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Book reviews

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The Future for Investors: Why the Tried and the True Triumphs Over the Bold and the New. By Jeremy Siegel. Crown Business, 2005, ISBN 1-4000-8198-X, 308 pages, Price $27.50. doi:10.1017/S1474747205211897

I recommend that everyone interested in investing—either for fun or for profit—should read this book. Jeremy Siegel is a clear thinker, an expert economist, and a wonderful writer. The themes he develops in the book are important, and he presents them with clarity and a lively style. Coming from me, this is high praise, because I usually hate popular books about investing in the stock market. In general, I find them misleading or boring and often both. So let me explain why I think Siegel's latest is a good book.

Investment managers distinguish between two types of decisions: asset allocation and security selection. Asset allocation refers to the choice among broad classes of securities—stocks, bonds, bills; security selection refers to the composition of the portfolio within each class. This book is primarily about stock selection, although parts of the book relate to asset allocation as well. The book's main theme regarding stock selection is one familiar to finance professors and their students. The basic concept is that buying the shares of high growth companies does not necessarily produce high returns to investors *if the price of the company's stock already reflects a high expected rate of growth*. The only way the investment will beat the market is if *actual*growth *exceeds* prior expectations.

But Siegel's research findings have persuaded him that there is a general tendency for investors to overestimate the growth prospects of new firms that offer their shares for sale to the public. Siegel calls this the "growth trap." He sums it up in the book's subtitle, "*The Tried and the True Triumphs Over the Bold and the New*." Siegel states his thesis eloquently:

"..in their enthusiasm to embrace the new, investors invariably pay too high a price for a piece of the action and are doomed to suffer poor returns. The concept of growth is so avidly sought after that it lures investors into overpriced stocks in fast-changing and overly competitive industries, where the few big winners cannot begin to compensate for the myriad of losers."

Therefore investors should stick to shares of companies that have been in existence for quite a while and have relatively low P/E ratios. Siegel makes the case for this strategy most convincingly by contrasting conventional S&P 500 indexing to a portfolio of "tried and true" companies. Going back to 1957, he has studied all the companies that were in the S&P 500 in that year. He shows that if you had reinvested all your dividends and other cash distributions in the stocks of those same companies and their "descendants," you would have done significantly better than investing that money in the ever-changing S&P 500 portfolio. He then shows that a similar "growth trap" holds with respect to international investing. The countries with the best prospects for growth do not provide the best stock market returns. Again, the reason

is that investors tend to overpay for the stocks of those countries with the best growth prospects. It is not economic growth *per se* that produces high returns to stock market investors; rather, it is high growth compared to prior expectations of growth.

I wonder whether Jeremy Siegel plans to join those finance professors who have started investment funds to try to cash in on their research findings. For the most part, these funds invest in value stocks with relatively low P/E ratios and spurn growth stocks. Siegel's "tried and true" strategy is very similar. One can implement a version of Siegel's strategy at low cost by investing in Vanguard's Value Index Fund, which invests only in the low P/E stocks included in the S&P 500 and excludes the growth stocks.

The second major theme of the book relates to asset allocation rather than security selection. Siegel is bullish on the stock market. In his earlier book, *Stocks for the Long Run*, he focused on the past; in this book Siegel looks into the future and likes what he sees. He argues convincingly against the prophets of doom who think that future stock returns will be depressed by aging people liquidating their portfolios to finance their retirement. He forecasts an average real rate of return between 5.5 and 6% per year, which is about 1% lower than the historical average for the U.S. stock market.

I generally agree with Siegel's economic analysis, but estimating an expected rate of return on stocks, no matter how well it is done, is only part of the analysis needed to choose an asset allocation. Careful consideration must also be given to the risks of investing in stocks. For this, the analyst must consider several possible scenarios, including the doomsday scenario. Surely there is some possibility—no matter how small—that the doomsayers could turn out to be right. What is that probability? On this issue, Siegel is silent.

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Managing Pension and Retirement Plans—A Guide for Employers, Administrators, and Other Fiduciaries. By August J. Baker, Dennis E. Logue, and Jack S. Rader. Oxford University Press, 2005, ISBN 0-19-516590-X, 351 pages, Price $135. doi:10.1017/S1474747205221893

The book, written by three academics, is designed to provide a foundation for individuals who work for employers with company retirement plans, pension plan providers, or pension plan consultants. The authors do an excellent job covering the basics across retirement plan types and the book is well suited for people who have recently moved into positions of responsibility in this area. Yet the book is uneven: sometimes the authors cover topics at an altitude of 30,000 feet, while others are examined at a much lower altitude. As such, the volume leaves the reader seeking more explanation on some topics while skimming through other areas explored too deeply.

The authors begin with a good overview and discussion of the concept of a prudent fiduciary under both ERISA and non-ERISA plans. Of note, they show that the evolution of financial theory has changed the perception of riskiness under "prudent investor rule" standards: in other words, stocks were once considered too risky for retirement plans, yet now practitioners of modern portfolio theory might judge it imprudent to exclude stocks from the investment mix. Some plan sponsors staff their investment committees with individuals not expert in finance, and as a result many are too risk-averse to introduce investment innovations. To this point, the authors emphasize that "prudent expert behavior on the part of the fiduciary mandates that the fiduciary be up-to-date on mainstream innovations in the investment and financial theory" (p. 31). In their discussion of behavioral finance, the authors revisit this theme when they show that plan sponsors seek to shield themselves from fiduciary risks by creating overly complex decision-making processes, which then sometimes prevent them from

making decisions altogether. These same decision-averse plan sponsors may also try to shift ERISA-defined risk by hiring an unmanageable number of external money managers in an attempt to fall back on prudent person standards. As the book points out, a good way to prevent plan sponsors from falling into such behavioral traps is to create formal guidelines that force the committee to behave in a fashion that yields rational and informed outcomes.

