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Committee on Ways and Means
Sub-Committee on Social Security Reform

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Countries around the world need to reform pension systems to meet demographic challenges and to reflect changes in labor markets and industrial, economic and social structures. There are valuable lessons to be learned from other countries' experiences. But the inherent complexity of pension systems has, in the past, hampered effective transmission of policy experiences across borders.

This testimony is in four parts. The first puts the United States' pension system in an international context. It uses three kinds of evidence: calculations of pension entitlements at an individual level, comparisons of older people's incomes with the rest of the population and how public pension spending is likely to develop.

The second part looks at structural pension reforms that have introduced some kind of mandatory 'individual accounts' (defined-contribution pension plans) as a substitute for all or part of public, earnings-related pensions. These have now been introduced by 10 countries in Latin America and more than 10 in Eastern Europe.

The third part of the testimony investigates an important but often overlooked feature of fundamental pension reform. Are the new defined-contribution accounts mandatory or voluntary? Which age groups are covered? If there is a choice, what are the terms of trade between remaining only in the public pension program and switching to a mixed public/private pension?

The issue of administrative charges for defined-contribution pensions is addressed in the fourth part. How large are these fees in different countries? What policies can help keep charges low?

1. The pension system of the United States in an international context

There are three main approaches to comparing pension systems between countries. The most common is the 'fiscal' approach, which looks at current and prospective pension expenditures. This is useful for assessing the financial sustainability of a retirement-income system, but it gives only the total for pension spending and is silent on how that spending is distributed among older people. The

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This testimony represents a personal view and commits neither the OECD Secretariat nor any of its member governments.

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second method is income-distribution analysis. This compares the incomes of today's older people with the incomes of the population as a whole. This is a backward-looking measure, since the incomes of today's pensioners depend on past rules of the pension system and past economic conditions. The third method is a microeconomic approach, calculating prospective pension entitlements for today's workers. Unlike fiscal projections, this looks explicitly at the distribution of pensions among workers of different characteristics. Unlike income-distribution analysis, it is forward-looking, assessing the pension promises made to today's workers under today's rules.

Microeconomic approach

The OECD recently published the first comprehensive, microeconomic analysis of pension entitlements in the report *Pensions at a Glance* (OECD, 2005). This first report (in what is hoped will be a biennial series) calculated prospective pensions of full-career workers at different levels of earnings.[2] The analysis includes all mandatory sources of retirement income: resource-tested benefits (including social assistance), basic and minimum pensions, public, earnings-related schemes and mandatory private schemes (both defined-benefit and defined-contribution). The calculations use common macroeconomic and financial assumptions to isolate the effect of pension-system design from these other factors. The parameters used are those applying in 2002, although subsequent reforms that have been legislated are assumed to be fully in place. The results, therefore, show the long-term stance of the pension system.

The two charts below (Figure 1) show the 'net replacement rate'. This is the pension, net of any income taxes and contributions due, divided by individual earnings, again net of taxes and contributions. Both charts show selected countries: OECD (2005) provides data for all 30 member countries of the OECD.

The left-hand panel shows the net replacement rate for a full-career with earnings equal to the economy-wide average each year. The highest net replacement rate is in Luxembourg, where the pension entitlement is calculated to be 110 percent of earnings when working. At the other end of the scale, the lowest net replacement rate is in Ireland, where it is 37 percent. The OECD average net replacement rate for an average earner is 69 percent. The replacement rate in the United States is low: along with Ireland and the United Kingdom shown in the charts, only Korea, Mexico and New Zealand have lower net replacement rates at this earnings level.

The right-hand panel shows the position of a low earner. The OECD average replacement rate at half-average earnings is 84 percent. This is higher than the replacement rate for an average earner because most OECD countries, the United States included, have redistributive pension systems. At this earnings level, the replacement rate in the United States is 61 percent. This is the lowest among the OECD countries apart from Mexico and the Slovak Republic. Countries with wholly flat-rate pensions, such as Ireland, with means-tested public schemes, such as Australia, or with predominantly flat-rate systems, such as the United Kingdom naturally have a large difference between the replacement rate at average and at low earnings. The main reason that low earners have very low pensions in the United States, despite the progressive benefit formula in social security, is the low value of the safety-net benefit. The means-tested program, supplemental security income (SSI), provides a minimum income worth 20 percent of average earnings. The safety-net retirement income across all 30 OECD countries is worth nearly 30 percent of average earnings (on average).

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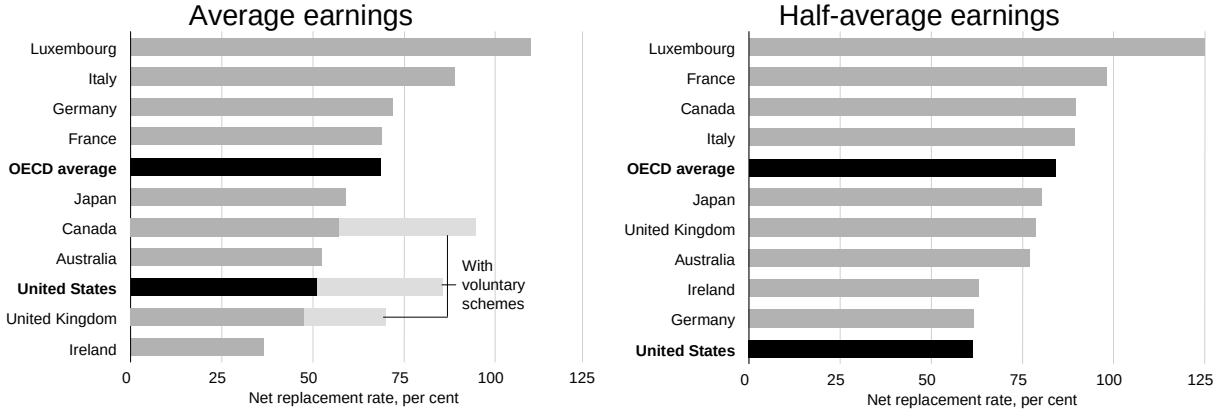
[2] Ongoing work is extending the analysis to include people with long absences from the labor market due to caring for children or long-term unemployment.

