# SOCIAL SECURITY REFORM: SUCCESSES AND LESSONS LEARNED

## HEARING

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DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

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# SOCIAL SECURITY REFORM: SUCCESSES AND LESSONS LEARNED

**Thursday, May 5, 2005**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Deborah Pryce [chairman of the subcommittee] presiding.

Present: Representatives Pryce, Biggert, Harris, Gerlach, Neugebauer, Price, Maloney, Waters, Moore, Frank, and Pearce.

Chairman PRYCE. [Presiding.] Good morning. The hearing of the Subcommittee on Domestic and International Monetary Policy, Trade and Technology will now come to order.

Thank you all for being here today to discuss Social Security reform and review the successes and lessons learned from both foreign countries and our own plan for federal workers, the Thrift Savings Plan. The witnesses at this hearing have immeasurable knowledge of the structural reforms undertaken by our international counterparts, and also the importance of incorporating private accounts into any reforms we make here at home.

We know that the United States is wonderfully unique in its history, its economy and its people. Therefore, the lessons learned by the systems that work well or do not work well in other countries may not be directly analogous to the United States. Differences in population, life expectancy, and savings rates are just a few examples of the fine nuances that can make the application of the same policies yield dramatically different results. Indeed, our goal should not be to mimic the retirement programs of other nations. Rather, we should aim to enact a system that is tailor-made for the people and the economy of our United States.

Having said that, examining the retirement security systems of other nations can and should be done by this committee and this Congress. Other countries's experiences in implementing these retirement security policies can provide very valuable lessons for us. By reviewing the successes and shortcomings of other nations's programs, we will find areas that can be improved upon and then made applicable to the American experience.

A case in point is the United Kingdom's efforts at pension reform. According to the Congressional Research Service, this misselling of personal pensions is said to have affected 1.5 million workers, mostly older and lower-paid, who were persuaded by overzealous sales agents to switch to risky, inappropriate plans based on unduly optimistic estimates on rates of return. The government has ordered companies to reimburse these workers at an estimated cost of $3.2 billion to date, with total costs projected to reach $20 billion.

Investor choice is just as significant as investor protection in any voluntary personal accounts. We have seen the stagnant rates of return in Chile, where workers initially had no investment choice, with only one portfolio offered for over 20 years. Finally, Chile reformed its system to offer five portfolios with different degrees of risk.

I was pleased to read Dr. Estelle James's quote in a recent Washington Post article saying, "If we create personal accounts in the United States, we should also make portfolio choices simple, limited and diversified, including international securities, to protect inexperienced investors from themselves."

As Congress moves forward in drafting legislation to reform our Social Security system, this committee must stay involved to ensure that proper protections for investors and increased financial literacy are included. In addition, any plan to reform Social Security will require a concentrated effort by Congress to craft a program that will remain solvent long after we are gone. We have an opportunity to broaden the discussion to include a range of retirement security issues and to educate Americans on the personal savings plans provided by the financial services industry today.

Financial literacy empowers individuals to manage money, credit and debt and become responsible workers, heads of households, investors, entrepreneurs and business leaders. While Congress can make laws and provide savings vehicles for Americans's retirement through Social Security or personal retirement accounts, only with an overall understanding of financial services can a person truly benefit from an investment in their future.

We must continue to do more to reach out to more people. Like the Thrift Savings Plan, voluntary personal accounts would provide safe investment opportunities. In addition to a no-risk option of investing in U.S. Treasury bonds, the accounts could be invested only in secure bond and stock index funds, including a life-cycle fund designed to protect workers from sudden market changes on the eve of their retirement.

With more than three million investors, the TSP is the largest individual account retirement system in the country. It has been successful in keeping costs to consumers low through the use of competitive bidding. In 2003, the TSP had $129 billion in assets under management and paid just over $2.1 million in investment expenses. The introduction of personal retirement accounts to the public means that they must be designed with adequate regulation and oversight. There must be a significant investor protection effort in addition to financial literacy so that people can understand the investments that are offered and make appropriate choices.

I look forward to a lively discussion today and appreciate the witnesses's sharing with us their knowledge on this issue. Without objection, all members's opening statements will be made a part of the record.

At this time, I would like to recognize my friend, the gentlelady from New York, the Ranking Member of this subcommittee, Congresswoman Maloney, for her opening statement.

Mrs. MALONEY. Thank you so much, Madam Chair. I am glad that you are focusing on this important issue.

I certainly welcome the distinguished witnesses that we have here today.

One of my amendments is up in a markup in another committee. I am going to summarize my remarks and defer to the Ranking Chairman for the continuation.

I just feel that this is extremely important, and that we need to look at what has happened in other countries. In many of the other countries it has not been successful.

To give one example, the U.K. adopted voluntary individual accounts very similar to the plan put forth by the administration. Many workers who switched lost money and have now switched back to the traditional plan. The scandal forced the government to introduce a variety of reforms and aggressive enforcements. Currently, financial firms are now repaying $22 billion to individuals who were given unsuitable recommendations.

At retirement under the plan being put forth by the Bush administration, workers would pay back the amount they contributed to private accounts, with interest, through a reduction in their guaranteed security benefit. The interest rate would be 3 percent above the rate of inflation, which is the same that they would get if they had left their money in the trust fund invested in Treasury notes.

I would like permission to place into the record a research paper that was written recently by Yale economist Robert Schiller that demonstrates that if workers invest in life-cycle accounts, which President Bush has suggested as the appropriate default investment option, about 70 percent of workers would be worse under private accounts than if they had stayed in the traditional system and they would not make more than they have to pay back.

Very problematic is the cost of transition. Earlier, Alan Greenspan testified that these private accounts will do nothing to help the solvency of the current Social Security system, but will add a great deal of debt. The administration's proposal includes zero funding for the President's proposal for private accounts, and thus would rely on increased government borrowing to pay the transition costs at a debt of over $7 trillion and over $450 billion deficit. This is very troubling to me. The administration estimates that the President's private accounts would add another $754 billion to the public debt in the current budget window.

Because this does not start until 2009 and then phases in gradually, the true costs are truly much, much higher and Vice President Cheney has conceded that it would be trillions. The plan would add an estimated $1.4 trillion of public debt in the first 10 years, followed by another $3.5 trillion in the second decade. The increases in debt are large and longstanding. The additional debt would continue to grow relative to the size of the economy, reaching 35 percent of GDP. I mean, that is truly frightening to me. If other countries should decide that they do not want to hold much of that debt, we would be looking at a very, very serious economic situation.

Another problem with privatization is the high cost of administrative and marketing that is estimated to be 30 percent from the worker's point of view, which is a great deal of money. I must say that I certainly support the Thrift Savings Plan. I would support a similar plan on top of Social Security as it exists now for federal employees, but that this system is one that has served our public well for so very long, and we should really look at the experience of other countries before dismantling a system that has served so many for so long and so well.

I have quite a lengthy statement. I am going to ask to have the entire statement placed in the record.

I would like to yield to the Ranking Member, and I will be right back after I offer my amendment in my markup in the other room.

Mr. FRANK. I assume there will be an opening statement on the other side first.

Mrs. MALONEY. Okay.

Chairman PRYCE. And then we will come back.

All right. Now, I would like to recognize the Vice Chairman of the committee, Mrs. Judy Biggert.

Mrs. BIGGERT. Thank you, Madam Chairman. I would like to thank you for holding this important hearing today.

As we work to establish solvency in the current Social Security system and find additional ways to increase the savings rate, I think it is prudent to examine programs that work or do not work, both within our own country and abroad. We know that our Social Security system works now, but it will not work in the near future. We know that programs like the Thrift Savings Plan for federal workers and 401(k) retirement plans have inspired Americans to save more, to save over longer periods of time, and to gain a return on investments that trump any return that the government could give them.

Today, I look forward to hearing from the witnesses about the benefits of personal account programs for individuals, things to avoid when setting up such accounts, and elements that should be included in these accounts.

With that, I yield back the balance of my time.

Chairman PRYCE. Thank you, Ms. Biggert.

The gentleman, the Ranking Member of the committee.

Mr. FRANK. Thank you, Madam Chair.

First, on the question of Social Security, I do want to note my dismay to read in today's New York Times the headline—let me read the first sentence: "The Bush administration has warned the nation's biggest labor federation that union-run pension funds may be breaking the law in opposing President Bush's Social Security proposals."

That is an outrageous effort to coerce people out of exercising their political rights. The notion that you have to be careful about advocacy is one which this administration has been very uneven in applying.

Apparently, it is okay to use taxpayer money to create phony videos and pass them off as objective news reports, but if a labor union decides that it would not be in the interests of its members for this bill to go forward, they are going to be threatened. I hope that the unions will ignore this threat. It is a gross example of the wrong kind of politicization.

Secondly, I am glad that we are having this hearing because I think it helps us make a couple of points. First, as I read the early rhetoric about letting people have private accounts, it had a strongly libertarian thrust. It was an individual should make the decisions, not the government; that we should free people to do what they want with their own money.

I have noted with some interest that as we have progressed to specifics, the individual choice involved has gotten narrower and narrower and narrower. We ought to be clear that what we are now being told should happen with regard to Social Security accounts severely restricts what the individuals can do.

That leads to a third point. President Clinton once suggested that Social Security funds could be invested in stocks to some extent, and that would increase the return for Social Security as a whole, with individuals still having their entitlements, but with more money coming into the fund. At the time, a number of people, including Chairman Greenspan of the Federal Reserve, expressed grave opposition to this, saying that it would be a terrible idea to let the federal government make these picks of what stocks should be in there.

But as I read the current proposal, we are getting back to that. The current proposal is not to let individuals decide fairly freely where to put their money, but to create some limited choices for them. The federal government presumably would be the one ultimately making those limited choices.

So the difference between what President Clinton proposed and what we are currently seeing is not, it seems to me, on whether or not the federal government has some influence over where the money goes, but whether or not we continue to have this guarantee to people or whether they are more at risk.

I was also struck, and I am not going to be able to stay for the whole thing, but I was pleased to see in Ms. James's testimony, actually, let me just say this. I have heard a lot from some of my Republican colleagues about the inappropriateness of America looking to foreign countries to make American policy. We have certainly heard that with regard to the Supreme Court, and we have often heard that this is America and we will make our own decisions, and borrowing from foreign countries is really not what we need to do.

I am glad to see that that I think somewhat silly notion has been waived in the interests of trying to get support in some ways for Social Security, since we have other systems that have done that, and the silliness of ignoring the experience of others. Now, everybody has joined into that.

One of the things that struck me as I read over Ms. James's statement was at the bottom of page two and the top of page three, saying that, “every country that has a personal account system also has a minimum pension, most commonly 20 percent to 30 percent of the average wage. This is designed to protect workers from both financial market and labor market risk.” So far, we, America, do not have a minimum pension in our current system or in the proposed new system. I think that is a very relevant point of comparison.

As I understand the President's proposal, with progressive indexation and with the private accounts taking a significant chunk, up to one-half of what you put in, it does not seem to me that we would reach that 20 percent to 30 percent minimum.

The final point I want to talk about is on progressive indexation. I want to congratulate the administration on its mathematical flexibility. When we are talking about the point at which we begin to reduce people's Social Security from what they would currently be legally entitled to, the President says he wants to protect low-income people and we will begin to go to a progressive, i.e. reductive, approach to their Social Security benefits as they get into middle and upper income.

Apparently for these purposes, for the purposes of reducing the benefits of Social Security below what they now are, middle income starts at about $30,000. What strikes me is when we talk about tax cuts in this climate in Washington today, middle income seems to start at about $150,000. So whether or not you are considered middle income apparently varies. If it is a question of giving you a tax cut, it is much higher. If it is a question of when we can reduce your benefits, it is much lower.

The last point I would simply note again is, and I have been asked, and others, and I always want to repeat this on Social Security, what is the approach. It is clear that from now until 2018, unlike any other aspect of the federal government, the Social Security system will take in more money than it pays out. So for the near term, it seems to me we have a very easy solution: put the money back.

Chairman PRYCE. The Chair recognizes Mr. Neugebauer for a brief opening statement.

Mr. NEUGEBAUER. Thank you, Madam Chairwoman, for having this hearing.

This is probably one of the most important things that I think that this Congress can do for the future of our children and grandchildren. I have two grandsons that are 4 and 6. I want them to have a better plan.

I think we lose the debate here sometimes about Social Security. We are really talking about if we were going to start over today, would we put the same system in place today that we have? I think the answer overwhelmingly from the people in the 19th District is no, we would not. We would go to a system of ownership.

I had a 75-year-old constituent call me yesterday. She said, "Congressman, please, please, please allow our grandchildren and children to have accounts that will give them a better return on their money." She worked in the private sector for a while and has Social Security, but she also opened up an IRA and she said it is amazing how much money that IRA accumulated in a relatively short 10-year period. She said it is a wonderful supplement to the income we have today.

The problem with Social Security today is that it yields about 2 percent to the folks. I do not think there is probably anybody in this room that would accept a 2 percent return on their money. The other problem with it is it is not a system of ownership. So today when families are trying to make retirement decisions, they cannot make retirement decisions because they are relying on the whim of Congress in the future of what those benefits are going to be.

So what we do need to do is we need to come to a system that gives ownership to the American people and to our children and grandchildren in the future, and then figure out how to also at the same time reform the system that we have to ensure its solvency. But why would we perpetuate a system that we know today is giving a poor return to our citizens? Because we are afraid to address some of those important issues. I think these kinds of decisions, Madam Chairwoman, are great discussions, ones that we need to have.

We are going to hear about a very successful program, the TSP program. But I also want to talk about the fact that there are examples, as Mr. Frank was talking about, looking to other countries. We can look to examples in our own country today, where teachers systems in Texas, for example, opted out of the Social Security system many years ago because they realized that it was a poor return on their investments.

Now, those people that put basically the same amount of money into their retirement system in the teacher retirement system in Texas, their retirement benefits are three to four times what their counterparts that have been paying into the Social Security system for the same period of time. I think that is compelling evidence of what ownership does for families's abilities to address retirement issues in the future.

Again, I thank the Chairwoman for having this very important hearing today.

Chairman PRYCE. Thank you.

At this time, I would like to introduce our distinguished panel of witnesses, and we can get on to hearing from them.

Mr. Gary Amelio is the Executive Director of the Federal Retirement Thrift Investment Board, which administers the Thrift Savings Plan. He joined TSP in 2003 with 22 years of private sector experience in private sector pensions and investment matters.

Dr. Estelle James is a consultant and Professor Emeritus at the State University of New York at Stonybrook. Dr. James is recognized as a scholar on pension and retirement reform in developing countries. She has written selected papers and reports on the subject and has conducted World Bank seminars and workshops on Social Security reform in such countries as Hungary, Thailand, China and Poland.

Mr. Patrick Purcell, who is a Specialist in Social Legislation for the Congressional Research Service, has written numerous reports on pension and retirement reforms for civilians and federal workers. He recently gave a well-received lecture on retirement reform at the University of Pennsylvania's Wharton School Impact Conference sponsored by the Wharton School's Pension Research Council.

Mr. Francis Cavanaugh was the first Executive Director of the Federal Retirement Thrift Investment Board. He is a recognized author and scholar in the area of market financing of debt securities, having penned the book, "The Truth About National Debt: Five Myths and One Reality," and other publications.

We welcome all the witnesses here today and recognize them for a 5-minute summary of their testimony. Without objection, your more lengthy statements can be made part of the record.

We will begin with Mr. Amelio.

Thank you all for being here.

**STATEMENT OF GARY AMELIO, EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD**

Mr. AMELIO. Good morning, Chairman Pryce and members of the subcommittee. My name is Gary Amelio and I am the Executive Director of the Federal Retirement Thrift Investment Board, an independent agency charged with administering the Thrift Savings Plan. I was appointed June 1, 2003 and serve as the managing fiduciary of the TSP. Prior to my appointment, I had 23 years of private sector experience in the employee benefits, tax and fiduciary industry.

Although the board has no express position regarding proposals to change Social Security, I am pleased to discuss the successes and lessons learned by the TSP.

Since 1987, the TSP has grown to 3.4 million participants with a total of $155 billion in account balances. I often comment that Congress could not have provided a better structure when it created the TSP. Congress fashioned the plan with a goal of providing retirement savings for federal employees at low administrative cost and with a limited number of funds that track broad investment markets. This simplified structure has protected the plan from political manipulation and consequently enabled the TSP to gain the confidence of federal employees and become the largest and arguably most successful defined contribution plan in the world.

The TSP's participation rate significantly exceeds the industry average, primarily I believe because participants find the plan simple to grasp. The TSP participants also enjoy low administrative costs. Last year, expenses were just six basis points or 60 cents for every $1,000, which is rock bottom in the industry. I like to say that the TSP is the most inexpensive legal investment in the world. It is perhaps cheaper than illegal investments, but I do not know that.

Through the years, the TSP and Congress have worked together to improve the plan. The TSP recently modernized its recordkeeping system to accommodate daily valuation and in the next couple of months life-cycle funds will be available to provide professionally designed asset allocation models appropriate for participants's investment time horizons. Last year, Congress improved the plan by approving the board's recommendation to eliminate open seasons.

In 1986, the concept of allowing federal employees to invest in a retirement savings plan which included private securities was untested. By mandating a sound and simple structure protected from political manipulation, Congress created a plan which passed the test, gained the confidence of federal employees, and strengthened their retirement security.

This concludes my summary comments. I ask that my extensive written statement be entered into the record. I would be pleased to respond to any questions.

Thank you.

[The prepared statement of Gary Amelio can be found on page 48 in the appendix.]

Chairman PRYCE. Dr. James?

## STATEMENT OF ESTELLE JAMES, CONSULTANT AND PROFESSOR EMERITUS, SUNY, STONY BROOK

Ms. JAMES. Thank you.

My comments are based on work that I did while I was lead economist at the World Bank for 9 years, and continuing research that I did after leaving the Bank. I am still involved in that research.

Over the past 25 years, more than 30 countries spread across Latin America, Eastern and Western Europe, Australia and Hong Kong have adopted social security reforms that include funded privately managed plans, usually based on personal accounts. Contributions to these accounts range from 2.5 percent to 12.5 percent of wages and they are projected to supply between 30 percent and 90 percent of total benefits. The accounts are basically part of the social security systems in these countries.

In Latin America and Eastern and Central Europe, the accounts were created by a carve-out. In industrialized countries such as Australia, Switzerland, Netherlands and Denmark, employers have long provided employer-sponsored plans on a voluntary basis, as we do in the United States. At some point, governments decided everyone should be covered by these plans because only half of the labor force was covered on a voluntary basis. So governments made these plans mandatory and they were in effect an add-on for employers that did not provide these plans previously.

It is interesting. This kind of option has not been discussed in the United States, but it is obviously one way that we could go.

Now, I am going to discuss how these 30 countries handled three issues: The issue of administrative costs, which is crucial; how to control risk and protect low earners; and how to make payouts. I would like to put this in the context of two over-arching themes. First, workers do not have free rein over the funds in these accounts, as Mr. Frank said. There is a lot of control and regulation over the accounts. I think it is very important to realize that complete government control is at one end of the continuum, and complete free choice and ownership is at the other end.

Most of these countries are somewhere in the middle. “In the middle” is where I think we should be. The important question is: Where do you position yourself in the middle? How much choice? How much control?

The U.K. ran into trouble when it gave too much choice and too little regulation. On the other hand, I could cite other countries that had complete government control and wasted the funds, had low rates of return and political manipulation. So I would say being at either end of the continuum is not the place to be.

The second point is that details really matter a lot. Seemingly small changes in rules, really the fine print, can determine whether you consider the outcomes good or bad. So it is really important to get down into the trenches and look at those details.

I would like to just make a brief comment about each of those three issues, and then I will be glad to answer questions. Administrative costs are obviously very important because if you pay an expense ratio of 1 percent of assets per year, when you retire that will reduce your final pension by 20 percent, which is obviously a large chunk. So keeping those costs low is very important. The Chilean system has been criticized for having high costs. People are very concerned about that.

In this connection, it is important to realize that costs are going to be high at the beginning. There are high startup costs. Many of the numbers quoted from Chile were their high startup costs. Currently, the expense ratio in Chile is 1.2 percent of assets per year, and it is slated to go down to .7 percent over the lifetime of a full career of a worker. This is lower than the average mutual fund and 401(k) in the United States.

However, I believe we should be able to do much better in a mandatory system by exploiting economies of scale and eliminating marketing expenses. The key point here is that the most important cost is the fixed recordkeeping costs per account, which I estimate we could keep to about $20 per account if we are careful. That is based on estimates of low-cost mutual funds and the Thrift Savings Plan.

If we keep to that number, then that means that once the average account size reaches $7,000, the expense ratio will be less than 30 basis points. So I would estimate that in the long run, we should be able to operate at 30 basis points or less. This will take us 8 or 10 years to get to that point. This is I think consistent with the plans that are floating around.

However, if people are allowed to jump out of this basic system once their accounts reach a certain size, such as $5,000, we will never reach that $7,000 point and then the administrative costs for everyone will be higher as a percentage of assets. So this little detail that you might not even think of looking at will really determine the expense ratio and therefore the subtraction from the final pension. It is an example of how details matter a lot.

In terms of controlling risk and protection of low earners, there are many techniques that we are familiar with: diversification, of course, in companies and sectors and international diversification, the life-cycle funds that have been mentioned. I can talk about them later on if you are interested. But in addition, every country, as Mr. Frank mentioned, every country that has a personal account system also has a minimum pension.

The variation in size of the minimum pension is actually quite substantial, from 15 percent to 40 percent, but you could say that there is a sort of concentration between 20 percent and 30 percent of the average wage. That does set a floor and it protects workers both from financial market and labor market risk. That is something we could think about having here. We do not have it in our present system, by the way, without personal accounts.

Chairman PRYCE. Dr. James, I just need to remind you to be mindful of the clock. I know you have another point to get to.

Ms. JAMES. Okay, yes. I am moving on to the other point. Thank you.

Payouts. Every country with personal accounts restricts payouts. Most European countries require annuitization to ensure that workers will have a life-long income. In Latin America, workers are given a choice between annuities or gradual withdrawals. In Chile where they have this choice, two-thirds of all retirees have chosen to annuitize.

Lump-sum withdrawals are not permitted unless the pension meets a very high threshold, which varies across countries, but it is about 70 percent of the worker's own wage and roughly 200 percent of the poverty line, depending on country. So the threshold you choose for lump-sum withdrawals is an extremely important detail that matters.

Some countries require that annuities be indexed. Many of them require that the annuity should be joint in order to cover surviving spouses. This is very important for women, obviously. In Latin America, women can keep the joint pension in addition to their own pension. Whereas in the United States, as you know, women who work in the labor market have to give up their own pension if they take the widow's pension. We have to choose. In Latin America in their personal account systems, women can keep both. As a result, women's expected lifetime benefits relative to men's have increased in the new systems.

So my final point just goes back to the point that details are very important. You really have to look at them. The accounts can be good or bad depending on the details. The experience of other countries shows if we carefully structure the choice of asset managers, the investments and the payouts, and we provide a pension floor, including personal accounts as part of our Social Security system, should be able to continue to provide lifetime income security for the elderly in a cost-effective and low-risk way.

Thank you.

[The prepared statement of Estelle James can be found on page 79 in the appendix.]

Chairman PRYCE. Thank you. Your full statement will be in the record, and hopefully you can get to some of your other points.

Ms. JAMES. Thank you. I put a lot of work into all the research. I am delighted when people read it and think about it.

Chairman PRYCE. Mr. Purcell?

**STATEMENT OF PATRICK PURCELL, SPECIALIST IN SOCIAL LEGISLATION, CONGRESSIONAL RESEARCH SERVICE**

Mr. PURCELL. Madam Chairwoman and members of the subcommittee, my name is Patrick Purcell. I am a Pension Specialist with the Congressional Research Service. Thank you for inviting me to talk to you today about the thrift plan for federal employees.

We already have two distinguished other panelists who are very expert in the thrift plan, so I am going to talk a little bit very briefly about the legislative history.

In the legislative history of the thrift plan, two things stand out: First, Congress chose then and has maintained to this day a system in which all of the funds that invest in the private sector are index funds. This was a carefully considered choice. As the House committee report on the legislation stated at the time, the three funds authorized as passively managed funds, not subject to political manipulation. A great deal of concern was raised about the possibility of political manipulation of large pools of thrift plan money. This legislation was designed to preclude that possibility.

Likewise, the Senate committee report stated: "Another concern the committee wrestled with was the potential for market manipulation through political pressure. The committee specifically designed the plan to avoid this problem. The legislation provides for three investment funds that are all essentially self-managed."

The second item that stands out in the legislative history is the strong interest that Congress showed in establishing the independence and authority of the Federal Thrift Investment Board. The legislation established the Thrift Board as an independent government agency, which is required by law to operate the plan solely in the interest of plan participants. The law charges the thrift board with responsibility for developing the investment policies of the plan and overseeing the management of the plan. The law authorizes the board to appoint an executive director who runs the plan on a day-to-day basis.

Three members of the board, including the Chairman, are appointed by the President. The President chooses a fourth member in consultation with the Speaker of the House and the House Minority Leader, and a fifth member in consultation with the Senate Majority and Minority Leaders. Members are subject to Senate confirmation and serve 4-year terms. All members are required by law to have substantial experience in managing financial investments and pension plans.

Its independence is furthered by the fact that the federal retirement board receives no appropriations from Congress. Administrative expenses are paid through agency contributions that are forfeited by employees who leave federal service before they have vested, and by charges against participant accounts. Congress maintains oversight of the thrift plan through the House Committee on Government Reform and the Senate Committee on Homeland Security and Governmental Affairs.

In summary, as we have heard and we will hear from Mr. Cavanaugh, the thrift plan is a key component of federal employees's retirement benefits. It is an efficient provider of retirement savings accounts to the federal workforce, which has achieved high participation rates and low administrative costs.

I have a longer statement to be entered in the record. This concludes my opening remarks, and I would be happy to answer any questions the subcommittee might have.

[The prepared statement of Patrick Purcell can be found on page 118 in the appendix.]

Chairman PRYCE. Thank you, Mr. Purcell.

Mr. Cavanaugh, welcome.

## STATEMENT OF FRANCIS X. CAVANAUGH, PUBLIC FINANCE CONSULTING

Mr. CAVANAUGH. Thank you. Madam Chairwoman and members of the subcommittee, I welcome this opportunity to discuss the important subject of establishing individual accounts in the Social Security system. I will focus on the administration's proposal.

The critical question, of course, is cost. Individual accounts are proposed to provide a higher investment return than would be realized by the Social Security trust fund. On this basis, individual accounts would not be feasible for the 68 million employees of 98 percent of the businesses in the United States. That is the 5.6 million small businesses with fewer than 100 employees.

To understand the cost of individual accounts for small businesses, we must first understand why 85 percent of them do not now have retirement plans for their employees. A major reason is that the 401(k) industry has found that it cannot profitably provide services for a company for less than approximately $3,000 a year, even though they enjoy economies of scale from combining thousands of employers in their centralized computer systems.

Further significant economies of scale would not be realized by a central TSP-type agency because there would still be millions of small business workplaces to be reached. Nor can we assume that a new central government agency would be more efficient than the major 401(k) providers who now serve this market. Thus, the annual cost for an employee of a company with 10 employees would be $300, or 30 percent of the President's proposed initial annual individual account contribution of $1,000, and most U.S. companies have fewer than 10 employees.

These figures confirm the findings of a number of earlier studies by the Department of Labor and the Employee Benefit Research Institute. Obviously, substantial government subsidies would be necessary to make individual accounts attractive to employees of small businesses. If all Social Security taxpayers participated in the individual account program, the administrative costs would be more than $46 billion a year, which would be a subsidy to support an uneconomic function.

In addition to the above costs, which are based on what the current providers are actually charging for establishing and serving 401(k) plans on the market, there are overwhelming practical obstacles to modeling individual accounts on the TSP or on private 401(k) plans.

First, the TSP is administered by just one employer, the United States Government, with an extensive network of agency personnel payroll and systems staff to provide the essential employee education, retirement counseling, payroll deduction, timely funds transfers and error-correction functions. These essential employer services in 401(k) plans could not possibly be performed by small business employers or by a new TSP central agency.

Second, the TSP is computerized, like all other large plans, with investments made promptly after contributions are deducted from the employee's paycheck. With individual accounts, it would be up to 22 months after payday under current Social Security Administration procedures before individual accounts could be credited.

Third, the TSP is balanced to the penny every day. The Social Security system is never balanced. Each year, there are billions of dollars in unreconciled discrepancies.

Fourth, the TSP and the federal employing agencies have a very effective communications system. TSP mailings consistently have reached more than 99 percent of employees, but 25 percent of Social Security Administration mailings are returned as undeliverable. Since individual accounts are certainly not feasible for employees of small businesses in particular, the only practical way to give them high returns is to invest part of the Social Security trust fund in equities. The likely increase in trust fund earnings would be an effective way to help maintain the solvency of the trust fund.

Every state in the United States has authorized public retirement fund investment in stocks, which can now be done through broad-based index funds which avoid the problem of direct government control over particular companies. As shown in the chart on page eight of my prepared statement, there is even less government influence over private companies under the trust fund alternative than under the Thrift Savings Plan or the administration's plan, less government influence.

In conclusion, Madam Chairman, the administration's plan for universal individual accounts is not feasible from a cost standpoint. The only practical way for the Social Security system to capture the higher returns available from investments in stocks is to diversify the Social Security trust fund investments and the trust fund alternative compared to individual accounts would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and could be effective virtually immediately, rather than the 2009 starting date proposed for individual accounts.

The multi-trillion transition costs of individual accounts would be avoided. The additional trust fund earnings would go a long way toward strengthening Social Security finances and would thus reduce, if not eliminate, the need for significant tax increases or benefit reductions.

Thank you for your attention. I hope that my longer prepared statement will be included in the record.

[The prepared statement of Francis X. Cavanaugh can be found on page 67 in the appendix.]

Chairman PRYCE. Certainly, without objection, it will be.

Thank you very much for your abbreviated testimony. I know that there is a lot that you all could offer up, and hopefully we will get to some of that in the questions.

Let me just start by saying that as a federal employee I am a participant in TSP and have enjoyed much success in that program. My own State of Ohio is one of a half-dozen states that has begun to offer a 401(k)-like retirement accounts through which eligible employees can invest in a handful of state-screened mutual funds or other portfolios. But we have not had as much success as TSP in Ohio.

Along with that, I would just like to offer up that I have a very friendly mailman. I see him when I am home. He stops in and we chat, and he likes to talk about all kinds of things we do here in Washington. He informed me the other day that if President Bush wants to really sell personal accounts, he should get the postal force out, because he and his wife have just made so much money in their Thrift Savings Plan and it is the best thing that ever happened to them, and he should just get all of the postal carriers from all over the country to come and share their experience.

