THE URBAN INSTITUTE

AN INTERNATIONAL CONFERENCE ON SOCIAL SECURITY REFORM IN SELECTED OECD COUNTRIES

FRIDAY, FEBRUARY 24, 2006
9:00 A.M.—4:30 P.M.

Transcript by:
Federal News Service
Washington, D.C.

BOB REISCHAUER: Good morning. I'm Bob Reischauer, the president of the Urban Institute. I want to welcome you all to this conference on Social Security reform in selected OECD countries.

Justice Lewis Brandeis once referred to the American states as laboratories for democracy, and what he was meaning in that was that states could experiment with policies and programs often sooner than the federal government because of the political dynamics within the state, and then we could watch these programs and policies as they developed in their early years and to the extent that some succeeded and were appropriate for application at the national level, the federal government could take the lessons and then put them into action across the country.

In a very real way, the developed democracies of the OECD can serve the same function for the United States when it comes to Social Security reform. Most are far ahead of us in their efforts to grapple with these problems. Most face the same kind demographic economic and programmatic challenges that we face, and we can look and see what they are doing and learn from that.

To be sure, there is a lot of differences with respect to the details of their programs and the specifics of the reforms that might be politically viable and the government systems that bring those about, but nevertheless, it is a very fruitful area for those involved in Social Security reform here in the United States to look to for lessons.

And so I think it's important that we in the United States continually test the waters, see what is happening abroad, see whether anything that is happening in Japan, Sweden, Canada, wherever, is applicable to us. And so I look forward and I think all of us do to learning a whole lot as the day goes on.

Rudy.

RUDOLPH G. PENNER: Well, thank you, and welcome, everybody. Unfortunately the debate over Social Security reform died an ignoble death last year in this country. I'm a little shaky on my Catholic theology but I believe that it went to purgatory. (Laughter.) But we do know that at some point there has to be a miraculous resurrection because the current system must be changed. And we also know unfortunately that every day that we wait, the changes are going to be more painful.

So I hope this conference makes some modest contributions to keeping the discussion alive in this country. As Bob said, I'm a strong believer that different countries have a lot to teach us both about what to do and about what not to do when you are reforming a system. And all of the countries represented here have had major reforms in recent years.

I'm sure I have insulted—(chuckles)—a lot of countries by not bringing them here because reform has been going on around the world. But in choosing countries to be represented I thought that we had the most to learn from countries that had established systems. But that of course leaves out some very interesting reforms going on in emerging economies, places like Chile obviously, and in the countries like the formerly communist countries.

But in countries like that the systems were in considerable disarray before you have reform and I just have a feeling it's a lot harder when you have a generous system in place already.

Another thing that Gene and I are particularly interested in is automatic mechanisms that would balance the system. We put out a proposal for this country that is at your places. Bob Reischauer has a farther-ranging proposal that would affect the whole budget, and Belle Sawhill at Brookings has a variant on that theme. And a couple of the countries represented here do have automatic mechanisms of that sort.

So we start with Canada and Sweden which take different approaches to making their systems sustainable. Let us start with my old home country of Canada. Real Bouchard is currently the general director of federal provincial relations and social policy branch at the Canadian Department of Finance. He graduated from Laval University. He has been a civil servant in Canada for a very long time, almost the entire time working on pension policy in one way or another.

So Real.

REAL BOUCHARD: Thank you, Rudy, for inviting me to this conference. As was just mentioned, many countries including the U.S. are concerned about the sustainability of their public pension system. Canada faced that situation in the mid-1990s and then my presentation today will try to shed some light on some of the events that led to what we see as successful reform.

My presentation is divided into four main sections: first, a brief description of Canada' retirement income system and where the Canada pension plan fits in it; second, a description of the main challenges facing the CPP prior to reforms. They are very similar to the ones that the States are facing now. And then what are the reforms that we proposed and put in place. And finally, my views as to why Canada was able to put in place successfully those reforms.

Let me begin by providing a brief overview of Canada's three-pillar retirement income system. First, there is the old-age security guaranteed income supplement pillar. It is essentially—those benefits provide a guaranteed minimum income for seniors. It is based on residence only. It is regardless of implement history. And it is financed through general revenues on a pay-as-you-go basis. The guaranteed supplement—a part of this system is really a top-up for low-income seniors. It covers about a third of the population that received the OES benefit.

The second pillar, the focus of my presentation today, is the Canada pension plan, public plan, partially funded a defined-benefit plan and financed from mediatory contributions based on employment. And then finally, a well-developed tax-deferred private savings pillar consisting of RPBs and RSBs, employer-sponsored registered pension plans, and then retirement—individual's—retirement savings plans—contributions, annual contribution limits on that private pillar are in the $20,000, Canadian. It is substantially lower than the equivalent in the States.

That chart illustrates the proportion of preretirement earnings replaced by public pensions in Canada, public pensions being the OES, the GIS, and the Canada pension plan component. It illustrates well how our system achieves its two principal goals.

First public pensions allow replacement rates sufficient to allow low-income individuals to avoid poverty. You could see that particularly in the first two blocks, the first two towers, the 15,000 and 30,000, the 70 percent replacement rates, which is the objective to maintain the living standard of retirement for low-income people. It's way in excess sometimes of 100 percent.

And then of course the tax-deferred private savings consisting of RPBs and RSBs allow individuals with those annual contribution limits of up to 19,000 a year to bring their income hopefully as close as possible to the 70 percent replacement mark.

In terms of retirement income flows, in 2003, $80 billion of retirement income was generated from those three pillars, 43 percent of which came from tax-assisted private savings, 32 percent from the old-age security guaranteed supplement part of the system, and then the Canada pension plan, 25 percent.

In total the public plans, the old-age security and the Canada pension plan in terms of benefit pay outs, that represented about 4.6 percent of GDP, which if you—I compare those two—the public system to the OESDI, it's almost equivalent. I think OESDI is about 4.3 percent of GDP.

Let me turn now to the Canada pension plan. It provides all workers in Canada with a taxable basic earnings related retirement pension, indexed the prices. It also provides ancillary benefits, survivor disability and death benefits. The retirement benefit replaced 25 percent of average pension earnings up to the average industrial wage. Both the 25 percent and the earnings being covered are lower than what the state has—maximum benefit, slightly about $10,000 (Canadian) in 2006.

It is finances by mandatory employer, employee contributions, 9.9 percent split equally between the two. Unemployment earnings between a year's basic exemption, $3,500, and the average industrial wage, 42,000. Only the maximum is index to wages.

The exemption has been frozen since the reform in 97. I'll come back to that. Then of course investment earnings on excess contribution helps pay for benefits.

CPP has some important unique features. The decisionmaking is a joint federal provincial responsibility. While the CPP is governed by federal legislation, the changes to the plan require provincial consent, two-thirds of the provinces with two-thirds of the population. And it's the ministers federal and provincial minister of finance that are the costewards of the Canada pension plan. It is not, for example, the human resources department who has actually administered a plan; it's the minister of finance.

Because of that joint responsibility, CPP revenues, expenditures and assets, are not part of the public accounts of the government. Therefore they have got no impact on the financial position of the governments of Canada. It defers, for example, with the unemployment insurance part of the safety net in Canada where unemployment insurance is integrated with the government books. Canada pension plan is not because of that joint responsibility.

A brief—before I pass the next section, just to compare the Canadian system with the system in the U.S. As I have said, the old-age security component, maximum of about $5,800, Canadians, based on residence, it's got no program equivalent in the United States, although the OESDI has some redistributed elements that are comparable to what the old-age security program does in Canada.

The guaranteed income supplement, which is part of the old age security program, is a top-up for seniors: $7,000, Canadians, maximum, and about a third of seniors get it. It is comparable to the SSI in the United States although the SSI is much more highly targeted. That is my understanding, although maximum benefits are equivalent.

And finally, the contributory pension plan, CPP, comparable to OESDI, maximum benefits of $10,000 Canadian versus a substantially higher benefit in the States. But of course in Canada, the CPP is smaller, less with distributive, and of course a contribution rate and the earnings being covered, as have mentioned, smaller—CPP expenditures as a percentage of GDP, about 2.4 percent versus OESDI more in the 4 percent range.

Number two—I will now outline some of the challenge that led to the reforms. In 1966 when the plan was established, it was essentially financed as a pay-as-you-go basis with a small reserve. It made sense in the '60s because from an economic standpoint, earnings, real earnings were really growing fast, and the real interest rates were really low. Pay-as-you-go financing made sense in the mid-'60s. At the time the architects of the plan thought that long-term pay-as-you-go contribution rate in 2030 would never exceed 5.5 percent. That was 1966.

Between 1966 and '86, the combined contribution rate was maintained at 3.6 percent. Then finally, starting in 1986, a 25 year schedule of contribution rate increase was put in place. By 1996 the rate was 6.6. The pay-as-you-go-rate then was 8.3 percent, so not only were current contribution needed to pay benefits but the investment earnings and what had been accumulated had to be used to pay for benefits. And then the rate, that 25 year rate of—schedule or rates was scheduled to increase to 10.1 percent by 2016.

Then came the 1985 actuarial report. It sent a shockwave across the Canadian population. In fact, in spite of significant legislative contribution rate increase, as I just alluded, a three–fold increase between 1986 and 2016 from 3.6 percent to 10.1 percent, the plan was growing broke. Further, the pay-as-you-go rate were to continue to grow to more than 14 percent by 2030.

That actuarial report came out just as governments across Canada were embarking on a sustained effort to improve their finances. For example, the federal government then had an annual deficit of $42 billion; the cumulative debt represented about 70 percent of GDP. So that actuarial report coming out at a time where the finances of governments, both the federal and provincial were in bad shape—really sent a shockwave across Canada.

What had gone wrong? The answer was simple: rising costs. The long-term pay-as-you-go rates by 2030 projected, as I was saying earlier, to never exceed 5.5 percent in the long term. We're now projected to reach 14 percent in 2030. There were four reasons to explain this increase in the long-term pay-as-you-go-rate. First, demographics had change between 1966 and 1996, notably a declining ratio contributors to beneficiaries. Most major industrialized countries face the same thing.

As I have alluded to earlier—earnings growth, which was very high in the '60s and early '70s were—went down considerably in the '70s and '80s. That pushed the pay-as-you-go-rate up. Successive benefit enhancement since—especially in the '70s and '80s with our contribution rate increases, and finally in the previous decade between 86 and 96, a doubling of disability of the number of people receiving disability benefits, due to looser administration, meaning taking socioeconomic characteristics of applicants in consideration to determine work capacity, and of course looser eligibility requirements.

Within weeks the federal government committed to work with the provinces to fix the public pension system for good. The view of the Canadians were sought through a major public consultation backed by a user-friendly information paper prepared by both levels of government, and that was important. It was not a single party, it was not a single government; it was 12, 11 governments really releasing that paper.

Four questions were put to Canadians during those consultations, and you could see almost on the slide the response. But let me repeat the questions that were asked to Canadians. How high can contribution rates go before they become unaffordable and unfair? What is the appropriate balance between contribution rate increases and change in benefits? If some prefunding is desirable, how should it be achieved and how should benefit expenditures' growth be slowed?

The response: broad consensus on the CPP has to remain a public defined benefit pension plan, no privatization. Contribution rates over 14 percent are totally unacceptable for a plan that provides a relatively modest benefit. Current contributors have to pay a fairer share of the costs. Prefunding is desirable. Provided assets are invested like other pension plans. And then avoid significant benefit reduction, particularly for those already receiving benefits, then the CPP reforms themselves.

Federal and provincial government decided on a three-pronged approach to reform. First, as significant and rapid increase in contribution rate to a level sustainable over a very long term—9.9 percent from 2003 onward over a 75 year period, adoption of a new investment policy with assets invested in marketable securities at arms length from governments; and then finally changes to benefits in the administration to slow expenditure growth.

I will comment on each of these points in the next three slides. Move towards partial prefunding: a contribution rate for 5.6 to 9.9 over a six-year period, and a broadening of the contribution base by freezing the year's basic exemption rather than wage indexing it. Initially that means not very much but over the long term that freeze of the basic exemption has a real impact on the contribution rate.

Of course the 9.9 percent was going to exceed the pay-as-you-go rate for a 25 year period which would allow to build a reserve fund over that—during that period of about five years of benefit which means funding of about 25 percent of liabilities. And then the contribution rate for the long term was to cover the full costs of new entitlements plus a share of the unfunded burden that had built up in the past because people paid less than what their benefits were worth, and full benefits were paid very quickly in the '60s and '70s.

The important thing is that that additional payment of the unfunded liability was to be spread over all future generations, not one or two generations, and I'll come back to that later. And then finally investment earnings were to help pay future benefits that otherwise would be financed by higher contribution.

The number two, the second prong was the creation of the CPP investment board. It was key because it made it easier for Canadians to accept the rapid increase in contribution rate to accept fuller funding. Canadians would not have accepted that rapid increase in contribution rate if the investment policy had not been changed.

The investment board was established to manage assets in the best interest plan of members, not for economic—not for other reasons like economic development, independent from the federal and provincial governments, and governed by a qualified board of directors—no public servants, no politicians on the board—assets invested in a diversified portfolio securities instead of only bonds to get higher returns. And then of course investment rules were to be similar to those of pension funds. And the CPP idea was to provide quarterly statements and annual reports.

Finally, measures were also taken to tighten benefits in their administration to lower the long-term pay-as-you-go costs. First, benefits in pay were grandfathered; secondly—and that was important—a balance package of measure taken to slow the growth of expenditures, not focusing on one benefit or the other. First, a change to wage indexation of retirement benefit calculation; two administration of disability benefits was tightened, as well as the eligibility criteria to get in by requirement more recent contributions and a longer labor force attachment. And then the death benefit was reduced and frozen—$2,500, Canadians, and there were also some minor—changes to survivor benefits.

By 2030, projected expenditures were to be reduced by almost 10 percent. So what that meant—it's not on the slide, but what that meant was that the three-pronged approach allowed the long-term contribution rate to be 9.9 percent rather than 14 percent. Two percentage points of that 4 percent was related to the partial funding of the plan as well as a freeze of the year's basic exemption. One percent point saving was related to the new investment policy, and 1 percentage point was related to the reduction in benefits.

For your information, since it is pertinent to the debate that is currently taking place in the States, there were a number of other options and approaches to reduce benefits that were examined but ultimately rejected, for example, the retirement benefit, a lower replacement rate from 25 to 22½ , an increase in the age of entitlement, an increase in the number of years required to full pension. As well, a move to partial indexing of pensions was also put on the table—CPI minus one rather than CPI.

And then—and it came up particularly after the consultations. It was not part of the consultation itself—privatizing the CPP or replacing it with individual retirement accounts.

On the first two, the change to the pensions, real resistance during those consultations, and governments decided not really to proceed on that front. The main change that was made and that was not included in the consultation paper—I alluded to earlier—is that the initial retirement pension was going to be slightly reduced through using the average in the maximum pensionable earnings in the last five years rather than the last three years, which corresponded really to a 4 to 5 percent decrease in the initial benefit, but some people argue that it was done in a pretty sneaky way.

The retirement account—individual retirement accounts—one fundamental reason why it was rejected—and I think the States are facing the same problem. It's because we would be asking one generation or two to pay twice: to pay for their benefits, like in the States. I think President Bush was talking about a 4 percent contribution. So we would be asking people to pay for that, as well as pay for the outstanding obligations. Rudy alluded to in a mature pension system there are always those outstanding obligations. And unless those are spread over all across generations that we did in Canada, it is done over one generation or two. It would be excessive and probably would be rejected by the population.

Finally, I would like to conclude by sharing my view on the factors which I contributed to the success of the reform. Success was explained by four factors: the right timing, a real sense of urgency then, back in 1995 when it was realized that the contribution rate was—will end up being triple what had been initially—what was supposed to be the long-term rate. And as I have said, the economic and financial context really, really buttressed the reform resolve to take action.

Secondly, the public consultation allowed to frame and acceptable balanced package. And the fact that it was not only the federal government; it was also the provincial governments—federal and provincial elected representatives attended all of the consultation that took place across the nation. Third, concrete measures build confidence that the plan would be fixed for good. New investment policy was key and new—and measures to strengthen the plan governance and accountability.

And on this point we essentially—three things, and I think the full paper briefly explain those. One, three-year actuarial reviews rather than every five years; second, a default provision in the legislation that if the long-term rate is to exceed 9.9 percent, and if ministers cannot arrive at a decision, there is a default provision that automatically kicks in. Half of the increase that is required to maintain the sustainability of the plan kicks in and the benefits are frozen; they are not indexed until the next review.

And finally, any benefit enhancements are to be fully funded like a private pension plan. That really acts as a deterrent to really increase benefits without the right contribution rate increases.

Finally, the federal provincial decisionmaking held the agreement together. Because the consent of provinces were required, it took longer to arrive at a package of reform, but once it was reached, it was very difficult to change—to make any change because the whole agreement would unravel, so that was key in having the legislation passed in the federal—in federal parliament.

The final slide—the CPP today—9.9 contribution rate, three actuarial evaluations since then—it has been almost 10 years now—have shown that that rate is sustainable at least for the next 75 years, and it's important to remember that even if the 9.9 percent is higher than the actuarially fair full costs of pensions, the current—the current and future contributors will receive a positive return on their contribution. The internal rate of return is estimated for cohorts born after 1980 to be 2.1 percent.

Those actuarial projections, by the way, are all vetted and reviewed by an independent panel of actuaries. And finally the CPPIB is recognized as a—internationally as a model of transparent arms length and professional management of public pension funds. With those reforms, Canada is on the right track, and the confidence in the CPP has significantly increased among the Canadian population since reform. Thank you very much.

(Applause.)

MR. PENNER: Thank you very much, Real. Our first discussant is Stuart Butler who is the vice president for domestic and economic policy studies at the Heritage Foundation. I would call Stuart a polymath, if I knew what that meant. (Laughter.) He has worked an enormous number of areas from enterprise zones, poverty, health to Social Security. More recently he has, with Belle Sawhill, has been chairing a group of us, a diverse group of us to see if there is anything at all we can agree with when it comes to budget policy, so Stuart.

STUART BUTLER: Thank you, Rudy, and thank you Mr. Bouchard.

When I was reading the paper, I had brought back a memory of actually one of my trips to Canada probably about 15 years ago to speak on Social Security. And I remember going through customs in Toronto Airport and I had a package of material for handouts, and the custom offices said, what is this? Is this something you were bringing to sell in Canada? And I said, no, these are economics papers that I am going to hand out.

So he wrote down "contents: economics papers; value: zero." (Laughter.) So I think it's important to kind of have that perspective when one is looking at giving advice or commentary on any of these issues.

When you look at other countries of course—and we are looking at a number today, it can be very, very instructive in all kinds of ways. And I think if we are going to learn from it, one of the things, or a couple of things we have got to learn is to think about the conditions that prevailed at the time of a change, and whether they are relevant to the United States, and also to think about whether the policies themselves can cross the border, and if they were to cross the border how would the United States undertake those policies.

So it is with those sorts of perspectives I just want to make a few comments quickly about the paper in that regard.

First of all, Mr. Bouchard emphasized very strongly that timing was critical in the reforms in Canada. The paper indicates that and his comments do, that prior to 1995, the planets were not in alignment in Canada. It took a real shock in 1995 with regard to the reports and also just the general economic conditions to begin to shake Canadians into thinking fundamentally different. He mentions in the paper that the public sector total debt had reached 70 percent of GDP, which in the United States it's not since 1950 that was had a sought out level. But there as a growing anxiety about the system.

Something I think we have not seen since probably the early '80s when literally Social Security checks may not have been delivered within a few weeks or months. So the sense of crisis I think that was a necessary condition for the Canadian approaches I think certainly is not evident today, and certainly wasn't evident in the 1990s either, a comparable period to look at.

Today those of us, as Rudy mentioned, that are trying to get Americans to think hard about the huge unfunded liabilities of the federal government have an enormous uphill struggle to try to convince people when interest rates seem to be low, the economy seems to be going well and so on. So I think the conditions in that sense that were so critical, it's hard to imagine those here at the moment and in the foreseeable future, at least in the short-term future.

Real also emphasized that it was critically important in terms of conditions to have broad public consultation, and I think that is a very, very important lesson. And as he pointed out, Canadians were forced or push to think about some pretty fundamental principles about their system: Should workers have to face or should they contemplate higher contributions in order to sustain both their system and not to pass on new debt to the next generation.

We don't seem to be there yet in being willing to accept those kinds of notions here in the United States. Certainly the notion of trying—of raising contribution levels in order to sustain the system and to ward of debt to future generations—certainly in our debates in the last year or so were not very, very, very strong.

Also I think it's important to compare the public discussion in the 1990s in the U.S. during the Clinton administration with a more recent public discussion. President Clinton, as you'll recall, held a number of town hall meetings around the country, public discussions, and so on, I think quite frankly in a very positive way in terms of beginning to engage the bigger issues that the baby boom generation had to face in terms of thinking about the Social Security system.

Unfortunately I think that momentum eroded towards the end of the administration for various reasons including political reasons, and morphed into the notion of using the then surplus to save Social Security, which was a typically American simple magic-bullet approach rather thinking about structural change. Let's find a quick answer. And I think that spilled over, continued over into current years.

I think it's also important to compare that with the Bush discussion, such as—I use discussion and inverted comments with the American people because it was a very, very different situation last year of an administration trying to sell a particular proposal to the American people. One can fault the administration for that, but I think in fact one can recognize that the conditions were very different in the country in terms of thinking about the long-term future of Social Security. It was not necessary to achieve any of the kind of rethinking that we saw in Canada.

In terms of the conditions, Canadians, as Mr. Bouchard points out, were much more willing to consider allowing the government to take funds and invest in the marketplace than we, certainly reformers of the Social Security system have been in the United States. It is probably instructive to remember Canada's motto is peace, order, and good government, whereas ours is life, liberty, and the pursuit of happiness. We tend to be more skeptical of government than the Canadians for perhaps good reasons. I am a lot more inclined to hand over powers for investment to the government.

When one looks then at whether the policies would cross the border, as mentioned, I think that a couple of the elements of the reform would find it hard to cross the border in the conditions that we face today. The very sharp rise in contribution levels that were required as part of the Canadian reform certainly last year suggestions that there is little stomach for that in the United States, and indeed to the extent that contribution levels were on the table of being raised in the United States, it was more raising the income, the ceiling for contributions rather than expanding or increasing the contributions for people already paying them, which is really a violation of the whole principle of solidarity and social insurance, so that was the—such as it was that we would contemplate.

Reducing benefits, which to some extent was done in Canada, as was noted with, particularly with regard to disability, certainly was not well received here in the United States.

And then the final thing I just want to touch on in terms of the policy is the idea of investing. In both countries, it was recognized—it has been recognized that investing funds in some way in the private market to get better returns, to improve the situation is critical to the long-term viability of a pension system in Canada for the reasons I mentioned and Mr. Bouchard mentioned, that that was entrusted to the government. Here of course we attempted to do that through personal accounts, which failed as the proposal did in Canada.

Now, what if we were in fact to achieve the objective of having government investment of Social Security funds in the United States? I think there is a lot more concern here about the impact that would have than we see in the debate in Canada. I think Alan Greenspan raised two particular concerns relevant here: one, economic or technical and one political. The technical one is unless we see a net increase in savings, particularly long-term savings for pensions—a result of government investment, all we may be seeing is just simply a zero-sum game, and the switching of portfolios and the switching of funds rather than net improvement—so the ability of the economy to sustain pensions.

And secondly, the issue of independence—Alan Greenspan—and I agree with him on this—stressed very vigorously that while in some other countries we may be able to achieve independence of a government investment system, it is hard to imagine it being so effective in the United States, and if it was no so effective to keep it independent. It could very much jeopardize the economy and the financial markets.

And he certainly came to the conclusion that our experience seemed to bear out a worry about this element of the Canadian system actually working in the United States, particularly if we look at the experience of state public investments of pension programs in the United States, where we see not just mistakes being made and inefficiencies, but investments being shaded by attempts to use that money to spur local economic changes, investments in favored companies or favored economic projects, that these are the kinds of things that would be of great concern here. So there is an enormous worry that that aspect which seems to work well in Canada, it just would not cross the border.

So in conclusion, I think that if we look at the lessons, I think it is important to just be depressed about the conditions, first of all, that while it may have worked in Canada then, certainly it would be hard to imagine the same conditions for some time to come here and maybe never given the aging of the baby boom generation and the politics that are associated with that. And secondly, that timing is everything and I think we'll be waiting for some time to get an alignment in the United States for anything comparable to Canada.

And the last point I would just make is the great irony it seems to me, of what has happened in the United States: Whilst on the one hand there has been a rejection of personal accounts and privatization here, a resounding rejection last year, in the long term, those who oppose privatization may in fact get their worst nightmare.

I think the real fear here is that we will see—from the left's point of you, if you like, the real fear is that we will see a continuous expansion of personal accounts in the purely tax-advantaged area—401(k)s, and IRAs, and so on, so that over the years, people become less and less concerned about the underlying Social Security system, and that in turn may over the years in fact reduce the political support for it, and cause it to erode, which as I said, would be the worst nightmare of AARP and others that may in fact be the end result. Thank you.

MR. PENNER: Thank you very much, Stuart. (Applause.)

The next discussant is Jim Capretta who is a visiting fellow in economic studies at the Brookings Institution, and also works with CSIS. He has had wide experience in the budget area. He worked on the Hill for the Senate Budget Committee under Senator Domenici, and also at OMB as an associate director for human resources

JIM CAPRETTA: Thank you, Rudy. It's certainly a pleasure to be here. Mr. Bouchard's paper and all of the papers I think today are very useful for us to read and think about because they do provide, as Stuart and others will say, a lot insights into our current U.S. situation. It gives a way to think about the discussion here a little bit differently and with perhaps some new insights into either pessimistic or optimistic view of the world depending on how you look at it.

I think the interesting big-picture question here for the Canadian paper and the Canadian system is, you know, how did they do this, right, which is they have a defined benefit pension plan with somewhat worse demographics than we have here—(audio break, tape change)—you have to step back from that question and sort of say, well, how did they do this; how does this work? Real did go through the very useful analysis of reduction from a 14 percent point stable rate down to 9.9, and I think there is a lot of insights in there that we can continue to look at.

One aspect of this I thought would be useful to think about was something that I can't attribute to myself, that someone brought to my attention, which was the role of immigration actually here, generally not a huge factor in most of these demographic projections.

But the difference between the Canada and the U.S.—it turns out to be modestly important that Nicholas Eberstadt and Barbara Boyle Torrey just wrote a paper about the "North American Fertility Divide" that the Canadian rate is much lower and has been lower for at least a decade now, and projected to be lower in the long-term projections.