The analysis offers several practical suggestions to help fiduciaries identify and satisfy their responsibilities, in the form of checklists. Yet the authors have a hard time explaining, identifying good uses for, and discussing implementation options for, complex strategies such as derivatives. In the same vein of practicality, the authors discuss cost management, which is useful since fiduciaries require a sense of a reasonable range of costs for different types of transactions. Yet little attention is paid to the cost of derivative transactions other than the existence of intermediary expenses. This same point applies to the general discussion of external manager and transaction costs – both areas of significant concern to fiduciaries. Numerical examples are also used inconsistently and, when applied, are sometimes difficult to follow because they are embedded in poor textual explanations instead of leveraging the power of visuals such as charts. In addition, terms are sometimes introduced without an explanation, including "futures swap contract(s)" (p. 230) and "surplus duration" (p. 228), and some equations suffer from typographical errors.

This inconsistency persists in the discussion of investment topics. The chapter on the asset allocation decision is too basic for most readers, though the book does a good job introducing the active-versus-passive decision and the difference between strategic and tactical asset allocation using overlay strategies. The author's discussion of investment monitoring and their focus on managing risk is well-positioned, but they go into too much detail on risk attribution measures (e.g. Sharpe, Jensen's Alpha, Treynor's measure and the Information Ratio) without offering easily-understood numerical examples which could enhance clarity enormously.

To some extent the book's focus seems more directed to the management of defined benefit (DB) plans than defined contribution (DC) plans, despite the decreasing presence of the former and the increasing popularity of the latter. With that said, some of the insights related to DB plans are valuable, especially as they pertain to the symbiotic relationship between a plan sponsor's fiduciary obligations and the impact of the plan on the company's financials and overall health. Readers with a DB interest will find a wealth of information on managing asset-liability basis risk, and the authors do raise awareness regarding the use of futures, options, and/or swaps to mitigate DB plan risk (despite the confusing section on derivatives). But the argument is at times confusing, leading readers to believe that corporate plan sponsors are effective at striking the right balance between their fiduciary obligations as plan sponsors and as financial stewards of their companies. At least some evidence suggests that some financial executives have attempted to use the pension plan to enhance short-term corporate results and, sometimes, their compensation. The authors also do a commendable job enumerating the various non-investment risks related to DB plan management, but at times, they fall short of recommending practical solutions to minimize those risks (for example, they discuss Sharpe's risk budgeting approach but are unclear on how a plan sponsor would implement it).

This discussion is linked to some of the deficiencies in the current pension system on a macro level. For example, ERISA-based DB plans are characterized as owning a synthetic put option, as they may be able to default on plan obligations by transferring the plan to the Pension Benefit Guaranty Corporation. Corporations understand that this default process is not easy to execute, but it is a viable exit strategy if they are no longer willing to incur the expense of maintaining their DB plans. The authors highlight that practitioners also need to understand that the existence of this in-the-money put creates incentive for underfunded plans to take on excessive investment risk in an attempt to reduce funding requirements.

Turning to the DC plan discussion, the book makes the valid point that it is more tax-efficient to allocate fixed income securities to DC plans and equities to taxable accounts, and this point, while not new, is often lost on plan sponsors and participants. Furthermore,

the evidence suggests that the high allocation of employer stock to many DC plans has not influenced employee to align their behavior more directly with executives and other shareholders. And it is hard to argue with the authors that plan design has a significant impact on participant participation and investing behavior, and plans should be constructed to help participants protect themselves from the tendency to avoid or make sub-optimal decisions. The authors point out that participants tend to take the "path of least resistance" making the case for more automated solutions such as automatic enrollment, automatic increases in payroll deductions when raises are provided, etc.

As might be expected from a book written by academics, readers will derive the most value if their desire is to learn about the central issues related to managing pension plans effectively and efficiently. This volume is also well suited to readers such as consultants, plan administrators, and benefits personnel, who need a strong appreciation for the nuances, risks, and most recent investment trends related to DB and DC plans. An introductory class on pension management might find this to be an extremely useful textbook, particularly if it targeted individuals wanting to learn to manage or service pension plans. The reader will come away with an appreciation for mistakes many plan sponsors make and reasonable ways to avoid them. Given the litigious society we cohabitate, avoiding mistakes is the key to sound risk management.

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Pension Reform in Eastern Europe: Experiences and Perspectives, International Federation of Pension Fund Administrators, (FIAP), 2004, ISBN 956-7265-29-1, 242 pages, Price $15.00. doi:10.1017/S147474720523189X

This volume is a collected set of works presented at the 2004 International Seminar on Pension Reform in Eastern Europe held in Kyiv, Ukraine, a seminar which attracted include pension regulators and experts from Central and Eastern European, and Latin American countries inaugurating pension reforms with mandatory, funded second pillars. Given that perspective, the book's findings are particularly interesting for Anglo-Saxon audiences, as they reflect the views of regional pension authorities rather than those of "international" experts. International interests are represented, nevertheless, with contributors from the World Bank and the OECD working in the regions.

The proceedings can be divided in two complementary parts. The first consists of sections devoted to the pension reforms of six transition countries, plus an overview chapter. The countries are Croatia, Bulgaria, Hungary, Poland, Kazakhstan and Kosovo, where a wide variety of multi-pillar old-age system reforms have been implemented. In addition, reforms scheduled for 2005 for the Slovak Republic and Macedonia are discussed. The second part of the proceedings address topics of interest to pension reformers and administrators, including supervision and regulation, implicit and explicit pension debt, and questions related to the political economy of reform.

The proceedings, published soon after presentation at the conference, would have benefited from substantial text editing; not every submission is up to English-language publication standards. Nonetheless the volume provides much useful information about reforms taking place in the majority of countries instituting mandatory funded schemes in Central and Eastern Europe. Only Estonia, Romania, and Russia are omitted. By having this information all in one place, the work constitutes a valuable reference volume, documenting the structure of the reforms and perceived problems in implementation.