Figure 1. **Prospective net replacement rate for full-career worker**



Source: OECD (2005)

In countries with low mandated pension replacement rates, there is space for voluntary retirement-income provision to develop. In Canada, the United Kingdom and the United States, for example, both company and individual pensions are widespread. The chart for the average earner therefore shows the entitlements under a 'typical' pension plan for these three countries. In Canada and the United Kingdom, this is a defined-benefit plan. For the United States, it is a 401(k), into which the worker and his employer are assumed to pay contributions of the national average (9.5 percent of earnings).[3] With these voluntary programs, the replacement rates for these three countries look rather closer to continental Europe. But these replacement rates are conditional on having a full-career covered by a voluntary plan. The issue then turns to the following questions. Are some people saving enough in defined-contribution schemes? Do people have significant gaps where they are not covered by a voluntary, private pension? How will the penalty to changing jobs in defined-benefit plans affect retirement incomes?

Income-distribution analysis

Figure 2 shows two charts that summarize the information relating to older people in the OECD's latest cross-country study of income distribution (Förster and Mira d'Ercole, 2005).[4] Again, selected countries are presented here while the original paper provides information for many more.

The left-hand panel shows the net income of 66-75 year olds as a proportion of the net income of the population as a whole. The OECD average is 87 percent. In the United States, the figure is the highest of the OECD countries at 97 percent. Most of the OECD countries are clustered closely together. One reason that the United States performs well on this measure, while mandatory replacement rates under social security are so low, is due to voluntary, private pension provision. But the main reason is due to the importance of labor-market income in the United States, even among these 66-75 year olds. Earnings make up 30 percent of the gross income of this age group in the United States. In most of Europe, this figure is only around 10 percent. Australia, Canada and New

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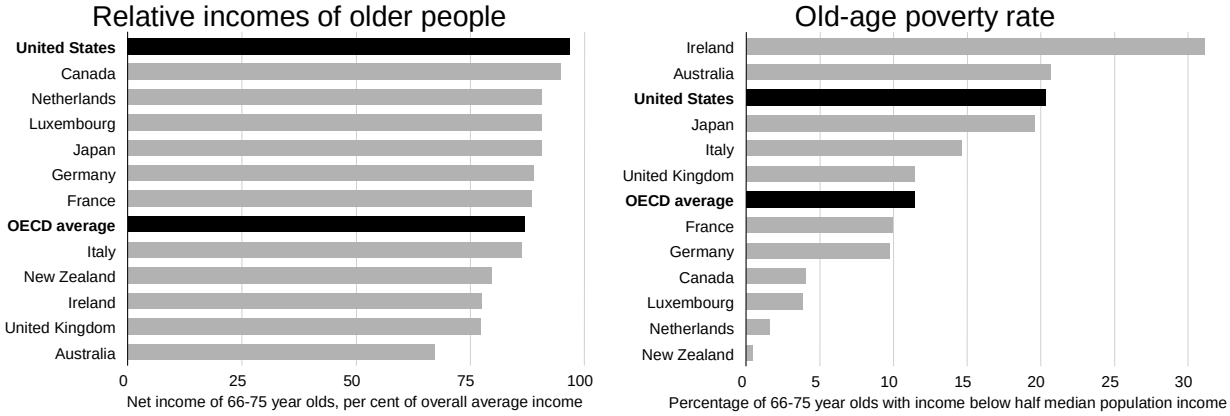
[3] The average contribution rate is taken from the Employee Benefits Research Institute/Investment Company Institute (EBRI/ICI) survey of 401(k) plans. OECD (2005) provides details of the modeling for Canada and the United Kingdom and calculations for a typical defined-benefit plan for the United States. It also includes a sensitivity analysis of the results.

[4] See also Disney and Whitehouse (2001, 2002).

Zealand lie between the two, with around 20 percent of gross income of older people coming from earnings.[5]

The right-hand panel shows the old-age poverty rate for the same, selected countries. This is defined as the percentage of 66-75 year olds with an income below half the population median. In addition to Australia and Ireland (shown in the chart), only Greece, Mexico and Portugal have a higher old-age poverty rate than the United States. The OECD average (11 percent) is nearly half the rate in the United States. This reflects the low value of SSI relative to safety-net incomes for older people in other OECD countries and narrow coverage of low-income workers by private pensions.