And then the question becomes how do they, how do they finance a stable workforce paying for these pensions over the long run. Well one of the issues is a little bit higher net immigration rate, that if one assumed a zero immigration rate for—a zero-net immigration rate for the U.S., which is not in our projections, but if you did assume it, more or less there would be about a 2 percent reduction in the working age population between now and 2050.

In Canada, it turns out it will be about a 25 percent reduction. They don't assume that in their projections, but that turns out to be a modestly important factor in making sure that the 9.9 tax rate can be sustained. So that is just something I think we should continue to look at: For those countries with low, even lower fertility rates than others, how much reliance are we anticipating for the workforce of the future to be new immigrants. And over a very long period of time it turns out to be a lot of people, although it certainly is consistent with the pattern over the last 30 years.

The second point I want to raise here is the—something that is touched on only briefly in the paper but I think it was an important development, and I want to put Canada in context of perhaps some other countries, that is the idea of making this a permanent reform that is stable and self-adjusting. Some of the other countries, Sweden, Japan, and Germany in particular, have provisions in place now that will adjust the benefit side of the equation automatically depending on new developments on the demographic projections.

And Canada has a similar provision although not quite with as much teeth in it as the other countries I would say, and is probably worth noting just the subtle differences there. The Canadian provision as I understand it says that if the actuarial report indicates imbalance, that the provinces and the federal government need to come to a solution otherwise there will be a freeze in benefits for three years and an automatic increase in the tax rate although—this is the kicker I think—the Canadian cabinet can vitiate that with a direct order. That doesn't need to go back through parliament.

So one could envision a political dynamic where that may play out. And I'm not a betting man necessarily but I wouldn't bet the ranch that the automatic cut will occur—

that is nonetheless important because it does set up a political expectation that this system is supposed to deal with these situations more directly in the future.

I guess what I would—the only observation that I would make about that is I think some of the other countries actually will come forward—and we'll hear more about through the day—with provisions that are even more robust in this area, and perhaps more self-adjusting in a way that can be sustained.

I'll make two more points. I think the Canadian's emphasis in their last reform on disability is also important, that so much of our discussion here is often about the retirement side. And it turns out in their '97 reform they did spend a fair amount of time working through the escalating costs in their disability program.

And I think it would be worthwhile for the U.S. to, again, remember that we have a two-part program here, that the retirement side in isolation actually, you know, is a solvable problem mathematically. The disability side does require more work and it's something that we need to pay attention to. If one were just to look at the disability side alone, its financial projections are actually more worrisome in the sense that the policy solutions are not really out there. And I so I think we would be well advised in the United States to—you know, even while we continue to fight about personal accounts and financing retirement to think again about the escalating costs on our disability programs as the Canadians have done.

And finally, just to echo a little bit what Stuart said about the investment board, you know, Canada and the U.S. are different, but in some sense we aren't that different in one aspect of this, which is we raised our payroll tax rates substantially in 1977 and 1983. I don't remember if it was exactly three percentage points, but it was probably in the neighborhood. And in effect, that was 15 years before it partially prefunded the program, right. We are running still big surpluses.

The question is do we get that extra percentage point that Real mentioned on private investment through those funds. And as we all know, that is a political economy question. It is a question of do we want those rates of return inside our government, or do we want them maybe outside of the government because I think most macroeconomic analyses of this are going to say, you know, if you take more rate of return inside, you are probably going to get a little less rate of return outside. And so the question is which of these do we prefer.

And so in some sense we have a little bit of partial prefunding without extra kicker so to speak, and, you know, I think that may be a subtle way of looking at this a little bit differently. So with that I will close. Thank you.

(Applause.)

MR. PENNER: Thank you very much, Jim.

I haven't been a very strict chairman so we are running a bit over time, but if there are question from the audience could you approach the mike and give your affiliation because we are doing a transcript of this?

While we are starting that, Real, just one factual question: When you defined the replacement rate, was it with respect to this five-year average at the end of a working life?

MR. BOUCHARD: Do you mean when one of the options that we looked at for example?

MR. PENNER: No, when you talked about a 25 percent replacement rate.

MR. BOUCHARD: Yeah, that is the—that is the maximum retirement benefit, 25 percent up to the average wage. So if your average income –

MR. PENNER: Average wage on a lifetime or in the last five years?

MR. BOUCHARD: The average earnings are indexed –

MR. PENNER: Oh, I see.

MR. BOUCHARD: Okay, to reflect the maximum pensionable earnings at retirement, but it's not the last year that it is being used; it is the average of the last five. It used to be the average of the last three. So that move was the equivalent may be of a one-year's reduction in the wage growth, so a 4 percent perhaps decrease in the initial benefit as a result of a change that was made.

MR. PENNER: Bob?

MR. REISCHAUER: Bob Reischauer, Urban Institute.

Real can correct me if I'm wrong, but this is a comment on Jim's reference to the fact that immigration is important because the net immigration figures are a little different. I think the difference is not so much in the net figures but the composition of immigration, that Canada has a pretty sophisticated policy of immigrants with high levels of human capital or high levels of financial assets. And so if you did a composition of who is going to contribute more in a sense to the economy over their lifetime, that makes a lot more difference than the difference is sheer numbers.

MR. BOUCHARD: Just one quick comment. I don't know about really the situation in the United States, but in Canada to some extent I think you're right, except that of course in spite of the fact that the skills and level of education is high among the immigrants in the last 10 years, there have been—we had some difficulties in having those new skilled educated immigrants to quickly reach the average income of Canadians. But overall your comment was right.

MR. PENNER: Bob Lerman?

Q: Bob Lerman, Urban Institute. I wonder how the investment board works with respect to international investments. Can it be a portfolio of any kind of investment anywhere or is there pressure to invest mainly in Canada?

MR. BOUCHARD: It used to be there was a 30 percent limit, and it did not only apply to Canada pension plan; it applied to private pension plans as well. There used to be a 30 percent foreign content limit, but that was lifted two years ago. Now it is open. So at the extreme it could be 100 percent U.S. investment.

MR. BOUCHARD: Yes, Gene?

MR. STEUERLE: Just clarification of a couple of things. In terms of the other two parts of your system, the old-age security and the guaranteed income supplement can you tell me how the parameters in those programs are indexed, if at all, and that reflects both the benefit and the brackets at which the benefit phases out?

MR. BOUCHARD: Yes, the Canada pension plan is indexed as CPI annually. The old-age security and the guaranteed income supplement are indexed fully to CPI as well but it is quarterly, okay. It counts as the same thing but it is more frequent CPI adjustments. And the—as far as the private pillars are concerned of course, it is simply that those annual contribution limits are scheduled—they are around 19,000 now. They are adjusted on an ad-hoc basis. They are supposed to be growing to 22 or 23 between now and 2010.

MR. STEUERLE: Am I correct in assuming then that technically in the projections, if I went out 300 years, the old-age security and the guaranteed income supplement in terms of replacement wages would approach zero? If they are only indexed for prices and there is wage growth in the economy?

MR. BOUCHARD: Yeah, okay, I understand your question. The OES component, which is more the universal part of that benefit versus the GIS, which is targeted, yes, it's been price-indexed, and there has been no adjustment to that—beyond price index in the last 30 years. In the case of the guaranteed income supplement which is a top up for low-income seniors, it is also indexed to CPI. However, there have been over the years ad hoc adjustments to the GIS. In fact, there is one that kicked in last January.

So to some extent—not totally—but to some extent it had allowed the GIS component overall, over a long period of time to be more closely indexed to wages because of those ad-hoc increases.

MR. PENNER: One last question on this component.

Q: Hi. Kathryn Olson with the Committee on Ways and Means.

The investment board, has it been under pressure, political or otherwise pressure to invest with goals other than just maximizing investment returns or getting the right risk return balance? And if it hasn't been under that pressure to pursue other goals like social investing policy, why has that been in the case? And if it has been under pressure how has that fended that off?

MR. BOUCHARD: Perhaps I can answer that question in two ways. When it was decided to have an investment board, investment based solely on the interest of members rather than other reasons, that was a very important part of the debate. And one of the reasons—because the kick back pension plan—I did not mention that today but Quebec has the parallel pension plan—Canada applies to nine provinces. Quebec has got a similar parallel plan, same contributions, same benefits.

But their investment policy, they have been on the market since the beginning in 1966. Their objectives were twofold: interest for plan members and economic development. And that had been criticized and so on. I'm not saying that that is one of the main reasons why the CPP went the other way, but certainly we were fully conscious and the government was fully conscious that there is some risks for your returns if somehow it is being influenced.

Now, I think it has been pretty good, and since the board has been established. I think where we have had the most pressures is not so much from an economic development perspective; it has been on ethical investing like the—(inaudible)—the Canadian medical association, for example, in saying it's pushing for—there shouldn't be any investment in tobacco companies and so forth, but not really on the economic development front, for example, or other political regional development and so on. So so far it's been okay.

Q: I think there was a strong and transparent public consensus for investing to maximize returns.

MR. BOUCHARD: Yes.

Q: But it is interesting that you bring up the ethical—is that a debate that is happening right now and is unresolved or has it been brought up and again—

MR. BOUCHARD: It is still happening. However, the CPP investment board has its own ethical investment policy, which goes quite far. So there is a self discipline policy that is part of the investment board strategy but for some people it is not going far enough, but overall it's pretty tight, compared with, for example, other private pension funds.

MR. PENNER: Well, thank you very much.

For the next speaker we have to change the technology here. We might as well do that. (Pause.)

MR. PENNER: Okay, the next speaker, Agneta Kruse from the Lund University. She is a senior lecturer with the department of economics. She worked in the 1980s with the parliamentary committee that was the basis for telling them everything that was wrong with their old system, so in that sense contributed to the Swedish reform.

AGNETA KRUSE: Okay, thank you for inviting me. It is really a pleasure to be here. When I entered the border of the United States, before entering I had to fill a form saying that I'm not a criminal and I do not intend to be a criminal here and so on. But there was a little box saying business or pleasure. As I didn't know what to say I didn't fill in that one. So when I came to the border they asked, okay, what are you doing here? Business or pleasure? Well, I said, I'm going to visit a conference on pensions. Okay, he said, and then he did something. Is that business or pleasure I said? It's business he said—(laughter)—very serious. But I think it's a pleasure to be here—very nice to be here.

Anyhow, as you perhaps know, in Sweden we have made a major reform of our pension system, and the major reform is not merely changing retirement age, benefits and things like that, but we have made a structural reform and changed fundamental principles. This paper, we focus especially on financial stability and what is within the central government budget. But I will end with a short discussion on what made the reform possible.

I have written the paper together with Ed Palmer who is the professor of economics at Lund University but also a senior—I don't know his title, sorry. He is the boss at a Swedish social agency of some of the departments, so I don't remember his title.

Anyhow, with the reform, the Swedish pension system has become a stable, a financially stable one, and a comparison with other countries within especially the EU shows that the Swedish rate, the Swedish expenditure, pension expenditure as a ratio of GDP, we remain rather low and stable throughout the projection period, and this is not true for some of the other countries. And this I think is due to the reform we have made. It is due to the new pension system.

The new system is earnings related. Sorry, the earnings-related part of the new system is defined contribution. And then that is one reason why it is stable and financially stable, and the other reason is that it is indexed by growth, mostly. And the distributional aspects, parts of the system has been divorced from the old-age pension system and is now within the budget. So it is no longer a part of the pensions system.

Before I tell you about the new Swedish system, I would just tell you about the old system. It was unsustainable and it was unfair. And the unsustainable showed up that if ordinary growth rate were expected, the contribution rate would have to increase very substantially up to 25, 35 percent of the wage sum from around 17 percent, and that was only in the period of 10, 15 years, so it really was deemed to be unsustainable.

And it was also unfair. And the unfairness was that if it was a defined benefit system, subsidizing people in career works, and taxing heavily blue-collar workers. So it took some time convince the Swedish people that this was true as the old system really was the Social Democrats who had introduced, and they were the fathers of the old system. And it is sort of difficult to believe if you a blue-collar worker that your own party had betrayed you in this sense. But finally it was realized.

The old system was vulnerable to demographic changes and also it was sensitive to economic growth. So these were the drawbacks with the old system. Now, the new system consists of three parts. One part is the notion of defined contribution. I'll come back and explain more thoroughly what is meant by notion of defined contribution. The other part is financial defined contribution, and the third part is a guarantee pension, and that one is defined benefit.

There are three obligatory systems—the notional-defined contribution system and the financial defined contribution system are both autonomous; they are not within the state budget. They are kept aside. The third one, the guaranteed pension is within the state budget. We won't go in to discuss the effects on the budget so that is why I make a special point on that.

The first one is pay-as-you-go system; it's growth indexed. The second one is a funded system, and the third one is, again, a pay-as-you-go system. In both the—in notion-defined contribution and financial defined contribution, there are individual accounts, so the money goes into an individual account.

And the first one, it is a notional money—that is what you get in your account is pension points or whatever. That is no real money goes into that account, as it is a pay-as-you-system. The contributions you pay go to contemporary pensioners, but in your account you get fake money, but those money are indexed. So really it doesn't matter whether they are real or fake, in that sense you get a rate of return of the growth rate in the wage, in the wages.

Financial defined contribution is, however, real money going into the capital market—again an individual account, but here you have the individual—you can decide where to put your money and what kinds of funds you are going to put the money, and of course rate of return there is then the rate of return on the funds you have chosen.

The guaranteed pension, I will come back to that. And perhaps I should tell you that this—I am now discussing the public part of the system, then there are negotiated parts as well. So apart from paying to the public system, you have from the individual's point of view an obligatory system at the labor market as well. You cannot say I do not want to take part of that one, and that is approximately 3 to 4 percentage points—percent of your wage—you pay it those negotiated pensions.

Okay, now, the large part of the new system is the notional-defined contribution system, the NDC. As I said, it is pay-as-you-go, so there is no real money going into the individual accounts. The contributions here—as it is a defined contribution system, the contributions are set at 16 percent by your wage, and you pay those contributions on wages, but you also pay—if you are unemployed and get an unemployment benefit, you pay unemployment insurance, sickness insurance, disability insurance, and parental leave. You get sort of pension points in your accounts for all of these activities.

And then there are some noncontributary rights as well. You get some points for childcare years, for military services, and higher education. The last two—to make it look nice; it doesn't matter for any for you pension you get. Childcare years may mean a little more, not very much, and the childcare years, I should say, is not because you stay at home and take care of your children, you may choose. I mean, it is enough that you have a child and then you get the points, and you have to decide whether the father or the mother is going to get the points into the account.

So it's sort of subsidizing children getting children, which is important, as you know, in a pay-as-you go system. Whether it helps or not, I'm not sure.

Okay, now the benefits are decided in the following way. When you reach retirement age, you have got what we call a notion of pension wealth. You have accumulated that during all years. And when you reach retirement age, you get and benefit that wealth divided by annuity divisor. And the annuity divisor is determined by the expecting remaining lifetime for a cohort you belong to, plus an imputed rate of interest.

Okay, that means that whatever you have got in your balance when you're going to retire, you can't—you can't get more out of it than you pretend apart from that it is an insurance against longevity, extraordinary longevity. But the device takes care that your cohort is supposed to live another 20 years, and then you divide the wealth on your account with that divisor. So that is a way of taking care of increased longevity.

The NDC is the largest part, and of course the most important part, and the thing here is that there is a very tight connection between the contributions you pay and the benefits you are expected to et, a very tight connection contrary to the old system where leisure time was heavily subsidized, which is a strange thing in a pay-as-you-go system, very detrimental to a pay-as-you-go-system.

And I think that here in the United States you are supposed to leave the labor force—well, supposed—it says that you should leave around 62—or no, quite wrong?

MR. PENNER: At that point you can, but you don't have to.

MS. KRUSE: But you have economic incentives to do so? No? Okay, very good. (Scattered laughter.) Very good. Anyhow, our old system did subsidize early retirement or not working because it was enough with 30 years of work and you calculated the benefit of the—average of the 15 best years. So really you had an incentive to retire early. That is not so anymore.

I think I'll show you how much the annuity devision means in the new system. Here are projections of how much you will get depending on which cohort you belong to and the calculation starts with those born in 1940 or just about to retire, and how much they get—sorry, the annuity divisor for those at the age of 65, and that annuity devise will increase for each and every cohort coming after due to increased longevity.

So here you have a column saying how much pensions at the age of 65 will be reduced due to this way of calculating the benefits. And of course the Swedish politicians hope that people will start work longer and longer hours or years, so here in these columns are shown how much longer you have got to work in order not to get a decrease in your benefit.

Okay, young people today say that they probably have to work until death, but that is not quite true. They will still have as many years as pensioners even if they delay their exit from the labor market. Now, another thing that is sort of problematic with the notional-defined benefit is that the politicians chose to have the index by growth, but not with the growth in the tax base or the contribution base, but we have to choose to have it indexed by average wages. And that means that they had to introduce what has become known as the automatic balance—oh, this—the automatic balance index.

This means that each and every year there is a calculation about the balance ratio, and the balance ratio is contribution assets plus the fund divided by liabilities. And that balance ratio is below one, the automatic balance mechanism is triggered. So of course that may be below one if, for example, the funds are decreased or if there are two people coming into the labor market or people are withdrawing from the labor market faster than you expected.

Then the index on the accounts and on outgoing benefits will be reduced. Well, that is sort of a difficult way of keeping the financial balance instead of just indexing with the growth of the total wage sum, but this is how it is, okay.

Now, the financial defined contribution part is much smaller than the notion one—2.5 percent of the wage sum goes into that part, so in total we have an obligatory contribution rate of 18.5 and 2.5 goes into the individual accounts, but this time real money. And the individual can choose. I think we are allowed to choose, to split the money between more than 700 funds to choose between, of which at least 40 are funds—world-market funds. If people do not want to choose, there is a default fund, a government default fund. It's publicly manage d. And this is not handled by the Swedish social insurance agency, but a special agency—we have a special publicly managed clearing house for this account.

The benefits, the benefits—you can choose whether you like unit link or traditional insurance. So that is what you can choose. And so for those being retired today or close to retirement of course these financial funded part is negligible but it might grow in importance depending of course on the difference between rate of return in the capital market and the growth rate in the economy.

Now, the last part of the public pension system is the guaranteed pension. And here is shown a slide showing the relation between the earnings-related pension and the guarantee pension. The red part here—oh, sorry—that is not possible to read—okay, I will have to tell you what is on the slide.

The guaranteed pension is means tested against the earnings-related pension, against the pension you get from the state. It is not means tested against any other fortune you have got or means tested against negotiated pensions or whatever. So it is only means tested against these public pensions. And then it's, as you can see, if you—as soon as your earnings rated pension start arising, your guaranteed pension is reduced. But the tax wage is smaller in this system than it was in the old one.

If you only get guaranteed pension, you live on a very low level if you don't have a fortune besides the pension system, and you will be living below what is assumed to be a decent level. There are then housing benefits for those having no other means—housing benefits, allowances, covering about up to 90 percent of your rent.

Oh, then in the middle of the '90s we abolished the former system of survivors' benefits. Today, within the old-age pension system we do not have any survivor benefits. That is also divorced from the old-age pension system and there are some survivor's benefits within the state budget, especially for children, surviving children.

In the old system, before the middle of the '90s, there were benefits for widows, but in order to achieve gender equity, it was abolished, and now we have what we call an adjustment pension. So if your wife or husband dies, you have a year to adjust, get some benefits in order to adjust yourself to the new situation and then it's—that's it. So survivors' benefits are very low in Sweden.

Okay, how much does this system give you? Is my time out?

MR. PENNER: Pretty much, yes. (Laughter.)

MS. KRUSE: Pretty much? Okay. This slide shows pension at age 65 in relation to income in the age groups 16 to 64 for different birth cohorts. This figure—the calculations made by Swedish social insurance agency—what it shows is really the different—the different parts of the Swedish pension system. For example, if we pick the birth cohort born in 1970 here, you can see that they will get—from the earnings related pension, they will get about, what, 55 percent is it? Something like that—no 45, and then they get another 10—that is the blue part. They get another 10 from the financial defined contribution system and nearly nothing from the guaranteed pension, so these are calculations made.

What is interesting here is that you cannot see that with the new system the benefits are expected to decrease. And it is very important to show how much of that is due to increased lifespan. So that is the last one. So if you are not going to increase your expected lifetime, then you can get the same pension as I will. I mean, I am going to retire somewhere here. I belong to these cohorts. And I can tell the youngsters coming after, okay, don't live longer and you will get—(laughter)—for the whole cohort, and you will get the same pension. Otherwise you can always increase your working hours and again get the same pension benefit.

The slide is nice I think because it shows how the old system, the ATP system is phased out and the new system is coming in. Okay. Is it two more minutes?

MR. PENNER: Yes, two more minutes.

MS. KRUSE: In that case, I'll just tell you that those figures shown—while the high replacement rate is—well, calculated in a strange way. We usually don't say, okay, I get 50 percent in relation to the whole working generation, those from 16 to 64. We usually compare what we had when we were between 16 and 65 or whatever. So here are other calculations showing what you can expect to get and, as you see, you have it there in the paper, it is quite lower benefit rates, replacement rates, than shown in the first slide.

May I give you two quick words on what made the reform possible? Okay, first of all we had many bankruptcies within the banking system, within the housing system, and so on. So people were aware that economics matters. And also, it was shown that the old system was unsustainable and unfair, so the reform group succeeded in getting the big blue-collar workers' unions on their side in doing the reform. And then, of course, it was five parties in the parliament who made the agreement. They had to give and take. I mean the Social Democrats did not want to go out into the capital market. But in order to keep the system mostly a pay-as-you-go system, they had to agree to that one, and so on. So really, it is a give and a take when it comes to the special features of the system. Okay.

MR. : Thank you very much. (Applause.)

MR. PENNER: Estelle James is currently a consultant to the World Bank, USAID, and a number of other organizations. Estelle is of course most famous for having been the principal author of Averting the Old Age Crisis, the famous World Bank book that looked at the problem of aging around the world. Right now, her most intriguing position to me is that she is on the governing board that makes the investments for the Kosovo pension plan. So if you're looking for a place to invest, Kosovo is probably it.

ESTELLE JAMES: The four main points that I want to make, which is on slide number one that you'll see in a minute—first of all, the Swedish system is very clever. I'm always impressed when I learn more about it. It's very generous. Every time I read about it, I learn something that makes me realize it's even more generous than I thought previously. Okay. It contains automatic stabilizers. It contains several automatic stabilizers that are interesting for us to look at. The two main forms that they take are they reduce benefits and they push the uncertain rising elements into the government's budget, which is not automatically stabilized, so it's important to realize that. And fourth, the U.S. has very different starting point from Sweden, which I think limits the relevance or the degree to which we could simply adapt their automatic stabilizers here. In particular, our benefits are much lower than the starting point in Sweden and we seem to have trouble controlling our government deficits.

I basically have one or two slides on each of those points. First of all, the Swedish system is very clever in that the notional defined—it consists basically of a large notional defined contribution plan and a small funded defined contribution plan. And the notional DC is really the innovation that Sweden gave to the world for better or for worse. It has its good points and its bad points.

So some of you may not be completely familiar with the NDC so let me just very briefly define it and describe how it works. It's clever in that it enables you to get the labor market advantages of a very close linkage between benefits and contributions, as in any defined contribution plan, without the transition costs that you would have if you shift to a funded system. You know that the transition costs are always the hang-up when we talk about shifting from pay-as-you-go to funded. The NDC avoids that problem because it remains pay-as-you-go. Basically, when you make a contribution, you have in effect a bankbook that records your contributions and adds them all up. And you get a notional interest rate on those contributions, the notional interest rate is equal to the average rate of wage growth. And at the time that you come to retire, all of these contributions and notional interest rates are added up, and you get a notional accumulation, which is divided by an annuity factor that depends primarily on your cohort's life expectancy.

But all of this is notional. That is, there is no real money in the account. Nothing is invested. Nothing is saved. The money that you pay in is actually used to pay benefits to current retirees as in any pay-as-you-go plan. So that's how you get the closed benefit/contribution linkage without having to pay the transition costs of a shift to a funded system. And of course, it's proved very tempting to some countries that have very large implicit pension debts. The transition costs would be huge, and this is a way of getting some of the defined contribution benefits without facing those transition costs.

But of course, there is always a price to pay. When you get something good, you always have to pay for it in some way. And the way that you pay in the NBC is that you retain a pay-as-you-go system. You get the low implicit rate-of-return that you get in a pay-as-you-go system. Its financial sustainability will be affected by population aging. You don't get an increase in national saving. So you know, there's a plus side and there's a down side.

Now, the Swedes recognized this and they do achieve financial sustainability for the system in other ways. That is, they bring in other mechanisms that Agneta talks about in her paper and that I'll briefly summarize here. I should also mention that the NDC is not redistributive in any way. That's one way that it differs from our defined benefit system, because it gives you that straight benefit/contribution linkage. But, they achieve redistribution in other ways. So it really requires other mechanisms to get you the redistribution and the sustainability. And the redistribution in particular is achieved by a very generous minimum pension.

Now, moving on now to my second point—the generosity of the system, just let me lay out what the different elements of benefits are and how much they might come to. The replacement rate is now estimated to be about 65 percent. But it's expected to fall in the future, because of the shift to the NDC, which explicitly gives you the low rate of implicit interest and explicitly adjusts the benefit downward as life expectancy increases. So it's expected to fall to about 55 percent. And of that total, about two-thirds will come from the NDC, one-third from the funded DC. I might mention that the funded DC is expected to play a larger and larger role in relative terms as the NDC declines. In addition to that average replacement rate, there is a minimum pension, which is—I've heard different estimates—30 to 40 percent of the average wage. The minimum pension is formerly price index, which means it would fall as a proportion of the average wage over time. However, I really appreciate the honesty of the authors in pointing out that this violates the Swedish political culture, and it's likely to end up being linked to wages over time. I've written a lot about Chile, and I might mention they have a minimum pension, which is also formally price indexed, but also has moved up with wages over time. So there is that political dynamic that we should always keep in mind when we talk about price indexation versus wage indexation. And this issue is very important because if it's price indexed, the minimum pension will become smaller in relative terms in terms of the role, the expenditures that it will require. But, if it's wage indexed, then it will actually play an increasing role over time. Minimum pension is one of the things that is financed out of the state budget, not out of the system, so when we talk about sustainability of the system, we are not including the minimum pension.