So my question is, what are the key features of TSP that makes it so successful, and participation rates so very high, compared to, for instance, what we have in Ohio? Maybe you are not familiar with that, but I just kind of described it, so if you have any insights, that would be great.

Mr. AMELIO. The size of the plan helps to keep the costs so low. We have large dollar-amounts, as well as a large number of participants, which you would not get from any individual state in order to spread the cost.

Secondly, the index funds that we utilize are about the lowest-cost investment that you can find. I am a very large proponent of them. We are able to minimize costs.

So if you combine those two features, the large size of the plan with the index funds, I think we are well managed. We do everything internally in terms of administration. That is how we keep the costs relatively low.

Chairman PRYCE. Mr. Purcell, and then Dr. James?

Mr. PURCELL. One thing I think that contributes to the high participation rate is the generous match. The federal government, of course, makes a 1 percent contribution on behalf of all employees covered by FERS regardless of whether the employee contributes, but then there are matching contributions so that in effect if you contribute 5 percent, your employing agency contributes an additional 5 percent. So that is a very strong incentive for participation.

Chairman PRYCE. Yes.

Doctor?

Ms. JAMES. Yes. Well, I think you also have to look at the wage-base. That is, the average wage of the employee group and the average contribution size, because ultimately that is what determines the size of the account.

As I said in my remarks, if you have larger accounts, you are dividing this fixed recordkeeping cost per account by a much larger number. So you can track the TSP costs over time and you can see that that expense ratio falls directly as the average size of the account increases, given the fact that those recordkeeping costs are largely fixed per account, whether it is $1,000 or $50,000.

Chairman PRYCE. You mentioned a $20 amount per account. Is that over 1 year or what period of time?

Ms. JAMES. Well, $20 is my kind of benchmark number. I take that out of looking at mutual funds which have recordkeeping costs, and that is the low end of the cheesy, the lower administrative cost mutual funds operate at about $20 per account in recordkeeping.

Chairman PRYCE. Per year?

Ms. JAMES. It is per year. And it is my estimate of TSP, because I have been unable to get the exact numbers from TSP, but it is my estimate of the ballpark that that is.

Chairman PRYCE. Let's real quickly switch over to Chile. What are the downsides of their system? You mentioned the high cost. What would you recommend us to do differently if we were to model from that? During our research on reforms in other countries, what are the mistakes we want to really be careful about?

Ms. JAMES. Chile and most of the Latin American countries use the retail market, that is pension funds that met certain rules and regulations could enter. They could approach the individual worker and try to attract the individual worker. So it was a direct pension fund-to-worker relationship. Most of the countries in Latin America and Eastern and Central Europe have used that approach.

I do not think that is the best approach for us because that is a costlier approach. It involves reaching a lot of little people with little accounts. It involves high marketing expenses. Marketing expenses can be half of total expenses in many of these countries. So I think the approach used in the Thrift Savings Plan, which is using the institutional market, aggregating the small accounts, using a competitive bidding process, using passive investments which Latin America could not use because they did not have indexes, they did not have markets the way we do.

So we have at our disposal institutions that they did not have. These can help us keep costs low by competitive bidding, passive investment, which keeps the investment part of the account practically to zero. I mean, if you index to the S&P 500, your investment costs are virtually nothing.

Chairman PRYCE. My time has expired. We will allow Ms. Maloney to proceed. Thank you.

Mrs. MALONEY. Thank you so much.

I thank all the panelists. There has been a lot of discussion about the Thrift Savings Plan, which is a great success, but this plan, of course, is in addition to Social Security. I would certainly support a similar Thrift Savings Plan for anybody in addition to Social Security.

My question, and I would ask Mr. Cavanaugh to begin this, what problems might arise if the Thrift Savings Plan really becomes the substitute for Social Security?

Mr. CAVANAUGH. If the Thrift Savings Plan or individual accounts became a substitute for Social Security, well, that would be way beyond any of the current proposals.

Mrs. MALONEY. Or a portion of it, a portion.

Mr. CAVANAUGH. A portion, well, if you take some of the proposals, the President's portion for the individual accounts would be up to $1,000 in the first year. It would go up $100 each year thereafter, and eventually people could put in 4 percent of pay, but it would be over 30 years before the higher income people would get to that.

That is relatively modest compared to total savings or the savings investment in the Social Security trust fund. I think the major question there in terms of impact is whether it is cost-effective. As I indicated in my prepared statement, it would not be. The expense ratio which the administration says would be .03 percent, according to my calculation based on the current market, it would be over 10 times that amount.

So to me, it is a nonstarter. I do not see how the program could get off the ground. I would bet that if the Congress enacted anything like the President's current proposal, you would have to recall it within 6 months, once you found that there is no market there, and the costs that would be required.

Mrs. MALONEY. Dr. James, building on the high cost, I am also concerned about the cost of transition. The plan would increase federal debt by, most economists's estimates, by about $5 trillion in the first 20 years and by increasing amounts after that. The transition costs of pension systems in Argentina contributed really to the country's financial difficulties. Of course, the United States is not Argentina, but we certainly have a huge national debt now of over $7 trillion.

How would you address the problem of the large transition costs? Shouldn't an honest proposal for private accounts include a way of paying for these costs other than simply increasing the federal debt?

Ms. JAMES. Actually, on individual accounts, I agree with you on that point. I think that how we handle the transition costs is crucial. In the case of Chile, they accumulated a fiscal surplus before starting this system. They started out with a surplus that helped cover the transition costs. We are not in that position, unfortunately.

Part of the object of an individual account system is to increase national saving. We have a very low national saving rate. Individual accounts would build up personal saving, but if we finance the transition purely through debt finance, then there would be a commensurate increase in public dis-saving, which would cancel it out, and we would not get the net increase in national saving that we desire.

So I do think that is a crucial issue. My own personal view is that we should do one of two things. Either we should come up with a transition-financing plan that does not rely exclusively on debt finance. There are two ways of doing that: cutting government spending or raising taxes. I think we should face that squarely.

The second way of doing it would be to use an add-on, rather than a carve-out. If you use an add-on, you do not have transition costs. You also do not have those offsets, the loan that gets subtracted at the end.

So there are virtues to that. I think that if you use an add-on, a voluntary add-on really would not be different from what we have now in the form of IRAs and other voluntary plans. So it would have to be a mandatory add-on, which would become part of the overall Social Security system. So I think we either need a transition financing plan, or we should go the route of at least a partial add-on approach. That is my opinion.

Mrs. MALONEY. Okay. My time is up, but I am also very concerned about the lower benefit because of the payback that you have to pay back into the system.

Ms. JAMES. But if there is an add-on, there is no payback.

Chairman PRYCE. The gentlelady's time has expired.

The Chair recognizes Ms. Biggert, the Vice Chairman of the committee.

Mrs. BIGGERT. Thank you, Madam Chairman.

Dr. James, Mr. Cavanaugh in his testimony expressed some skepticism that small companies could manage the burden of administering participation in a personal accounts system. He also indicated that the economies of scale from outside management groups would not be available to them. Would you agree with that analysis?

Ms. JAMES. You mean if you required every employer to provide its own plan? It was not clear to me exactly what model Mr. Cavanaugh had in mind, because certainly the plans that we are talking about, that are being discussed now, would not be a company-by-company plan.

Mrs. BIGGERT. I think probably it would be rather than like the Thrift Savings Plan, where there is a huge plan, that that would be a lot of little companies who would be managing the personal accounts.

Ms. JAMES. No, I do not think it would work that way. I think the idea is there would be a large pool, and under the current plan that is being discussed, as I understand it, the small company would not even be involved in what was going on because money would continue to be withheld. If you used the carve-out approach, then some portion of that would be at the aggregate level subtracted off and put into people's accounts. It would not involve company-by-company costs.

Mrs. BIGGERT. Would it involve, though, there still has to be somebody who administers it.

Ms. JAMES. Yes, certainly that is true. I think the collection would be done through the Internal Revenue Service, just as Social Security taxes are now collected. And then there would have to be a recordkeeping mechanism, that is what I was referring to, that would keep track of how much of that money went into each person's account.

This is done in Sweden, by the way. They have centralized recordkeeping through the tax collection system. They have centralized recordkeeping for all their workers. Workers then choose among 600 mutual funds. They have a lot of choice there, but the mutual funds do not even know which individuals are going with them.

Rather, an aggregate pot of money goes to the mutual funds that workers have chosen. And they of course are now 70 basis points, and they expect it to be getting down to about 30 or 40 in the future. But they manage to give so much choice and keep costs low because they really have a price control system. I do not think we would want a price control system. That is why I think we would have to go the other route and use competitive bidding.

Mrs. BIGGERT. But of course, Sweden is a lot smaller country——

Ms. JAMES. Yes, it certainly is.

Mrs. BIGGERT.—than we are. And so to have one agency that would manage this whole thing, don't you think that it would probably be farmed out to various companies who deal in these type of funds to manage those?

Ms. JAMES. I think it would need to be done. I think there are substantial economies of scale in the recordkeeping function. Even mutual funds outsource to two or three large companies that do all the recordkeeping because of the economies of scale.

So I think you would either have one large system or you would have a small number of regional systems as we have for Medicare, for example. I do not think you would have a lot of small companies doing this. That would not be an efficient way to go.

Mrs. BIGGERT. I think in your testimony that you agreed with Mr. Cavanaugh that startup costs could be quite high initially. You suggested that amortizing startup costs over time is a way to ensure that costs are not so crippling in the beginning, besides having a surplus, which would be probably the best, if that were possible.

Ms. JAMES. Yes, yes.

Mrs. BIGGERT. Have other countries done amortization?

Ms. JAMES. Well, for example, the countries that have used the retail approach where pension funds have entered on a competitive basis, you see that in fact their costs in the early years were higher than their fees. They actually made a loss in the early years which they recouped later on. The estimate is that the break-even point comes somewhere after 5 or 10 years.

So in a sense they have amortized in that way. If we did this in a more centralized way, we would need a policy decision about that. What they did was their own private competitive approach. We would need to make that policy decision, and I think we would amortize over a large number of years so that the costs would be spread across more cohorts.

Mrs. BIGGERT. Okay, thank you.

I yield back.

Chairman PRYCE. I recognize Mr. Frank.

Mr. FRANK. Thank you, Madam Chair.

Dr. James, I have a copy of a paper that was on your Web site, "Why Personal Accounts?," authored by you and Deborah James. I assume there is a connection.

Ms. JAMES. My daughter.

[Laughter.]

Mr. FRANK. Good. It is nice to promote family.

Ms. JAMES. She is one of the baby boomers.

Mr. FRANK. I appreciate the balance with which you approach this, because you do advocate private accounts, but within a certain context. Ms. Maloney got at some of these, and I would like to go further.

The minimum pension, one of the bullet points on page three of the paper, a minimum pension should be, you said, between 20 and 30 percent. Under the system that the President has proposed, you could put up to half of your money into private accounts ultimately, as I understand it, but we also would have that reduction in a progressive way.

Do you have any sense, that if I retired, say, making about $50,000 a year and I put about half into that, when you say a private pension, would that refer to the amount of Social Security I would get from the other half? Or do you mean in addition to that?

Ms. JAMES. I do not exactly understand.

Mr. FRANK. You say there should be a private pension of 20 to 30 percent in your statement, in addition. Would that be met by the part of your Social Security that was not in the private account, if it was 50-50?

Ms. JAMES. You mean the minimum pension?

Mr. FRANK. Yes.

Ms. JAMES. You know, different countries handle the minimum pension——

Mr. FRANK. Right. But what would you propose for us? A minimum pension should be added to offset labor and financial market risk.

Ms. JAMES. You are reading from the paper.

Mr. FRANK. From the paper, yes.

Ms. JAMES. The little thing. Right. Well, I have my own sort of complicated view of what a minimum pension is and how it might be handled. I think of the public and the private part as together encompassing Social Security. So I do not think of just the traditional part.

Mr. FRANK. I agree. Let me ask you this.

Ms. JAMES. And I would think the minimum would apply, in my view, the minimum would apply to the total, and I would like to see it also linked to years worked per worker, so that people who work longer get a larger return, and that is complicated.

Mr. FRANK. Let me just put it this way. Under our current system, if we were to do what has been proposed, allow private accounts with up to half and then do that progressive indexation, would the residual pension part be adequate in your judgment?

Ms. JAMES. I am sorry. I do not——

Mr. FRANK. Let me try again. Suppose we adopted what the President had proposed. You are aware of that?

Ms. JAMES. Yes.

Mr. FRANK. Up to half could go into private accounts.

Ms. JAMES. I think he has 4 percentage points going in. Right?

Mr. FRANK. Yes, up to half of what——

Ms. JAMES. It is a little bit less than half.

Mr. FRANK. Right.

Ms. JAMES. Yes.

Mr. FRANK. And also progressive indexation, as he calls it.

Ms. JAMES. Yes.

Mr. FRANK. If that is all we did, would that meet your standard for an adequate minimum pension?

Ms. JAMES. Oh, well, no. There is no minimum in there.

Mr. FRANK. Okay. Thank you.

Ms. JAMES. Nor is there a minimum in our current system.

Mr. FRANK. I understand that, but we are talking about changes.

Ms. JAMES. Yes.

Mr. FRANK. In fact, on that subject, you do say also in the paper, wage indexation of the traditional benefit should continue. If you switch to price indexation, the benefit would call drastically relative to the wages and contributions that rise over time. Many seniors will end up way below the average standard of living.

So that you would not support the progressive indexation as it has been proposed, at least not at the level of cut-off where it now is?

Ms. JAMES. I think progressive indexation is better than pure price indexation.

Mr. FRANK. That is not what I asked you.

Ms. JAMES. If I were——

Mr. FRANK. Dr. James, excuse me. I am trying to deal with this.

Ms. JAMES. I understand. I want to tell you what my——

Mr. FRANK. I am asking you for your opinion. If you do not want to give it, just tell me.

Ms. JAMES. No, no. I want to——

Mr. FRANK. All right. This is what you said. Wage indexation should continue.

Ms. JAMES. Yes.

Mr. FRANK. There has been a proposal that it should not continue at a fairly low level of cutoff. I am just asking for your opinion on that.

Ms. JAMES. Yes. I would like to see the current replacement rate be maintained into the future out of the two parts of social security, including the accounts.

Mr. FRANK. All right. I appreciate that.

Ms. JAMES. That would be my objective in structuring a new system. I would try to make sure that the relationship of the pension to the wage remained where it is today, but I would think of the two income streams as contributing to that.

Chairman PRYCE. Thank you. The gentleman's time has expired.

Mr. FRANK. Dr. James, I am kind of disappointed. I was really trying to have a straightforward conversation. I gather you are kind of reluctant to look like you might disagree with the administration. I do not think we have a good discussion if you feel constrained in that way.

There are other things in the paper. Would you mind if I put some of these in the record?

Ms. JAMES. No. I am delighted to put it in the record.

Mr. FRANK. Thank you.

Chairman PRYCE. I recognize Mr. Pearce.

Mr. PEARCE. Thank you, Madam Chair.

Mr. Amelio, when I called the TSP office and asked them the relative costs, and I know you cannot give it exact, but they tell me the cost of administering the plan is about .001, and maybe even as low as 0.006, 1/10 of 1 percent down to 60 percent of 1/10 of 1 percent. Is that about right?

Mr. AMELIO. The cost on a basis point level would be 0.006. That is six basis points. If you take our entire budget and divide it among the participants, it comes to approximately $26 per participant per year. That is 100 percent of the cost.

Mr. PEARCE. Right, 0.006.

Mr. AMELIO. A basis point would be 0.001. You would have to get another——

Mr. PEARCE. Yes, I understand.

Mr. Cavanaugh testified that the administrative costs would be at least 10 times that. If we went from three million participants, or three-and-a-half million, whatever you have now, to 40 million, because we are told that 40 million baby boomers are going to go into retirement. Let's say that only another 10 million or 15 million, so if we go from 3 to 15 million people in the plan, can you see where you administrative costs are going to go up by 10 times?

Mr. AMELIO. If we increase the number of participants substantially, is that your question, Congressman?

Mr. PEARCE. Yes.

Mr. AMELIO. The costs may go up marginally. They would not go up incrementally. In other words, if we doubled the number of participants in our plan, we would not necessarily double the amount of costs in our plan, no.

Mr. PEARCE. So the cost structure might stay the same, but not increase dramatically.

Mr. AMELIO. With respect to the TSP, that is correct, yes.

Mr. PEARCE. Mr. Cavanaugh, in your testimony you declare that the system of personal accounts would not work because private companies like my company, and I have a small company, at one point we had 50 employees. I never visualized, when I am sitting here talking about Social Security reform, I never visualized that I would do anything more as an employer than what I do right now. I simply get the employee to fill out a W-2 for the Internal Revenue; maybe a W-4; maybe add a little bit of WD-40 to make it work well when I send it in, but I do not do much.

I do collect the taxes from my employees, and I write the check for myself, and I send that to Social Security. Your whole assumption in saying that personal accounts will not work is that I am suddenly going to take the administrative function from Social Security away from Social Security and start doing it myself. I never conceived of that as we are sitting here in the broad stage of discussion.

Would your opinion about the personal accounts sustain if we did not make your initial assumption that I, as an employer, was going to take over the Social Security Administration's functions? If we do not make that assumption, if we instead leave the functions with Social Security, will your evaluation stand in the same position?

Mr. CAVANAUGH. The problem is, and I speak in terms of the current market, the market looked at this problem years ago. They thought since they had already provided 401(k) plans successfully for large corporations——

Mr. PEARCE. My question, sir, if you would address that, is will your perception stand if you do not go in with your initial assumption? The assumption of your entire argument is that I as an employer am going to take the function of Social Security Administration, which I never believed that that plan would do.

You say that small companies cannot administer 401(k)s and that they do not have them. All I do right now with Social Security is I take the money from my employees; I write a check to Social Security or the government.

I think that is all that we would be doing if we had personal accounts. The administration would slide over to an agency like TSP. I would not be required to find people to administer the plan. I do not have people to administer a plan right now. With four or five employees, it just does not get that far.

But I do not perceive the initial assumptions that you make, and we come to a different conclusion. My question is, would your conclusion stand if you do not make your initial assumption? If we instead expect Social Security to set up a TSP plan, would your conclusions still stand in the same position they do now?

Mr. CAVANAUGH. Yes. My conclusion would still stand because if you do not do anything more as a small company than deduct the tax and send it in to IRS, which is what you say you are doing now, that is not what the administration or any of the individual account proponents are talking about.

They are talking about a 401(k)-type plan. The industry, when they try to bring these 401(k)-type plans, such as is proposed now, to small business, they have found that if the business has less than 10 employees, they do not want to talk with them, because there is too much involved beyond what you are talking about in terms of taking money——

Mr. PEARCE. My time has elapsed. In due respect, I never think that the plan that we are talking about is going to be set up that way. I think that what we are talking about is that the money will be sent to Social Security and a person can opt with Social Security to put some in a personal account, and it will be very similar to the TSP plan that we have, and that TSP plan will be administered by an administration very much like we have.

Chairman PRYCE. The gentleman's time has expired.

Mr. PEARCE. Thank you, Madam Chair.

Chairman PRYCE. Ms. Moore, the gentlewoman from Wisconsin.

Ms. MOORE. Thank you, Madam Chair.

I would like to yield 3 minutes to Mr. Frank.

Mr. FRANK. Thank you.

I want to try again, Dr. James. It says in this paper here, wage indexation of the traditional benefit should continue. Do you still believe that?

Ms. JAMES. Yes.

Mr. FRANK. Then even if we have private accounts, you would still want there to be wage indexation and not price indexation?

Ms. JAMES. I would want it to be wage indexed.

Mr. FRANK. Good. Okay.

Ms. JAMES. But could I add something to that? Because I do think we are going to need to have to figure out some way to save money on that traditional part so other changes would have to be made.

Mr. FRANK. Right.

Ms. JAMES. For example, raising the retirement age is one thing.

Mr. FRANK. I understand. But another change you mentioned, and again you mentioned it, but I think you believe that if we do not stick with wage indexation, even with private accounts there could be a reduction in the cost of living, in the standard of living of people. That is what you said, Dr. James.

Ms. JAMES. Yes.

Mr. FRANK. Okay, second question then. On the transition costs, you say they should not be debt-financed as the current proposal is.

Ms. JAMES. Right.

Mr. FRANK. Here is what you say, instead the limit could be raised on earnings subject to payroll tax. You note that recently most of the wage increase has been above the $90,000.

Ms. JAMES. That is right.

Mr. FRANK. Or better still, a surtax on all incomes could be imposed. Do you still prefer those methods, to debt?

Ms. JAMES. Yes, I still do.

Mr. FRANK. Okay. So you are for private accounts, but with wage indexation remaining and an increase in retirement age, and it being financed, the transition, by some increase in taxation. Is that correct?

Ms. JAMES. That kind of plan. You know, I was outlining something very briefly and I still stand by the——

Mr. FRANK. I am not putting words in your mouth. You put this on your Web site.

Ms. JAMES. That is right.

Mr. FRANK. I did not have a search warrant. I really just read it. Thank you.

I yield back.

Ms. JAMES. If I could just add to that. Consistent with what I said, I think that personal accounts have the propensity to improve our system, but I think how you do it and how you get there——

Mr. FRANK. I understand that. What I will say is this, there are various ways to do it. I should have added also that you propose that personal accounts be partly with an additional contribution and partly out of Social Security. So yes, if you are talking about increasing taxes one way or the other, raising the retirement age, keeping wage indexation, and financing them partly by additional and partly from, that is a good proposal. Nothing that we have seen resembles it, that is all, other than yours.

I yield back.

Ms. MOORE. Thank you. This is a very distinguished panel and I would love to ask all of you questions, but I guess I want to pursue the line of questioning that Mr. Pearce started with Mr. Cavanaugh, and indeed with Dr. James. I want a clarification on the cost of the thrift saving plan.

It is my understanding, Mr. Cavanaugh, that the reason that you think that cost efficiencies could not be realized is because literally 200 million workers and all of those employers would have to have payday of the very same day as the federal government; they would all have to submit the paperwork. There are now about 13,000, thousands of telephone counselors that would be needed. Could you just explain that a little bit more?

To follow up, Dr. James, can you explain to me why you believe that we could avoid the transition costs when the thrift saving plan and the federal government under Social Security enjoys not paying those costs because it buys those Treasury bills itself and does not have to pay, and it is not the retail approach. So I am very confused as to how you think we could avoid those costs.

Thank you.

Ms. JAMES. Who is going to answer first?

Ms. MOORE. It is up to you.

Mr. CAVANAUGH. Go ahead, Estelle.

Chairman PRYCE. There are 48 seconds remaining, so divide it up appropriately.

Ms. JAMES. Are you referring to the transition costs or the startup costs? Transition costs come from a carve-out. The startup costs are the costs that you have to incur to get the IT system going and get the whole system established. Which are you referring to?

Ms. MOORE. Well, you are the one that is telling us that——

Ms. JAMES. Well, I think the startup costs, you cannot avoid. There are going to be startup costs. My proposal for that is that it should be amortized over many years because in fact it will serve many future cohorts of workers.

With respect to transition costs, that is a whole other story. There, I think you need a transition cost financing plan which would come partly out of taxes, partly out of cuts in government spending. These are the possible places it could come from. I think it should not come exclusively from debt finance.

Chairman PRYCE. The gentlelady's time has expired.

I recognize Mr. Neugebauer.

Ms. MOORE. The witness will not be allowed to answer me, Madam Chair?

Chairman PRYCE. We are up against a series of votes and I think she completed her sentence. So we will go on.

Ms. MOORE. Thank you.

Mr. NEUGEBAUER. Thank you, Madam Chairman.

Mr. Amelio, I have a TSP account. Do I have an account number, or do you use my Social Security number?

Mr. AMELIO. Your account is recognized by your name and your Social Security number.

Mr. NEUGEBAUER. So at payday, you get an electronic notification that I have withdrawn a certain amount of money, and that information from all the federal employees is sent to you electronically, is it not?

Mr. AMELIO. There are 130 payroll offices throughout the federal government. Each of those payroll offices transmits to us. I believe we actually receive money on a daily basis, although every other week are the heaviest transmissions.

Mr. NEUGEBAUER. But you probably receive that electronically, is that correct?

Mr. AMELIO. They are all electronic. Yes, sir.

Mr. NEUGEBAUER. And so when we are talking about a system where we are going to divert, and one other question, and you do not own any securities in TSP? You contract, when I give you money, you give money to a fund that is tracking the S&P, but your organization does not buy stocks every day. It just invests into the funds that you have contracted with. Is that correct?

Mr. AMELIO. The fund holds five investments. One of them is, of course, the G Fund or Treasury securities. The other four are index funds. They are managed by Barclay's, which has to get an award by competitive bidding. There are commingled funds, which are similar to, but not identical to mutual funds. We hold funds. We do not hold individual securities.

Mr. NEUGEBAUER. Right. So you hold the funds. So really what we are talking about, and this notion of having employers managing accounts, is not the president's proposal.

The proposal on the table is, or one of the proposals that have been brought forward is basically taking Social Security, where we already have account numbers, we already have names, and so basically transitioning that money rather than into the federal treasury, a portion of that, 2 percent or 4 percent, whatever the number is, is transitioned into an account that says Randy Neugebauer now has $100 more in his retirement account this month through the new personal account system than he had last month.

At the end of the month now when I get a statement, it says so much went into TSP, and then it says so much went into Social Security. But you know what the balance in my Social Security account is? It is zero. I have a balance in my TSP account.

What we are talking about, we already have a very sophisticated collection system in place with the IRS. It has accounts in the Social Security numbers. That is very easily transitioned, and that information and those funds transferred to a third-party provider that we would contract for, and then everyone would have an account. So I think to just kind of scare people off that this is going to cost $200 for $1,000, you know, I think that is bad information.

One of the things that I wanted to ask Dr. James about, what is your perception of the downside of going to private accounts? Some people are worried about the benefits being less, but we already have seen a track record where actually the returns are better.

So if you want to put a floor on what the benefits would be, it looks like to me we are actually from an annuity standpoint, actually reducing the potential for liability, even if we looked at a minimum guarantee as staying on the current system, or are going to a system where we are investing a portion of those funds in a higher account.

Ms. JAMES. I am sorry. I do not exactly——

Mr. NEUGEBAUER. I think the point some people were trying to say, is there a minimum retirement level that we think you would maintain.

Ms. JAMES. I think I was asked about whether there should be a minimum pension built into our system. I would favor a minimum pension that was tied to years of work so that people who work many years at low rates of pay are assured of a certain minimum relative to the average wage. I think that would also help to assuage some of the fears that with an individual account you might experience bad investment returns, and that would be particularly bad at the low end of the income scale where people would have a hard time cushioning.

So a minimum pension is one way to assure people that if they invest and if there is a prolonged period of poor investment returns, people who had worked most of their lives would be assured of a certain minimum standard of living. That is what I would favor and I think it would help to overcome some of the fears of accounts.

Chairman PRYCE. The gentleman's time has expired.

Mr. NEUGEBAUER. My time has expired.

Chairman PRYCE. We will go on to recognize Ms. Waters.

Ms. WATERS. Thank you very much. I appreciate this hearing. I think this is very important. We still all have a lot to learn.

I was interested in the discussion about the minimum account guarantee. Do you know if the President has adopted this kind of thinking of a guarantee for those who may find themselves at risk because they have invested in ways that cost them? Do you know if this concept has been included in anything that has been produced by the President and this administration?

Ms. JAMES. As far as I know, that is not in the current plan. As you know, we do not have a lot of details about the current plan. I have not seen that. It also is not in our current system, let me reiterate. So we have to put it in that perspective.

Ms. WATERS. Well, but it is a little bit different. The reason I like the idea, if we ended up going that way, for some kind of a minimum guarantee, is that the current system guarantees you that for as long as you live, that Social Security check will be deposited in your account. We have that guarantee.

Ms. JAMES. Right.

Ms. WATERS. Even out through the year 2042, it guarantees that 80 percent of it would be there. Most people agree you could do some very simple things, as you suggest doing, in the way that you have the minimum guarantee, while the transition costs I suppose of all of this, or increasing or lifting the ceiling on the payroll tax. You talk about using that for transition costs. Is that right?

Ms. JAMES. I think in the piece that Mr. Frank referred to, I talked about how that could be financed by raising the payroll tax or having a surtax on incomes is one way to finance the transition. That is right.

Ms. WATERS. Okay. But I suppose what I am getting it is, number one, that I like the idea of the minimum guarantee; that we do have a guarantee now. And even at 2042 where 80 percent perhaps could only be guaranteed if in fact you lifted the ceiling on the amount of payroll taxes and increased that somewhat, we could fully fund Social Security, in the same way that you describe that you could fund transitional costs. Is that correct?

Ms. JAMES. It would require a substantial increase to fund the entire Social Security benefit. Your question actually gets to a very key point. If we are going to put more revenue into the system, should it go into the traditional benefit or should it go into personal accounts.

Ms. WATERS. That is right. What I did not hear was, because I keep hearing this huge amount that it would take to transition and to set up these accounts, whether you are suggesting that you lift the ceiling, you lift the payroll taxes to finance that.

Ms. JAMES. If I could just respond to that, because it is really the central question and I think we ought to focus on that a little bit in the broader debate. One problem with raising taxes and putting more revenue into the traditional system, is that in the interim period, over the next 30 or 40 years, that will be building up the trust fund. You then have to ask how will the money in the trust fund be invested.

Now, right now the money in the trust fund is invested exclusively in government bonds. There is some evidence that that actually increases the government's deficit; that it is not only invested in government bonds that would have existed otherwise, but it encourages additional deficit finance because here is this pot of money sitting there that only the government gets access to.

Now, if this increases the government deficit, then eventually taxpayers are left with a larger set of obligations that they have to fulfill. That will simply result in a larger taxpayer burden down the road. In other words, really the question is can we effectively save in this way by simply building the trust fund. The proposal to put all that extra revenue into the trust fund would run the danger that we really would not be saving; that it would be in the trust fund, but it would become an additional government deficit.

Ms. WATERS. I understand that, but I would have to look closely at that deficit argument to see if really that is what happens. What worries me a bit about this discussion of the private accounts even, particularly about your take on this, that a minimum guarantee as done in other countries that you have identified, would give you some kind of safety net.

What I am really concerned about is this: Over the past several years, last two years or so, even in the TSP accounts, those people that were heavily invested in one of those markets lost money. With these investment accounts, if you are in your last couple of years of retirement and you do not have a minimum guarantee, and you lose the money that you are allowed to invest, how then do you recoup it? What do you do? Because I think we have seen some evidence of that in TSP, even though it is considered pretty good. I mean, it is pretty safe.

Chairman PRYCE. The gentlelady's time has expired. I would be happy to allow a brief answer, and of course we can submit further questions.

Ms. JAMES. Right. I will make my answer very brief. I am sure you know the historical data. All we have is the past. We do not know for sure what the future will hold. Historically, we know that for any 20-year period in the past, you would not have lost money. You would have come out ahead with a stock market investment rather than bonds. Now, the future may be different and no one is proposing all this money should be put into the stock market. So that is part of my answer.

