

An Event of the CSIS Global Aging Initiative



“Funded Pensions in Great Britain: A Good Idea Gone Awry?”

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TRANSCRIPT

David Willetts: It is a great pleasure to be here at CSIS and I greatly appreciate and enjoy working on your Global Aging Initiative. I am grateful to you for inviting me to speak here today. I expected to see Richard Jackson here because Richard’s research, which lies behind the *2003 Aging Vulnerability Index*, I found invaluable. In some ways it is a jumping off point for my talk. Let me also, just before I turn to that, say how much I appreciate Syl Schieber for coming along. I have learned an enormous amount from Syl, and it is heroic for both Syl and Peter to be here when they have not the faintest idea what I am going to say. So it is really very good of them to offer to be commentators on remarks of which they have not had any advanced notice. It also shows how much knowledge they have of the system and surely they will be able to discharge their task as commentators with great skill.

Now, most of the work that the Global Aging Commission has done and which appears in the *Aging Vulnerability Index* and in other publications at CSIS, I agree with and I suspect all of us in this room agree with and I am not going to delay you by talking about what we all agree about. Instead I want to focus on some areas of disagreement or at the very least a puzzle. The puzzle that I want to tackle today is that in just about every international assessment of the Pension C, including the CSIS work, Britain appears as one of the most favorable places. We look like we have one of the best combinations of funded pensions and low levels of state public expenditure in the future. So it appears on any international measures that Britain is doing rather well, but we think we have a terrible crisis. We believe that we have a very serious problem indeed. Now how is it that we can think that we have a crisis and everyone else thinks that we are doing better than the rest of the world. I want to make sense of this conundrum in my parts today.

My starting point is what I am going to call the Thatcher strategy of pensions. I had the honor and privilege of working for her government, first in the treasury and then helping her start the number 10 Policy UK. I would summarize the Thatcher strategy on pensions in two parts. First of all, to hold down the value of state benefits to pensions, particularly by linking the basic state pension to prices not earnings. That position taken in 1980 has been fundamental to the relatively low growth of public expenditure of pensions in the UK compared to other advanced countries. It wasn’t just that, also a few years later the reductions in the value of SERPS, which

stands for the State Earnings Related Pension Scheme, which is the second contributory Social Security System benefit on top of the basic state pension. So the Thatcher strategy was to hold down the value of the main benefits made by public sector to pensions.

There was a second part of the strategy as well, and the first part of the strategy was only sustainable because of the second part, which was to boost funded pensions to encourage people to build up funded savings as an alternative. So as you look at the assets in our pension funds, they went from 42 billion pounds in 1975 to 657 billion pounds in 1997. We had a surge in both the occupational pension division defined benefit and also personal pension division defined contribution. And when the Blair government came in, Blair in his triangulation mode was very keen to accept this strategy and to take it further.

The Blair government set a framework where they said their aim was to shift from a 60/40 split of pensionary income where 60 percent came in state benefits and 40 percent came from in funded pension saving to reverse it. So their strategic goal was that 40 percent of the future of pensionary income should come from benefits and 60 percent from funded savings. I am certainly not over here to do partisan politics. I am very happy to accept that as a strategic goal and happy to work within that strategic framework. If a labor minister were here, I think that the point that the minister would add, and I understand why they would wish to say this, is they would say that the Thatcher strategy worked better for the more affluent pensioners and that there was a problem of poorer pensions on low incomes. Labor ministers would say that behind the averages, if you look at the distribution of pension income, you see that the spread of funded pension saving helped the more affluent pensioners but did not reach the pensioners with modest employment records. There is an important truth here and it is an important problem and it is captured in some of the figures if you look at the *Aging Vulnerability Index* which shows how even the third quintile of British pensioners really are heavily dependent on state benefits. I sometimes think that there is an important truth here.

You know the great story of Conrad Hilton, who was asked on some TV show after years and years of running one of America's biggest hotel chains, 'Well Mr. Hilton you must have had tens of thousands of guests coming through your hotels for many decades now. Do you have any great words of wisdom based on your lifetime here running hotels to offer us?' And he said, 'Yes. Please remember to tuck the shower curtain inside the bath.'