Figure 2. **Income distribution measures**



Note: all incomes are household incomes adjusted for household composition using an 'equivalence scale'
Source: Förster and Mira d'Ercole, 2005

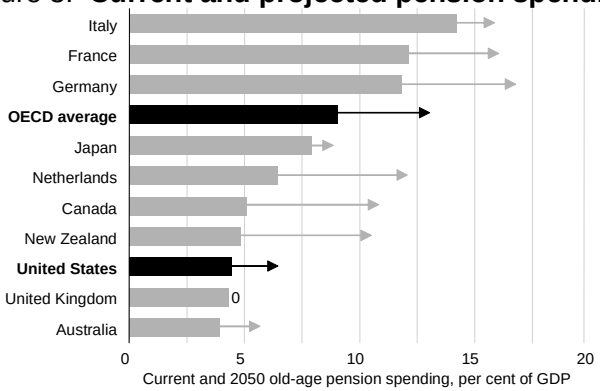
Fiscal projections

The OECD has also compared the effects of ageing on a range of public spending programs. The chart below (Figure 3) looks at public spending on pensions alone. Public pension expenditure in 2000 averaged 7.5 percent of gross domestic product (GDP) across 21 countries. (Other countries' data are available in Dang, Antolín and Oxley, 2001.)

Italy had the highest spending on this measure, nearly double the OECD average. Australia's spending, at 3 percent (less than half the average) was the second lowest. The United States spent around the same as the United Kingdom, around 4.5 percent of GDP. The arrows show how spending will change between 2000 and the projected peak (between 2030 and 2050). Italy's series of pension reforms have reduced the growth rate of pension spending. It is expected to peak at 16 percent of GDP, less than in France or Germany (on the policies in place in 2000). The peak in the United States is estimated to be 6 percent of GDP, compared with an OECD average of 10 percent.

[5] The low measure of relative incomes of older people in Australia reflects the fact that many withdrawals from private pensions are in the form of lump sums rather than income streams. These are not measured in income-distribution analysis. This is also an important factor in Ireland and the United Kingdom, although to a more limited extent.

Figure 3. **Current and projected pension spending**



Note: peak values are in 2050, except Italy and the United Kingdom (2030), France and the United States (2035) and Netherlands (2040)
Source: Dang, Antolín and Oxley (2001)

2. International experience of introducing individual accounts

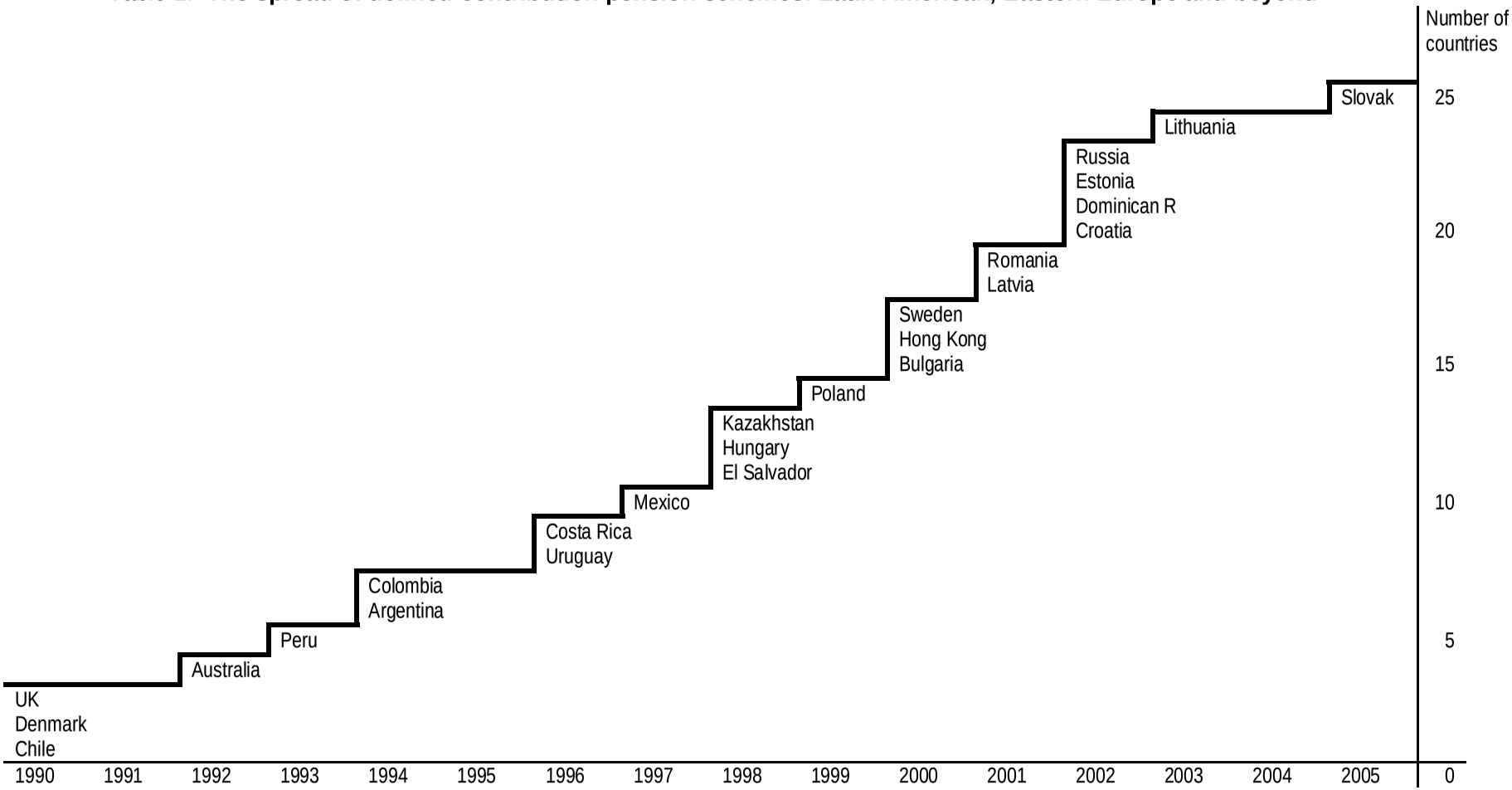
Some 25 countries around the world have now introduced individual accounts as a substitute for all or part of their public, pay-as-you-go pension schemes. The spread of these schemes through Latin America from the mid 1990s and through Eastern Europe in the years since then is quite dramatic. Many more countries are at various stages of the reform process, including Lebanon and Ukraine.