Another part of the answer is, I think people should move out of stocks gradually as they are approaching retirement age. I think waiting until the last moment is dangerous for the very point you mentioned. The market could fall on the day that you decide to move out. So I think a gradual move-out during the 5 to 10 years prior to retirement is the way that I would recommend doing this.

Finally, I think we are mostly concerned about the low end of the spectrum in this regard, and that is where I think some kind of minimum guarantee would be useful.

Ms. WATERS. Thank you, Madam Chair.

With unanimous consent, just to raise the question of who is going to tell Ms. Mary Jones how to do that strategy. I am at retirement age and nobody told me. So where do they get this information from?

Ms. JAMES. It has to be built in. It has to be structured. You cannot depend on individuals to think it through.

Ms. WATERS. That is right. That is absolutely true. Thank you.

Chairman PRYCE. Thank you.

We are at a vote now, and the Chair notes that some members may have additional questions for this panel. They are encouraged to submit them in writing. Without objection, the hearing record will remain open for 30 days for members to do so and for the witnesses to place their responses in the record.

We are very, very grateful to all of you for spending time with us this morning. It was most informative, and thank you for being here.

This hearing is adjourned.

[Whereupon, at 11:45 a.m., the subcommittee was adjourned.]

# A P P E N D I X

May 5, 2005

Opening Statement

## Chairman Michael G. Oxley

**Committee on Financial Services**

**Domestic and International Monetary Policy, Trade, and Technology Subcommittee**
**Social Security Reform: Successes and Lessons Learned**
**May 5, 2005**

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Last month, we initiated discussion of Social Security reform with a full Committee hearing focused on the relationship between the reform proposals and financial literacy initiatives. These initiatives are key to ensuring that an informed investor class can take full advantage of all the opportunities and risks that financial markets have to offer. I strongly believe that we have a responsibility to making reform of the social security system work well for working Americans, especially as we age.

Today's hearing picks up where we left off in April. We look at successes achieved in reforming public pension systems at home and abroad. And we look at the lessons learned so far, so that we do not make the same mistakes. We do not need to look very far to find success in American reform efforts.

All we have to do is look under our own roof at the Thrift Savings Plan, created after the 1983 social security reforms. By offering limited choice, specialized investment options, increased customer services from a Web-based platform, and low administrative costs, the TSP has shown that a private account system can work well for a large number of people.

The TSP is the largest pension system in the country. And yet only government employees can participate. I agree with the President that the opportunities to grow retirement savings through personal accounts should be available to all Americans, not just federal government workers.

To be sure, expanding the system to cover a broader group of Americans holds challenges, and reforms must be undertaken thoughtfully. And so I appreciate the leadership of Subcommittee Chairman Pryce, who is using the jurisdiction of this subcommittee to focus on the lessons learned both here and in other countries that have reformed their public pension systems. For example, in Chile, close to 70 percent of the working population opted into the personal account system. Given the choice between government pensions and personal pensions management, people chose to take more ownership of their retirement savings. This is a success, by any measure.

Not all reform efforts have been completely successful. Faulty technology infrastructure, too many investment choices which confused investors, insufficient investor protection for plan participants which fostered fraudulent selling opportunities—-these are all avoidable mistakes. I do not agree with naysayers who point to these problems and say that we cannot do better.

America has a tradition of innovation, and social security reform will continue in that great tradition. We can do better than some of the examples that are out there.

The issues raised by reform efforts abroad highlight the need to ensure that full transparency and a robust investor protection system. Transparency enables investors to understand the risks posed by various investment options. Financial literacy efforts help individuals understand those disclosures. A robust supervisory and investor protection system can help ensure that individuals are protected from unscrupulous agents. It is possible that existing securities laws can provide this protection. International experience indicates that we need to consider carefully exactly how existing laws and standards will apply if the new system is going to work well.

We have an obligation to future generations to get this right and get it done now. We have the luxury of making reform decisions before a solvency crisis caused by demographic trends is upon us. Let's take advantage of that opportunity to make good decisions based on all information available.

Thank you, Madame Chairman, for holding this important hearing.

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Opening Statement
Rep. Carolyn Maloney
"Social Security Reform: Successes and Lessons Learned"
May 5, 2005

Thank you Madam Chair and welcome to our witnesses.

I am glad that we are holding this hearing
on the experience of other nations
with privatization of
their social security systems.

I hope that this is an indication
that we will also look at the social systems
of other nations
in areas such as health care,
parental leave, or other benefits –
areas where the United States
is regarded as woefully deficient
compared to the rest of the industrialized world.

But by comparison to any other system
the United States Social Security program

is a bright light,
a model for others to emulate
and a tangible expression of our belief
in the dignity of every person.

Countries that have shifted from a public
to a privatized system
are facing strong pressure
to get back to where they once belonged
as the song goes.

As a result of privatization, these countries
have seen
lower benefits for retirees
high transition cots
and high administrative an marketing fees
that reduce benefits.

As we compare their experience
to the Administration's proposal
to privatize Social Security
we see that the Administration's proposal
runs smack into many of the problems

encountered in these other countires
and that the United States
is in a worse position
to deal with many of these issues
than these countries were.

For example, private accounts in most countries have resulted in reduced benefits.

- The U.K adopted voluntary individual accounts, similar to the plan put forth by President Bush. Many workers who switched lost money and have now switched back to the traditional plan.
- This scandal forced the government to introduce a variety of reforms and aggressive enforcements. Financial firms are now repaying $22 billion to individuals who were given unsuitable recommendations.

Similarly, in the U.S., workers would have a one-time option to choose to open a private account under the President's plan.

- At retirement, workers would pay back the amount they contribute to private accounts, with interest, through a reduction in their guaranteed Social Security benefit. The interest rate would be 3 percent above the rate of inflation (a 3 percent real rate).

- A recent research paper by Yale economist Robert J. Shiller demonstrates that if workers invest in "life-cycle" accounts – which President Bush has suggested as the appropriate default investment option – about 70 percent of workers would do worse under private accounts than if they had stayed in the traditional system. They would not make more than they have to pay back.

Let's look at transition costs,
that is the problem of simultaneously honoring
the current obligations
of the existing retirement system
while contributing resources to the new system.

- In Chile, the government amassed several years of budget surpluses to help pay the transition costs by raising tax revenues, reducing spending, and selling government assets.

- In Argentina, the government faced a crisis when it had less revenue flowing into its old system's coffers while still paying significant benefits to existing retirees. Those obligations, combined with growing budget deficits led to a towering debt. By 2001, the costs for the social security overhaul approached the entire government budget deficit for that year. Worried investors stopped lending the country

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money which led to its economic collapse in December 2001.

Alarmingly, we are more like Argentina than Chile in terms of being able to pay transition costs.

The Administration's budget
includes zero funding
for the President's proposal for private accounts
and thus would rely
on increased government borrowing
to pay the transition costs.

- The Administration estimates that the President's private accounts plan would add $754 billion to the public debt in the current budget window (2006-2015).
- Because the plan doesn't start until 2009 and then phases in gradually, the true costs are actually much higher. Vice President Cheney conceded that the plan would cost "trillions."

- The plan would add an estimated $1.4 trillion of public debt in the first ten years (2009-2018), followed by another $3.5 trillion in the second decade (2019-2028).

- The increases in debt are large and long-lasting. The additional debt would continue to grow relative to the size of the economy, reaching 35 percent of gross domestic product (GDP) by 2060.If other countires decide that they do not want to hold that much of our debt, we could be looking at a very serious economic situation.

One problem with privatization that is nearly universal across all countries is the high administrative and marketing costs of individual accounts. Again, the Administration's proposal raises serious questions in this regard.

- In Chile, the system had very high initial administrative costs. Although these costs now amount to only about 1 percent of assets, according to a recent World Bank study, administrative fees consumed between 28 percent and 33 percent of total lifetime contributions for an average worker retiring in 2000.

The Bush Administration has advocated
a system that is similar to the Thrift Savings Plan (TSP) –
the government run 401K plan
for federal employees
which offers limited choice and very low administrative expenses –
as a way to keep costs low.
However, there are key differences
between TSP costs
and the cost of private accounts for Social Security – as I am sure our witnesses will point out.

- The TSP program has only one employer, while private accounts would cover about 6 million employers including about 4 million small employers with 10 or fewer employees.

- Administrative costs for small employers would be prohibitively high. More than 85 percent of small employers currently do not offer 401(k) plans, in part because small businesses lack the personnel and payroll staff to administer those plans.

These problems with privatization
are not to be disregarded.
We should listen carefully
to the experience of other countries
before dismantling a system
that has served so many so well for so long.

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# Opening Statement of
# Congresswoman Deborah Pryce
# Domestic and International Monetary Policy, Trade and Technology hearing on Social Security Reform: Successes and Lessons Learned

**May 5, 2005**

Thank you for being here today to discuss social security reform and review the successes and lessons learned from both foreign countries and our own plan for federal workers—the Thrift Savings Plan. The witnesses at this hearing have immeasurable knowledge on recognizing success in the structural reforms undertaken by our international counterparts and also the importance of incorporating private accounts into any reforms we make here at home.

We know that the United States is wonderfully unique in its history, its economy, and its people. And therefore, the lessons learned by the systems that work well or do not work well in other countries may not be directly analogous to the United States. Small differences in populations, life expectancy, and saving rates are just a few examples of the fine nuances that can make the application of the same policies yield dramatically different results. Having said that, examining the retirement security systems of other nations can and should be done by this Committee and this Congress. Other countries' experiences in implementing these retirement security policies can provide very valuable lessons for us.

In reviewing where other countries have failed, we are able to see where the U.S. Congress can and should include greater investor protections. A case in point has been the U.K.'s efforts at pension reform. According to the Congressional Research Service, "The mis-selling of personal pensions is said to have affected 1.5 million workers, mostly older and lower paid, who were persuaded by overzealous sales agents to switch to risky, inappropriate plans based on unduly optimistic estimates and rates of return. The government has ordered companies to reimburse these workers at an estimated cost of $3.2 billion to date with total costs projected to reach $20 billion."

As Congress moves forward in drafting legislation to reform our social security system, this Committee must stay involved to ensure proper protections for investors and increased financial literacy are included.

Any plan to reform Social Security will require a concentrated effort by Congress to craft a program that will remain solvent long after we are gone. The average American is not an expert in individualized investment plans or financial services products ——we have an opportunity to broaden the discussion to include a range of retirement security issues and educate American's on the choices of personal savings plans provided in the financial services industry today—it would be unwise to offer personal retirement accounts and investment choices without appropriate safeguards and education efforts.

Financial literacy empowers individuals to manage money, credit, and debt and become responsible workers, heads of households, investors, entrepreneurs, and business leaders.

The link between social security, personal retirement savings accounts and the need for increased financial literacy in America is closer than you think. While Congress can make laws and provide savings vehicles for Americans retirement through social security or personal retirement accounts, only with an overall understanding of financial services can a person truly benefit from the investment in their future. We must continue to do more- to reach out to more people.

Like the TSP, voluntary personal accounts would provide safe investment opportunities. In addition to a no-risk option of investing in U.S. Treasury bonds, the accounts could be invested only in secure bond and stock-index funds, including a life-cycle fund designed to protect workers from sudden market changes on the eve of their retirement.

With more than 3 million investors, the TSP is the largest individual-account retirement system in the country and has been successful in keeping costs to consumers low through the use of competitive bidding. In 2003, the TSP had $129 billion in assets under management and paid just over $2.1 million in investment expenses.

The introduction of personal retirement accounts to the public means that they must be designed with adequate regulation and oversight. There must be a significant investor protection effort, in addition to financial literacy so that people can understand the investments that are offered and make appropriate choices.

Financial Services Committee – Subcommittee on Domestic and International Monetary Policy, Trade and Technology

"Social Security Reform: Successes and Lessons Learned"– 5.5.2005

Opening Statement from Rep. Debbie Wasserman Schultz (D-20th, FL)

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Thank you Chairwoman Pryce, Ranking Member Maloney, and distinguished panelists. There has been a great deal of debate and hype about the current state of our Social Security system, but I want to reiterate this at the outset - **Social Security isn't about to disappear**.

We must address funding problems, but we have time to do it right and without undermining the entire system. **Privatization does nothing to solve Social Security's funding problems. Privatization costs trillions of dollars & privatization explodes the national debt.**

We spend most of our time in this committee, as we should, debating and investigating programs, policies and regulations that affect our nations markets and capital flows. But I want to encourage my colleagues to step back for a moment and think about the individuals, whose lives depend directly on the decisions we make.

Back home – in the largest county in my district, 273,865 individuals depend on social security.

- Approximately 70,000 of those people are not retirees – they are children, survivors and disabled workers.

**Think about that for a moment.**

**Across this country, one-third of all Social Security's beneficiaries are <u>not</u> retirees** – they are children, widows, and people with disabilities. Social Security offers a set of insurance protections for workers and their families, providing protection against poverty in the event of death, disability or old age, **the likes of which are simply not available in our private markets.**

Privatization threatens the certainty that all Americans – and especially women – rely upon when planning for retirement. Here is something to think about as we head into Mother's Day weekend:

- Women comprise the majority of Social Security beneficiaries.
- Women represent 58% of all Social Security recipients at the age of 65.
- Women represent 71% of all beneficiaries by age 85.

**Women account for more than 70% of older adults living in poverty.** Without Social Security 52% of white women, 65% of African American women and 61% of Hispanic women would live in poverty upon retirement. Social Security provides more than half of total income for female widows and single women.

There are a number of factors that leave women even more vulnerable to the radical agenda proposed by the Bush Administration. For women, poverty in old age is often rooted in the realities that shaped their lives early on: the reality of a wage gap, the reality of caregiving, and the reality that flexible jobs offer few benefits – especially pensions.

Older women are less likely than older men to receive pension income – only 28% of women versus 43% of men. When they do receive pensions, the benefit is only about half of what men receive.

**More than 40 years after the Equal Pay Act became law, women still earn only 76% of what men earn. <u>You can't save what you don't earn</u>**

**I raise these points today because we will be hearing from some of our panelists about experiments with social insurance programs in other countries that – by and large – failed. I ask my colleagues here today to consider the individuals – the women – the mothers – whose lives would be directly affected by the destabilizing effects of privatization.**

**Thank you. I yield back the balance of my time.**

STATEMENT BY GARY A. AMELIO
EXECUTIVE DIRECTOR
FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
BEFORE THE
HOUSE SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

Good morning Chairman Pryce and Members of the Subcommittee. My name is Gary Amelio. I am the Executive Director of the Federal Retirement Thrift Investment Board and, as such, the managing fiduciary of the Thrift Savings Plan, or TSP, for Federal employees and members of the uniformed services. I welcome this opportunity to appear before the Subcommittee on behalf of the Board.

You have invited my testimony as part of your review of large individual account programs in the United States and other countries. Your purpose is to consider individual account approaches for Social Security. Although the Board has expressed no view regarding any proposals to change Social Security, our experience with the TSP may provide some useful information for the Subcommittee. The relevant issues include plan structure, governance, benefits, communications, and investments. I am pleased to describe how the TSP functions in each of these areas and to discuss how the Congress addressed important TSP issues in the Federal Employees' Retirement System Act of 1986 (FERSA).

The TSP is a voluntary savings and investment plan that allows Federal and Postal employees (and, since 2002, members of the uniformed services) to accumulate savings for their retirement. It offers employees of the Federal Government the same types of savings and tax benefits that many private corporations offer their employees under Internal Revenue Code section 401(k) retirement plans. The TSP currently has approximately 3.4 million individual accounts. The Thrift Savings Fund has grown to $155 billion. Each month, participants add more than $1.4 billion in new contributions. Participants may invest in any individual, combination, or all of five investment funds; transfer their monies among the funds; apply for loans from their accounts; transfer money into their accounts from other eligible employee plans or individual retirement accounts; and receive distributions under several withdrawal options. TSP administrative expenses are borne by the participants, not by the taxpayers.

The Government-wide Federal Employees' Retirement System (FERS) employee participation rate is 86.4 percent. TSP participation by Civil Service Retirement System (CSRS) employees is currently about 66 percent. Additionally, after only three years, nearly half a million members of the uniformed services also now have TSP accounts.

PLAN STRUCTURE

Employees who are covered by FERS, CSRS, or members of the uniformed services contribute via payroll allotment to the TSP. The maximum percentages they may contribute are prescribed by law. These limits are scheduled to increase next year to $15,000 annually for most employees and $20,000 annually for those age 50 and over.

FERS employees receive an automatic contribution to their TSP accounts, paid by their employing agency, which is equal to one percent of their basic pay each pay period. Their employing agency also matches the first five percent of basic pay contributed -- dollar-for-dollar on the first three percent and fifty cents on the dollar for the next two percent. CSRS employees and members of the uniformed services receive the same tax benefits as FERS employees, but receive no automatic or matching contributions from their agencies.

GOVERNANCE AND ADMINISTRATION

The TSP is administered by the Federal Retirement Thrift Investment Board, which was established as an independent Federal agency under FERSA. There are approximately 90 employees of the Agency. Governance is carried out by six individuals who serve as fiduciaries of the Plan. Five are part-time presidential appointees (confirmed by the Senate) who serve four-year terms, and the sixth is a full-time Executive Director. The latter is selected by the appointees and serves an indefinite term. Each of these persons is required by FERSA to have "substantial experience, training, and expertise in the management of financial investments and pension benefit plans." 5 U.S.C.

§ 8472(d). With input from the Executive Director and Agency staff, the Board members collectively establish the policies under which the TSP operates and furnish general oversight. The Executive Director carries out the policies established by the Board members and otherwise acts as the full-time chief executive of the Agency. The Board and the Executive Director convene monthly in meetings open to the public to deliberate policies, practices, and performance.

FERSA provides that all monies in the Thrift Savings Fund are held in trust for the benefit of the participants and their beneficiaries. As fiduciaries, the Executive Director and the Board members are required to act prudently and solely in the interest of TSP participants and their beneficiaries. This fiduciary responsibility gives the Board a unique status among Government agencies.

Congress wisely established this fiduciary structure because it recognized that all Plan funds belong to the participants, not the Government, and thus must be managed for them independent of political or social considerations.

The Conference Report on FERSA, House Report 99-606, dated May 16, 1986, states in the Joint Explanatory Statement of the Committee of Conference:

> Concerns over the specter of political involvement in the thrift plan management seem to focus on two distinct issues. One, the Board, composed of Presidential appointees, could be susceptible to pressure from an

Administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes. Neither case would be likely to occur given present legal and constitutional restraints.

The Board members and employees are subject to strict fiduciary rules. They must invest the money and manage the funds solely for the benefit of the participants. A breach of these responsibilities would make the fiduciaries civilly and criminally liable.

The structure of the funds themselves prevents political manipulation. The Government Securities Investment Fund is invested in nonmarketable special issues of the Treasury pegged to a certain average interest rate. The Fixed Income Investment Fund is composed of guaranteed investment contracts, certificates of deposits or other fixed instruments in which the Board contracts with insurance companies, banks and the like to provide it with a fixed rate of return over a specified period of time. The Board would have no knowledge of the specific investments.

Finally, the stock index fund is one in which a common stock index such as Standard & Poor's 500 or Wilshire's 5000 is used as the mechanism to allocate investments from the fund to various stocks.

. . . .

The investment approach chosen by the conferees is patterned after corporate, state and local government, and the few existing Federal pension funds. Political manipulation is unlikely and would be unlawful.

As to the issue of Congress tampering with the thrift funds, the inherent nature of a thrift plan precludes that possibility. Unlike a defined benefit plan where an employer essentially promises a certain benefit, a thrift plan is an employee savings plan. In other words, the employees own the money. The money, in essence, is held in trust for the employee and managed and invested on the employee's behalf until the employee is eligible to receive it. This arrangement confers upon the employee property and other legal rights to the contributions and their earnings. Whether the money is invested in Government or private securities is immaterial with respect to employee own-

> ership. The employee owns it and it cannot be tampered with by any entity including Congress.

H.R. Conf. Rep. No. 99-606, at 136-37 (1986), reprinted in 1986 U.S.C.C.A.N. 1508, 1519-20.

In keeping with the intent of Congress that the Plan be administered in accordance with fiduciary standards derived from those applicable to private sector employee benefit plans -- as distinct from the usual administration of an executive branch agency -- Congress exempted the Board from the normal budget and appropriations processes and the legislative and budget clearance processes of the Office of Management and Budget. The Plan's independence is critical to ensure the fiduciary accountability envisioned by FERSA. So long as the Plan is managed by the fiduciaries named in FERSA (the members of the Board and the Executive Director) in accordance with the statute's strict fiduciary standards, Federal employees and members of the uniformed services can be confident that their retirement savings will not be subject to political or other priorities which might otherwise be imposed by these clearance processes.

FERSA protects the Thrift Savings Fund through more than just the independent fiduciary governance by the Board members and the Executive Director. Additional safeguards to protect TSP participants include the provisions in FERSA relating to (1) the role of the Secretary of Labor in establishing a program of fiduciary compliance audits; (2) the requirement that the Board contract with a private accounting firm to conduct an annual audit of the TSP on the basis of generally accepted accounting principles; and (3) the participation of the 15-member Employee Thrift Advisory Council, which includes representatives of the major Federal and Postal unions, other employee organizations, and the uniformed services.

The Board has benefited greatly from hundreds of audits conducted by the Department of Labor over the past seventeen years. These audits, which have covered every aspect of the TSP, are reported to the Congress annually under the Inspector General Act of 1978, as amended.

The accounting firm retained by the Board has conducted annual reviews as required. The result has been eighteen unqualified audit opinions.

The Advisory Council meets with the Executive Director and advises on investment policy and the administration of the TSP. These meetings are very helpful in providing the Board with insights into employee needs, attitudes, and reactions to the various programs undertaken by the Board.

The TSP also benefits from the cooperation of every agency and service in the Federal establishment. Although the Board is an independent body, successful administration of the TSP is highly dependent upon all Federal agencies and the uniformed services, which have direct responsibilities under FERSA for the administration of the TSP.

PLAN SERVICES AND BENEFITS

Employees and service members who participate in the TSP are served primarily by the personnel, payroll, and other administrative employees in their own agencies. The agencies are responsible for distributing TSP materials, providing employee counseling, and accurately and timely transmitting participant and employer contributions and necessary records to the TSP record keeper. TSP record keeping services are currently provided by the National Finance Center (NFC), which is part of the Department of Agriculture. The TSP Service Office in New Orleans performs a wide variety of services for TSP participants.

In addition, the TSP maintains parallel call centers at NFC in New Orleans, Louisiana, and in Cumberland, Maryland. Participants with questions may call a toll-free number which routes calls to participant service representatives at one of these sites. Further, we maintain a primary data center and a back-up data center.

Actively employed participants may borrow their own contributions and earnings from their accounts according to rules established by the Executive Director and regulations of the Internal Revenue Service. Participants repay the loans, with interest, and the money is reinvested in their TSP accounts. A $50 fee is charged to cover the costs of loan processing.

The other major benefit program is the TSP withdrawal program. Participants may withdraw funds from their TSP accounts before separation after reaching age 59½ or in cases of financial hardship. Upon separation, a participant may:

- withdraw his or her account balance in a single payment (and have the TSP transfer all or part of the payment to an Individual Retirement Account (IRA) or other eligible retirement plan);
- withdraw his or her account balance in a series of monthly payments (and, in certain cases, have the TSP transfer all or part of each payment to an IRA or other eligible retirement plan);
- receive a life annuity; or
- keep his or her account in the TSP, subject to certain limits.

Participants may also elect a combination of these withdrawal options.

COMMUNICATIONS

The Agency maintains its communication program on a number of levels within the Federal establishment in order to achieve employee understanding of the investment choices, benefits, and the administration of the program. This is especially important given the voluntary nature of the Plan and the participants' degree of individual control over investments and benefits.

The communication effort is initiated by the Board for eligible individuals through the issuance of a "new account letter" to each new participant after the employing agency establishes his or her account. Employing agencies distribute program information, including the *Summary of the Thrift Savings Plan for Federal Employees*, which provides a comprehensive description of the Plan, as well as booklets describing the loan program, withdrawal programs, and annuity options for employees to review at the time they are examining those benefits. Investment information is provided by the TSP Fund Sheets and the Managing Your Account leaflet which discusses operations. Copies of these publications are also available on our Web site at www.tsp.gov or through the ThriftLine.

In addition, we issue materials related to specific events. For example, the *TSP Highlights* is a newsletter issued with the quarterly participant statement. Copies of the newsletters, which address topical items and convey rates of return, are provided on our Web site. Participants can also obtain their daily balances from the Web site, request contribution allocations and interfund transfers or, in some cases, loans and withdrawals, and use various calculators located there as convenient planning tools.

A TSP video is available explaining the basics of the TSP in an animated format. TSP Bulletins are issued regularly to inform agency personnel and payroll specialists of current operating procedures. The ThriftLine, the Board's toll-free automated voice response system, also provides both general plan and account-specific information.

In connection with new Lifecycle funds we plan to introduce this summer, we will revise all of our communications materials and feature the benefits of the asset allocation approach used in "Life" funds as discussed below. We have budgeted $10 million for this major overhaul of our communications materials.

The Agency also conducts quarterly interagency meetings. These have proven to be an effective means of communicating program and systems requirements to Federal agency administrative personnel. These meetings also allow the TSP to hear and address representatives' concerns and to incorporate their suggestions in the establishment of TSP policies and operations.

INVESTMENT FUNDS

The TSP is a participant-directed plan. This means that each participant decides how the funds in his or her account are invested.

As initially prescribed by FERSA, participants could invest in three types of securities -- U.S. Treasury obligations, common stocks, and fixed income securities -- which differ considerably from one another in their investment characteristics. In 1996, on the Board's recommendation, Congress authorized two additional investment funds, which allow further diversification and potentially attractive long-term returns. The Small Capitalization Index Investment Fund and the International Stock Index Investment Fund were first offered in May 2001.

The Government Securities Investment (G) Fund is invested in short-term nonmarketable U.S. Treasury securities guaranteed by the full faith and credit of the U.S. Government. 5 U.S.C. § 8438(b)(1)(A), (e). There is no possibility of loss of principal from default by the U.S. Government and thus no credit risk. These securities are similar to those issued to the Social Security trust funds and to other Federal trust funds. See 42 U.S.C. § 401(d) (Social Security trust funds); 5 U.S.C. § 8348(d) (Civil Service Retirement and Disability Fund).

The Fixed Income Index Investment (F) Fund, which by law must be invested in fixed income securities, is invested in a bond index fund, chosen by the Board to be the Lehman Brothers U.S. Aggregate (LBA) index. The LBA index represents a large and diversified group of investment grade securities in the major sectors of the U.S. bond markets: U.S. Government, corporate, and mortgage-related securities.

The Common Stock Index Investment (C) Fund must be invested in a portfolio designed to replicate the performance of an index that includes common stocks, the aggregate market value of which is a reasonably complete representation of the U.S. equity markets. The Board chose the Standard & Poor's 500 (S&P 500) stock index in fulfillment of that requirement. The S&P 500 index consists of 500 stocks representing approximately 78 percent of the market value of the United States stock markets. The objective of the C Fund is to match the performance of that index.

The Small Capitalization Stock Index Investment (S) Fund must be invested in a portfolio designed to replicate the performance of an index that includes common stocks, the aggregate market value of which represents the U.S. equity markets, excluding the stocks that are held in the C Fund. The Board chose the Dow Jones Wilshire 4500 Completion index, which tracks the performance of the non-S&P 500 stocks in the U.S. stock market. The objective of the S Fund is to match the performance of the Wilshire 4500 index. The Wilshire 4500 index represents the remaining 22 percent of the market capitalization of the U.S. stock market. Thus, the S Fund and the C Fund combined cover virtually the entire U.S. stock market.

The International Stock Index Investment (I) Fund must be invested in a portfolio designed to track the performance of an index that includes common stocks, the aggregate market value of which represents the international equity markets, excluding the U.S. equity markets. The Board chose the Morgan Stanley EAFE

(Europe, Australasia, Far East) index, which tracks the overall performance of the major companies and industries in the European, Australian, and Asian stock markets. The objective of the I Fund is to match the performance of the EAFE index. The EAFE index was designed by Morgan Stanley Capital International (MSCI) to provide broad coverage of the stock markets in the 21 countries represented in the index.

This summer, the TSP will introduce Lifecycle Funds. The Lifecycle Funds will be invested in various combinations using the five existing TSP funds. Participants will benefit from having professionally designed asset allocation models available to optimize their investment performance by providing portfolios that are appropriate for their particular time horizon. This is known in the financial world as investing on the "efficient frontier." We are very excited by the prospect of providing these funds to participants this summer. We have just placed preliminary information regarding the Lifecycle Funds on our Web site, and will be issuing much more over the coming months.

One likely concern associated with a Federal agency's investing in equities is the potential for the Government to influence corporate governance questions and other issues submitted to stockholder votes. FERSA provides that the voting rights associated with the ownership of securities by the Thrift Savings Fund may not be exercised by the Board, other Government agencies, the

Executive Director, a Federal employee, Member of Congress, former Federal employees, or former Members of Congress. 5 U.S.C. § 8438(f). Barclays Global Investors (BGI), the manager of the C, S, and I Fund assets, has a fiduciary responsibility to vote company proxies solely in the interest of its funds' investors.

The fund assets held by the F, C, S, and I Funds are passively managed indexed funds; that is, they are invested in portfolios of assets in such a way as to reproduce market index returns. The philosophy of indexing is that, over the long term, it is difficult to improve upon the average return of the market. The investment management fees and trading costs incurred from passive management through indexing generally are substantially lower than those associated with active management. Passively managed index funds also preclude the possibility that political or other considerations might influence the selection of securities.

The manager of the assets held by the F, C, S, and I Funds has been selected through competitive bidding processes. Proposals from prospective asset managers were evaluated on objective criteria that included ability to track the relevant index, low trading costs, fiduciary record, experience, and fees.

The Board has contracts with BGI to manage the F, C, S, and I Fund assets. BGI is the largest investment manager of index funds in the United States, which had over $1.36 trillion in total assets under management as of December 31, 2004.

The centralized management of TSP investments was carefully considered in FERSA by Congress. According to the Joint Explanatory Statement of the Committee of Conference quoted earlier:

> Because of the many concerns raised, the conferees spent more time on this issue than any other. Proposals were made to decentralize the investment management and to give employees more choice by permitting them to choose their own financial institution in which to invest. While the conferees applaud the use of IRAs, they find such an approach for an employer-sponsored retirement program inappropriate. . . .
>
> The conferees concur with the resolution of this issue as discussed in the Senate report (99-166) on this legislation:
>
>> As an alternative the committee considered permitting any qualified institution to offer to employee[s] specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services. The committee concluded that employees would not favor such an approach. Second, few, if any, private employers offer such an arrangement. Third, even qualified institutions go bankrupt occasionally and a substantial portion of an employee's retirement benefit could be wiped out. This is in contrast to the diversified fund approach which could easily survive a few bankruptcies. Fourth, it would be difficult to administer. Fifth, this "retail" or "voucher" approach would give up the economic advantage of this group's wholesale purchasing power derived from its large size,

> so that employees acting individually would get less for their money.