Now, in addition to the minimum pension per se, in addition to the cash flows, apparently the recipients of the minimum pension get a housing supplement, which pays 90 percent of their rent. This was something new that I learned from reading this paper. Now, in this country, that would be a huge addition to the average Social Security benefit, let alone some minimum. But, the housing markets may work differently in Sweden. At any rate, that's another benefit.

The fact that there is such a generous minimum really permits the funded defined contribution plan to play a larger expected role because it provides such a comfortable cushion. That, plus the large size of the NDC provides a very comfortable cushion, which means that when people invest their small funded account, they can invest it in a very risky way. In fact, they mainly invested in equities, which means if you're calculating expected returns rather than risk-adjusted returns, you'll get a pretty high expected return, which will give you a nice replacement rate from the funded DC that will make up for some of these declines that are anticipated in the notional DC part. Just to put this in—to compare it with the U.S. situation, the minimum benefit in Sweden if you include the housing supplement is really larger than our average benefit, and it's important to keep that in mind when we think about the applicability of the automatic adjustment mechanisms that I'll talk about in a minute.

Now, of course generosity costs, so you might be interested in knowing how much this total system costs. The NDC costs 16 percent of your wages up to a ceiling. You put another 2.5 percent into the funded DC. Apparently, 8 percent is paid in addition to this without any benefit credits for all wages above that ceiling. That was also something that I didn't know before. Then, another 3 to 4 percent goes into this almost universal occupational pension. In addition, the government budget pays for the guaranteed pension, housing allowance, disability and survivors' insurance, pension credits for those on parental or sickness leave, child-carrying years, unemployment, et cetera. I tried to figure out exactly how much these expenditures that were coming out of the state budget cost and this was—I couldn't figure it out exactly. But I sort of—it looked to me as if it was costing the equivalent of approximately 12 to 14 percent of wages although it comes out of broader, general revenues, so that the total cost, it seemed to me, was about 35 percent of payroll if you sort of added up all those items.

Now, you know, that seems unimaginable in the U.S. context, and whenever I see these numbers, I think, well, the Swedes just behave differently. The Swedes don't behave like economic man and woman. Of course, we'd expect their economy to implode with these numbers, but of course their economy keeps chugging along pretty nicely. Agneta assures me that they are. They do behave the way we would expect, but at any rate, these are the numbers. So it's a very generous plan and it's quite different, you can see, from our starting point.

Now, what are the built-in stabilizers? They do have some very clever built-in stabilizers in this system. First of all, there is the annuity factor. You have this notional accumulation, and it's turned into a pension when you retire basically by dividing it by this annuity factor, which depends mainly on your life expectancy. And this is adjusted every year so that's an automatic—that takes increased longevity out of the equation in terms of destabilizing the system. So I think this is a very clever device.

The fact that the accounts are indexed to real wages is another automatic stabilizer. It means that your notional accumulation doesn't grow very much if the economy doesn't grow. If real wage growth is less than 1.6 percent per year, then actually benefits that current retirees receive are also reduced. Now, if all those things don't achieve stability for the system, we have the automatic adjustment mechanism, which adds up the notional assets plus the buffer fund, and compares it with the present value of pension liabilities. And if these assets, both real and notional, are less than the liabilities—this could happen due to falling fertility rates or lower labor force participation rates, then the notional accounts decline—that is, the index, the interest that you get on notional account declines—and also the current benefits decline, so you know, both future and current beneficiaries immediately bear the burden if it turns out that the system is not in this long-run balance. But, notice that there is no automatic adjustments to the guaranteed minimum, the housing supplements, disability insurance, and other supplements from the government budget. And in fact, we would expect those to increase.

So where does the risk go to, I mean if it's not borne by the system, someone has to bear it. Well, first of all, it's borne mainly by present and future benefit cuts in a very explicit way. Secondly, by increases in general government spending in a very implicit, non-spelled-out way, and in fact the paper really doesn't even make estimates of how the government expenditures might increase under different scenarios. It's interesting to look at the things that don't bear the risk. People at the bottom end don't bear the risk because the minimum pension is there to catch them. And I might say, a lot of people receive that minimum pension, and if it continues to be wage indexed, even more may receive it in the future. Another thing its not borne by is an explicit increase in retirement age, although it's assumed that people may adjust their retirement age upward when they see their benefits going down. It's also not borne by an increase in contributions, which of course makes sense in the Swedish case considering their starting point. In other words, benefits bear most of that brunt of any adjustment that is needed, and that makes sense in a system that has very high benefits and a high contribution rate to begin with.

But really, most uncertain items like the cost of the minimum pension, the cost of disability benefits, they're all put into the government budget, and as I say, there is no calculation of how those expenditures might change. The authors claim that some of this government spending will increase national saving, and that of course depends on how that government spending is financed. If it's financed out of taxes, it will increase government saving. If it's financed out of larger deficits, it won't.

So this is my last slide—relevance to the U.S. Clearly, these in principle, each of these stabilizers could be applied in theory and on paper. I mean we could have an indexation to longevity. Personally, I think we should index something to longevity. We could, when we find the system is out of balance, we could just automatically draw down benefits and do the other things that Sweden does. However, we have a very different starting point as I said at the beginning. We're starting with much smaller benefits, with no minimum benefit, so it's not clear that we would want benefits to bear the entire brunt of adjustments as they do in Sweden.

Now then, we could go a step beyond that and say, well, we'll still use a formula. I mean we could say, every year we will compare the expected present discount in value of future expenditures and future revenues. And we could have a formula for saying, if it's out of balance—which, of course we know it's out of balance right now—we will distribute that imbalance among benefit cuts, contribution hikes, and so forth. But, we would have to specify in much more detail than Sweden, you know, what the distributional effects would be, how much would come out of benefits, how much would come out of contributions, which groups of beneficiaries and taxpayers, and we would have a very hard time agreeing on this kind of formula. I mean this is really the kind of discussion we should be having. But I think given the polarization of political views and the polarization of wages in our country as compared to Sweden, it would be much more difficult for us to agree on a formula. We could also shift a lot of the uncertainty into the government budget, as Sweden did, but that would also be difficult given our starting point in terms of deficits.

So just to sum up, I mean I think it's a very clever system. I think it is something we should think about. In the end, I think the differences in our initial conditions will make it very difficult to adopt those kinds of measures here.

MR. PENNER: Thank you, Estelle. (Applause.) The next discussant is Larry Thompson who is a senior fellow here at the Urban Institute. He was president of the National Academy of Social Insurance. Like so many of us in Washington, he's never been able to hold a job very long. He was, for a time, acting commissioner of the Social Security Administration, and has worked at GAO, and the old HEW.

LAWRENCE THOMPSON: Yeah, thank you. Your story about Canada reminded me of when I—I was in Mexico City. I had just left the GAO and gone to Social Security and there was some international meeting in Mexico City, an ILO meeting. And coming back, I go through passport control and I show them my official passport. And the guy says, what agency do you work for? And I said Social Security. He says, gosh, I'm just waiting to get somebody from the GAO, because their report on us, it cost us our overtime pay. (Laughter.) So timing is everything and I had it that time.

I'm going to focus my comments on the automatic adjusters and the relevance that may have for the U.S. system. And it's a rare situation that actually Estelle and I agree mostly on this, so that I don't have to dwell on some of the points as long as I might otherwise have done. There's basically three adjusters you've heard about, and one is the conversion of the balance using life expectancy. Another one is the way they adjust the postretirement benefit increases if our real wages grow, diverting from 1.6 percent. And the third is this more complicated adjustment that compares liability and assets and then basically changes the accrual rate.

Now, the first and the last of those in the way I mentioned them basically can be done in our system through the mechanism of saying, every year when we do the trustees' report, we do our calculation. And if there is a deficit, we will simply automatically change the benefit formula, and we can just sort of proportionately reduce the factors of the benefit formula. And if we had started this in 1983 when we were projecting balance and then we just annually made these basically modest adjustments each year, my guess is that by now we would have had a cumulative reduction of about 13 percent from the current scheduled benefits. So instead of the formula having brackets of 90 percent, 32 percent, and 15 percent, it would be 78, 28, and 13. Thirteen percent is not a lot, but if you go forward, this process accelerates rather quickly. And if you look at the last year's trustees' report, I make it that by 2035, to equalize the annual flow would require about a 21 percent benefit cut. And since the game here is not just the annual flow but the projected flows for 75 years in the future, it's probably close to a 30 percent cut or so. The experts are back there. They're probably never done this calculation, but they can go back and prove me wrong later. And by 2050, I'd guess it's going to have to be at least a 35 percent benefit cut in order to make the process work, so the cuts are going to get larger and larger.

We could also institute the Swedish approach to adjusting the postretirement adjustments for real wage growth. Ours would be—our money wage is –1.1 percent, which is the long-range assumption of the gap. I'm not sure what that achieves, by the way. I think the Swedes went to this because they had this, as I understand it, this very traumatic experience in the early 1990s when the price indexing of the benefits caused them to rise much, much more rapidly than wages, and they just felt they had to cap that somehow. If you do do it, you end up increasing the variability of the year-to-year adjustments. I went back and looked. If we'd done this in the last ten years, actually we would have had higher adjustments in the '90s and lower adjustments in the early 2000s it won't surprise you. Actually, the mean adjustment would have been 2.9 percent under this alternative, when it was actually 2.3 percent over the last ten years. But the standard deviation is 1.7 percent under the alternative and .6 percent under the actual. So you end up having much more fluctuation. But the numbers are relatively small, at least given the experience of the last few years, probably not a big deal.

So we could do this. Is it a good idea? We could do these things the Swedish have done and we could insulate our system from financial uncertainty. Is it a good idea? I argue no, and I argued that for two-and-a-half reasons. My first reason is that I think that the way they've set this up as Estelle has explained is socially undesirable. Basically, you've decided that for whatever reason, you want to insulate your public fisc from uncertainty involving demographics and economics, and so you transfer all of the risk to the retirees. And I don't know under what social welfare function that is an increase in social welfare. It seems the only way that you could reach that result is if you assume that there is absolutely no social value in insulating retirees from uncertainty, because otherwise your difference curves are going to cause you to share the risk somehow. So I would reject the idea that we are going to insulate the budget by transferring all the risk to retirees. I would think that the budget is probably in a better position to share the risk or assume the risk than retirees.

Now, the second reason is, as Estelle alluded to, forcing all these changes to—setting up a system where all these changes lead to reductions in benefits is going to cause benefits to shrink and they're going to shrink from a rather low base. Steve calculates that—or his people calculate—a hypothetical average earner each year, and that's a very famous person in Social Security policy debates—a hypothetical earner in 2004 would have gotten a benefit of about $14,500, which was about 41 percent of the average wage that year. But it turns out the hypothetical average earner is a whole lot better off than the actual average beneficiary, because the actual average benefit award in 2004 was for $11,500, which is 32 percent of the average wage. And of course, if you know, as someone who has retired—nobody in the room here probably is collecting benefits yet—you will—oh, Stan—anyway, you don't actually get that. You get that less your SMI premium, which pulls another 2 percent out so that in fact the actual average check going out is 30 percent. We are, as Estelle says, our average is equal to the

Swedish minimum not including the housing. A 30 percent reduction, which is what my guess of what this automatic adjustment process would produce by 2035 would pull that down to about a 20 percent replacement rate. Now, that's my second objection—it simply is forcing adjustments in an area where there's not room to adjust.

My third objection is sort of a second version of the second objection, which is that even if I didn't care, even if I thought a 20 percent replacement rate was all right, I submit the political system would never stand for it. And so, that sort of an adjustment process would be politically unstable. And here I want to make a point, which is that we have a habit of looking at systems and doing calculations and saying this is fiscally sustainable because our calculations show that the costs are something that we can absorb, it's insulated, blah, blah, blah. But something is not fiscally sustainable—I submit to you—if it's not also politically sustainable, because if the political system will never allow those kinds of changes to go into effect, then the calculation is simply a silly game of calculating something that is never going to happen.

And we see this in a couple of countries, which were famous for their fiscally sustainable Social Security systems, and then in the last few years, discovered that these systems were producing inadequate benefits and are now agonizing about how to expand the benefits to provide more generous benefits. I refer to Chile and the United Kingdom, illustrating that fiscal stability is more than just a calculation. And I think that in the U.S., any notion that the average benefit would get down to 20 percent would be simply politically unsustainable, something would change. And it may not be the benefits, by the way, it seems to me that the kind of dynamic that we have in this country is we'd figure out a way to reduce health care costs for the aging. I mean the drug benefit, I would submit, is in part motivated by sort of a gut reaction, the Social Security benefits aren't high enough to cover these costs. So rather than addressing that directly, we figure out a way to try to relieve the pressure on some people.

As with Estelle, if we were going to do this in the United States, I would say that one should focus on some combination of changes in revenues and, I would say, changes in the retirement age, because the problem here is that we are going to have to make some changes to balance the Social Security system. In my judgment, lowering the average benefit is the least desirable way of doing it and shouldn't be done at all, and that leaves tax increases and retirement age changes. I predict we do a combination of them. Some people would like more on the retirement age, others would like more on the tax. The point is it will be some combination. And if we're going to have an automatic adjustment and it's going to be politically stable, it should be defined so it reflects what the political system is likely to produce.

Now, the problem is, as Estelle said, we probably couldn't get it enacted. I think we might be able to get it enacted, but I don't think it would ever go into effect, because the difference between what the Swedes have done and what I'm proposing is that the Swedish adjustment is through a mechanism that probably is understood in Sweden fully by fewer people than are now in this room, and so the process goes on and it produces these miraculous little changes in benefits and no one notices. What I am proposing is an automatic adjustment in which you change your tax rate and your retirement date. Everyone is going to notice. And as soon as Steve announces it, they're going to say who is Steve Goss? And he is going to—and they're going to climb up there and they're going to say how do you know that we're going to have a deficit and that we have to make these changes? He's going to say well, I made these assumptions and I made these calculations and it's all going to sort of come to a cropper right there. Right, you'll give it to Alice. (Chuckles.) So I'm a little dubious that the whole process would work in the way that I think would be acceptable.

And I close by making one observation, which is that as usual, reformers tend to be hard at work reforming the last reform. And in Social Security, the last reform was when in 1972 we decided that an arrangement, which was fiscally stable but politically unstable should be shifted to an arrangement that was politically stable, but is fiscally unstable. And now, we're talking about shifting back. Of course, the previous arrangement was that the benefits never increased unless the Congress enacted an increase so that there were continual benefit increases enacted, which some people decided were producing larger benefits than there would be if they had just indexed it. But there was never a financial problem. After 1972, we indexed the benefits. I call your attention to the fact that we have never changed the benefit formula since 1972, except for a little hiccup in '77, and we've had several financial crises. So let us be careful that in reforming the current process, we don't go back to the one that we've reformed in order to produce the current process. Thanks.

MR. PENNER: Thank you very much. (Applause.) Well, being fully half-an-hour behind my schedule now, let's just take a couple questions.

MS. KRUSE: Okay, I have a couple of things I'd like to raise. First of all, as being an economist, I do not like, Estelle, that you call the system generous. We pay for it. We get exactly what we pay for, nothing less, nothing more. So generous? Well, when I buy a dress, am I generous to myself? No, I pay what I want to have and that's what we are doing here. When it comes to those being out of the system, I figure this about 3 to 4 percent of the wage sum. It's about 2 percent of the GDP, 4 percent of the wage sum, something around that. So it's not as much as that.

Now, to Larry, I just say that no, all the risk is not on the pensioners when the automatic balance mechanism is triggered. It is on the workers who get a lower rate-of-return on their accounts and on the pensioners who get a lower benefit. So no, that is a misunderstanding. And of course you can't say that it's better to change retirement age or something else. Yes, you can do that if you want people in Stockholm or Washington here to decide when you're going to retire. I'd say, living in the south of Sweden, no, I don't want the politicians in Stockholm to tell me when I am to retire. I get a calculation saying if you retire when you are 61, you get that benefit. If you retire when you're 65, the benefit will be that. And if you retire when you're 70, the benefit will be this. So I prefer those in Stockholm not deciding when I'm going to retire. I prefer to decide that on myself and I can do that in the Swedish system. Sorry, that's how I prefer it to be.

MR. PENNER: Well, let's take a short break. Let's try and hold it to about five minutes so I can catch up a little bit. (Break.)

MR. STEUERLE: (In progress)—the frigid zones of Canada and Sweden. I'm thinking that, you know, they have this interesting combination of both a hard work ethic from being in cold climates and for some reason rather libertine cultures on the other hand. You try and see what that did to Social Security reform. Now, we switch to the island kingdoms of Japan and the United Kingdom. And you know, the islands have—they also have this interesting mix. They're never, not quite like the continents. They always sort of do things their own independent way, often having great success for a while and then trying to live off of their success. And we'll finally end up with the Holy Roman Empire, and I'll let you figure out what that means in terms of Germany and Italy. So we're off to the island kingdoms of Japan and Great Britain.

And our first speaker is Tesuo Kabe. I have the fortune of actually knowing all the people on our panel very well. I am a great admirer of all of them. Mr. Kabe is a counselor of the Embassy of Japan responsible for fiscal and tax policies and financial regulations. He has a variety of other offices that he has held such as deputy director for budget review on Social Security and social reform in the budget bureau. He also has the distinction of having law degrees, masters and bachelors of law degrees both from the United States and Tokyo, and is licensed to practice law in both Japan and the United States, as well as accounting here. So I don't know what that means except that you have an extraordinarily range of skills. I'm not quite sure why you're applying them to Social Security. Maybe you will explain that to us as you get into your talk. Mr. Kabe.

TESUO KABE: Thank you very much for inviting me to speak today. When I was budget officer in charge of the 2000 reform of public pension in Japan, it was a time for the Japanese economy in deep trouble with the background of the Asian currency crisis and the financial crisis. So it was not the easy setting for us to convince the public to complete reform. People said when the Titanic is sinking, who cares about the design of the cabins? However, I am pleased to tell you that the Titanic did not sink and cabin was renovated.

So let me start with the demographic illustration of Japan. Japan's population decreased last year for the first time since the World War Second. By 2050, the total population will decrease by 21 percent. And people older than 65 years old will account for 36 percent of the total population due to the low fertility rate and aging of society. The high level and rapid pace of Japan's aging society will exceed other developed countries' cases. It surely causes huge challenges for our public pension system and also the overall budget, which is already deep in deficit. Japan therefore is now in the forefront of dealing with challenges of an aging society and tries to be the first to succeed rather than the first to fail in those efforts.

Today, I intend to illustrate Japan's public pension system and its reform efforts with emphasis on two mechanisms. The first one is mandated review obligated by the legislation of the financial status of public pensions every five years, which often triggered and helped to complete reforms. And the second one is the automatic adjustment of benefits levels introduced in the 2004 reform.

For your information, let me begin with very briefly explaining Japan's public pension system. Japan's social insurance system includes the public pension system, the public medical care insurance system, and the public long-term care insurance system. We also have other welfare services financed by general revenues. Speaking about public pensions in Japan, it is mandatory for everyone older than 20 years old to enroll in the public pension system. The public pension system in Japan consists of the national pension system—it is also called the basic pension—in which everyone is enrolled, and also the employees' pension insurance and the mutual aid pensions, both of which are earnings-related components for employees. The national pension for self-employed persons and farmers is a defined benefit public pension with fixed amount pension premiums and fixed amount payments. On the other hand, the employees' pension insurance is a defined benefit public pension, and it levies earning-related pension premiums, which is nearly 14 percent of annual wages and pays the first-tier fixed amount part is the basic pension and also the second-tier earnings-related proportional part. The first tier is the black tier and the second tier is the violet or blue part on top of that. And its financing is practically pay-as-you-go system. Individuals and enterprises may also opt to enroll in other types of private corporate pensions or private personal pension plans. My discussion here mainly focuses on the aspects of financial sustainability of the reforms of the employees' pension insurance.

Let's move on to the recent reforms of public pensions in Japan. Before 1985, the history of public pension system in Japan was a history of expanding coverage and improving benefits, which was enabled by high economic growth and demographic pyramid favorable to pay-as-you-go system. Since 1985, however, the public pension system in Japan has experienced repeated reforms in order to achieve its financial sustainability in response to an aging society and a transition from economic growth to stable economic growth. In the 1985 reform, a nationally based pension system was established. All of the public pensions were financially and statutory integrated in the first tier as the basic pension.

During the late 1980s, the Japanese economy experienced higher economic growth driven by a bubble economy, and the Japanese government succeeded in fiscal consolidation. However, since 1994, reviews and actuarial evaluation in every five years have always necessitated reforms of public pensions, largely due to further aging of society evidenced by the new demographic projections, which were also conducted every five years. The '94 and 2004 reforms were implemented during the fifteen years of economic struggle after the burst of the bubble economy when fiscal balance was deep in deficit again. The 1994 reform raised the pensionable age and it changed the indexation of benefits from based on wage to based on disposable income, which is wage minus taxes and social insurance premiums.

Nevertheless, the renewed demographic projection in '97 once again made the future projection of public pensions much worse than expected five years before. The reform intended to close a financial gap by equally sharing the pain between retirees and working generations. The reform plan eliminated 530 trillion yen or over 100 percent of GDP of unfunded liabilities by cutting total future benefits roughly by 20 percent and raising pension premiums gradually. The reform raised the pensionable age and it changed indexation of existing recipients' pension benefits from based on disposable income to based on price. It also decreased benefit outright by 5 percent. The reform faced political difficulties under the coalition government because it intended to cut benefits and raise pensionable age again, and also because there was concern over the averse effects of increasing pension premiums on deteriorating economies. Generally speaking, lower economic growth tends to help people realize the potential vulnerability of the pension system and the need for reform to improve sustainability of the pension system. However, a significant economic downturn makes it tougher to implement measures, which could have a negative macroeconomic impact, such as benefit cuts or increase of pension premiums. Although its passage at Diet was delayed by half a year and the increase of pension premiums was suspended, the bill for the reform was passed by the Diet finally.

Nevertheless, I have to say once again, nevertheless, the revised population projection published in 2002, once again revealed that demographic change is progressing again more rapidly than anticipated. This change was mainly triggered by the lower-than-expected fertility rate. We have experienced an ever-decreasing fertility rate in the last decades. That was the major unexpected changes in the demographics. Based on the new projection, pension premiums would need to be raised to 36 percent of annual wages instead of the previously expected 20 percent of annual wages if future benefits were to be maintained.

The 2004 reform aimed to balance benefits and contributions over the next 100 years. First of all, it fixed the final pension premium level from 2017 and over at 18.3 percent of annual wages. And after that point, pension premiums were to be raised by 0.354 percent every year. Secondly, in order to minimize future revisions of benefits and premiums, the 2004 reform incorporated automatic adjustment of benefit levels called adjustment indexation. Thirdly, a road old map for raising the national subsidy to the basic pension from one-third to one-half of its payments was also adopted.

The 2004 reform once again improved public pension fiscal position by over 100 percent of GDP in net present value terms. The rapid aging of Japanese society is projected to push up the ratio of the Social Security benefits to national income from the current 23.5 percent to 29 percent in 2025. If the 2004 public pension reform had not been implemented, the ratio could have reached 31.5 percent in 2025.

I should also point out public pension reform constitutes a significant part of a broader agenda of Social Security reform including the reforms of the public long-term care insurance and also the reforms of the public medical care insurance. I would like to point out a significant mechanism facilitating pension reforms in Japan, which is the periodical mandatory review. In Japan's case, all of recent major pension reforms were triggered by the mandated review of the financial status of public pensions conducted every five years. Such legislative requirements also helped greatly to persuade the related parties and complete the reforms.

Both of the employee pension insurance law and the national pension law require the government to review current financial status and the future financial projection of the expected pension system at least every five years and publish the result of such reviews without any delay. Both laws also require expected pension system to maintain financial balance in the long term, and in the case the financial balance is to be lost significantly, such measures should be taken immediately as to restore a balance. Following those provisions in the laws, the government reviews financial status and the projection based on updated economic assumptions and demographic projections. When the government finds that future pension premiums are unbearable, it proposes options for reform and compiles a reform plan in consultation with the Social Security council and the ruling parties. That's how the mandatory review works.

Next, I would like to point out automatic mechanism designed to slow the gross benefits in Japan. The 2004 reform introduced automatic adjustment of benefit levels by fixing final pension premium levels and implementing adjustment indexation. Before 2004 reform, the employees pension insurance law used to prescribe an explicit table for increases of the pension premiums only for the next five years, even though projections for pension premium increases was made for indefinite future. The 2004 reform law explicitly prescribes a table for increase of the pension premiums for the next 100 years. With the future premium level being specifically fixed, the level of benefits is to be automatically adjusted within the revenues. The adjustment indexation serves to implement such automatic adjustment. It modifies the indexation, taking into account the decline in number of those paying into the system and the improvement of life expectancy of all the people. In the case of new recipients of pension, indexation is based on disposable income growth rate minus adjustment rate. In case of existing recipients of pension, indexation is based on price minus adjustment rate. The adjustment rate is around 0.9 percent until year 2023 according to the benchmark scenario.

Adjustment indexation is carefully designed not to impair income security of retirees in two ways. First, it does not reduce the benefit below the level of existing benefits, nor does it function in case that regular indexation is negative. Secondly, the replacement ratio of the model pension, which is now 59 percent shall not fall below 50 percent. Those restraints of course restrain the extent to which the financial sustainability is maintained. However, those measures taken in order not to make retirees or the working generation feel that their future income security is jeopardized too much. Introducing those automatic adjustments of benefit levels, we can now prevent unexpected change of demographic projection from causing too frequent reforms of benefits and premiums. We surely learned lessons from our experiences of consecutive reforms. Such automatic adjustment contributes a lot to improve both retirees and younger generation's confidence in the future of public pensions.

Finally, let me touch upon how information was conveyed in Japan's public pension reforms. In order to communicate with the public and to persuade the public of the need for the reform, we used projection of future pension premiums and also the projection of pension liabilities and assets on net present value basis. And in case of the 2000 reform, which I was involved with, five alternatives were presented to the public in early stage of discussion. In terms of how deeply benefits should be cut and how high final premium might be allowed to raise, the alternatives included maintaining benefits, cutting benefits by 10 percent, by 20 percent, by 40 percent, or even privatizing the employees' pension insurance. The alternatives were accompanied by specific options of how to cut benefits, including raising pensionable age, changing indexations, and cutting benefits level. After repeated open and public discussions, the alternative of cutting benefit levels by 20 percent was adopted with the specific measures to accomplish that goal. That's my presentation. Thank you very much.

(Applause.)