It is important to note that these reformed pension systems are very diverse, despite the common theme of individual accounts. Bolivia, Chile, El Salvador and Mexico, for example, have shifted nearly all retirement-income provision to the defined-contribution plans (although all of them retain publicly provided minimum pensions. In contrast, Argentina retains a large basic scheme (expected to provide around two-thirds of total pension benefits in the long term). Costa Rica and Uruguay retain earnings-related public schemes (which are likely to provide more than three-quarters of total benefits). All countries in Eastern Europe retain public, earnings-related plans as a complement to the new defined-contribution schemes. The balance between the two again varies. Half or more of pension benefits in the long term are likely to come from the funded component in Croatia, Latvia and Poland, compared with a third in Hungary and 16 percent in Bulgaria, for example.

Differences in the relative role of public and private provision in these new pension systems also arise because of differences in the size of the mandatory contribution. In Bulgaria, for example, the contribution is just 2 percent of earnings and it is 2.5 percent in Sweden. Contribution rates in Latvia and Lithuania were initially set low (2 and 2.5 percent respectively), but are planned to increase over time to 10 and 5.5 percent respectively. In Latin America, total contributions (including survivors' and disability insurance and administrative charges) exceed 10 percent of earnings in Chile, Colombia and El Salvador.

The mandatory contribution to the superannuation guarantee in Australia is 9 percent. Contribution rates are also fairly high in Hungary (8 percent), Poland (7.3 percent) and the Slovak Republic (9 percent). The minimum contribution to personal pensions in the United Kingdom (for individuals choosing that option) varies with age, from 3.8 to 9 percent. Again, the other elements of the pension system differ. In Australia, for example, the individual accounts were added onto the public, means-tested pension. In the United Kingdom, those choosing the personal-pension option are also entitled to public basic and means-tested pensions.

Table 1. **The spread of defined-contribution pension schemes: Latin American, Eastern Europe and beyond**



Source: Palacios and Whitehouse (1998), European Commission (2003), OECD (2001, 2002, 2005), Chlon (2000) and Acuña (2005)

3. Coverage of individual-accounts schemes

The transition from a public-sector, pay-as-you-go pension system into one in which individual, privately managed pension accounts form part of the mandatory retirement-income system does not directly affect those receiving pensions at the time of the reform. Nevertheless, such a reform could affect all current and future workers. A critical policy choice, therefore, is whether current and future workers should be allowed, encouraged or forced to switch part of their pension provision to the new private element. There is a spectrum of possible policy options. At one end, all workers, including new labor-market entrants, might be allowed choose to stay in the pay-as-you-go system or switch part of their contribution to the funded plan. At the other end of the spectrum, rights in the old scheme are frozen and all new rights of all workers are earned in the defined-contribution, funded plan. In between are policies where only some workers must join the new funded element, usually defined by age.

The experience of 19 reforming countries (Table 2) covers the full spectrum of possible outcomes. However, this masks some important differences. In Mexico, for example, people who contributed to the old system can switch back to the public scheme on the day they retire. So there is an implicit guarantee that the return on investment in the private scheme is at least as large as the (implicit) return on contributions to the public plan. As new labor market entrants are not offered the same guarantee, Mexico's policy is probably closer to those of Chile or Hungary than to those of Bolivia and Kazakhstan. Switching back to the public plan is also possible indefinitely in Colombia and the United Kingdom and for a limited period in Argentina, Hungary and Poland.

Who should be covered by structural pension reform?

It is readily apparent from Table 2 that most countries have focused the pension reform on younger people. Among the Latin American countries Chile, El Salvador and Uruguay all required new labour-market entrants (and in the last two, younger workers) to switch. Similar policies were adopted throughout Eastern Europe and in Sweden.

There are three main reasons why restricting switching to younger people is a sensible policy. First, changing the pension entitlements for older workers is difficult, because they have made their labour-market and savings decisions based on the expectation that the current system will remain. They can not retrospectively change these decisions to reflect the change in the pension system.

Secondly, the compound-interest effect means that defined-contribution pensions put greater weight on earlier years' contributions than accruals in earnings-related schemes (such as social security). With only a short period for investment returns to accumulate, there is less point in older workers switching. This is strongly reflected in people's behavior during structural pension reforms. In the United Kingdom, for example, around 25 percent of 20-34 year olds took out a personal pension in 1987/88, compared with 10 percent of 35-49 year olds and virtually no one over age 50.[6] There was a similar pattern in Latin America, with switching rates of 80-90 percent among under 35s in Argentina, Chile and Colombia. Among 50 year olds, just under half switched in Argentina and Chile and less than 10 percent in Colombia.[7] The results from Eastern Europe also confirm this.