H.R. Rep. No. 99-606, at 137-38, reprinted in 1986 U.S.C.C.A.N. 1508, 1520-21.

INVESTMENT RETURNS

By law, TSP investment policies must provide for both prudent investments and low administrative costs. From the beginning of the G Fund's existence (April 1987) and the beginning of the F and C Funds' existence (January 1988) through December 31, 2004, the G, F, and C Funds have provided compound annual returns net of expenses of 6.7 percent, 7.7 percent, and 12.1 percent, respectively. The related BGI funds closely tracked their respective markets indexes throughout this period. Because the S and I Funds were introduced in May 2001, the Board has no long-term history for them. The indexes which they track, however, have produced compound annual returns of 11.9 percent and 5.6 percent, respectively, for the ten-year period ending December 2004.

In order to make the performance of the TSP funds more easily comparable, I have attached a chart which displays the growth of $100 invested in the underlying indexes for 20 years. The chart also includes the growth related to G Fund securities as well as inflation.

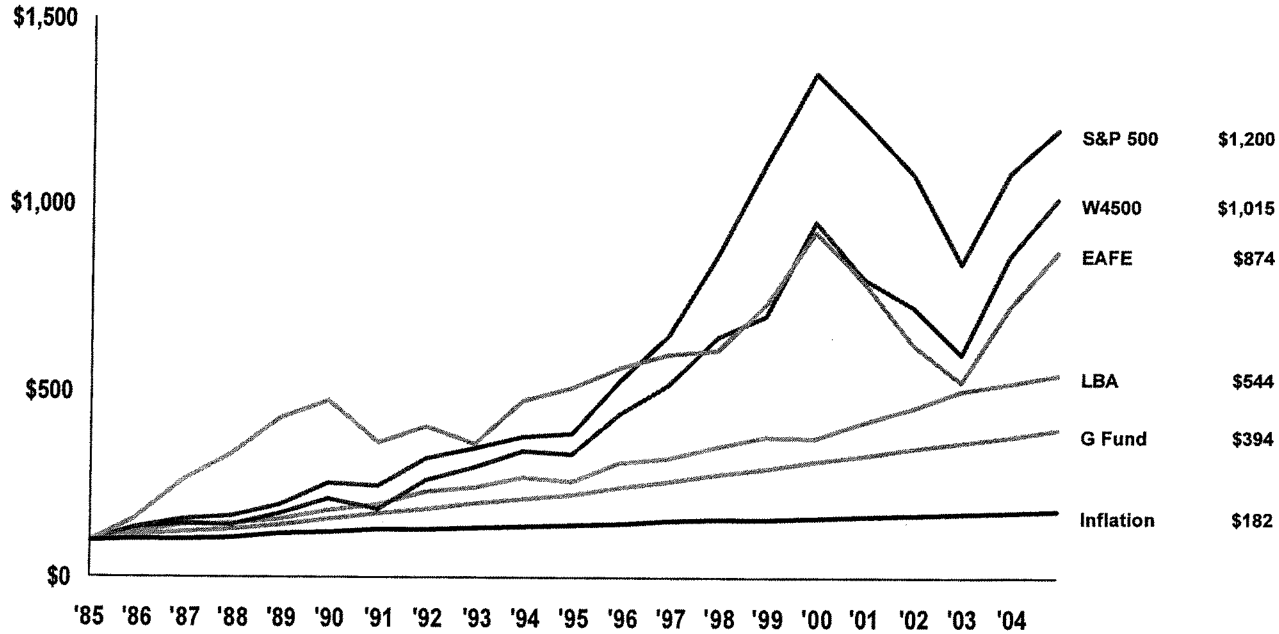
For calendar year 2004, the net Plan administrative expenses were .06 percent. This means that the 2004 net investment return to participants was reduced by approximately $.60 for each $1,000 of account balance. The expense ratio would be approximately .01 percent higher in the absence of account forfeitures, which offset expenses. These costs compare very favorably with typical private sector 401(k) service provider charges.

In summary, I believe that the Thrift Savings Plan has effectively and efficiently realized the numerous objectives Congress thoughtfully established for it nineteen years ago. To the extent that our experience is useful to the Subcommittee, I welcome the opportunity to provide any additional information you may require. I would be pleased to respond to any questions you or other members of the Subcommittee may have at this time.

Attachment

# G Fund, LBA, S&P 500, Wilshire 4500, EAFE, and Inflation Growth of $100

1985 - 2004



**Statement by Francis X. Cavanaugh**
**Before the Subcommittee on Domestic Monetary Policy,**
**Technology, and Economic Growth of the**
**Committee on Financial Services**
**U.S. House of Representatives**
**Washington, D.C., May 5, 2005**

## Administrative Feasibility of Social Security Individual Accounts

Madam Chairman and members of the subcommittee:

I welcome this opportunity to discuss the important subject of establishing individual retirement accounts in the Social Security system.

I am a public finance consultant, but I speak only for myself. I have no clients with an interest in Social Security individual accounts. From 1986 until 1994, I was the first Executive Director, and thus the chief executive officer, of the Federal Retirement Thrift Investment Board, the agency that administers the Thrift Savings Plan (TSP) for federal employees. Before that I was a financial economist in the Treasury Department for 32 years, and was the senior career executive responsible for developing federal borrowing, lending and investment policies, including those for the Social Security and other federal trust funds.

My comments will focus on the administrative considerations in establishing and maintaining a system of individual accounts.

### The Administration's Proposal

While there is no specific proposal before your committee, the Administration's current broad proposal, according to White House statements and press reports, provides a basis for at least a preliminary analysis of its feasibility.

The following features of the Administration's approach would have significant impacts on its feasibility:

- Social Security individual accounts (IAs) would be voluntary for all Social Security taxpayers under age 55, but would be mandatory for employers of employees who chose IAs.

- A major purpose of IAs would be to encourage savings by young and low-income workers and employees of small businesses that do not now have 401(k)s or other pension plans.

- The maximum amount of an individual's initial annual contribution to an IA would be $1,000, which would increase by $100 a year, to 4 percent of pay eventually. It would take more than 30 years for the highest income individuals to be able to contribute the full 4 percent of pay.

– Eligible investments for IAs would be Treasury securities and stock and bond index funds, which would be similar to eligible investments of the federal Thrift Savings Plan.

– IAs would be centrally managed, apparently by a TSP-like agency with a part-time board, appointed by the President with the advice and consent of the Senate, and a full-time executive director and CEO appointed by the board. Following the TSP model, the board members and the executive director would be independent of the Administration, and would be fiduciaries required to act solely in the interests of the holders of the IAs and their beneficiaries.

– Unlike contributions to 401(k)s or to the TSP, IA contributions would not be eligible for matching contributions or exclusion from taxable income, and loans or withdrawals before retirement would not be permitted.

**Cost Analysis**

A critical question, of course, is costs. IAs are proposed to provide a higher investment return than would be realized by the Social Security trust fund. Thus IAs would not be feasible if their administrative costs were so high as to offset the advantage of diversified investments in stocks and other securities that yield more than the Treasury securities in the Social Security trust fund.

The Administration assumes that IAs would earn an average investment return of 4.9% after inflation, and that administrative costs of .3%, that is, 30 basis points, would reduce the net return to 4.6%, or 1.6% more than the assumed net return of 3% on the Treasury securities in the Social Security trust fund. Thus, if one accepts the Administration's assumptions, IAs would outperform the trust fund investments so long as the administrative costs were less than 1.9%. In my view and that of many other economists, the 4.6% assumption is much too high; indeed, the Congressional Budget Office's estimate of the net return is reportedly only 3.3%.

The Administration's estimate of 30 basis points is optimistically low; even the Cato Institute, a leading advocate of individual accounts, estimates IA expenses at 55 basis points. Yet this higher estimate is also too low. Like so many others I have heard, these estimates are based mainly on experience with large 401(k)s for large organizations, like the TSP,[1] with economies of scale and comprehensive payroll, personnel, and computerized systems support. They have little relevance to the likely costs of a universal system of IAs. More than 85 percent

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[1] The administrative cost, or expense ratio, of the TSP is 6 basis points.

of the 5.6 million small business employers in this country offer no pension plans at all and, accordingly, have *none* of the administrative apparatus to service them.

To understand the costs of bringing IAs to employees of small businesses, we must first understand why 85 percent of them do not now have retirement plans for their employees. Fortunately, the 401(k) industry has already done part of the job for us. Companies like Citigroup, Fidelity Investments, Merrill Lynch, State Street Corporation, and T. Rowe Price have been competing for two decades to provide investment, record keeping, counseling, and other 401(k) plan services to small businesses. They have found that they cannot profitably provide these services for a company for less than approximately $3,000 a year, even though they have for years enjoyed economies of scale from serving thousands of employers in their centralized computer systems.[2] Further significant economies of scale would not be realized by a central TSP-type agency, because there would still be millions of small businesses or workplaces to be reached. Nor can we assume that a new central government agency would be more efficient than the major 401(k) providers who now serve this market.

Thus the cost per employee of a company with 10 employees would be $300, or 30 percent of the President's proposed annual IA contribution of $1,000 – and most U.S. companies have fewer than 10 employees.[3]

Even the largest business that is classified as a "small business," one with 100 employees, would therefore have an expense ratio of at least 3 percent, which would be ten times the Administration's estimate of 30 basis points. And for the 60 percent of employers in this country that have fewer than 5 employees, the initial expense ratio would be more than 60 percent, that is, 6,000 basis points. In fact, commercial 401(k) providers routinely discourage small businesses from establishing 401(k) plans if they have fewer than 10 employees and, in some cases, fewer than 25 employees.

Obviously, substantial and continuing government subsidies would be necessary to make IAs attractive to employees of small businesses. If all Social Security taxpayers participated in the IA program, the administrative costs would be more than $46 billion a year (155 million participants times more than $300 per account), which would be a subsidy to IA administrators for

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[2] Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP Public Policy Institute, Washington, D.C., Sept. 2002, pp. 4-6. The $3,000 charge is still common today. *See* "Big Fees Hit Small Plans: Costs Take Huge Toll on Retirement Accounts of Firms With Fewer Than 50 Employees," Wall Street Journal, Oct. 31, 2004, p. D1.

[3] *See generally* U.S. Department of Labor, Pension and Welfare Benefits Administration, "Study of 401(k) Fees and Expenses,"Apr. 13 ,1998. The study found that average charges by 17 major 401(k) providers for plans with 100 participants and $2 million in assets ranged from $114 to $428 per participant, and averaged $264. *Id.* at 51. Charges obviously would be much higher for much smaller plans.

performing an uneconomic function. These figures are reinforced by a number of studies, including those cited in a review of administrative costs by the Employee Benefit Research Institute.[4]

I recommend that your committee secure the testimony of individuals from financial institutions that are actually providing 401(k) services to the nation's businesses, large and small. Give them a specific set of assumptions to cost out that reflects the makeup of our country's 5.7 million employers subject to Social Security – of which 98% are small business employers of 68 million employees.[5] Then and only then will you know whether the Administration's proposal – or anything similar – will produce reasonable net investment returns, or, in the alternative, how much of a government subsidy would be necessary to achieve them.

**Critical Administrative Problems**

In addition to the above costs, which are based on what the current providers are actually charging for establishing and servicing 401(k) plans, there are overwhelming practical obstacles to the creation and maintenance of IAs. Because President Bush seemed to idealize the Thrift Savings Plan – the largest of all 401(k)-type plans – as the model for IAs in his February 2005 State of the Union message – and because many others have done so as well – I would like to point out the considerable dissimilarities between the TSP and the Administration's proposal. (Most of these dissimilarities would hold true for a comparison between any large corporate 401(k) plan and the proposal.)

**Too Many Small Employers.** The TSP is administered by just one employer – the U.S. Government – with extensive personnel, payroll, and systems staffs to provide the essential employee education, retirement counseling, payroll deduction, timely funds transfers, and error correction functions. The Thrift Investment Board is only a wholesaler of services; the federal employing agencies deal with the individual employees participating in the plan. In fact, the TSP statute directs the Office of Personnel Management to provide for the training of TSP counselors for each federal agency.

The Administration's plan is intended to reach all employees, but it makes no provision for the performance of what are now essential employer functions in 401(k) plans. They could not possibly be performed by small business employers who are now responsible only for the relatively simple payroll deduction and transmission of Social Security taxes to the IRS. Since most businesses have fewer than ten employees, they do not have the experience or administrative resources to support the new plan. These are barbershops, beauty salons, garages, restaurants, laundries, lawn services, households, nanny services, and other very small businesses that

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[4] *See, e.g.*, Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998. *See also* Ellen E. Schultz, "Poodle Parlor Retirement Plans," Wall Street Journal, Nov. 13, 1998, p. C1.

[5] Patrick Purcell, Congressional Research Service, "Social Security Individual Accounts and Employer-Sponsored Pensions," Feb. 3, 2005, pp. 3, 5.

could not be expected to meet the high fiduciary standards required of those responsible for educating and counseling employees, for presenting a new plan in the context of the employer's existing pension or other benefits, and for the timely and accurate transfer of funds for investment. The new TSP-like agency obviously could not provide such employer-type services to deal with tens of millions of diverse employees, either directly or on a contract basis.

Consider, as but one example of several profound administrative and legal issues, that about 650,000 businesses go out of business *each year*. By whom and how would the enforcement of contributions by delinquent or bankrupt employers be prosecuted? (Judicial remedies for denial of TSP benefits must, in general, be pursued by the affected individual TSP participant in the federal court system.) For that matter, by whom and how would breach-of-fiduciary-duty suits be brought against "mom-and-pop" fiduciaries? Can the employer of a housekeeper or a manicurist be expected to exercise the "care, skill, diligence, and prudence" demanded of every 401(k) plan fiduciary by current law? What would be the measure – and the limit – of their personal liabilities, say, for untimely or inaccurate investment of their employees' contributions? These questions only scratch the surface of the inevitable pathology of plan administration – pathology that, even if represented in small percentages among 155 million Social Security participants, would result in enormous absolute numbers.

**Untimely Investments.** The TSP is computerized, like all other large plans, with investments made for each employee's account on the same day that contributions are deducted from the employee's paycheck. Social Security taxes are deducted on paydays, but many small businesses send them to the IRS once each quarter. In 2003, 72 percent of employer reports to the Social Security Administration were submitted *on paper*. Moreover, individual Social Security taxpayers are identified only once each year, with their employer's annual income tax filings; and it would be up to 22 months after payday, under current SSA procedures, before individual IAs could be credited.

Furthermore, the Administration's proposal is to pay IAs the same annual return, regardless of when contributions were actually made during the year. Thus a contribution in January would not earn any more than a contribution of a similar amount in December. During a year of highly volatile markets, the attempted explanation of this provision to millions of outraged participants with irregular tax payments, because of illness, seasonal, temporary, or other periods of unemployment, would be a daunting challenge to the plan's telephone counselors.

**Unbalanced Accounts.** The TSP is balanced to the penny every day. The Social Security system is never balanced. Each year there are billions of dollars of unreconciled discrepancies between Social Security taxes paid to the IRS and reported to the SSA. These discrepancies are tolerated because they generally have little impact on the ultimate calculation of employee benefits. Such discrepancies are never tolerated by financial institutions responsible for timely investment of individual funds. Theoretically, IA contribution errors might be largely corrected by a rigorous examination of employer records. Yet the error correction procedures, including retroactive adjustments of investment gains or losses in volatile markets, could bring the entire system to a screeching halt.

**Inevitable Account "Leakage."** Unlike the TSP, the Administration's plan would prohibit loans and emergency withdrawals, and would require individuals to purchase annuities on retirement. I find it inconceivable, however, that Congress – or an Administration – would long be able to resist calls for emergency access to funds before a worker's retirement, and in lump sum amounts. Suppose, for example, that an individual has suffered a devastating personal financial loss, such as thousands experienced in last year's Florida hurricanes in the destruction of their homes. Would these persons be told that they may not access their IA balances to mitigate such dire misfortunes? What about a catastrophic illness, leaving a family's breadwinner unable to work? Could such persons be denied their account balances to sustain spouse and children? I don't think so. There are, of course, scores more such examples, and with 155 million potential participants, you can be sure that they all would arise. Administering the inevitable emergency withdrawal or loan program would add enormously to the cost of the Administration's plan.

**Communication Problems.** The TSP has a very effective communications system, because it can rely on the federal employing agencies to distribute plan materials and to educate and counsel their employees. Even so, the TSP found it necessary to have the central record keeper for its 3 million accounts maintain a staff of more than 200 telephone counselors to respond directly to questions from individual participants. Since more than 200 million Social Security taxpayers and retirees eventually would be eligible for IAs, the required number of telephone counselors would be more than 13,000, based on the TSP experience, and probably much higher because of the special IA deficiencies noted above.[6] Also, TSP mailings consistently have reached more than 99 percent of participants, but 25 percent of SSA mailings are returned as undeliverable.

Congress would undoubtedly insist that every effort be made to advise all Social Security taxpayers of the IA benefits Congress intended to provide them. The TSP sent summary plan documents to all 3 million eligible employees, which required 18 trailer trucks of printed materials. Similar documents would have to be sent eventually to the more than 200 million Social Security-covered employees and retirees.

The eventual costs of such massive efforts at this point are unknown, but they clearly would have a significant impact on IA expenses.

**Small Employer Antipathy.** Even if small businesses were able to perform normal employer functions for IAs, would they want to? IAs would be voluntary for employees but, if employees elect to have IAs, mandatory for their employers.

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[6] Fidelity Investments, a major 401(k) provider, has estimated that the administration of a 401(k)-type plan for Social Security taxpayers would require a total staff of 100,000. *See* Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998, p. 166.

The TSP and 401(k) plans generally are enthusiastically sponsored and supported by the large employers who offer them as a major benefit for their employees, and as a means to move away from defined benefit retirement plans that require employers to bear substantial investment risks. The major attractions of the TSP and 401(k)s generally are the matching employer contributions and the immediate tax benefit from excluding employee contributions from taxable income. The ability to borrow or withdraw funds to meet emergency needs is also a significant benefit. IAs, as currently proposed, would offer none of these benefits, and would be a relatively unattractive product that employers might be reluctant to support, especially small employers who do not have any pension plans. Moreover, it would be unrealistic to expect small-business employers to act as large corporate employers do in assuming the costs of investment losses because of, say, employer error in transmitting funds for timely investment of 401(k) accounts, or for myriad other commonplace employer errors. These serious concerns for small businesses would have to be addressed during congressional hearings on IA proposals. (See the examples of legal issues on page 5 above.)

**The Trust Fund Alternative**

Since IAs are certainly not feasible for employees of small businesses – the vast preponderance of the business community – the only practical way to give them the higher returns available from equity investments is to invest part of the Social Security trust fund in equities. That way, the overwhelming administrative costs and practical problems of the Administration's plan would be avoided. The total administrative cost of having the Social Security trust fund invest in the private funds proposed for IAs would be no more than one basis point, based on the actual costs of market investments by the Thrift Savings Plan. The likely increase in trust fund earnings would be an effective way to help maintain the solvency of the trust fund without having to resort to significant increases in Social Security taxes or reductions in benefits.

Every state in the United States has authorized public retirement fund investment in stocks. Yet the federal government still clings to the old notion that governments should not have an ownership stake in private companies, which made some sense when individual stocks were involved. Today's broad based index funds, however, remove the investor from direct control over particular companies. Small business employees should not be denied the benefits of portfolio diversification in the Social Security trust fund simply because the federal government has not kept up with the states in understanding the evolution of financial markets.

**Less Government Influence Over Private Companies.** As shown in the following chart, there is even less government influence over private companies under the trust fund alternative than under the TSP or the Administration's plan.

Government Influence Over Private Companies

| | Thrift Savings Plan | Administration Plan | Social Security Trust Fund Alternative |
|---|---|---|---|
| Selection of stock and bond index funds | Government decides | Same | Same |
| Selection of fund managers | Government decides | Same | Same |
| Selection of private record keeper | Government decides | Same | N/A |
| Selection of auditors and consultants | Government decides | Same | N/A |
| Selection of annuity providers | Government decides | Same | N/A |
| Selection of allocations among index funds | Individuals decide | Individuals decide | Government decides |

N/A – not applicable. (There would be no need for private record keepers, auditors, consultants, or annuity providers for trust fund investments.)

**Special Benefits for Trust Fund.** Unfortunately, some political leaders have convinced many of the public that the Social Security trust fund is not really invested because it has been "looted," and that the trust fund consists of "worthless IOUs." Nothing could be farther from the truth, and such statements betray an apparent ignorance of federal finance in our highest circles of government. The trust fund is fully invested in the best securities in the world – U.S. Treasury obligations. Private trust funds invest in Treasury securities in the open market, but the Social Security trust fund buys its Treasury securities directly from the Treasury, which is more efficient than if the Treasury were to issue the securities in the market and then buy them back for the trust fund.

Moreover, the trust fund actually gets a much better deal than the private funds that buy Treasuries in the market. The trust fund, by law, may redeem its securities before maturity at par value, rather than at the sometimes deep market discounts suffered by private investors during periods of rising interest rates. Also, since the trust fund gets its securities directly from the Treasury, it avoids the market transaction costs which private investors must pay. Finally, the law requires the Treasury to pay the trust fund an interest rate on all of its investments in Treasuries equal to the average yield on long-term Treasury marketable securities. This is a significant benefit to the trust fund, since long-term rates are generally much higher than short-term rates. Thus in recent years, private investors have been earning about two percent on their short-term Treasuries, while the Social Security trust fund was earning about four percent on effectively the same maturities. The public seems to be totally unaware of these subsidies to the Social Security trust fund, which have been there for many decades.

**Trust Fund Dedicated to Social Security.** The assets of the Social Security trust fund consist of investments in Treasury securities solely for future beneficiaries. Yet political leaders from both parties complain that the Treasury has "spent" the trust fund surplus on government programs. What on earth do they expect the Treasury to do with the money – bury it in the Treasury's back yard? The Treasury also spends the money it raises by issuing Treasury securities in the market. Does that mean that the private investors in Treasuries are also being "looted" by the Treasury? Of course not. The scandal would be if the Treasury left the trust fund uninvested and not earning interest. Then the Secretary of the Treasury would be in effect saying "I *don't* owe you," and that indeed would be a worthless IOU.

So why do government officials find fault with perfectly sound financial practices? From ignorance, as I suggested earlier? – or is it is because they are trying to hide the real problem, which is the unique way this major government program is treated in the budget? Social Security expenditures are excluded from the budget and thus from the restraints on other government spending, which is proper since they are entitlements, and cannot be restrained under existing law. But the Social Security surplus is then, inconsistently, included in the calculation of the overall budget deficit, for the sole purpose of appearing to have achieved deficit, and thus spending, reduction. Then, having committed this accounting farce, officials have the audacity to complain that the misleading budget treatment of the trust fund surplus makes it available to finance other programs. The problem here is not the financing of the trust fund, but the political gimmickry of its budget treatment.

**Conclusion**

In conclusion, the Administration's plan for universal IAs is not feasible, and it should not survive the process of responsible Congressional hearings. The only practical way for the Social Security system to capture the higher returns available from investments in stocks is to diversify Social Security trust fund investments. The trust fund alternative, compared to IAs, would involve less government influence over private companies, would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and could be effective virtually immediately, rather than the 2009 starting date proposed for IAs. The multi-trillion dollar transition costs proposed by IA proponents would be avoided. The additional trust fund earnings would go a long way toward strengthening Social Security finances, and would thus reduce, if not eliminate, the need for significant tax increases or benefit reductions.

Thank you for your attention. I would be pleased to answer any questions.

**Testimony by Estelle James, House Committee on Financial Services, May 5, 2005**

Over the past 20 years more than 30 countries, spread across Latin America, Eastern and Western Europe, Australia and Hong Kong, have adopted social security systems that include funded privately managed plans, usually based on personal accounts. Contributions to the accounts range from 2.5% to 12.5% of wages and they are projected to supply between 30% and 80% of total benefits.

In Latin America and Eastern and Central Europe the accounts were created by a carve-out from existing payroll taxes. In industrialized countries, such as Australia, Switzerland, Netherlands and Denmark, employers have long provided plans that covered about half the labor force on a voluntary basis. Governments decided it was important to cover the remaining half so they made employer-sponsored plans mandatory, as an add-on for employers that didn't already provide them. Although this option hasn't been much-discussed, this suggests one way that we could go in the US.

I am going to discuss how these 30 countries handled three issues—how to keep administrative costs low, how to control risk and protect low earners, and how to make payouts. I would like to stress two things: First, workers do not have free rein over the funds in the accounts. Instead, the accounts are tightly regulated and ownership rights are attenuated. The UK ran into trouble when it gave too much choice and too little regulation. Second, details matter. Seemingly small changes in rules can have a large impact on final outcomes. So you really need to look at dry details very closely.

**Administrative costs**

If a worker contributes to an account each year and pays an annual administrative fee that is 1% of the assets in the account, when he retires his accumulation and pension will be 20% less than it would be if there were no fee at all. Obviously, keeping costs and fees low is essential in order to get good value for money. Much criticism of personal account systems, such as that in Chile, has focused on its supposedly high administrative costs. Chile indeed had high costs in its first few years—start-up costs are always high—but currently they are 1.2% of assets per year and projected to be .7% of assets for full-career workers. This is lower than the average mutual fund IRA and 401k in the US.

However, I believe we should be able to do better still in a mandatory system, by exploiting economies of scale and eliminating marketing expenses. If we adopt measures such as competitive bidding for a limited number of asset managers, passive investment, and centralized record-keeping, I estimate that the expense ratio will be less than .3% or 30 basis points once the average account size exceeds $7000—that is, after 8-10 years of operations. This estimate is consistent with the Administration's plan.

However, if workers are given the right to opt out into a broader range of mutual funds once their accounts reach $5000, as some have suggested, the average account size in the basic system will never reach $7000 and costs will remain over .3% for everyone. This is a good example of how little details matter a lot.

**Controlling risk and protection of low earners**

We can never fully eliminate risk in financial markets but we can adopt measures that keep risk relatively low. Diversification across companies, sectors and even international diversification is a classic way to reduce volatility. Gradually reducing exposure to equities as retirement approaches, so workers are not hit with an unusually low stock market or interest rate on the date they convert to annuities is another important technique. In addition, every country that has a personal account system also has a minimum pension, most commonly 20-30% of the average wage. This is designed to protect workers from both financial market and labor market risk. So far, we do not have a minimum pension in our current system or in the proposed new system.

**Payouts**

Practically every country with personal accounts restricts payouts. Most European countries require annuitization, to ensure that workers will have a life-long income. In Latin America payouts must take the form of annuities or gradual withdrawals. In Chile, 2/3 of all retirees have annuitized. Lump sum withdrawals are not permitted unless the pension meets a high threshold, such as 70% replacement of the worker's own wage and 200% of the poverty line. This is much higher than the threshold proposed by the Administration, which allows lump sum withdrawals at 100% of the poverty line.

Some countries also require that annuities be indexed (to provide inflation insurance) and joint (to cover surviving spouses)--which is very important for women. In Latin America women are allowed to keep their own pension in addition to the joint annuity, so that married women who work in the market and contribute for many years are not penalized, as they are in this country. As a result, women's expected lifetime benefits relative to men's have increased in the new system.

**Conclusion**

In sum, the devil is in the details. Personal accounts can give us good or bad outcomes, depending on how we design them. The experience of other countries shows that if we carefully structure the choice of asset managers, investments and payouts and provide a pension floor, including personal accounts in a reformed social security system will continue to provide lifelong income for the elderly in a cost-effective, low risk way.

# Pre-Release Draft

## Reforming Social Security: Lessons from Thirty Countries

by

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## Executive Summary

Social Security reform in the United States has become a nationally debated topic, but privately managed, funded plans are already a component of the social security systems of more than 30 nations around the world. Chile, Switzerland, the Netherlands and the United Kingdom were the first countries to reform, in the 1980s. Most countries in Latin America, Eastern and Central Europe, as well as some in the Asian-Pacific region, created similar systems during the past 10 years. The Latin American and Eastern European countries funded their worker-based personal account systems by diverting money from a pre-existing payroll tax. By contrast, the industrial countries in Western Europe, along with Australia and Hong Kong, made employer-based retirement plans mandatory, in addition to their tax-financed systems.

Examining these reformed systems may offer useful insights for the United States as we consider our own social security reforms. The experience of other countries suggests problems to be avoided and solutions to be emulated. In particular, we can learn how to keep administrative costs low, how to reduce risk, how to handle payouts and how to ensure that the elderly are kept out of poverty.

**Structural Differences and Similarities.** Although most pension reforms have similar goals, we find dramatic structural differences and also some striking similarities among them. For example:

- Contributions to personal accounts range from a low of 2.5 percent of wages in Sweden to a high of 12.5 percent (including fees) in Chile.
- In most cases, contributions are made with funds that otherwise would have been paid as payroll taxes (called a "carve out"); however, in the mandatory employer-based plans the contributions are typically in addition to payroll taxes (an "add on").
- Most countries that use a carve-out approach gave individuals already working a choice between the old and new systems; but practically every country (except Argentina, Colombia and the United Kingdom) requires new labor market entrants to enroll in the new systems.
- Most of the reformed systems use worker-based accounts and workers choose their own fund managers and investment portfolios, subject to regulations. In a smaller number of countries, mostly industrialized ones, employers, sometimes together with unions, choose investment strategies for the private pension plans.
- Administrative costs are generally much lower after several years experience, as the asset base grows. Currently they range from a low of 0.7 percent of assets or less in Sweden and larger, mature employer-based plans in Australia, Switzerland and the Netherlands — to 1.2 percent in Chile — to a high of 20 percent or more during the first year of operations in countries like El Salvador and Poland.
- The private benefit is projected to provide workers with more than 70 percent of their total mandatory retirement income in most of the Latin American countries and around half of the

total in Western Europe and Australia. Eastern and Central Europe and the former Soviet Union have adopted a variety of systems — ranging from Kazakhstan, which adopted the Chilean model, to Bulgaria and Latvia, where the private benefit provides less than 30 percent of the total.

- Typically countries require workers to receive their retirement benefits in the form of an annuity or gradual withdrawal from their personal retirement accounts. However, most Latin American systems allow lump-sum withdrawals once retirees have a stringent threshold, such as purchasing a pension that is 70 percent of their preretirement wages or 200 per cent of the poverty line.
- Every country with individual accounts provides a minimum income, in the form of a minimum pension guarantee or a flat (uniform) benefit to retirees, most commonly between 20. In most cases this is between 15 percent and 30 percent of the average wage.

