central to Moody's way of thinking about the public finance consequences of aging. When we talk about problems of pensions and healthcare we are really talking about future standards of living in a particular society. The question is not so much which particular pension approach we take, but rather how do we put in place an economic framework which produces the highest output over time so that society will have as many resources available as possible in the future.

A key part of the problem is fundamentally demographic. The good thing is that some of the dire predictions we're now used to working with – such as the dependency ratio forecasts given in the table below – will probably turn out to be unrealistic. We are convinced that some of these developments will not take place, at least not to the extent now feared. This doesn't mean we don't have a problem, it just means that we may be

focusing on only one part of the problem: we are so caught up with the effort to change the benefit systems that we're failing to address the core issue of improving the demographic framework. My point is that simply reforming Social Security and Medicare is not enough, in fact some of the changes are likely to have consequences that are the opposite of their intent. For example, raising contribution levels and payroll taxes makes it more expensive for workers to have more children, discourages innovation, and reduces labor force participation rates.

Old-Age Dependency Ratios (Workers aged 20-64 per person aged 65+)

	2000	2050
US	4.6	2.6
France	4.0	2.0
Germany	3.8	1.9
Italy	3.5	1.5
Japan	3.6	1.5
UK	3.8	2.2
Average OECD	4.2	2.0

Source: UN

Don't get me wrong – the decline in the number of workers per retiree is a serious concern – but just like unfunded pension cost predictions, I think this particular point is exaggerated. It is clear to me, for example, that before Italy and Japan reach dependency ratios of 1.5, and in fact before any of the sample drop to the levels indicated above, three things will probably have already happened: 1) Birthrates in all countries will have risen. Children will have become one of the best insurance policies for adults to have a more comfortable retirement. Youth unemployment will have become a distant memory, causing a surge in relative incomes for all workers, and even more so for younger workers. 2) The concept of working beyond age 65 will revert to more traditional norms. For instance, in an admittedly extreme example, as recently as 1950-1955, nearly 47% of Italians over 65 were still in the workforce. Today that figure is down to 4.5%. For the developed world as a whole, over the same time period, the labor force participation rate for those above 65 has declined from 23.3% to 9.1%. 3) In all of these countries, immigration will rise.

I wouldn't dismiss entirely either the potential threat posed by the declining dependency ratio or another aspect of the aging problem: that a higher proportion of the elderly population will be comprised of the "very old" (those aged 80+) in the years ahead. Unless advances in medicine are so great that we will be much healthier in our 80s than we are today, society will face a significant healthcare burden in caring for the frail elderly. Once again, the US doesn't look quite as bad as Western Europe, with Japan looking the most problematic.

Very-Old Persons Ratio (% aged 80+ as % of aged 65+)

	2000	2050
US	26.5	36.1
France	22.2	37.5
Germany	21.1	37.5
Italy	21.0	37.1
Japan	21.9	42.2
UK	25.0	37.3
Average (OECD)	22.4	35.1

Source: UN

Going back to my essential point, Social Security or Medicare reforms are not the only answer – they won't change the demographic dynamics that are the fundamental source of the problem. The basic question is how will our societies divide up the economic pie when we are down to a smaller number of workers per retiree, no matter the specific ratio? On top of that, what happens when that pool of retirees will be more heavily comprised of the very old?

We believe there are a number of different approaches that can be taken to alleviate some of the demographic stress that have little to do with altering benefits or raising contributions. First, we need to make our society much more child friendly. We must do everything possible to encourage families to have more children. We must, as a society, make it easier for women to have children and yet continue working, which basically means better childcare. One reason why the US looks somewhat better than the other countries in this small sample is our fertility rate: more children are born per woman than most other industrialized countries. The problem is that despite our higher birthrate, it is still insufficient. Furthermore, because of voting demographics, societal incentives are often actually moving in the opposite direction. We spend and will continue to spend less on children relative to the elderly.

Besides adequate childcare, we need to provide the best possible healthcare for the young. We need to spend far more on their education. We also need to continue to provide incentives for technological advances that would improve our productivity even further. We are going to have to get used to looking at a society where human capital is in short supply. That means society will have a vested interest in on-going worker training to improve the flexibility of the existing workforce. We will need to remove any laws that discriminate against the young –zoning laws, education funding based on local real estate taxes, healthcare for the young based on means testing, etc.

A second change we need is to shift the entire retirement dynamic by encouraging people to continue working well beyond age 65. In the US, we have already moved to increase the retirement age for full social security benefits to 67. Other countries are moving in the same direction albeit starting often from even earlier retirement dates. We might

consider using the tax structure to encourage retirees to continue working beyond 65. One possibility is to reduce or eliminate income taxes for non-social security related wage income. Various countries have different incentives to encourage hiring older workers. Wage subsidies are given to companies in France, Germany, Japan and Korea to hire older workers. In Korea companies are given a subsidy if more than 6% of their workforce is aged 55 or older. The subsidies might increase with age. In general, we should encourage the view that retirement is dependent on one's health, both mental and physical, not on the calendar. People should look at aging as representing career transition opportunities. Employers should encourage flexibility for older workers who do not wish to work the long hours they did during their youth. Our pension system and our tax system should reward workers who work beyond the normal retirement age.

The third alternative way to deal with the shortfall in labor supply is to encourage immigration. Immigration can be used by the developed world over the next several decades, but in the long-run immigration won't help because birthrates are falling around the world. For instance, we all know that many people around the world would like to emigrate to the United States. However, what we don't often realize is how rapidly demographic changes are occurring in so-called emerging market countries. For instance, the median age in Mexico in 2000 was 23.3 years compared to 35.5 years in the US. By 2050, the median age in Mexico is projected to rise to 39.5 years compared to 40.7 years for the US. Those under 14 years old in Mexico in 2050 will have reached 19.3% of the population compared to 18.5% for the US. Both countries will have similar demographics. Mexico is not alone in this. By 2050, China will have a median age of 43.8 years, or even higher than the US. At the same time, 22.7% of Chinese will be over age 65 compared to 21.1% of Americans. In 2050, China's population will be older than ours!

To sum up, we have examined various kinds of retirement systems across the developed world, and we have concluded that most of the differences can be explained by cultural and political preferences of the individual countries. However, we would emphasize that what matters most is countries' demographic situation more than on their specific pension and healthcare programs. Countries with disparate pension and healthcare programs like Italy and Japan, for example, end up facing nearly the same scale problem because they share the same demographic challenge. Unfortunately most governments have gotten bogged down in the minutiae of reforming benefit programs and have ignored the wider problem. It is our belief that we would be better served if we turned our attention to strategies designed to improve the role of woman in society, increase the supply of quality childcare, foster education and technological innovation, and finally increase incentives to lengthen working lives and promote sustainable immigration.

I must say that I am an optimist, in that I believe we who live in the advanced democracies will make the right choices. I would hope, however, that if we wish to maintain our preeminent position in the world, that we will undertake the reforms required early enough to avoid acrimonious political debate in the future. Dividing up the economic pie is always easier when it's growing than when it's stagnant or worse yet, shrinking.

The CHAIRMAN. Let me turn to you, director Boersch-Supan. Please proceed.

STATEMENT OF AXEL BOERSCH-SUPAN, THE INSTITUTE FOR ECONOMIC RESEARCH, UNIVERSITY OF MANNHEIM, MANNHEIM, GERMANY

Mr. BOERSCH-SUPAN. Thank you, Mr. Chairman, for having me here. Just picking up on what you said before, it is actually already the last minute to do reforms, essentially because reforms——

The CHAIRMAN. Thank you for saying that. I think it is, too.

Mr. BOERSCH-SUPAN. Reforms take a while, and you have got a problem in 2018. In any case, in the grand scheme of things, Germany and the United States have very similar pension systems, so there are a lot of lessons which can be drawn on either side.

Social Security is still the most dominant income source for most of the elderly. It is financed pay-as-you-go. It is earnings related. The big differences are, and that is a little bit strange if you think of European programs, the German system redistributes less than the American system. The other thing is the German system is very generous, much more generous on average. Replacement rates are 70 percent rather than about 50 percent.

The reform pressures also in Germany are much higher, and that is mainly due to a lower birth rate in Germany and to a somewhat higher life expectancy than the United States. Actually, we had a picture here which shows that the ratio of workers to retirees in Germany right now is what the United States will have in 2050. So look at Germany now and you will see what the United States will look like in 50 years, 45 years.

Because of the reform pressure, we had a string of recent reforms in Germany. The main reform process started in 2001, 4 years ago, 3 years ago, and that was a two-pronged approach. One was to scale down pay-as-you-go benefits. That is what you call default. The second was to increase occupational and personal pensions.

That reform more or less failed for two reasons, because the benefit cuts were not transparent and they were very unpopular, but nobody understood how they actually worked. The second and third pillar pensions, occupational and private pensions, are highly overregulated. So there was little acceptance. These were voluntary pensions and nobody took them up.

That required another reform fairly soon after. In 2004, actually, it just went through the Bundestag in March, it deregulated the second and third pillar pensions so the uptake, it will be hoped, will be higher. But the crucial step, and that is a real important step, was to index benefits to the financial basis of the system. So the benefits are now indexed to what we call the system dependency ratio. That is the number of workers per the number of beneficiaries. This automatically creates solvency in the system by reducing, according to the financial basis, the benefits. It is a brutal way, but it works for sure just because you index to what you can pay.

So Germany essentially converted the current defined benefit system in a notional defined contribution system. It is the contributions which define what can be paid to the pensioners.

This will lead to a reduction in the replacement rate from about 70 percent now to 60 percent in 25 years, in 2030. So it is about a 15 percent benefit cut. That is not as hard as——

The CHAIRMAN. Fifteen percent?

Mr. BOERSCH-SUPAN. Fifteen, yes. So it is not the 27 percent you were talking earlier, but still is substantial.

The system is self-stabilizing by this very construction. That is, if there is higher than expected fertility, for example, or labor force participation, then these benefit cuts will be milder than currently expected. On the other hand, if life expectancy increases even faster than we used, to think then benefits will automatically go down by that proportion.

So I think there are four main lessons which we have learned, which one can learn from the German reforms. First, indexation to the system dependency ratio is politically feasible. It went, although with a lot of talking, through the Bundestag.

Second, the mechanics of what we call the sustainability factor, that is this indexing mechanism, is relatively easy to communicate to the public, and that was one reason why this reform actually went through.

Third, the sustainability factor provides an automatic budget stabilization feature. I think that is really important for having solvency in the long run.

The fourth one is the resulting pension gap, this 15 percent, which is not little, but it can actually be filled by personal pension accounts and that is what the government is now pushing by using tax privileges.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much and we appreciate that testimony.

[The prepared statement of Mr. Boersch-Supan follows:]

Testimony before the Senate Special Committee on Aging, May 18, 2004

"Strengthening Social Security: Can We Learn from Other Nations?"

by Axel Boersch-Supan

Mannheim Research Institute for the Economics of Aging, Mannheim, Germany

(A) In a nutshell: The German social security system through American eyes

Given the large variety of pension systems in the world, the German and US systems are close to identical in their fundamentals:

- In both countries, public pensions are the main income source for most elderly, and about the only formal retirement income source for the lower third of the income distribution.
- Both systems are financed pay-as-you-go. There are no real assets backing up future claims on benefits.
- Both systems are earnings related (benefits increase with earnings, other income sources not included). Benefits are defined by a benefit formula which converts [a close approximation of] life time earnings to annual pension benefits.

The main differences are redistribution and program generosity:

- The German system redistributes less from rich to poor (benefits are proportional to AIME, there is no progressive PIA conversion as an intermediate benefit computation step)
- The German system is considerably more generous on average. Generosity takes three forms: it permits earlier retirement (on average: 3.1 years earlier; no actuarial adjustments); it provides higher replacement rates (70% rather than 53% for mean productive worker); and it indexes pensions by wages (rather than COLA).
- Germany faces a considerably more severe aging problem (current dependency ratio equals that of the US in about 2025; in 2035 about twice as high as in US. Reason is a particularly pronounced birth dearth in the early 70s – in about 5 years from 2.4 children to 1.3 children

per woman, US 2.0 children, and a steadily increasing life expectancy – now at 77.7 years, US 76.7 years).

- The last two points amplify each other and imply that pension expenditures take about 2.5 times more of GDP than in the US (11.8% of GDP rather than 4.4%)
- Two technical details are important to understand the political process: (a) Since there are no sizable reserves, the German system is vulnerable to business cycle fluctuations. This has sparked the 2002 crisis. (b) Benefits are re-calculated every calendar year for all pensioners ("annual pension increases"), hence cohorts are not locked-in at a certain program generosity. This gives program changes a much stronger leverage than in a "new entrants' system" because the "annual pension increase" affects the entire stock.

(B) The recent German reform process

Four major events: (1) the "Riester Reform" in 2001; (2) the budget crisis in 2002; (3) the proposals of the "Rürup-Commission" in 2003; and (4) the "Sustainability Law" passed by the Bundestag in early March of 2004.

The process produced two crucial reform elements: (1) the introduction of a formal third pillar with subsidized individual accounts ("Riester pensions") in 2001, and (2) the indexation of future pension benefits to the ratio of pensioners to workers ("Sustainability factor") in 2004.

2001 "Riester Reform":

(a) Introduced tax-privileged private retirement savings ("Riester pensions" in individual accounts, comparable to tax- privileged IRAs), heavily subsidized for the poor (1:1 matching by the government) and highly regulated (forced annuitization). Goal: Induce private retirement savings equal to 4% of gross earnings.

(b) Reduced *all* public pension benefits in proportion to the *hypothetical* uptake of Riester pensions ("Riester steps"). Goal: Reduce average net replacement rate from 70% in 1999 to 64% in 2030.

(c) Introduced non-earnings-related minimum pension for all persons. Benefits equal social assistance level plus 15%.

2002 Budget Crisis:

Reserves were exhausted due to unexpectedly severe business cycle downturn. Contribution rates needed to be increased from 19.1 to 19.5% of gross earnings rather than decreased as was scheduled. This sparked a coalition crisis and the installment of a high level reform commission. At the same time, the uptake of Riester pensions was minimal (it was not much better in 2003 and is now considered a failure).

2003 Proposals by "Rürup-Commission on Sustainability in Financing Social Security":

Mixture of a political and a technical commission (members were: (1) administration and politicians, (2) union and employers association representatives, (3) scientists; about a third each). Cleavages are not partisan but between unions and government, and, less so, within the government between young and reformist green party members and older more conservative social democrats.