So after working on social policies for nearly 20 years now. I sometimes think that the most important single idea that I have ever had is that there is a difference between the average and third quintile and do not just look at the average, but look at the third quintile. Quite often the picture from the third quintile is very different from the average. If a labor minister here would say look at the third quintile, not the average, and you would find in Britain that even the third quintile average is very heavily dependent on state benefits. Therefore funded pensions are skewed towards higher income pensioners. Their stakeholder pension was introduced exclusively to try to spread funded pensions further down the earning scale and sadly, I think that it is widely accepted now that their stake holder pensions have not succeeded in spreading funded pensions to a wider group that have been before. Affluent husbands have taken them out for non-working wives or grandparents have taken them out for grandchildren. They have not really been taken out by people in the target group of people earning between 10 and 20 thousand pounds per year. What is now happening is that both sides of that two-part Thatcher strategy are now breaking down.

First, what is happening is we are seeing a collapse of funded pensions. It is a crisis, which I have compared to the Hollywood movie *The Perfect Storm*. You only get something as big as what we are going through if a whole range of different factors come together. You cannot break it down to one single thing. Some of the factors are outside government's control such as the bad market; the falling equity prices have a big impact on the value of funded pensions. Secondly, low inflation, Britain adjusting to a low-inflation world and the impact that this has on the size of future liabilities has certainly also been a big hit for companies. Then the government's 5 billion pound a year tax on our pension scheme has made a bad situation worse.

What we have ended up with is something like the EU's problem of excessive pension promises, but with one crucial difference. On the constant, the problem is that they have excessive pension promises made by governments. Our problem is that we have excessive pension promises made by companies. Companies have been raising expectations amongst their employees of the pensions which they can enjoy in the future and the companies have not been in reality. Now we can see in the light of day the money needed to meet those promises. So we too have a problem of excessive pension promises, but it is mediated by the corporate sector rather than by the political process. It may be, as a result of being mediated by the corporate sector, more transparent and may be easier to tackle, but it is still painful for the people involved because companies have to demand higher contributions, change the terms of the company pension schemes, or even tragically close them entirely to new or even existing members as well. And all these changes have been going on in the corporate sector because it just cannot afford the pension promises it has been making. Let me give you some statistics that shows you the scale of this retreat of funded pensions in the UK. 72 % of UK occupational pension schemes are now closed for new members. In 1997, 67% of recently retired pensioners had access to an occupational pension. Within 5 years that was down to 59% of newly retired pensioners. So funded pensions in the UK are in retreat. That half of the Thatcher strategy is not reversing.

The other half of it, holding down public expenditure options, is also therefore coming under pressure. We have the spread of means-testing benefits. In particular we have new benefits and pensions being brought to you by the chancellor. In 1997, 40% of our pensions were means-tested welfare on top of the basic state pension. By the autumn of 2003 that number will rise to 57%. Our Independent Institute for Fiscal Studies has predicted that in the future, on current policies with no change, that it could get to 82% of pensions claimed means-tested welfare.

This is not my vision of the direction I want my country to be headed. I don't want to see the collapse of funded pensions and the spread of means-tested welfare. I want the opposite. I want that vision which I sure everyone of us in this room shares of more funded pension savings and people less dependent on the state. As a British Conservative and as my party's spokesperson on pensions, my task is to try to develop policies and convey the political messages that enable us to get that strategy back on track. But what I want to do with you here today is to tackle this puzzle.

If that is the situation in the UK, why do so many international forecasts show the UK in such a good position? Let me give you one example of many. Paul rightly mentioned the OECD. Let me quote to you European Union Commission figures on public pension spending as a percentage of GDP. France 12.1% in the year 2000, 15.9% in the year 2040. Germany 11.8% in 2000, 16.6% in 2040. For the UK 5.5% in the year 2000 and 5.0% in 2040. It is due to fall by a half percent. I doubt that there is any other advanced Western country that shows a decline.

And just to add to the puzzle, although Britain does not face the extremely unfavorable demographics of some countries such as Spain, Germany, and Italy, we are now going to emerge from a period when the number of pensioners has been flat to go through a big increase of pensioners as the baby-boomers retire. So over the next 50 years the number of pensioners in the UK is going to increase from 10.8 million to 15.1 million even after the fact that we have increased the pension age of women from 60 to 65. So these forecasts are saying that we are going to have a reduction in the percentage of GDP going to pensioners while at the same time the number of pensioners increases by almost 50%. I just cannot understand it. I cannot believe it. Let me now take you through why these figures are nonsense and should not be believed.