Thirdly, restricting the switch to a smaller group of workers means that it is possible to afford to divert a larger slice of contributions into the new individual accounts. With fewer accounts with larger balance, the administrative costs can be kept lower.

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6 See Disney and Whitehouse (1992*a*,*b*) and Whitehouse (1998).

7 See Disney, Palacios and Whitehouse (1999) and Palacios and Whitehouse (1998).

Table 2. **Rules for voluntary and mandatory switching in structural pension reforms**

Country	*Mandatory switching*	*Voluntary switching*	*No switching*	*Option to return*
Latin America				
Argentina		entire labor force		yes, for 2 years
Bolivia	entire labor force			no
Chile	new entrants	current labor force (during first five years of operation)		no
Colombia		entire labor force		yes, indefinitely
El Salvador	labor force <36	labor force 36-55 (f -50) during first 12 months	labor force >55 (f >50)	no (yes during first 18 months after introduction)
Mexico	entire labor force			yes, indefinitely (not for new entrants)
Peru		entire labor force		yes, for 2 years
Uruguay	labor force <40, higher income		?	no
Eastern Europe/Central Asia				
Bulgaria	labor force <40			
Croatia	labor force <40	labor force 40-50 (during first year of operation)	labor force >50	
Estonia	new entrants	labor force <61, those 56-60 can join until 10/2002	labor force >60, >55 after 10/2002	
Hungary	new entrants	entire labor force (during first 20 months of operation), <30 again from 01/2003		yes, until 12/2003 (also for new entrants of 2002), indefinitely in case of disability
Kazakhstan	entire labor force			no
Latvia	labor force <30	labor force 30-49	labor force >49	
Poland	labor force <30 (except for agriculture)	labor force 30-50 (only during first year of operation)	labor force >50	no
Romania	labor force 20+ years before retirement	labor force 10-20 years before retirement		
Slovakia	new entrants	current labor force (during first 18 months of operation)		
Other				
Sweden	labor force < 45		labor force > 45	no
UK		entire labor force		yes, indefinitely

Source: Palacios and Whitehouse (1998), European Commission (2003), OECD (2001, 2002, 2005), Chlon (2000) and Acuña (2005)

What should the 'terms of trade' be for people choosing to switch?

The terms of trade under which people can exchange pay-as-you-go pension rights for contributions to their individual pension account is a fundamental design issue.

The United Kingdom, for example, made a very serious mistake in setting these terms of trade, underestimating the incentive given to younger workers to switch. This also meant that the government seriously underestimated the numbers that would switch.[8] The government forecast 300 000 would take out personal pensions, and a contingency plan allowed for a maximum of

[8] See Disney and Whitehouse (1992*a*,*b*) and Whitehouse (1998).

500 000. In the end, 3.2 million people switched in 1987/88. As described above, switching rates were strongly related to age, just as the incentive structure would suggest.

The financial implications were substantial. Between 1988/89 and 1995/96, the government paid £17.7 billion into people's personal pension accounts ($32 billion at today's exchange rate). Actuarial estimates put the long-run saving on pay-as-you-go benefits at £9.2 billion. The net cost — £8.5 billion, $15 billion — arises because the government did not adjust the payment into personal pensions to reflect different returns at different ages until 1996. With age-related rebates, the annual net cost was cut from £1.8 billion to £0.5 billion a year. It is now probably around zero.

However, the opposite risk is also possible: that the terms of trade are set so that it is not worth most people switching. This would undermine the whole reform. There is a difficult balance to be struck between successful reform and financial prudence.

4. Administrative charges for defined-contribution pensions around the world[9]

The issue of administrative charges for defined-contribution pensions has become central to pension-reform debates in many countries. How can we measure administrative charges? How large are they in practice? How can governments keep them low?

Countries' different approaches to charges

Table 3 summarizes different countries' policies on charges. At the top are the systems with the least regulation on charges. Countries lower down impose direct regulations on the structure or level of charges or regulate industry structure with important indirect effects on charges paid.

Measuring charges

Measuring the price of financial services is more difficult than comparing the cost of other goods or services. Providers can levy many different kinds of fees. There are examples of both one-off and ongoing charges. Some fees are proportional and some are fixed rate. Some are levied on contributions, some on the value of assets in the fund, some on investment returns.

These different kinds of charge accumulate and interact in complicated ways over the lifetime of membership of a pension plan. This leads to the second problem: how to summarize these charges in a single number to compare charge levels both between different providers in a single country and across countries.

The measure of administrative charges most familiar to investors and policy-makers alike is the 'reduction in yield'. This adds together all the charges over the lifetime of a pension policy, and expresses them all as a percentage of assets. An alternative approach is to measure charges as a proportion of contributions. This is the same as calculating the charges over the lifetime of the fund as a proportion of the balance accumulated at retirement. This second measure is known as the 'reduction in premium' or the charge ratio.

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[9] This section summarises the analysis of Whitehouse (2000*a*,*b*,*c*, 2001). See also James *et al.* (2000) and Shoven (2000).