**Keeping Administrative Costs Low.** A 1 percent annual expense ratio reduces the final accumulation and pension by 20 percent for the full career worker. Administrative costs vary widely across countries and time, allowing us to learn which techniques keep costs low. In all systems, startup costs mean that expenses will be high initially and economies of scale mean that they will fall over time as a percent of assets, as average account size grows. Administrative costs have been lower in the wholesale, or institutional, market used by employer-based systems and higher in the worker-based systems that invest small individual accounts through the retail market, incurring high marketing expenses. Passive investment also reduces costs. All Eastern and Central European countries (with the exception of Hungary) and about half the Latin American countries use centralized collection systems, piggybacking on the tax or social security system (or, in the case of Croatia, a private clearinghouse) to keep marginal collection costs low. The employer-based systems in Western Europe, Australia and Hong Kong, in contrast, use a decentralized method, since each employer manages its own plan.

What could a well-run U.S. system expect? Assuming that the system (1) keeps record-keeping and communication costs per account to about $20 per year (the estimated cost in the Thrift Saving Plan for U.S. federal workers and low-cost mutual funds), (2) invests in low-cost index funds and (3) chooses a limited number of asset managers in a competitive bidding process (thereby harnessing the institutional market), after eight to 12 years the annual expense ratio in the new personal account system will be 3/10ths of 1 percent of assets (30 basis points) or lower. This isless than what people with small accounts would pay in the mutual fund market today.

**Reducing Investment Risk.** In most countries with worker-based plans, financial markets were undeveloped and investment choices were tightly circumscribed at first, limited to government bonds and bank deposits. In some cases, most notably Chile, financial markets have matured considerably in part due to their pension reforms. As a result, investments are now diversified across corporate bonds, equities, mortgage-backed securities and international funds — diversification is the best way to reduce risk.

Although a variety of investment portfolios are now offered in Chile, the proportion that can be invested in stocks remains limited for those nearing or past retirement age. This is an example of "life cycle investing" (a gradual shift out of stocks and into bonds or annuities over a period of years for older workers), designed to reduce their exposure to a sudden drop in the stock market or the interest rate.

In addition, some countries require fund managers to offer absolute or relative rate of return guarantees for the private accounts. For example, pension funds in Kazakhstan must guarantee that no one will lose money (or earn a negative rate of return). Switzerland's pension funds must pay at least a 4 percent nominal return (recently reduced to 2.5 percent) over the worker's tenure with his employer. Chile and many other Latin American countries penalize funds whose rate of return deviates from the industry average by more than 2 percentage points. The object is to reduce volatility across time and disparities across individuals. A better way to accomplish this, in countries with well-developed financial markets, is to require that portfolios closely track broad stock market benchmarks such as the S&P 500 or Wilshire 4500 or to use options to protect workers from a sharp downturn in the stock market. Large employer-based plans have used these techniques for many years. New financial instruments are being developed for sharing risk between individuals, asset managers and insurance companies, during the accumulation and payout stage.

**Protecting Against Poverty.** All countries with individual retirement accounts guarantee a minimum benefit to workers who participate in the system. This is usually financed by the government, out of general revenues. Most Latin American countries guarantee a minimum income from private accounts, while most Eastern and Central European countries maintain a floor on the traditional pay-as-you-go benefit. Most countries with employer-based plans accompany these with a flat benefit that is paid to all older residents regardless of earnings and contributions, although in some casesthese benefits have been partially replaced with means-tested benefits. Most commonly, the minimum pension varies between 20 percent and 30 percent of the average wage.

**Protections for Women.** Minimum benefit guarantees are especially important for women, who are at a greater risk of old-age poverty than men due to their longer life expectancies and time spent out of the labor market. In Latin American countries, wives are also protected by a group survivors insurance policy that covers all workers and by a requirement that, upon retirement, husbands purchase a joint pension from their individual accounts. Widows of retirees get a survivor's benefit — but it is financed by their husbands rather than by taxpayers. Widows get to keep their own pension in addition to the joint pension. In Chile, Argentina and Mexico, the minimum pension combined with the joint pension mean that the relative position of women is projected to improve after the pension reform. The lifetime benefits of married women with full work careers are projected to equal to exceed the lifetime benefits of men.

# Introduction

Since 1980, more than 30 countries around the world have adopted some kind of privately managed plan, usually based on personal accounts, as part of their social security systems. Each has done so in a different way. As the United States considers Social Security reform, including some form of personal accounts, it may be useful to examine options that other countries have implemented. This paper surveys the approaches they have used to resolve key issues, such as how to keep costs and risks low, protect vulnerable groups and make sure that the accumulation in the account lasts for the individual's lifetime. The experiences of these countries do not offer answers to all our questions, but they do suggest the range of options available to us and some of their potential effects (both good and bad).

*"More than 30 countries have reformed their social security systems to prefund some benefits, usually from personal accounts."*

Prefunding Social Security through investments that earn a market rate of return can help make the system more sustainable. It would avoid passing a large debt on to our children, and could help to increase national saving, and therefore productivity and growth. But if the government manages the funds, several dangers emerge that could negate these potential advantages: If invested exclusively in government bonds, the funds may end up increasing government deficits; if invested in the stock market, they may lead to conflicts of interest between government as regulator and as investor; and their use could be subject to political manipulation and the misallocation of capital. These are the main arguments for establishing personal accounts, with private management of the funds.

But private management of social security funds also entails potential problems. Administrative costs may be high, thereby reducing final pensions; financial market risk adds uncertainty to retirement income; some workers may not accumulate enough to keep them out of poverty during old age; retirees may use up their accumulation too quickly; and the transition financing gap may increase the nation's explicit debt.

How we solve these potential problems determines whether the new system is good or bad and whether it improves or harms the welfare of future workers and retirees. The devil is in the details. Fortunately, we can learn from the experience of others.

## The Basic Structure of Personal Accounts

Most of the countries we examine in this study began with traditional pay-as-you-go defined benefit systems, similar to the United States. When these countries reformed their retirement systems, they shifted part of the responsibility for benefits to the private sector, usually to defined contribution plans, also known as personal accounts. But the proportion of benefits that was shifted varied widely, as did the management of funds. How much of these systems remain as government-paid, pay-as-you-go benefits? How large are the personal accounts? How are they managed? And what explains the differences across countries?

**Worker-Based versus Employer-Based Plans.** In the well-known case of Chile, the worker chooses the investment manager for the retirement funds, a pattern evident across Latin America and Eastern Europe. When these public systems were reformed, they were typically near insolvency, beset by evasion and inequities, and publicly discredited. Major change was needed.

In Western European countries (Switzerland, Denmark and the Netherlands), as well as Australia, the employer, sometimes together with a union, makes the investment choice [see Table I]. In these countries, employers are primarily responsible for private pensions, while the government continues to provide a separate public benefit, as it did before the reform. These are countries with long histories of employer-sponsored plans, traditionally defined benefit and often due to collective bargaining. During the 1980s and 1990s the governments of these countries realized that while employer-sponsored plans provided good pensions for half of the labor force, they did little or nothing for the other half. They also realized that, with aging populations, the bottom half of the income spectrum would become a growing fiscal burden unless private pensions were in place. Therefore, they mandated that virtually all employers provide retirement plans for virtually all their workers.[1]

*"In Latin America and Eastern Europe, workers choose a private manager to invest their personal accounts."*

In effect, this was an add-on for employers who didn't already provide such plans. The mandate was made explicit in Switzerland in 1985, and later on in Australia and Hong Kong. It was achieved in a less formal way in Denmark and the Netherlands, but with similar effects. In the United Kingdom, employers are not required to provide a pension plan, but they can opt out of the government plan by providing an equivalent private pension and they get a tax rebate if they do so. British workers can opt out of the government system or their employer's plan into their own personal plans.

In most of these countries, employers who didn't previously have pension plans have added defined contribution plans. And, many employers are transforming their preexisting defined benefit plans into defined contribution plans, just as has occurred in the United States. As this happens, control over investment choices for the personal accounts shifts toward workers.

**Defined Benefit versus Defined Contribution Plans.** Employers around the world have found that in globally competitive labor and product markets they are unable to credibly insure against longevity and investment risk, which is the goal of defined benefit plans. If investment returns are lower than expected, or if workers live longer than expected, employers (facing competition from other firms without these pension burdens) will be unable to come up with the extra money needed to keep their promises in the long run. And if employers try to avoid these risks by conservative funding policies, their costs will be higher than those of competitors who accept higher risk, in the short run. Regulations have placed increasing financial burdens on defined benefit plans to make their promises credible. Additionally, defined benefit pensions are difficult for workers to carry from one job to another. In contrast, defined contribution plans are typically more portable and help employers avoid longevity and investment risk. As a result, even though some employer-sponsored defined benefit plans remain, they are gradually being phased out, and in this paper we sometimes refer to all private plans that are part of social security as personal accounts.[2]

Although employers (sometimes together with unions) chose the trustees and the investment strategy under defined benefit plans, it is likely that workers will increasingly demand this power as the shift to defined contributions takes place — since they bear the risk and receive the return. In Australia, legislation has just given workers increased choice, and this will probably happen elsewhere as well.

**Contribution Rates to Personal Accounts.** Table I depicts the contribution rates to personal accounts, which vary from 2.5 percent in Sweden to 10 percent or more in a number of other countries. Assuming a worker works for 40 years, has real wage growth of 1.5 percent per year, realizes an investment return net of administrative expenses of 4.5 percent per year, and retires with 20 years of expected lifetime, these varied contribution rates will provide pensions from the accounts that range from 14 percent to 56 percent of final salary. Except for Sweden, no country plans to keep its contribution rate to the accounts below 4 percent. In fact, it would not be efficient to have smaller accounts, because the fixed administrative expense per account would significantly reduce gross investment returns. (Sweden can do this only because its high average income results in fairly large accounts, even with a 2.5 percent contribution rate, and it has taken special measures to keep administrative costs low.)

*"Contribution rates to personal accounts vary widely among countries."*

Contribution rates to the employer-sponsored plans tend to be higher than average, perhaps because defined benefit plans require higher contribution rates, given the aging labor forces in these countries.

**Private Sector versus Public Sector Benefits.** All countries have retained some kind of public benefit, in addition to the new private benefit. Table I and Figure I depict the share of total benefits an average worker can expect from his account. The private share of benefits is much larger than the private share of contributions, since the expected rate of return on the accounts is usually greater than what pay-as-you-go systems can credibly promise. For example, in Sweden, which has the smallest private pillar in relative terms, about 14 percent of total contributions go *into* the accounts; but 30 percent of total benefits are projected to come *from* the accounts.

In most some cases the public benefit is partly or wholly financed out of general revenues, rather than by an earmarked contribution [see Table III]. Often the public benefit is progressive, so it provides a higher proportion of

TABLE I

# Nature and Size of Private Funded Pillar

(personal accounts)

| | Year Operations Began | Rate of Contributions to Accounts[a] | Percent to Total Benefits from Accounts[b] | Add-on (A) or Carve-out (C) | Mandatory or Voluntary[c] | Worker- or Employer-Based |
|---|---|---|---|---|---|---|
| **Latin America** | | | | | | |
| Argentina | 1994 | 7.7% | medium | C | V | W |
| Bolivia | 1997 | 10.0% | high | C | M | W |
| Colombia | 1994 | 10=>12% | high | C | V | W |
| Chile | 1981 | 10.0+2.5% | high | C | V | W |
| Costa Rica | 2000 | 4.25% | low | C | M | W |
| Dom. Rep. | 2003 | 8.0% | medium | C | V | W |
| El Salvador | 1998 | 10.0% | high | C | V | W |
| Mexico | 1997 | 7.0% | high | C | M | W |
| Peru | 1993 | 8.0% | high | C | V | W |
| Uruguay | 1995 | varies | medium | C | V+M | W |
| **Eastern and Central Europe and Former Soviet Union** | | | | | | |
| Bulgaria | 2002 | 2=>5.0% | low | C | V | W |
| Croatia | 2002 | 5.0% | low | C | V | W |
| Estonia | 2002 | 4.0+2% | medium | C+A | V | W |
| Hungary | 1998 | 6=>8 | medium | C | V | W |
| Kazakhstan | 1998 | 10.0% | high | C | M | W |
| Kosovo | 2001 | 10.0% | high | A | M | W |
| Latvia | 2001 | 2=>9.0% | low | C | V | W |
| Macedonia | 2003 | 7.0% | medium | C | V | W |
| Poland | 1999 | 7.3% | medium | C | V | W |
| **Western Europe and Asia-Pacific** | | | | | | |
| Denmark | 1993 | 9% | medium | A | M | E |
| Netherlands | 1986 | 14% | medium | A | M | E |
| Sweden | 2000 | 2.5% | low | C+A[d] | M | W |
| Switzerland | 1985 | 10%[a] | medium | A | M | E |
| UK[d] | 1978-88 | varies | medium | C | V | E or W |
| Australia | 1992 | 9.0% | medium | A | M | E |
| Hong Kong | 2000 | 10.0% | high | A | M | E |

Notes:

a. Contribution rate is usually gross of fees, but in some cases fees are additional. In Chile fees totaling about 2.5 percent of wages are added to cover disability and survivors insurance and administrative costs. In some cases, e.g., Bulgaria and Latvia, contribution rates start small but are supposed to rise. For employer-based plans in Western Europe, which include some defined benefit plans, a required contribution rate is not specified and contributions vary by year and age of worker — usually between 10 and 15 percent of wages. In Switzerland 10 percent is the estimated average contribution, based on current total contributions by employers/total wage bill.

b. High means 70 percent or more, low means 30 percent or less, medium means 40 to 60 percent. (See Figure I.)

c. Except in Argentina and Colombia, all new entrants to labor market had to join new systems. This column indicates cases where current workers were given a choice to voluntarily join the new system, versus cases where participation was mandatory. In Mexico everyone had to switch but retained the right to return to the old system upon retirement if this yields a higher pension. In Uruguay the switch was mandatory for high earners, voluntary for others.

d. The U.K. state earnings-related plan (SERPS) started in 1978. Employers were given the right to opt out at that time if they provided benefits that were at least equivalent. In 1988 workers were given the right to opt out of state plan or employer plan to start their own account. Currently, the United Kingdom has worker and employer-based plans as well as the state plan. Workers or employers who opt out get age-related payroll tax rebates. In Sweden the new system explicitly required an 18.5 percent contribution, of which 2.5 percent was allocated to the account; in that sense it was a carve-out. However, this was a political compromise in which some influential parties were unwilling to raise the total contribution above 16 percent without the accounts; in that sense it was an add-on.

Sources: Contribution rates for Latin America and Eastern Europe are from Robert Palacios, "Pension Reform in Latin America: Design and Experiences," and Agnieszka Chlon-Dominczak, "Evaluation of Reform Experiences in Eastern Europe," both in *Pension Reforms: Results and Challenges* (Santiago, Chile: Federacion Internacional de Administradoras de Fondo de Pensiones, 2003). Contribution rate for Netherlands is from van Ewijk, Casper and M. van de Ven. Draft paper on second pillar in the Netherlands, 2005. Contribution rate for Switzerland is based on personal communications with Monika Buetler. Other contribution rates and benefit shares from Estelle James and Sarah Brooks, "Political Economy of Structural Pension Reform," in *New Ideas About Old Age Security*, Robert Holzmann and Joseph Stiglitz, eds. (Washington, D.C.: World Bank, 2001). Numbers in other columns from miscellaneous country studies.

*"The percentage of benefits paid from personal accounts also varies."*

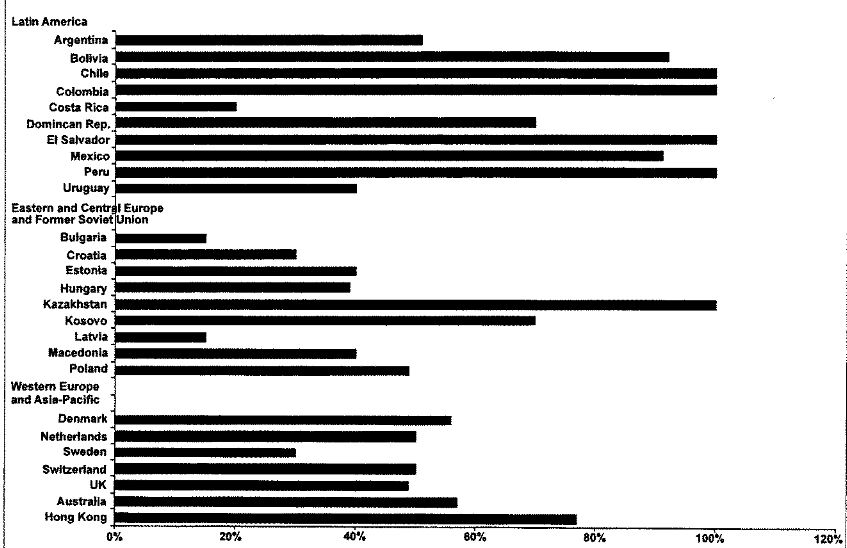
total pension income to low earners than to high earners. For example, in Chile, which has the largest private pillar in relative terms, 100 percent of contributions go into the accounts and, for the average worker, the personal account pays 100 percent of benefits. [See Figure I.] But the minimum pension guarantee, which is Chile's public benefit, is financed from general revenues and will provide about 20 percent of the total benefit for low earners.

Table I and Figure I show that countries are basically divided into three groups: those where the personal accounts have almost the full responsibility (high) for supplying retirement benefits, those where personal accounts have supplementary responsibility (low), and those where the responsibility is shared roughly equally between the public and private benefits (medium).

FIGURE I

## Share of Benefit from Funded Accounts Across Countries

**percentage of benefit from private pillar for average worker**




Sources: Simulations from Estelle James and Sarah Brooks, "Political Economy of Structural Pension Reform," in *New Ideas About Old Age Security*, Robert Holzmann and Joseph Stiglitz, eds. (Washington, D.C.: World Bank, 2001 and data from Robert Palacios, "Pension Reform in Latin America: Design and Experiences," and Agnieszka Chlon-Dominczak, "Evaluation of Reform Experiences in Eastern Europe," both in *Pension Reforms: Results and Challenges* (Santiago, Chile: Federacion Internacional de Administradoras de Fondo de Pensiones, 2003).

- Most Latin American countries depend primarily on the personal accounts, following the Chilean example, where workers may divert (carve out) their full payroll tax to the accounts while the government simply provides a minimum pension guarantee.
- In contrast, some Eastern and Central European countries, as well as Sweden, depend primarily on the traditional benefit, with the personal account playing only a modest supplementary role (in some cases, this role is projected to increase over time).
- In between are the industrialized countries of Western Europe and Australia, where responsibility is shared almost 50-50 between the public and add-on private benefits.

*"Many countries have funded personal accounts by diverting payroll taxes from the old system."*

How can we account for these differences in relative size of the private benefit and the use of add-on versus carve-out? Countries of Eastern and Central Europe typically have large implicit pension debts due to aging populations and generous benefits owed to workers and retirees in the traditional systems. These countries were more likely to start relatively small private plans, because they could not afford the high transition costs they would face with a larger shift of contributions. Nor could they afford an add-on in view of their already high payroll tax rates, which often exceeded 25 percent.

The opposite is true for countries with younger populations and smaller pension debts, such as those in Central America. Workers could and did divert most of their contributions to the accounts. Finally, countries like Switzerland, the Netherlands and Australia were able to move toward a 50-50 division with an add-on approach. They had relatively small contribution rates or financed their public benefits from general revenue, and they added mandates for substantial employer pensions that will provide about half of most workers' total pension.[3]

*"Given the choice, most workers have switched to the new system."*

**Voluntary versus Mandatory Personal Accounts.** Practically every country that has established worker-based accounts used a payroll tax carve-out — diverting part of the contribution from the traditional system.[4] Switching to personal accounts was usually voluntary for existing workers but mandatory for new entrants to the labor force. Once a person switched, this choice was usually irrevocable.[5] Allowing individual choice over changing from public to private plans reduces political opposition and transition costs, since some workers may choose not to switch. However, the past 25 years have shown that, given the opportunity, the vast majority of workers have switched; almost all younger workers have switched; and in total, many more workers switched than was projected — demonstrating their lack of confidence in their old systems. Therefore, transition costs have been higher than expected.

Making the new system mandatory for new entrants to the labor force ensures that the old system will eventually phase out of existence. Colombia and Argentina have not included this mandate and have kept the two systems existing side by side. The old system has few participants, but imposes duplicate administrative costs on everyone.

## Personal Account Investments in Chile

Chile's personal account retirement system has extensive regulations to reduce the disparities on investment returns across time and individuals. Workers are required to invest their retirement savings with one of a small number of highly regulated pension fund administrators (known by their Chilean acronym as AFPs). When the personal account system began in 1981, almost all the money was invested in bank deposits and government bonds, practically the only investments available in Chile's then-undeveloped financial markets. However, financial markets have developed in Chile over the past 20 years and funds are now invested in a variety of instruments including mortgage-backed securities, equities and foreign securities.

Until recently, each AFP could offer only one investment portfolio, and all portfolios were similar. In 2002 Chile modified the rules to allow each AFP to offer five different portfolios with different degrees of risk. The allowable proportion in stocks for prime-age workers varies from 0 to 80 percent, although the equity limit is 60 percent for workers near retirements and 40 percent for pensioners on gradual withdrawal. The default limit on stocks for workers who do not choose is 60 percent, 40 percent and 20 percent, for these three groups, respectively.

Chile, like some other countries, requires AFPs to guarantee a relative rate of return, which sets limits on the degree to which an asset manager can deviate from the industry average. For example, if an asset manager in Chile beats the industry average return by more than 50 percent or 2 percentage points (whichever comes first), it must put the excess into a special reserve fund. Conversely, when the manager earns 2 percentage points less than the industry average, it must make up the difference by drawing down the reserve fund and then by dipping into owners' equity, if necessary. This has led to "herding," such that all AFPs have offered very similar portfolios. When multiple portfolios were authorized to solve the herding problem, different rate-of-return bands were established for each type of portfolio. While herding may have reduced investment choices in the past, the purpose of this guarantee — to reduce volatility across time and disparities across individuals — remains worthwhile in a mandatory system. In a country like the United States, with well-developed financial markets, indexing to a benchmark such as the S&P 500 or the Wilshire 4500 would be a better way to accomplish this goal. Such benchmarks did not exist in Chile in 1981.

Over the first 22 years of the private system's existence, the annual rate of return after fees averaged 10 percent above inflation — far above the rate that any country could maintain in the long run. However, even lower returns can ensure comfortable retirements for workers who contribute over their entire working life. Currently, the AFPs manage more than $50 billion in assets.

In contrast, countries that used employer-based plans as the basis for privately funded social security benefits effectively imposed an add-on for employers who did not already offer such plans, and participation was mandated for virtually everyone. (If an add-on is voluntary, it is no longer part of the mandatory social security system.) While employers were required to add a benefit, the cost of that mandate was undoubtedly passed back to workers in the form of lower wage growth over time. For example, in Australia the new pension contribution by employers was an explicit trade-off for wage growth in an inflationary environment.

**How Much Choice among Investment Portfolios?** When the Latin American and Eastern European countries initiated their personal account systems, their financial markets were undeveloped, with limited financial instruments. And, few workers had any investment experience. As a result, investment choices were tightly circumscribed, with strict limits placed on equities, derivatives and foreign investments. Bank deposits and government bonds were the main investments. Diversification was limited because financial instruments were limited and international investment, which would have permitted much greater diversification, was restricted. Moreover, relative rate of return guarantees (described below) led most asset managers to offer similar portfolios — giving workers little choice. [See the sidebar, "Personal Account Investments in Chile."] The basic ethos at the beginning was to be cautious, prevent disasters and wide disparities across individuals, and liberalize later as workers developed financial experience.

*"Chile allowed more investment choices as financial markets developed."*

In some cases, most notably Chile, financial markets have developed considerably over the past 20 years, in part due to their pension reforms. Consequently, countries are now gradually liberalizing these restrictions, with Chile taking the strongest steps in 2002, when it opened the door to multiple portfolios, including some with considerable equity and international exposure.

Employer-sponsored plans, in contrast, were mandated in countries with well-developed financial markets and employers who had years of experience operating in those markets. So a much wider range of investment choice and diversification was permitted from the start.

In worker-based defined contribution plans it is desirable for individuals to have some discretion over investment portfolios, allowing workers with different degrees of tolerance for risk to make different risk-return trade-offs. However, the British experience, where workers could choose between their own account, their employer's plan and the state plan, illustrates that unconstrained choice is not necessarily better. Many inexperienced workers chose poorly. Choices need to be carefully structured to enable inexperienced investors to use it well. [See the sidebar, "The British System."]

**Lessons for the United States.** Compared with other industrialized countries, the United States currently has a trust fund surplus and a relatively small pension debt stemming from our younger population — which makes it easier to divert some of the current payroll tax into personal accounts. On the other hand, we have a relatively low contribution rate, which makes an add-on easier. Our public benefit rate is relatively low, which limits the degree to which it should be cut. Viewed from this comparative perspective, the United States should be able to move toward personal accounts that have a contribution rate of around 4 percent (which could be phased in), on the basis of a mixed add-on plus carve-out. This would cover about half of the total expected benefit for the average worker.[6]

## The British System

The experience of the United Kingdom shows that personal retirement accounts can be good or bad, depending on how they are designed.

Until the late 1970s the United Kingdom had only a simple "flat" (uniform) social security benefit — about 24 percent of the average wage, supplemented by generous, voluntary employer-sponsored defined benefit pensions that covered about half the labor force. In 1978 the government added an earnings-related component — the State Earnings-Related Pension Scheme (SERPS) — to the flat public benefit. Employers who offered equivalent benefits could opt out of SERPS and get a tax rebate. Beginning in 1988, workers were also allowed to opt out of their employer's plan or SERPS by putting a tax rebate (like a carve-out) into a personal account. Initially, there were few regulations on the accounts and little oversight.

About three-fourths of all workers have taken up one of the private options (the employer plan or their own plan). However, low-income workers generally would have done better by staying in SERPS, which has a progressive benefit formula, and workers with long-tenured jobs would have done well to stay in their employer's plan, since they lost their accumulated benefits when they opted out. But the commissioned salesmen who sold the personal accounts didn't mention these details. Nor did they mention the high fees many accounts carried, that will reduce final pensions by 25 to 30 percent or more. Many workers made the wrong decision, switched and lost billions of pounds in forgone benefits. The lesson is that unfettered choice is a mistake in a mandatory old age security system because many workers are inexperienced in assessing financial alternatives. Structured choice is needed to prevent big mistakes and high fees.

U.K. workers can also opt back into SERPS. The system gives them incentives to do so. You earn more by putting your contribution into your personal account when you are 20, since it will compound interest for 45 to 50 years. But when you are 50 you get a better deal by putting it into the government's pay-as-you-go system, which gives you the same credit for a year of contributions regardless of age. Older workers are now switching back and that will be costly for the public treasury.

In 1981, the government changed its flat benefit, which had been indexed to wages, to price-indexation. Wages generally go up 1 to 2 percent per year faster than prices, due to productivity gains. As a result of the change, the basic pension is now barely 15 percent of the average wage — considerably below the poverty line or the average standard of living. In fact, it is lower than the income threshold for means-tested (welfare) benefits. The British have practically eliminated the unfunded liability of their basic benefit. But more than one-third of British pensioners receive means-tested benefits and this proportion is expected to increase.

The British system was designed with too much choice and too little safety net. But no British government has proposed getting rid of personal accounts. That is because it would require a large increase in the current tax rate to pay the full pension that people expect through a public pay-as-you-go system.

We could move directly toward a new system of personal accounts that workers manage themselves, or we could build on existing employer-sponsored plans. First some comments on the latter option.

The most common employer-sponsored plans are 401(k) plans, under which contributions are deducted from employees' wages before taxes and are deposited in mutual funds, often with a matching contribution from the employer. These plans appear to be working well for much of the labor force. But some participants make poor investment choices or face high administrative costs, and therefore experience low net rates of return. Some concentrate their investments in the company where they work, thereby increasing their risk because of the lack of diversification. Some young and low-income workers do not participate, or withdraw their savings before retirement, and many small employers do not offer any retirement plan for their workers. If we wanted to make employer-sponsored 401(k) plans part of our Social Security system, we would have to regulate them more tightly and make participation mandatory. Small employers who do not currently have such a plan (and larger employers who want to avoid the administrative burden) could be required to "add-on" contributions to low-cost pooled index funds, patterned after the Thrift Saving Plan (the retirement plan for federal civil servants). This approach would eventually achieve lower administrative costs than existing 401(k)s and could gradually replace many existing employer plans.

*"A 4 percent contribution to personal accounts would fund about half the scheduled retirement benefits of U.S. workers."*

In contrast, if we choose to develop a new system of worker-based accounts, this could be done through an add-on or a carve-out or a mixture of the two. If a carve-out is used, switching could be voluntary, to defuse opposition from workers who do not want to face financial market risk. If they did stay in the old system, transition costs (discussed later in this study) would be reduced — but in making projections we should anticipate that most workers under the age of 50 are likely to switch. The choice to participate in these accounts should be irrevocable and mandatory for new labor market entrants or for all workers under a designated age, such as 35.

If we finance the accounts partly through an add-on, participation for all workers under some age such as 35 would have to be mandatory from the start (otherwise it would simply be part of voluntary retirement saving, which we have now, and is unlikely to expand coverage). In either case, some degree of mandate would be involved and low risk investment options, such as inflation-indexed treasury bonds would have to be offered for those who preferred to avoid financial market risk.

The United States has the most sophisticated financial markets in the world. But many workers, especially low-income workers, have had little investment experience. Therefore we would be wise, especially at the beginning, to give workers very limited choices, to prevent big mistakes and disparate outcomes. Unlike Latin America, all the permitted portfolios in the United States should be broadly diversified among industries and sectors — the best recipe for reducing risk — and indexed to well-known benchmarks. The Thrift Saving Plan for U.S. federal employees is a good model. It started with only three portfolios — money market, large cap stocks and bonds — which individuals could mix in varying proportions. It has just added two additional portfolios — a foreign fund and a small cap fund — and is on the verge of adding a life cycle fund that combines the underlying funds in different proportions automatically as the individual ages. Other risk-reducing techniques using modern financial tools should also be considered (see section on guarantees).

## Reducing Administrative Expenses

*"Account fees can be reduced by limiting investment choices."*

If administrative expenses consume 1 percent of assets annually, they reduce a 4 percent rate of return by 25 percent (to 3 percent) and final pensions by 20 percent for a full-career worker who contributes throughout his working life. It is obviously important to keep these costs of pension funds costs and fees charged to worker-contributors under control, and this has been a source of considerable controversy and criticism in the overseas pension systems. Comparisons of costs and fees across countries are difficult because data are not always available. Moreover, fees are based on contributions in some cases and on assets in other cases, and converting contribution-based fees to equivalent asset-based fees depends heavily on how long workers keep their money in the system after the fee is charged.[7] In most of this paper we compare systems in terms of their equivalent asset-based fees for full-career workers, because this immediately tells us how much the fees reduce gross returns and eventually the pension. The following generalizations emerge from a variety of studies [see Table II].