(a) Reduce public pension benefits in a "rational and transparent fashion" by relating annual pension increases to a weighted mixture of increases in (1) wages and (2) system dependency ratio (ratio of full time equivalent pensioners to full time equivalent contributors). "Rational and transparent" refers to the fact that the budget of a pay-as-you-go system is fundamentally determined by the number of pensioners on the one hand (expenditures) and the number of contributors on the other hand (receipts); it also reflects the dissatisfaction with the 2001 Riester reform which related pension benefit cuts to the hypothetical uptake of private accounts which never actually took place.

(b) Increase normal retirement age from 65 to 67, increase early eligibility age from 60 to 64.

(c) Simplify regulation of private retirement savings to increase uptake.

Only (a) becomes immediately law:

2004 "Sustainability Law":

Indexation to system dependency ratio becomes law, effective from January 2005 on. This new element introduced into the benefit indexation formula is dubbed "sustainability factor".

This step effectively converts the German defined benefits system (contribution rate set to finance promised benefit levels) to a "notional" defined contributions system (financial possibilities at given contribution rate dictate benefit levels). The economics of the new German system are very similar to the "notional defined contribution" system in Sweden, although the accounting mechanics are quite different.

The indexation to the system dependency ratio will decrease the average net replacement rate from 70% in 1999 to about 60% in 2030, hence the recent reform deepens the Riester benefit cuts by another 4 percent points. The system is self-stabilizing, that is, higher than expected fertility and labor force participation will increase pension benefits relative to current projections, while higher life expectancy will automatically decrease pension benefits.

The other proposals of the "Rürup-Commission" were not taken up in the 2004 Sustainability Law. Legislation for simplified regulation of private pensions is under way, likely to be passed before this summer. The highly unpopular legislation on later retirement ages, however, was postponed until after the next elections, but it is expected to become law after a formal review of pension system which is scheduled for 2008.

(C) Main Lessons

Indexation to system dependency ratio (in addition to indexation to wages or COLA) provided a politically feasible mechanism for benefit cuts. The mechanics of the "sustainability factor" are simpler to communicate than discretionary benefit cuts. The "sustainability factor" provides automatic budget stabilization features. The resulting pension gap is sizable (about a 15% benefit cut) but it should and can be filled by IRA-type private or occupational pensions at moderate contribution rates (about 4% of earnings for older cohorts, 2.5% for younger cohorts); uptake, however, has been very sluggish so far.

The CHAIRMAN. Now let me turn to David Harris, director of Watson Wyatt Worldwide in London. David, welcome to the committee.

STATEMENT OF DAVID O. HARRIS, SENIOR CONSULTANT, WATSON WYATT WORLDWIDE, LONDON, ENGLAND

Mr. HARRIS. Mr. Chairman, thank you and committee members. I am pleased to appear before the Senate Aging Committee to discuss Social Security reform experiences in Australia and the United Kingdom. Equally, as a former resident of this good country, I am also a member of Social Security, so I have got a personal vested interest, if you like.

The CHAIRMAN. I am glad for that disclosure. Thank you. [Laughter.]

Mr. HARRIS. All right.

The CHAIRMAN. Now we will understand all your bias. Please proceed.

Mr. HARRIS. For many countries, the need for Social Security reform is becoming more pressing as populations rapidly age. Moreover, through generous promises linked with Social Security programs in many developed nations, chronic economic and social reforms will likely have to be implemented against the backdrop of either cutting benefits or increasing associated contributions, and indeed, difficult political situation to confront.

The ongoing relative success of Australia and the United Kingdom's retirement model is a clear proof that successful pension reforms can be achieved in developed nations that benefit the entire nation as a whole. I think it is important to point here that women, minority groups, and blue-collar workers have been seeing significant benefits flow to them in having the ability now to efficiently craft out their own retirement savings.

It is important also to note, simply put, that the countries like Australia and the United Kingdom have moved toward encouraging individuals, especially lower-income groups and women, to save on an individual retirement basis, so offsetting the economic impacts of rapid aging.

I will just move to some of the important points or features of both systems. The old age pension in Australia is seen by many as providing both a foundation or a bedrock of our retirement system. It is non-contributory and largely is drawn out of taxation. The view by most Australians is if you work for 40 or so years, you are entitled to an old-age pension, and that was shared by my mother and my late father.

But the important point here to note is that Australia in the 1980's recognized, like the United States, that through aging populations and fiscal constraints, new ways or new measures needed to be executed, if you like, to ensure that retirement savings were stimulated.

It is important to note in 1983 that only 40 percent of the workforce was covered by some form of second pillar pension and that in total asset terms, Australia had roughly 32 billion Australian dollars. Today, Australia has 88 percent of its workforce covered by a mandatory second pillar retirement system with 568 billion Australian dollars in assets. It is interesting to note that 80 percent

of our assets in second pillar are invested abroad, largely in the United States, which is an important point.

How did Australia move toward individual funding in the second pillar? There was a general recognition that something had to be done certainly in the first pillar with regard to its fiscal constraints. The Australian old-age pension only provides 26 percent of male total average weekly earnings as a benefit.

In 1992 to 1993, the then-Labor government, supported by trade unions—and that is an important point—supported the notion of individual retirement accounts, a stark contrast to this country. What happened thus far is that Australia has implemented a retirement system that is predicated on the basis of 9 percent of every employee's salary being committed to an individual retirement account.

It is important to note, Mr. Chairman, that on average also, Australians contribute up to 3 percent on a voluntary basis to individual retirement accounts in the second pillar.

So today, Australia has moved from, if you like, reliant on a pay-as-you-go non-earmarked first pillar system to an enriched compulsory environment where it argues that individuals should pay significant amounts into their retirement future.

It is important also to note, and I would leave you with this thought, if we are talking about taxation of pensions, was to tell you that taxation of superannuation in Australia can be described as TTT. In Australia, we tax the contributions. We tax the income coming out of the fund. We tax the fund flows coming from the fund itself, TTT, quite a significant amount, and for a politician, an interesting trick if you can perform that and then you can get elected with a successful majority the next year, which was cleverly done.

Moving now toward our former colonial masters, if you like, the United Kingdom, where I am proudly a resident now of, the United Kingdom has underlying a first pillar pension predicated on the basis of a very major first pillar pension, that is, 20 percent of average male total work earnings or male full-time working earnings equals the first pillar pension.

To put it in real terms, the first pillar pension in the United States equates to 79.60 pounds per week. A round fare, I can assure you, return to Edinburgh is 84 pounds a week. So it is very, very, very meager in terms of amount in the first pillar. This has been uplifted or increased by pension credits or improvements to this first pillar.

But what is important to note with regard to the United Kingdom is in the 1980's and 1990's, there was very much a fundamental shift, partly sponsored by the then-Thatcher government and later Major government, to ensure that individuals move toward more fully funded or more, if you look, took great responsibility in their retirement savings.

This notion of the individual taking or crafting out their own retirement savings is being picked up, if you like, by the mantra of the Blair government, and in April 2001, they moved toward what was called stakeholder pension, where individuals who are now entitled to a low-cost, very efficient, if you like, pension product largely driven on an individual basis. This product, called the stake-

holder pension product, has only a maximum price cap of one percent. No further charges above that can be levied. Importantly now, the Blair government is enacting more significant reforms to their broader-based pension saving.

It will be interesting to note, and just finally concluding, which is most startling is that the pension reform approach now being adopted by the Blair government is predicated on the U.S. experience. Like the PBGC in the U.S., which the current United Kingdom government believes is a success, a pension protection fund will now be enacted in the United Kingdom to cover shortfalls in existing defined benefit schemes.

Importantly, critics like Mike Crick and Chris Mapp of the Investment and Life Insurance Pension Committee suggested regulatory complexity still dogs the United Kingdom pension system. So overall, where the United Kingdom's retirement model is moving, Mr. Chairman, to one of sustainability and with the individual taking greater control in regard to their retirement.

Just finally, I would leave you with my conclusions. In the United States, the challenge of Social Security reform might seem immense, if not impossible, from initial observations. Yet what countries like Australia and the United Kingdom demonstrate is the ability for a nation to give its people a greater ability to craft out a sufficient and appropriate level of retirement wealth to meet expected future needs and demands.

Certainly no one country's experiences with regard to Social Security reform can be easily translated to another. Yet what countries like Australia and the U.K. can demonstrate to public policy planners in the United States is the strong propensity that the individual is ideally placed to determine his or her own retirement needs and assess market risk, which is a very important point to make.

Give people certainty with regard to retirement or Social Security is an important basis to the two models I have described. This harnessing of the individual's need to maintain retirement security in retirement will increasingly become a major political and social issue, not only in the United States but equally continue on in Australia and the U.K.

Ideally, Social Security reform should encompass all perspectives of a country's society. Failure to act or to simply adopt a myopic position by lawmakers is no answer in the long term for the citizens in a nation like the United States. Thank you.

The CHAIRMAN. David, thank you very much.

[The prepared statement of Mr. Harris follows:]

Pension Reforms and Ageing Populations: Lessons from Australia and the United Kingdom

By

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Testimony before the
US Senate - Special Committee on Ageing

May 18, 2004

The views in this testimony are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide LLP or any of its associates or related companies.

Mr Chairman, I am pleased to appear before the Senate Ageing Committee to discuss the social security reform experiences in Australia and the United Kingdom. For many countries, the need for social security reform is becoming more pressing as populations rapidly age. Moreover through generous promises linked with social security programs in many developed nations, chronic economic and social reforms will likely have to be implemented against the backdrop of either cutting benefits or increasing associated contributions via taxation. The ongoing relative success of the Australian and UK retirement models are clear proof that successful pension reforms can be achieved in developed nations that benefit the entire nation as a whole. Women, minority groups and 'blue collar' workers have seen significant benefits flow to them in having the ability to efficiently craft out their own retirement savings structures. This was especially seen in Australia.

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

An overview of Australian retirement system

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

"Only three countries rely heavily on private mandatory saving policies for retirement, these include Australia, Switzerland and Chile."[1]

Australia's experience to date with the initial reforms of its retirement system in 1987 and subsequently in 1992 have generally been viewed as positive. In 1983 the Australian Labor Party (social democratic) led by Mr Bob Hawke MHR came to power. The ALP was determined to deregulate Australia's economy so as to compete more effectively on a world level. A vital ingredient in achieving this goal was seen to be significant reductions in wages growth. With this as a backdrop, the need for change in the retirement policy of Australia was also sharply defined by the Labor Government in 1983.

Like its counterpart in the United Kingdom, the Australian Labor Party is fundamentally a social democratic party based on largely collectivist principles. It had and still remains strongly linked with the trade union or organized labor movement, through its peak body, the Australian Council of Trade Unions (ACTU). Superannuation during this time was provided through traditional employer sponsored plans on a voluntary basis. Surprisingly for some in the United States, it was the Australian Labor Party, a social democratic political party who, with trade union (organized labor) support began to generate the momentum for change of Australia's retirement system. In the first instance the newly elected Federal Government began the process of ensuring the long-term viability of the Old Age Pension at its current level. Maximum payments per fortnight by the mid 1980s were now determined through the interaction of a comparatively stringent income and asset tests.

The Old Age Pension in Australia is seen by many as providing both a foundation and an important source of income for those retirees who have limited resources to sustain themselves in retirement. Its impact on Australia's GDP is seen in Appendix 1, Table 5. Many older Australians who are or have retired in the past often have not build up sufficient retirement savings. A common perception in the past by many workers was that they were entitled to an old age pension after paying taxes all their working life. Largely this view was encouraged by many governments but in the 1980s increasingly, the Commonwealth Treasury and the Federal Government expressed concerns over the direction of expenditure for providing the first pillar of Australia's retirement framework. Increasingly expenditures in providing the first pillar were also linked to a concern over the demographic position of Australia in the next century.

"For Australia the percentage of the population aged over 65 is expected to rise from 15% of the population, 2.9 million, to 23% by 2030, that is, 5 million people. The percentage aged over 85 is expected to more than double from around 2% to more than 5% amounting to 650,000 Australians over 85."[1]

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

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

'maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce."[2]

For trade unions, which had strongly supported the election of a Federal Labor government in 1983, increasing superannuation coverage was seen as a major priority. Before the introduction of mandated, second pillar, superannuation accounts, the extent of coverage of superannuation was limited to roughly 40 percent of the workforce. Typically employees who were covered by superannuation were employed in middle class, 'white collar' jobs where usually women and people from minority groups were under-represented. Brandishing this as a major bargaining tool, the trade union movement set about convincing the Federal Government that the level of superannuation coverage needed to be extended, via compulsory contributions into individual accounts. As early as the 1970s, the trade union movement in Australia had expressed reservations in how the retirement framework of Australia excluded certain workers based on income and profession. Many of the younger trade union officials argued for a more comprehensive system of retirement provision that in effect required all workers to be proactive in contributing and managing their own retirement needs. Some had noted the successes of the national provident funds, as seen in Malaysia and Singapore.

Significant dissatisfaction also existed amongst the labor movement over the extent and coverage of non-management or 'blue collar' workers. Moreover the union movement also realized that comprehensive wage increases were becoming increasingly difficult to successfully negotiate and that deferred savings benefits may be an alternative to simply striving for an increase in workers net pay. Initially the union movement's policies was effectively to increase employee coverage of superannuation

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

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

but by the mid 1980s the union movement had shifted its stance whereby it would play a more direct and active role in the day to day operations of superannuation, via industry funds. These industry funds, grouped around a particular economic sector of the Australian economy saw union and employer representatives come together as trustees to manage the administration and investment of many thousands of individual retirement accounts. The increasing involvement by the union movement in superannuation matters challenged some industry participant's views that effective administration and investment decisions would be distorted in favor of policies that stressed mutuality rather than economic reality.

Notwithstanding the active policy position taken by trade unions in Australia regarding superannuation for employees, a more pragmatic view of such support is linked with the steady decline in trade union membership. Between August 1986 and August 1996, the level of trade union membership reported by employees declined sharply from 46 percent in 1986 to 31 percent in 1996.[2] Such a significant decrease coupled with the decline in traditional union based industries such as heavy manufacturing further reinforced the union's enthusiasm to support such retirement reforms as they felt that they were in effect increasing their profile and relevance for existing and potential members.