The more general discussions deal with issues related to fund administration, to some extent from a Latin American perspective, including portfolio allocation (prudential regulation or

quantitative limits), rates of return on investments, and the impact of commissions and other operational costs on future pensioners and fund management. In addition, the heavy allocation of pension assets to government bonds in Latin American pension funds is highlighted. Some of this material is old hat, however, such as criticisms of the IMF with regard to its adherence to rules on the primary fiscal deficit, and explanations of the difference between implicit and explicit pension debt, an issue reformers ought to have mastered well in advance of the reform.

One of the most interesting presentations highlights the lack of knowledge by participants in Chile about their own pensions, despite the fact that information is systematically sent out to contributors. Among those members who read their statements, over half say they do not understand them. A lack of attention to certain other issues, however, continues to be a hallmark of many discussions of mandatory pension reform around the world. For example, only the presenter of the Polish reform addresses the basic role of pensions in society—old-age income security—by suggesting that voluntary 'third-pillar' measures need to be developed further if retirees are to achieve a target replacement rate of 60 percent. A target replacement rate is mentioned for Macedonia, as well, but one that appears to be quite optimistic.

Coverage is another issue that is honored mainly in the breech. One presenter reiterates the myth that Latin American systems have "a mandate that involves the whole population," although it is well known that coverage is far from universal even in Chile, as the informal economy encompasses a significant share of employment. Another commenter, however, redresses the balance by indicating that a "first challenge is that of extending coverage" which is "a consequence of the characteristics of the labor markets themselves."

Several contributions discuss political economy aspects of multi-pillar systems, as in the case of the Slovak Republic. Here the contributor suggests that it was fortuitous that the reform was implemented quickly as the "strongly reform-oriented government [which instituted the reform, now] has a minority in the Parliament." The lack of reform mindedness in Slovenia and the Czech Republic is also mentioned and attributed to the fact that "the people liked the present system." Only once is the high degree of controversy surrounding funded pension systems mentioned, but it hit home with the comment that "it is surprising to see how the friends of the reform suddenly change sides and criticize it. So dealing with enemies is a very, very important aspect."

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Social Security Programs and Retirement around the World: Micro-Estimation. Edited by Jonathan Gruber and David A. Wise. Chicago: University of Chicago Press, 2004 ISBN 0-226-31018-3, 752 pages, Price $99.00. doi:10.1017/S1474747205241896

Public pension schemes provide massive incentives to retire before the statutory retirement age in most industrialized countries. This now-undisputed fact lies at the center of two impressive volumes edited by renowned experts Jonathan Gruber and David Wise. Both volumes contain detailed analysis for a number of countries, as well as an introductory chapter by the editors summarizing common methodology and key findings. The message of the first volume, which appeared in 1999, was that incentives created by public pension schemes have greatly contributed to the decline in the labor force participation of older persons. Unused productivity capacity between ages 55 and 65 is strongly related to the tax force implied by the social security system. And the departure from the labor force corresponds very closely to the age at which some form of benefits becomes available.

Using these findings as a starting point, the present (second) volume examines work incentives in more detail at the *individual* level, using longitudinal micro data for each of the countries analyzed. There are two advantages of having individual data. First, additional incentive measures can be constructed to assess the impact of returns to work over a longer term than the increment in social security wealth (SSW). This turns out to be important, as the estimated impact of SSW is often not statistically different from zero at the individual level since it only captures the impact of one additional year at work. A new measure offered here, called the "peak value," corresponds to the age at which the largest discounted value of pension benefits can be expected. Taking into account that additional time at work also leads to labor income, a second, more complex long-term incentive measure, the "option value," is also derived. In its simplified version, it is equal to the difference between the present value of future wage income to the optimal retirement age, minus the peak value. A second advantage of individual-level analysis is that the microdata permits controls for other determinants of the retirement decisions. This, however, may also create some identification problems as some aspect of the retirement decision are contained in the incentive measures as well as in the controls.

The use of individual data also allows for interesting policy experiments for which regression results are used to simulate the response to two common reforms. One simulated reform delays the pension eligibility by three years, while the second imposes a similar pension scheme across all the countries studied. The methodology, as well as interpretation issues and a cross-country comparison of results, are nicely outlined in the introduction. This chapter is extremely helpful, as the country chapters are somewhat tedious to read due to literally dozens of graphs, and data-induced variations in the computation of incentive measures. (To mention a small critique here: a naming convention for variables used across all the empirical studies would have been extremely helpful.)

The findings of the micro estimations are impressive, though not really surprising given the result of the first volume. Yet the use of individual data allows the authors to quantify the impact of incentives, and to demonstrate that they are statistically significant and huge. It is shown that peak value and option value perform significantly better than SSW. Although there are differences in magnitudes across countries, the results consistently show that retirement decisions are largely caused by the incentives provided by the scheme.

I would have liked more information and discussion on three points. First, there remains an unsolved puzzle, acknowledged by the editors: why do people often retire at the earliest possible date? Exit rates from the labor market are very small before some form of benefit is available, and high after that. Potential explanations for the phenomenon include liquidity constraints (or perhaps, equally likely, an unwillingness to run down accumulated assets), social norms (which might have changed in the last decades), and perhaps a customary retirement effect. It could well be that an increase in the eligibility age would distort individual life-cycle plans and, as a consequence, reduce welfare, regardless of the policy's positive impact on the labor force participation of elderly workers.

Second, there is too little discussion about multiple pathways into retirement, although alternative exit routes have become much more important (as the German example convincingly illustrates) and constitute one of the main obstacles for successful pension reforms in Europe. I am therefore skeptical that the first simulated policy reform (an increase in the eligibility age) delivers meaningful results. Perhaps the eligibility age for retirement benefits might be easily increased, but it may not be possible to do so for other programs such as disability and unemployment benefits. And an increase in the statutory retirement age will increase, rather than decrease, take-up rates for these supplementary forms of income support.