**Retail versus Wholesale Securities Markets.** Costs are much higher in worker-based systems that use the retail market than they are in employer-sponsored plans that use the institutional market. Latin Americans used the retail market because they had poorly developed financial systems. The institutional market was not available unless they sent their money abroad. In the retail market, fund managers must attract and sell to individual workers, one sale at a time, and they incur high marketing expenses to accomplish this — often more than 50 percent of total costs — which they pass on to workers in the form of higher fees. In contrast, the employer-sponsored plans described above use the wholesale or institutional market and get much lower costs. For example, costs are less than 0.1 percent of assets in the U.S. Thrift Saving Plan for federal employees and 0.3 percent to 0.7 percent of assets in large company or industry plans in the United States, Western Europe or Australia. This compares with personal account administrative costs of 1.2 percent in Chile currently, 2.5 percent in Mexico and 4.4 percent in Argentina.[8] We can structure our personal account system to reap the cost benefits of the institutional market — as several countries described below have begun to do.

TABLE II

# Administrative Costs and Charges (Net of Insurance Premiums)

| | Fee as Percent of Assets[a] | Fee in US$ per Account[b] | Reduction in Final Capital and Pension[a] | Centralized Collections |
|---|---|---|---|---|
| **Latin America** | | | | |
| Argentina | 4.4% | $72 | 23% | x |
| Bolivia | 1.6% | 12 | 11% | |
| Colombia | NA | NA | 14% | |
| Chile | 1.2% | 60 | 16% | |
| Costa Rica | 2.1% | 20 | | x |
| Dom.Rep. | NA | NA | NA | x |
| El Salvador | 9.5% | 50 | 18% | |
| Mexico | 2.5% | 45 | 22% | x |
| Peru | 3.8% | 65 | 19% | |
| Uruguay | 2.6% | 39 | 14% | x |
| **Eastern and Central Europe and Former Soviet Union** | | | | |
| Bulgaria | NA | NA | NA | x |
| Croatia | NA | NA | NA | x |
| Estonia | NA | NA | NA | x |
| Hungary | NA | NA | NA | |
| Kazakhstan[c] | 3.7% | 9 | NA | x |
| Kosovo[d] | 1% | 2 | 20% | x |
| Latvia | NA | NA | NA | x |
| Macedonia | NA | NA | NA | x |
| Poland[c] | 4.3% | 19 | NA | x |
| **Other** | | | | |
| Sweden[e] | .7% | | 15% | |
| TSP[e] | .1% | 27 | 2% | x |
| US, retail[e] | 1.5% | 360 | 30% | |
| US, institut'l[e] | .7% | NA | 15% | |
| Australia, av[f] | 1.0% | $150 | 26% | |
| Australia, retail[f] | 2.0% | NA | 40% | |
| Australia, corporate[f] | .7% | NA | 15% | |

Sources and notes:

a These fees include contribution-based and asset-based fees and cover investment and record-keeping services, marketing costs and profits. They are expected to fall as percent of assets as asset volume increases. Fees for Latin America in column 1 are for 1999. Numbers and simulations for column 3 are from (and details on methodology can be found in) Estelle James, Gary Ferrier, James Smalhout and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph Stiglitz, eds., *New Ideas About Old Age Security* (Washington DC: World Bank, 2001), revised version published in *Private Pensions Systems: Administrative Costs and Reforms* (Paris: OECD, 2001). Simulations in col. 3 assume that current fee structure remains in the long run.

b Latin American numbers are derived from fees per contributor for 2002 in *Pension Reforms: Results and Challenges* (Santiago, Chile: Federacion Internacional de Administradoras de Fondo de Pensiones, 2003). A distinction must be made between contributors and affiliates. An affiliate is a worker who has contributed at some point, therefore has an account. About half the total affiliates contribute at any point in time. Money and accounts are managed for all affiliates, including those who have temporarily dropped out of the labor market or the system and therefore don't contribute currently. These calculations assume that the number of accounts is twice the number of contributors, which is a typical case. Fee per contributing worker would then be double the number given.

c. Numbers for 2002 from Agnieszka Chlon-Dominczak, "Evaluation of Reform Experiences in Eastern Europe," 2003.

d. Start-up costs in excess of 1 percent of assets per year in the new Kosovo system are subsidized by the United Nations. Kosovo was still in start-up phase taking in new contributors in 2004. These numbers are estimates.

e. U.S. numbers are from Estelle James, Gary Ferrier, James Smalhout and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," 2001. Numbers are averages across mutual funds, weighted by assets, for 1997. Swedish numbers are from 2004, based on personal communications with Annika Sunden.

f. Data are for 2001. Australian data are from Ross Clare,"Are Investment and Administration Fees in the Australian Superannuation Industry too High?" (Sydney: ASFA Research Center, 2001). Conversion to US $, by author, is based on exchange rate in December 2001.

**Startup Costs versus Long Run Costs.** Brand new personal account systems incur high startup costs. Pension funds managing the accounts must invest in information technology systems, staffing and marketing, often for two or three years before the contributions start flowing in. Furthermore, fees charged by pension fund companies do not cover their costs in the early years, although they hope to recoup them later on. It typically takes five to 10 years for pension fund companies in these countries to break even.[9]

- In El Salvador, fees were 29.8 percent of assets in 1999, the year after they started operating, but fell to 9.5 percent by 2002.
- Similarly, in Poland, costs were 21 percent of contributions in 2000, its second year of operation (half of those costs for marketing), but by 2002 had fallen to only 8 percent of contributions (less than one-quarter of this was for marketing).
- In Poland, fees covered only two-thirds of costs in 2000 but they reached 90 percent of costs in 2002.

*"It is typically five to 10 years before private account managers make a profit."*

**Economies of Scale.** Incremental costs decline rapidly as the volume of assets rise. Systems with large asset bases and large accounts have lower costs, as a percentage of those assets. Economies of scale have led to mergers in the new systems, so the number of asset managers diminishes over time. Incremental costs of record-keeping also decline as the number of accounts increases, which is why many mutual funds in the United States outsource their record-keeping functions to a small number of companies that specialize in providing that service. The combination of startup costs and scale economies means that costs and fees will inevitably be high relative to assets in the early years of a new personal account system and will fall over time.

- In Chile, costs of pension funds and fees charged workers were 12 and 9 percent of assets, respectively, in the first year, 4 to 6 percent of assets in the next couple of years when average account size was around $1,000, but fell to 1.2 percent by 2002, when average account size exceeded $5,000 [see Figure II].
- Based on the current fee structure, they are estimated to be equivalent to 0.7 percent of assets per year for the full-career Chilean worker who contributes for 40 years.

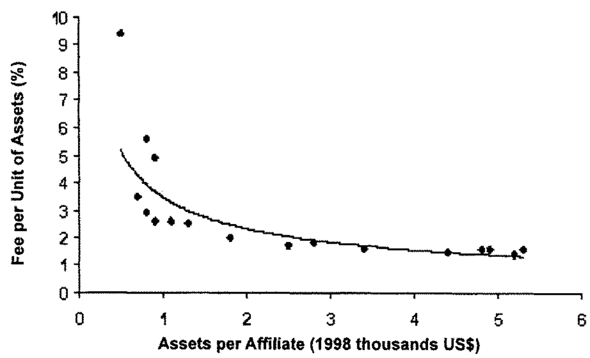
**Costs of Record-Keeping and Communications.** Aside from marketing expenses, the biggest cost item in personal account plans is the cost of record-keeping and communications. These tend to be fixed per account — the same for a $200 account as for a $20,000 account. Thus, record-keeping costs as a percent of assets fall rapidly as average account size increases — which in turn means that the net return on investments grows. For example:[10]

- In the U.S. Thrift Saving Plan, the expense ratio fell from 0.7 percent in 1988, when average account size was $3,000, to 0.1 percent

"Administrative costs fall over time as a percentage of assets."

FIGURE II

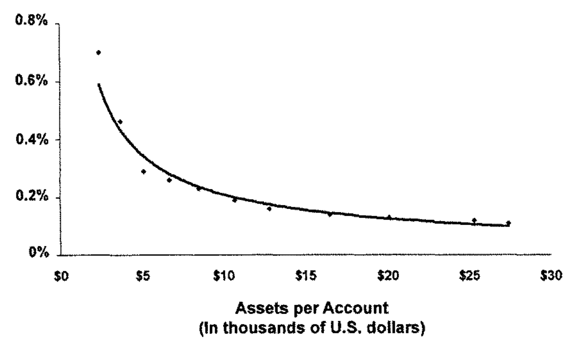
## Costs as Percent of Assets in Chile, 1982-98




"Investment and record-keeping costs have fallen to less than 0.1 percent in the U.S. Thrift Savings Plan."

FIGURE III

## U.S. Thrift Saving Plan Costs as a Percent of Assets, 1988-98




Source: Estelle James, G. Ferrier, J. Smalhout and D. Vittas, "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in A Social Security System?" in John Shoven, ed., *Administrative Costs and Social Security Privatization* (University of Chicago Press, 2000).

in 1998, when average account size reached $27,000. [See Figure III.]

- Most of these costs were for record-keeping and communications. The estimated dollar cost for record-keeping per account was roughly constant at about $20 in both cases.

**Examples of Cost Reduction Techniques.** Several countries have taken special measures to keep costs low. For example, Bolivia entered the institutional market and used an international competitive bidding process to choose two asset managers to handle all the funds in the system; workers choose between them. The fee set by the bidding process leaves few resources or incentives to spend a lot on marketing. This accounts for the fact that Bolivia's expense ratio is one of the lowest in Latin America, despite its small account size. Kosovo has also used a competitive bidding process to choose two asset managers, thereby avoiding marketing expenses; its fees are much lower than those of other countries in the region [see Table II].

Sweden collects contributions centrally and allocates them among some 600 mutual funds according to the workers' choices, but the funds do not get the names of the workers; they only get the aggregate amounts. The funds report back their investment earnings, which the central record-keeper records in the individual accounts. This blind allocation is designed to rule out sales commissions. However, Sweden does not have total confidence in this process, so the country also uses price controls. High-cost funds must pay a rebate to participants, which reduces their effective fee. The net result is an expense ratio of 0.7 percent of assets, which is expected to fall to 0.5 percent within 15 years as average account size grows [see Table II].

*"Administrative costs can be reduced by competitive bidding and centralized collection and record-keeping."*

All Eastern and Central European countries (with the exception of Hungary) and about half the Latin American countries use centralized collection systems, which is usually the social security administrator or tax authority (although Croatia uses a private clearinghouse). In worker-based schemes, piggybacking on the tax system keeps marginal collection costs close to zero and builds in an automatic monitoring mechanism — providing it is a well-functioning tax-collection system. Centralized record-keeping exploits scale economies. One reason for the Swedish system's low cost is that it has an efficient tax-collection system and uses centralized record-keeping. The employer-based plans in Western Europe, Australia and Hong Kong, in contrast, use a decentralized method, since each employing unit essentially applies its money to its own plan.

The U.S. Thrift Saving Plan for federal employees uses a competitive bidding process and passive investing, which is much cheaper than active investing. Passive investing means that the asset manager simply replicates the benchmark index and moves with the entire market, rather than attempting to pick individual stocks or sectors. Most studies have shown that in large efficient markets (as we have in the United States), index funds get a higher net return than the average actively managed fund — because they (1) save money on research operations, (2) have less product differentiation to market, and (3) active managers often guess incorrectly. Passive investment costs can be less than 0.01 percent of assets. The Thrift Saving Plan indexes to such benchmarks as the S&P 500 and Wilshire 4500, and most large company pension funds also index to a large extent.

**Lessons for the United States.** The United States will be starting from scratch and will have millions of small accounts. This environment will exist for many years, due to the large number of low-income earners and part-time workers. Therefore, strong measures must be taken to keep administrative expenses low, or they will consume much of the investment return. This suggests the United States should:

*Use the institutional rather than the retail market.* Aggregating assets and choosing a small number of asset managers will give the system "all or nothing" bargaining power. The asset manager will spend less on marketing. This should result in lower costs and fees. The Thrift Saving Plan sets a good example, since it chooses the asset managers for its portfolios in a competitive bidding process, with very low costs. Of course, there is always a trade-off. The trade-off in this case is that workers have less choice in the institutional market than they would in the retail market. As discussed in the previous section, restricted choice in a mandatory program may be desirable as well as cost-effective.

*"Aggregating small accounts and using passive investing reduces costs."*

*Use passive investing.* Passive investing keeps costs low, reduces disparities across workers and also prevents inexperienced investors from making mistakes by trying to "beat the market." Some analysts worry that this emphasis on passive investment will reduce the number of active investors, who are needed to keep the market efficient. However, the personal accounts will be a small part of total market capitalization in the United States for many years to come. Moreover, currently large company plans use passive investing much more than small investors do — one reason for their lower costs. Perhaps some of these large investors will switch to active investing if the personal account system focuses on passive investing — and they will be more effective at maintaining market efficiency.

*Amortize startup costs over a long time period.* Otherwise, older workers who only participate in the system for a few years prior to retirement during the start-up phase will pay a high price. Amortization requires a loan upfront, probably from the government, that is gradually paid off over the first 20 years or so of the new system.

*Charge asset-based fees.* Asset managers should base fees on a percentage of assets rather than a flat fee per account. Otherwise, low earners with small accounts will receive a lower net rate of return on investments, further deterring growth of their savings. (This does not decrease total costs but it involves a policy decision to cross-subsidize small accounts).

*Estimated cost for a personal account system in the United States.* Assuming that the new system will (1) keep annual record-keeping and communication costs per account at $20 (the estimated cost in the Thrift Saving Plan and low-cost mutual funds), (2) use index funds and (3) choose asset managers in a competitive bidding process — the expense ratio for the new personal account system will be 30 basis points (0.30 percent) or lower, after eight to 12 years. This is a lower administrative fee than workers with small accounts could get for themselves in the mutual fund market today.

## Preventing Poverty and Controlling Risk

*"Every country with personal accounts offers a minimum pension that reduces the risk of old-age poverty."*

Personal account systems are not inherently redistributive and they entail financial market risk. So how do we prevent poverty and control risks? One way to reduce market risk, discussed previously, is to limit investment choices to less risky portfolios that track broad market indexes. Another way, discussed in a following section, is to encourage or require annuitization. There is also a risk that workers with low wages or workers who spend a number of years out of the labor market will have insufficient balances in their personal accounts to provide adequate retirement incomes. This is especially important to women, who are likely to work fewer years and at lower rates of pay then men. [See the sidebar on "Protections for Women."] It is also important to all workers who fear the possibility of a prolonged downturn in investment or labor earnings. To reduce the risk of old-age poverty, every country with a personal account system includes a minimum pension, usually financed out of general government revenues.

The minimum pension takes one of several alternative forms: a minimum pension guarantee (MPG) the personal accounts, a floor on the traditional defined benefits from the accounts, a floor on the traditional pay-as-you-go benefit only, or a flat (uniform) benefit that every eligible person receives, regardless of other benefits [see Table III]. Women have been disproportionate gainers from the minimum benefit, whatever form it takes.[11]

**Minimum Pension Guarantees on the Personal Accounts.** Most common is the minimum pension guarantee, which guarantees a minimum retirement income from the social security system, including the personal accounts, for all eligible workers (those with 20 to 25 years of contributions). Most Latin American countries and Kazakhstan incorporate this feature into their plans.

**Floors on the Traditional Benefit.** A second type of minimum pension sets a floor on the traditional defined benefit only, regardless of the size of the personal accounts. This is common in the Eastern and Central European countries, which retained large earnings-related defined benefit plans. In these countries the public benefit increases with work and contributions, but it also has a floor. This has the disadvantage that the government's liability is not reduced if benefits from the personal accounts are larger than expected — nor does it protect retirees from unexpected negative outcomes in the accounts. Often, this feature is a remnant of the old systems and, as such, the years of work required for eligibility are quite low (five to 15 years). Not surprisingly, the minimum is smaller in the "floor" countries — 10 percent to 20 percent of average wage in most "floor" countries versus 20 percent to 40 percent in most minimum pension guarantee countries [see Table III].

**Tradeoffs with Minimum Pension Guarantees and Floors.** In both minimum pension guarantee and floor countries, the government incurs an unfunded contingent liability that is often not calculated in advance. Mexico reduces the unfunded liability in its minimum pension guarantee by putting a peso-per-day-worked into the account of every worker, thereby making it less likely that they will fall below the minimum and encouraging work at the same time.

*"Joint annuities raise the retirement income of married women."*

## Protections for Women

On average, women spend less time in the workplace than men. They generally earn less and contribute less, but live longer. Married women are typically younger than their husbands, so they are prone to becoming widows with low incomes. Older women form pockets of poverty in many countries. Research has shown that Latin American women will be the biggest gainers from their countries' individual account reforms for three reasons:

- The minimum pension helps low earners, many of whom are women. This takes the form of a minimum pension guarantee in Chile, a flat benefit for all qualifying workers in Argentina and a uniform contribution by the government to the worker's account, per day worked, in Mexico.
- Upon retirement, husbands are required to purchase a joint pension from their individual account, so widows get a survivor's benefit — but it is financed by their husbands rather than by taxpayers. (Thus single women are not taxed to subsidize married women).
- Widows get to keep their own pension plus the joint pension.

In contrast, in the United States, widows must choose between their own Social Security benefit and the widow's benefit (which is equal to the individual benefit based on her husband's earnings, or two-thirds of the benefit they receive as a couple). Thus, many women who work in the marketplace receive no additional benefit from years of contributions.

In Chile, Argentina and Mexico, the recent pension reforms improved the relative position of women, due to the minimum pension and the joint pension. Projected lifetime benefits of married women with full work careers are now equal to or higher than the lifetime benefits of men.

Sources: Estelle James, "Social Security Reform: Reducing the Risk of Poverty," National Center for Policy Analysis, Brief Analysis No. 505, February 25, 2005; and Estelle James, Alejandra Cox Edwards and Rebeca Wong, "The Impact of Social Security Reform on Women in Three Countries," National Center for Policy Analysis, Policy Report No. 264, November 2003.

TABLE III

## Minimum Pension and Guarantees

| | MPG, Floor or Flat[a] | Min pen/ Av. Wage | Years for Eligibility[b] | Financed by | Relative Rate of Return Guarantee[d] |
|---|---|---|---|---|---|
| **Latin America** | | | | | |
| Argentina | flat | 28% | 30 | Payroll Taxes+General Rev. | x |
| Bolivia | flat | 7% | NA | General Rev. | |
| Colombia | mpg | 50% | 25 | General Rev. | x |
| Chile | mpg | 25% | 20 | General Rev. | x |
| Costa Rica | floor | 20% | NA | Payroll Taxes | |
| Dom. Rep. | mpg | 41% | 30 | General Rev. | x |
| ElSalvador | mpg | 32% | 25 | General Rev. | x |
| Mexico | mpg | 23% | 24 | General Rev. | |
| Uruguay | floor | 20% | NA | Payroll Taxes | |
| **Eastern and Central Europe and Former Soviet Union** | | | | | |
| Bulgaria | floor | 19% | 15 | Payroll Taxes | |
| Croatia | floor | 10.5[c] | 15 | Payroll Taxes | x |
| Estonia | floor | 13%[c] | 5 | General Rev. | |
| Hungary | mpg | 17% | 20 | General Rev. | x |
| Kazakhstan | mpg | 20% | 20F/25M | General Rev. | x |
| Kosovo | flat | 20 | universal | General Rev. | |
| Latvia | floor | 17% | 10 | Payroll Taxes | |
| Macedonia | mpg | 35-41[c] | 15 | Payroll Taxes | |
| Poland | mpg | 30% | 20F/25M | General Rev. | x |
| **Western Europe and Asia-Pacific** | | | | | |
| Denmark | flat | NA | universal | General Rev. | |
| Netherlands | flat | 28-38% | universal | Payroll Taxes | |
| Sweden | MPG | 40% | universal | General Rev. | |
| Switzerland | floor | 22%[c] | 44F/45M | | |
| UK | flat | 15-20% | b | Payroll Taxes | |
| Australia | mt flat | 25% | universal | General Rev. | |
| Hong Kong | flat | 15% | universal | General Rev. | |

Notes:

a. MPG means that the personal accounts are covered by the guarantee. (In Peru this was recently established and is being phased in.) Floor means that the public pay-as-you-go plan is earnings-related but has a floor that is independent of earnings. Flat refers to a public benefit that is uniform for almost everyone. In Australia eligibility for the flat is means-and asset-tested, excluding about 30 percent of retirees. In Denmark the flat benefit has been means-tested against wages since 1993. In the United Kingdom, the flat benefit is price-indexed and less than the means-tested minimum income guarantee, which is wage-indexed; many old people get the means-tested benefit. In the Netherlands the flat benefit is about 38 percent of average wage for a single person, 28 percent for each member of a couple. In countries where minimum pension is price-indexed, it will be a smaller percentage of average wage every year, if wages rise faster than prices.

b. Eligibility for the MPG and the floor usually requires a minimum number of contributory years. Eligibility for the flat benefit is usually universal, based on residence. In the UK both years of market work and years of child or elder care count toward eligibility.

c. Minimum pension is higher for those with more years of work. (In Switzerland, floor is lower for those with less than 44 years of work).

d. Asset managers that deviate from the industry average or benchmark by more than a specified amount are penalized. Kazakhstan also requires a 0 real rate of return guarantee. Switzerland has an absolute average annual rate of return guarantee over the worker's tenure with an employer.

Sources: Robert Palacios, "Pension Reform in Latin America: Design and Experiences;" Agnieszka Chlon-Dominczak, "Evaluation of Reform Experiences in Eastern Europe;" Gordon L.Clark and Noel Whiteside, *Pension Security in the 21st Century* (Oxford University Press, 2003). Also, country studies and personal communications.

The eligibility requirement for the minimum pension guarantee or floor poses another problem, as workers who miss it by one year receive no protection while workers who have many extra years get no additional reward. Some countries (for example, Switzerland and Croatia) counter this problem by offering a higher minimum for workers with more years of contributions. All three examples (Mexico, Switzerland and Croatia) illustrate ways to reduce the trade-off between work incentives and the safety net.

**Flat Benefits.** The remaining countries have established a minimum by giving a flat (uniform) pension to all people who have passed a specified age, such as 65, even if they haven't worked and contributed. This is characteristic of the industrialized countries that recently added mandatory employer-sponsored plans to the flat public benefit that they had had for many years. Since money goes to every person, the flat benefit is considerably more expensive than the minimum pension guarantee or the floor. While the minimum pension guarantee and floor countries concentrate their subsidies on the bottom 20 percent of pensioners, the flat benefit redistributes as well to the second and third quintiles, whose members are likely to receive, on average, more than they put in the tax pool. Thus, the choice between these methods depends in part on the degree and nature of redistribution desired and feasible.

*"Flat public benefits to all workers are expensive but avoid moral hazard problems."*

To control the fiscal costs, some countries have tried to downsize their flat benefits and replace them with means-tested benefits. Britain, for example, shifted from wage to price indexation of the flat benefit to accomplish this. As wages grew over the last two decades, the basic benefit fell from 24 percent to 15 percent of the average wage. Fiscal costs are very low as a result. But expenditures have increased on means-tested benefits, where the income threshold is wage-indexed and now exceeds the basic benefit. If the current system continues, more than half of all Britain pensioners will qualify for means-tested benefits as they age. Reliance on means-testing may discourage voluntary saving. Reliance on means-testing may discourage voluntary saving. The recent report of the British Pensions Commission pointed out that either the basic benefit or the personal accounts would have to increase (or the span of retirement would have to decrease), in order to keep pensioners above the poverty line without excessive use of means-testing.

*"Public benefits will fall relative to the average standard of living if indexed to prices rather than wages."*

Australia cuts the cost of its flat benefit in a different way: by income- and asset-testing eligibility to exclude the top income group. About 70 percent of retirees are below the threshold receive the benefit. Argentina requires 30 years of contributions for eligibility and gives a reduced flat benefit to those with only 10 years of work. Most women get the reduced flat benefit.

**Wage or Price Indexation of the Minimum?** In all these minimum pensions, indexation is a key issue. Wages usually rise faster than prices, due to productivity growth. If the minimum pension is indexed to wages, its cost may grow more rapidly than expected and it may become a large unfunded liability. But if indexed to prices, it will fall in value relative to the average standard of living in society, which is set by wages. Which is better? Temporary price indexation is a possible method to reduce the fiscal burden in cases where the minimum is very high to begin with. In Sweden, for example, the minimum was 40 percent of the average wage and is now being reduced through price indexation. The Netherlands, which pays a flat benefit of 38 percent of the average wage to single individuals (28 percent per person to couples), is also considering temporary price indexation or no indexation at all when finances are strained. But if wage indexation does not resume eventually, the minimum will become irrelevant (as discussed above for the United Kingdom).

In Chile, the minimum pension guarantee is currently 25 percent of the average wage — almost double the poverty line — for workers with at least 20 years of contributions. It rises to 27 percent once workers pass age 70, but is lower for workers who retire early. The minimum is formally indexed to prices; however, due to a series of political decisions, it has increased with wage growth over the past 20 years, and the increase applies to all retirees, not simply to new ones. As a result, it may lead to higher costs than were initially projected.

If Chile wants to slow down the growth in expenditures on the minimum pension guarantee, one option is to wage-index the minimum for new groups of retirees but to price-index after retirement (as we do for our defined benefit in the United States). Another option is Swiss indexation — which is a combination of wage and price indexation. Benefits would then grow as wages grow, but at a slower rate. Still a third option is to modify payout rules so that fewer retirees fall below the rising minimum.

*"A disincentive to work can be avoided if the minimum guaranteed pension rises with years worked."*

**Moral Hazard Problems.** The minimum pension guarantee has the advantage of being less expensive than a flat benefit and easier to administer than a means-tested benefit, since it doesn't require a careful check of all income sources. Its main disadvantage is that it may involve moral hazard problems; that is, risky behavior may increase, which raises total costs, when a minimum is guaranteed. Evidence from Chile suggests three types of moral hazard:

- First, low-income earners may stop working, or try to evade contributions, once they pass the 20-year point required for eligibility, since any small addition to their pension would simply displace the government subsidy.
- Second, when given a choice of investment options, workers near the minimum may choose the riskiest option, since they will benefit from the upside potential while the government bails them out of the downside risk. (This has only become relevant in Chile since investment choice was expanded in 2002.)
- Third, retirees with small accumulations — who are not necessarily required to annuitize their accounts — may use up their retirement

savings as fast as possible because they know that the government will pay their pension when their own money is gone.

These moral hazard issues could be mitigated by making the minimum pension guarantee a positive function of years worked, ruling out very volatile investment strategies, and setting stringent payout rules that prevent lump sums and front-loading.

**Rate of Return Guarantees.** Besides the minimum pension, many countries have established rate of return guarantees designed to smooth returns in the personal accounts over time and reduce variations among individuals. Asset managers, not the government, bear these costs, but ultimately pass them on to worker-investors.

Absolute rate of return guarantees are rare. Kazakhstan requires a zero real rate of return guarantee. This is likely to be called upon very rarely if it applies as an average over the workers' lifetime, but it can obviously be costly and distortionary if it applies on a year-to-year basis.

Switzerland has a more binding floor on returns to accounting contributions in employer-sponsored plans. Until 2002, a worker's account was required, over his tenure with a particular employer, to earn an average nominal return of at least 4 percent per year. During the 1980s and early 1990s this was not a demanding rate to achieve, as even conservative government bonds yielded more than 4 percent. However, as interest rates plummeted over the last few years, asset managers found it difficult to earn 4 percent without taking on considerable stock market risk, and this risk meant that at times the floor would not be reached. Pressure grew for a change in regulations. Finally, in 2002, the Swiss government began a downward readjustment of the guarantee, and by 2005 it had fallen to 2.5 percent. Moreover, a process to re-evaluate the rate automatically every two years was put in place. This illustrates the dangers of absolute rate of return requirements: they become political footballs when rates in the broader economy unexpectedly change.

*"Many countries limit the disparities in rates of return on personal accounts."*

More common than absolute rate of return guarantees are relative rate of return guarantees, in which limits are set on the degree to which an asset manager can deviate from the industry average [see Table III]. For example, if an asset manager in Chile beats the industry average return by more than 50 percent or 2 percentage points (whichever comes first), it must put the excess into a special reserve fund. When the manager earns less than the industry average by more than 50 percent or 2 percentage points, it must make up the difference in the accounts by drawing down the reserve fund and then by dipping into owners' equity, if necessary. Understandably, asset managers were reluctant to deviate from the typical industry portfolio — thereby creating "herding," where all the investment portfolios are very similar. To overcome this problem, Chile has recently allowed pension funds to offer multiple portfolios, with different bands and penalties allowed for each portfolio (see earlier sidebar on Chile).

While herding may have reduced investment choices, the purpose of this guarantee — to reduce volatility across time and disparities across individuals — remains worthwhile in a mandatory system. A better and more transparent way to achieve this goal is to require that all portfolios be indexed to broad market benchmarks such the S&P 500 or Wilshire 4500, rather than allowing concentration in particular companies or sectors. The Latin American and Eastern European countries did not have this option, given their undeveloped financial markets, but we do. Additionally, some financial analysts have recommended "life cycle investing" (a gradual shift out of stocks and into bonds or annuities over a period of years as individuals approach retirement) or the use of options, to protect older workers from a sudden downturn in the stock market. These arrangements would automatically reduce disparities among individuals and across different age cohorts.

**Lessons for the United States.** As we revise our system to include personal accounts, the United States needs to rethink how high the safety net should be, how it should be financed, and what linkages and trade-offs we want to make between work incentives and poverty prevention. In this context, we should seriously consider establishing a minimum pension as a way to redistribute income to low earners and protect retirees from investment risk.

One simple way to accomplish this could be to modify our current defined benefit to become a flat benefit that pays a poverty-level pension (currently about $750 monthly for an individual living alone[12]) to everyone, as in several Western European countries. Our current average defined benefit from Social Security is $1,000 per month and it is slated to go up around 1 percent per year. Flattening out the public benefit to the poverty level would make the system solvent and, in fact, would generate a surplus that could be used to help fund the individual accounts.

*"Personal accounts should be accompanied by a more progressive public benefit to protect low-wage workers."*

Alternatively, and more consistent with good work incentives, the benefit could be a flat sum per year worked. For example, retirees could be promised a public benefit that is 1 percent of the average wage per year for the first 20 years of contributions, and 0.5 percent per year thereafter. A 20-year worker would then get $600 per month while a 40-year worker would get $900 per month. If defined in terms of the average wage, it would grow over time together with the average standard of living — it would thus be wage-indexed for successive cohorts but could be price-indexed after retirement, as our current benefits are. This would be a highly progressive public benefit, with work incentives built in, that would cost less than our current scheduled benefits. Yet, together with an annuity purchased with a 4 percent account, the total benefit would exceed that received by the average worker today.