By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. The Federal Government argued that as the Australian economy was undergoing a period of significant economic readjustment from a largely primary producer to becoming more services orientated, the old age pension structure and its related drain on public finances could not be sustained. Effectively the government insisted that it was in the "public-interest" to have a national, compulsory, employment-related retirement income scheme in place.[3] This aspect of the Australian political environment and how the government of the day felt that it was acting in the best interests of all Australians would be later echoed in 1992 by then Hon. Treasurer Dawkins, when he commented that the retirement income scheme in place would provide "...a coherent and equitable framework in which retirement incomes objectives can be progressed ...and [would] permit a higher standard of living in retirement than if we continued to rely on the age pension alone."[4]

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

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

"Australia-unlike most other developed countries meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments."[5]

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

minor support the Federal Government's proposed legislation quickly generated wide acceptance through working in 'partnership' with organized labor, business interests and industry associations.

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

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

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

Similarly in Australia, business saw the advantages of reforms to retirement policy in terms of nurturing the capital market and overall level of national saving. Some concerns were raised over the active involvement of trade unions in the day to day operations of superannuation funds but these concerns were alleviated through adjustments in regulatory settings. A major concern for business after the broadening of compulsion in 1992 was the increased costs that would be levied on the employer as contributions lifted eventually to 9 percent by 2002. Larger business interests in many cases offered such contributions already on voluntary basis through their in-house corporate superannuation funds. Yet it was small business that strongly opposed the reforms arguing principally that the increased burden of cost linked with an expanded retirement provision would cause many business failures. In summary business played only a moderate role in supporting the government's reform agenda. This tacit support was co-ordinated in part by large financial providers who would develop or modify the financial infrastructure of such mandated retirement accounts. Some moderate opposition from business interests also centered on

the political concept of individualism, in that the concept should not force individuals to save for their retirement using a particular financial product or mechanism.

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

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

In March 1996, the then Labor Federal Government lost office and was replaced by a conservative, Liberal Coalition Government under Prime Minister John Howard. It had been the intention of the Australian Labor Party, with trade union blessing to further expand the compulsory nature of superannuation by gathering a 3 percent contribution from individual workers and providing an additional 3 percent to certain workers who met pre-defined income criteria. In total this would have meant that many workers' individual superannuation contribution accounts would have been receiving total contributions of 15 percent. Treasury estimates suggest that over a forty-year period these contributions would translate out to be approximately 60 percent of one's salary on retirement.
With regard to the taxation of superannuation, Australia has pursued a course which is quite unique and which on the whole I cannot agree with in terms of design and the overall rate of taxation applied. Based on Andrew Dilnot's model developed at the Institute of Fiscal Studies in London, Australia's taxation of superannuation can be described as TTT. Taxation of contributions at a rate of 15 percent, along with possible additional taxation of 15 percent for members' contributions earning over a certain threshold. A further tax of 15 percent is levied on the investment income of superannuation fund and finally the benefits can be subjected to varying tax treatment of between 0-30%, depending on timing of the contributions. The profile of the second pillar of Australia's retirement system depicts both a diversity and adequacy of return that reflects strong and vigorous competition among the financial services industry in Australia. Through a trustee structure, superannuation funds are managed in the most efficient and effective manner for members.

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

The success of consumer policy and integrated distribution platforms has meant that large scale consumer detriment has been minimized in Australia with its move towards a more fully funded system. Through sound regulatory transparency and significant improvements in the competency levels of distributors eg. financial advisers and financial planners public confidence in the overall retirement

system has continued to increase significantly. This perception of security has nurtured a steady increase in the level of overall voluntary contributions made into superannuation accounts. In effect through sound regulation has come an acceptance by most Australians that saving for one's retirement is beneficial on both an individual and national basis.

By March 2001 the Australian superannuation system had combined assets of $A565.9 ($US253.00) billion. For just over 9 million workers this level of retirement savings is considered to be quite significant. It is important to note that 17.6% of these assets are invested internationally. Furthermore large levels of the superannuation assets are invested in equities and unit trusts. This investment category has grown steadily and is now estimated to be 46.1% of superannuation assets in Australia.

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

Type of Fund	Total Assets ($billion)	Number of Funds (March 2001)	Members (000's)
Corporate	55	1582	990
Industry	63	105	7,738
Public Sector	116	65	2,979
Retail (including RSAs) – RSAs	192	245	13,340
Small Funds	128	523,000	523
Annuities, life office reserves etc.	13	na	na
Total Assets/Funds/ Members	566	283,842	25,570

Source: APRA Bulletin, Australian Government Publishing Service, December 2003

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

Recently the Australian government announced that it will widen eligibility criteria for the Government's co-contribution scheme (whereby the Government matches an eligible member's after-tax superannuation contributions dollar for dollar, up to a prescribed annual maximum, and subject to an income test). In the recent May 2004 Budget the Australian government announced further measures whereby it would seek to encourage lower income families and workers to bolster their retirement savings via government co-contributions.

Overview of the British Retirement System

The United Kingdom's success in stabilizing its public expenditure on social security is notable in comparison with other European economies. Yet strong criticism has been leveled at the industry for its inability to remedy the mis-selling problems which occurred in the late 1980s and early 1990s. Widespread media comment on the issues related to this matter has progressively filtered into public policy developments, initiated by the bureaucracy and responsible Government ministers. A further concern expressed by some in industry is how the European Monetary Union (EMU) in the long term will impact on the United Kingdom's position, with regard to outstanding pension liabilities and contributions derived from the public. Compared with France and Germany, the United Kingdom is in a significantly healthier position. Yet a common fear expressed is that the United Kingdom will have to support directly

or indirectly, the maintenance of these two country's pension systems and possible overall reform in the long term.

Currently the United Kingdom's pension system is very fluid with a Pensions Bill before parliament looking at the modification of various aspects linked with the funding of second pillar retirement programmes and the creation of a compensation scheme – Pension Protection Fund (PPF) which in part is similar to the US PBGC. Occupational schemes are certainly an area where the Government is considering reform.

In summary, the political landscape of the United Kingdom has been clearly flattened by the large majority which the current government still commands in the House of Commons. Yet the issue of pensions still remains a controversial one with many vested interests calling for a major overhaul of the existing retirement framework.

The associated problems of old age and inadequate provision for retirement was debated for decades towards the end and beginning of the nineteenth and twentieth centuries in the UK. In 1908 the Old Age Pensions Act was introduced to provide a systematic, centrally organized provision for the elderly in retirement. This scheme, though the forerunner of the modern day basic pension was not a 'social-insurance' system. It was means-tested and non-contributory. Entitlement started at 70 and was restricted to the 'respectable' poor.

In 1925 the Widows, Orphans and Old Age Contributory Pensions Act introduced the notion of a contributory social insurance scheme for the over-65s, although means-tested non-contributory benefits continued to be paid to those over 70. The current unified compulsory social insurance scheme was instituted following the Beveridge Report of December 1942.

Currently the basic state pension entitlements equate to £79.60 per week (from 12 April 2004). This level is approximately 20% of average full-time male earnings. Such pension payments can be enhanced by the pensions credit that seeks to give further financial assistance to those people who meet related income and assets tests. The pension it should be noted is taxable. Increases in the state pension are in line with retail price inflation. Between 1975 and 1980 the policy was to uprate the pension in line with prices or average earnings, whichever was the greater. Before 1975 adhoc increases had maintained the level of the pension in line with earnings increases since 1948.

Table 3: Estimated Cost of Basic Pension with Price and Earnings Uprating

(£ billion in 1994-95 prices

Cost basic pension	**1994-95**	**2000-01**	**2010-11**	**2020-21**	**2030-31**	**2040-41**	**2050-51**
Price indexed	26.9	29.8	33.6	35.2	41.9	44.5	42.3
Earnings indexed	26.9	32.6	42.6	51.8	71.6	88.3	97.4

Note: 1.5% real earnings growth assumed
Source: Johnson P, Disney R and Stears G: The Retirement Income Inquiry - Pensions: 2000 and beyond Volume 2 - 1996, p.11, Retirement Income Inquiry, London, United Kingdom

Table 4: Target benefit pensions of selected developed nations

Country	Relative value of benefits
United States	43% of final salary
Australia	26% of Male Total Average Weekly Earnings
Germany	53% of average earnings
France	75% of average of 10 best years
Italy	68% of final salary (in 2013)
United Kingdom	20% of average income
Canada	25% of average wages
Belgium	60% of lifetime earnings

Source: Radaelli G & Shea R: 'Public Pension Systems: The Challenge Ahead', 1996 Lehman Brothers, London, United Kingdom, p.22

In 1948 the Beveridge Report had developed a compulsory pension system which consisted only of the first tier. In effect this was the basic state pension and means tested National Assistance. Yet increasingly, pressure on the Government to provide a more substantial second tier approach for all workers developed, partly as a result of the strong growth in occupational schemes. Between 1953 and its peak in 1967, occupational pension coverage expanded from 28 to 53% of employees. This coverage in recent years has declined which partly can be attributed to an overall trend in changing employment patterns.

In 1975 the Social Security Act introduced the State Earnings Related Pensions Scheme (SERPS). Its design allowed occupational schemes to contract out of SERPS to avoid the scheme substituting for private sector provision. Effectively the design of the second tier pension was for those people not in occupational schemes.

During the initial period of this second tier pension scheme benefits, were comparatively generous with today's levels. SERPS guaranteed contributors to the scheme an additional pension of 25% of their earnings between lower and upper earnings limits. The scheme was compulsory. As indicated, employers and contributors could contract out of SERPS only into a salary-related occupational scheme if it offered benefits at least equal to those provided by SERPS.

Earnings in the best 20 years counted towards the pension at a rate of 1.25% of earnings between lower and upper limits. These limits were revalued in line with average earnings. Once payments commenced, the additional pension was uprated annually in line with consumer prices. The cost of uprating the basic pension (first tier) and SERPS was met by the National Insurance Fund.

Pensions under SERPS matured in 20 years and, as a result of the 20 best earning years formula, were especially advantageous to some groups. Employees earning more than the Lower Earnings Limit (LEL) for National Insurance Contributions (NICs) £57 per week for 1994-95 pay Class 1 NICs earn entitlement to SERPS as well as the basic pension unless they are contracted out. The Upper Earnings Limit (UEL) must by law lie between 6.5 and 7.5 times the basic state pension, and stood at £430 per week in 1994-95-around 120% of average male earnings.

An associated development that influenced the calculation of SERPS was that in 1980 the newly elected Conservative Government broke the earnings link for the annual uprating of the basic state pension and linked it instead to the Consumer Price Index. This factor is important as the LEL is itself tied to the flat-rate pension and the UEL is in turn increased in line with the LEL.

In June 1985 the Conservative Government published a Green Paper, *Reform of Social Security*. This document highlighted the implications of the basic state pension and SERPS over the following 50 years. The concerns raised by this paper in regard these two forms of pensions provisions can be summarized by Budd and Campbell:

"The Green Paper pointed out that the increased cost of the basic pension would benefit all pensioners equally. However the case was different for recipients of SERPS. Its earnings- related nature meant that the newly retired would benefit more than older pensioners would. Also half the extra cost would result from payments to members of contracted-out schemes (to provide indexation top-up to the Guaranteed Minimum Pension). The cost of SERPS (in 1985 prices) was expected to be about £24 billion in 2035, compared with a basic pension cost in 1985 of about £15 billion."[6]

A significant change to SERPS took place in the second half of the 1980s when the Social Security Act 1986 provided that from 1999 onwards, SERPS additions to the basic state pension would be calculated not on the basis of the best 20 years rule but instead on lifetime average earnings. Now SERPS would provide 20% of average earnings over the whole working life of the individual.

As identified up to April 2002, the additional State Pension was called SERPS. SERPS was based on your record of National Insurance contributions and your level of earnings as an employee. On 6 April 2002, the State Second Pension reformed SERPS to provide a more generous additional State Pension for low and moderate earners, and certain carers and people with long-term illness or disability. The State Second Pension gives employees earning up to £26,600 (in 2004/05 terms) a better pension than SERPS, whether or not they are contracted out into a private pension, with most help going to those on the lowest earnings (up to around £11,600 in 2004/05 terms)

If an employee has annual earnings above a certain amount (£4,108 in 2004/05) you cannot leave the Basic State Pension. However, the employee can choose to leave the Second State Pension and join a private pension scheme instead. This is called contracting out. By contracting out and joining an employer's contracted-out occupational pension scheme, the employee and employer benefits from lower, reduced rates of National Insurance contributions.

In 1988, the contracting out option was extended to a further range of products, principally personal pension products. The reason for this decision is subject to some conjecture. Some elements say it had an ideological basis spawned by the then Prime Minister, Margaret Thatcher who felt that Government should not be involved in pensions provisions linked with the former SERPS. More likely was that advice provided by the Treasury and Government Actuary's Department indicated that through the affects of an ageing population, the UK's economy would be crippled by overly generous welfare payments.

The condition for leaving SERPS is not, that a guaranteed minimum pension should be paid, but that a guaranteed minimum contribution should be made. This minimum level is the contracted-out rebate. Levels of rebate offered to people newly contracted out into personal pensions (or group defined contribution schemes) was set above the rebate for those in occupational pensions. Initially, an extra 2% 'incentive' rebate was offered with the aim of 'kick-starting' the personal pensions sector. In 1993-94, this declined to an incentive rebate of 1% restricted to the over 30s. The rationale for this policy was that a large number have already taken out personal pensions, and so a kick-start is no longer required. The following is an extract from the paper 'The Roles of the Public and Private Sectors in the UK Pension System' by Alan Budd and Nigel Campbell of HM Treasury that details the associated costs and problems encountered from the contracting-out of SERPS.

"The contracted-out rebate and the additional 2 per cent incentive made personal pensions a very good deal particularly for the young since the rebate was the same for all ages whereas the value of the SERPS benefit given up increases with age. The Department of Social Security's working assumptions were that about 500,000 people would take out personal pensions and the number might ultimately reach 1 ¾ million. In the event take-up reached 4 million by the end of April 1990. By 1993-94 the take-up had risen to 5.7 million, of whom about 4 million had rebates paid into their APPs. The National Audit Office (1990) commissioned a survey of the cost to the NI Fund of the rebate and the additional incentive for the period to April 1993. It estimated that the gross cost could be £9.3 billion and that the present value of the savings in payments of pensions was about £3.4 billion. Hence there was a net present value cost of £5.9 billion (in 1988 prices). However, this does not take account of the step change in personal pension take-

up, which will have reduced state pensions yet further in the next century even after the end of the continuation of the 2 per cent incentive."