Third, the book makes too little use of variations in income, wealth, and income-specific aspects of the pension schemes. This is a bit disappointing, given that the second policy simulation imposes an across-the-board replacement ratio of 60 % (although it is not entirely clear whether this applies to all income groups), and thus potentially involves *increasing* the

replacement rate for high-income earners and reducing it for low-income people. It would have been very interesting to see the impact of this simulation by socio-economic group.

Differential responses to changes in retirement incentives across income groups may have important policy implications. What seems to emerge from the country regressions is that a higher (lifetime) income raises the retirement age (probably by a lower disutility of work), while higher pension benefits reduce it. These two income concepts are related, however, since a higher lifetime income often implies a higher pension income. A shift to a more funded system, as discussed in many countries, typically increases the replacement rate of high income earners relative to that of lower income individuals – with the possible exception of very low income individual if they are sheltered by minimum pension guarantees. As a consequence, such a policy could have a detrimental effect on the labor force participation of the better qualified workers (as is observed, for example, in Switzerland). It is doubtful that such an outcome would be in the countries' best interests.

Despite these criticisms, the book is extremely informative and useful. It provides researchers with ideas for further work, and policymakers with a wealth of facts as well as information on how planned social security reforms may change retirement patterns.

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The Economic Impacts of Population Ageing in Japan, by Landis MacKellar, Tatiana Ermolieva, David Horlacher, and Leslie Mayhew. Edward Elgar, 2004, ISBN 1-84376-360-5, 256 pages, Price $114.00 doi:10.1017/S1474747205251892

Low fertility, population aging, and population shrinkage are not issues for the future in Japan; instead, they are topics of current concern. The latest statistics show that the Japanese total fertility rate (TFR) is now 1.29 (2003), population growth has fallen to 0.05% per year (2004), the ratio of population age 65+ to total population is now 19.5% (2004), and the male population increment is negative, at −0.01% per annum (2004). Though the Japanese government has adopted pro-family policies including the "Angel Plan", the "New Angel Plan", the "Law for Measures to Support the Development of the Next Generation", and so forth over the last few decades, but so far these have not met with remarkable success.

Since low fertility and population aging are recognized as challenges for economic vitality, the Economic and Social Research Institute of the Japanese Cabinet Office (ESRI) initiated a project to explore "Sustainable Economic and Social Structures in the Twenty-first Century". One report from this project is the current volume, prepared by the International Institute for Applied Systems Analysis (IIASA), an inter-disciplinary research organization from Austria. Its goal was to undertake a comprehensive study on the likely economic impact of population aging in Japan, using a quantitative economic and demographic simulation model to evaluate how population ageing will affect the macroeconomy. Furthermore, ageing also affects consumption and saving patterns, investment on a macro level, and costs of pension, health programs, and long-term care.

The volume's first two chapters include a valuable and comprehensive review on the economics of population aging, both in general, and in Japan, in particular. If we define "population aging" as a declining support ratio (the ratio of population age 15–59 divided by those age 60+), most OECD countries and especially Japan already are experiencing this phenomenon. In turn, this implies a shrinking labor force, which is exacerbated by productivity declines with age. Yet labor force aging is not a simple phenomenon, since new technology might boost productivity for older workers. As a result, aging does not have a clear-cut impact on labor output. In Japan, increasing life expectancy also affects demographic change, along

with labor force participation rates. At present, no one knows whether and how much labor market participation will rise for Japanese women and older people.

The next two chapters provide a useful analysis of the impact on the economy of population aging in Japan, using the quantitative economic and demographic simulation model. The model offers a long-term picture of what will happen if total population declined by 10%, on the one hand, versus if total population were unchanged but the share of old-aged people increased. Each would affect per capita economic growth rates, reduce the national saving rate, exert downward pressure on capital productivity, boost contributions required for pensions, and curtail net foreign assets. Focusing on a 55-year period from 1995 to 2050, the authors explore a baseline scenario and two alternative scenarios, one with lower-than-expected fertility and another with greater-than-expected longevity. Reforms of pension, health, and long-term care programs are discussed and simulated. The analysis suggests that the model's results appear robust to alternative assumptions.

It is of interest to note that the volume offers an optimistic conclusion, despite the fact that Japan will face a slowdown of economic growth and declining saving rates. This is because, using their model, the authors predict that disposable income of both the young and old will rise, and intergenerational distribution of income will be relatively stable in the long term. In other words, the conclusion should be seen as good news for Japan, since the impact of population aging has generally been thought to be pessimistic. For example, the Ministry of Trade and Industry (METI) has estimated that if the contribution rate to the national Employee Pension Insurance program is raised from its initial rate of 13.58% to 20%, employers' burdens will rise by about 10 trillion yen and unemployment rate will increase by 1.3% (about 1 million people will lose jobs). METI has also noted that boosting pension contributions will reduce international competitiveness and personal consumption. Indeed, the Ministry of Finance has suggested that social security expenditures must be cut by about 10 trillion yen, if primary budget balance is to be achieved within a decade.

Not only is this an optimistic message for Japan, but it is also an important and positive message for other nations as well. People welcoming this good news should carefully read this book to review why it arrives at such a result, while those with a more pessimistic view of the future should also read the book to see where their assumptions are in question. One shortcoming of the volume is the extreme model detail provided in the Annexes, which will be difficult for nonspecialists to understand.

In sum, this book should serve to guide future discussion about the relationship between population aging and its economic effects in Japan. Furthermore, the modeling should be extended to include other industrialized countries to ensure international comparability.