In general, countries with large accounts complement them with very progressive public benefits to get desired distributional outcomes over-all. Our public benefit is not as progressive as we sometimes claim, given the longer life spans of high-income earners. We should consider making it more progressive — yet still positively related to years worked — as part of the package of changes that establishes personal accounts. This would protect low-income earners both from labor market instabilities and financial market volatility.

As an alternative to government-financed minimum pensions, financial analysts are now developing alternative market mechanisms (sometimes called "collars"), in which worker-investors agree to give up some of their upside gain in order to qualify for a downside floor. The worker must also relinquish control over the portfolio to private market guarantors. A contract would peg returns to a particular index, but the guarantor rather than the worker would control specific investments, in order to avoid moral hazard (excessive risk-taking) problems. While this may turn out to be a promising way to guarantee a minimum pension without incurring a contingent liability for the government, it introduces two new risks: 1) workers may not be able to evaluate these guarantees, to figure out whether they are getting a good or bad deal, and 2) the private market guarantor may not be able to honor its commitment when it comes due. This is particularly a potential problem given that many workers will be trying to collect at the same time if the market drops precipitously. Such private market guarantees are promising, but they place an extremely heavy burden on regulators — and introduce a third new risk — 3) that regulators may fail and government (or workers) will end up bearing the burden after all.

## Paying Retirement Benefits

How can we be sure workers won't spend all the money in their accounts before they die, then live at the minimum pension level, or worse, in poverty? Most countries with personal accounts require that workers annuitize or take their money out of the system in very gradual installments. Annuities are desirable because they guarantee workers a life-long income. However, retirees who need the money early — say, because they have high medical expenses — can't get it. And if everyone is put into a community-rated annuity pool, those with short lifetimes (who are also disproportionately low-income earners) end up subsidizing those with longer lives (who are disproportionately high earners).

*"Annuitization of the personal account ensures that retirees do not outlive their pensions."*

Can the private sector handle annuitization, given the inherent investment and longevity risk, as well as the inflation risk, if the annuities are price-indexed? The annuities market is currently tiny in practically every country — in part because in the past, defined benefit social security systems have paid public annuities, leaving little demand for the private market. How will this change if the defined benefit is partially replaced by individual accounts? Will annuities be offered on good terms? Will workers buy them if annuities are not required? The Chilean experience suggests that these problems can be resolved. Chile has the most extensive annuity market in the world. The annuities provide a good money's worth ratio on price-indexed annuties. Life

## Case Study: Annuities in Chile

Chile has had its personal account system for more than 20 years. Many workers have retired, and two-thirds of all retirees have annuitized, in large part because regulations encourage workers to do so [see Figure IV]. Retirees are required to take their payouts in the form of an annuity or a gradual withdrawal. Lump sum withdrawals are permitted only in rare cases where the worker has purchased a pension that exceeds 70 percent of his own wage and 150 percent of the minimum pension guarantee. The government insures the annuities up to the level of the minimum pension guarantee plus 75 percent of the value of the annuity in excess of the minimum pension guarantee, in case the insurance company should become insolvent. (The government also heavily regulates the companies to makes sure that doesn't happen.) Given the choice between guaranteed annuities and gradual withdrawals without insurance, most Chilean workers (except those near the minimum pension guarantee) choose annuities.

The Chilean government also gives insurance companies a competitive edge. Independent sales agents get a commission from an insurance company when they sell annuities, but not from the pension administrators when they sell gradual withdrawal pensions. As a result, sales agents have marketed annuities aggressively and competition forces insurance companies to offer a high rate of return. (Annuitants get the government term structure of interest rates plus insurance.) The annuity market grew rapidly after 1981, from practically nothing to a multi-billion dollar industry.

Regulations also determine the nature of the annuity. It must be price-indexed, so annuitants get inflation insurance in addition to investment and longevity insurance. (Most long-term transactions in Chile are price-indexed, including both public and private financial instruments, which assists in this process.) Variable annuities have not been permitted, to avoid surprises and volatility during the payout stage, although they will be allowed starting in 2005. Joint annuities are required for married men, and widows keep the joint annuity in addition to their own pension, if they worked and contributed. This contrasts with the situation in the United States, where widows must give up their own pension in order to receive the widow's pension. Chile uses gender-specific, rather than unisex, mortality tables. This might be expected to hurt women, but in the context of joint annuities, gender-specific and unisex tables yield very similar pensions to married individuals. So on balance, the minimum pension guarantee for low-income earners, the joint annuity for survivors and the provision that widows can keep both their own pension and the joint annuity have made women big winners in Chilean pension reform.[1]

In Chile, the normal retirement age is 65 but a worker can start withdrawing money earlier, as soon as his account can finance a 70 percent replacement rate of his own wage and 150 percent of the minimum pension (until 2004 this requirement was 50 percent and 110 percent, respectively). Given a high real rate of return on accounts — more than 10 percent on the average, since 1981 — and the favorable terms on annuities, many workers reach this point well before the "normal" retirement age. Indeed, the majority of Chilean workers start their pensions in their 50s. The annuity has a constant purchasing power since it is price-indexed. But the minimum pension has been rising in real terms with wage growth. Early withdrawal increases the chance that the rising minimum pension guarantee will eventually overtake the private pension and government will have to pay a pension top-up.

Starting to withdraw the pension, however, does not mean that individuals stop working. Chile exempts pensioners from the pension payroll tax. As a result, the labor supply of older workers has risen dramatically since the reform — which is good for the income of the workers and the broader economy.[2]

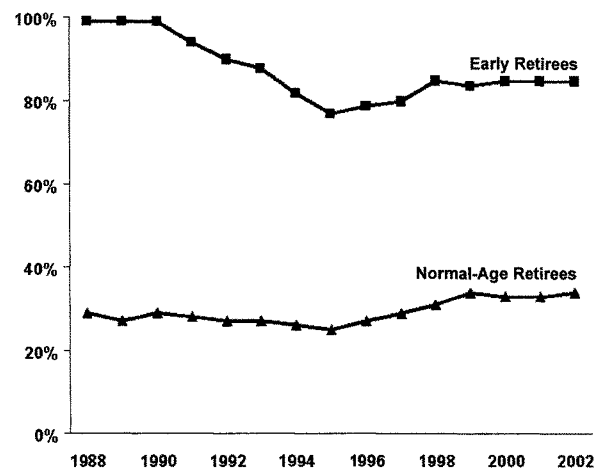
Notes:

[1] James, Edwards and Wong, "The Gender Impact of Pension Reform." Also see Estelle James, "Private Pension Annuities in Chile," National Center for Policy Analysis, Policy Report No. 271, December 2004.

[2] See Estelle James and Alejandra Cox Edwards, "Do Individual Accounts Postpone Retirement: Evidence from Chile." Draft manuscript.

FIGURE IV

**Percentage of Policies Annuitized in Chile, 1988-2002**




Source: Estelle James, "Private Pension Annuities in Chile," National Center for Policy Analysis, NCPA Policy Report No. 271, December 2004.

*"Chilean workers stop contributing to their accounts before the normal retirement age, but can keep working after they fund their annuity."*

insurance companies sell more annuities than life insurance. [See the sidebar "Case Study: Annuities in Chile."]

**Annuitization in Eastern and Central Europe.** All these countries require annuitization through insurance companies, except in cases where the accumulation is too small to make this feasible. Kosovo, for example, initially required annuitization, but has not been able to implement this requirement because accounts were simply too small. Other countries that require annuities may find this, too. They may also find that costs are higher and payouts lower than expected due to the absence of good mortality tables and the risk of longevity improvement. Many of these countries require that unisex mortality tables be used, so that women do not receive a lower monthly payment because of their greater expected longevity. It is not yet clear how this requirement will work in private insurance markets, where insurance companies prohibited from basing premiums on longevity, will try to enroll only those individuals who are good risks.

**Annuities versus Programmed Withdrawals in Latin America.** Either annuitization or gradual withdrawals are permitted in Latin America, but lump sum withdrawals are not allowed unless the pension exceeds a speci-

TABLE IV

## Annuitization Rules

| | Annuity Required | Gradual Withdrawal Permitted | Lump Sum Allowed[a] | Threshold for Lump Sum (percent own wage)[a] | Threshold for Lump Sum (percent MPG)[a] |
|---|---|---|---|---|---|
| **Latin America** | | | | | |
| Argentina | | x | x | 70 | 300 |
| Bolivia | | x | | | |
| Colombia | | x | x | 70 | 110 |
| Chile | | x | x | 70 | 120 |
| Costa Rica | | x | | | |
| Dom. Rep. | | x | x | | 50 |
| Ecuador | | x | | | |
| El Salvador | | x | x | 70 | 160 |
| Mexico | | x | x | | 130 |
| Peru | | x | x | 80 | |
| Uruguay | x | | | | |
| **Eastern and Central Europe and Former Soviet Union**[b] | | | | | |
| Bulgaria | x | | | | |
| Croatia | x | | | | |
| Estonia | | | x | | |
| Hungary | x | | | | |
| Kazakhstan | | | x | | |
| Kosovo | | | x | | |
| Latvia | x | | | | |
| Macedonia | x | | | | |
| Poland | x | | | | |
| **Western Europe and Asia-Pacific** | | | | | |
| Denmark | x[c] | | | | |
| Netherlands | x[c] | | | | |
| Sweden | x | | | | |
| Switzerland | x[c] | | | | |
| UK | x | | | | |
| Australia | | x | x | | |
| Hong Kong | | x | x | | |

Notes:

a. Lump sums are sometimes allowed once the pension passes a threshold, specified as % of worker's own wage and % of MPG. Australia and Hong Kong have no threshold.

b. Estonia, Kazakhstan and Kosovo allow gradual or lump sum withdrawals for small accounts. Most accounts are still small. Other countries that supposedly require annuitization may find this impractical until account size grows.

c. Employer-sponsored plans often started as defined benefit plans. Annuitization was implicit. As switch to defined contribution occurs, explicit choices will have to be made regarding and annuitization. In many Swiss plans annuitization is the default option.

Sources: Robert Palacios, "Pension Reform in Latin America: Design and Experiences;" Agnieszka Chlon-Dominczak, "Evaluation of Reform Experiences in Eastern Europe;" and country studies.

*"Most countries require annuitization or gradual withdrawals from accounts under strict regulations."*

fied threshold. Generally, the threshold is 70 percent of a worker's own wage and 120 percent to 160 percent of the minimum pension guarantee. [For more details and variations, see Table IV.] This is a compromise that enables retirees to get some of their money out early, but it is supposed to ensure that these withdrawals are not at the expense of a minimally acceptable lifetime income. Of course, for any of these arrangements to work well, good mortality tables are needed. Today, many Latin American countries face problems stemming from an undeveloped insurance industry and obsolete mortality tables.

**Other Practices.** Britain requires price-indexed annuitization of the mandatory contribution by age 75. Sweden requires annuitization, through the public sector. In Switzerland, annuitization is not required but it is usually the default option (pensions are annuitized unless the retiree deliberately requests some other payout mode). The Swiss government also sets the annuity terms at very favorable rates. Calculations from 1999 have shown that the present value of expected lifetime benefits is substantially greater than the premium — due to increases in life expectancy combined with decreases in interest rates.[13] While this situation was unsustainable in private insurance markets, government regulations prevented efficient change. Starting in 2005, however, the conversion rate is scheduled to decline gradually from 7.2 percent of the premium per year until it reaches 6.8 percent in 2014.[14] If current trends continue, that will still be a very good deal for retirees. The combination of favorable terms and default inertia has led 70 percent of all Swiss retirees to annuitize.

**Lump Sum Withdrawals in Australia and Hong Kong.** These countries deviate from the norm — they do not require annuitization or gradual withdrawals. Some analysts fear that retirees will spend down their accumulations quickly and thereby qualify for the means-tested old age pension. As a counter-incentive, Australia has recently instituted strong tax advantages for gradual withdrawals.

**Lessons for the United States.** There is a trade-off between giving retirees control over their retirement funds versus ensuring that they will have an income even if they live 30 or 40 years after retirement. Mandatory old age plans exist precisely because we believe that a) not all individuals will make the right decisions, and b) if they become destitute society will have to pick up the bill. At the same time, some people desperately need their money earlier, perhaps to pay medical bills, and others know they will not live long after retirement. The latter group includes retirees in ill health and others with low life expectancy. The solution to this trade-off is to choose a guaranteed income threshold, after which lump sum withdrawals are permitted. The threshold should take into account that the poverty line or minimum pension is likely to rise over the retirement period, as the average wage and standard of living rise. For this reason, all countries have chosen a threshold well above the poverty line; the United States should follow this example.

Once a realistic threshold is reached, we should also consider exempting pensioners from the requirement to contribute further to their accounts. In Chile this exemption has increased their net take-home pay and therefore the labor supply of older workers— which is beneficial for the economy as well as the workers themselves. (Contributions to the traditional benefit should continue, however, because of its redistributive function.)

Of course, a number of other issues remain. Should joint annuities be required? Should variable annuities be permitted? Should gender-specific or unisex mortality tables be used? Should rate differentiation by socioeconomic group and DNA group be encouraged or allowed? Countries with personal accounts are only now beginning to confront these questions, and the United States will have to address them, too.

## Covering Transition Costs

When money that used to pay benefits to pensioners is instead diverted to personal accounts, a temporary financing gap is created, known as the "transition cost." This is not a real cost in the long run, since eventually the accounts will offset future government promises and reduce costs. But that is many years into the future. How will ongoing benefits be financed in the meantime? All countries that started their personal accounts by diverting money from the payroll tax faced the issue of how to finance the transition (though the few countries that used add-ons avoided this problem). How did they do it?

*"Transition costs disappear in the long run, as benefits from the accounts allow a reduction in government obligations."*

It is difficult to answer this question because money is fungible, many other government policies were changing at the same time, the old systems were usually insolvent and so would have had to change anyway, and the counterfactual (what would have happened otherwise) is unknown. For those reasons, we don't really know the degree to which tax hikes, spending cuts or debt finance were used to finance the transition to personal accounts. We do know that Chile accumulated a fiscal surplus before the reform to help cover transition costs. Most countries downsized their traditional systems so they had a smaller pension debt to cover. And all countries used some degree of debt finance.

**Honoring Past Promises and Recognition Bonds in Chile.** In Chile, old system pensions were downsized, mainly by raising the retirement age. Beyond that, workers who stayed in the old system got their old pensions, and Chile is still paying that bill. Over the past 20 years, the Chilean government has paid between 2 and 3 percent of GDP per year to old system retirees — the government was paying almost as much to subsidize the old system before the reform[15] — and this will be a considerable part of total government spending for another 10-20 years.

Workers who switched to the new system received "recognition bonds" for their past service. The bonds could be cashed in and applied toward their pension upon retirement. This was equivalent to a forced loan from workers to the government, with redemption tied to their dates of retirement. The cash-ins therefore did not begin until the late 1980s and have been growing since; they now cost the government about 1 percent of GDP.[16] This financing gap will slowly diminish until all workers who switched have died — about 40 years from now. Econometric studies indicate that the government has financed these expenditures largely out of higher taxes and lower government spending on other goods and services, not out of debt finance as a primary source. This has produced an increase in national saving to which economists attribute much of Chile's dramatic and prolonged economic growth.

*"Short-term transition costs can be financed in a variety of ways, but pure debt finance should be avoided."*

**Debt Finance in Argentina.** Unlike Chile, Argentina did not issue recognition bonds, but promised to pay all workers who switched part of their old benefits. This implied a longer redemption than Chile's, since the loan was to be gradually repaid over the workers' entire retirement period. Also unlike Chile, Argentina had greater political difficulties in raising taxes and cutting benefits or other government spending. Thus, transition costs added large amounts to Argentina's debt and was one factor leading to its economic crisis, rather than to the economic growth that occurred in Chile.

**Lessons for the United States.** The impact of reform on the U.S. economy will be largely determined by how the transition is financed. And the broader economic impact largely determines whether or not the reform was desirable in the first place. As we plan for personal accounts in the United States, we should take care not to do what many other countries have done — underestimate transition costs by underestimating the propensity of workers to switch. And we should include an explicit strategy for covering transition costs, which does not place heavy reliance on borrowing. If we finance the transition primarily by borrowing, this will negate one of the primary goals of the accounts — to increase national saving — and will perpetuate the burden that will have to be paid by future generations. Increased personal saving would be offset by increased public dissaving. Options we should consider include, among others, downsizing benefits by raising the retirement age or slowing benefit growth, raising the ceiling on wages subject to the payroll tax, postponing income and estate tax cuts for the wealthiest Americans, creating a new "legacy debt surtax" or financing the accounts in part by an add-on, which does not create transition costs.

## Conclusion

Although workers will "own" the money in their accounts, it is clear that ownership comes with many strings attached, regarding allowable investments and withdrawals. The reason for having a mandatory system in the first place is that some people won't save enough or will make extremely poor investments, if given unfettered choice. The mandatory system should avoid this outcome, for the sake of the individuals directly concerned as well as the rest of society. Also, properly constructed rules should result in lower costs for a mandatory program than is available to individuals on a voluntary basis.

The way we design the personal account system will determine reform's winners and losers, the economic status of the elderly as a group as well as the cost to the coming generations, and its impact on the broader economy. Other countries' experiences don't give us answers to all the design issues, but they do show the variety of options available and some of their effects. Administrative costs and risk vary widely across plans, depending on their particular design features; low cost, low risk options are available — and they imply limited choice. The most important commonalities among all these systems involve the creation of a minimum pension and strong restrictions on payouts, both consistent with the original purpose of Social Security — to ensure that the elderly remain above a reasonable income level throughout their retirement years.

# Notes

[1] Workers with very low earnings were often excluded, to avoid the high administrative costs associated with small accounts.

[2] Most defined benefit plans in the United Kingdom are closed to new members. In Australia the new plans are all defined contribution and many old plans have been transformed as well. In Switzerland, even when the plan is described as defined benefit, it must meet certain defined contribution criteria (the accumulation at the end must be at least as great as would be achieved by a contribution rate and interest rate that is specified by law). In the Netherlands, which is one of the last strongholds of defined benefit plans, employers are beginning to actively consider a switch to defined contributions. [3] See Estelle James and Sarah Brooks, "Political Economy of Structural Pension Reform," in Robert Holzmann and Joseph Stiglitz, eds. *New Ideas about Old Age Security* (Washington, D.C.: World Bank, 2001).

[4] In Kosovo, an add-on contribution was used and the new system is mandatory, but this is because the old system was left behind in Serbia. In Sweden the new system raised the total contribution rate — it is now 18.5 percent of wages — with the agreement that 2.5 percent would go to the account. Some influential parties would not have agreed to 18.5 percent without the accounts. In that sense, the Swedish agreement was an add-on/carve-out hybrid that might be relevant to the United States.

[5] In the United Kingdom., switching back and forth is permitted, which has the perverse effect that it becomes financially advantageous for workers to switch back into the state defined benefit system as they age — and that seems to be happening now. New entrants to the labor force can also choose between the public and private systems. This adds cost and uncertainty to the public plan. Switching to the accounts for existing as well as new workers was mandatory in Bolivia, Kazakhstan and Mexico. However, in Mexico workers were given the right to switch back to the old system upon retirement, if this raises their pension.

[6] A worker who contributes 4 percent of wages for 40 years and retires for an expected lifetime of 20 years, with wage growth 1.5 percent and rate of return 4.5 percent per year, will be able to purchase an annuity that provides 23 percent of his final wage, with his retirement accumulation. Given the progressivity of our defined benefit system, the proportion of total benefits coming from the accounts would be smaller for low earners and larger for high earners. This is desirable because high earners are more able to cope with the volatility of account investment returns.

[7] If a person pays a year-end fee at the end of the year that is 20 percent of first-year contributions and retires immediately afterwards, that fee equals 20 percent of his year-end assets. But if he keeps that money in the system for 40 years, it will have the same effect on final pension as an asset-based fee that is only 0.6 percent of his year-end assets, for each of the 40 years. If he contributes every year for 40 years, paying a 20 percent fee on each new contribution, all these fees together are equivalent to an annual fee of 1 percent of assets per year. This will reduce his final pension by 20 percent. See Estelle James et al., "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph Stiglitz, eds., *New Ideas about Old Age Security* (Washington, D.C.: World Bank, 2001); a revised version was published in *Private Pension Systems: Administrative Costs and Reforms* (Paris: Organization for Economic Cooperation and Development, 2001). Also see Estelle James et al., "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in A Social Security System?" in John Shoven, ed. Administrative Costs and Social Security Privatization (Chicago: University of Chicago Press, 2000).

[8] Ibid.

[9] See *Pension Reforms: Results and Challenges* (Santiago, Chile: Federacion Internacional de Administradoras de Fondo de Pensiones, 2003).

[10] James et al., "Administrative Costs and the Organization of Individual Account Systems."

[11] See Estelle James, Alejandra Cox Edwards and Rebecca Wong, "The Gender Impact of Pension Reform," *Journal of Pension Economics and Finance*, 2003, and "The Impact of Social Security Reform on Women in Three Countries," National Center for Policy Analysis, Policy Report No. 264, November 2003.

[12] Or $1,000 monthly for a couple. See the poverty guidelines of the U.S. Department of Health and Human Services.

[13] See Estelle James and Dimitri Vittas, "Annuities Markets in Comparative Perspective: Do Consumers Get Their Money's Worth?" in *Private Pension Systems: Administrative Costs and Reforms*.

[14] At present, annuitants get an income of $7,200 annually for a $100,000 premium. In the future, they will get $6,800.

[15] *The Chilean Pension System* (Santiago, Chile: SAFP (Superintendencia de Administradoras de Fondos de Pensiones), 2003).

[16] Ibid.

# About the Author

**Estelle James** is principal author of *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* (Washington, D.C.: World Bank and Oxford University Press, 1994) and is currently a consultant to the World Bank and other organizations. She was previously Lead Economist in the Research Department of the World Bank and Director of its Flagship Course on Social Security Reform. She also served as a member of the President's Commission to Strengthen Social Security in the United States.

# About the NCPA

The NCPA was established in 1983 as a nonprofit, nonpartisan public policy research institute. Its mission is to seek innovative private sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs), now known as Health Savings Accounts (HSAs). The *Wall Street Journal* and *National Journal* called NCPA President John C. Goodman "the father of Medical Savings Accounts." Sen. Phil Gramm said MSAs are "the only original idea in health policy in more than a decade." Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs. A June 2002 IRS ruling frees the private sector to have flexible medical savings accounts and even personal and portable insurance. A series of NCPA publications and briefings for members of Congress and the White House staff helped lead to this important ruling. In 2003, as part of Medicare reform, Congress and the President made HSAs available to all non-seniors, potentially revolutionizing the entire health care industry.

The NCPA also outlined the concept of using tax credits to encourage private health insurance. The NCPA helped formulate a bipartisan proposal in both the Senate and the House, and Dr. Goodman testified before the House Ways and Means Committee on its benefits. Dr. Goodman also helped develop a similar plan for then presidential candidate George W. Bush.

The NCPA shaped the pro-growth approach to tax policy during the 1990s. A package of tax cuts, designed by the NCPA and the U.S. Chamber of Commerce in 1991, became the core of the Contract With America in 1994. Three of the five proposals (capital gains tax cut, Roth IRA and eliminating the Social Security earnings penalty) became law. A fourth proposal — rolling back the tax on Social Security benefits — passed the House of Representatives in summer 2002.

The NCPA's proposal for an across-the-board tax cut became the focal point of the pro-growth approach to tax cuts and the centerpiece of President Bush's tax cut proposal. The repeal by Congress of the death tax and marriage penalty in the 2001 tax cut bill reflects the continued work of the NCPA.

Entitlement reform is another important area. With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare. This work is under the direction of Texas A&M Professor Thomas R. Saving, who was appointed a Social Security and Medicare Trustee. Our online Social Security calculator, found on the NCPA's Social Security reform Internet site (www.TeamNCPA.org) allows visitors to discover their expected taxes and benefits and how much they would have accumulated had their taxes been invested privately.

Team NCPA is an innovative national volunteer network to educate average Americans about the problems with the current Social Security system and the benefits of personal retirement accounts.

In the 1980s, the NCPA was the first public policy institute to publish a report card on public schools, based on results of student achievement exams. We also measured the efficiency of Texas school districts. Subsequently, the NCPA pioneered the concept of education tax credits to promote competition and choice through the tax system. To bring the best ideas on school choice to the forefront, the NCPA and Children First America published an *Education Agenda* for the new Bush administration, policy makers, congressional staffs and the media. This book provides policy makers with a road map for comprehensive reform. And a June 2002 Supreme Court ruling upheld a school voucher program in Cleveland, an idea the NCPA has endorsed and promoted for years.

The NCPA's E-Team program on energy and environmental issues works closely with other think tanks to respond to misinformation and promote commonsense alternatives that promote sound science, sound economics and private property rights. A pathbreaking 2001 NCPA study showed that the costs of the Kyoto agreement to halt global warming would far exceed any benefits. The NCPA's work helped the administration realize that the treaty would be bad for America, and it has withdrawn from the treaty.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA scholars appear regularly in national publications such as the *Wall Street Journal*, the *Washington Times*, *USA Today* and many other major-market daily newspapers, as well as on radio talk shows, television public affairs programs, and in public policy newsletters. According to media figures from Burrelle's, nearly 3 million people daily read or hear about NCPA ideas and activities somewhere in the United States.

The NCPA home page (www.ncpa.org) links visitors to the best available information, including studies produced by think tanks all over the world. Britannica.com named the ncpa.org Web site one of the best on the Internet when reviewed for quality, accuracy of content, presentation and usability.

## What Others Say about the NCPA

*"...influencing the national debate with studies, reports and seminars."*

***- TIME***

*"Oftentimes during policy debates among staff, a smart young staffer will step up and say, 'I got this piece of evidence from the NCPA.' It adds intellectual thought to help shape public policy in the state of Texas."*

***- Then-GOV. GEORGE W. BUSH***

*"The [NCPA's] leadership has been instrumental in some of the fundamental changes we have had in our country."*

***- SEN. KAY BAILEY HUTCHISON***

*"The NCPA has a reputation for economic logic and common sense."*

***- ASSOCIATED PRESS***

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United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy, Trade and Technology

"Social Security Reform: Successes and Lessons Learned"

May 5, 2005

Statement of Patrick Purcell
Specialist in Social Legislation
Domestic Social Policy Division
Congressional Research Service

Madame Chairwoman and members of the subcommittee, my name is Patrick Purcell and I am a specialist in pension issues with the Congressional Research Service. Thank you for inviting me to speak to you today about the Thrift Savings Plan for federal employees.

The Thrift Savings Plan is a retirement savings plan for federal employees and members of the uniformed services. It was authorized by Congress in the *Federal Employees' Retirement System Act of 1986* (P.L. 99-335). The Thrift Plan provides federal employees and members of the uniformed services with a tax-deferred savings vehicle similar to those provided by many employers in the private sector under section 401(k) of the Internal Revenue Code. The Thrift Plan was designed by Congress to be a key part of the retirement benefits for employees who are covered by the Federal Employees' Retirement System (FERS), which covers all federal employees hired on or after January 1, 1984.

Origin of the Federal Employees' Retirement System

Prior to enactment of the *Social Security Amendments of 1983* (P.L. 98-21), federal employees were not covered by Social Security. Federal employees were covered instead by the Civil Service Retirement System (CSRS). Because the Social Security system needed additional cash contributions to remain solvent, the 1983 amendments mandated coverage for civilian federal employees hired in 1984 or later.

Congress recognized, however, that Social Security provided some of the same benefits as CSRS. Moreover, enrolling federal workers in both plans would have required payroll deductions equal to more than 13% of employee pay. Consequently, Congress directed the development of a new federal employee retirement system with Social Security as the cornerstone and which would incorporate many features of the retirement programs typical among large employers in the private sector. The result of this effort was the Federal Employees' Retirement System, or FERS. FERS consists of three elements: (1) Social Security, (2) a traditional pension called the FERS basic retirement annuity, and (3) the Thrift Savings Plan.

The Thrift Plan is administered by an independent government agency, the Federal Retirement Thrift Investment Board, which is charged in statute with operating the Thrift Plan prudently and solely in the interest of the participants and their beneficiaries.[1] The assets of the Thrift Plan are maintained

[1] See 5 U.S.C. § 8472(h).

in the Thrift Savings Fund, which invests the assets in accordance with participant instructions in five investment funds authorized by Congress to be included in the plan.

Federal employees who participate in FERS, or its predecessor, the Civil Service Retirement System ("CSRS"), and members of the uniformed services are eligible to join the Thrift Plan immediately upon being hired. Generally, FERS employees are those employees hired on or after January 1, 1984, while CSRS employees are employees hired before January 1, 1984, who have not elected to convert to FERS. Each group has different rules that govern contribution rates.

As of March 31, 2005, there were 3.4 million participants in the Thrift Plan, with approximately 2.5 million contributing to the plan.[2] Among employees covered by FERS, 86% of those eligible to participate in the Thrift Plan do so. Among CSRS employees, about two-thirds participate. Assets of the plan totaled $154 billion as of March 31. In terms of both assets and number of participants, the Thrift Savings Plan is the largest employer-sponsored retirement savings plan in the United States.

The Thrift Plan is legally a "defined contribution" plan. This means that it specifies how much an employee may contribute and how much the employing agency must contribute to each FERS employee's account. The employee owns the account and his or her benefit is equal to the account balance, which can be taken as a lump-sum, an annuity, or a series of periodic withdrawals.

Contributions

In 2005, FERS employees can contribute as much as 15 percent of basic pay on a tax-deferred basis, up to the $14,000 maximum specified in section 402(g) of the Internal Revenue Code. Participants in FERS are entitled to receive employer matching contributions on the first five percent of pay that they contribute to the Thrift Plan.[3] Participants age 50 and older who are already contributing the maximum amount for which they are eligible are allowed to make supplemental tax-deferred "catch-up" contributions of up to $4,000 in 2005.

In 2005, CSRS employees and members of the uniformed services can contribute up to ten percent of basic pay on a tax-deferred basis, subject to the $14,000 maximum specified in the tax code. Members of the uniformed services also may contribute up to 100% of designated special pay, incentive pay, and bonuses to the Thrift Plan. Neither CSRS participants nor members of the uniformed services receive employer matching contributions because both CSRS and the military services provide pension benefits to career employees and career military personnel that are substantially larger as a percentage of career-average pay than the FERS basic retirement annuity.

All FERS participants receive from their employing agencies an automatic contribution equal to one percent of basic pay.[4] Participants may also transfer funds from a traditional individual retirement accounts (IRA) or another eligible employer plan into the Thrift Plan.

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[2] See **Table 1** for complete Thrift Savings Plan enrollment statistics.