The introduction of the Social Security Act 1986 provided a new avenue for employers to pursue in offering benefits to their employees in occupational pension schemes, this being in the form of contracted-out defined contribution schemes. Since 1988, the number in contracted-in defined contribution schemes has remained at about 500,000 but 430,000 is now in the new contracted-out schemes.

There is little support for the assertion that the shift to defined contribution schemes among employers reflects companies' changing views towards defined benefit schemes. Most recent data on the issue from the 'Government Actuary's Department suggests that 50000 members had seen their scheme change from DB to DC between 1987 and 1991, accounting for just 10% of the total increase in numbers'.[7]

Another significant change resulting from the introduction of the Social Security Act 1986 was that choice for the first time was provided to individuals on whether to join employer-provided pension schemes. Before 1988, most firms providing occupational schemes made membership compulsory for eligible employees. Just 8.5% of scheme members were in voluntary plans. This accounted for 17% of private sector members, with none in the public sector.

Overall since 1987, the total percentage not joining has increased from 18 to 23%, with a slightly more rapid increase among full-time women. More recent data from the National Association of Pension Funds (1994) annual survey suggests that the take-up among new employees for pension products was about 80% and has remained around this level since 1990.

Through allowing people to contract out of their SERPS entitlements and transfer from occupational schemes personal pensions in 1988 received a significant boost in sales growth and long term product development. The popularity of these products was quickly established and thus by 1992 % 23% of male and 19% of female employees had contracted out and was in personal pensions. Concern in Treasury and other areas of Government was that these new retirement vehicles were only being used to receive the rebate provided through transferring out of SERPS. In 1991, 24% of employees had contracted-out into personal pensions yet about three-fifths of these personal pensions had been established simply to receive the associated rebate and incentives provided by the Government. Such a situation led or induced the mis-selling of pensions, which has continued to erode a recovery in the public confidence, within the industry.

Overall personal pensions today are 'manufactured' by a number of providers. These companies are mainly life insurance companies although building societies, unit trusts and other financial organizations are permitted to administer pensions (at least up to retirement). Restrictions on investments are relatively few and it is important to note that even supermarkets in the United Kingdom are offering such financial services products on an execution basis.

In general, the deposits from personal pension funds must be used to purchase annuity. Recent legislative amendments have increased the individual's freedom of choice between annuity suppliers. The Government has ensured that the same tax privileges extend to personal pensions, as which exist for occupational schemes.

A concise summary or assessment of personal pensions and the future role that they are likely to play in the British market is provided by Mr CD Daykin, the United Kingdom's Government Actuary in his report to the European Commission.

" Personal pensions at the minimum level for contracting-out are unlikely to provide a very inadequate income in retirement. A major challenge for education (and marketing) is, therefore, to persuade people that they must make additional voluntary contributions and that the responsibility for ensuring an adequate retirement is theirs. The State will not provide more than the basic flat-rate pension. Of course, there will still be the possibility of means-tested income support, but the whole thrust of encouraging private provision for a pension is to lessen the dependence on State Benefits.

Views differ as to the likely success of these objectives. Trade unions and staff associations in general remain very suspicious of personal pensions, which they see as putting too much of the risk (particularly of investment performance relative to inflation) on the individual and too much money (commission, profit, etc) into the hands of financial intermediaries, insurance companies and other financial institutions. The preferred option of organized labour is the final salary occupational pension scheme, if possible with full price indexation of pensions, both in payment and in deferment."[8]

With rapid transfers out of an existing Government pension tier and membership movement out of occupational schemes, principally through industrial and economic restructuring, the demands placed on existing distribution networks have been extreme. Coupled with an increased volume of business, commission restrictions were lifted in the late 1980s which allowed intermediaries to dramatically increase the up front commissions. Poor disclosure of product design and general information on pension policies was provided to the consumer under existing mandatory provisions.

Minimum competency standards for intermediaries were also a major concern. Without any minimum set standards of advice and training, intermediaries often provided inaccurate and in the most extreme cases misleading advice. Such features of the life insurance and pensions industry, the 'seeds were clearly sown' for problems to occur in the future. Improved disclosure standards that are anticipated along with the introduction of a de-polarized distribution environment are anticipated to improve the distribution standards for individually based retirement products.

A major shift in retirement thinking took place in April 2001 when the current Government initiated a low margin, high volume retirement product called the stakeholder pension. Such a product places a mandatory price cap of 1% on all fees, charges and commissions linked with its manufacture and distribution. The product can be distributed on a group as well as an individual level and is available to consumers who are outside the employment nexus. In some cases spouses and children purchase such products in response to related taxation incentives. Unfortunately such a product has not widely extended pension coverage and related contributions as was anticipated by the government. While employers are compelled by law to offer facilities for its employees to make contributions into stakeholder pension products, only 8% of stakeholder pension products receive regular contributions.

One of the major issues British policy makers have been grappling with has been the sharp decline in pension coverage by defined benefit schemes. Through revised accounting standards and a general economic downturn many leading Footsie 100 companies have either closed their defined benefit schemes for new members or have required their plan participants to increase their contributions. This shift from defined benefit to defined contributions will likely continue if significant regulatory and social policy issues are not addressed via related legislation or regulations.

As identified the Government over the last 15 months has moved to address some of these regulatory and legislative concerns via pension taxation simplification and social policy refinements. It is intended by April 2006 that the existing eight pension taxation treatments will be simplified down to one. This will allow an individual 'pension pot' to accrue £1.5 million over an individual's lifetime along with being able to receive maximum annual contributions of £200,000. Equally in respect of social policy, planned pension reforms will see importantly an increased consideration for planned financial education and communication. While the detail of this policy initiative is still to be finalised it remains clear that the likely direction will draw heavily on the enhanced communication and education experiences of US 401(k) model. Moreover the related research conducted by US academics into behavioral finance further reinforces the likely attractiveness of such a planned policy direction.

To conclude, the most startling pension reform approach adopted by the UK during the recent raft of reforms was announced by the Secretary of State for Work and Pensions, Andrew Smith on February 12th 2004 with the creation of the Pension Protection Fund (PPF). Like the PBGC in the US which the PPF is modeled on in part, this planned regulatory body will seek to develop a compensation mechanism for defined benefit plan members whereby if the scheme fails, premiums, initially flat but eventually risk based will ideally cover the shortfall for plan members. While such a legislative approach offers some practical policy benefits, wider cost and pension policy considerations need to be carefully understood if such a policy is to succeed in the long term.

Conclusions

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

Appendix 1

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

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

Source: OECD, cited in Johnson (1999)

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The CHAIRMAN. Now to our last panelist, Mr. Rodriguez, service analyst for the Cato Institute. We are pleased to have you with us this morning. Please proceed.

STATEMENT OF L. JACOBO RODRIGUEZ, FINANCIAL SERVICES ANALYST, THE CATO INSTITUTE, WASHINGTON, DC

Mr. RODRIGUEZ. I am pleased to be here. Thank you, Mr. Chairman, for your invitation to appear before this committee. In my remarks today, I will focus on the pioneering effort of Chile because that effort remains still to this day the standard against which other pension reforms in Latin America are and should be measured.

Indeed, if there is a main lesson to be drawn from the collective experiences of Latin American countries, it is that not all reforms are created equal. Some Latin American countries have introduced important flaws in the design of their private pension systems that have limited the success and popularity of those systems.

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

Since the Chilean system was implemented, labor force participation, pension fund assets, and benefits have all grown. Today, more than 95 percent of Chilean workers have joined the system. The pension funds have accumulated over $50 billion in assets, an amount that is equivalent to about 67 percent of Chilean gross domestic product. The average real rate of return has been over 10 percent per year.

The system's popularity with workers has turned it into the third rail of Chilean politics, one that politicians by and large have not dared touch. Of course, there have been regulatory improvements and updates, but those have been carried out by a highly technical and independent agency that regulates and supervises the system and its participants.

Abroad, if imitation is the sincerest form of flattery, the Chilean system should be blushing from the accolades it has received. Since 1993, ten other Latin American nations have implemented pension reforms modeled after Chile's. In short, the Chilean system has clearly become the point of reference for countries interested in finding an enduring solution to the problem of paying for their retirement benefits of aging populations.

The basic story is well known, but it is worth recapping briefly. Every month, workers deposit 10 percent of their income in their own individual pension savings accounts, which are managed by the specialized pension fund administration company of their choice. These companies invest workers' savings in a portfolio of bonds and stocks, subject to government regulations on the specific type of investments and the overall mix of the portfolio.

Contrary to a common misperception, there is no obligation to buy government securities, a requirement that would not be consistent with the notion of privatization, and the pension funds can invest up to 30 percent of the portfolio overseas, a measure that allows workers to hedge against currency and country risk.

Workers who want to retire early or with a higher pension can contribute up to an additional 10 percent of their wages. The pension fund companies are required to take out life and disability insurance on behalf of their clients and to provide them with statements of account at least every 4 months.

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

The government provides a safety net for those workers who at retirement do not have enough funds accumulated in their accounts to obtain a minimum pension. But because the new system is much more efficient than the old one and because under the new system, a worker must have at least 20 years of contributions to qualify for the minimum pension, the cost to the taxpayer of providing the minimum pension has been so far negligible.

Through their pension accounts, Chilean workers have become the owners of the means of production in Chile and they have grown much more attached to the market economy and to a free society. This has had the effect of reducing class conflicts, which in turn has promoted political stability and helped depoliticize the Chilean economy, which is an important factor to consider in the context of Latin American societies.

Pensions today do not depend on the government's ability to tax future generations of workers nor are they a source of election-time demagoguery. To the contrary, pensions depend on the workers' own efforts and, thereby, afford workers satisfaction and dignity.

The Chilean system, of course, is not perfect and has some shortcomings. Critics often point to high administrative costs, the lack of portfolio choice, and the high number of transfers from one fund to another as evidence that the system is inherently flawed and inappropriate for the United States.

Chilean authorities have taken some important steps to improve an already good system. The most important structural reform of the last three or four years is the introduction of multiple investment funds. After the year 2000, the pension fund administration companies could only manage one fund. In early 2002, the regulatory agency that supervised the system instituted a rule that mandated the pension fund administration companies to offer five different funds, funds that range from very low risk to high risk.

This adjustment allows workers to make prudent changes to the risk profile of their portfolios as they get older. For instance, they could invest all the mandatory savings in a low-risk fund and any voluntary savings in a riskier fund, or they could invest in a higher-risk fund in their early working years and then transfer their savings to a more conservative fund as they approach retirement.

This reform has been an important step and there are indications that consumers are behaving as one would expect; that is, by diver-

sifying their investments across the menu of funds. There are other steps which are described in my written testimony that Chilean regulators have taken or should take to ensure the continued success of the private pension system. These adjustments should be consistent with the spirit of the reform, which has been to adopt a more liberalized regulatory structure as the system has matured and as the fund managers have gained experience.

But all the ingredients for the system's success—individual choice, clearly defined property rights and contribution, private administration of accounts, and a strong and independent supervisor—have been present since 1981. Some shortcomings remain, to be sure, but the Chilean model still provides an excellent example to those countries, industrialized and developing alike, that are thinking about their retirement systems.

I thank you, Mr. Chairman, for the opportunity you have given me today and I look forward to your questions.

The CHAIRMAN. Thank you all very much.

[The prepared statement of Mr. Rodriguez follows:]

STATEMENT

of

L. Jacobo Rodríguez
Financial Services Analyst
The Cato Institute

On *Strengthening Social Security: Can We Learn from Other Nations?*

before the

U.S. Senate
Special Committee on Aging

SOCIAL SECURITY REFORM IN CHILE

May 18, 2004

My name is L. Jacobo Rodríguez and I am a financial services analyst at the Cato Institute. I would like to thank Chairman Craig and Ranking Member Breaux for inviting me to testify on social security reform in Chile and its lessons for the United States. In the interest of transparency, let me point out that neither the Cato Institute nor I receive government money of any kind.

The aging of the world's population is the result of two demographic trends. First, life expectancies at birth and at retirement have increased substantially as a result of technological and medical advances. Second, fertility rates have decreased drastically, the result in part of economic progress and greater opportunities for women around the world. Those two trends combined mean that in the future the rates of growth of the population and the labor force will slow down or even decrease, and the ratio of the elderly to the working-age population will increase. While the aging of the population per se is not a bad thing, especially because the

elderly today can have a much higher quality of life than in the past, it does have important effects on the fiscal situation of countries.

Although the prospects for the United States are not as severe as those for some industrialized nations of Europe and Japan, U.S. policymakers will nonetheless face daunting challenges as they seek to reform and strengthen Social Security in the context of an aging population. In the absence of any reform, Social Security will start to pay out in benefits a larger amount than what it collects in payroll taxes in 2018, according to the Social Security Administration's own actuaries. Trust fund assets and payroll taxes are projected to be sufficient to pay out scheduled benefits only until 2042. My colleague Jagadeesh Gokhale, who testified before this Committee in January 2004, estimates that Social Security's fiscal imbalance—that is, the total financial shortfall that Social Security faces—is approximately $7 trillion.[1]

Fortunately for the United States, there are other countries, both industrialized and developing, that have already addressed the challenge of structurally reforming their retirement system under conditions that were similar or even more drastic than those the United States faces today. In my remarks today I will focus on the pioneering reform of Chile, because I think that it still remains the standard against which other private pension systems in Latin America should be and are measured. Indeed if there is a main lesson to be drawn from the collective experiences of Latin American countries is that not all reforms are created equal. Some Latin American countries—notably, Argentina, Uruguay, and Colombia—introduced important flaws in the design of their private pension systems that have limited the success and popularity of those systems.

In 1981 Chile replaced its bankrupt pay-as-you-go retirement system with a fully funded system of individual retirement accounts managed by the private sector.[2] That revolutionary reform defused the fiscal time bomb that is ticking for countries with pay-as-you-go systems under which fewer and fewer workers have to pay for the retirement benefits of more and more retirees. More important, Chile created a retirement system that, by giving workers clearly defined property rights in their pension contributions, offers proper work and investment incentives; and acts as an engine of, not an impediment to, economic growth.