The first reason why they are nonsense is that some of the international organizations are simply using out of date information. The new Labor government has significantly changed the benefits regime for pensioners and not all of the policy changes that have been introduced have yet been absorbed into international forecasts. I wrote to the OECD about this and let me quote from a letter I have back from the OECD from December of last year. I quote,

“We recently undertook an exercise asking member countries to project for pensions expenditures to 2050 on the base of common assumptions. However, this project started just before the initial minimum income guarantee was introduced. There was a footnote to all our tables based on the project stating, ‘The United Kingdom pension objections do not cover minimum income guarantee. They assume that the existing old age pension will remain indexed to prices.’ Now back to the letter,

“Obviously, taking the minimum income guarantee into account, especially given the tendency to increase as an amount of earnings, would have an effect on the results. Indeed, I think that it fair to say that the UK has recently changed pension policies so dramatically that I would not be confident with the continued validity of any of our assessments of future UK pension span.”

That is the OECD writing to me in December. The OECD figures are still widely used as evidence that the British position is sustainable. So partly, we have a problem at least just behind the curve of policy changes in the UK.

The second reason why these figures are wrong is that you in America rightly distinguish between social security and welfare, terms which in Britain have become in many ways muddled up. I am not going to sound like some tiresome Oxford dog, but many of these statistics measure state expenditure on pensions. They do not measure state benefits for pensions. Now in the UK, pensions is very different from benefits from pensions. And we are almost unique in advanced Western countries in that being in a situation where this distinction matters. Let me give you just the current figures. In the year 2003-2004, there was 67 billion pounds of public expenditure which translates into benefits. I am not getting into health benefits or other things but just in benefits, public benefits from pensions. And out of those 67 billion pounds 39 billion pounds were on the contributory state pension which is the basic state pension. About another 7 billion pounds was on SERPS, the second state-owned pension. In addition, there was another 20 billion pounds of income related benefits of various sorts. The sort of benefits, and I do not expect any person outside the details of the British social policy debate to be familiar with these and there is no reason why you should. There are housing benefits to help people who have rents which they can not afford to pay. There is a council tax benefit, which is a means-tested assistance in helping to pay local tax bills. There is a minimum income guarantee I referred to earlier which is the basic means-tested welfare to assist pensioners with low incomes. There is the pension credit, which is coming in the autumn, that extends means-tested welfare payments for pensions up the income scale. We have noncontributory disability benefits, many of which

particularly help pensioners. Many of the definitions used by international organizations only measure what the US terms as Social Security benefits for pensions. And if your Social Security benefits are relatively generous, you do not have many pensioners on welfare. But because in the UK our Social Security benefits are relatively modest, we have large numbers of pensioners on welfare. Unless you include welfare expenditure of pensions, you will significantly understate public expenditure, the cost of benefits of pensioners in the UK. So this is a second reason why the statistics are misleading.

There is a third reason. If you have a system that is heavily dependent on income related benefits and pensions, it is also going to be unlike other advanced Western countries in that it is going to be very sensitive to assumptions about what happens to your funded pension income. For most countries, predicting your future expenditure on pensioners is the same as predicting the value of your future Social Security benefits for pensioners, and predicting your future Social Security benefits for pensioners requires understanding the formula and the rules guiding and setting your Social Security System. But the UK it is completely different. In the UK, you have to also understand and include in the expenditure the welfare benefits of pensioners. The crucial determinate of welfare benefits of pensioners is the value of their income from other sources. Now the government, in order to bring down its estimates of the cost of these welfare benefits in the future, assumes that income from funded pension savings will rise in line with earnings. My view is that it is now impossible, sadly. That's too strong. Given what has happened to the occupational pensions and the reduction in the value of people's personal pensions, it is most unlikely that in the future British pensioners will enjoy incomes from their funded savings that run in line with earnings. And if you simply assume, and I think that even this in some cases is optimistic, that income from funded pensions in future rises with prices, not earnings, that change in assumption alone adds one percent of GDP to public expenditure on the pension credit in 30 years time. So our welfare bills are highly sensitive to assumptions about incomes from funded savings. This is just how the current rule should be understood.