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Pension Security in the 21st Century: Redrawing the Public-Private Debate, Ed. Gordon L. Clark and Noel Whiteside, Oxford University Press, 2004, ISBN 0-19-926176-8, 308 pages, Price $84.50. doi:10.1017/S1474747205261899

This book is a welcome addition to the literature on old age security, focusing on systems and reforms in a variety of OECD countries. Each chapter surveys the history and political economy of social security in a particular country, written by a scholar from that country; systems covered include the UK, Netherlands, Sweden, France, Germany and the US. The finding emerges that most of these countries have been moving toward pre-funding, defined contribution pensions with private fund management. Yet this process occurred at very different rates, with different forms of private management, and with different politics. In the UK, for instance, employers may opt out of the state-provided plan into their own plans, and employees may opt out of both into personal schemes. By contrast, the Netherlands made funded employer-sponsored schemes virtually mandatory, while Germany recently gave workers the

option to put 4% of their earnings into funded retirement accounts with tax exemption. Sweden now has a mandatory notional (largely pay-as-you-go) plan and a much smaller funded private DC plan. By contrast, France has not made such schemes mandatory, but the authors argue that private voluntary saving has increased as a result, due to widespread misgiving about whether the state will be able to continue providing generous retirement income. In the US, funded employer-sponsored schemes are common, increasingly of the DC variety, and a mandatory funded DC component in Social Security has been proposed though not yet adopted.

This collection also emphasizes other important policy choices in the pension reform process, between higher benefits versus earlier retirement, price versus wage indexation, and universal versus targeted public benefits. The Dutch system, despite its high degree of pre-funding, remains vulnerable to population aging because of the generosity of its pensions (especially the wage-indexed flat benefit). The political consensus has been to try to sustain a high benefit level by taking steps to increase employment and decrease early retirement. In the UK, costs are lower and the system is less demographically vulnerable, mainly because of its lower basic benefit which is price – rather than wage – indexed. To keep retirees above the poverty line, this is substantially supplemented by means-tested benefits that are targeted at low earners. Politically, these are controversial choices.

One problem with the volume is that some chapters seem dated. This may be inevitable given long publishing lags, it poses a problem for a book that seeks to illuminate a rapidly changing field. For example, the chapter on the US makes many references to the 1994–96 Presidential Commission on Social Security, rather than the 2001 Presidential Commission. Further, unlike other chapters, that one offers the contributor's own normative analysis of the pros and cons of various potential reforms, rather than a positive historical-political analysis of the development of the current system. Another shortcoming is the lack of chapters on reforms in Eastern and Central Europe, where debate about social security reform has raged in the past decade, and where many nations have radically changed their systems. Some attention to the radical reforms in Eastern Europe would have counterweighted the picture of the Western European gradualist approach. Further, there is no discussion of Latin American countries making major structural changes over the past decade.

Another shortcoming of this book is that it misses an opportunity to address key cross-cutting questions. For instance, it would have been useful to explore why these differences emerge, in public-private shares, pre-funding, and system generosity. Analysts and reformers would benefit from a discussion of how much path-dependence is involved, through what mechanisms does it operate, and how change evolves, despite path dependence. Further, a critical reader would want to know what the consequences of these changes are for old-age income adequacy, poverty, financial markets, and incentives to work and save. While I expected such themes to be addressed in the concluding chapter, they were not. Instead, the final chapter contains some puzzling generalizations, such as the statement that "until recently, employer-sponsored pension schemes were of limited significance in continental Europe." This overlooks strong employer-sponsored plans in the Netherlands, Switzerland, Sweden and France, including some discussed in earlier chapters. Moreover, though the book mentions supplementary employer-sponsored pensions and financial market risk, it does not pull these together in analyzing who should bear these risks – government, workers, or employers – nor does it address the relative costs, incentives, and credibility of these different risk-bearing arrangements. Ultimately, it would also have been useful to explore how these answers are influenced by globally competitive product, labor, and financial markets.

In summary, this volume offers insights into the politics and, to a less consistent extent, the economics, of current issues regarding old age security in Western Europe and North America. The individual chapters are useful, but the whole is not greater than the sum of the parts.

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Pension Reforms: Results and Challenges. 2003, International Federation of Pension Fund Administrators 498p. Santiago de Chile: Corporación de Investigación, Estudio y Desarrollo de la Seguridad Social, ISBN: 956-7265-25-9, pp. 498, Price $15.00. doi:10.1017/S1474747205271895

Latin America has been a world pioneer in structural pension reforms involving a shift from public systems (defined benefit, pay-as-you-go, public administration) into private systems (defined contribution, fully-funded, private administration). Chile implemented the reform in 1981, followed by Peru (1993), Argentina and Colombia (1994), Uruguay (1996), Bolivia and Mexico (1997), El Salvador (1998), Costa Rica (2001), and Dominican Republic (2003). Reform laws passed in Nicaragua and Ecuador (2000 and 2001) have not yet been implemented due to unsustainable transitional fiscal costs and a pending unconstitutionality appeal.

The long and varied experience of the region has prompted numerous studies assessing the reform outcomes. The present book includes a dozen papers and several commentaries presented at a 2003 conference organized by the International Federation of Pension Fund Administrators (FIAP). This entity, including representatives from 22 nations across Latin America and Eastern Europe, has as its aim "to propagate, promote, defend, publicize and facilitate in any way the development" of private pension systems. The book describes and evaluates results of both Latin American and Eastern European reforms; examines the macroeconomic and deficit impacts of the Chilean reform; explores the impact of prefunding on capital markets and the impact of investment regulation; offers the perspective of pension industry and regulators on what has been achieved and what still remains to be done; and outlines political risks and threats faced by the system.

It is not surprising, given the sponsorship by the FIAP and the relationship of half of the authors with the pension fund industry, that the book takes an overwhelmingly positive view of the reform and its outcomes. Further, the chapters are of uneven quality and overlap on several themes. The book emphasizes economic and financial aspects of the reforms, pension fund investments, and regulation. Little or no attention is given to social aspects such as coverage of the labor force, equity, solidarity, and impact on gender. Political threats to the system receive short shrift, despite Argentina's recent catastrophe.

In the introduction, Robert Palacios describes and analyzes reforms in ten Latin American countries, and he evaluates their performance in coverage, costs, capital accumulation, rate of return, etc. Although Palacios finds mostly positive effects, he concludes that only Chile has consolidated its reform and taken advantage of its ancillary benefits on the economy, while the other nine reforms are not consolidated. Furthermore he points to problems in Argentina, Bolivia and El Salvador which suggest that their systems are not well protected from politics.