Since the Chilean system was implemented, labor force participation, pension fund assets, and benefits have all grown. Today, more than 95 percent of Chilean workers have joined the system; the pension funds have accumulated over $50 billion in assets, a sum that is equivalent to about 67 percent of Chilean gross domestic product; and the average real rate of return has been over 10 percent per year.[3]

If imitation is the sincerest form of flattery, the Chilean system should be blushing from the accolades it has received. Since 1993 10 other Latin American nations have implemented pension reforms modeled after Chile's.[4] In March of 1999 Poland became the first country in Eastern Europe to implement a partial privatization reform based on the Chilean model. In short, the Chilean system has clearly become the point of reference for countries interested in finding an enduring solution to the problem of paying for the retirement benefits of aging populations.

Although the basic story is well known, it is worth recapping briefly. Every month workers deposit 10 percent of the first $22,000 of earned income in their own individual pension savings accounts, which are managed by the specialized pension fund administration company of their choice.[5] Those companies invest workers' savings in a portfolio of bonds and stocks, subject to government regulations on the specific types of instruments and the overall mix of the

portfolio. Contrary to a common misconception, fund managers are under *no* obligation to buy government securities, a requirement that would not be consistent with the notion of pension privatization, and can invest up to 30 percent of the portfolio overseas, a measure that allows workers to hedge against currency fluctuations and country risk. At retirement, workers use the funds accumulated in their accounts to purchase annuities from insurance companies. Alternatively, workers make programmed withdrawals from their accounts; the amount of those withdrawals depends on the worker's life expectancy and those of his dependents. The government provides a safety net for those workers who, at retirement, do not have enough funds in their accounts to provide a minimum pension. But because the new system is much more efficient than the old government-run system and because, to qualify for the minimum pension under the new system, a worker must have at least 20 years of contributions, the cost to the taxpayer of providing a minimum pension funded from general government revenues has so far been negligible. (Of course, that cost is not new; the government also provided a safety net under the old program.)

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

Critics of the Chilean system, however, often point to high administrative costs, lack of portfolio choice, and the high number of transfers from one fund to another as evidence that the

system is inherently flawed and inappropriate for other countries, including the United States and European countries. Some of those criticisms are misinformed. For example, administrative costs are about 1 percent of assets under management, a figure similar to management costs in the U.S. mutual fund industry. To the extent the criticisms are valid, they result from a single problem: excessive government regulation.

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

The product that the managers provide--that is, return on investment--is subject to a government-mandated minimum return guarantee (a fund's return cannot be more than 2 or 4 percentage points, depending on the type of fund, or 50 percent below the industry's average real return in the last 36 months).[6] That regulation forces the funds to make very similar investments and, consequently, have very similar portfolios and returns.

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

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

Although, in the eyes of the Chilean reformers, restrictions made sense at the beginning of the system in a country with little experience in the private management of long-term savings, it is clear that such regulations have become outdated and may negatively affect the future performance of the system. Thus, in addressing the challenges of the system as it reaches adulthood, Chilean authorities should act with the same boldness and vision they exhibited 24 years ago when they drafted the pension reform law.

Fortunately, they have taken some important steps, but there are other equally important steps that are yet to be taken. The most important structural reform of the last 3 or 4 years is the introduction of multiple investment funds. Up until 2000, the pension fund management companies could only manage one fund. That year, the regulatory framework was changed to allow the AFPs to offer a second fund, invested only in fixed income instruments. That reform proved to be insufficient, as very few workers decided to switch their savings from the diversified fund to the fixed-income one. Indeed, consumer demand for the fixed-income fund was negligible. What was needed was to let pension fund management companies manage more

than one variable-income fund.[7] Chilean authorities finally adopted this reform in early 2002 when they instituted a rule that mandated AFPs to offer 5 different funds that range from very low risk to high risk. One advantage of having several funds administered by the same company is that that could reduce administrative costs if workers were allowed to invest in more than one fund within the same company. This adjustment also allows workers to make prudent changes to the risk profile of their portfolios as they get older. For instance, they could invest all the mandatory savings in a low-risk fund and any voluntary savings in a riskier fund. Or they could invest in higher risk funds in their early working years and then transfer their savings to a more conservative fund as they approached retirement. Table 1 shows the maximum percentages of equity investment allowed in each fund:

Table 1

	Maximum Percentage Allowed	Mandatory Minimum Percentage
Fund A	80%	40%
Fund B	60%	25%
Fund C	40%	15%
Fund D	20%	5%
Fund E	Not Allowed	Not Allowed

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

- The lengthening of the investment period over which the minimum return guarantee is computed to 36 months from 12 months and the widening of the band from 2 to 4 percentage points for some type of funds;

- The further liberalization of the investment rules, so that workers with different tolerances for risk can choose funds that are optimal for them; and
- The expansion of consumer choice with the signature of a bilateral accord with Peru that allows workers from those two countries to choose the pension system with which they want to be affiliated.[8]

Other specific steps that Chilean regulators should take to ensure the continuing success of the private pension system include:

- Liberalize the commission structure to allow fund managers to offer discounts and different combinations of price and quality of service, which would introduce greater price competition and possibly reduce administrative costs to the benefit of all workers.
- Let other financial institutions, such as banks or regular mutual funds, enter the industry. If financial institutions were allowed to establish one-stop financial supermarkets, where consumers could obtain all their financial services if they so chose, the duplication of commercial and operational infrastructure could be eliminated and administrative costs could be reduced.
- Give workers the option of personally managing their accounts. Thanks to the emergence of the World Wide Web as an investment tool, individuals could gain greater control over their retirement savings if they decided to administer their accounts themselves.
- Reduce the moral hazard created by the government safety net by linking the minimum pension to the number of years (or months) workers contribute.
- Adjust contribution rates in such a way that workers have to contribute only that percentage of their income that will allow them to purchase an annuity equal to the minimum pension. In other words, if a high-income worker can obtain an annuity equal to the minimum pension

by contributing only 1 percent of his income, he should be able to do so and decide for himself how to allocate the rest of his income between present and future consumption.

Those adjustments would be consistent with the spirit of the reform, which has been to adapt the regulatory structure as the system has matured and as the fund managers have gained experience. All the ingredients for the system's success--individual choice, clearly defined property rights in contributions, and private administration of accounts--have been present since 1981. Some shortcomings remain, to be sure, but the Chilean model still provides an excellent example to those countries—industrialized and developing alike—that are thinking about reforming their retirement systems. Unlike a pay-as-you-go system, a fully funded individual capitalization system such as Chile's can anticipate *fewer* problems as it matures.

Let me conclude by commending this Committee for its willingness to learn from the experiences of other countries and how those experiences may be applied to the United States. I believe there's much to learn from the experiences of Latin American countries, both from their successes as well as from their mistakes, and I thank you very much for the opportunity you have given me today.

FREQUENTLY ASKED QUESTIONS ABOUT CHILE'S PRIVATE PENSION SYSTEM

1. **What percentage of retirees draws a minimum pension from the government? How is that figure expected to change over time as personal accounts build up?**

As of March 2002, the government had supplemented 33,029 pensions, including 11,759 old-age pensions, out of over 400,000 pensions, in its role as the financial guarantor of last resort in the new private system. Because the new system has tougher requirements to qualify for the minimum pension and is far more efficient than the old one, the cost to the Chilean taxpayer of providing a general safety net is lower than under the old system. Indeed the cost to the government of supplementing these pensions has been about $33 million. Projections about the percentage of pensions that will receive a government subsidy range from about 10 percent to close to 50 percent, but if returns continue to be above 4 percent in real terms and workers contribute to their accounts regularly, the government contribution will continue to be minimal.

2. **Chile has been criticized for having high administrative costs? Do you believe this criticism is accurate? What has the rate of return been net of administrative costs?**

The often-cited figure of 18-20 percent represents administrative costs as a percentage of current contributions, which is not how administrative costs are usually measured. This figure is usually obtained by dividing the commission fee, which is on average equivalent to 2.3 percent of taxable wages, by the total contribution (10 percent plus the commission).[9] This calculation fails to take into account that the 2.3 percent includes the life and disability insurance premiums (about 0.7 percent of taxable wages on average) that workers pay, which are deducted from the variable commission, and thus overstates administrative costs as a percentage of total

contributions.[10] Also, if, for instance, the mandatory contribution were lowered to 5 percent of total wages instead of 10 percent, then administrative costs measured as a percentage of the total contribution would increase from 18.69 percent to 31.51 percent (2.3/(2.3 + 5)), even if those costs measured in absolute terms or as a percentage of assets under management remained the same.

When administrative costs are compared to the old government-run system, the criticism is not accurate. Chilean economist Raúl Bustos Castillo has estimated the costs of the new system to be 42 percent lower than the average costs of the old system.[11] However, comparing the administrative costs of the old system with those of the new one is inappropriate, because the underlying assumption when making that comparison is that the quality of the product (or the product itself) being provided is similar under both systems, which is certainly not the case in Chile.

Furthermore, the Congressional Budget Office reported in 1999 that, "In Chile, the country with the longest experience with private retirement accounts, [administrative costs] can be equivalently expressed as 1 percent of assets, which is similar to costs of mutual funds in the United States."[12] The CBO report goes on to say that, "It is difficult to convert a charge on contributions to a charge on assets (typical for a U.S. mutual fund). The calculation depends on the rate of return and the length of the investment horizon and therefore does not yield a single figure."[13] Chilean economist Salvador Valdés has estimated the average annual cost of the AFP system to be equivalent to 0.84 percent of total assets under management over the life cycle of the worker, which is lower than the average cost of the mutual fund industry in Chile but higher than other savings alternatives.[14]

To the extent that such administrative costs are still considered too high, that is the result of government regulations on the commissions the AFPs can charge and on the investments these companies can make. The existence of a "return band" prevents investment product differentiation among the different AFPs. As a result, the way an individual AFP tries to differentiate itself from the competition is by offering better service to its customers. One way to provide better service would be to offer a discount on the commission fee to workers who fit a certain profile—e.g., workers who have maintained their account for an extended period of time or who contribute a certain amount of money to their accounts; however, government regulations do not allow that. Those regulations state that the AFPs may only charge a commission based on the worker's taxable income and expressed as a percentage of that income.

Another reason administrative costs are not as low as they could be is that AFPs have a monopoly in the administration of pension savings accounts. Mutual funds, banks, insurance companies, and individuals themselves are not allowed to manage those accounts. The existence of this monopoly (which is part of the fragmentation of the financial services industry in Chile across product lines) prevents the establishment of one-stop financial supermarkets, where consumers can obtain all their financial services if they so choose.[15] Such supermarkets would substantially reduce administrative costs by eliminating the duplication of commercial and operational infrastructure.

The average rate of return net of administrative costs for the average retirement savings account has ranged from 7.18 percent to 7.50 percent, depending on the type of account, from 1981 to April 2001, according to the Chilean government agency that regulates the industry.

3. Some people say that women and low-wage workers will disproportionally end up receiving the minimum benefit guarantee, increasing income disparity. Do you believe this is correct, and why?

That claim is partially accurate. It is true that women and low-wage workers are likely to accumulate less than the average worker. Women because they tend to earn less than men, have more irregular professional lives, and may stop contributing to their accounts at age 60 (that age is set at 65 for men). (Women also tend to live longer, a factor that also contributes to making the average pension for women lower than the average pension for men, all other things being equal.) All those characteristics are common to women everywhere and not just Chilean women and should not be considered features of the Chilean system. Since the new system gives every worker property rights in his or her contributions, every worker with 20 years of contributions will receive at least the minimum pension. That was not the case in the old pay-as-you-go government system, a system that especially penalized women (and other workers) with irregular professional lives.

Low-wage workers in general accumulate less than average workers because they are low-wage workers. Low-wage workers also tend to start working at an earlier age than other workers, which conceivably can make up for the smaller amount contributed per period, and to have a shorter life expectancy, which conceivably can allow workers to make larger withdrawals per period of time than other workers with a longer life expectancy.

Therefore, it is not correct to say that women and low-wage workers will disproportionally end up receiving the minimum pension. The reform was undertaken under the assumption that if a worker contributes to his account 10 percent of his salary for 35 years, and the real rate of return on his investment is 4 percent on average, he will have enough funds

accumulated in his account upon retirement to fund a pension that is equivalent to 70 percent of the average salary over the last 10 years of his working life.

I think that focusing on whether income disparity increases under a private system or not is mistaken. What matters is that poor workers (as well as rich ones) have property rights in their contributions and can invest their savings in productive investments, so that they live their old age with comfortable means, even if other workers are much wealthier. The income disparity between Bill Gates and I, for instance, matters nothing to me. What matters to me is that Bill Gates has developed tools that allow me to become a more productive worker and, consequently, earn a higher salary, which in turn allows me to live more comfortably now and, hopefully, in my old age.

4. **You mention that the current commission structure encourages funds to seek out higher-wage workers. How would your suggestions to liberalize commission structure (allow funds to offer discount and different combinations of price and service) affect low-wage workers? Would funds be interested in attracting low-wage workers?**

AFPs are not allowed to offer discounts for permanence, for making voluntary contributions, for groups, or for maintaining a specific balance in an account. For instance, if workers were able to negotiate group discounts, then their bargaining power would significantly increase. That would allow them to negotiate lower commissions, which would benefit low-wage workers the most. Funds would continue to seek out low-wage workers so long as the marginal cost of administering the account of a low-wage worker (or a group of low-wage workers) does not exceed the marginal revenue derived from administering those accounts. If the administration companies were allowed to adjust their service to the ability and desire of workers to pay for

those services, low-wage workers would have nothing to lose if the commission structure were liberalized. Those concerned that the services provided to low-wage workers would drop to unacceptable low levels need not be, as the government already mandates a minimum of services that AFPs have to provide to their clients.

5. **If the worker dies before retirement, what happens to the account balance? What if the worker dies after retirement?**

If a worker dies before retirement, the balance in his account belongs to the beneficiaries of his estate, as workers now have property rights in their contributions. If a worker dies after retirement *and* if he chooses the programmed withdrawal option, then the balance in his account belongs to the beneficiaries of his estate. If he chooses to purchase an annuity from an insurance company, the balance in his account upon retirement is used to purchase the annuity and the account is closed, so money is left to the beneficiaries of his account.