The fourth and final topic on my list is of course to bring in politics. I'm a realist and I fully understand that in a democracy and in a modern flourishing capitalistic society we should expect organized citizens to enjoy the fruits of a successful and growing economy. Pensioners are not going to vote for political parties that say bad luck you are getting poorer or you are not enjoying any increase in your living standards when everyone else around you in your society is growing richer. They simply will not accept that. They will vote for political parties that offer them the prospect of increases in their incomes as well. You could argue that is one of the reasons why we lost in 1997. We had a particular swing against us amongst pensioners. We had rather large swings against us among just about every electoral group, but if anything it was even larger amongst pensioners. Now, my estimate, and this is me personally doing some rather clumsy back and gambler/ calculations. This is the sort of operations exercise which the CSIS would be able to do with much greater skill than I could, but from my estimate, I can easily project UK public expenditure on benefits for pensions in 2050 at 9% or 10% of GDP just by applying these four basic rules. It is definitely nothing like 5%. These figures are simply not accurate and they rest from applying a model that applies in other countries. In this respect the UK is indeed different.

So what is happening is that, I mean in no way to, the critics used to say of Margaret Thatcher that she had defaulted on the state's pension plans. What has been happening is that we

are now defaulting on the default and we are getting back to a system where there are going to be significant increases in the public expenditure on pensioners for years to come.

Now for some international comparisons, and I am just going to make some comments about the USA and then, this is dangerous diplomatic territory, I am going to make some comments about France. Let's start with the USA. My tease to my American friends is always to say that your Social Security System is far more Socialistic than ours. Your Social Security System is much more generous than ours. One of the reasons why you do not have quite the same issues we do, which is people on Social Security also claiming welfare. That is the big debate in Britain and it does not really happen in the USA. In fact, talking to Syl and learning from Syl as I always do, it struck me in some ways that our debate is more like your debate on pensioners and prescription drugs and Medicare health covering and whether they might need Medicaid. If you apply the Medicare\Medicade debate to the UK debate on pensions, you have something much more like it. We have the equivalent of limited Medicare coverage on debate about what the responsibilities of Medicare will be. Think of that as our debate.

Now because your Social Security System is more generous, you do not have to estimate in transfer payments. Spending down onto welfare is not an issue, and perhaps also, if I may say so, I think one of the benefits that flows from this view as well is that although your regulations are bad, and I think your pensions industry is over regulated, ours is even more over regulated because the government knows that if anything goes wrong with these occupational pensions it will directly face a bill in terms of higher welfare. Hence, this being one of the reasons why the costs for companies of providing these pensions are always going up. The government is permanently legislating to put new obligations on companies so that the pension benefits are generous enough to reduce future dependence on welfare. That is one of the reasons why we have gotten into this mess with our company pensions. People have been used to floating on means-tested welfare in order to save people money. So that is where you in America have an advantage.

Now this really is going to be perverse, but I would now like to say something, I am swallowing hard, in favor of France. We all have a picture of France where they have a problem of large amounts of dependence on public benefits for pensioners with low amounts of savings. But I would like to suggest that there is a, the logical corollary to what I have said about the way in which international statistical treatments of benefits for pensions work is the way in which international organizations treat the funded savings of pensions. Because again there is a puzzle. Let me give you the figures for 2002. They are estimates and there are problems in the consistency of the series, but here roughly is the percentage of household income being saved in major European countries: France 11.9%, Germany 10.4 %, Italy 15.8 %, UK 5.1 %. We are historically a nation with a relatively small savings ratio. So if we are saving so little, how come we have all these pension assets and if countries like France are saving so much, where is the money going? That is the next part of the puzzle. Well the answer to this puzzle is to be found in the Table 8 of the CSIS publication of the *2003 Aging Vulnerability Index*. It is a fascinating table that I found to be very illuminating and Richard, I always appreciate Richard's assistance on the statistical points, because what it does is it shows the sources of the after-tax income of the elderly. If you look at France, you will see private pensions. Sorry, let us stick to that rule. Let us look at the third quintile. France's private pensions 0.4%. This is because they have not got many pension assets. So 0.4% of the income of a French pensioner in the third quintile comes from private pensions. Just what we feared, their problem that they have insufficient

pension saving. But if you look at the line below, asset income is 18.0 % and public benefits are 78.2 %. If you compare that with the UK third quintile, private pensions are 11.3 %, much greater than the French, asset income is 10.0 %, and public benefits are 74.8 %, only a tad bit lower than French. What France has got is large amounts of savings which do not count as pension savings. And the reason is that the statistics only treat assets as pension assets if they have an age condition attached to it. You are only counted as having pensions saved for your pension, if you have put your money into a stock that you can only access when you have reached a certain age. That is how the statistics for pension assets are assembled. That's what the OECD and everybody go around measuring.