The macroeconomic effects of the Chilean pension reform are evaluated by Vittorio Corbo and Klaus Schmidt-Hebbel, who conclude that these have been significantly positive. The authors estimate that domestic saving increased at an average annual rate of 2.3% of GDP over the period 1981–2001; included in such calculations are the fiscal costs of the operational deficit of the closed public system and the state-guaranteed minimum pension, but the authors exclude the value of contributions paid to the public system by insured who moved to the private system, and the cost of social welfare pensions. This is important since other scholars who include those fiscal costs find that the reform had a negative effect on domestic saving. A chapter by Luis F. Alarcón further evaluates fiscal deficits generated by reforms, and concludes that in the Colombian case, "exaggerated privileges" were maintained in the public systems which drove up costs. However, intial projections of transition costs in Argentina, Bolivia, Chile and El Salvador prior to the reforms were also considerably lower than realized costs.

Capital market impacts of reform are taken up by Jorge Roldós, who points out that in Latin America, pension funds have accumulated huge asset pools (worth 64% of GDP in Chile, 10–21% in five other countries). The concern is that these capital markets are small and

regulations have required a significant share of investment to be held in state securities rather than in the stock market. Roldós concludes this "may cause considerable distortions in share prices and risk concentrations" (p. 414). Several authors suggest, as a potential solution, the option of investing in foreign instruments; on the other hand this has been banned in five countries and faces strong political opposition in others.

Another problem taken up is the fact that the insured often suffer from inadequate information and knowledge of the system. Alejandro Ferreiro, Superintendent of the Chilean pension system, affirms that "the system lacks roots in society" (p. 454), as a 2003 survey shows: 44% of the insured didn't know how much they have saved in their individual accounts, and 96% ignored how much providers charged for managing such accounts. These are shocking figures given that the reform has been in place for over twenty years.

This book devotes only perfunctory attention to the grave problem of low pension coverage of the labor force. Palacios points out that less than one-third of the working age population is covered in eight countries (and only 34% in Chile); these low levels he blames on the existence of the large uncovered informal sector. In turn, Mario Budebo, president of Mexico's pension supervisory agency, reports that 23 million people in his country are excluded from pension coverage, but he anticipates that voluntary affiliation by the self-employed, mostly informal, workforce will help. Since he believes that coverage problems are not specific to private systems but rather endemic to labor markets, he further suggests that self-employed workers should be obliged to contribute to the system (only 5% are currently insured in Mexico), a view echoed by the President of FIAP, Guillermo Arthur. While it is clear that the informal sector has expanded over time, from 42% to 47% over the decade of the 1990s, aspects of the pension reform have also been important causes, in my view, including higher worker contributions, and high administrative costs paid by the insured. Moreover, I suspect that mandating affiliation by the self-employed will not boost coverage of this group, without other policies.

In summary, this is an interesting book with some important studies which should be read by experts on pensions and social security. Yet readers must be aware of the book's lack of balance.

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Reforming Pensions in Europe: Evolution of Pension Financing and Sources of Retirement Income. Gerard Hughes and Jim Stewart, eds. Edward Elgar, 2004, ISBN 1843765225, 336 pages, Price $100.00. doi:10.1017/S1474747205281891

This volume has the ambitious goal of describing recent pension reforms in Europe and analyzes their consequences for different actors in the systems now and in the future. While it offers interesting data and commentary, it ultimately falls short. This is because to understand the effect of reforms, one must begin with a clear statement of the counterfactual – what would have happened in the absence of reforms, and how the reforms changed what happened.

In Europe, the core of most traditional social security systems has long been the pay-as-you-go (PAYGO) defined benefit (DB) plan, where current payroll contributions finance retiree benefits which depend on a formula based on years of work and earnings; the plan objective is to redistribute income. Under the DC approach, by contrast, contributions are held in workers' accounts and benefits are determined by contributions plus investment earnings which accumulate over the participants' lifetimes.

Increases in life expectancy and declines in fertility have imposed financial strains on these systems, to the point where the original benefit promises cannot be honored. As a result, to keep the systems in operation, contribution rates have had to be raised and benefit formulas reduced. Further, many countries have gradually curtailed the role of their DB plans in favor

of a DC plan, so as to relieve governments of some of their future financial obligations. Yet the formulas, as well as the reforms adopted, differ dramatically from one country to another. Different weights have been placed on years of service and retirement ages, life expectancies in retirement, market returns, benefit formulas, whether benefits are payable to survivors, indexation clauses applied to contributions and/or benefits, household composition. Pension reforms have changed contribution rates, the relative importance of the DB and DC pillars, life expectancy indexes, and other key parameters.

The country experiences reviewed in this book include Germany, the UK, Poland, Hungary, Sweden, France, and Italy. Not all systems are at the same point in their evolution, so adjustment efforts have differed. For example, Hiebrook shows that Germany recently permitted employees to redirect part of their payroll taxes to a private account. Ward, in a chapter on the UK, notes that workers already had this option; indeed by the late 1990s, 40% of pensions were provided by private pension schemes. Pizzuti, writing on Italy, shows how the nation implemented two reforms in the 1990s which changed the program from a DB to a defined contribution (DC) scheme. In Sweden, as Granqvist and Stahlberg show, the social insurance pension changed from a traditional DB to a notional DC while tax incentives were introduced to encourage private pension provision. In Poland and Hungary, as Fultz notes, notional DCs were adopted in the late 1990s though Hungary delayed implementation for a decade.

To evaluate a pension reform process, it is critical that researchers examine the effects of changing specific pension parameters. Unfortunately, only one of 12 chapters in this volume attempts to do so in a systematic way, and even here, there is no attempt to identify separately the impact of the various reform components adopted. Thus Viebrook shows that the 2001 German pension reform act introduced a change in the pension formula and further allowed employees to redirect up to 4 percent of pay to the statutory pension contribution ceiling to a private DC account. A subsequent change in 2002 added a subsidy for DC contributors as long as these DC contracts satisfied certain rules (including continuous contributions and the payout of benefits after age 60). To simulate the impact effect of the new rules, the author used "typical working careers," which assumed that individuals redirected to a private account exactly the minimum amount to qualify for the subsidy. He further specified that the effect of the reform was a function of the worker's age at the time of reform. The simulation results indicate that older individuals could anticipate losing from the reform, while younger individuals would gain. This result is interesting, since it contradicts the notion that the German reform gives all workers an attractive option.