MR. STEUERLE: I was reminded when Mr. Kabe did his presentation and actually stayed within his time limit of how courteous most of my Japanese friends and colleagues have been over the years. And I was reminded of a trip I made to Japan, which happened to be during the World Cup soccer. And those of you again who are familiar with the Japanese and this courtesy will know that the Germans—perhaps it was Mr. Mersmann's colleague at the embassy, I can't remember—proceeded to say, to actually make formal announcements in the public that visitors to Germany during the next World Cup soccer should not necessarily expect the same level of courtesy. But I was reminded that maybe the same difference wasn't true in America, because I happened to go to a baseball game, and at the end of the game, the attendees all took all of their extra trash and they passed it horizontally to the left to be collected at the end of the game. And I was thinking this is just like America with two exceptions. One, we didn't wait until the end of the game. And two, instead of passing it horizontally, we passed our trash vertically. (Scattered laughter.)

Anyway, enough of that. So our first commentator is Richard Jackson, another colleague and friend of mine. Richard Jackson is a senior fellow at the Center for Strategic and International Studies, where he directs the Global Aging Initiative and actually conducts a very, very useful set of seminars these days. He's also an adjunct fellow at the Hudson Institute, author of many briefs, books, aging vulnerability index. And in fact, in many of the very fine publications, you often see out of the Concord Coalition, often either don't have Richard Jackson's name at the bottom or if they do it's very low key, but in fact he's—the very, very nice writing there is due in no small part to him. (Confers off-mike.)

RICHARD JACKSON: Thanks, Gene. I appreciate the kind words. Let me just start by complimenting Mr. Kabe on what I think is an excellent paper and an excellent presentation that really does a lucid job of explaining not just how the system works, but the history of reform and the motivations for recent reforms. The 2004 Japanese pension reform, I think, and particularly the automatic stabilizer, is really a watershed reform. This is something that Gene Steuerle has written about, others have written about. But the current pension systems in most developed countries are on a automatic-rising autopilot.

Initial benefits are indexed to wages, and given the coming shift in the ratio of workers to retirees, total benefits will inevitably rise as a share of payroll in the future. What the Japanese reform does in effect, like the Swedish reform, and to some extent, the German reform—because the German reform is actually only a partial stabilizer—but what the Japanese reform does is to build in or invent a new kind of autopilot that builds in constraint rather than cost growth. In effect, what we're doing now is to pre-commit the economic progress of the next generation, and what a reform like the Japanese reform does is say, well let's stabilize pension costs as a share of the economy and we'll leave it up to future generations to decide how to allocate resources to meet priorities.

I took the liberty of making a chart out of some fascinating numbers that Mr. Kabe included in his paper. These are the projected ultimate contribution rates immediately before the 1994 reform, the 2000 reform, and the 2004 reform, and then immediately after subsequent actuarial review. It's not so much that fertility plummeted in this short span of time; it's that expectations about future fertility were successively ratcheted down. So this chart, there's sort of one of these dolls that kids play with that you—one of these beanbag clowns that you kick and it keeps on bouncing back up. It created a political climate in which I think strained even Japan's legendary ability to build consensus, and which created a sense of rising alarm among younger generations that they were facing an indefinite rise in payroll taxes in the future.

I think that the reform and in particular the stabilizer is a very positive development, but let me just add a word of caution here. I don't think the way it's structured, it's actually a permanent long-term solution. And I have just a series of three or four charts that explain why I've come to that conclusion.

First of all, you can see this is total expenditures on both tiers of the pension system, the employee pension insurance and the national pension. You can see that the stabilizer indeed stabilizes internal expenditures of the share of the wage bills through 2025, but thereafter once the stabilizer sunsets or is suspended, expenditures rise rapidly. At the same time, the system is far from pay-as-you-go balance. The top line is total expenditures. Now we're looking at the EPI system alone. Total expenditures is a share of payroll. The bottom line is the contribution. So you can see that expenditures indefinitely they may exceed contributions by a wide margin for many today and indeed exceed contributions indefinitely.

Well, so how is it that the system is balanced over the next 100 years? Well, it's balanced, of course, because it depends on large general revenue subsidies and it depends on a reserve fund revenue and ultimately a liquidation of Japan's large reserve fund. The bottom part of the (stacked bar ?) is contribution. You can see that that rises over the next couple years as the contribution hikes for the 2004 reforms come into effect, but then declines again over the long term. It's just another way of looking sort of at the same point. This is the trust fund ration for the EPI system before and after the 2004 reform. You can see that the reserve fund was projected to be exhausted in 2021 actually. Now, there is a sort of buildup and drawdown that lasts really the better part of the century.

What's the concern here? Well, I guess the concern is twofold. One point is the subsidies, which are due to rise from a third to one-half of the national pension expenditures. It's not clear where the new tax revenue will come from. And the second point is the presumption that the reserve fund somehow constitutes genuine financial savings that can be drawn down in the future to cover future benefit costs. I'm not an expert on the reserve fund. I think it isn't identical to the U.S. Social Security Fund. It's more than a memo account within the federal budget. But I think there is at least some question about whether that is a realistic assumption or not.

Well, because I direct the program on long-term demographics, I thought I'd just broaden it out on the end, and I have a couple charts that put Japan's aging challenge in an international or in a G7 context, if you will. You know, we think we have a big aging problem in the United States, where the elder share of the U.S. population is due to rise from 12 percent to 20 percent according to the UN over the next 45 years. In Japan, according to—this is the UN constant fertility scenario—from 20 percent today to 39 percent. It's not just hyper-aging; it's an imploding workforce—33 percent fewer working-age adults in 2050 than there are today and the declines among younger entry-level workers are even greater.

So this is all sort of my way of saying that although pension reform is the subject of the conference and we are appropriately putting emphasis on it—but in the end, there to adjust to an aging transformation of this magnitude, there have to be a series of fundamental economic and social restructuring that occurs in Japanese society. I don't want to dwell on these broader questions, but obviously, increasing the productivity of Japan's huge service sector will probably require far-reaching educational reform, strengthening what has traditionally been one of Japan's historical advantages, the strength of its extended family and its ethic of filial piety, which is in steep decline. And finally, helping develop new institutions and new attitudes and behaviors that help women juggle jobs and babies—there' s a whole generation of young women in Japan who see little percentage of getting married and having children. At a 1.3 fertility rate, there really is no long-term solution. Thank you very much. I hope I didn't go too long for you.

(Applause.)

MR. STEUERLE: Thank you, Richard. Our next commentator is Jagadeesh Gokhale who is a senior fellow at the Urban Institute, again a colleague on many issues not just this—what'd I say? Oh well. We'll take it too. (Chuckles.) At the Cato Institute. He has been at other places such as AEI, the Federal Reserve Board of Bank of Cleveland. He's well known for his work on intergenerational distributional effects of fiscal policy, and actually, as I say, he's working with me on some issues having to do with children's budgets as well, which is sort of the flip side of the elderly budgets. So we're honored to have you here, Jagadeesh.

JAGADEESH GOKHALE: Thank you very much. Quite an honor to have the opportunity to comment on the Japan paper. This paper, if you want to be simultaneously extremely exhilarated and extremely depressed—read this paper. I was exhilarated because here is a community, society that is really trying to face up to the hard challenges that they face due to the changing demographics, but depressing also because a) despite trying to deal with those challenges, several times they've come up short, and also because the U.S. situation we haven't even started. And if we do start at some point to implement reforms, we might find ourselves in the same boat. You implement the reform and you find you have to run harder and harder to stay at the same place. So let me just kind of compliment also Mr. Kabe for his paper. It's a very nice summary and in fact, given how short the paper is, actually a surprisingly comprehensive review of the history of the reforms in the Japanese public pension system.

The history of Japan's public pension system is roughly parallel to that of the United States. It started in 1942. You know that the U.S. pay-go system started in '39, and it expanded coverage and increased benefits all the way through the '70s, which was also similar to the U.S. And given the prospective demographic changes, they instituted their first reform in 1985, similar to the U.S. with our reform directed at restoring long-range stability was in 1983, the first one. But then, the Japanese have undertaken several reforms after 1985, in '94, 2000, 2004. Each time, after implementing the reform and thinking that they had restored some semblance of balance in their long-term projections for their public pension system, the next actuarial evaluation revealed that wasn't the case. In fact, they were back to square one. The target or projected premium rate for the pension system went back to 25, 29 percent, and so they had to start all over again. The difference in this case, you might ask why is that the case that they could implement these reforms when we're finding it so challenging to even start, well the legal institutions surrounding their public pension systems are different. The government is obligated by law to do this periodic review and assess the long-term balance of the system and if they find a substantial balance, they are obligated to make a decision as to how to resolve it. And this legal institution is what induced them to implement reforms periodically as they discovered that the demographics had shifted relative to what they had projected earlier.

Now, the paper doesn't actually go into any speculation or describe why they face this need for repeatedly reforming the system. It may be because when demographics—they're facing such a tremendous demographic transition—it becomes really difficult to project with a fair degree of precision the future course of demographics and they have to make revisions. Or it might be that the reforms were legally passed but may not have been implemented as strictly. Maybe they were evaded. There is some reference in the paper to noncompliance in terms of getting registered to pay premiums for the pension system and so on.

But the other interesting feature of the reform is that they had, in the reforms prior to 2004, they actually measured the long-term imbalance using an infinitarizing measure of the imbalance. And the reforms actually sought to eliminate the entire infinitarizing imbalance, which is another reason why I'm exhilarated, since you might know my research is about the desirability of using infinitarizing imbalances compared to the short-term 75—yes, short run 75 horizon—he's laughing back there—estimates to base reforms on.

Now, despite targeting the infinite rise in imbalance and implementing reforms that at the time of reform was thought to have taken care of the entire imbalance, after a few years, they found, no, that wasn't the case. So what does this—I mean some might argue that, you know, that just shows that infinitarizing is not appropriate. I don't think that's the right conclusion. It's just that they're not sufficient to guarantee that you'll achieve long-term sustainability. In fact, had Japanese policymakers adopted a shorter-term, shorter-horizon measures, the reforms may have been milder and the remaining imbalance that the country faced today would have been bigger. So actually adopting these really long-term measures, the infinitarizing measure probably helped the Japanese to go further in the extent of the reform they implemented.

Now, having to repeatedly reform their system taught the Japanese another lesson, which was that they needed to adopt smart reforms, which is introduce these flexible measures and automatic adjustment systems to deal with unforeseen demographic changes. Now these type of measures obviously have several advantages. One is simply that you avoid the delay in implementing reforms. They become automatic through whatever indexing mechanisms that adjust the system's revenue or outlays. And we know that delays make the adjustment costs larger, so that's one clear advantage.

The other clear advantage that I guess was only indirectly alluded to was that the automatic adjustment rules, if they are clearly communicated, help households to appreciate the true degree of uncertainty that they face in constituting their own personal budgets. And it also communicates that there is some uncertainty embodied even in a Social Security system or a public pension system that is run by the government. It's not a guaranteed retirement income that they should expect to receive, but there will be future adjustments. And it's probably better to communicate that clearly rather than fool people into thinking that their retirement is secure. That's something that we don't have in the U.S. because we don't have any automatic adjustment mechanisms designed to deal with long-term unsustainability of the system. And the third advantage is clearly that automatic adjustments are potentially consistent with tax (moving ?) because they help to distribute the adjustment costs more evenly among current and future generations.

Now, despite adding these automatic and flexible adjustment factors, the Japanese system has also built in some constraints to how far these adjustments will go. So that suggests that if the constraints really bite and they limit the extent of the—extent to which the automatic adjustments are implemented, it means that the 2004 reform may not be the last reform that Japan has to implement. Secondly in the 2004 reform, the Japanese government has decided to do away with the infinite horizon calculations and base their future actuarial review on a hundred year forward looking measures. I think in doing that they've essentially done the wrong thing. They shouldn't abandon the infinite horizon measures because, as I've argued elsewhere, doing so—adopting shorter horizon measures really imparts a bias in the policymaking process, and future reforms will probably miss a lot of the information that should be taken into account in designing the reforms. So let me stop there, and thank you again for inviting me.

(Applause.)

MR. STEUERLE: Thank you, Jagadeesh. Our next speaker is Alex Beer from the United Kingdom. She's the senior work, pensions, and education advisor now at the British Embassy in Washington, where she tried to identify and facilitate a U.S.-U.K. best practice on domestic policy. I don't know whether we have too much to contribute on best practice on Social Security, but I hope at some point we will. She has also worked as an economic advisor to the U.K.'s Department of Work and Pensions, and she has degrees from University College in Oxford among her many other –

ALEX BEER: All right, thanks. All right, thanks—thanks very much for having me here, and thanks for that introduction, Gene. After immersing myself in U.K. pensions and then over the last six months trying to familiarize with what the U.S. are doing, it's interesting to get this wider international perspective. My presentation, however, is going to focus on the situation in the U.K. Just to give you a quick overview of what my presentation is going to cover—it's going to look at current pension provision, how sustainable the situation is now and in the future, and highlights the real issue in the U.K., which is the adequacy of future pensioner incomes. It outlines the Independent Pensions Commission proposals for the reform of the U.K. system and discusses responses to reform.

State pensions—these can be compared to Social Security available here in the U.S., and in addition to state pensions there are other pensioner benefits available, either targeted on low-income households or universally available to all the people. Taking a look at the overarching framework for state pensions or the Social Security element of the U.K. pension system, they're financed on a pay as you go basis from national insurance contributions, possibly similar to the payroll tax. Contributions are mandatory for people in work earning above a minimum level. The state pension age is 65 for men and 60 for women, although for women it will rise from 60 to 65 between 2010 and 2020, although it should not necessarily be confused with the age at which you need to retire. There are more than actually fair deferral options for receipt delayed beyond the state pension age, and state pensions and payments are indexed by at least inflation, although between 1974 and 1980 they were rated by earnings.

So the Social Security element is made up of two parts—a flat rate element, the basic state pension—the maximum is currently equivalent to around $145 a week—and also an earnings related element currently called the State Second Pension. Entitlement is based on the number of years of credited contributions, and for the earnings related element it is based on earnings also. Low earners and people who are out of work can be credited with contributions for activities such as caring or when people are disabled and home responsibilities protection, which is available mainly—it's mainly for mothers who are caring for children—actually decreases the maximum number of years needed for the maximum pension. For employees, participation in both pension elements is mandatory, but participation in the earnings related element can also be achieved by contracting out, where equivalent pension saving is made in an occupational or personal pension instead of participation in the State Second Pension.

Comparisons have been made between contracting out and proposals—proposals to carve out individual accounts from Social Security because the state pays rebates into individuals' private pensions instead of giving them rights to future State Second Pension, the state earnings related element. However, the rebates are calculated such that the individual's pension—private pension—will give them at least as much as a state scheme would have done. And also contracting out isn't a one-off decision. It's possible to contract in, contract out, and contract back in again. I think you can make that decision at least once a tax year.

This slide details some of the noncontributory state benefits that are available for pensioners. The pension credit is a means tested benefit targeted at low-income pensioners—so for poverty alleviation—to ensure that their incomes do not fall below a certain level. It's equivalent to about $193 a week per single person. There are further universal age related payments. For example, for households including age 60 or over, there is a winter fuel payment equivalent to $353 and higher when the household includes someone over the age of 80. And also for those on low incomes, there are additional income related benefits that help with housing costs and local taxes.

And so just—just in case you're wondering what it all looks like when put together, this graph shows how all the elements of state income per pensioner fit together. It looks at the composition of state income for single male retiring in 2004. The X-axis shows income when in employment, which obviously will have affected their pension building capacity, and the Y-axis shows income in retirement. For those who had low incomes in employment, i.e. to the left-hand side of the graph, it is likely their pension income will include some basic state pension, the blue section, some state earnings related element, here shown by the yellow section, the guarantee credit element of pension credit, which is making sure their income reaches at least 109 pounds—that's the orange section—and also the savings credit element of the pension credit, which rewards people for additional income they may have saved, removing the pound for pound withdrawal that previously existed before the savings credit did. So the savings credit was introduced within the last few years, but prior to that you would have just had the orange section and then at the lower end of the income distribution and 100 percent marginal deduction rates. The savings credit has smoothed those out. For those who have higher incomes on the right-hand side of the graph, their pension will be made up with a flat rate basic state pension plus a larger amount of the state earnings related element. But because they have higher incomes than the pension credit guarantee, they don't receive it.

Right, and when I us the term private pensions, I use it to refer to sort of occupational and personal pensions. Private pension saving is tax privileged, albeit within limits. It can be into occupational pensions or personal pensions, and stakeholder are a low-cost personal pension which were introduced in 2001. Private pensions in the state system overlap through the opportunity to contract out into a private pension as I've just mentioned. So the government is paying rebate into individual pensions, thus decreasing its future State Second Pension obligations. Around half of all final salary schemes are contracted out, and around 13 percent of defined contribution employer schemes are. And for these individuals, contracting isn't necessarily an active decision because they opt out as a default of joining their employers' scheme. It is also possible to contract out into a personal pension, which requires more of an active decision. And finally, in all but a small minority of cases, at least 75 percent of your pension entitlement must be annuitized.

So what does all this mean for state spending on pensioners and pensioner income? Generally today's pensioners are okay, although we did see some unequal increases in income through the 1980s and '90s and women's state pension entitlements aren't as good as those for men due to broken work records and the various carers credits and home responsibilities protection not being in place sufficiently for women to build up a full record. Although the minimum income guarantee, which is what—which is a pension credit predecessor—and then pension credit are targeted on those at lowest incomes. And nearly 2 million (people) have been lifted out of absolute poverty since 1997.

But looking forward, in common with most developed countries, we have an aging population. Looking above the red cross, we can see the dramatic increase in the dependency ratio over the next 20 to 30 years. And the dotted line on there is just showing what the dependency ratio would have looked like if we hadn't had a baby boom. Yet at the same time as the population is aging, state spending on pensioners doesn't show huge increases from just over 5 percent of GDP to 6.7 percent in 2055. And yet the dependency ratio is projected to increase by 47 percent. These projections are calculated in a bottom-up fashion, calculating expenditure, providing current trends and trends in indexing pension—pension spending continue. The price indexing of state pensions and payments means that pensioner expenditure grows at a slower rate than the economy and is sustainable since contributions increase by earnings. As a result, state spending per pensioner as a proportion of GDP is projected to decline. Pensioners will become poorer.

Private pensions aren't necessarily—on current trends—aren't necessarily going to be there to pick up the slack. There's been declines in occupational—occupational pension participation from a peak of 12.2 million in 1967 to 9.8 million today. And although there's been an increase in personal pension participation, these are much less likely to include any kind of employer contribution. In the late '80s—(audio break, tape change)—contact out into a personal scheme away from their employers' scheme. And that's away from an employer contribution. Personal pensions also tended to have very high charges. In 2001, the introduction of stakeholder pensions, a type of extra-regulated personal pension with capped charges, dramatically reduced charges across the personal pension market.

Also introduced at the same time as stakeholder pensions was the requirement that employers without existing suitable provision do what is known as designate a stakeholder pension, that is identify a stakeholder pension that employees could contribute to. And although this manage to increase pension coverage to over 90 percent of employees, many of these stakeholders do not actually have any members, and given falling state provision and projections that private saving will not fill the gap, is working on a possibility. And although in the last few years we have seen increases in the employment rate of the over 50s, what you generally see is at post 50, the employment rate of individuals dramatically declines although this isn't just through to early retirement. It's explained by a number of factors, including disability and caring responsibility. The need for reform therefore is driven by concerns about adequacy, not sustainability. State and private pensioning confluent pensioners is not forecast to increase dramatically between now and 2050, and yet the number of pensioners is. So on current trends, this means that the future pensioners get poorer relative to the rest of society, or they have to work much longer.

The government clearly identified the problem in a publication in 2002, and at the same time established the Pensions Commission to review the regime for private pensions and long-term savings. Among recent reforms have been attempts to—among recent government reforms as well, there have been recent attempts to simplify and restore confidence in pensions. We established the Pension Protection Fund, an organization along the same lines as the Pension Benefit Guarantee Corporation to ensure defined benefit pension saving. We also created a more proactive pension regulation body, the Pension Regulator. And the Finance Act 2004 swept away eight complicated tax regimes of pension saving, replacing them with one—a lifetime limit of tax-privileged pension saving of 1.5 million pounds in the year 2006–7. The Informed Choice program has also been attempting to make clearer to people that own prospects for retirement, including established joint pension forecasts so that people get to see on one piece of paper what the state plus occupational pension income will be. So they've also been promoting pension education and financial literacy.

The government has also been thinking about what more extensive reforms should look like and published five guidelines against which proposals for reform should be measured against. Does it promote personal responsibility, providing incentives to save and work? Is it fair? For example, does it protect women and carers with broken career histories? Is it affordable as the life expectancy continues to rise? And is it simple and transparent such that people are able to make informed choices? In 2004, the Pensions Commission published their first report, setting out the stark choices that the U.K. faces—poorer pensioners, people saving more, people working longer, or a higher proportion of taxes going to pensioners.

And in November 2005, the Pensions Commission published their recommendations. It's around 780 pages long is their document, including appendices, so this slide is a short version. (Laughter.) Their main proposals were automatic enrollment in a national system of personal accounts. So this would be for everyone in work who currently isn't participating in a pension. And with this would also come mandatory matching employer contributions of around 3 percent of salary. The automatically enrolled employee would be contributing around 4 percent of their salary, and then there'd be government tax credits or tax relief of around 1 percent of salary. It also proposed erosion of the earnings replacement role of the state through freezing of the accrual rates, accrual limits, and the state's second pension, which would also have the impact of gradually eroding the complex contracting out arrangement I tried to explain. Also the basic state pension would be indexed to earnings from 2010 and made universal so that entitlement would be based on residency rather than contribution history. And they also proposed that, in order to pay for this or help pay for some of this, that state pension age should increase gradually in line with projections for increases in life expectancy.

So what's going to happen next? The government has welcomed the Pensions Commission proposal and is currently considering them. It's looking at them in the context of the five principles for reform it has set out, and as yet nothing has been ruled in or out. It's also established a national pensions debate to try and establish wider consensus. And so what the government will actually publish—their proposals for reform—are the actions it proposes to take forward in response to the Pensions Commission and the wider debate. They'll publish these proposals later this Spring. On the whole, the government seems committed to change, including sort of increases in the state pension age and that there will be a proper basic state pension and making it easy for people to save.

And more widely there has been agreement on the problem, but not necessarily the shape of the solution. The conservative party are pushing the government for reform. There is a reluctant acceptance by many stakeholders that the state pension age has to rise. And pension providers have stepped up to the challenge of designing a structure for the national pension savings scheme that the Pensions Commission proposed. Public views are more difficult to get a hold on, but it seems that they are reluctant to accept the hard choices, be it increases in state pension age or tax increases. But the outcome of this debate and the government proposals will—so part of the conclusion to this presentation will happen later this Spring when the government decides what it is actually going to take forward. Thank you.

(Applause.)

MR. STEUERLE: Thank you, Alex. I guess the island economy is competing because Alex was also on time so I have to make kind comments about British courtesy as well. Our next speaker is Stan Ross. Stan Ross is an old friend of mine and has an extremely distinguished and illustrious career starting off almost in all the major areas of reform in the United States—starts off working, among other places, at the Office of Economic Opportunity, works in tax policy, right?

STANFORD ROSS: (Off mike.)

MR. STEUERLE: Tax policy, sorry. You were in the White House though, right?

MR. ROSS: (Off mike.)

MR. STEUERLE: In the White House, sorry. Go ahead.

MR. ROSS: (Off mike.)

MR. STEUERLE: Okay, working on poverty, sorry, and has also been commissioner of Social Security, has been the head of the Social Security Advisory Board, and also has many years working with Arnold & Porter. So Stan, we're honored you joined us.

MR. ROSS: Well, it's a great pleasure to be hear and look around the room and see so many old friends. If you've worked in the Social Security area for as many years as I have, it gets to be a pretty small fraternity. I want to commend Rudy for putting this together. I think it's not only important to keep talking about Social Security reform, but also it's very interesting to try to find new ways to get people to think about it. One way of looking—getting into what I'm going to say about the U.K.—and Alex did an excellent paper and has given you a pretty good sense of what the U.K. system is about—is to say all the OECD countries under review here may be seen as making a tradeoff between social protection concerns and fiscal burdens. The issue is how to strike an appropriate balance.

Many of the continental European countries, some of which we'll get to like Germany and France that's not represented here, appear at one extreme since they have the largest fiscal costs and maintain the greatest amount of social protection. It's doubtful they have achieved an appropriate balance for the long term. The U.K. may be seen at the other end of the spectrum. It's done the best job of constraining fiscal costs, but it has basically lost a fundamental core of reliable social protection. You can't read Alex's paper and analyze the Pension Commission without seeing that they don't have a basic core benefit that supports the needs of a highly diverse country. The U.S. is somewhere in the middle. It has fiscal costs that are only modestly excessive by OECD standards and still maintains a strong measure of social protection. Our average replacement rate—they'll say I'm wrong, but they'll help me make it right—is somewhere between 35 and 40 percent. It's not huge, but, given the size of the country and the diversity of it, it's a good measure of protection particularly because lower income people get more return and higher income people get less.

I was struck by how timid the U.K. response to its dilemma seems. The Blair government has shown it can be aggressive at times, but it surely hasn't been aggressive in attacking this issue. A commission that has strung it out, and now there are going to be consultations. And even looking at the commission, I found, when I went and read its recommendations, that the word timid strikes me as being there again. Given a country with the social welfare traditions of the U.K., it strikes me that its inability to establish a tax-based pension system of even modest proportions like the U.S. is quite remarkable. Its recommendations of this commission seem to me to continue to reflect the second best solution of trying to use tax incentives to create still another optional individual account system. So what lesson do you draw from that? The lesson I draw is that it may be that an

OECD country today cannot accept increasing fiscal costs for social protection in a highly competitive global economy. It also suggests to me, if this is so, being very careful in your reforms, not to reduce fundamental social protections too much or too fast or incoherently, which I think the U.K. has done. It's left itself with a lot of people who ultimately—they may need to step forward and do even more means tested things. The amount of means testing and little supplements and stuff in their system would—is already much more than you'd ever find acceptable in the United States.

The missing element in this discussion, though—I don't want to be too hard on the U.K. because I admire many things about it—is they have—is the health care. They do provide affordable health care for retirees, and the U.K. is way ahead of the U.S. on this score. And perhaps the health care aspect is why the U.K. can get away, for the time being, with inadequate provision for pensions. The U.S. may be at the other end of the spectrum here. One thing that may inhibit Social Security reform here is the difficulty of our health care system. And the Medicare reform stuff seems to me not to be a solution. It seems just to be exacerbating the problem, which is that the public is going to be very concerned about any attempt to erode basic pension benefits when they know they need to hold on to cash to take care of health care needs as they're in old age.