Table 3. **Strategies on administrative charges for pensions**

No restrictions	Australia
	Hong Kong
	United Kingdom (personal pensions)
	United States (401k)
Cross-subsidies to low-paid workers	Mexico
Limits on charge structure	Argentina
	Chile
	Hungary
Partial ceiling on charges	Poland
Variable ceiling on charges	Sweden
Competitive bidding, multiple portfolios	United States (thrift savings plan)
Fixed ceiling on charges	El Salvador
	Kazakhstan
	United Kingdom (stakeholder pensions)
Competitive bidding, single portfolio	Bolivia

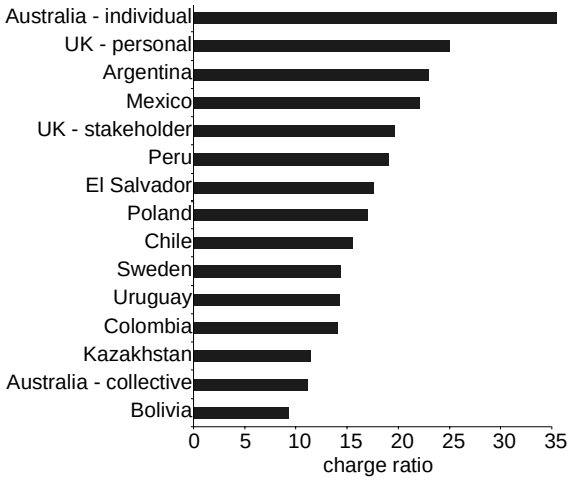
more restrictive

Source: Whitehouse (2000*a*,*b*,*c*; 2001)

International comparisons

Figure 4 summarizes data on charges for 13 countries with mandatory funded pension systems. Even very similar pension systems with similar approaches to charges deliver very different levels of fees in practice. Among Latin American countries with individual accounts systems, the average charge ratio varies from under 15 percent in Colombia to nearly 25 percent in Argentina. Looking at all systems, average charges range from under 10 percent in Bolivia to 35 percent in Australia's retail superannuation funds. As noted above, the three cheapest systems offer very limited choice of provider and/or investments. As a rule-of-thumb, a charge ratio of 20 percent over a 40-year pension plan equals a reduction in yield of 1 per cent.

Figure 4. **Paying for pensions: the charge ratio for individual accounts in 13 countries**



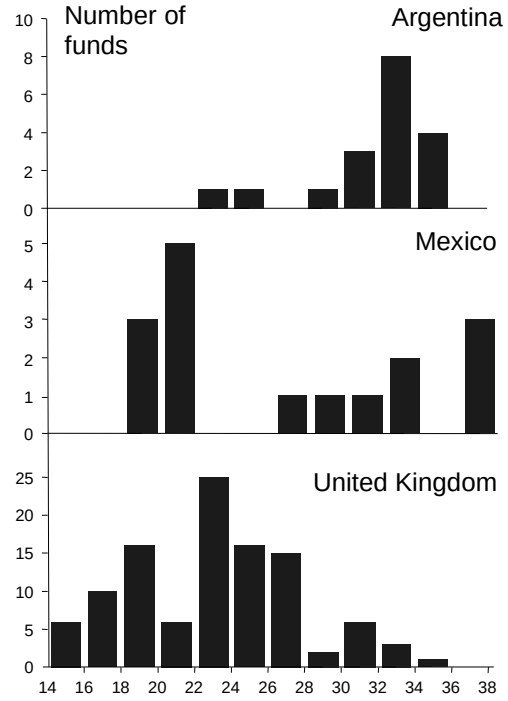
Note: charge ratio: total charges over the lifetime of the pension as percentage of accumulated balance at retirement. The calculations assume 40 years' contributions and 3.5 percent annual real return. Australia: 'collective': industry-wide funds; 'individual': 'master trusts' (provided by financial-services companies)
Source: Whitehouse (2000*a*,*b*,*c*; 2001)

Charges levied by different providers

Most studies of administrative fees for pensions look only at the average. But the average disguises a huge range of different charge levels between different providers. Figure 5 shows the distribution of charges in three countries. In the United Kingdom, the cheapest funds levying 15 percent of contributions and the most expensive, 35 percent. The range in Mexico is 17 to 37 percent. Even in Argentina, with the narrowest range, charges vary between 23 and 36 percent, meaning that the most expensive fund costs over 50 percent more than the cheapest.

These large ranges raise a difficult question: why do consumers choose expensive funds? Improved levels of service, for example, are unlikely to explain such a large differential. There is evidence in the United Kingdom that funds with higher charges perform better, but the out-performance is insufficient to offset the higher charge burden on typical pension policies. Perhaps some consumers fail to take proper account of the burden of charges. The most likely reason, particularly in Latin America, is excessive marketing (see below).

Figure 5. **Distribution of charge ratios across funds: Argentina, Mexico and United Kingdom**



Source: Whitehouse (2000*a*,*b*,*c*, 2001)

Policy options for charges

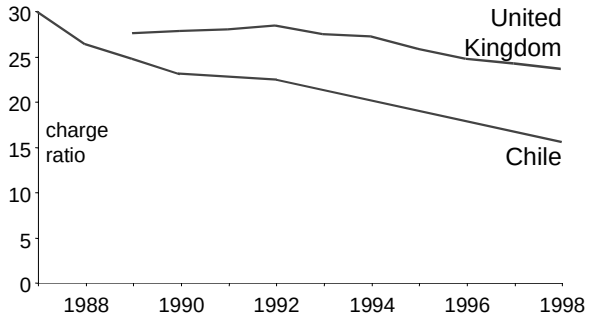
1. No regulation

An important assumption of the calculations above is that charges remain constant until pensions are withdrawn. But pension providers' revenues, especially from charges on fund assets, are back-loaded while expenses are front-loaded because of set-up costs. Also 'learning by doing' and the

consolidation of the pension fund industry in most reforming countries might put downward pressure on costs over time.