But the statistics do not mean that these countries are not saving. What it means is that they are saving in forms such as money market funds and life insurance. These forms are, in practice, used heavily by their old people to boost their incomes, because they do not have an age condition and therefore they are not counted as pension assets. Now Britain paradoxically, benefits from funded assets on the funded pension side from the way in which international statistics are collected because the statistics measure pension assets, assets related to your age. That is the only thing that they are interested in. Just as it has the effect of reducing France's apparent level of public benefits of pensioners, since it is only measuring those related to age, it also had the effect of exaggerating our savings because almost all of our savings go into age related instruments, age related pension funds. We do not have many of these other forms of savings which they do have in France and Germany. So we are flattered on the expenditure side by the exclusion of many of our state benefits, where as France and Germany, are I think, unfairly treated in the measure of their funded savings by the exclusion from international statistics of the main forms of savings that take place in those countries. And you can see it when you look at asset income as well as at pension assets.

In practice, the truth is that the US and the UK, with our funded pension schemes, are also countries with unusually low levels of saving. If anything there is an inverse correlation. If anything, countries with funded pension schemes seem to have lower savings ratios than countries that do not have funded pensions. And what might be the explanation of this apparently perverse correlation, I would like to suggest that there might be a coarse connection. First of all, it might be the case that if the main form of saving, certainly in the UK and the US system is a little more flexible, is in the main tax incentives and the main public debate focuses on forms of savings that you can only access when you reach pension age, that this is a deterrent to save. The main form of saving is very inflexible. It might be the case that people would be willing to save much more if they knew that they could access the money if they really needed it. It might be the very fact that in these countries you don't have an age hold for accessing money, which makes people more willing to put more money in the first place. It is similar to the paradox that the best single device for enabling us to drive our car more rapidly is the brakes. If the brakes work you can drive faster. If you can exit the money from your savings package, you might save more. So my view is that it may be the case that tying the savings regime to rules and access at a certain age lowers the amount countries save.

Secondly, the real point of funded pension savings is surely not that it increases the amount that you save. There is no evidence that they do that. If anything it is the opposite. What they do is they insure that we get higher returns on capital. The real purpose of these is not to have higher volumes of saving. It is to ensure that there is a higher return on the capital that you do save. So for any target level of income that you have, you need to save less. The great

success of British and American capitalism is not the volumes of savings; it is the returns on capital. That is what our systems do. I think that it is one of the frustrations of the debate that all of us are tempted to say that the case for our systems is they increase savings. They do not. What they do is they increase returns to savings.

So let me wind up. In the US, you have a Social Security System that is more generous than in the UK. And I think, looking across at you, I am very envious of the policy mix that you have. In France they have high propensities to save and they have built up large amounts of savings, but they do not appear in international statistics because they do not count as pension assets. In the UK, we come out particularly well from these statistics. The explanation of this puzzle that I started with is that much of our public expenditure on benefits on pensions is excluded because it counts as non-age related welfare. But almost all of our rather modest savings are included because they are all age related and counted as pension assets. The lesson that I draw from this is that perhaps we in Britain, do have more of a problem than some of the international statistics would lead on. And I am very grateful to CSIS and Global Aging Initiative. I have wrestled with this puzzle for so long. Thank you very much in deed.

Sylvester Schieber: I think David's observations this morning helped clarify something that I have found puzzling for a long time and that I have been trying to sort through. That is his very flat projection on their Social Security obligation. If you look at their underlying demographics they are like most of the developed world. They will be different in nuance, but there is this expected rate of growth of the elderly population. If that population is going to be growing, but the share of the output that is going to them is going to be relatively steady, that means that the relative incomes of the elderly, at least from that portion of the retirement system, have to be declining over time. It always occurred to me that that the situation in the UK is probably not very different than the situation we face here in the United States or elsewhere around the developed world in the political sphere.

I always think back to the 1960s when poverty rates among the elderly were much higher in the United States than they were among the general population. There is a visualization that comes to mind which helps explain why this situation is not tolerable. Some of you remember Walter Cronkite, who then had a regular evening news program on CBS. Periodically, he would run a feature looking at the income status of the elderly and would often end up with them eating dog food because they could not afford to sustain a more reasonable standard of living. Out of all of that, not just Walter Cronkite, but the general perceptions about the elderly standards of welfare led to very significant increases in Social Security benefits in the late 1960s and early 1970s, and we indeed drove the poverty rates among the elderly below what they were for the general population.