What is the U.K.? I think it's a cautionary tale that advocates of voluntary individual accounts for the United States have yet to adequately address in their proposals. The U.S. voluntary private and individual account system are quite substantial, and it's a glass half full, glass half empty situation. But they do provide useful supplements, mainly because the public financed Social Security system continues to provide a basic core of pension support that they can rely on. So if Microsoft and IBM and the rest pull back on retiree benefits and pensions and make it more defined contribution, more 401(k)s and less retiree health care, as long as we keep the basic Social Security system somewhat where it is, they can do that, and what they're doing is very useful. But if you ever lose our basic Social Security system, then I think our voluntary supplements will cause much more concern than they have been.

In the end, I suppose, the U.S. and the U.K. are probably unique, as are France, Germany, Japan, and every other OECD country. In all these countries, the political systems work in quite distinctive ways. Whether they're producing what people need is hard to say. In the end, a democracy produces—and these are all democracies—what the citizens currently vote for. And it may take quite a while for these problems to be worked out responsibly, as all the case studies this morning show. From my standpoint in the U.S., the present stalemate be a far better—a far better thing in the short term than ill-advised change. Ultimately, the U.S. needs to improve the social protection efficiency and financial sustainability of its public pension system, but it should be able to do this without seriously eroding the basic level of social protection the system presently provides. As Larry Thompson said earlier, some modest changes on the revenue side and in the retirement age in the long term could get the job done, as I testified before the Senate Finance Committee last summer. I was the last Democrat to testify and give the Bush proposals their burial.

I remain an optimist on these pension matters, but I do so only as long as I don't have to comment on the health care issue. I'd be glad to be here and clarify whatever I've said. Thank you.

MR. STEUERLE: Thank you, Stan. (Applause.) Our final speaker for this session—or commentator—is John Turner, who I've also known for some time now, a senior advisor in the AARP Public Policy Institute. He previously worked at the International Labor Office in Geneva. He's edited or coedited or authored 12 books already and over 100 articles on various pension and Social Security issues in the United States. He has been a Fulbright Scholar, received an award for the best article in the Journal of Risk and Insurance, and has a Ph.D. from the University of Chicago among his many accomplishment. Thank you, John, for joining us.

JOHN TURNER: My comments today do not necessarily represent the position of AARP. United Kingdom is a major policy innovator, and I'm going to talk about three policies that Alex discussed, just focusing on three aspects of her presentation. These three aspects are first privatizing Social Security using the voluntary carve-out individual accounts, extending pension coverage over the greater degrees of compulsion, and raising the Social Security early retirement age to 65 or higher.

Social Security privatization—the United Kingdom is the only high income country having voluntary carve-out individual accounts, the type of account that President Bush has proposed. Japan has carve-out accounts, but they're using defined benefit plans. And so in this way, the United Kingdom is a particular good country for us to discuss at this conference. As we know here, with voluntary carve-out accounts, participation in the earnings related part of Social Security is not compulsory, but workers who opt out must participate in alternative arrangements.

Now being at AARP, I've participated in the Social Security debates. That's sort of the background. I believe there's a number of individual account miss (?), and I'm going to talk about one of them with respect to the United Kingdom. This is a myth in the United States that's not held in the United Kingdom. I'm with the University of Chicago, and we view choice as always being a good thing. More choice is better than less choice. So in that framework, having the voluntary carve-out account would be a good thing. It expands the rates of choice for the U.S. citizens. Instead of having the monopoly Social Security system, you're giving people choice. And anybody who takes that choice is made better off.

Well, I consider that statement to be a myth. And the U.K. experience shows a problem with that. Due to a lack of financial sophistication, many U.K. workers have been made worse off by taking the voluntary carve-out accounts. And behavioral economics has shown more generally that choice is not always a good thing. Now Alex mentioned the mis-selling scandal, which is well known, I think, to most of us here. But what is not well known is the very large magnitude of the errors that were made. Thirteen billion pounds have been paid to the victims of mis-selling—people who chose voluntary accounts, voluntarily chose voluntary accounts, who were deemed to have been mislead and have made a poor decision. And even though that's a large amount of money—$26 billion—you have to keep in mind that the U.K. economy is a sixth the size of the U.S.'s economy.

And I think that this next slide is a little bit murky, which is perhaps the main point of the slide. And that is it's very difficult to get right the tradeoff between being fully in partial Social Security and partly in Social Security and partly in the voluntary carve-out account. Now, if you make the tradeoff very generous for workers, that makes it expensive for the government. If you make it not so generous for workers, then workers would make a mistake by taking it. And the U.K. has had problems with this, and this is a very important issue of the practicability of the voluntary carve-out accounts. In the U.K. they reset the rebate that goes to the accounts every five years, and the last time they reset the rebate was several years ago.

Recently two large insurance companies have advised their clients—clients of theirs—to not participate in the voluntary carve-out accounts; in other words, stop being their clients and return to Social Security. And the reasons why is that they feel that error was made in setting the rebate. And this—it's a little bit complex, but it just indicates the problems in trying to set the relationship with the two. When the rebate was set, the interest rate was quite low, and the government actuary's department said, well, we think the interest rate is going to rise so we're going to set the rebate so that you will—we anticipate you'll get a higher return on your voluntary carve-out account. Well, it didn't rise, and so the rebate wasn't sufficient to keep people whole who took those accounts.

The idea of voluntary carve-out accounts is being rejected in the United Kingdom, which is ironic that it's being proposed at the United States at this time. Alex has shown me some data, and if I have interpreted this correctly, if you look only at the individual accounts—people who have taken individual accounts as a voluntary carve-out accounts—that number has declined by about 40 percent since the early 1990s. And that's despite the growth of the labor force. And the Pensions Commission, which I prefer to refer to it by the informal name of the Turner Commission—(laughter)—it has recommended the end of the voluntary carve-out accounts as part of Social Security—the phasing out.

So my second point is not about Social Security. It's about extending coverage with private pensions. And I'm going to use the concept of greater degrees of compulsion for extending coverage. In the U.K., employers are not required to provide a pension plan—the same as the United States. However, for employers with five or more employees who do not offer a plan, the employer is required to designate a pension provider to whom employees can contribute. Now that's a complicated way of saying what we would call a universal IRA, which has been proposed recently, that the employer was required to have a payroll deduction facility for employees. And the idea behind that is that it makes it easier for workers to participate because they can do it through a payroll deduction, instead of having on their own to make the contribution. And so we can have insight from the United Kingdom how something like this might work.

It hasn't been around for very long—only a year or two. But there has been widespread noncompliance; that is, many employers who are required to offer such plans are not doing so. And I assume that the compliance issue will eventually be taken care of. Because of the short time, it hasn't been adequately addressed. More importantly, there has been a low take-up. The majority of employers that have offered these plans have no participants in them. They're required to actually set up a plan with a financial service provider so there is a cost to the employer to doing this, even though their contribution is not required. And most plans without an employer matching contributions have no participants.

Now the Pensions Commission, which Alex mentioned, is taking compulsion a degree further. And the proposal would be that employers would not only be required to offer pension, they would be required to automatically enroll everybody into that pension. But people could opt out if they way, and they would be required to contribute to it. So we're talking about degrees of compulsion, and this is one step short of actually mandating the pension.

My third and last policy I'm going to discuss is the Social Security pensionable age. As Alex said, the pensionable age—that's the earliest age for benefit receipt—is 65 for me. It will be raised to 65 for women by 2020. Now in comparison to other countries, it's 62 in the United States. It's 61 in Sweden, and it's 60 in Canada. So 65 is significantly higher than the other countries. And I think Japan is raising it from 60 to 65. So with respect to the other countries, the U.K. is way ahead in terms of having set a very high pensionable age.

People often say, well, how does this actually work? You know, when there's a high pensionable age, do people actually work until that age? And the answer is no, they don't. In looking at the U.K., but in many other countries that I've said the pensionable age is 65, there's—as a result of political pressure no doubt, alternative ways of retiring have developed. Many people take disability benefits at a younger age. You can take employer provided benefits earlier. An interesting aspect of the contracted out benefits—those are the ones that replace Social Security. So you can take your contracted out benefits earlier than you can actually receive the benefits if you had not contracted out. And so if you look at the labor force participation rates for persons aged 55 to 64, it's actually slightly lower in the U.K. than the United States. Actually they're very similar to each other.

Now several people have mentioned with increasing longevity there are only three options, all of them unpleasant—reducing old age benefits, raising taxes, or raising the age at which benefits can be received but without an actuarial adjustment for benefits because you've postponed the receipt of them. Nicholas Barr, who is a distinguished economist at the London School of Economics has recently stated, quote, the central problem of pension finance is the age at which people are first eligible to claim their pensions. And I think that he has perhaps been influential with the U.K. Pensions Commission because the Pensions Commission has proposed that the pensionable age be indexed to life expectancy so that a constant proportion of adult life would be spent in retirement.

I just want to comment about this for a minute. This may seem like a certain and in some ways a logical extension of indexing, but the U.K. is the first country to—if they actually do this, it would be the first country to index the earlier age—the earliest age at which you can receive benefits to life expectancy. Other countries have indexed the benefits to life expectancy, and Sweden is an example. But no country has indexed the early retirement age to increases in life expectancy. So it really is, in some respects, quite a radical proposal.

Well, three more slides and it's time for lunch. In conclusion, I've discussed three major proposals that the U.K.—three major policies of the U.K., which have some relevance for the U.S. discussion. U.K. is the only country that has voluntary carve-out accounts—individual accounts of the type that President Bush has proposed, and they are considering phasing out these accounts. And whether or not they're phasing them out, workers are not taking them as much as they did at one time. The U.K. has a short but largely unsuccessful experience with the mandatory universal IRA accounts, and people—the essential problem is that people who have been offered these accounts have not participated in them without there being an employer match. Lastly, the U.K. has a relatively high pensionable age of 65 and has proposed indexing that age from improvements in life expectancy. And I'm not going to comment really on which proposals are—you know, I would recommend to the United States. Really the point of my comment is just the insights that we can get. But I think that we can get useful insights from the U.K. experience. Thank you.

(Applause.)

MR. STEUERLE: I held off taking questions on the paper on the Japan pension reform so that we could actually consider both Japan and Britain together and partly just to get back on schedule. Just for those of you who might be worried about it, we did build an extra half an hour in lunch to take care of possible overrun. So we're essentially back on schedule. So I'd like to—as people line up for question, we'll take a few questions on either the paper on Japan or the paper on Great Britain. I'd like to pose the first one, and, as I say, those of you can come to the microphone. And this has to do with some of my own recent work, which largely relates around the issue of work, which was John Turner's very last comment, which was largely related to the minimum pensionable age. And this work shows that when you can induce more work in the system—Social Security system—it has all sorts of additional effects that generally are not calculated by the Social Security actuaries or by those—look at a Social Security reform in the narrow sense of Social Security.

And that is a particular of the additional work—not only yields a higher GDP, if we assume these are actual more workers in the economy thus producing higher incomes for workers in old age, but it also produces higher revenues throughout the government. You have increased income taxes, increased income taxes at the state level. You have increased sales taxes from the higher amount of purchases. And so you actually provide some relief for the rest of the budget to the extent that Social Security is impacting on that. And I'm just curious whether those broader issues were all addressed or even thought about in either Japan or Great Britain, these ultimate impacts of work upon the broader fiscal issue.

Would either –

MS. BEER: An extending working life as a sort of area it is called in the U.K. is a big part to addressing the situation posed by an aging population. And so not only is within government a whole program looking at how to get people to stay and work for longer and how to work with employers in order to get them to retain workers for longer, the Pensions Commission did actually propose in their vast report various measures that should encourage people to stay in the work force longer. So getting people to stay in the work force longer is continued in part of the wider debate. But give there's so much material to cover, unfortunately I wasn't able to fully address it in my presentation.

MR. KABE: (Off mike)—Japan on this issue. In the reform of 2000, we extended the coverage of the insurance up to the 70 years old, rather than 65 years old in order to subject them to pension premium collection. We recognized that there are more and more people working in their late 60s, and they could be a candidate for bearing the burden of the pension premiums. So in one—I can point out two things. First, we—(inaudible)—coverage of the insured recognizing the fact that we have more people working in late 60s, and also we have been increasing the pensionable age. And during those periods, we try to promote more work in the early 60s or in later 60s to have them participate as a working force. So this is a very major issue to be taken care of and to be considered in designing our pension reforms.

MR. BOUCHARD: It's either a question to both presenters, or it's food for thought. When increasing the age of entitlement or thinking of increasing the age of entitlement—certainly an issue that we faced in Canada when we considered that possibility—our enthusiasm cooled down when we realized that half the savings were offset by increasing disability costs for each prior to age 65. So depending on the benefits structure of the disability component of the system, especially prior to retirement if it's too generous and so on, the savings that you're getting by increasing the retirement age is offset quite a bit. Even up to 50 percent, if you've got too generous a system, and I'm wondering if U.K. or Japan faces that same kind of situation or whether in the states that you start increasing the age of entitlement, whether you see that phenomenon.

MS. BEER: Certainly, I think—I'm not necessarily going to get my dates right. But I think in the 1990s you did see large increases in the numbers of people on incapacity benefit, which is our disability benefit. However, more recently these increases have stopped, and so what we've got is we've got quite a number of people who have been on incapacity benefit in the long term. But we've managed to abate flows onto incapacity benefit. But you're right that sort of in terms of reasons why people leave the labor market before the state pension age, you have through disability and the fact that they can retire onto incapacity benefits, which are more generous than sort of otherwise unemployment benefits. But people do also leave as a result of caring responsibilities and—caring either for partner or possibly for a parent.

In recognition of the fact that people are leaving—have been leaving the labor market early and going on to incapacity benefit, there has been a huge big—there have been recent reforms that have focused on reducing the number of incapacity benefit claimants. And I think these have focused at helping people work with their—work with their disabilities and assess what it is they can do and have a much more work-focused element to the incapacity benefit, so a much more interventionary regime rather than just being signed off as disabled and then you go on to incapacity benefit. But the new reforms have focused on working with people to try and work out what—what work they are able to do even if they weren't possibly able to do that previous job. And so it's hoped through those—through the recent incapacity benefit reforms that the numbers on incapacity will be reduced. The prime minister has actually set a target that overall we'll reach an 80 percent employment rate in the longer term. And the way that figure is reached is by reducing the number of people on incapacity benefit by 1 million and also increasing the number of older work from the labor market by a third million.

MR. KABE: (Off mike)—the benefit or the disabled benefit strictly limited to handicapped persons. So it doesn't work to promote early retirement. So we have a different situation.

MR. STEUERLE: (Off mike)—I think I'll do. I'm not sure how many more question we have here. Just so we get a—(inaudible)—just comment on this. Yes, please.

MICHAEL MERSMANN: (Off mike.) Well, it fits not really in my small speech after the break so I will place it here because we all speak about disabilities. We speak about people who are not able to work eight hours or more—only three hours. Maybe as you know, Germany increased just a few weeks ago the retirement age to 67. And to say that—for me, I'm not the pension specialist. I'm a unionist. But to say that means—I know exactly this 67 is on the paper—now today on the paper. The reality is I don't know—63, 63.5 or something like that. But I think, to be frank, what did we—well, what was the way to deal with, let me say, unemployment, with economic problems in older industries in the past? We create possibilities for the people to get their pensions earlier, to hold unemployment figures down. And we did that in Germany about years, and in every case you find solutions together with the pension system, unemployment system, a mixture of both. And so the reality was the people left work at 59 or 60. So when we increase now to 67, the hurdles become a little bit higher, and I think that is a way to increase on a long term. And when I speak about a long term and I look on Germany, I think 67 would be a reality in 10, maybe 12 years, not earlier.

MR. STEUERLE: What I'll do just so we can stay with the schedule is anybody who has a question, I'm going ask them all—let them all pose their questions, and we'll just have so one final set of comments in response to them. So Steve, you're standing up. If anybody else has questions, please put them forward now.

MR. GOSS: Thank you, Gene. Let me be real brief. First of all, really just a suggestion. A lot of people were using the word sustainability in many different contexts here, and I would just suggest that we all be a little bit careful about how we use the word sustainability. We heard, I think, a very good comment about, if you're willing to pay for it, it's sustainable. And even with increasing worker or decreasing worker to beneficiary ratios, if as a society anyone of our countries decides we're willing to pay a greater share of GDP, as long as that falls short of 100 percent, that probably could be sustainable. So we probably should not put ourselves in the box in saying if we have a legislative tax rate of X, that we cannot go above that and, if the cost of a system did tend to go above that, that that would be unsustainable.

What I think we tend to do for our Social Security system here in the U.S. is to say that the currently scheduled benefit levels are not sustainable with the currently scheduled tax rate, and that statement is a statement of fact. I would say something about the infinite horizon, but I think Jagadeesh and I will probably debate that point endlessly or indefinitely. And I think frankly that, you know, 75 year or infinite horizon estimates would lead us to essentially the same conclusions or could and should in the case of the Japanese system. The only other point really is on—what we're really talking about here in every single case, I think, is how we're going to struggle with dealing with the demographic changes coming forth. If the only thing any of us in our countries were dealing with in the future was extending longevity, that would be pretty easy. We'll just adjust the normal retirement age, do some of the things that Sweden has done and some of the other countries by way of modifying the extent of the monthly benefits as we go forward. But we're dealing with something much more fundamental than that. And fortunately for us in the States, we're dealing with it a whole lot less than every single other country that is represented here today, and that's the drop in fertility rates. That's the real story of the demographic challenge. That's why you all are really being hit with the big change in the worker to beneficiary ratio.

So when we're talking about sustainability, here's a question I would pose to each of you to hit after the break or whenever or at least to think about—is the relatively recent drop in fertility rates dramatically below replacement levels in each of the countries represented here today and even more in some other countries—well, not more in probably many other countries—is that sustainable? Do you really expect in the infinite horizon or even in the next 75 years that fertilities will stay down to 1.2 to 1.6 range? Is that really sustainable because the implication for the natures of your—of your countries, especially if there isn't dramatic immigration net coming to the countries, is obviously that the population disappears. And that doesn't really sort of seem like a plausible scenario. Just really a thought because if that's not sustainable, if that doesn't happen, then a lot of the problems we're talking about here may be resolved in ways other than just reducing benefits or raising taxes.

MR. STEUERLE: Are there any other questions? Anybody on the panel? I'm going to view that last one then as a statement. Do you want to make –

MS. BEER: I just wanted to make a comment on that, which I think—it's right that the level of fertility—that the fertility rate is an issue. But in terms of the timeframe of when the U.K. is facing its vastly increasing population and the need to provide for more pensioners, even if we were to increase the fertility rate dramatically as of today, it still wouldn't be able to kick in by the time we actually needed sort of our extra workers.

MR. KABE: Very good question, and we know that we don't know the answer to that question. We projected our fertility rate at the level of 1.39 for the indefinite future. However, if it—(audio break)—improved the fertility rate by way of making environment better for the working women so that they can have both career and child rearing. However, we are not forcing them, and we don't want to force them. So it's up to the women or their husbands how many kids they are going to have. So we did not incorporate the increase of the fertility rate into our projection. We just incorporated the present level of fertility rate because we don't know whether it's going up or going down. We did not want to be too optimistic about the environment which surrounds the pension scheme.

MS. KRUSE: Well, so far aging in Sweden so far is mainly caused by increased—increased life expectancy. Now, it turns out that we have pretty high replacement—well, not replacement rate but—pretty high fertility rate. It used to be 2.1 in the '90s, but it's come down. But we are heavily subsidizing child raising, as well. So we do react to economic incentives. (Laughter.) We do, and there are lots of studies showing how fertility varies in Sweden with the subsidizing. So yes.

MS. JAMES: (Off mike)—automatic balancing mechanism in Sweden takes account of the uncertainty of fertility rates because that's one of the things that would get picked up there.

MR. STEUERLE: I'm sorry, Jagadeesh.

MR. GOKHALE: Just a couple of comments about the fertility issue—well, if you think about what drives fertility, you know, people have tried to kind of create some prototype models about what drives fertility.

MR. STEUERLE: We do not have a PowerPoint on that here.

(Laughter.)

MR. GOKHALE: No. Without talking about models, I mean, it's clear that gender relations are different now and fertility rates are lower than they were in the '50s. And there's some evidence that declining fertility is correlated with more generous pension systems. There's a paper by—I forget the author's name, but I can tell you after the—after lunch—which shows a very significant correlation between declining correlation between declining fertilities and the generosity of pension systems. So if you have reason to think that fertility rates—current low fertility rates themselves may not be sustainable, it may be another reflection that the current way of paying for retirement itself is not sustainable.

MR. STEUERLE: Okay, with that, we'll break for lunch. We are going to reconvene promptly at two. I ask you to try to come back at maybe five minutes to two so we don't have to do too much cat herding at that time. So we'll reconvene, as I say, promptly at 2:00.

(Break.)

MR. PENNER: Okay, this afternoon our first speaker will tell us what's going on in Germany. Michael Mersmann from the German embassy has been very active in the union movement in Germany with the German Industrial of Miners, Chemicals, and Energy Workers. He, however, since January 2004, has been a counselor in Labor and Social Affairs in the German embassy in Washington. Thank you.

MR. MERSMANN: Thank you, Mr. Penner. Hopefully I'm loud enough. Yes, I fear that there is sound. Well, let me say first I think it is not normal the labor counselor is introduced like me as a unionist. In Germany, we have a special regulation. We have an agreement since early '50s that 22 places on the world are filled of the labor counsel with unionists—not a typical diplomat, no experience in diplomatic abilities, in almost every case no experience, not really good experience in foreign languages. So please take that in consideration when I try to be engaged and to give you a feeling not only about pension system in Germany because you have a paper. You will get another one. I spoke with Mr. Penner on Monday. You can have the detailed paper on the reforms we do with the three pillars—statutory system, the occupational system, and the private system, what we set up in 2001.

But let me say first—well, Stan spoke about that earlier and also a little bit Lawrence about this. One reform is before the other, or the democratic process are after people—they have to come with me in such a process. And that is what is going on really in Germany at the moment. You know, we have the same problems than in every industrialized country—aging society. We have problems with unemployment rate. We have real problem since 1990—20 million additional people in our system who never paid contributions from eastern Germany. And with all this around this eastern Germany—I worked there for a few years from 1990 to '91, and I know companies with a workforce of 40,000 people and three years later 5,000 people, with unemployment rates from nearby 50 percent in some towns, some regions. I try to—I mention that because to understand what is going on in Germany you have to understand these 10 years. They are not over. The people are paying these solidarity contributions still with our taxes, and it goes to eastern Germany. It's not a problem. I don't criticize that. But it is a fact in Germany to understand what's going on.

Then we have a next precondition. We have three big reforms in the last—last five years, let me say. The first one was a big health reform—health care system. You spoke about health care system. We have the next health care reform directly in front of us. We did the last one a few years ago, and the next one will come by the end of the year hopefully if the grand coalition is able to find a solution. We made this big—really big reform of the labor market and unemployment insurance. You know, maybe you heard from big demonstrations in eastern Germany. We put together the unemployment, let me say, insurance, unemployment income, and the welfare system. And that was a big argument in Germany. And, well, I repeat, you have to get the people with you if you want to make reforms. And so maybe our pension reform is not the last reform we will have to do. But I think we are on a way to break up a little bit this tradition about social—for you Social Security have a totally different meaning. It's a pension system. For our understanding and translation, our social security system is everything. It's health care. It's unemployment, and it's pension. And we have it about 110 years. And so now try to change, to convince a people we have to change. The younger ones know that. But convince also the older ones.

And so what we did with the pension reform in 2001 was to find a first step, a first way for to create a more sustainable way to make pensions safer. Someone asked me, where are the sustainability in this, any reform or something like that? Well, I mentioned before we raised the retirement age a few weeks ago to 67. It was planned for 2008. We can't wait until 2008. The new demographic development says, well, we have to do it now. And they did it. It is not decided up to now, but the grand coalition is in favor such a regulation. And I think, at the moment, no one will let the grand coalition die on such a point. That would be terrible for Germany, a disaster.

From this view, I think it will come—67. But that's not the reality. As you know, we have a lot of reasons that people, well, stop working with 63 or 60. At the moment we are setting up a new regulation for women and for men to raise the real retirement age from 60 to 65. That is a regulation. It's setting up in the years 2006 to 2008. And if you want to go earlier later on, then you will lose 0.3 percent of your pension for every year what you—for every year what you go. You can first time in Germany also decide to work longer and for example to 70, and then you will have an increasing 0.5 percent per year of your pension. From this view, I think there are a lot of things changing, and let me describe a little bit besides this paper, what gives you a brief overview, what we think about this new system with three pillars of our pension system. And as I mentioned, I will give Mr. Penner a long version of this paper for the Internet site so you can have a more detailed view on that.

Well, as you know, we have now since 2001 the compulsory schemes—(inaudible). That's a main provision of our statutory pension system. And in the last 100 years—let me say 50 years ago, this was 90 percent of your pre-retirement income. Today we speak about a little bit more than 50 percent. And the forecast says, well, we don't want to go below 46 percent in 2020, and we don't want to go 43 percent in 2030. So you see, they're trying to look on a longer view, let me say, and find figures where the people can work with. And 43 percent of your income is not enough survive in Germany.

And so what we set up was two additional pillars. The second pillar is the occupational retirement provision. We had that already, but we tried to improve that. We tried to, well, to find, for example, tax advantages for companies to enable companies, also smaller companies to set up and set up those occupational retirement provisions. And it's a very important thing. What we did in this connection was—what we try to do in this connection was, what is about supportability of an occupational pension system if you change your employer? We don't have that in Germany. And now, since 2005, everyone is able to take after five years his money, for example, give it into a new occupational pension system with a new employer. He can take it everywhere. That is totally new for Germany. And we had now—we had, in connection with the third pillar, the private system, let me say, a little bit like what you call 401(k) system. Everyone is able to decide whether he gets his money, for example, in direct insurance, for example, in pension funds, or in any insurance for himself and decide also, will I go a big risk or not, more conservative, more progressive?

Those things are possible today, but there is only, let me say, the law. What is going on really in Germany is to, well, to get the people on this wave, to invest their money, to realize my pension in 30 years or 25 years will not cover all the costs I have then—only 50 percent. And the thinking of the people is, well, my pension system—the state is there. And that is what we have to change. And unions had a lot of problems with that. Fortunately my union not—we were the first union—we made collective bargaining agreement on this occupational—on a combination of this occupational pension system and the private pension system to insure the people and to, let me say, to bring the people on this wave to change their thinking. And all the details about that you will find is this detailed paper with all the figures you need. And I think I don't have to repeat my paper, what you already have. And you will get another one. Thank you.