6. **The government has started allowing companies to lower their variable fees while raising flat fees. What effect will this have on workers at different wage levels?**

Increases in flat fees and reductions in variable fees would eliminate the cross-subsidy from high-wage workers to low-wage workers that is present today.

7. **Why did Chile choose to primarily base administrative fees on contributions and not assets?**

When the system began, AFPs were allowed to charge fixed and variable commissions on assets under management, fixed and variable commissions on contributions, or any combination

thereof. AFPs were not allowed to offer discounts for permanence, group discounts, discounts for making voluntary contributions, or for maintaining a specific balance in the account. In 1987, the commission structure was changed by eliminating all commissions on assets under management.[16] This change had the effect of providing a cross subsidy to (1) workers who do not contribute to their accounts regularly, because the fund manager is still providing a service (administering the account of those workers) for which he is not receiving compensation; and (2) to low-income workers, because the administrative costs of managing the account of wealthier workers are not proportionally higher than the administrative costs of managing the accounts of low-income workers, although the commissions paid by high-income workers are proportionally higher than those paid by low-income workers. In that sense, it cannot be said that the commission structure is fair, because some workers are paying more than others are for the same type of service.[17]

The rigidity in the commission structure prevents the AFPs from adapting the quality of their service to the ability to pay for that service of each segment of the population and also explains why the AFPs have an incentive to capture the accounts of high-income workers and attempt to do so by offering them better customer service.[18] AFPs will continue to spend money until the marginal cost of trying to capture new accounts is equal to the marginal revenue derived from those accounts. In addition, the AFPs generally do not charge entry fees, even though the law allows them to do that, which means that consumers do not pay a penalty by changing from one AFP to another.[19]

8. How does the government certify the companies that offer individual accounts? How does the government keep politics out of the decision on what companies to certify and what investments they may use?

There is free entry and exit into the industry, even for foreign companies, provided that certain capital requirements, which are specified in advance, are met. The minimum capital required to create an AFP is 5,000 Unidades de Fomento (UF), a Chilean indexed unit of account. If an AFP has 5,000 affiliates, then the minimum increases to 10,000 UF; if it has 7,500 affiliates, then it increases to 15,000 UF; and when an AFP reaches 10,000 affiliates, the minimum capital requirement increases to 20,000 UF. By specifying clear and simple rules in advance, the whole process of creation of management companies is completely depoliticized. The government agency that regulates the industry sets, within the framework of the law, general investment rules in conjunction with the Central Bank of Chile. Both the Central Bank and the regulatory agency are highly technical and independent agencies.

9. Could you explain in more detail how the government's rate of return guarantee works? For example, doesn't the government require that investment returns exceeding certain amounts be set aside for buffering returns in case they fall below certain prescribed amounts in the future? Doesn't the government guarantee funds that go bankrupt? How many funds have gone bankrupt and at what cost to the government?

Each year each AFP must guarantee that the real return of the AFP is not lower than the lesser of (1) the average real return of all AFPs in the last 36 months minus 2 or 4 percentage points, depending on the type of fund, and (2) 50 percent of the average real return of all AFPs in the last 36 months. If the returns are higher than 2 or 4 percentage points above the average return

of all AFPs over the last 36 months, or higher than 50 percent of the average return of all AFPs over the preceding 36 months, the "excess returns" are placed in a profitability fluctuation reserve, from which funds are drawn in the event that the returns fall below the minimum return required. For instance, if the industry's average return for the preceding 36 months is 10 percent and an AFP has a return of 17 percent, then the "excess returns" are 2 percentage points (10 percent plus 50 percent of the average return, which is 5 percent, equals 15 percent, which is the threshold in this case). If, on the other hand, the industry's average return is 2 percent and an AFP has a return of 4.5 percent, then the "excess returns" are 0.5 percentage points (2 percents plus two percentage points equals 4 percent, which is the threshold in this case, since it is higher than 2 percent plus 50 percentage of the average, 1 percent, which would be equal to 3 percent. Should an AFP not have enough funds in the profitability reserve, funds are drawn from a cash reserve, which is equivalent to 1 percent of total assets under management. If that reserve does not have enough funds, then the government makes up the difference and the AFP is liquidated. To date, no AFP has gone bankrupt, although three have been liquidated for not meeting the minimum capital requirements, so the cost to Chilean taxpayers has been zero. It is also worth noting that the system establishes two different legal entities for the management company and the fund it administers, which is the property of workers. So, it is possible that a management company go bankrupt (that is, its net worth is negative) without it affecting the fund.

10. Could you describe the pay out requirements for personal accounts?

The new private system provides workers with three different types of retirement benefits:

a) **Old-Age Pensions**. Male workers must reach the age of 65 and female workers the age of 60 to qualify for this pension. However, it is not necessary for men and women who

reach these respective ages to retire, nor do they get penalized if they choose to remain in the labor force. No other requirements are necessary.

b) **Early-Retirement Pensions**. To qualify for this option, a worker must have enough capital accumulated in his account to purchase an annuity that is (1) equal to at least 50 percent of his average salary during the last 10 years of his working life; and (2) at least 110 percent of the minimum pension guaranteed by the state.[20]

c) **Disability and Survivor's Benefits**. To qualify for a full disability pension, a worker must have lost at least two thirds of his working ability; to qualify for a partial disability pension a worker must have lost between 50 percent and two thirds of his working ability. Survivor benefits are awarded to a worker's dependents after the death of said worker. If he did not have any dependent individuals, whatever funds remain in his pension savings account belong to the beneficiaries of his estate.

Types of Pensions. There are three retirement options:

a) **Lifetime Annuity**. Workers may use the money accumulated in their accounts to purchase a lifetime annuity from an insurance company. This annuity provides a constant income in real terms.

b) **Programmed Withdrawals**. A second option is to leave the money in the account and make programmed withdrawals, the amount of which depends on the worker's life expectancy and those of his dependents. If a worker choosing this option dies before the funds in his account are depleted, the remaining balance belongs to the beneficiaries of his estate, since workers now have property rights over their contributions.

c) **Temporary Programmed Withdrawals with a Deferred Lifetime Annuity**. This pension option is basically a combination of the first two. A worker who chooses this

option contracts with an insurance company a lifetime annuity scheduled to begin at a future date. Between the start of retirement and the day when the worker starts receiving the annuity payments, the worker makes programmed withdrawals from his account.[21]

In all three cases a worker may withdraw in a lump-sum (and use for any purpose) those funds accumulated in his account over and above the money necessary to obtain a pension equal to at least 120 percent of the minimum pension and to 70 percent of his average salary over the last 10 years of his working life.

11. If a worker takes programmed withdrawals, but outlives his account balance, what happens? Is there a safety net to insure he still has a source of income?

If a worker outlives the balance in his account, then the government provides the minimum pension, as defined by the Chilean Congress, if that worker has contributed to his account for a minimum of 20 years. If a worker does not have at least 20 years of contributions, he may apply for a welfare-type pension that is lower than the minimum pension. So, yes, there is a safety net under the Chilean private pension system, as there was one under the old government-run system. However, since the new system is far more efficient than the old one, the cost to the Chilean taxpayer is considerably lower.

12. Chile has been criticized in the past for having high rates of transfers between funds. What actions has the government taken to help reduce transfer rates?

Because of investment regulations and rules on fees and commissions, product differentiation is low. Thus companies compete by offering gifts or other incentives for workers to switch to their companies. Switchovers increased dramatically from 1988, the year when the requirement to

request in person the change from one AFP to another was eliminated, until 1997, when the government reintroduced some restrictions to make it more difficult for workers to transfer from one AFP to another. The number of transfers in 1998-2000 decreased to less than 700,000, less than 500,000, and slightly more than 250,000, respectively, from an all-time high of almost 1.6 million in 1997. Transfers have stabilized around 250,000 annually since 2000.

13. **Are workers aware of the options they have? Do they know through government or industry efforts how the system works? Has there been an educational campaign about the features of the system? Is it not true that this is a system that handicaps low-income workers because they are less likely to not be familiar with investment strategies?**

There are three points that I would like to make. First, in Chile there was a roughly six-month period between the day on which the reform was approved (4 November 1980) and the day on which the new system started (1 May 1981). In that time, the architect of the reform, Dr. José Piñera, who was then the Chilean Minister of Labor and Social Security, would appear once a week on national television for three minutes each time to explain different features of the system.[22] Second, the Pension Fund Administration companies also perform an educational campaign, explaining the main features of the system in flyers that are available at the branch offices of those companies. During a trip to Chile, I walked into a branch office of a Pension Fund Administration company in downtown Santiago and I asked the saleswoman some basic questions about the Chilean system. I found her to be very polite, helpful, and knowledgeable of the system. Third, the Pension Fund Administration companies are supervised by a highly technical and very transparent government agency that imposes stiff penalties to those companies that commit fraud or provide misleading information to their clients. Furthermore, that

regulatory agency provides very clear and concise information about the private pension system.[23]

14. Are there any restrictions on how the funds can be used? Can workers use the funds accumulated in their retirement savings accounts for purposes other than retirement?

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

Other countries, such as Mexico, for instance, allow workers who have been unemployed for at least 45 days to withdraw the lesser of 10 percent of the cumulative balance in their account or the equivalent of 75 times their daily taxable base salary if they have contributed to the account for at least 250 weeks and have made no withdrawals in the previous 5 years. Workers with 150 weeks of contributions may withdraw from their account the equivalent of their monthly salary if they are getting married. Although it would probably be best that the savings be used for retirement purposes only—especially in the presence of a government guarantee of some kind, which creates a moral hazard—workers should be the ones deciding what to do with their money.[24]

15. How was the transition financed?

The true net economic costs of moving from an unfunded pay-as-you-go system to a fully funded system are zero. That is to say, the total funded and unfunded debt of a country does not change by moving from an unfunded system to a funded one.[25] There is, however, a cash flow problem when moving toward a fully funded retirement system. In the case of Chile, transition costs can be broken down into three different parts. First, there is the cost of paying for the retirement benefits of those workers who were already retired when the reform was implemented and of those workers who chose to remain in the old system. That makes up by far the largest share of the transition costs at present. These costs, of course, will decline as time goes by. Second, there is the cost of paying for the recognition bonds given to those workers who moved from the old system to the new in acknowledgement of the contributions they had already made to the old system.[26] Since these bonds will be redeemed when the recipients retire, this cost to the government will gradually increase as transition workers retire (but will eventually disappear).[27] It is worth stressing that these are new expenditures only if we assume that the government would renege on its past promises. The third cost to the government is that of providing a safety net to the system, a cost that is not new in the sense that the government also provided a safety net under the old pay-as-you-go system. Because the new private system is much more efficient than the old government-run program and because, as stated above, to qualify for the minimum pension under the new system, a worker must have at least 20 years of contributions, this cost has so far been very close to zero.[28] The size of this expenditure will, of course, depend on the success of the private system.

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

state-owned enterprises. Third, a fraction of the old payroll tax was maintained as a temporary transition tax. That tax had a sunset clause and is zero now.[29] Fourth, it cut government expenditures. And, fifth, pension privatization and other market reforms have contributed to the extraordinary growth of the Chilean economy in the last 13 years, which in turn has increased government revenues, especially those coming from the value added tax.[30]

In sum, the transition to the new system has not been an added burden on Chile because the country was already committed to paying retirement benefits. On the contrary, the transition--the fiscal requirements of which have varied between 1.4 and 4.4 percent of GDP per year--has actually reduced the economic and fiscal burden of maintaining an unsustainable system.

Notes

[1] See Jagadeesh Gokhale, "The Future of Retirement in the United States." Statement of Jagadeesh Gokhale before the Special Committee on Aging of the United States Senate, January 22, 2004.

[2] A lengthier treatment of the Chilean reform can be found in L. Jacobo Rodríguez "Chile's Private Pension System at 18: Its Current State and Future Challenges." *Cato Institute Social Security Paper no. 17*, July 30, 1999. An updated summary of the Chilean system is Superintendencia de Administradoras de Fondos de Pensiones, *El Sistema Chileno de Pensiones* (5th ed.), http://www.safp.cl/sischilpen/index.html. The fourth edition of that publication is available in English at http://www.safp.cl/sischilpen/index.html.

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

[4] These countries (and the year of implementation of the new system) are: Peru (1993), Argentina (1994), Colombia (1994), Uruguay (1996), Bolivia (1997), Mexico (1997), El Salvador (1998), Dominican Republic (2003), Nicaragua (2004), and Ecuador (2004). A good summary of all these systems can be found in Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones, *La Capitalización Individual en los Sistemas Previsionales de América Latina* (December 2003), http://www.aiosfp.org/documentos/libro.pdf.

[5] At present there are 6 AFPs. The system began with 12 AFPs, reached a high of 23, and has gradually consolidated to the present number. Most of the consolidation has occurred through mergers. There have been, however, three AFPs that were closed down by the government for not meeting the minimum capital requirements.

[6] Until recently, the period for computing the minimum return was 12 months, which increased the "herd effect" of having a minimum return guarantee.

[7] I first made this proposal in Rodríguez (1999). The reform adopted by the Chilean regulators closely resembles the proposal that I made, although I cannot determine whether it was influenced by my research or not.

[8] Again, this measure resembles a proposal that I made in Rodríguez (1999). In that paper I recommended that, "As Latin American markets become more integrated, [pension regulators should] expand consumer sovereignty by allowing workers to choose among the systems in Latin

America that have been privatized, which would put an immediate (and very effective) check on excessive regulations."

[9] 2.3/(10+2.3) = 0.1869, or 18.69 percent.

[10] Commissions are also overstated in the case of workers who receive gifts or outright lump sums from sales agents as an enticement to transfer from one AFP to another.

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

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

[13] Ibid., sec. 3, p. 11.

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

[15] Allowing banks and other financial institutions to enter the AFP industry might present potential conflicts of interest. In principle, so long as those institutions compete under the same rules as other market participants, they should be allowed to administer the pension savings accounts of Chilean workers. It is likely that in a market environment banks would have to develop effective separations between the banking department and the administration of pension accounts to attract and protect workers' investments. Furthermore, the banks may invest in instruments of a higher quality to allay any fears that the public might have about the safety of the investments.