My concern with much of this analysis is that researchers are seeking to assess reforms which have changed many pension parameters at once. Perhaps a clearer way to assess the impact of a pension reform could use "typical" career earnings paths, holding constant overall contributions. Then the microeconomic effects of reform on individual benefits per euro of contributions would flow from three factors: changes in the old DB plan parameters; changes in the relative importance of the DB and DC plans; and an assessment of the internal rate of return associated with the DC plan. Of course, there is also the problem that reforms might make the system more or less sustainable, influencing the chances that a pension promise can actually be met. Conversely, if the pre-reform system is clearly unsustainable, it is unreasonable to estimate future benefits based on the pre-reform DB formula, since those benefits are not payable. In this sense, estimates of pre-reform system benefits based on pre-reform formulas are useful to gauge relative benefits, but they will overvalue benefits that would be paid absent reform.

In my view, this book offers a first step in explaining European pension reforms, but difficult methodological challenges require that more work must be done. Experts should be aware that reforms need not be bad news for pension participants; rather, in the absence of reforms, their situation would arguably be worse. Further, most reforms have taken place too recently to provide analysts with a clear picture of behavioral responses to these pension changes.

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Perspectives on the Economics of Aging. David A. Wise, ed. Chicago. The University of Chicago Press, 2004, ISBN 0226903052, 392 pages, Price $75.00. doi:10.1017/S1474747205291898

Ninth in the Economics of Aging series at the National Bureau of Economic Research (NBER), this volume includes chapters by respected researchers in the aging field. One topic on which the book focuses is the long-term shift in how Americans save for retirement. Retirement saving today often takes place in defined contribution (DC) plans managed and controlled by individuals, rather than in employer-controlled defined benefit pension (DB) plans. Poterba and co-authors trace the growth of private retirement assets from the mid-1970s to the end of the 1990s, during which time retirement assets grew five-fold relative to wage and salary income due to increases in individual contributions. People saved about twice as much per active participant in 401(k) plans than in DB plans, partly due to favorable returns on those assets in the 1990s. The authors dismiss the contention that the growth of 401(k) type assets substituted and crowded out DB assets, though that merits further exploration in future research. Additional analysis of DC plans is offered by Choi and co-authors, who examine how retirement plan features influence plan participation. They show that automatic enrollment provisions of 401(k) plans have a profound impact on participation and asset allocation choices. Because most new participants save at "default" contribution rates and invest in the default fund chosen by the employer, employer decisions about plan features may have long-term implications for individual retirement savings. Nonetheless, it is difficult to know whether these results can be generalized, since they rely on only three firms over only four years.

The book also explores wealth accumulation, bequests, and housing equity. Brown and Weisbrenner evaluate the role of bequests in wealth accumulation and they conclude that they account for about one-quarter of aggregate transfer wealth; not surprisingly, the share is substantially larger for lower-wealth households. Housing wealth is re-assessed by Venti and Wise who reaffirm their earlier conclusions that housing equity makes up a large fraction of the assets of elderly Americans but it is seldom used to finance non-housing consumption. Instead, they argue that housing equity is treated as saving for "a rainy day", liquidated in an emergency following the death of a spouse or admission to a nursing home. Banks and co-authors offer a comparative look at the wealth portfolios in the US and the UK using an innovative modeling framework. Compared to US households the British hold a much smaller proportion of their wealth in financial assets and a much larger fraction in housing equity. Much of this cross-country difference can be traced to rental market inefficiencies and higher housing price volatility in the UK, which steer young adults to home ownership earlier than in the US.

The other six chapters examine a diverse set of topics including health, wealth, income inequality, medical care utilization, and mortality. Readers unfamiliar with US and UK mortality trends during the 20th century will find the work of Cutler and Meara, and Deaton and Paxson, of particular interest. The former chapter describes US mortality declines by age and cause of death: explanations for the decline in the first half of the 20th emphasize nutritional improvements and public health measures, while developments in personal health practices and medical technologies drove changes in the second half. Cohort mortality trends post 1950 in the US and the UK are linked to changes in income and income inequality by Deaton and Paxson, in an extension of their prior work. Here they find that income growth and income inequality do not explain mortality decline at the national level, in contrast with their previous US findings. Instead, they suggest that new medical technologies, and particularly improvements in the treatment of heart disease, played a major role in mortality declines.

While little association has been found between income and mortality at the national level, many studies have used individual-level data to show an inverse association between income and mortality. Whether this relationship is causal, with the direction running from income and wealth to health, or health to income and wealth, is subject to active debate. A chapter by Case exploits data from the South African old-age pension system to compare the health status of persons living in households with and without pensioners; her results indicate that higher

income improves the health of all household members when they pool their incomes, but in non-pooling households, only pensioners are in better health. She therefore finds a causal effect of income on health and also points to the need to take a closer look at household decision-making and its implications for the health of older individuals. The volume also includes a previously published article by Adams and co-authors with a description of updated data and analyses, and the authors' response to comments regarding this mostly methodological paper. Two other chapters on health and mortality include Jensen's account of the link between health and socioeconomic status (SES), and the association between SES and nutrition in Russia; a paper by Fuchs and co-authors explores differences in US medical care utilization and mortality among the elderly.

This compendium will interest researchers and policymakers engaged in the debate over the future of Social Security and the tax code in the US, as well as analysts interested in the links between health and SES. Distributional consequences of personal retirement accounts and the implications of changes in the financing of retirement savings for low income workers would merit further exploration. The material is accessible to specialists and non-specialists alike, and it is recommended to graduate students working on aging themes. The comparative work is particularly useful, as it has potential for shedding new light on issues of key concern in Europe.