(Applause.)

MR. PENNER: Our first discussant is Maya MacGuineas. While her sign says that she's at the New America Foundation, those of us on her other board of directors, the Committee for a Responsible Federal Budget—we claim her for ourselves basically and don't notice that she really has two jobs. Maya has published a lot in major newspapers and magazines. She was an advisor to Senator McCain during his run for president, and she has worked in a bunch of places and was educated at the Kennedy School at Harvard.

MAYA MACGUINEAS: Thank you. I am also married to a German so it's good that I'm commenting on the German pension system. And we are in the process of trying to bring up our kids bilingually. So I was going to say something in German to you, but all I have learned is all the little ducks are swimming in a row—(laughter)—so nothing really applicable to what we're talking about. But I'm working on it. And I apologize for missing the morning. There may be a couple of comments that I think are innovative, which everyone has already talked about. But just to begin, clearly there have been, I think, mixed results on the reforms in Germany, as there have been in all the countries that have really moved forward in addressing some of the demographic challenges, where the U.S. in many ways is lagging. And I think that there are lessons to be learned, both from thinking about the solvency measures, which different countries have incorporated to their reforms, and the diversification strategies or how they've gone about trying to prefund their pension systems.

So first on the solvency front, when you're looking at the European countries, you do have a bit of a different situation because you're starting with higher contribution rates almost across the board. And that's certainly the case in Germany. So where in the U.S. one would generally think that there's more room for maneuvering on the revenue side, you bump up against general inefficiencies in the European systems more quickly than you might here or than you would here. Germany has already moved forward with a lot of the sensible measures that come to mind when one thinks about solvency issues in reforming pension systems basically on the retirement age side from adjustments for early retirement to changing the average number of years that you need to qualify for full retirement, and now this presumably going forward with raising the retirement age. A lot of these things are very similar to the kinds of approaches that we saw in the U.S. in the 1983 reforms.

Also I think I'm right that there is something written into the German law that now every four years the German government has to go an weigh in on whether, if there are imbalances, how to address these. And I think that that is a very important approach and lesson for the U.S. in terms of our budget is structured—discretionary spending and mandatory spending. And the mandatory portion of the budget receives a lot less scrutiny. There's not automatic ways that the government has to look at the programs, see whether they're working, see whether there are imbalances in them. And there has been some discussion—very tense discussion—here in the U.S. on the budget front about whether the notion of entitlements make sense, whether there should be any programs on automatic pilot. But sort of a moderated version of changing that notion while still recognizing that there need to be promises for the long term—intergenerational promises—is building this kind of change into the system, where there is a regular need for oversight built into the government, where you're forced to come up with new changes whenever you meet certain thresholds. And I think that this is an important kind of change. We've seen a little bit of that in our Medicare program, not so much in Social Security.

And then here is where I think I missed the discussion. I was going to talk about automatic stabilizers as though that was a whole new issue, but I gather we've already talked about that this morning. So just to weigh in very quickly, I think the kinds of reforms, in terms of solvency, that build in automatic stabilizers are crucial. And I think that they are the wave of the future for how we're going to reform programs, whether it's indexing things to things like dependency ratios or longevity indexing, the automatic stabilizers do to things. Clearly they mean that the program is going to be in alignment with itself over time even as demographic or economic factors change. But also I think it makes a very important point related to transparency, and I know that there's some discussion about who bears the risk under different kinds of stabilization regimes.

But the important thing is to keep in mind that there's no such thing as getting rid of risk, and many of these pension programs and health care programs and parts of social contracts both in the U.S. and around the world try to spread risk in the most useful and practical way, but they also sometimes perpetuate the notion that you can get rid of risk, which you cannot. And it think it's helpful when you have an automatic stabilizer for all participants in any program—pension program in this example—to understand that there is no guarantee that something will be there down the road, that Congress cannot bind the hands of future Congresses, that we cannot make promises for the long term, particularly when we don't know about the factors that will be at play in the future. So I think automatic stabilizers not only can help the programs add up in terms of promises met—promises made and how they'll be met, but also the notion that you have to see a whole suite of ways that you're preparing for your future because there's no one guarantee that will get rid of all risk. So I'll just throw that into the discussion that's already begun.

And then there's the second issue of the private savings where Germany has moved forward with the—is it Riester? Riester pensions. See? I can't even say ducks with the right pronunciation in German probably. But –

(Off mike.)

MS. MACGUINEAS: The private—yes. Well, I was going for the name. But, yes, they're the private portion, the private saving, the prefunded portion of the pension system. And the take-up rate for this was quite low. It was about—I think it was one-seventh of what people had anticipated, and I think there's some lessons to be learned here too. If the U.S. moves forward with prefunding either as a part of Social Security or with separate pension plans, there are a lot of lessons that can be learned. A couple that I would just point out were that the regulations on these pensions were probably too complex in many ways—very alienating to the participants of the programs. And I think one of the lessons should be that, in the U.S., simplicity is key, certainly if we're starting up a universal type of pension systems.

So specific policies that we might consider are the widespread use of defaults, which I think are very useful and helpful to people in terms of simplifying and taking kind of the edge off of a scary new investment component, looking at TSP as a model, which is most—most of the Social Security reform plans do that. I think that's wise. I realize there's always a tradeoff between oversimplifying the investment vehicles and being able to tailor-make them for certain—for different situations. I think different annuity products is a good example of something where you could argue you want different annuity products for different family situations or different life expectancies. But I do think when you're starting a new kind of program, if we're looking for prefunded programs to deal with pensions, simplicity will make it much more accessible to people and less alienating.

Also as I was thinking about that, I noticed that, while I would argue for simplicity when it comes to defined contribution portions, one of the interesting things is that you actually argue for complexity when we looked at defined benefit changes. Most people across the board—while I am a big believer in transparency in budgeting, when it comes to the political realities, a lot of times you actually have to slip the medicine in there. You don't want to advertise how hard things are. My budget group does a lot of, you know, we need to make tough choices. But politicians don't like to go out there and talk about how hard the choices are. So it actually is somewhat useful when you're changing or dealing with the solvency issues to make things a bit more complex, meaning deal with bend points, deal with longevity indexing, things people don't understand, rather than the things they do understand like raising taxes, raising retirement ages. So it's kind of an interesting tension in the lessons there.

Another reason that the take-up rate was low was certainly concerns about the market during the bear market situation, and again I think the U.S. has—most of the proposals out there recognize this, but there's still some tensions on these ideas. But I do think it's important that investment strategies that are widespread and/or universal and/or mandatory are as safe as possible in many ways, both to keep the risk down, but also to keep the cost down. And I think the use of passive investments and widely diversified investments is key here as well, and that can also be combined with the default kinds of things that are included in the savings portions of plans.

Because of the low take-up rate, I think this just goes to a point that I feel like the whole political system has been very hesitant to embrace—there's so much resistance here in the political arena. But I do believe that it just—there is little sense in making all of these savings components of pensions voluntary. They really should be mandatory from almost every policy perspective, there is little reason to talk about making something voluntary. Not only does it make sure that the people who you most care about saving sufficiently for retirement are doing so, it also allows you to skip this very tricky question of how you design benefit offsets and plans where you're moving from DB to partially DB and DC. You have very tricky—if somebody is going to take up a private portion of the plan, what is their benefit offset going to look like? There have been very few successful benefit offsets designed. And mandatory saving, which has many benefits, also has the benefit of avoiding that quagmire.

Finally, there's the interesting issue, I think, of that what you found in Germany is that people still aren't saving enough. And I think that this is widespread. Whenever you have a government role in something, on one hand, we have the world of tight budgets right because of demographic challenges mainly. But many governments are trying to figure out how to pull back on their role and target their spending to the places where it's most needed. So how would you target subsidies or pension payments to the people who are most in need of them. At the same time, if you scale back to the bare minimum, the real risk that we see all over the place is that people think of the government as telling you to do something. That's usually sufficient. There is just a psychology that if there is a Social Security system out there, people, even though they're told that this is only meant to be one leg of a three-legged stool, believe that that's going to be enough. And that's true all over the place. So this is one I don't have an answer for, but I think it's an important question of how do you maintain a government role in providing saving while also having people truly understand that they need to be saving more on their own?

Then just my final point, an issue that still needs to be addressed across the board, across the international spectrum, I believe, is one of the biggest challenges here is how you get the political system to care more about—or as much about the long term as they do about the short term. And the answer is it's pretty much impossible, but how, when you're looking for proposals and solutions that have generational equity within them, how do you work that into it? And I wonder if there are budget process solutions that might be useful here. In the U.S., everybody here I'm sure knows what pay-go rules are—you pay as you go. There seemed to me an opening for both automatic stabilizers, but also kind of long-term pay-go solutions, meaning, if we are making promises for three decades down the road to spend something—some level of GDP on a program, shouldn't we be willing to pay that much today? Or should we make a relationship between how much we're able to promise in the future versus what we're paying today? So I just think that one of the new kinds of budget rules that may start to bubble up here and around the world will be budget process rules that are time sensitive and equalize the kinds of treatment that you see from today to decades into the future. So I don't know what those will look like precisely, but I think budget rules often gain momentum because there a little bit easier than actual policy choices. And so if we start looking at budget rules here or elsewhere around the world, I think the focus on long-term budget rules may be one of the new innovations that comes along. Thank you.

(Applause.)

MR. PENNER: Thank you very much. Our next discussant is Neil Howe, who works all over town but I guess a lot at CSIS. He writes very eloquently, as all of us who know him know very well, and his books include "On Borrowed Time," "Generations," "The Fourth Turning," "Millennials Rising," and so forth. One really important thing he doesn't have on his bio, for reasons I don't understand, is that he crewed for me as I sailed down from Cape Cod last summer, as did Richard Jackson, and their presence here is evidence that I'm not as dangerous a sailor as a lot of people believe. (Laughter.) But I also knew that if I sank, we would lose two really important contributors to the Social Security debate in this country.

NEIL HOWE: Thank you, Rudy. I'm still a bit seasick so I'm going to grab this lectern here. It's useful to keep in mind some parallels—obviously important parallels and differences between the German situation and the American situation, and there are some interesting similarities. The German system in the 1950s made its decision pretty much irrevocable to go to a totally pay as you go system, as did the U.S. system in the early 1950s. The German system in 1972 enacted a hugely more generous pension formula and made an extraordinarily early retirement available to most classes of workers. This was also the year in the United States in which we had our final largest increase in Social Security benefits—20 percent increase, automatic COLA indexing and all the rest. In both countries this was just before the OPEC embargo and everything went south, right?

And we both had problems with that reform. In the United States system we had something called double indexing, which made benefits go out of control. That was solved six years later in 1978 with the Carter reform of Social Security. The Germans also had a little bit of instability because they indexed both their initial benefits and their current benefits to gross wages, which, for various reasons, because it didn't actually include—it actually included the amount that workers were paying to keep the system going, had some negative feedback effects, which also led to some instability. This was solved under the Kohl reform in 1992, 20 years later.

There are, obviously, some major differences between these two systems. Most obviously the German system is much, much larger: a 70 percent replacement rate historically. It is, as a share of GDP, two-and-a-half times larger than the U.S. Social Security old-age insurance pension system. It is the largest, I believe, in the OECD except for Italy's. German is experiencing extremely low fertility, one of the lowest in Europe. They have had a history of extremely early retirement, and Germany also has—the German society has a very low reliance on funded private pensions. This also creates challenges because I believe that only about—private-funded assets, pension assets, are only about 10 percent of GDP in Germany, which I think is, again, one of the lowest in Europe.

This led to a number of reforms. We heard a little bit of talk about the Riester reform that happened in 2001, which, like a lot of the other reforms, tried to tighten up on early retirement, and did a lot of complex adjustments to try to bring down the long-term cost and long-term replacement rate. There is a pension benefit formula and the adjustments were highly complex, but actually did succeed in bringing that down. And then most recently the Rürup reform, or the Rürup Commission, which actually issued in several reforms, and one of these—the major reform was something called the sustainability factor, and I want to say a few words about that because I think this group is all about kind of long-term parametric reforms, and I think that this is Germany's sort of unique contribution to our thinking about how to reform the system for the long term.

You know, BMW has that ad about the perfectly designed automotive machine. Well, in a way, the sustainability factor is the perfectly designed pension reform device. And it works particularly because—you have to remember that Germany has a pension system which is pay as you go, but it has a current-year driver. The new pensions are indexed to the current wage, and then ever afterwards the benefits yearly are indexed to wages. So it is a wage-wage system. We don't have many of them. Germany is one. We usually are familiar with the U.S. or Japanese or Canadian system, which is wage-price, right? It's initially determined by wage and then after they're granted, it's price. We even have the U.K., which is price-price, okay? I don't think we have any example of price-wage. That would be odd. But anyway, we at least have those three varieties.

Well, the reason that this particular adjustor works so well for the German system, the adjustor basically changes the benefit both for new pensioners and for current beneficiaries by the change in the ratio of the number of beneficiaries to contributing workers plus the unemployed. The reason it works so beautifully is that there is an exact correspondence at all times between the average pension and the wages of the average worker because they're all going up in tandem. You know, the 70 percent replacement rate works even if someone has been retired for 15 years. They still have that 70—well, now it's more like 60 percent or 55 percent.

But anyway, this is a perfect reform. I just want to tell you that. The only problem was is that they implemented it—they tacked it on to this complex Riester formula and they only gave it a 25 percent weight, okay? So they had the perfect reform but they only gave it 25 percent weight. That is why the sustainability adjustor does not automatically bring the thing to absolute constancy as a share of payroll in future decades. In fact, I have seen, and a number of people have calculated, what would happen if they only did one reform—that is the sustainability adjustor, and in instead of having the alpha equal .25 had it equal 1.0, and it is amazingly flat. I mean, it really is the prefect adjustment.

And when you compare it to some of these others, particularly in Italy and Sweden with some of these notional-defined contributions, it seems very crude by contrast because these are things which—you know, certain things are triggered but they're long term and the benefit payout is based on certain accruals over long time periods, and it's very unclear in these other systems how fast they respond to forces—demographic forces that are driving the system out of adjustment. The amazing thing about the German system, it would be absolutely precise if they had the alpha at 1.0. But they don't; it's at .25.

What is odd about the German system—and this is kind of the over-engineering of many things that are German, I found—is that they have only .5 on that device but they have all these other devices, right? For instance, they're increasing the normal retirement age from 65 to 67 without any increase in the minimum retirement age. It's perfectly equivalent to an additional benefit reduction, okay? And they have these other Riester benefit—in other words, you've got all of these kind of complicated devices to reduce, in various decades and various future years, tacked on to each other along with this one device, which would be perfectly adequate to replace them all. What they could have done is just have this one sustainability adjustor and then just have a schedule for the alpha. You know, you can make it whatever you want—0.5, raise it to 0.7, take it down to 0.3.

(Off mike.)

MR. HOWE: Sustainability adjustor is the change in the ratio of current pensioners—the number of current pensioners to the number of current contributors plus the unemployed. They added the unemployed because they didn't want the thing to swing if there happened to be a recession.

MS.   : That changes the replacement rate.

MR. HOWE: That changes both current benefits and new beneficiaries coming onstream. And because it's a wage-wage system there is a perfect correspondence between the average wage and the benefit. So really there is very little slippage in the system. In other words—

MS.   : The benefit changes—the wage that workers are getting doesn't change, or does it, because the contribution rate changes?

MR. HOWE: The benefits change in tandem with the change in the average wage, for everyone—incoming workers as well as the workers onstream. It would be much more complicated if, for instance, it was a wage price system because then they would be lagging behind wages a bit, assuming that wages are rising faster than prices. But it only works perfectly in a wage-wage system. That's why it's a perfect German solution. But it would be—you could have the same solution. You could even do it—you could even tack it onto a notional-defined contribution plan, like Sweden or like one of the other countries, by simply having an adjustor simply add it to—you could get the same economic efficiencies of the notional-defined contribution and still have this automatic adjustment if you just tack something like this on, like this pyramid thing on.

Let me just say a few additional words on some of the other questions raised. One is the question—obviously one of the challenges, because of Germany's very low historic reliance on private pensions—and this was done with the Riester reform—is try to raise people's participation in funded private pensions. I totally agree with Maya that this would be much better done if it was simply made mandatory. I mean, the whole idea is to construct a floor of protection. Government is assuming the responsibility for this. If this is part of what is supposed to be the minimum provided for people, it ought to be mandatory.

I guess the final question is whether this is going to endure politically. It's easy to put parametric reforms—even very complex reforms, or parametric reforms with feedback into place. The question is, will it politically endure? Will people continue to ratify that once they actually find out what's going on, right? And as you mention, the interesting point about—or maybe it was Maya made the point about sometimes it's easier to do something that's incomprehensible because people don't know what it is. It's a little bit like the higher retirement age in the United States, which people had a hard time figuring out. It also is why opinion polls have consistently showed that trimming benefits gets a less negative reaction than raising the normal retirement age, even though functionally they're identical. You don't want to tell anyone that they can't retire as early as they wanted to. That's always bad politics. But if you trim their benefits, which saves the system the same amount, that's more palatable politically.

The final question about politics—one of the things that impressed me about the German reform is how much the crunch hits quickly. The decline in the replacement rate occurs long before the Riester pensions. Even assuming that everyone takes up a Riester pension, the decline in replacement rate occurs much earlier than the Riester pensions could possibly replace that income because of the long buildup time required.

So a really interesting question really involves the cohorts born between 1950 and 1970. This is kind of your Green Party generation in France. It's sort of the acht und sechziger. This is the 1968ers on. These are going to be retiring over the next 20 years.

They will be the ones most hit. Assuming everyone participates in the Riester reform, later-born people will do a little bit better.

Philipp Missfelder of the CDU, I think a leader of the Youth League, is famous recently for complaining about young people having to pay for health and pensions of old people, but it turns out under this reform, he won't be the one who really suffers that much. If it all goes according to plan, it will be his older brothers and sisters or maybe his parents. Anyway, thank you very much.

(Applause.)

MR. PENNER: Thank you very much. Our least speaker is Alicia Cackley, who will speak on Italy. She's an assistant director in the Education Workforce and Income Security Team at the U.S. Government Accountability Office. She received her Ph.D. from Michigan. She has been working for a long time on Social Security reform, retirement and aging issues, and even on immigration issues, so she brings it all together.

ALICIA CACKLEY: Thank you. It's a pleasure to be here. I first want to make it very clear that I am not an expert on the Italian pension system at all. In fact, I don't speak Italian—(chuckles)—or anything. But I did lead a GAO team recently on analysis of—a broad analysis of OECD countries, and we got a lot of information about Italy, and so when Rudy asked me if I would be willing to take on Italy because he really wanted them included in this conference I said we would give it a shot, and that's basically what we've done.

The story I wanted to tell because we were talking earlier about the fertility rate is that back in 1993 I was doing some GAO work in Italy on a completely different subject, and I happened to be pregnant with my third child, and I was astonished at the number of people who, when they found that out, they were amazed. There were people coming out of their offices to see the woman who was pregnant with her third child because it was so unheard of at that point in time already in Italy. And I thought, there is a problem here. This is definitely a problem.

So because it's late and we've all been here a long time, I'm going to be pretty quick, just trying to take you through sort of what the Italian system was like, some of the major reforms that happened in the 1990s, and a little bit of thoughts about sort of where that sort of leaves them now.

In the early 1990s, the Italian system was and still is a pay-as-you-go system. It was a defined benefit pension—actually had several parts—a mandatory old-age pension that was a combination of—it was a payroll tax of 26.4 percent that was a combination of one-third from the employees and two-thirds from employers. The benefit was based on final salary, the number of years of contribution for eligibility was 15, and normal retirement age was 60 for men and 55 for women. It was possible to take early retirement after 35 years of contributions, and benefits were indexed to nominal wage growth. But there was no actuarial penalty for taking early retirement, so there was that big incentive for early retirement as a result.

They also had a seniority pension that was available at age 57 after 35 years of contributions, or at any age after 38 years. And they also had a means-tested minimum pension and a social assistance—(audio break, tape change)—program that is equal to 7.41 percent of earnings every year as paid by employers into a fund that employers control and then it's paid out as a lump sum to the worker at retirement, but in the meantime it's a source of capital for the employer, and that has some implications for early retirement decisions that employees make as well.

The key reforms that I discussed in the paper were—and it happened in the 1990s—were first, in 1992, the reforms are labeled by who was prime minister at the time that they took place. So the first one were the Amato reforms in 1992, which did a number of things. They were designed partly because Italy had fiscal imbalances.

They were trying to meet the requirement of the Maastricht Treaty for the—for participation in the European Union monetary policies, and so they did a number of things. They increased the normal retirement age to 65 for men and to 60 for women. They changed the benefit calculation from the final years of salary to a career average of earnings.

They increased the number of years of eligibility, the number of years for contributions for eligibility from 15 to 20, but they didn't change that lack of actuarial adjustment for early retirement. So they still—that was still an issue in terms of being an incentive to retire early because there was no penalty in terms of there being any actuarial change.

The other thing is that the reforms that they put in place, they phased in over a 10-year period. So they were not immediately evident and they were basically accepted by the population at the time because there was a fiscal crisis and there was this understanding that something needed to change in order to deal with it in the immediate term.

The second major reform happened in 1995. These are called the Dini reforms for the prime minister at the time. And those reforms were not so much done in a state of crisis; they were much more structural reforms—the design of the system was changed and that had implications for how they were both—how it was designed and how hard it was for the population to accept them and have it actually enacted.

And the major element of that reform was the introduction of the notional defined contribution program, and similar to Sweden it's still a pay-go system, but it's a notional account where an employee's account is credited. In Italy they are credited with one-third of the amount of gross wages each year, and the balance in the account earns interest at a rate that is equal to a five-year moving average of growth in GDP.

Workers have to contribute for at least five years in order to be eligible to get a benefit, and they are eligible to retire at age 57 as long as they have enough money in their account to provide a benefit that is 1.2 times the social assistance benefit. Benefits are calculated based on the amount in the account, the worker's age at retirement, and a factor that is adjusted periodically that is based on changes in life expectancy at various ages. And that factor—the period—that factor changes or is reassessed every 10 years. So the effect of it is watered down by the fact that it doesn't adjust very often or very quickly.

After retirement, benefits are linked in part to prices. Actually, I should have said, before reforms, benefits were linked to wages under the amount of reforms that was changed to a price—benefits were linked to prices. Under the Dini reform that is still true although there is some distributional differences. So a portion of the benefits that is—that is up to three-times the level of the minimum pension is linked—100 percent linked to prices. The portion of the benefits that is between the three-times the minimum and five-times the minimum is linked to prices—is 90 percent of the price increase, and anything over five-times the minimum is 75 percent of the rate of price inflation.

And these reforms also were phased in over a long period of time; that is to say, they are relevant for workers, for anyone who started work in 1996, and later they are covered by the new system.

And another result of that is if you—people who are in the workforce pre-1992 for any significant link of time could actually—and are retiring in the future could actually be having their benefit calculated over as many as three different types of benefit calculations, but pre-'92—a time between '92 and '95, and then post-'95, and that has I think implications just for how easy it is for people to understand what their benefit is going to be and whether they then think differently about when they are going to retire and whether they are going to retire early or later than they would have otherwise.

Those are the two main reforms. There have been certainly other things that have gone on in between some of the reforms that were proposed that did not pass partly because they—these were reforms, because they were phased in and because they had their biggest impact on later generations, the voting population at the time was sort of more willing to accept them because they weren't going to bear the brunt of them. Some reform suggestions that were distributed more evenly and fairly across all age groups did not in fact get passed.

But most recently in 2004, there was a pension reform act that tried to deal with the issue of the continued incentive for early retirement and so they are phasing in minimum age restrictions that start in 2008 and set the minimum retirement age at 60 in 2008 up to 61 in 2010 and up to 62 in 2042. But again, with 40 years of contributions, workers still have the ability to retire at any age over 57.

Let me see, okay, well, I talked a little bit about sort of the political context in terms of what was acceptable—what was seen as acceptable and what wasn't at various times. I don't really have a lot of—any information about how difficult it was for the—in terms of explaining the reforms to the population and the specific implementation issues that have come up since then because that just isn't something that we were able to learn anything about in the work that we did.

But in thinking about where that leaves us and what we might learn from the Italian experience, I think that one of the things that comes to mind is just the long phase-in period for the reforms. It puts Italy in a place where in the long term they project having a sustainable system in 2050 and onward, but in the short term they still have fiscal imbalances and there are still short-term need for revenues to cover the pension processes.

And in some ways it's sort of the opposite of the U.S. system where in the short term we are all right but in the long term we are not looking so hot. So I'm not sure that there is anything that we could do differently than the Italian speaks to on that question.

The other thing that came to mind is just the fact that so many different changes were enacted during the course of the 1990s and the early 2000s that there really is a question about how much do people understand about what their pension is going to be, how to calculated it. And as I said before, it's unclear—not enough time has gone for the '95 reforms, for enough people to be retiring under the new system to know if they are—if they really can make sense of what they will be getting.

So it will be interesting to see in the future if we can tell that people really understood as they made their decisions that they really knew what they were getting when they made their decision about when to retire.

I think one of the things I didn't—I wanted to mention also is that a recent law, legal change in Italy that has to do with the severance pay that I mentioned previously, because that money has always been controlled by the employers, employees had an incentive to retire early because then they had access to that lump sum and they could invest it themselves and possibly get a better rate of return.

The law has just been changed so that people now have access to that money while they are still working. They can invest it themselves in occupational pensions outside of their own employment, and therefore it is possible that that will be an incentive to stay in the workforce longer because they are actually making a better rate of return than they would have otherwise.

So that is a piece of the sort of second pillar of saving for Italian workers that hasn't really been very strong in the past, and so this change in the law may be one way to boost the private saving of workers that I think will be important in the future.

And I guess the only other thing that we thought about in terms of the—where things stand now with the Italian system is that while—because there is the—there are short-term imbalances and it's possible that—and the long term looks like it can be—that solvency will in the long term is possible, but there is a lot of political risks in the interim that could make, as people do retire and see their benefits falling in retirement, there may be more pressure to raise benefits or do other things that will make even the long-term situation not as stable as it's projected to be.

And so that is an unknown that we will have to sort of see where it turns out. But it's something that certainly is raised in this country in terms of what are the political risks in various types of reform changes that are being considered. So I will leave it there. Thank you very much.

(Applause.)

MR. PENNER: Thank you.

The first discussant is Paul Van de Water. He is a vice president for health policy at the National Academy of Social Insurance. I had the pleasure of working with Paul at CBO when I was there. He was deputy assistant director for budget analysis, became assistant director. And in between he has served at the Social Security Administration. Paul?