So as I have looked at the UK situation and seeing those projections, I wondered how they were going to be able to sustain this politically and David has said this morning that they are unlikely to. The substitution of private pensions for the public pension, as David points out, has been somewhat successful in certain segments of the work force and the population there. But their system, like ours, is a voluntary system. In any voluntary system you are not going to get universal coverage. Indeed, you are going to have a skewed coverage toward the higher income distribution and that is why his focusing on the third quintile certainly makes sense. In terms of

David's comments this morning, I think one of the most startling statements, at least if they were being delivered to the general public here in the United States, was his conclusion that our general system of support of the elderly is far more Socialistic than the UK's. I think the vast majority of the people in our society think of the United Kingdom as being much more of a Socialistic society than ours. I think his observations are right on. We do have a more generous Social Security System. We have a richer safety net retirement income support system for the middle class than they do.

I found his observations about the regulation of the private element of the retirement system interesting, but I'm not sure if I agree with that part of his observations. I believe that there is a difference and it is an important difference in the nature of our regulations of the employer based pension system here in the United States and the employer based pension system in the United Kingdom. I think in the UK they have tried to regulate the level of generosity of the benefits that the employer's system will provide so you have index benefits and things of that sort. Here in the United States we have not focused on the overall generosity of the benefits but we have focused very much on the security of the benefits. That is really where the regulatory environment is directed. So if you are an employer and you are going to sponsor a defined benefit pension plan, you have an obligation to fund those accruing liabilities as they are being earned. Now there is certainly some wiggle room around that, but we have more stringent regulations on our defined benefit system than in the UK.

As a result of that, I think our benefits are probably not as susceptible to the economic variations that take place in any economy as the UK is finding their benefits right now. If you have an obligation that is largely unfunded, and now to the extent that you have got some funding there, the funding values are plunging because the markets are going down. The value of the liabilities is skyrocketing because interest rates are so low and annuities are so much more expensive. You do not have the kind of buffer that you would have in a more funded system. So in some regards this lack of regulation in the security side is really what has made them sensitive to particular problems that they are now facing. The system is responding and it is responding very rapidly, and my guess is it will continue to respond. Even in the defined contribution side I believe that we have more regulations towards security than they do in the ability to go get individual pensions, the ability to wander around through the market place. My sense is that the system is not as efficient as our defined contribution system where the assets tend to be concentrated. Where you have got limited investment choices people do not have to learn all of the things that they have to learn to be efficient users of a system that is much more unrestricted.

In terms of the long-term prospects of dealing with their problem, I am certainly an advocate of having a larger share of benefits being funded rather than a smaller share. The one observation that I would make is that if we are going to depend on the employer side of our economies to help resolve this issue, we need to understand that the benefits that an employer is going to sponsor and workers will accrue through an employer plan will tend to be proportional to earnings over the lifetime. Employers, whether we like it or not, are not social redistribution entities. They are entities that pay workers on the basis of the contributions that people make to the organization. And to the extent that they are going to sponsor a retirement plan, if it is a mandated plan and everyone is in it universally, you will tend to have some what of a flat benefit or in cases like ours, maybe even somewhat of a redistribution benefit towards the higher income to offset some of the tilt that is in our Social Security System. If it is not a mandatory program that everybody had to participate in, then by self-selection, higher income people are going to

participate in greater rates than lower income people. So to the extent that we are trying to couple the employer based system with some other basic government run system to provide people true retirement security that gives them standards of living that grow over time in accordance with the standards of living in the economy, we are going to need to be very mindful of the people in the bottom two quintiles or three quintiles in terms of the design of our public plans and the incentives to save under the private plans.

Now, going back to this comment on the relative Socialism of our two societies. Lord Beverage when he was introducing the pension system towards the end of World War II started a discussion about cradle-to-grave welfare benefits. Franklin Roosevelt, who had started our own Social Security System and much of the welfare system in the United States, felt that he had actually be the author of this term cradle-to-grave welfare and was somewhat chagrined that Beverage had made off with his term. In retrospect it seems that maybe Roosevelt won after all.