[16] The issue of the commission structure has generated a vast literature in Chile. See, for instance, Salvador Valdés, "Comisiones de AFPs: Más libertad y menos regulaciones." Economía y Sociedad (January/March 1997), pp. 24-26; Salvador Valdés, "Libertad de Precios para las AFP: Aún Insuficiente." Estudios Públicos 68 (Spring 1997), pp. 127-47; José de Gregorio, "Propuesta de Flexibilización de las Comisiones de las AFP: Un Avance para Corregir las Ineficiencias." Estudios Públicos 68 (Spring 1997), pp. 97-110; and Alvaro Donoso, "Los Riesgos para la Economía Chilena del Proyecto que Modifica la Estructura de las Comisiones de las AFP." Estudios Públicos 68 (Spring 1997), pp. 111-126.

[17] The unfairness does not come from the fact that some workers are paying more than others for the same type of service. In a free-market economy sellers should be able to price discriminate if they wish to in order to capture the consumer's surplus. The problem here is that the government is mandating this price discrimination.

[18] Critics of privatization often point to the giving of toasters and other consumer goods as incentives to switch from one AFP to another as proof of the excesses of the Chilean system. Retail banks in the United States engage in similar practices on college campuses without any negative effects to the banking system or consumers. Of course, these practices have decreased as the banking industry has been deregulated and banks in the United States have found other ways of competing with each other, such as offering better interest rates or lower fees.

[19] Entry fees are usually given back (or a part thereof) by sales agents as a rebate to their customers as an enticement to switch from one AFP to another. Exit fees are not allowed by law in an effort to promote competition.

[20] There is now a bill before the Chilean congress that would increase the percentage from 110 percent of the minimum pension to 150 percent.

[21] This option is ideal for workers who are about to retire at a time when the value of their accounts is down.

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

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

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

[25] See Milton Friedman, "Social Security Chimeras." The New York Times (January 9, 1999). See, also, Milton and Rose Friedman, Free to Choose, (New York: Harcourt Brace Jovanovich, 1990), p. 124.

[26] The value of these recognition bonds was computed by taking 80 percent of the worker's average salary in the 12 months leading to mid-1979 (indexed for inflation), multiplied by the number of years the worker had contributed to the system (up to a maximum of 35 years), and multiplied by an annuity factor of 10.35 for men 11.36 for women.

[27] This cost is projected to reach a peak of 1.06 of GDP in 2005.

[28] Of course, since the system is only 23 years old, the only workers who would be eligible for the government safety net would be those who contributed to the old system as well because those workers are the only ones who could have today more than 20 years of contributions.

[29] That tax was still lower than the payroll tax of the old system. In fact the total contribution to the new system plus the tax was also lower than payroll taxes under the old system.

[30] The financing of a transition from a pay-as-you-go system to a fully funded individual capitalization one is a complex issue that has to take into account the fiscal resources of each country.

The CHAIRMAN. No matter which country it is, the challenge is one of substantial magnitude, and for those of us who are the shapers of public policy, I will also say it has a political challenge to it. But there appears to be a common theme as adjustments and changes in these pension or Social Security systems go forward. Is it fair to say that common theme is a growing increase—or let me put it this way—a growing belief that individuals ought to be more responsible for their retirement than they were in the past? That would be a question to all of you. Therefore, government incentifies that responsibility?

Mr. TRUGLIA. Around the world, we have found that there has been less willingness on the part of societies to socialize risk, so yes, it is almost across the world that we are calling upon people to be more responsible than they were in the past.

Mr. BOERSCH-SUPAN. Well, I think the most important insight is that there are no miraculous solutions. Babies are nice. They stabilize the system in the long run. But they are definitely no substitute for pension reform in the short run. In the short run, I mean the next 30 years. Actually, in the short run, the next 30 years, it would make things more expensive.

Productivity, as your colleague Senator says, is also no solution, because as long as you pay, like in the United States, pensions in proportion to wages, pensions go up just as much as wages go. So productivity cannot finance pensions.

Fully prefunding, so fully making everybody responsible for himself, is not an option anymore. That had been an option in the 1980's, but the baby boom generation actually retires in 15 to 20 years. So a full transition is just not feasible anymore.

Given all these constraints, the only logical solution is to cut Social Security, the public pension pillar, somewhat, as much as you can afford politically, and offset that by prefunded pensions. You will see this solution necessarily in all the countries across the world, and I am sure we will also see it in the United States.

Mr. HARRIS. Mr. Chairman, I agree with the thoughts here. I think taking control for the individual of guiding or crafting out their own retirement savings and future is very much ingrained, very much in the Australian and the U.K. model. I think it is important to also stress an underlying premise, is that of political risk. Both countries, both Australia and the United Kingdom, have witnessed a significant shift or movement away from the underlying predication of the regional Social Security models, i.e., it was basically if you worked in Australia for 40 years, you would get an old-age pension. Now, there is a very stringent income and assets test. Equally, in the United Kingdom, the old-age pension in the first pillar used to be indexed to average wages rather than prices.

So I think, importantly, what you are seeing in both countries, and certainly they have certainly less generous first pillar pension arrangements than, say, Germany, is that the individual is being provided with the tools to craft out their own retirement needs more effectively, and this links very much into the principle or concept of market-based risk and allowing the individuals to be empowered to, if you like, determine their own retirement destiny.

The CHAIRMAN. Mr. Rodriguez.

Mr. RODRIGUEZ. I think I would answer your question in the affirmative. I think that there has been a trend toward greater reliance on individuals and on their ability to manage risk, and I think that when given the proper incentives, individuals have shown that they are quite adept at managing their own risk and making wise and informed decisions about how to allocate their own resources between present and future consumption.

The CHAIRMAN. When the Chilean model is looked at and juxtaposed against our system, one of the criticisms is the transitional costs to get us from where we are today progressively toward a personal retirement account. Would you discuss with us those costs and how they affected Chile or the Chilean programs as you transitioned out of and into where you are today?

Mr. RODRIGUEZ. Let me give you a little bit of background before I answer that question directly. When Chile was considering this reform, the ratio of workers to retiree had decreased to 2.2. In the United States, I think it is about three today, or a little bit over three. The implicit debt of the system was estimated about 80 percent of GDP.

My colleague, Jagadeesh Gokhale, who testified before this committee earlier this year, has estimated that the implicit debt of the United States system is about $7 trillion. So that figure would be a little bit less as a percentage of GDP than what it was in Chile.

There were three rules for the transition that were set up. The first rule was respect your promises. That is, to those people who were already retired, their pension benefits as promised were guaranteed.

The second rule was to those workers who are already in the labor force, they were given the choice of moving to the new system or staying in the old system under the rules of the game that had been established when the new system was implemented.

The third rule of the transition was to new workers, they had to go. Because the old pay-as-you-go system, wasn't sustainable, they had to go to the fully funded private system.

The Chilean government used five different methods to finance the transition. The first method was to recognize part of the implicit debt, to recognize it explicitly by issuing recognition bonds. One thing that I did not mention was that those workers who decided to move from the old system to the new system were given a recognition bond that recognized the contributions that they had made into the old system. That way, they did not have to start under the new system with a zero balance in their accounts. So the Chilean government recognized part of the implicit debt, about half of it, by issuing recognition bonds. That was the first method.

The second method was there was a difference between what they had to contribute under the new system and what they had to contribute in payroll taxes under the old system. Under the old system, it was about 20 percent of wages. Under the new system, it was 10 percent plus the administration cost and the life and disability insurance premiums. So the total contribution under the new system was about 13 percent of wages. Under the old system, it was 20 percent of wages.

The CHAIRMAN. The new system is what?

Mr. RODRIGUEZ. Thirteen percent.

The CHAIRMAN. Thirteen?

Mr. RODRIGUEZ. Ten percent that went into the account, and then initially, the administration costs were about 3 percent of wages, and that included the life and disability insurance. Today, those costs have come down to about 2.3 percent of wages.

So there was a difference there of 7 percentage points. What the Chilean government did was to maintain that difference as a temporary tax on the transition. That tax has decreased gradually over the years, and today, that tax is zero so that the payroll tax in Chile is zero. That was the second method.

The third method was to privatize state-owned enterprises and other state-owned resources and use the proceeds from those privatizations to fund the transition.

The fourth method was to cut government spending at all levels, and this was a sustained effort that had to be maintained over a number of years. It is still being maintained.

Finally, the reform, plus other reforms, have improved the functioning of the economy, which has led to an increase in the rate of economic growth and the increase in the rate of economic growth has led to an increase in general tax revenues, especially those coming from the value-added tax.

So those are the five different methods that the Chilean authorities used, and their situation that I think was more drastic than the situation the United States faces today, yet they were able to accomplish the transition to a fully funded system.

The CHAIRMAN. I thank you for that, because I knew that it was a significant change and I know that it wasn't just the system itself that was changed. It was literally government reform somewhat across the board. That, of course, is significant. What are the participation rates today?

Mr. RODRIGUEZ. When we talk about participation rates, we have to be careful about what we are talking. If you take the number of Chilean workers who have a private pension account, that is over 100 percent of the labor force because there are workers who may have been in the labor force before, especially young workers and women, who have come out of the labor force. Of course, these workers still have a pension account and whatever balance is in their accounts is theirs and that money is still earning interest.

If we talk about the people who contribute on a regular basis, the number is lower. It is about 60 percent of the people who have a pension account.

Then if we are talking about as a percentage of the total number of account holders, the number is still a little bit lower because there are people who come in and out of the labor force or of the formal sector of the economy and there are people who may become salaried workers at one point in their lives and then become independent workers. This reform was only mandatory, as the old system was only mandatory, for salaried workers, not for independent workers or members of the military.

But the participation rates are similar to participation rates under the old system overall. Of course, to the extent that participation rates are low, they have more to do with the structure of the labor market that may encourage some workers to leave the formal sector of the economy and go into the informal sector of the

economy and not so much with the structure of the system, which I think provides the right incentives to save.

Let me add that participation rates in Chile are higher than in other Latin American countries, and the size of the informal sector in Chile, because it has a better functioning economy, is much smaller than in other Latin American countries.

The CHAIRMAN. Thank you. Axel, the main innovation of the reforms that you were talking about in part was the introduction of a tax-favored individual account similar to our IRAs. Why do you think the take-up on the IRAs has not been as high in Germany over the past few years as it was in the United States, let us say in the 1980's?

Mr. BOERSCH-SUPAN. Well, two, actually three points. Also in the United States, as much as I remember, it took quite a while until IRAs were really sort of a broad financing instrument——

The CHAIRMAN. Then it became so popular we had to reduce it.

Mr. BOERSCH-SUPAN. Right. But that took about six, 7 years. Now, we introduced in Germany these accounts in 2001, so it is not even half the time.

The CHAIRMAN. Well, then that wouldn't be a fair comparison.

Mr. BOERSCH-SUPAN. So one may want to be patient here. The other thing is——

The CHAIRMAN. What is your reaction to the current——

Mr. BOERSCH-SUPAN [continuing]. They are highly regulated, and I think that is the big problem, and they are regulated both on the buyer's side, so everything has to be annuitized. The payouts have to be paid out as an annuity, so they are not bequeathable, for example, or they cannot be used to pay down a house, for example. That restricts the popularity quite a bit.

On the seller's side, there are quite a few restrictions. For example, the commission if you sell a policy of this sort was heavily backloaded, and that is obviously what the sellers don't like. They want frontloaded schemes.

The CHAIRMAN. Sure.

Mr. BOERSCH-SUPAN. So these were two restrictions. So the buyers didn't really like the product and the sellers didn't like the product, either.

I think the third point, and that comes back to what you said earlier about information, people pick up, I think, the second and the third pillar if they realize that the first pillar is going to be decreased.

The CHAIRMAN. Yes.

Mr. BOERSCH-SUPAN. In the case of Germany, the first pillar would shrink to about two-thirds of its current size. That is a large amount of shrinkage and that has to be communicated to the public and that is a real hard job. We do this in a little bit similar to the way you do it in the United States. Social Security sends out these little sort of statements. But these statements do not really communicate what will happen in 30 years. They don't give the signal, well: "You get much less than the current generation does." Very often, the numbers are actually expressed in nominal dollars or Euros. Well, people can't handle these numbers.

So it has got to be a quite clear message: "You won't get what your parents currently do." That is something no Social Security administration likes, neither in Germany nor in the United States.

One of my toughest jobs as the Chairman of the German Reform Commission was to communicate these things and try to push those changes through, because it is obvious that if you force people to realize that Social Security won't be as it was, that does not go well with your constituency. But you have to do it anyway because otherwise the uptake of the second and third pillar won't work. So you are caught between two hard places here.

Mr. TRUGLIA. Might I make——

The CHAIRMAN. Yes.

Mr. TRUGLIA [continuing]. One observation about the various reforms that were discussed here, and I think it is important looking at them as to how they occurred.

The CHAIRMAN. In answering this question, would you also put it in this context, not only what you plan to say, but you were here and listened to the representative of the Japanese Diet and the reforms they are making. Bring that into it, if you would, because I am a bit frustrated by the reforms they are talking about as it relates to where that country goes in debt structure and the other point that you made earlier about its very large debt and its ability to sustain.

Mr. TRUGLIA. In the case of Chile, which I think has unique circumstances, one has to remind ourselves of 1981 and the nature of the government at the time. So it didn't really need public support to institute a radically changed system.

In the industrialized countries, when you take a look at when Australia made its changes and the U.K. made its changes and some of the Scandinavian countries made their changes, they were occurring at a period that was following a fiscal and/or balance of payments crisis. So there was a sense of crisis in the country. If you go to the Italian reforms of the mid–1990's, it was a crisis that they had to deal with.

Now you are seeing the West German, the Germans, the Italians, the French today. It has become a crisis because of Mastricht criteria. So all of a sudden, what were once modest deficits are now unacceptable deficits. So it is no longer a 30-year problem, which is always there. It has now become, we have to get our deficits down to meet the criteria over the next one to 2 years. What do you do there? So when you are fixing that, you have got the longer-term problem to fix.

In the case of the Japanese, the Japanese people do not believe—they fully understand their system cannot support them in terms of the present pension promises. So the real challenge for the Japanese government is that since no one trusts the system as it is, Japanese people are saving more. So the problem has been to get consumers once again believing that the future is going to be brighter. So all the growth we are seeing in Japan recently has been due to higher export earnings and higher capital spending related to the export sector.