[3] The formula for agency matching contributions is specified in law at (5 U.S.C. § 8432(c)).

[4] Basic pay is defined in statute at (5 U.S.C. § 8401(4)).

Investment Options

As provided for in statute, Thrift Plan participants are offered five investment funds. Participants may allocate their contributions among any or all of the five investment funds, and they may reallocate their account balance among the five investment funds. The four funds that invest in private-sector securities are all index funds. These funds purchase securities in the same proportion as they are represented in an index of stocks or bonds, rather than through the decisions of an investment manager. Index funds have lower administrative costs than actively-managed funds, and because they purchase securities in the same proportion as they are represented in an index, there is little or no opportunity for the purchase of securities by the fund to be influenced by third parties who might benefit from having the fund invest in particular companies or sectors of the economy.

The five funds in the Thrift Plan are:

- the *Government Securities Investment Fund*, (the "G Fund"). This fund invests exclusively in U.S. Treasury Securities and other securities backed by the full faith and credit of the United States. Over the period from 1988 through 2004, the "G" fund earned an average annual rate of return of 6.6%.[5]

- the *Fixed Income Investment Fund*, (the "F Fund"). This fund invests in a bond index fund that tracks the performance of the Shearson Lehman Brothers Aggregate (SLBA) bond index. These securities consist of government bonds, corporate bonds, and mortgage-backed securities. From 1988 through 2004, the "F" fund earned an average annual rate of return of 7.7%.

- the *Common Stock Index Investment Fund* (the "C Fund"). This fund invests in stocks of the corporations that are represented in the *Standard and Poor's 500* index in the same proportion as they are represented in that index. During the period from 1988 through 2004, the "C" fund earned an average annual rate of return of 12.0%.

- the *Small Capitalization Stock Index Investment Fund* (the "S Fund"). This fund invests in the stocks of small and medium-sized companies incorporated in the United States. Stocks in this fund are held in the same proportion as they are represented in the *Wilshire 4500* stock index. The average annual rate of return on the *Wilshire 4500* from 1988 through 2004 was 12.7%

- the *International Stock Index Investment Fund* (the "I Fund"). This fund invests in the common stocks of foreign corporations represented in the Morgan Stanley Capital Investment EAFE (Europe, Australia-Asia, Far East) index. The average annual rate of return on the EAFE Index from 1988 through 2004 was 6.1%

The Thrift Board has contracted with Barclays Global Investors to manage the index funds in which the F, C, S, and I Fund assets are invested. The contracts for each fund are open to competitive bids by qualified investment managers every three to five years.

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[5] See **Table 2** for annual rates of return from 1988 through 2004.

Participant Vesting

Thrift Plan participants are immediately vested in all of their own contributions and investment earnings on those contributions.[6] Participants also are immediately vested in agency matching contributions made to their accounts and attributable earnings. In order to be vested in the agency automatic (1%) contributions, a FERS employee must have either 2 or 3 years of service as described in section 8432(g) of title 5 of the U.S. Code. FERS employees who are not vested and who separate from the federal government forfeit all agency automatic contributions and attributable earnings. Forfeited funds, consisting primarily of monies forfeited pursuant to 8432(g), totaled $10,822,000 in 2004 and $7,824,000 in 2003. By law, these funds are used to pay accrued administrative expenses of the Thrift Plan. If the forfeited funds are not sufficient to meet all administrative expenses, earnings on participant investments are then charged for administrative costs. In its most recent annual report, the plan reported administrative costs of six basis points, or six-hundredths of 1%. Thus, the administrative expenses of the Thrift Plan are about 60 cents for each $1,000 invested.[7]

Participant Accounts

The Thrift Plan maintains individual accounts for each participant. Participant accounts are credited with the participant's contributions, agency automatic and matching contributions, and charged with withdrawals. The value of the participant's account reflects the number of shares and the daily share prices of the funds in which it is invested. Administrative expenses are a component of the share price calculation. The benefit to which a participant is entitled is the participant's vested account. Thrift Plan participants can receive account-balance information and conduct transactions by automated telephone service or on the Thrift Plan's web site.[8]

Participant Loans

Participants may borrow from their accounts. There are two types of Plan loans: general purpose and residential. General purpose loans can be obtained for any purpose, with a repayment period from 1 to 5 years. Residential loans can be obtained for the purpose of purchasing a primary residence, with a repayment period from 1 to 15 years. Participant loans may only be taken from participant contributions and attributable earnings. The minimum loan amount is $1,000. The interest rate for loans is the "G Fund" interest rate at the time the loan agreement is issued by the Plan's record keeper. The rate is fixed at this level for the life of each loan. Interest earned on loans is allocated to the participant account upon repayment. Participants whose loans are in default have until the end of the following calendar quarter to pay the overdue amount. If not repaid by that time, the loan plus accrued interest is treated as a taxable distribution to the plan participant, which may be subject to the 10% penalty on retirement plan distributions made before age 59½.

Benefit Payments

After leaving service, participants may elect benefit withdrawals in the form of a partial withdrawal or a full withdrawal as a single payment, a series of payments, or a life annuity. Participants may

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[6] To "vest" in a benefit is to gain a legally enforceable right to receive it.

[7] See **Table 3** for the Thrift Savings Plan's assets, income, and expenses in 2004 and 2003.

[8] The URL of the Thrift Savings Plan web site is www.tsp.gov.

choose to combine any two, or all three, of the available withdrawal options. The Board has contracted with the Metropolitan Life Insurance Company to provide annuity products to Thrift Plan participants. The contract to issue Thrift Plan annuities is open to competitive bids every three to five years.

The Federal Retirement Thrift Investment Board

The Federal Retirement Thrift Investment Board was established by the FERS Act of 1986.[9] The Board is responsible for developing the investment policies of the Thrift Plan and overseeing the management of the plan, which is under the day-to-day direction of an Executive Director appointed by the Board.

Three of the five members of the Board — including the Chairman — are appointed by the President. The President chooses a fourth member of the Board in consultation with the Speaker of the House and the House Minority Leader and a fifth member in consultation with the Majority and Minority Leaders of the Senate. Members of the Board serve 4-year terms and all nominations are subject to Senate confirmation. The law requires that all nominees to the Board must be individuals with "substantial experience and expertise in the management of financial investments and pension benefit plans."[10]

The authorizing legislation that established the Thrift Board defines the Board's authority and responsibilities, and provides for substantial independence of the Board from political pressures.

Authority

The Thrift Board has the authority to:

- Appoint the Executive Director of the Thrift Plan;
- Remove the Executive Director for cause (This requires 4 votes of the 5-member Board.);
- Establish investment policies for the Thrift Plan;
- Instruct the Director to take whatever actions the Board deems appropriate to carry out the policies it establishes;
- Submit to the Congress legislative proposals relating to its responsibilities under federal law.

Independence

Members of the Board are nominated by the President and confirmed by the Senate, but once confirmed they cannot be removed from their 4-year terms without good cause. The selection and nomination process are designed to assure that Members of the Board are individuals who are supported by the President and Congress. They serve in times of good behavior, rather than at the pleasure of the President or Congress, assuring that they can carry out the responsibilities of their positions without of removal from office. The Federal Retirement Thrift Investment Board receives

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[9] See 5 U.S.C. § 8472.

[10] See 5 U.S.C. § 8472(d).

no appropriations from Congress. Administrative expenses are paid through agency-automatic contributions forfeited by employees who leave federal service before they have vested and charges against participant accounts.

Responsibility

The law requires that the members of the Board shall discharge their responsibilities solely in the interest of participants and beneficiaries. In practice, this means that the investment policies and management practices of the fund are evaluated by the Board exclusively in reference to the efficient and prudent management of the Fund's assets. This exclusive responsibility serves to further insulate the Board from pressures to adopt investment policies or management practices that might not be in the long-term interest of preserving and increasing the security and investment performance of the Fund's assets.

Oversight

To assure that the Members of the Thrift Board remain aware of the interests and concerns of Thrift Plan participants and beneficiaries, the authorizing legislation established the Employee Thrift Advisory Council. This 14-member council is appointed by the Chairman of the Thrift Board and must include representatives of federal employee and Postal Service labor organizations, managerial employees, supervisory employees, female employees, senior executives, and annuitants.

All fiduciaries of the plan, including members of the Thrift Board are required by law to be bonded.[11] The Secretary of Labor is authorized by law to investigate any suspected breach of duty by a fiduciary of the plan. The financial statements of the Thrift Board are audited regularly by an independent accounting firm. Congressional oversight of the Thrift Plan is performed by the House Committee on Government Reform and the Senate Committee on Homeland Security and Governmental Affairs.

Conclusion

The Thrift Savings Plan is an efficient provider of retirement savings accounts to the federal workforce. It has achieved high participation rates and low administrative costs. The Thrift Plan is a key component of federal employees' retirement benefits. This is especially true for workers in the middle and upper ranges of the federal pay scale who would be unlikely to achieve adequate retirement income from just Social Security, the FERS basic annuity, and the government's automatic contribution of 1% of pay to the plan. Later this year, the Thrift Plan will begin to offer life-cycle funds that will allow employees to have their investments re-balanced with a greater weight toward corporate and government bonds as they approach retirement age, thus protecting their accumulated assets from a sudden downturn in the stock market just as they are about to retire.

This concludes my testimony and I would be happy to answer any questions that members of the subcommittee might have.

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[11] A "fiduciary" is a person in a position of trust or confidence with regard to the property of another. A "bond" is form of insurance against the potential malfeasance of a plan fiduciary.

# Table 1. Thrift Savings Fund Statistics

| Fund balances, in millions | March 2005 | | February 2005 | | January 2005 | |
|---|---|---|---|---|---|---|
| "G" Fund | 61,060 | *40%* | 60,066 | *39%* | 59,760 | *40%* |
| "F" Fund | 10,079 | *7%* | 10,222 | *7%* | 10,279 | *7%* |
| "C" Fund | 64,368 | *41%* | 65,589 | *42%* | 64,163 | *42%* |
| "S" Fund | 9,847 | *6%* | 10,028 | *7%* | 9,681 | *6%* |
| "I" Fund | 8,678 | *6%* | 8,325 | *5%* | 7,451 | *5%* |
| **Total** | **$154,032** | ***100%*** | **154,230** | ***100%*** | **151,334** | ***100%*** |
| **Twelve-month returns** | | | | | | |
| "G"Fund | 4.45% | | 4.36% | | 4.38% | |
| "F" Fund | 1.17% | | 2.36% | | 4.07% | |
| "C" Fund | 6.76% | | 6.99% | | 6.24% | |
| "S" Fund | 7.95% | | 10.42% | | 10.14% | |
| "I" Fund | 14.96% | | 18.64% | | 16.22% | |
| **Participants (thousands)** | | | | | | |
| FERS, contributing | 1,539 | | 1,543 | | 1,553 | |
| FERS, agency 1% only | 243 | | 237 | | 234 | |
| FERS participation rate | 86.4% | | 86.7% | | 86.9% | |
| FERS, without agency 1% | 71 | | 63 | | 55 | |
| Total FERS with contributions | 1,853 | | 1,843 | | 1,842 | |
| CSRS contributing | 449 | | 454 | | 465 | |
| Uniformed services | 476 | | 478 | | 458 | |
| Participants, not contributing | 661 | | 663 | | 657 | |
| Total TSP participants | 3,439 | | 3,438 | | 3,422 | |
| **Loans outstanding** | | | | | | |
| Number | 859,386 | | 872,240 | | 883,357 | |
| Amount (millions of $) | $4,908 | | $4,969 | | $5,033 | |

**Source**: Federal Retirement Thrift Investment Board.

**Table 2. Annual Rates of Return for Thrift Savings Plan Funds**

| Year | G Fund | C Fund | F Fund | S Fund | I Fund |
|---|---|---|---|---|---|
| 1988 | 8.8% | 11.8% | 3.6% | 20.5% | 26.1% |
| 1989 | 8.8% | 31.0% | 13.9% | 23.9% | 10.0% |
| 1990 | 8.9% | -3.2% | 8.0% | -13.6% | -23.6% |
| 1991 | 8.1% | 30.8% | 15.7% | 43.5% | 12.2% |
| 1992 | 7.2% | 7.7% | 7.2% | 11.9% | -12.2% |
| 1993 | 6.1% | 10.1% | 9.5% | 14.6% | 32.7% |
| 1994 | 7.2% | 1.3% | -3.0% | -2.7% | 7.8% |
| 1995 | 7.0% | 37.4% | 18.3% | 33.5% | 11.3% |
| 1996 | 6.8% | 22.8% | 3.7% | 17.2% | 6.1% |
| 1997 | 6.8% | 33.2% | 9.6% | 25.7% | 1.5% |
| 1998 | 5.7% | 28.4% | 8.7% | 8.6% | 20.1% |
| 1999 | 6.0% | 21.0% | -0.8% | 35.5% | 26.7% |
| 2000 | 6.4% | -9.1% | 11.7% | -15.8% | -14.2% |
| 2001 | 5.4% | -11.9% | 8.6% | -2.2% | -15.4% |
| 2002 | 5.0% | -22.1% | 10.3% | -18.1% | -16.0% |
| 2003 | 4.1% | 28.5% | 4.1% | 42.9% | 37.9% |
| 2004 | 4.3% | 10.8% | 4.3% | 18.0% | 20.0% |
| **1988-2004** | **6.6%** | **12.0%** | **7.7%** | **12.7%** | **6.1%** |

**Sources:** www.tsp.gov, www.wilshire.com, www.msci.com.
**Note:** Rates of return for the C, G, and F funds are shown net of TSP expenses.

## Table 3. Financial Statements of the Thrift Savings Fund
## Statements of Net Assets Available for Benefits
## as of December 31, 2004 and 2003

*(In thousands)*

| | 2004 | 2003 |
|---|---|---|
| **ASSETS:** | | |
| Investments, at fair value: | | |
| U.S. Government Securities Investment Fund | $ 56,670,880 | $ 51,121,034 |
| Barclays U.S. Debt Index Fund | 9,732,943 | 10,071,287 |
| Barclays Equity Index Fund | 63,218,611 | 54,303,506 |
| Barclays Extended Market Index Fund | 9,644,143 | 5,622,444 |
| Barclays EAFE Index Fund | 7,021,069 | 2,211,875 |
| Participant loans | 5,105,715 | 5,130,170 |
| **Total investments** | **151,393,361** | **128,460,316** |
| Receivables: | | |
| Employer contributions | 166,045 | 151,497 |
| Participant contributions | 507,034 | 446,574 |
| Total receivables | 673,079 | 598,071 |
| Fixed assets, total: | 41,839 | 39,715 |
| Other assets | 5,460 | 11,236 |
| **Total assets** | **152,113,739** | **129,109,338** |
| **LIABILITIES:** | | |
| Total liabilities | 99,984 | 179,216 |
| Funds restricted for the purchase of Fiduciary Insurance | (4,829) | (4,978) |
| **Net Assets Available for Benefits** | **$ 152,008,926** | **$ 128,925,144** |

**Source**: Financial statements of the Thrift Savings Plan [ http://www.tsp.gov/forms/financial-stmt.pdf ].

**Table 3, continued. Financial Statements of the Thrift Savings Fund Statements of Changes in Net Assets Available for Benefits, Years ended December 31, 2003 and 2004**

*(In thousands)*

| | 2004 | 2003 |
|---|---|---|
| **ADDITIONS:** | | |
| Investment income (loss): | | |
| U.S. Government Securities Investment Fund | $ 2,346,104 | $ 2,074,004 |
| Net appreciation (depreciation) in fair value of Barclays funds: | | |
| Barclays U.S. Debt Index Fund | 408,397 | 455,956 |
| Barclays Equity Index Fund | 6,115,843 | 11,316,657 |
| Barclays Extended Market Index Fund | 1,249,934 | 914,990 |
| Barclays EAFE Index Fund | 870,403 | 358,102 |
| Interest income on participant loans | 237,684 | 222,422 |
| Asset Manager rebates | 1,778 | 1,616 |
| Less investment expenses | (4,503) | (3,708) |
| Net investment income (loss) | 11,225,640 | 15,340,039 |
| Contributions: | | |
| Participant | 11,980,077 | 10,366,123 |
| Employer | 4,238,199 | 3,887,260 |
| Total contributions | 16,218,276 | 14,253,383 |
| **Total additions** | **27,443,916** | **29,593,422** |
| **DEDUCTIONS:** | | |
| Benefits paid to participants | 4,110,891 | 2,774,685 |
| Administrative expenses | 91,896 | 75,038 |
| Participant loans declared taxable distributions | 157,496 | 130,559 |
| Total deductions | 4,360,283 | 2,980,282 |
| Change in funds restricted for the purchase of Fiduciary Insurance | 149 | 375 |
| Net increase | 23,083,782 | 26,613,515 |
| **NET ASSETS AVAILABLE FOR BENEFITS:** | | |
| **Beginning of year** | **128,925,144** | **102,311,629** |
| **End of year** | **$152,008,926** | **$ 128,925,144** |

**Source**: Financial statements of the Thrift Savings Plan [ http://www.tsp.gov/forms/financial-stmt.pdf ].

**Why personal accounts and why now?**

By Estelle James and Deborah James[1]

Why should we fix the social security system when it won't go bust until 2042? Because this enables us to make the right choice while we still have the chance. The choice we can make now, but not later, is to build personal retirement savings accounts. Total social security benefits would then come from two sources: income from funds accumulated in the retiree's own account plus a defined benefit financed by current workers. We're better off with funds and we're better off if individuals, rather than the government, invest those funds.

**Using today's cash surplus to jump-start the accounts**

Social security's "crisis" is not here yet. The social security trust fund still runs a surplus each year, as total revenues from payroll taxes exceed total benefits paid. This is projected to continue until 2018. If we start now, for 13 years the trust fund will have money with which to jump-start the personal accounts.

**Avoiding the build-up of a hidden government debt to the trust fund**

Right now the OASDI trust fund is required to lend the surplus to the treasury and receives iou's in exchange. The surplus cancels out some of the treasury's deficit in the government's unified budget--which may encourage the treasury to incur larger deficits than it would have otherwise. These accumulated iou's currently add almost 40% ($1.6 trillion) to the publicly held debt number that is usually reported. Eventually taxes will have to rise (or government spending fall) to enable the treasury to repay its debt to the trust fund. In contrast, if the money is put into personal accounts it won't automatically be lent to the treasury and won't offset the treasury's deficit. This is more likely to impose some fiscal discipline, reduce the growth in hidden government debt, and cut down on the extra taxes we will have to pay later for iou redemptions to fulfill the commitment to retirees.

**Trust fund investments in the stock market create new problems**

If control of the government debt is our objective, why don't we limit the ability of the treasury to borrow from social security and instruct the trust fund to invest in the stock market instead? The problem is--this would concentrate substantial stock market power in the trust fund and would create a conflict of interest with other government agencies (the SEC, FCC, FDA, etc.) that regulate companies in which it invested. Can effective informational firewalls be set up within the government? Would the regulators impose penalties on companies in which the trust fund has invested? Would the trust fund's portfolio include small companies—it might end up as their major stockholder? How would the government deter lobbying to include or exclude certain industries in the trust fund's portfolio?

**Personal accounts can do better**

Private individuals can invest their accounts in the stock market and earn the equity premium without these conflicts and political pressures that are inevitable when the government invests for us. Investment does involve risk—but this risk can be reduced by broad diversification , investment in government bonds, or public or private guarantees. The account makes the benefit more secure—because workers in the future may not be willing to pay the high payroll tax rate we will need to maintain scheduled benefits under the current system.

But it takes a long time for savings accounts to grow. They won't be there in time for the baby-boomers and post-baby-boomers unless we start building them now.

**Individual accounts promote economic growth**

Most importantly, individual accounts are good for the economy. Putting money into the accounts increases national saving and therefore productivity. With higher productivity, more goods and services will be available for workers and retirees. As global capital become increasingly scarce relative to labor, due to the entry into global labor markets of a billion workers from China and India, retirees will benefit from diversifying their income sources and holding some of that capital. Very few workers in the bottom half of the income distribution do so now.

**Tinkering with the system to increase the trust fund—not a good idea**

Some people suggest that tinkering with the current system--reducing benefits or raising contributions a bit here and there—will make it unnecessary for us to make more radical changes, such as personal accounts. But these small changes are designed to stretch out the periods of annual cash surpluses, without addressing the issue of how the surpluses will be invested. If government increases its borrowing and we miss the opportunity to save and invest productively, we will have only an illusion of progress and a larger bill at the end.

These are the reasons why over 30 countries (for example, Switzerland, Australia, the UK, Sweden, Hong Kong, Poland, Hungary, Chile and most Eastern European and Latin American countries) now include privately managed personal accounts in their mandatory social security systems.

**How to do it right**

Of course, for personal accounts to help they must be done right. Extra money is needed, beyond the current payroll tax, and the safety net has to be strengthened:

- The accounts should be financed, in part, with an additional contribution (an "add-on"), to help maintain total benefits.
- The add-on should be matched by money "carved out" from the payroll tax or trust fund. The match should be progressive—higher for low earners.
- A minimum pension should be added, to offset labor and financial market risk. (Practically every country with personal accounts has a minimum pension).
- Transition costs (the financing gap created by the carve-out after the trust fund surplus runs out) should not be debt-financed, which would defeat the object of increased national saving. Instead, the limit could be raised on earnings subject to the payroll tax. (Most wage increases in recent years have gone to earnings above the current taxable ceiling of $90,000). Or, better still, a surtax on all incomes (not simply wages) could be imposed.
- Wage indexation of the traditional benefit should continue. If we switch to price indexation, the benefit would fall drastically relative to wages and contributions that rise over time. Many seniors would end up way below the average standard of living.
- Retirement age should be automatically linked to increases in life expectancy, which are expected to accelerate. There is no way that the same contribution rate can pay the same benefit for more and more years.
- Workers should be given a choice among a limited number of investment options, indexed to broad diversified market benchmarks, with asset managers chosen in a competitive bidding process, to keep administrative costs and risk low. This is similar to the Thrift Saving Plan, currently used by federal civil servants.
- Most payouts should take the form of annuities or gradual payouts designed to last the individual's full life, with joint pensions required for married couples.

This plan would put social security on a more sustainable financial footing, maintain total benefits and promote economic growth. It would be a win-win solution for politicians of both parties and for all Americans—if we adopt it soon.

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[1] Estelle James was a member of President Bush's Commission to Strengthen Social Security and is currently a consultant to the World Bank and other organizations. Previously she was Lead Economist at the World Bank and principal author of Averting the Old Age Crisis, the World Bank's study of global social security problems. Deborah James, an attorney, is a baby boomer who has a vested interested in the outcome. For analyses of social security reforms in other countries see www.estellejames.com.

1
Congresswoman Barbara Lee
DIMP Subcommittee Hearing on Social Security
May 5, 2005

**Question for Gary Amelio: Executive Director of Federal Thrift Investment Board**

As you point out, the Federal Thrift Savings Plan is the largest individual account retirement system in the country, with over $155 billion in assets and over 3.4 million individual accounts.

By aggregating small accounts, the TSP has enormous bargaining power both to lower administrative costs and to potentially influence financial markets.

At the hearing this morning, Congressman Frank asked me about my views on price vs. wage vs. progressive indexation. I didn't realize that we would be discussing that issue so didn't have a well-thought-out opinion at my fingertips. Now that I've had a couple of hours to think about it, I would like to modify my answer:
Given social security's financial situation, I think that progressive indexation is a good idea, with some qualifications:
1. I would make the cut at the median wage, which is about $38,000, rather than the $20-25,000 number that has been mentioned. That is, I would continue wage indexation for the bottom half of the labor force, and start the movement to price indexation for those above the median.
2. I would plan to continue this process only for a finite period of time, such as 30-40 years, after which I would resume wage indexation for everyone.
3. As mentioned in my article that Congressmen Frank quoted, I would also raise the normal retirement age as longevity increases. In the interest of truth in advertising, we should all realize that an increase in the normal retirement age is equivalent to a benefit cut in the sense that workers who continue to retire at the pre-existing NRA will get a lower benefit than they would otherwise, even if wage indexing is used. We can't expect to provide the same benefit to retirees for more years, without a substantial contribution increase. A higher NRA signals that people are expected to work longer to get the same benefit, and hopefully some people will respond.
4. Raising the retirement age, however, seems to be very unpopular politically. If that isn't feasible politically, then the trade-off would be direct benefit cuts through indexation for a broader group, as in Pozen's proposal. I would do that in such a way that the annuity from the accounts was at least large enough to bring those below the median to currently scheduled levels, even if invested in a conservative portfolio.
In other words, there are are many ways to put the parts together, to achieve roughly equivalent outcomes, both in terms of benefit levels and distribution. In thinking about measures to make social security sustainable, we really have to look at the package as a whole, not at each element in isolation. But my first-preference about the separate parts is as stated above.
I would appreciate it if you would pass this message on to Congressman Frank as well and other members of the Committee (also for the record, if that is possible). Thanks.

Estelle James

Reply to the questions from Congresswoman Barbara Lee to Estelle James:

I believe it is important to continue paying scheduled benefits to your constituents and others. To accomplish this will require more revenue for the system whether we use personal accounts or not. But if we use personal accounts we will get better value for that money—that is, we will either get higher benefits or require lower contributions or some of each. The reason is that personal accounts will earn an investment return that will help to finance the benefits, and they will also help to raise national saving and output, which will increase the real goods and services that the benefits can buy.

Because more money is needed to accomplish this, I would finance the accounts mostly through a small add-on—that is, through an additional mandatory contribution that would go into the accounts. The accounts would be heavily regulated and would form part of the total social security system. For low earners (below the median) I would partially match the add-on with a small contribution from the trust fund or general revenues. This would be in recognition of the fact that the add-on would be more difficult for low earners to make, and furthermore that low earners often do not have the benefit of an employer match to a 401k, as higher earners do. As far as I know, the President is not proposing this match, but of course that could always be added.

As for the traditional benefit, I would gradually cut back on the rate of growth for earners above the median. Also, as longevity increases I would gradually raise the retirement age and the number of working years that are averaged to get the social security wage base. Data show that your constituents are living longer and healthier so will be able to work longer—and will probably benefit socially and mentally if they do so. Increasing the age at which full benefits are received is a logical response to the longer years of healthy life that we are experiencing; we can't expect society to continue to pay for more and more non-working years. These measures—slowing down the growth rate of benefits for workers above the median and raising the retirement age and the number of years averaged into the social security wage base—should bring the traditional system back to solvency.

The extra money in the add-on accounts would be mandatory retirement saving that would enable your constituents to continue to retire at an earlier age if they choose to do so or to supplement their benefits if they postpone retirement.

That is the way I would make sure that your constituents do not suffer from benefit cuts. If properly implemented, personal accounts are part of the solution. If not properly implemented, they are part of the problem. That is why I wish that you and your colleagues would focus attention on what is the proper way to implement them.

Response to Questions for the Record from
Congresswoman Barbara Lee

Ever since the TSP began investment activity in 1987, it has been suggested that the Board should be acting in such a way as to support favored investments or to oppose disfavored ones. In the 1980s and 1990s, the Board was urged to invest in mortgages to support housing, to avoid investments in South Africa, and to support (or oppose) investments based on corporate compliance with the "Macbride principles" in Northern Ireland. Later he Board was urged to concentrate investments in support of minority-owned businesses and to promote many other seemingly very legitimate purposes.

Congress addressed the issue of non-financial investment considerations such as the one raised in your question when it created the TSP. The legislative history of the TSP provisions of the Federal Employees' Retirement System Act of 1986 (FERSA), the TSP's enabling legislation, confirms that there was concern that neither the Board, the Congress, nor the Administration be in a position to manipulate the assets of the Thrift Savings Fund for purposes other than furtherance of the financial interests of the participants and beneficiaries. As noted in the conference report that accompanied the final version of FERSA:

> A great deal of concern was raised about the possibility of political manipulation of large pools of thrift plan money. This legislation was designed to preclude that possibility.
>
> Concerns over the specter of political involvement in the thrift plan management seem to focus on two distinct issues. One, the Board, composed of Presidential appointees, could be susceptible to pressure from an Administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes. Neither case would be likely to occur given present legal and constitutional constraints.

H.R. Conference Report No. 99-606, at 136 (1986), reprinted in 1986 U.S.C.C.A.N. 1508, 1519 (hereafter cited as "Conference Report").

To eliminate the possibility that the Board might make investments in pursuit of goals other than the interests of the participants and beneficiaries of the TSP, Congress imposed strict fiduciary responsibilities, and structured the investment funds in a manner that precludes any political manipulation:

> The Board members and employees are subject to strict fiduciary rules. They must invest the money and manage the funds solely for the benefit of the participants. A breach of these responsibilities would make the fiduciaries civilly and criminally liable.
>
> The structure of the funds themselves prevents political manipulation. The Government Securities Investment Fund is invested in nonmarketable special issues of the Treasury pegged to a certain average interest rate. The Fixed Income Investment Fund is composed of guaranteed investment contracts, certificates of deposits or other fixed instruments in which the Board contracts with insurance companies, banks and the like to provide it with a fixed rate of return over a specified period of time. The Board would have no knowledge of the specific investments.
>
> Finally, the stock index fund is one in which a common stock index such as Standard & Poor's 500 or Wilshire's 5000 is used as the mechanism to allocate investments from the fund to various stocks. . . . Hence no individual or group of individuals are capable of manipulating investments. The legislation bars Board members, the Executive Director and employees from voting proxies owned by the stock index fund.

Conference Report 136-37.

Section 8495 of the original Senate version of the bill that eventually was passed as FERSA, S. 1527, required that the Board's investment policies provide for prudent investments, low administrative costs, and "investments likely to receive broad acceptance by participants and the public, taking into consideration the views of the Employee Advisory Committee." Although this section did not explicitly mention investments designed to further social goals other than participant and beneficiary interests, at a Senate hearing on S. 1527, held September 11, 1985, it was pointed out to Senator Ted Stevens, Chairman of the Subcommittee on Post Office, Civil Service and General Services of the Senate Governmental Affairs Committee, that this language could be interpreted as an endorsement of social investing.

Senator Stevens stated that "I don't think that [social investment] should be our function" and that the language should be changed "more toward a strict economic investment." Hearing Before the Comm. on Governmental Affairs, United States Senate, on S. 1527 to Amend Title 5, U.S.C., to Establish a New Retirement and Disability Plan for Federal Employees, Postal Employees, and Member of Congress, and for Other Purposes, 99th Cong. 521 (1985) (remarks of Sen. Stevens). Senator Stevens' comments are consistent with the intent expressed in the Conference Report, and the language in S. 1527 suggesting that social investing would be acceptable was not incorporated in the final version of FERSA.

Thus, the Board must make all investment decisions solely in the interests of the participants and beneficiaries of the TSP without regard to other objectives, however meritorious. The legislative history of FERSA makes it clear that Congress recognized that a long-term commitment to such protection is an essential part of the TSP.

O