Peter Orszag: Thank you. I want to talk about three things. Three things that I want to do: first provide some brief comments on his remarks, second pose another puzzle, one that he did not mention, and third talk a little bit about Social Security reform. First, on just picking up certain aspects of his remarks, the availability of preretirement withdrawal options or preretirement liquidity options for saving does seem to be important to savings levels, even in the United States. I am on a National Economy and Social Insurance Panel that is looking at this issue. The research in this area is not what I would call stellar, but for what it is worth, it does suggest that the availability of a preretirement loan option on a 401k plan does substantially increase both participation and contributions. That effect may be so large that even netting out any preretirement withdrawals loans that are then not repaid still results in higher assets at retirement because the participation margin and contribution margin is so large.

The second point is the savings offsets. I think this is a fundamental point that is not remarked upon enough in debates over Social Security and pension reform. The asset shifting, if you will, instead of saving in taxable Form A, depositing funds in tax preferred Form B is a fundamental point. It is a point that Joe Stiglitz and I tried to emphasize in a paper (tape cut) in which we talked about the difference in narrow prefunding and broad prefunding. Narrow prefunding means the assets are accumulating in a public or a private pension fund. Broad prefunding means that you are raising national saving. And one need not imply the other. They are fundamentally different concepts and we often get confused because we focus on narrow prefunding (building up the assets in pension funds) when we should be focusing on building national saving which is the more fundamental point.

I think that it also speaks to the attractiveness or lack there of tax breaks on retirement savings. I did have an opportunity, Mr. Willetts noted that we were sort of off the cuff here, as it were, but I did have an opportunity to look at some of his speeches which he kindly posted on his website. In those he notes that he is not in favor of a proposed lifetime limit on contributions or actually withdrawals or asset accumulation in tax preferred retirement vehicles in the UK. Syl noted that most of the US regulations are geared to funding, but there are in the tax law a complicated set of limits on how much tax preferred saving can occur in both defined contribution and defined benefit limits. The purpose of those limits, or what I see as the

economic rationale of those limits beyond progressivity, is that the evidence suggests that the asset shifting is much more prevalent at higher income levels. It is just sort of intuitive. If you have other assets, lots of other liquidity, it is much easier to shift assets into a tax-preferred vehicle than it is at lower income levels. Or to put the point another way, a dollar or a pound, showing up in a tax preferred savings vehicle contributed by someone at \$10,000 per year is much more likely to represent new saving than a dollar contributed to such a tax preferred vehicle by someone making \$1,000,000. That is intuitive. It is also backed up by research by Eric Engen at the American Enterprise Institute and my colleague Bill Gale. What that means is, that these limits on tax preferred savings vehicles are at least partially intended to promote national saving and the reason is that if you are providing a tax break for saving that would have occurred anyway, you are reducing national saving because you are reducing public saving in exchange for no increase in private saving. By concentrating the tax benefits, somewhat at least, on people for whom the contributions would represent new private saving, you are making it more likely that you will raise national saving as a result. I also think that this fundamental savings offset is a very important thing to keep in mind when considering individual account proposals in the United States, in the degree to which the contributions made to those accounts would result in reduced saving elsewhere.

I have two other comments on his comments before turning to other things. First I will comment on the expansion of means-testing. My understanding of what has occurred there is that there is a minimum income guarantee that exists. That minimum income guarantee is being raised, but at the same time and more importantly, the implicit tax imposed on other sources of income is being substantially reduced from a 100% implicit tax. In other words, any income you have offsets your means-tested benefit dollar for dollar to 40%. When you think about why lower income or moderate-income workers do not take up private funded pensions, presumably the implicit tax imposed in the previous systems is one of the reasons.

We actually have a similar problem in the United States, the means-tested benefits that are available, admittedly more modest than in the UK, under supplemental security income, Medicare, and food stamps all have asset tests. For those asset tests defined benefit plans are typically exempted but defined contribution plans are included. Let's say a person puts money into a defined contribution plan and a recession hits. They would otherwise be available for food stamps or Medicare, but they can be disqualified because they had saved in a defined contribution plan. I am not aware of any research showing that this is an important effect, but the direction seems clear.

I would also just briefly note that the interrelationships between other income and Social Security income is present in the US, but much more modestly because we do have a progressive system of income taxation of benefits that does depend on other sources of income. So it is a more trivial interaction, but it does exist.

Ok, let me talk now about another puzzle that Mr. Willetts did not mention. This puzzle is why ideologues in the United States in favor of individual account reforms often point to the United Kingdom as being a paragon of how an individual account system operates, or as a successful example of individual account systems. You often see it listed along side other countries that have individual accounts, where my experience talking to people in the UK is that their experience has not been overwhelmingly positive, and I'll be interested to hear reactions to this.