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Pension Fund Management: Governance, Accountability and Investment Policy. Alberto R. Musalem and Robert J. Palacios, eds. The World Bank, 2004, ISBN 0-8213-5998-3, 287 pages, Price $30.00. doi:10.1017/S1474747205301892

As a former member of the World Bank's Treasury responsible for managing its pension fund, and as one diametrically opposed to the World Bank approach to pension reform during the 1990s, it is gratifying to see that that the Bank is now refocusing attention on learning from best global pension practices. This book, a compendium of views from industry experts, is a treasure trove of information for reformers, researchers, and practitioners of pension fund management. It is a must-read for anyone seeking to be informed about how to manage assets effectively through good governance, accountability, and investment policy.

In the 1990s, the World Bank sought to encourage developing countries to reform their faltering pay-as-you-go (PAYGO) defined benefit (DB) systems by converting them into a 3-pillar system. The three pillars usually involved a small PAYGO DB plan; a mandatory defined contribution (DC) plan invested with private managers; and a voluntary DC pillar. This structure, often identified with "pension privatization" and the closing of public Social Security agencies, appealed to many market-oriented fans who perceived that PAYGO systems suffered shortcomings which included wastefulness and fraud. It was often argued that giving workers the right to decide how to invest their retirement reserves was sure to be a great improvement over the old approach to pensions.

When the 21st century brought a changing of the World Bank guard, with it came the realization that the real problem was not DB systems, *per se*, but rather how retirement system money had been managed. This book's introduction lays out the challenge: "[o]ne approach to pre-funding is to license private asset managers, under close supervision, to manage individual accounts that are fully funded and subject to at least limited competition. The more common approach, however, remains the public management of reserves, guided by the imperative of smoothing out the democratic effects of a population aging" (xxiv).

Instead of insisting that governments inevitably were poor managers of public retirement assets, the new message is that "new governance designs and investment policy can shield public pension funds from the kind of political interference that has plagued them in the past" (xxv).

One reason public pension money has often been mismanaged has to do with principal-agent problems. For instance, pension trustees may be considered agents of the government, but when they oversee staffer to implement portfolio investment decisions, they become principals and the staff act as their agents. In turn, staffers hire and supervise external managers, in which case they become principals and the external managers the agents. As a result, good governance, transparency, and accounting become crucial for successful pension management. This point is made concrete with illustrations from a range of successful public plans in Canada, Ireland, Norway, and New Zealand, while challenges are identified for Poland, Singapore, India, and Kenya.

Strong system design and insulation from political influence prove to be key. Design elements include knowledgeable trustees, clarity of mission, and a visible, accountable chief investment officer (CIO), as in Canada and Ireland, and in New Zealand where trustee selection is not politically influenced (New Zealand even permits foreign nationals to serve on the pension board). In these countries, conflicts have been managed internally rather than eliminated, by requiring board members to disclose conflicts and recuse themselves from conflicted decisions. Accountability is ensured by giving a clear mandate to the pension boards and then monitoring them effectively. To ensure verification, custody of the assets is handled externally and independently of all concerned parties. Thereafter, periodic reporting and audits are essential (and in the case of the Norwegian Petroleum Fund, press conferences as well!). The audits should cover not only processes, but also external actuarial valuations and verification of investment returns. Asher contrasts the extent of clarity in some countries with current practice under the provident funds of Singapore and India. Here and elsewhere, the absence of external audits and cost-based accounting has allowed such centralized funds to credit participant accounts with returns not reflective of actual performance. In Kenya too, the pension assets are not clearly accounted for and investment decisions have been poor.

The discussion on investment policy recognizes that one of the most politically appealing ways to help countries out of their pension crises is to boost returns on asset pools (as opposed to reducing benefits or raising contributions). Unfortunately, investment policy is a very complex task and the book sheds insufficient light on the issue. A pension fund can have many, and often competing, objectives such as maximizing return, minimizing risk, boosting the asset-liability ratio, minimizing contributions, and others. Further, some trustees may have long-term while others have short-term objectives, so setting investment benchmarks can be difficult in practice. While best practice in setting such benchmarks has been developed in the Netherlands, the Dutch experience is not discussed in depth in this volume. Nevertheless, the case studies from developed countries show that good investment policy requires a clear and transparent benchmark (i.e., asset performance must be benchmarked to publicly-available market indices for specific asset classes), and as the Norwegian case shows, the amount of risk that may be taken relative to this benchmark must also be stipulated. Many of these funds have struggled in recent periods for having invested in equities, but that is only to be expected when the investment policy is made for the long term, and it appears that the boards and the general population understand the same.

One issue not sufficiently addressed in the book is compensation of key pension fund staff. Successful pension systems tend to ensure that staff remuneration to other public sector jobs, but they must also keep an eye on the private sector to ensure that staff turnover is not an issue. Another of the volume's shortcomings is that it is silent on the overall question of whether a nation's pension fund commands sufficient assets. Thus, even if the managers can achieve a given rate of return, the fund may still have too little money to pay an adequate pension, depending on the benefit and contribution formulas. The only way to determine this is to specify clearly the intended replacement rate, the projected tax rates, and a target

rate of return. In my research, I have developed a model that can ensure adequate pensions, good governance, and successful investment policy, by having the public pension offer a guaranteed rate of return and requiring pension assets to be protected by a swap written between the Ministry of Finance and the Social Security Agency. It is interesting that World Bank staff have a similar pension (a cash-balance scheme) and this model is worthy of more discussion.

One key contribution of this volume is the extensive and detailed information on global best practice including several Appendices with country case studies. The contributors also clearly acknowledge the wide gap between what the developed world has achieved, versus what developing countries have accomplished. Finally, the book proves that future World Bank efforts can help ensure retirement safety through better investment practices without necessarily abandoning the DB approach to retirement security.

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