The consumers have been very reluctant because they understand the problem very well. So having now the Japanese Prime Minister even admitting that he didn't pay for many years into the

system just sort of feeds into their distrust of the whole system. However, at the same time, what it does provide is that there is an ongoing fiscal crisis in Japan, is that they are probably freer to do what they want to do with the system.

The difficulty is that they are in such an economic bind that anything they do risks putting the economy back into a potential deflationary spiral, and I would be really surprised if they wind up actually carrying out the present pension reform and not push it back a little when they suddenly realize that higher payroll taxes is not maybe what they want so soon.

The CHAIRMAN. We are up against a time crunch here. We have just been joined by my colleague, Tom Carper, who may wish to ask a question, and Tom, I will let you do that and then we will allow you to adjourn the committee and I will go off to vote.

I will say by your last observation, if you ask the average young worker in this country today if they should rely on a Social Security system in their retirement, most will say no. That is a growing attitude in our country today, that Social Security will not be there to sustain them as a retirement system and they have got to look at other methods and approaches.

I think that it appears to be a growing dominant belief in our country today, so that is something we will have to wrestle with also as it relates to the willingness to participate in a future reform that will reward the recipient enough to want them to participate without it being such a negative mandatory. I think that will be a part of what we struggle with as we get into reform of Social Security.

Now let me turn to my colleague, Senator Carper, and I will, Tom, allow you to rap the gavel when you are through. Thank you.

Senator CARPER [presiding]. Mr. Chairman, it has been a while since I got to rap the gavel and I look forward to doing that, maybe several times. [Laughter.]

Mr. Truglia, you mentioned the Japanese Prime Minister. I remember a conversation I had on a trade mission I led as Governor to Japan and at the time, they were struggling with their economy and were talking about what they might do to stimulate it. I was kidding with him and I said, "In our country, we can cut taxes by one dollar and we will go out and spend two. In your country, if you cut taxes by one yen, your people go out and save two yen. That is part of their strength and part of their problem.

In the information provided us by our staff in anticipation of the hearing, one doctor in here says that some 30 nations, including the U.K. and Australia, Sweden, Mexico, and Chile, have chosen in whole or in part to increase the rate of return on assets by enacting prefunded personal retirement accounts. I don't know if you can share with us today whether there are some countries that we might look to as a model who have gone from the kind of Social Security system that we have to one that also includes prefunded personal retirement accounts and how they have made that transition in a way that enables them to fully meet the commitment to those who are retiring under the old system.

Part of the problem, as you know, here is that if those people in my generation or my children stop paying into the fund the full

amount, my mother and her generation aren't going to have enough money for the benefits that were promised to them.

Among those 30 nations, there is probably somebody who has figured out a reasonable way to do this that is fiscally responsible. If there is a model out there for us, just share it with us, please.

Mr. BOERSCH-SUPAN. I think the approach should actually start at the first pillar, at Social Security as it is right now, because that is the dominant income source for most people. So the art is to slowly decrease the benefits, and here is where actually productivity comes in.

Aging is slow but steady. It does take away——

Senator CARPER. I have noticed that. [Laughter.]

Mr. BOERSCH-SUPAN. It leaves enough room, as a matter of fact, even in the European countries to have still in nominal terms increasing pensions, and I think that is very important in communicating. Pensions will still increase, but they will increase somewhat slower than wages. Decoupling pensions from wages, I think is the important step which gives you the ability to sell the entire thing politically. Then automatically, people will pick up second and third pillar pensions, occupational pensions, 401(k)s, IRAs.

But the trick is to sell the benefit cuts, and that is the difficulty. That is quite difficult as a relative decline, not an absolute decline. If it were an absolute decline, it would be a disaster because that really means poverty for some of the people. But it is only a relative decline.

So in terms of numbers, if I may come back to my country, which ages faster than the United States, we take away out of, 1.5 percent wage growth for the next 30 years, we take away two-tenths of a percentage point. So pensions will grow 1.3 percent, wages will grow 1.5 percent. That little gap accumulates over the next 30 years and allows financing Social Security on a solvent basis without doing too much damage.

Senator CARPER. Thanks very much. What is your country?

Mr. BOERSCH-SUPAN. It is Germany.

Senator CARPER. OK. Let me just ask for the record, we have a 15-minute vote that started 12 minutes ago and I need to get over and vote. Otherwise, I miss my opportunity. Anybody else, just real quickly? My question was, as you may recall, is there a country out there that can serve as an example, and it may be Germany, it may be another one. But if you have a thought quickly. If not, just maybe submit something for the record.

Mr. HARRIS. Just a quick comment, Senator. I think there is no one particular country that identifies a magic bullet or a complete answer. It is a blend, if you like, a blending. I think countries like Switzerland, how Switzerland has achieved 122 percent of their GDP in pension assets, they moved to fundamentally a compulsory system and that is what it largely comes down to. Do you have an incentive-based tax system or do you move toward compulsion, as in my country in Australia, or the country I now reside in, in the U.K., where they are still grappling with the issue of incentives, a tough issue.

The fundamental tenet I would leave you with the Generation X, which I am part of and a little bit behind, is that education and

communication is critical. It can be sold and politicians can be reelected on the basis of pension reform.

Senator CARPER. All right. Going, going, gone. Now I get to take this gavel. Just think of all the legislation I could bring up for votes and for enactment and everything in the absence of the chairman of the committee, but I won't do that. Otherwise, he will never let me have this gavel again.

Let me conclude by thanking you all for joining us today and helping us to address what I think we will all agree is a ticklish and challenging issue. Thank you very much.

[Whereupon, at 11:52 a.m., the committee was adjourned.]

APPENDIX

Testimony submitted to the

Senate Special Committee on Aging

Hearing on
"Strengthening Social Security: What Can We Learn from Other Nations?"

by Richard Jackson

Director and Senior Fellow
CSIS Global Aging Initiative

May 18, 2004

Mr. Chairman, you are to be commended for your tireless efforts in focusing Congress' attention on the challenges posed by the aging of the population. I want to thank you for the opportunity to submit testimony today on what may well turn out to be the most momentous development of the twenty-first century.

The world stands on the threshold of a great demographic revolution. It's called global aging, and it is about to turn the world on its head. For most of human history, the elderly comprised a tiny fraction of the population—never more than 2 or 3 percent in any country. Today in the developed world, they comprise 15 percent of the population. By 2030, that share will be approaching 30 percent, and in some countries it will be shooting past 35 percent.

Global aging poses the greatest threat to Japan and continental Europe, which is where we find the fastest aging populations, the most expensive retirement systems, and the most unsustainable projections. The United States, with its younger population and more dynamic economy, is better positioned to confront the challenge But make no mistake: Global aging could wreck the economy of any nation that fails to prepare—even our own.

Global aging is the result of two fundamental forces. The first forces is falling fertility. People are having fewer babies, and this decreases the relative number of young in the population. The entire developed world is in the grips of an unprecedented birth dearth. A generation ago, every developed country was at or above the 2.1 "replacement rate" needed to maintain a stable population from one generation to the next. Today, every country is at or below it—most far below it. In Japan, the fertility rate is 1.4; in Germany, 1.3; and in Italy, 1.2. Only the United States hovers near the replacement rate.

The second force behind global aging is rising life expectancy. People are living longer, and this enlarges the relative number of older people in the population. Fifty years ago, average life expectancy in the developed world was everywhere was in the late sixties. Today, it is everywhere in the late seventies, except in Japan, where life expectancy has reached 80. On average, life expectancy in the developed countries has

risen by roughly two-and-one-half months per year over the past fifty years. Few demographers expect this trend to slow, and a growing number believe that it may accelerate as breakthroughs in biomedicine unlock the secrets of the aging process itself.

Longer life spans may be a great personal boon, but they also pose a great collective challenge. Graying means paying—more for pensions, more for health care, and more for nursing homes. Falling fertility and rising longevity translate directly into a falling support ratio of taxpaying workers to retired beneficiaries. This in turn translates into a rising cost rate for pay-as-you-go retirement systems like our Social Security system.

The good news is that governments are beginning to take action. From Australia to Sweden, a growing number have already enacted major reforms of their old-age benefit systems. As a rule, the reforms aim to encourage longer work lives, reduce unfunded pension liabilities, and strengthen funded retirement savings. All share a common goal: to make retirement systems more secure, more reliable, and more sustainable.

The bad news is that the time for corrective action is running short—and that the problem is worse than is generally assumed. According to the OECD, the total cost of public pensions and health-care benefits for the elderly now consumes an average of 11 percent of GDP in the developed countries. By 2040, the OECD projects that this cost will rise to 18 percent of GDP, or by 50 percent. And this estimate may be too low.

The OECD projections rest on a remarkably optimistic demographic and economic scenario. Under the scenario, unemployment is expected to fall in every country except Japan and female labor-force participation to rise in every country except Norway. Even as more women go to work, they have more babies. Meanwhile, the rate of growth in per capita health-care costs under the scenario slows to the rate of growth in the economy, while the rate of improvement in mortality falls to just half its historical pace. While this last development may seem like pessimism, it brightens the fiscal outlook.

The CSIS Global Aging Initiative has developed alternative old-age benefit projections that assume a continuation of historical trends in fertility, mortality, labor-force participation, and health-care cost growth. We believe this scenario provides a more realistic basis for assessing the sustainability of today's retirement promises.

According to the CSIS projections, total public retirement spending in the developed countries will grow from its current average of 11 percent of GDP to 23 percent of GDP by 2040, or by 100 percent. Just the growth in spending—12 percent of GDP—is three and one-half times everything that the United States now spends on national defense. It is also the equivalent of an extra 30 percent of workers' taxable payroll in countries where payroll tax rates often exceed 30 percent already.

Few countries will be able to pay for the projected growth current-law old-age benefits. Most European countries are already at or beyond their thresholds of efficient

taxation, meaning that, rather than generate new revenue, higher taxes are more likely to slow the economy, exacerbate structural unemployment, and push more workers into the growing gray-market economy. Nor is cutting other public spending to accommodate the growth in old-age benefits a solution. The projected growth is so large that the United States could eliminate *all* general-purpose spending—from education to law enforcement—and still find itself running widening deficits twenty-five years from now.

In the end, most countries will have no choice but to make substantial reductions in the generosity of their public benefit promises. But simply cutting benefits isn't a solution either. The problem is that the elderly in most countries are highly dependent on government. Even in the United States, with its strong traditions of financial self-sufficiency, the typical retiree in the middle of the income distribution gets more than half of his or her income in the form of a Social Security check. In Europe, the share ranges from 75 to 85 percent. Ominously, the countries that most need to cut benefits may be the least able to do so without imposing hardship on vulnerable elders.

Reform must therefore proceed simultaneously on two fronts. While scaling back pay-as-you-go benefits, governments must also put in place alternative means of support. The most promising solution is to require workers to prefund a greater share of their own retirement income by saving more during the employment years. At the macro level, funded pension systems can shield government budgets from demographic pressures and help maintain adequate rates of savings and investment—one of the greatest challenges facing our aging societies. At the micro level, they offer individuals higher returns, higher benefits, and the security of ownership. The funding strategy is not a magic bullet. Saving more requires consuming less, at least until the productivity benefits of higher savings kick in. Over the long run, however, funded systems offer decisive advantages over pay-as-you-go systems, which is why they are being embraced by countries as diverse as Australia, Mexico, Poland, Singapore, Sweden, and the UK.

In confronting the challenge of global aging, the United States enjoys considerable advantages. We now have the youngest population of all the major developed countries—and, thanks to our high rates of fertility and immigration, our population will remain the youngest for the foreseeable future. By 2050, more than half of all Europeans will be over the age of 50. Meanwhile, across the Atlantic, the median age of the United States will be a comparatively youthful 40.

We also have the developed world's most flexible labor markets. The United States has the highest overall labor-force participation rate of all the major developed countries. Among the elderly, our labor-force participation rate is second only to Japan's. Eighteen percent of Americans aged 65 and over are still on the job, compared with 6 percent of Italians, 5 percent of Germans, and 2 percent of Frenchman.

Along with favorable demographics and a strong work ethic, we have a relatively inexpensive Social Security system. Yes, Social Security is fiscally unsustainable in its current form. Under the pay-as-you-go status quo, current-law benefits will ultimately have to be cut by one-third or current-law payroll taxes will have to be raised by one-half. Still, compared to the size of the economy, Social Security is small by European

standards. All told, the United States now spends roughly 6 percent of GDP on public pensions, including Social Security and the civil service and military retirement systems. CSIS projects that this cost will rise to 10 percent of GDP by 2040—a sizeable burden. Yet incredibly, several European countries already spend considerably more today than we will be spending in 2040 after the last of the Baby Boomers have retired.

Finally, there is our large and innovative private pension system. Outside the United States and the other English-speaking countries, the dependence of retirees on public benefits is almost absolute. In the United States, private pensions help take pressure off government budgets. According to Intersec, a standard source for international pension data, US pension funds own an astonishing 59 percent of global pension assets. France, Germany, and Italy combined own just 2 percent.

None of this means that America can afford to be complacent. While we enjoy some real advantages, we must also overcome real obstacles. We have an extraordinarily expensive Medicare system whose ballooning cost could easily cancel out our advantage in Social Security. Overall, America now spends nearly twice as much per capita on health care as the next runner-up, Switzerland. Although US pension funds own 59 percent of global pension assets, nearly half the private workforce remains uncovered, even by a 401(k) that can be cashed out long before retirement. Reform must also reckon with the world's most powerful senior lobby—and an entitlement ethos that considers public benefits earned rights, tantamount to personal property.

Let me conclude by answering the question posed in the title of today's hearing: What can we learn from other nations? At first glance, the answer might seem to be "very little." But in fact, other developed countries have much to teach us about Social Security reform—and in particular, about the many different ways that countries can move toward greater funding. Australia and Switzerland have implemented systems of mandatory employer pensions. Germany has added a second tier of voluntary personal accounts to its venerable pay-as-you-go system. Sweden, the quintessential European welfare state, has added a second tier of mandatory personal accounts. Meanwhile, Social Security reform in the United States remains gridlocked.

We live in an era defined by many challenges, from global warming to global terrorism. But none is as certain as global aging. And none is as likely to have such a large and enduring effect on the shape of national economies and the world order. Time is running out. We can engage the challenge constructively. Or we can wait for it to overtake us. But we cannot avoid it.

Thank you again, Mr. Chairman, for the opportunity to share my views on this vitally important issue.

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