There are several aspects of the UK system that I think do have lessons for the United States. First, it is voluntary. You can opt out of what was SERPS, what will be the state's second pension into either an employer provided plan or an individual account. And Mr. Willetts did not mention it, but there have been problems with decisions between various forms of opting out. A well known misselling scandal in which people who had been in employer provided schemes were told by financial firms that it would be advantageous for them to go into individual accounts. They did so and the financial firms are now being forced to make them whole because it was not actually in their interest to do so. The cost numbers vary but estimates of 15 billion dollars being sort of floated around suggests that this is a substantial issue. If you look at the UK press and discussion it certainly is an important issue.

Secondly, and I think partially because it is voluntary, the administrative costs on the individual accounts have both been opaque and high. At least, this is the case until the introduction of the stakeholder pensions. I think that this is a fundamental point that deserves more discussion because often in the United States and elsewhere you'll here statements that competition alone, regardless of the form of the individual account, will drive administrative costs down. I think the UK experience suggests that we should be substantially wary of that argument. There are ways of reducing administrative costs in individual accounts and in fact the UK government appears to have succeeded in doing so by capping the fees on stakeholder pensions, which then appears to have driven down administrative costs on non-stakeholder pensions. But I think that it is an important lesson that has not been fully appreciated in the US.

Thirdly, the UK is not only voluntary, and I want to emphasize the movement over the last 5 years in the United States has been towards making individual accounts proposals voluntary. So you could voluntarily opt out of the Social Security System. I think the reason is that it seems better politically. You could say, "No one is forcing you to do anything," but it is important to emphasize that making it voluntary dramatically complicates the system in terms of the education that must be provided and in terms of the administrative tracking of the accounts. Therefore something that sounds good politically may make things much more complicated in practice.

In relation to this, the UK allows people to sort of switch back and forth among the various different options so it is not a permanent choice that you have to make. You can kind of flip back and forth and what that means is that the system of opting out into the individual accounts, in which there are rebates on your payroll taxes paid, is related to your age. That has to be the case because if it were not the case and you had a voluntary system, then everyone would go into the individual account when young and go into the defined benefit state run plan when old. Your cost would be much much higher then and they would be not taking into account that behavior response.

No one has talked about age related rebates in the United States, another layer of complexity that would be involved in running an individual account. Now ostensibly many of the individual account plans say that there would have to be a permanent choice. So at age 21 or at age 18, you would make a lifetime choice that you would always be in the individual account plan. And I'll leave it up to you to evaluate the political credibility of that choice when someone is 47 and says, "Oh, I was just a teenager what did I know?" If you do not have that kind of permanent choice you run smack into the trade off between complexity and insensitive effects that I mentioned earlier. I have some other comments on the UK system, but I'll leave them for further discussion.

Let me just briefly comment on the US Social Security debate. Here I think that Mr. Willetts' connection of the Social Security programs and other governmental programs, admittedly in the UK more sort of welfare-oriented benefits for pensioners, has a parallel in the United States. I think that the prospects for Social Security reform in the United States have deteriorated substantially over the past three or four years because we have dissipated the revenue that could have been used for Social Security reform on tax cuts. And if you just look at the magnitudes involved it is remarkable that the tax cuts that we have enacted over the past two years, in the long-term, amount to between 2.3-2.7% of GDP. The entire social security deficit over the next 75 years amounts to 0.7% of GDP. For the permanent horizon it amounts to 1.5% of GDP. There is a level of disconnect in which the Social Security policy makers in the United States say, "Oh that is not my problem. That is the other side of the administration that is doing that," but it seems to me that you can not just separate things that cleanly. We are talking about long-term fiscal gaps and in the United States the long-term fiscal gap now amounts to between 6-8% of GDP. It is a huge number and we have made it substantially worse. Not only that, but from a political economy standard, it seems almost impossible to achieve Social Security reform when you have just given away that amount of goodies. It is the equivalent of one spouse saying to the other, "Sorry honey, you can't remodel the kitchen, but oh by the way, I've just bought a Lexus." It just does not work politically when you go to one of these Social Security groups and tell them you are going to have to accept a reduction in Social Security benefits because they can turn around and say, "Well if you just froze that tax cut for the top 1% of the population, I would not have to suffer that reduction in benefits." I think that you are making it very difficult to achieve reform.