Most mandatory funded pension systems were introduced within the last five or ten years. But reforms in Chile and the United Kingdom have been in place for longer. Average charges have declined in both countries (Figure 6): by almost one half in Chile (from 30 to 15.5 percent) and one sixth in the United Kingdom (from 27.5 to 23.5 percent). If other countries follow this pattern of declining charges over time, then the charge ratio measures above, which assume constant charges, are over-stated.

Figure 6. **Evolution of average pension administrative charges, Chile and United Kingdom**



Source: Whitehouse (2000*a*,*b*,*c*, 2001)

2. Improve disclosure

Measuring the impact of charges on pension fund returns is very complicated. The minimum government policy should therefore be a requirement for funds to disclose charges in a standard format. This will help consumers make informed comparisons between different funds. Regulators can make the task easier by producing 'league tables' of charges. The supervisory authorities in Latin America regularly provide comparative information on different pension fund managers, and the Financial Services Authority in the United Kingdom has issued data on the charges for a wide range of financial products.

A second step to bring charges to consumers' attention is to levy charges on top of (rather than out of) mandatory contributions. This encourages shopping around because charges reduce current net income rather than future pension benefits. Four Latin American countries have adopted this approach. A related issue is ensuring that whoever pays the charges makes the choice of pension provider. In Australia, employers choose the superannuation fund, but the charges are effectively borne by their employees in the form of a reduction in the money flowing into their funds. There is a potential 'agency' problem because employers pick the pension while employees pay the pension charges.

The third policy related to disclosure is educating consumers about the effect of charges on their investments. For example, over the life of a pension policy, a charge of 1 percent of assets per year adds up to a charge ratio of 20 percent. Few investors appear to be aware of the major impact that fees can have.

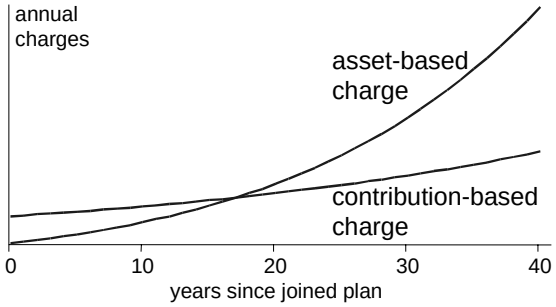
3. Facilitating comparison of charges

By ensuring all providers stick to a common charge structure, it is easier to compare fees between them. Unregulated charging regimes can be very complex and confusing. A regulated fee structure, in contrast, can mean there is a single 'price' that consumers can compare across providers. And a single proportional charge, on assets or contributions, means that the relative cost of choosing a different provider does not vary with earnings or contributions.

The important policy option for governments taking this route is the type of charge to be permitted. There are four features of the two charges important in making this choice.

The first is the time profile of charge revenues. Fees on contributions generate more up-front revenues than fees on assets (Figure 7). This allows providers to cover their start-up costs more quickly. This might boost competition by encouraging more entrants to the pension market when the system is established.

Figure 7. **Pension funds' revenue streams under different types of charge**



Source: Whitehouse (2000*a*,*b*,*c*, 2001)

A second issue is the incidence of the levies across different types of consumer. If there are fixed costs per member — and the evidence suggests that these are sizeable — then levies on assets redistribute from people with large funds to people with fewer assets in their plan. Older workers, with larger funds on average, would cross-subsidize younger workers, for example. Contribution-based charges redistribute from people with high levels of contributions (typically higher earners) to people with low levels of contributions.

Indeed, there would be no revenues from people who do not contribute. This might be because they have lost their job, withdrawn from the labor force or moved into the informal sector of the economy. But pension providers would still have to bear the cost of administering these people's funds. Asset-based fees ensure a continuing flow of revenues from non-contributors, but this means that the fees bear more heavily on people who withdraw from work early.

Finally, a charge on fund value encourages providers to maximize assets, both by attracting funds from other providers and, more importantly, by maximizing investment returns.

The choice between the asset-based and contribution-based approach is finely balanced. Unsurprisingly, different countries have taken different options. Levies on contributions are the norm in Latin America, while the United Kingdom has opted for asset-based fees. The government's main arguments were fund managers' performance incentives and the continuing revenue stream from members suspending contributions.

4. Ceilings on charges

Quantitative restrictions on charges are rare. Only El Salvador, Kazakhstan, Poland, Sweden and the United Kingdom, in the new stakeholder plans, have such limits.

The problem with this approach is the risk that governments set the 'wrong' ceiling. Too high a limit would be ineffectual. Too low a ceiling might mean that fund managers could not cover their costs. This will restrict competition and choice. It could even lead to the failure of weaker providers, undermining public confidence in the system. Ceilings all too often become a de facto minimum charge as well as the legal maximum. Price competition, beyond meeting the regulatory requirement, would be curtailed.