PAUL VAN DE WATER: Like Alicia, I have become an instant expert in the Italian social security system. Virtually everything I know about Italy I have learned in the past weeks, but that won't dissuade me from making what I hope are not excessively outrageous comments.

My take on the Italian situation based on a week of learning is to paraphrase a famous American. We seem to have "mis-underestimated" the Italians. Now, I'm not talking about the winter Olympics, which are running smoothly, but rather as Alicia said, the Italians seemed to have stabilized the long-run cost of their social security system, and in the process of doing so, they have had to cut pension wealth of current workers by about 40 percent. This type of fiscal macho should be enough to please even the deficit hawks for the Committee for Responsible Budget.

If you still have with you the copy of the paper by Agneta Kruse, I would call your attention to the table on the first page, which actually cites some of the figures I was going to use. You know, first of all we are told that the Italians didn't suffer any pain in the short run, that they put off all of the pain to the long run. Well, that turns out not to be true. One number that is not on the table here is that in 1992, just before the reforms, public pensions in Italy took up about 14.9 percent of GDP. As you will see on the table in front of you, that figure has now declined to about 14.2 percent of GDP. So that looks pretty impressive to me.

Moreover, when you look at the projected increases, yes, the cost as a percentage of GDP goes up a bit between now and 2030 by about eight-tenths of the percent of GDP, but then it slides back again after that. So if you compare the Italian figures to most of the others on this particular table, again the Italians don't look to be in relatively good shape.

The one thing that does stand out of course, as Neil mentioned in passing, is that the Italian system is still after all of these changes, the most expensive in absolute terms.

Now, what did the Italians do to achieve, if not fiscal sustainability, at least this improved situation? Well, as Alicia said, they seemed to have done a little bit of everything. In the GAO report that Alicia and her colleague worked on, there is a table that lists all of the changes that were implemented by major OECD countries in the past while since 1980, and it's noteworthy that Italy is the only country listed in which every single column has a checkmark, that is the Italians have done everything that you could think of.

First, as she said, they changed the indexing of postretirement benefits, which formerly were indexed by wages, are now being indexed by prices, and for high-income people by less than prices. Secondly, as she didn't mention, they increased payroll tax contributions. And then third and most important, they restructured initial retirement benefits in a way as to encourage longer work lives, and Alicia enumerated most of the changes. The earliest age of eligibility has been raised, required number of years of contributions for benefits has been increased, replacement rates have been paired back at all ages, and incentives to retire early have been reduced.

As a result, analysts seem to expect that the reductions in Italian spending compared to what would have happened will be achieved primarily by lengthening work lives, thereby allowing people to maintain their total income when they are counting both earnings and the pension benefits together, and this approach should—while we have pleased CRFB folks, this approach should also make people like Gene Steuerle and me happy since we have been arguing for a long time that increasing work lives is really the way to go rather than focusing on much on increasing saving and investment.

Now, despite all of these good features, my fellow economists still seem to be able to find a cloud in any silver lining or a reason to rain on any parade, and they raise at least three major problems with the Italians reforms.

First, the reductions for early retirement are still less than fully actuarial as far as I can tell at least. So there still remains a tax on additional years of work, although given the aggregate figures on spending, it seems to me the Italians have some room to fix that problem fairly easily. Moreover, again, as Alicia mentioned, just in 2004, they have made some further changes to improve the situation.

Secondly there is complaint that the reductions are not being phased in quickly enough. But, again, I think if we just look at the numbers on the table, that complaint doesn't seem to carry a whole lot of weight. And in fact, that complaint also misses one of the key features of the Italian reform, is that most observers seem to think that it was precisely this relatively slow phase-ins that allowed these reforms to be put into place without overwhelming objections. It is the same way of course that the U.S. managed to phase in the increase in the retirement age by scheduling it almost 20 years in advance.

And I guess in contrary to Maya, I don't think that was hard to understand; I think it was just put into place with a long amount of lead time.

If there is a problem with phase-ins, it is the one that Alicia mentioned, is that the automatic stabilizers in Italy don't seem to be fully effective so that adverse demographic or economic events can still require ad-hoc corrections.

A third complaint is that the funded second pillar is being phased in too slowly, but when you look at the replacement rates in the Italian system, you have to wonder why they need a second pillar at all. In Alicia's paper she cites calculations from the OECD, which shows that even in the long run the Italian system will have a gross replacement rate of 79 percent and a net replacement rate of 88 percent, again, attesting to the generosity of the system.

Now, while no reforms are ever final, and while the Italian system will doubtless need further adjustments, I still find this—what the Italians have accomplished to be pretty amazing. What I don't really understand still is exactly why they took all of these dramatic steps. Alicia and her coauthors credit the impetus of the Maastricht Treaty, but the reductions in spending that the Italians achieved both in the first 10 years and over the long run seem to me to at least go far beyond what might have been required simply to meet the Maastricht criteria.

Secondly, Alicia also cites a budget process rule, but, again, at least the way it is described there, that doesn't seem to be—to me to be a full explanation either since what she has described is something like a pay-as-you-go rule, which would constrain increases in spending, but which doesn't seem to be well structured to reduce reductions in spending.

Now, others typically cite as a motivating factor Italy's 1992 foreign exchange and public finance crisis occurring about the same time as the problems in Sweden and other European countries. And one writer that I encountered said that this crisis forced the unions to accept reform and reports that the government was there upon granted authority to reform the system within guidelines set by the parliament. That is, that they apparently didn't need to reach agreement in the parliament on every jot and tittle of the changes, but left to some flexibility to the government.

Now, the 1992 reforms, as Alicia said, were parametric changes, which were designed just to get overall spending under control, and therefore didn't really set up a long-run structure. That was left to the 1995 changes. But even those—again, based on what I have read—seemed to have been put together rather hurriedly and therefore there has been need for further changes since then in 2004 most recently but also in 2001 and 1997.

Since there seem to be a lot of at least minor areas where improvement is needed, I think we can expect further reforms, but as the Italians say, Rome wasn't built in a day. (Laughter.)

(Applause.)

MR. PENNER: Thank you very much, Paul.

Our next discussant is Dalmer Hoskins. Dalmer is a senior managing director of policy at AARP. He was elected in May 1990 to the position of secretary general of the International Social Security Association, and he has also worked with the U.N.

DALMER HOSKINS: Thank you. I would like to congratulate the organizers of this conference for having put Italy on the agenda at all. And no one should have to make any apologies about not being an expert about the Italian system because there are very few experts even in Italy. (Laughter.) And I think there are a lot of people in Rome who would like to keep it that way. (Laughter.)

So it is, however, one of the most important OECD countries, and it is a really great pity that we don't know more about it, particularly because it really is one of the worst-case scenarios as you have already heard several times today. They have just about the demographic situation along with Japan that you can imagine, and somewhere around 2040 there will be as many people over age 60 as there are adults of the population. So it really is a daunting future for this country.

And I think, along with Japan, it's the first countries to actually—and I think next year probably for Italy in 2007 will be the country whose population will shrink in real terms. There will be fewer Italians than there are today, and this is the prospect for the future, even with immigration, which is a very big issue in Italy.

And if you don't take these things to heart, look at the report that was produced by CSIS, the Watson Wyatt report on the vulnerability—aging vulnerability, and you'll see that Italy there just repeatedly comes out worst case, worst case, worst case one after another. So it is the country where people retire early. They are the champion early retirees in practically all of the OECD countries.

Now, one thing that I think we have to keep in mind is that does not necessarily mean that they stop working. The issue of why they have accepted this reform so easily I think that has to be calculated as part of the picture because they get their pension and they often work off the books. It's calculated that about 20 percent of the Italian economy is off the book. And so it's a wide spread accepted part of life that you put your pension and reappear doing something somewhere for money. So it's not that the Italians are lazy; they are just very creative in their retirement. (Laughter.)

Another feature of Italy that I find absolutely extraordinary is they are so optimistic about their future. The European Union does over and over and over again something they call the Euro barometer and they ask people what they think about their future as retirees and the Italians come up very high in that. They are very optimistic about how much they will be getting as a retiree and how well they are going to be living, which just goes to show you that there is absolutely no relationship between how people think about retirement issues and the reality of the pension system or the retirement system. They are seemingly two quite different things.

Now, not being an expert also in Italian social security, I did turn to some people who are. And the first person I called is a gentleman named Giovanni Tamburi, former head of social security at the ILO—well known expert, and one of the architects of this Italian reform, which was cooked up in the ministry of finance without any interference whatsoever from the labor unions, the employers' federation, or the social security institutions who were completely just out of the process.

They blamed it all on Brussels—(laughter)—that it was all the fault of the European Union and it really is an example of how an incredibly complicated really structural reform can be shoved through a system, and as was mentioned just a moment ago by Paul, without parliamentary by in the since that they passed what they call a—(unintelligible)—a framework law, and then the details had to be worked out later. And so they have an NDC system, and we don't have to go into that I presume.

When you talked about Sweden, you heard all about the beauties of the NDC, and if you haven't seen a very nice article in the economist this week, it sort of gives an assessment on the NDC developments, quite a fair assessment I think.

Another person who I consulted about this who is a close observer is my former colleague, Warren McGillivray. And Warren has written about Italy that it is therefore possible—I quote, "a consensus can involve such a complicate paramedic modification to a GB system that no one really understands it." And that I am afraid is probably the case in Italy. There is very, very little understanding of what has been done.

It's being phased in over such a long period of time that no one has paid that close of attention. And unfortunately, as has been mentioned here before, in the long run, you do achieve some fiscal solvency, but there are some very severe short-term problems. They have tried once to fix the short-term problems, ended in a huge national strike and they backed off.

Now, they have an election on April 6 and we all hope that Mr. Berlusconi will be reelected and that he will be able to resume his active sexual life—(laughter)—because he has promised the pope that he wouldn't do anything in the meantime. (Laughter.) But he and his government will have to address these short-term problems and it is going to be very, very rough sailing because I think it's one thing to phase it in over a long term but these short-term cuts are not going to be so easy to do.

There are some interesting bells and whistles in the Italian reform that I thought I would mention here today because they have some interesting implications for the United States. You heard about the desperate urge in Italy, the policy to keep people working longer. They are returning too early and disability, which we haven't mentioned at all was one of the biggest problems in the Italian case where there were a few years when there were more disability people going on the roles than there were people retiring. Now that is a dramatic.

Now, they have done a lot to fix that but they need to do more to keep people working. And one of the ways that they have done or it or are trying to do it is to experiment between the years 2004 and 2007 by actually paying people stay in the labor force. They are going to give cash payments equal to the social security contribution to those people who have already fulfilled the requirements to retire but nevertheless continue to work.

Now, those cash payments are significant because they represent 32 percent of the salary. That is how much the contribution rate for the Italian pension system is: 32.7 percent of salary up to a ceiling.

So there are a few other countries—I think the U.K. is one, who are experimenting with this idea to actually give people a payment, not just an extra pension, delayed gratification, but to give them cash now if they continue to work. So let's see how the Italian experiment works out. Interesting.

Another interesting thing is something that Maya mentioned, and that is the beauty of default arrangements. Now the Italians have had this whopping 7 percent of their salary in severance pay, and everyone of course has—it didn't take the finance ministry geniuses to figure out that wouldn't it be lovely if you could persuade people to use that severance pay and put it in a supplementary second-pillar pension because, as you have heard, the private pension sector in Italy has been very underdeveloped in comparison with the other European neighbors.

And so they have passed a law in 2005, which does that and you have to opt not to do it if you want your cash. So it will be interesting to see how this default really works. The money is going to go directly into one of three supplementary pension vehicles by default, and whether or not the Italians are going to be happy with that remains to be seen because of course I think a lot of people look forward to getting that money with cash. But the default idea is an interesting one and is being talked about in our own context with 401(k)s, by trying to put as many defaults as possible in so people will raise their retirement savings.

So I think it is an interesting country. It has all kinds of dramatic aspects to the social security reform. Do Italians understand what happened? Probably not, but they are going to get the picture because you had heard, the replacement rates, although mentioned very high by Paul Van de Water, in fact, we know that these are theoretical replacement rates, and the real replacement rate for most people is much less than that and is going to decline quite rapidly.

And in the CSIS report, Italy comes out as one of the most vulnerable countries for poverty among the elderly, which means that Italian governments in the future are really going to be under tremendous pressure to really solve the problem of elderly poverty. So the show is not over but I think all of us would agree that if any country can muddle through and rely on combinatsione (ph), it's Italy, and I am optimistic in that sense. Thank you.

(Applause.)

MR. PENNER: Thank you very much, Dalmer.

I think rather than to go into discussion of Germany and Italy right away, we will go into our last session and ask what we have learned from all of this, and if there are questions about Germany and Italy that come up later we can deal with them.

Gene and I are going to lead this session, so Gene, why don't you go ahead.

MR. STEUERLE: Well, thank you, Rudy. I divided my comments into basically six compartments. The first one is to try to understand what the motivators for reform have been. The second one is to ask whether there is transparency in what has happened. The third one is one that really hasn't been addressed very much at all except in sort of the broad sense of replacement rates down the road, which is were issues of fairness really addressed?

The fourth one is this really big issue that, at least—it's always been very big on my agenda as well as Paul Van de Water—there is a few other people around here, which is the work issue.

The fifth issue I want to talk about is whether there is flexibility in the system built in to make changes in the future and whether that is actually thought of as part of the process, and the sixth one is just almost a listing, and in my mind is incomplete of are there within these systems adjustments, almost actuarial adjustments for such things as changes and birthrates and longevity in real-income growth and the types of things. And in a lot of case they are but they are very implicit.

Those are my six compartments and I'll try to go through them fairly quickly in part because I don't fully know the answer, but I think it's a useful way to try to think about what is going on. And I would invite especially the paper presenters to tell me where I could help fill out—fill in this particular matrix.

So the first question is what had been the motivators for reform in the first place? And it's sort of interesting, I would say that in Japan, Germany, and Italy, at least as I read it, the situation basically had become dire enough that basically reform of some sort was almost inevitable. In some sense we might think of them of being where the United States would be in 2015 or 2020, not that that means the reforms in every case were complete or entire, but basically they had almost—they almost got to a point where every year, every four years or something, they simply had to start doing some things.

That is stated very simply because in fact it looks like in the case of Italy there was also just this—which is an interesting institutional issue, there is just apparently a very strong, as Dalmer explained, a very strong finance ministry that apparently—for those of us who are old Treasury hands and long for the days when—(laughter)—Treasury used to be a dynamic force in the U.S. economy, I think that tells us something about the importance of institutions. The finance industry may have blamed this on Brussels and the Maastricht Treaty, but in fact the treasury is always good at blaming the actions they had to take on—something or the other. I am reminded of the stock market crash in '87 that led to all sorts of things that didn't have to do with the stock market crash.

In Britain's case it is the toughest for me. I don't really know. I almost get the sense that in some sense it has a strong parliamentary system, and I always think of—and maybe this is unfair to our own presidents, but I always think of Margaret Thatcher as sort of being a little more savvy than Ronald Reagan on thinking about institutions and Tony Blair as a little more savvy than Bill Clinton, even though I think of them sort of in the same categories.

But maybe I have got it wrong, but I always sense that in the first case, there was just a sense that we needed to have a more conservative slower growing government, so we will do things like price index the system and we will do some privatization. And I don't know that there was some huge pressure—but you will have to correct that, Alex, when you get a chance.

And now, on the reverse end with the system having been in place for a while there is now pressure to go in the opposite direction which makes Britain somewhat unique in our discussion because they are already—they are trying to figure out how they are going to try to increase the cost of the system.

And in Canada—I talked to Mr. Bouchard briefly during the break and he claims that actually part of what went on there—and this may be in some ways the best lesson for the United States, that there was in some sense—basically a broader budget problem, right, and that the broader budget problem was the excuse for doing social security reform as part of this other budget issue.

The reason I say that has lessons for the United States. As we know we are in deep, deep trouble in terms of the broad budget right now, and especially as we go forward the next three or four years because the crimp being put on partly by our health and retirement programs and the tax cuts means everything else in the budget is going towards zero, and that is happening right now. So we are in some sense even without other things having a financial crisis. So that is the issue one—motivators.

On transparency I can be a little simpler. It seems to me none of these reforms really have been—(chuckles)—totally transparent. In Canada what was not clear at all was that a lot of saving in the system seems to have been in this—I don't remember whether it's the first tier or the third tier, but these basically income taxed-based, the general revenue financed tiers, because where there was a lot of savings, and in some way that meant that whatever else you did in the—that this more-straightforward traditional social security DB system still made the overall budget look better.

In Sweden we have this issue of money inside the government; what is going on with the stock market investments. We have this in places. In Japan I'm still not quite sure how all of these constant adjustments are going to work out or how much the public understands about it in terms of how transparent that system will be. I guess the adjustments are so large in the case of Japan and Italy, I don't know how to make all of that transparent without doing some stuff.

Britain, there is certainly not much transparency in the accounts, which I think was one reason that there is—that the public has made apparently a lot of mistakes, and it's not clear to me the choices have been clear there. There is more transparency I think in the price index system. Italy, both our commentators indicated there is very little understanding. So I don't know that transparency stands out high on this list of issues.

I should mention by way of counter-example, I did talk to visitors from New Zealand, which had a very simple defined benefit system, that as I understand is essentially a flat benefit. Everybody simply gets about the same thing. And at one point they went to the public and said do you want to increase the retirement age or do you want to cut back the annual benefit? They said well, let's increase—at least there was some consensus to increase the retirement age because when the decision was that simple to understand, it turns out you can explain that increasing the retirement age—partly because it brings in more revenues in the system, requires less of a benefit cut than does a benefit cut, because you have got more revenues to play with.

That is very hard to explain to people. Several commentators today have said, oh, we can't change the retirement age or we can't do adjustments there because that is what the public least wants, but I think the reason they least want it is because it's the most apparent of the benefit cut as opposed to some of these vague national accounts and other indexes. When it's quite clear that you have got a choice between a benefit cut and an increase in the retirement age, they increase in the retirement age in many cases is the least harsh because it requires the least benefit cut. It also leaves the most money for old age for—it doesn't leave you more of a lifetime benefit; it leaves you more of an annual, a much higher annual benefit.

The third issue: fairness to families. It's interesting, nobody in any of these papers today presented any distributional estimates of the impacts of these proposals anywhere. The United States doesn't do it either, which is one of my constant complaints to my friends from Social Security, Alice and Steve who are working closely with another part of the Social Security Administration, but even several years later we don't have distributional results. We don't even know what affects their own poverty rates when we do reforms—all of these other types of things.

We get this intimations: Well, maybe if we do this and we don't adjust for 20 years and we don't wage index versus price index, maybe we will have this effect on lower-income people, and maybe we will have this effect on replacement rates, but there is no such thing as a measure of what are we doing to people at relative poverty. And this gets into an issue which Larry Thompson raised, which is this ratcheting back and forth between political sustainability and financial sustainability.

It seems to me what you want to do is get financial sustainability for the most needy parts of the population and then we can debate over how much we want to provide the middle and upper class people, and the number of years of retirement benefits—you know, do we really need to impart 20, 25 years. Let's get financial stable and politically stable that part of the system we want most. But we are not going to do it if nobody presents things like distributional tables and nobody did that which I find very interesting. It's partly because none of these systems prepared them.

The fourth—(audio break, tape change)—they have very have strong disincentives to work, it seems to me, in this backup system because you get this means-tested benefit, and that really works—there are all sorts of things here I could talk about. I've got a lot of notes on—actually, for the same lifetime benefit I actually like wage indexing postretirement because it gives you—for the same lifetime benefit it gives you a lower benefit up front and a higher benefit down the road, which actually promotes work. There are just all sorts of really interesting issues here—the change in the 32 percent tax rate for people who work postretirement. I mean, the tax rate is a big influence on whether you get these work incentives. So that was the fourth issue that I thought really interesting.

The fifth issue that I said I would talk about is flexibility and slack in the budget, and this goes back to this issue of political versus financial sustainability. I don't know why—I really fought both conservative economists and liberal economists and actuaries who think we should design the Social Security system we're going to have 70 years from now. I mean, what do we know about what life is going to be like 70 years from now, or whether, you know, because of disease eradication or additional disease coming on or wars coming on, what do we know about these systems that we feel that we should control and dominate some percentage of the economy into the future, and particularly our growing percentage, which is the sustainability issue, but even a constant percentage? I mean, no other program in the budget—I mean, why don't we wage index teachers; salaries? Steve Goss doesn't like that example, but why don't we wage index every—why don't we determine all these budgets for the future?

Well, the reason we don't is because we have to leave room for contingency. And it's interesting to see which systems do or don't—it seems to me Britain does. This raises the issue of stability over time, but it would be interesting to see whether Britain itself, when they make their upward ratchets now, whether they do it in a way that leaves some choices for the future. And it's not just flexibility for elderly programs versus nonelderly. I think we do a very bad job with elderly programs. And those of you who are familiar with some of our work, it's this issue that we constantly pay a higher and higher percent of the total budget for people further and further from debt.

So basically the system is not progressive in that sense; it's regressive. We keep giving more and more benefits to people who are more capable of work, who have higher incomes, and we give a smaller percent of the pie to people who are really owed. And, again, there are a lot of specific examples to figure out whether these systems are moving towards providing more flexibility—certainly as they move more toward sustainability they get their—I don't sense that a lot of them are thinking about beyond the issue of what's often called sustainability. You don't see any of these systems, except perhaps for Britain in some cases, where the percent of GDP scheduled is going to go down, leaving some flexibility to make adjustments into the future.

And my final issue, which I'm basically going to throw out as a question because I'd love to have almost a table at the end to think about which of these systems do adjust now for certain things like birthrates, for life expectancy, for changes in real growth rate. Clearly the notional account systems do. They have some adjustment—whether it's adequate or not, I haven't figured out all the details—for all of these things. Anyway, I throw that out as something to the extent to which these systems do make actual judgment. It seems to be most of them do make adjustments there—something we don't. If our birthrate falls, there is really nothing in our system that helps bring it back into balance. And at least as I heard in the papers, most of these systems that we talked about here actually do have some adjustment. It might be inadequate, it might be a 25 percent adjustment in the case of Britain or something, depending on how you view these various factors, but they do at some level have some adjustments for these factors. And maybe that's a lesson for the United States, that that's not quite as hard to do as we think it is.

Thank you.

MR. PENNER: Thank you, Gene.

Well, as I look at this conference I feel exactly like Jagadeesh did after the discussion of Japan. I'm mixed with both elation and depression. The elation comes from the fact that we have seen today that democracies can indeed reform, and some of these reforms are pretty painful. I suppose a little bit of depression in that maybe they have been made complex enough that nobody understands them, which may have facilitated them—but even more depression from the fact that in almost all the countries we discussed, reforms were not undertaken unless they faced severe economic or budgetary problems. And as Stuart Butler said today, that makes one depressed for the United States because while these problems are almost inevitable, it's very probable that they won't become apparent until the next decade sometime, or maybe not even until the 2020s

Returning to the elation a bit, I do feel somewhat optimistic because while the reforms in various countries were criticized here and there by the discussants, for the most part they're quite reasonable. They were very different country to country, but you can't say they're absurd or irresponsible. A lot of people fear that in this country if we do not reform until we're in the middle of some sort of financial crisis, there will be so much panic that we'll do a lot of stupid things. I don't think you can say that happened in other countries.

Now, the exception to the reforms being provoked by some sort of pressure is of course the United Kingdom, and I think there really is an important lesson there in that there they were provoked by a feeling that existing benefits simply weren't generous enough, and that in turn is because they've been price indexed for so many years. And I'll get back to that, what Larry called a politically unstable system. But before that I'll note that I'm actually old enough to receive Social Security benefits—and I thank all you taxpayers for that. My wife and I do appreciate it. But not only that but old enough even to have been active in our debate in 1972 when we went from a completely discretionary system to an indexed system.

And the most interesting thing about that debate when it occurred is that indexing was seen as a money-saver. We had gone through a time when the Congress had passed various discretionary increases and benefits in the late '60s and early '70s that not only exceeded the rate of inflation but exceeded the rate of wage growth, and indeed in 1972 the discretionary increase was some 20 percent. And I, as I say, was in full agreement that this was a good thing to do because it would save money in the long run. With the ability to look back in history I think one can question that. We don't know what discretion would have done in the absence of indexing, but it's hard for me to believe that discretionary increases would have been as generous in the face of the economic difficulties that we faced in the 1970s and early 1980s.

So what we are left with, as Gene and I have written about, is a system—an automatic system which leads to bigger and bigger—bigger and bigger deficits all the time if you do absolutely nothing. Now, it's interesting that Larry referred to this as a politically stable system. And what's really scary is that I'm afraid he may be right—(chuckles)—maybe it is politically stable to move to bigger and bigger deficits all the time, but if so, that is indeed very alarming.

I would like to see an automatic system which would purposely cause political instability by being too niggardly, if that's all you relied on, because I think the trick in designing all of this is to give the politicians a chance to be generous from time to time and increase the benefits that are provided by current law.

Well, how would the various mechanisms discussed today in other countries work in this respect? First of all, I think it's fascinating that within a fairly short time, so many countries have adopted various kinds of automatic adjustments to their system if that system gets into trouble. The problem is right now is that they're too young to really know how they're going to work in the longer run. And I think they're very different—and I may be wrong about this and may not totally understand them, but if I'm right, Agneta, it's almost certain that your automatic restraints will go into effect sometime in the next couple of decades, or maybe more than once in the next couple of decades, whereas the Canadians obviously feel, I think, that their system won't be invoked; it will only be invoked if they're making big mistakes with regard to their economic and demographic assumptions. And I guess in a sense Japan feels the same, although those assumptions have been deteriorating so fast in the past that that may be quite a different situation. Well, it will be hard—it's really hard to comment on these systems and how well they'll work until we actually see what happens.

In the United States of course a key issue in our debate here is President Bush's proposal for personal accounts. I'm not really sure what today's discussion teaches us about that. The Swedish and U.K. system of personal accounts are very different. Indeed, as one looks around the world, the personal account systems differ so much that it's almost hard to put them all in one class. I was foolish enough to think that you maybe have to introduce some sort of personal account system to give people something positive—that is to say, an ability to diversity out of an uncertain public traditional system, and an opportunity, if they wanted to take some risks, to make up for whatever benefits they were going to lose. But in fact, in our debate, the whole notion of personal accounts were demonized, and there were legitimate problems with President Bush's actual design, but I'm not sure that we ever really got into the details in our debate. I think there was a very legitimate reason to debate how much resources should go into the individual accounts versus how much resources should go into the traditional system, but that was almost a subtlety as our debate evolved.