The experience with the new stakeholder pensions in the United Kingdom has, however, been encouraging. Providers initially said that the 1 percent ceiling would be too low. However, a number entered the market, a few even undercutting the ceiling.

5. Treatment of low earners

A common reason for any regulation of charges is to protect low-income workers. This is particularly important in mandatory funded pension schemes. It would be manifestly unfair if low earners saw most or even all of their contributions eaten up in charges.

Regulating charge structures can provide a significant degree of protection. Limiting fees to proportional charges (either on assets or contributions) means that there are no fixed charges, which bear disproportionately on the low-paid. Nevertheless, most countries provide a minimum pension guarantee, a universal flat-rate pension or social assistance incomes in retirement. People with persistently low earnings are unlikely to build up a funded pension above the minimum level.

A sensible solution is to exempt low paid workers from the requirement to contribute to a funded pension or to allow them to opt out. The United Kingdom, for example, will aim the new stakeholder schemes at people earning more than 55 percent of average earnings. Australia excludes workers on less than 15 percent of average pay, and has plans to allow people earning between 15 and 30 percent of the average to opt out.

An alternative approach is to cross-subsidize low-paid workers' accounts directly. The Mexican government ensures a contribution of at least 5.5 percent of the minimum wage. Coupled with a tax-credit system that boosts the incomes of low-paid workers, this encourages Mexicans into the formal sector. Together, these policies promote broader coverage of the pension system. A second advantage of direct subsidies is that they make the redistribution from higher-paid to lower-paid workers transparent.

6. Alternative institutional structures

The pension plans discussed above are mainly decentralized: people choose between a range of competing pension fund managers. An alternative approach is some sort of collective mechanism.

Australia's collectively provided industry funds, for example, charge just one third of the price of funds that single employers buy from financial-services companies. Australian experts have proposed that this intriguing gap reflects 'a difference in governance, historical ethos, institutional practices and industry structure.' Industry funds, with a captive membership, have no need for marketing or a sales network. And information, services and investment choice tend to be more limited in the industry funds than they are in the retail sector.

A step further is to move to a single, publicly managed fund. However, research has shown that public management has typically led to poor returns. Even with good management, the state as a

large shareholder raises corporate governance concerns that are very difficult to resolve.[10] Centralized record-keeping (as in Latvia and Sweden, for example) can, nevertheless, reduce costs.

Another institutional means of keeping costs low is to 'piggy-back' on existing structures. For example, employer pension plans in the United Kingdom have been able to contract out of the public, earnings-related scheme since it was introduced in the late 1970s. The United States already has a large, employer-based pension infrastructure, including 401(k)s. Costs might be lower if individual accounts were merged with these plans. Such a policy would, however, require careful attention to the regulation and supervision of these plans, particularly 401(k)s.

7. Restricting choice of funds

The main cost of strict regulation of charges is the reduction in pension members' choice. Low-cost regimes, such as the thrift savings plan (TSP) for federal employees in the United States, offer only a small range of funds, often indexed to avoid the extra cost of active management. (TSP charges are also low because the scheme only deals with one employer.) Bolivia offered no choice of fund initially and only a choice between two funds after a few years.

This restriction of choice has a cost. Pension members are unable to choose investments that suit their preferences. For example, older members might want to invest more conservatively than younger people, but both can be constrained by a 'one-size-fits-all' fund.

The counterpart to restricted choice is limits to competition, which might result in poorer service and performance than a deregulated, decentralized market.

8. Avoid excessive marketing costs

The Latin American pension reforms have been, to varying degrees, plagued by excessive marketing costs. Pension funds have competed fiercely to persuade people to switch between them. Given that the portfolios of the different funds were, until recently, highly uniform, there was little economic reason for this churning of members. More recent reformers have sought to avoid this problem. In Sweden, for example, the contribution to the new individual accounts is only 2.5 percent. There was therefore a risk that administrative expenses could eat up a substantial proportion of these contributions. Individuals can choose to invest there money in any mutual fund. But record-keeping is centralized (which might also cut costs) and fund managers do not know who their members are (so reducing the inventive for excessive marketing expenditure).

9. Promote consolidation

The potential for economies of scale in managing pension funds has important consequences for public policy on charges and industry structure. The evidence, unfortunately, is inconclusive. Figure 5 showed the very broad distribution of charges across providers in three countries with mandatory funded pension systems. Despite this variability, there is no relationship between fund size and charges.

Various studies have suggested anything from under 100,000 to 500,000 members as the minimum to achieve efficient scale. In mutual fund markets, which share many of the features of pension markets, some studies have suggested that the fall in costs with size comes to a halt once funds reach $0.5 billion. Others suggest this could be as high as $40 billion.

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[10] See Iglesias and Palacios (2000) and Palacios (2002).

Currently available evidence does not demonstrate that highly centralized approaches to managing funded pensions will significantly reduce costs. And the potential gains must be balanced against the cost of stifling competition, which in the medium term should act as a spur to innovation and cost control.

Conclusion

Governments should, at the very least, ensure clear and transparent disclosure of charges so that people can compare different companies' fees. A program of financial education that spells out the large impact charges have on pension values would also be useful. There is a good case also for regulation of the structure of charges, which can significantly ease comparisons between providers. However, imposing a ceiling on charge levels has the risk that limits are set at the wrong level, discouraging entry to the pensions market and reducing competition.

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