One of the interesting things that I think we heard today, and differences between various countries, involve this value judgment. That is, if you are going to reform—and this gets to Gene's equity point—just how should the various age cohorts or generations bear the pain of that reform? And again we see very big differences. In this country you have almost 100 percent agreement about the currently retired and the near retired—and that's defined often as people over 55—shouldn't bear any pain at all. They should be totally unaffected by this reform. And that always seemed odd to me since it's the old folks that have gotten the biggest windfall out of the traditional system, but there is just no debating the point. If I understand it correctly, Canada and Sweden have basically agreed that—at least Canada—(laughter)—that those who are retired should not face reductions, whereas Japan and Italy I think did not. I mean, I think they have really cut back on the currently retired.

So those are just some of the differences and similarities that we've heard about today, but I would be very interested in hearing from the audience and from the other participants just what they think we've learned from today's proceedings, so I'll stop. (Pause.) I guess we haven't learned anything at all. (Laughs.) Oh, I'm sorry. Yes, John?

MR. TURNER: I'll just make one comment about lumping all individual accounts into one bundle, and I think it's important to distinguish between two different kinds of individual accounts. One is the kind that the U.K. has, which is a carve-out account from the existing Social Security system, and the other is the type of individual account that Sweden has, which is an add-on to a generous system. So I would say that you should not lump all individual accounts into one category but you should lump them into two categories—the carve-out accounts and then the accounts that are add-on accounts.

MR. PENNER: Yes, Agneta?

MS. KRUSE: Just a few comments on what you said, Rudy. Well, we have very long—we have a long transition period. That is, those who earned their pension rights in the old system keep them. But the indexing has changed. If you have a large part of the population being aged—like in Sweden we have around 20 percent above—well, being pensioners—then you can't really protect them from what happens ever after. That's too large part of the population. So what we said was they will share good times and bad times, so we share it. If there is negative growth rate, we all suffer. If there is a positive growth rate, we all enjoy that. So that's one thing. The pensioners will lose if we have a very bad time. So do we. We lose as well. So that's one thing.

May I comment on the transparency that Gene brought up? I didn't have time to tell you that, well, of course at first people said, we knew what we got from the old system; we don't like this new system where we don't know how much we'll get. And the answer is of course, well, you get 18.5 percent of what you put—of your wage for each and ever year plus interest. That is what you get. Divide it on your expected lifetime.

Now, in order to make people understand what they get, once a year the Social Insurance Agency sends us an envelope. We call it the "orange envelope," and that's very famous in Sweden. That states what you are to expect from the different parts of the pension system. This month they are sending it out to 5 million Swedes telling exactly what can you expect from the pension system. And of course my daughter, being a student, she is very happy with the envelope because it says, well, you will get a very low pension because you don't have very much on your record yet, so you just get the minimum pension. And she says, wow, that's very much. Will I get all of that, she says. Well, well. But it says in the envelope that we will correct it—the closer you get to the retirement age, the more we will be able to make an accurate statement.

So it really—asymptotically it really tells you what you get. Sorry.

MR. PENNER: I think Steve has the two-handed intervention here.

MR. GOSS: (Off mike.)

MS. KRUSE: Actually it says what you would get today if you retire today. It doesn't say what you—well, it tells you how much you have on your account today.

MR.   : (Off mike.)

MS. KRUSE: Yes.

MR.   : (Off mike.)

MS. KRUSE: Yeah. And it tells how much you will get if you retire when you are 61, when you are 65, when you are 70 because that's when it's actuarially recalculated.

(Cross talk.)

MS. KRUSE: Sorry?

MS.   : Is it based on the amount in your account?

MS. KRUSE: Yes.

MS.   : (Off mike.)

MS. KRUSE: No. Well—

MR. PENNER: That could be pretty misleading, I would think.

MS. KRUSE: Oh, of course it is. That's why they are telling it. Be aware—my daughter is very happy to get that minimum pension because it's more than she gets as a student.

MR. PENNER: Jagadeesh?

MR. GOKHALE: When Gene made the point about not fully comprehending why people like to emphasize fixing the system for all time to come is a good idea, I heard Steve whisper my name, so that obligates me to respond, I think. (Laughter.)

Well, I mean, I know the administration, when it was making proposals to put forth—implement reform along—you know, adopting personal accounts and fixing the system and targeting sustainability, that's all very well, and that's what you may have been addressing rather that the point Kent Smetters and I have been talking about, is to dig down to all the information available or the best projections that you can make and not just limit them to an artificial, finite horizon. There is a difference in the two things. I'm just responding; I don't know whether your comments were directed to the administration or to our point.

There is a difference between taking account of all information available and going much further than 75 years when deciding on reforms today. That has nothing to do with giving up flexibility in the future for making changes as you go along. I mean, that's still an open possibility.

MR. STEUERLE: My point was simply about making very large promises way into the future when you don't know whether those are the best set of promises to make, not your point as to whether you want to account for those promises.

MR. GOKHALE: But not taking into account that future information implicitly makes the assumption that beyond the limited horizon there is really nothing to worry about and the imbalances are zero. I don't think that's—that's the implicit assumption. So I just wanted to—

MR. STEUERLE: I would account. However badly the accounting might be, I would—if you're going to make a promise you should account for it.

MR. PENNER: Stan?

MR. ROSS: Yeah, I think that the day would be incomplete if I didn't observe that an awful lot of the discussion shows a sort of fascination with more and more sophisticated automatic stabilizers and abstract formulas and that, when in truth I think if you really look at a lot of these situations, a lot of these countries have gone back to basics and done some very simple things to improve their system, like collecting contributions—(laughter)—Italy being a good example.

Italy is the most recent OECD country to unify the collection, to take it away from the social security institution and give it to the tax institution, and it's made a huge difference. Sweden did that earlier, and although Sweden's dual system was quite efficient, they got more efficiencies by unifying the collection of social contributions. The U.S. is not a problem child in this universe because we've always had a unified collection system, as I believe Canada has, but the U.K. integrated collection, and indeed I understand Japan would, except there is some recalcitrant powers there surrounding the social security. Japan would, my understanding is, like to unify. Germany is probably a fairly efficient dual-collection system.

The reason I get back to this is that as you get more and more esoteric about the reforms you need, sometimes going back to just some fundamentals is good, and there I commend what Rudy said. I think with 20/20 hindsight it wasn't such a bad system before '72 when—and on the income tax side too—when you didn't have indexing and the growth in the economy produced more revenues automatically, because then Congress had something it knew very well how to do, which is not to let collections be too high.

I think, you know, as we get more and more sophisticated and the economists have taken over more and more of the debate from lawyers, among others, and just administrators and bureaucrats, among others, I don't know that that's been a—you know, you can look back over a long period. It's led to a lot of cleverness, and we've certainly heard a lot of the clevernesses today, and I must admire what Sweden has done, although I agree; there are probably fewer people in Sweden who understand it than the number of bodies in this room.

But I would make the plea that as you write up the notes from this, that people not forget about the other end of the spectrum, which is just going back to basics. And the U.S. probably should be there too. The tax gap and the social contribution area is growing. Some of the most vibrant parts of our economy are nonpayors like the self-employed, telecommuters who run these businesses. Some of it is purely administrative and some of it is legal, and there is a good chunk of our deficit that could be fixed simply by collecting the legally required contributions.

MR. PENNER: A number of years ago I was in a discussion with an Italian deputy secretary of the Treasury who was responsible for social security, and I asked her, I said, you have a lot of trouble, don't you, collecting payroll taxes, especially in the south? And she said, yes, we do, but we don't pay benefits either. (Laughter.)

MR. STEUERLE: Just as a footnote, Stan, you know, indirectly I think there is an illusion also to the issue of just what is the tax base, which I have a feeling was—at least in some of the countries may have been an issue too, although it didn't come up in the papers. You know, our country has to deal with employee benefits, but some of the countries with very high benefit systems elsewhere, those benefit systems themselves tend to create a lot of nontaxable income, perfectly legal. But the whole question of what the tax base is I think is something I think we haven't discussed that I take out of your comment.

MR. PENNER: Estelle, do you have a point?

MS. JAMES: Yes, I have a just a couple of short comments. On your question of whether you always have to leave the current retirees alone, it sounded to me from the discussion as if the transition periods were usually long, so in that sense you didn't hurt the current retirees, and that was a matter of political expediency. They're going to be an articulate group that will be up in arms if they're hurt. But on an ongoing basis—that is if you're 20 years out and those people aren't thinking about it too seriously—it's not clear to me that the retirees are necessarily a protected group in the future, and as in Sweden they're subject to those mechanisms.

Second point is, you know, one of the commonalities in the countries you had here today is I think they've all relied to some extent or other on additional prefunding. Now, in some cases it's voluntary and in other cases it's part of the mandatory system. In the case where it's voluntary, as in Germany with the Riester accounts, it's not clear to me that's a political equilibrium. I think sometimes countries go to a voluntary prefunding hoping that people will do it and then they won't have to take the politically painful steps of mandating it when they cut the traditional benefits, so it will be interesting to see how that plays out.

There is also a different—most of the countries chose some kind of private management of the funds but Canada is an example where they have centralized management, which they're trying to keep insulated from political control, and so it will be interesting to see if they succeed.

MR. PENNER: Yes, Mr. Kabe.

MR. KABE: Responding to the question about the transparency issue in Japan's pension system, I'm a big believer of transparency. A pay-go system definitely needs support from the working generation for the purpose they have to know what amount of pension they can get when they retire. And coupled with the reforms I mentioned in my presentation, we introduced a new system of notification of points, which a working generation gets. And they will get—(unintelligible)—notification of how much point they got, and they will also get a formula and they can calculate how much pension they can get with those figures of points and also the formula. So we introduced a system to improve the transparency of the system for the working generation.

MR. THOMPSON: Just to make your day I'll remind you that when we did cut benefits—when we did refinance the program in 1983 we allegedly got half the money from the beneficiaries. That was a little creative accounting. But there was a benefit cut and income tax imposed so that we—we've demonstrated that the retired are not held harmless necessarily in these things.

MR. PENNER: I'm not sure you can do that today.

MR. THOMPSON: Well, I don't know, Rudy.

MS. BEER: I just wanted to give my immediate thoughts on sort of what has motivated the sort of proposals for reform in the U.K. I'm less familiar with the sort of environment at the time that Thatcher was cutting costs by price indexing pensions and removing the earnings indexing. But I do know that that was done at a time when the occupational pension environment was in a—did seem more favorable and so it's less obvious that indexing state pensions to prices was going to be a problem because people had reasonable occupational pension provision.

But in terms of the changes under Labor, I mean, I think it stems from Labor's focus on poverty, and the chancellor has been very concerned about both child and pensioner poverty. And certainly you saw—through the 1980s and early 1990s you saw really unequal increases in pensioner incomes. I mean, for example, the lowest—the poorest fifth of pensioner couples, their incomes grew by 34 percent; the richest fifth grew by over 80 percent.

And I'm rather distressed actually that I chose to leave out the distributional charts I had, which showed the improvements by quintile in pensioner income since 1997. And so first sort of Labor actually chose to focus on today's pensioners and poverty, and that led to the introduction of the minimum income guarantee and the pension credit. But I think that then led to a wider discussion about, right, well, what does this mean in terms of poverty in tomorrow's pensioners? And so that has provided the environment which has led to us looking around for wider reform because knowing that the state couldn't just continue with sort of increasing means testing, which is how it originally dealt with poverty in today's pensioners.

Oh, and also there is this whole other question about—there is even debate about what is pensioner poverty, and it's not—(unintelligible)—from the debate that what has already happened on child poverty, you know, we're measuring absolute and relative incomes and changes in poverty under those measures, but also sort of wider measures of poverty as well.

MR. STEUERLE: Aren't you giving a little support, though, to Rudy's claim that there is a little slack in the system and there is room for the elected officials to do something on the giveaway side; that there is a lot more maneuver room that if you're sort of on the takeaway side? Because you're talking about increasing benefits. Mainly when you're talking about poverty you're not talking about we've got this poverty problem so let's take even more away from some group to get more—you're basically talking about how to increase benefits, aren't you, when you're talking about the focus on poverty more currently?

MS. BEER: Yes, but it was on targeting benefits to a specific group of the population.

MR. STEUERLE: Right, but aren't most of the reforms now being considered actually increases in benefits at the bottom?

MS. BEER: At the bottom, yeah.

MR. STEUERLE: More than decreases for across the board or something?

MS. BEER: In—

MS. : (Off mike.)

MS. BEER: Yeah, the state—the way they have actually changed the state earnings related element, it's much more redistributional than the previous state earnings—

MR. STEUERLE: But your commission did suggest increasing the retirement age, so I guess that's—

MS. BEER: Yeah.

MR. PENNER: Real, did you have a point?

MR. BOUCHARD: Yeah, a few comments about impacting on benefits for the current generation of retirees versus future generations. As I have said earlier, and you have alluded to it, we grandfathered the existing benefits. Nevertheless, the CPI-minus-one indexation of current retirees—I've mentioned that this morning—is one thing that we looked at. It was looked at very seriously. It was looked at very seriously, not only to save money. It was looked at from an intergenerational equity issue. There was really widely shared sentiment that the current generation of retirees under the Canada pension plan had had an incredible rate of return coming out of the plan, and it was only—it would have been only fair that somehow they would contribute to trying to reduce the long-term costs of future generations. At the end of the day the government chose not to do it, but it was seriously considered from that perspective.

On the issue of fairness as well and transparency, I don't quite agree with what you've said a bit earlier about Canada. Sure, half of the savings that we generated to reduce the long-term rate came from partial funding as well as freezing the basic exemption. But again—and I'm making the link with my comment on the indexation of current benefits. The main reasons—the main reason we did partial funding was to make sure that the people near retirement. For those already retired then it was too late, but the ones, let's say, age 45 to 65 that also had benefited from the low contribution rate of the past should pay more before they retire because otherwise, again, you are passing the burden to future generations.

So, the partial funding served a number of purposes, but one of them was an intergenerational equity one.

MR. PENNER: Paul?

MR. VAN DE WATER: I would like to bring up the same point about reducing benefits for current retirees or people approaching retirement. I think that—because I'm not as pessimistic as you are on that topic, and I think you may have picked up that point of view because the administration has been so focused on trying to tell people over age 55 that they wouldn't be affected by the administration's personal account proposal. Now, to my mind I think that the supporters of that plan have been sort of mesmerized by their own rhetoric about greedy geezers, that in fact older people are not on average opposed to personal accounts because they think it would disadvantage them personally but they actually think that they're not a good idea.

And for much the same reason, I think that actually as part of the comprehensive plan, older people, including even current retirees, might be willing to accept some form of benefit reduction if it was for part of a plan they supported rather than one that they found unattractive.

I'd also like to comment about Gene's point about earmarking growing shares of GDP for various activities. I mean, I don't disagree with Gene in entirely, but I think when you're faced with a situation like almost all countries have where we're facing an aging population, trying to avoid having a growing share of GDP going to the elderly is probably an overly harsh recipe. I mean, you talked about the U.K. I mean, even the U.K. has a growing share of GDP going to pensions, if you look at the table under "Current Projections."

So, again, I think that any good idea can be taken too far and you have to be careful about perhaps not pushing yours too far as well.

MR. STEUERLE: Just as a quick reaction, I agree with you, but unfortunately, in a classic sort of liberal sense, we take a baseline that's very, very high and then we say, well, we've got to keep that and then adjust for aging, and then we say just for aging, which has two components. One is the fertility rate aspect, which means the percent of the population who's really getting older. The other one is we're living longer, which doesn't mean the percent of the population who's getting older. In fact, I would fault all the papers here following the tradition of our literature defining dependency rations as being 65 plus. I mean, that very statistic, which is very misleading, which we've kept for 50 or 60 years—I mean, you do it over a long enough period of time. It's silly, you know, as you go for mass statistics, the average person in the United States in 1940 retired at age 68. If they were to retire today with the same number of years of life expectancy they'd retire at 74, and if we go 40 years in the future they'd be retiring at 78. So, yes, we're aging but meanwhile we've increased enormously versus the number of years of benefits. So you have to decide what your baseline is.

Having said all that, you're right. As we age, that increases the percent of the population who will be needy because of aging. I don't disagree with that.

MR. PENNER: I'm not going to work till I'm 74, Gene. (Laughter.) Other comments? Yes, John?

MR. TURNER: I have another question, and the question is, I wonder if people would comment on the idea about life expectancy indexing? Now, Sweden has life expectancy indexing of benefits so that your lifetime benefits are maintained constant, and the U.K. has proposed life expectancy indexing so that the share of your adult life in retirement would be maintained constant. So I think that would be something like for every four years' increase in life expectancy there would be a three-year increase in the pensionable age. In other words, it's not one for one; it's a little bit less than that.

But anyway, my question is generally what do people think about automatic indexing for life expectancy, either for benefits or for the pensionable age?

MR. PENNER: Anyone with a response?

MS. : Well, one thought that comes to mind is do you want to look at life expectancy or active life expectancy, which is not the same thing, and that really has to be looked at much more—I don't know enough about how big a difference there is in that—in those two statistics and how much it's different across different countries, but that would be something that I would want to think about.

MR. STEUERLE: We've looked at a number of statistics that essentially could inform this, for instance, the physical demands of jobs have declined greatly. So if you were to put that into your formula for active life expectancy, it's actually going up faster than life expectancy. We've looked at health of people, at least self-reported health, which is crude, and it turns out actually you see very little difference between the health reported status of people in their 60s and people in their 50s. It actually doesn't differ that much anymore between what they report as health. Yeah, there is some declining health but not actually a lot.

So I think if you make the adjustment you say, you might actually index even more for life expectancy. But my point here beyond this—of course, Rudy knows how I feel about this—is when you don't index for life expectancy, it's not like you've left the system alone. Because people are living longer you've put a larger and larger share of the pie of benefits to people who are younger and younger who are relatively more capable for work than those who are older. So indirectly you are adjusting the system. You're not just not adjusting for life expectancy, you're actually saying let's put fewer shares of benefits to the people who are really old. Forget about what size of system you want as a whole; give it a tax rate and a system you're going to support, you know, regardless—don't think about it as a financial reform; just think about it as a distributional reform. Where do you want those benefits to go? It seems to me you want them to go to those—the purpose of an old-age system is not to give people—it's not really a retirement—I mean—(unintelligible)—that's not the goal of the system is to give people years in retirement; it's to help people who are vulnerable, and those are the people who are more old and less capable of work.

MS. : But I guess the issue is while it may be true that on average physically demanding jobs are—our jobs are less physically demanding there is still a segment of the population for whom it is not possible for them to work longer, and so somehow there has to be some—

MS. : (Off mike.)

MS. : Right, well, so you either have to bring that into it or—

MR. STEUERLE: Right, but the logic to that argument—if you think you don't want to increase the age of retirement now, the logic of that—and the fact that people are disabled—the logic of that says we shouldn't have a minimum retirement age of 62 now; we should reduce it to 55 or 40. I mean, why—if you care about a declining portion of the population—the disabled with 20 years of life expectancy in the future—why don't you worry about people with 20 years of life expectancy today who might be 60 or 59 or—I mean, it's not a consistent system to not adjust for life expectancy because you are digesting the distribution of benefits generally to people who are less needy.

MR. PENNER: You had a point on this, Agneta?

MS. KRUSE: Yeah, I can just tell that this indexing by life expectancy in Sweden really has got through to the knowledge of people. That is, young people born 1970 and things like that, they are saying, oh, we will have to work until—so they realize that, yes, there is some indexing with life expectancy but you can cope with it by working longer hours or longer years. I mean, you can work more when you are around 50s; children are out and you can work then and put money into your national account, or you can retire later, or you can accept a lower benefit. So that is a flexibility where you can choose between having time—leisure time, or goods. Your choice.

MR. PENNER: Neil?

MR. HOWE: Yeah, I just wanted to add, one of the great things about the German reform, the sustainability adjustors, the life expectancy adjustment becomes redundant. In other worlds, why should life expectancy be treated any differently from a decline in fertility rate or change in the productivity of workers? I mean, it all comes down to the same thing, unless you are changing the age of early retirement. That's a different kind of reform, but otherwise it all comes down to the same thing: Just have one adjustor to match these two things. You know, it can be a lot simpler.

I had one other comment because Gene raises a whole point about the motivators, what made all this possible, because I think that a little bit of subtext underlying the conference is Europe and Japan, so many of the other OECD countries, have done so much, particularly over the past 10 years, and the United States seems to not have done much—(chuckles)—I think it's fair to say, and a lot of people are wondering why. Back in the early 1990s I remember no one was talking about this outside the—there was more discussion in this country than there was abroad. Now it's, if anything, tremendously reversed.

And it raises the question, aside from just the quantitative—(audio break, tape change)—deferential to expertise in many of these countries. Americans are famously nondeferential to expertise. I often think if you've got a bunch of experts together in one room, even if different political parties and ideologies, it's amazing how they could probably agree on a certain framework for a solution. In many of these other countries people tend to defer a little bit more. Americans, famously, do not.

Another value is the cultural value of stewardship. A lot of these other—this is another famous characteristic of the United States. We always kind of think about getting through things today and we'll leave tomorrow for tomorrow. A lot of these other countries have a tradition of thinking about future generations. You know, Canada is a good—because it's so close to the United States, is a good example of a country which very self-consciously has ideas about generational stewardship.

Another difference is one-party governments. It's easier for these other countries to ram something through. I mean, if there is not a demonstration in the streets—(chuckles)—they figure, hey, that's it, you know, we've got all the votes in our hand and we can do it. We do not have that situation here.

And finally, because there is so much being written today in the genre of sort of counterfactual history—so this a very postmodern thing where, you know, the Germans actually won World War II, or just something happened slightly differently and everything could have come out differently. So I simply throw on the table that maybe one of the things going on here is just accidents. I do, for instance, think, for instance—

we mentioned earlier—Gene, I think you brought it up—that Thatcher was successful in price indexing, the U.K. system, but Reagan, famous—you know, it's well known he never really got anywhere, but maybe that had to do with the whole—you remember the Schweiker (sp) mess and you remember the early retirement—it was a whole—and then he just said, that's it—(chuckles)—I'm not touching this again. And that may have been a window that was lost forever. I sometimes think tiny changes that we don't know what the result is sometimes make a big difference.

A great example is the nonindexation of tax thresholds for the taxation of benefits. Did anyone give that any thought? It's now a generator of significant income for Social Security. I don't think anyone gave that any thought at the time that we—

(Cross talk.)

MR.   : It was not enacted.

MR. HOWE: It was not enacted. I mean, in this room everyone gave it thought because everyone was looking down the road 30 years, but I'm saying, the general public I'm sure did not really care—what?

MS.   : (Off mike.)

MR. HOWE: They generally did not care. And I'm sure that Stan Ross and a number of other people, they know much more about this than I do, but I understand—and correct me if I'm wrong—but that price indexing was actually seriously considered in 1977 when we were fixing the double indexing. Is that correct? It was on the table.

MR. ROSS: There were so many things that were all possible forms of indexing it's hard to find any kind that wasn't, you know, sort of on the table. (Laughter.) No—serious.

MR. HOWE: But how did it come out the way it did? I guess it was just jettisoned along with other ideas.

MR. ROSS: You know, it was so difficult to get back to the table to get the double indexing, so to speak, fixed. There had been so many studies that by the time you got to 1978, my impression was that they Congress just wanted to get it done at that point.

MR. THOMPSON: This is a crude reading of history. Congress never considered price indexing seriously. The debate inside the administration was fairly spirited, but I don't—the most famous price-indexing proposal was made by some people who were commissioned by the Senate Finance Committee.

MR. HOWE: You mean price indexing initially?

MR. : Yeah.

MR. HOWE: A price-price system? No, that was never—

MR. : But that was never seriously—

MR. HOWE: No.

MR. : It was battled inside the administration—

MR. HOWE: There was a debate on it, but—okay, no.

MR. STEUERLE: I think the (accent on ?) history there is very important. Steve Goss can correct me if I'm wrong, but reading Bob Myers—you know, all the way from the beginning of Social Security they had this idea of this 40 percent replacement rate for this average wage worker. It goes all the way back into like 1940 or maybe '35—I don't know—and then it got greatly reduced when they went through World War II, but there were people in Social Security who said, we've got to get that back up. Of course, we were in good times then.

And so there had been this—by the time we got into '72 or '73 I think there was this long tradition—we've got to keep that 40 percent replacement rate, and how do you do that if you're going to all of a sudden index the system? Well, you wage index it. That seems to me it was a very powerful force coming out of the actuaries office, but you can correct me if I'm wrong.

MR. PENNER: I guess the one point I disagree with you about, Neil, is the notion that one-party government makes it easier. In Real's presentation he pointed out that in Canada they have to deal with all sorts of different parties in the different provinces to bargain this out. But our '82 reforms were a case of Reagan plus a Democratic House, and Jake Pickle being the one who—

MR. HOWE: (Off mike)—insolvency within months helped a little bit too.

MR. PENNER: Well, sure, sure, but I think more generally when we have a Democratic House and Republican Senate we made a lot of progress on the budget problem as well because they had to deal with each other; you couldn't have this totally poison partisan atmosphere that we have today.

Yes?

MR. : Sorry, I was not here this morning so I apologize for that, but I do want to bring a point to the table that I'm not sure was discussed up to this point, and that is that one of the very important distinctions between the United States and the countries about which we're talking is that there are huge subsidies to the pension systems coming from the state budget. They're not being financed entirely by workers' and employees' contributions. The United States is still reliant on that two-part form of financing to a large extent. But the European countries have had—for a number of years you heard Germany being the dramatic case where there are huge subsidies going into supporting these systems, and that creates a policy environment where they compare each other because, you know, these countries all have to come within an alignment of the fiscal policies of the government.

And so they are watching each other and moving in certain directions. And, interestingly enough, the redistribution part is also watched very carefully because no one in that EU environment wants to be too far out of line now, east or west, and the U.K.—certainly that was a factor. The U.K. was just beaten to pieces in the EU environment saying that you are creating a country with poverty. And so they responded to that. There is this new EU sort of culture which is not directive—you know, there's still—subsidiarity is very important, but nevertheless there is an environment to which they are responding, and there is alignment.

MR. PENNER: Well, let me just take the last couple of minutes to thank some people. They're not here actually—(chuckles)—but Alicia Archie really did a lot of work in getting this conference organized, as did my own assistant, Akosua Meyers. I would also like to thank the Smith Richardson Foundation that financed the whole works. So I thank you all for coming. I think it's been a great day.

(Applause.)

(END)