Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

November 2003

Europe

Germany

Chancellor Gerhard Schröder has proposed the first cut in benefits to current pensioners in post-war German history in an effort to plug an estimated €9 billion (about US$10.3 billion) shortfall in the national pay-as-you-go pension system next year. The proposal, which faces a tough fight in parliament, places a greater burden on retirees while trying to encourage economic growth. As expected, the measure passed by a vote of 302 to 284.

On October 24, Germany's lower house, the Bundestag, debated the first draft of the emergency legislation. Chancellor Schröder's governing coalition has now negotiated final adjustments to the draft. All but 15 of his party's 251 deputies agreed to support the measure, as did all deputies belonging to their junior partner, the Greens.

The reform package includes only some of the recommendations by the Rürup Commission, which reported earlier this year. The reform would eliminate the regular, scheduled pension increase in 2004 and would require that retirees pay the full cost of long-term care insurance instead of the half they currently pay. The proposal also would shrink the pension reserve fund's legal reserve requirement from 50 percent to 20 percent of one month's total benefit payments and require that new pensioners be paid at the end of the month rather than at the beginning. This latter measure will effectively reduce the cost to the system by one month. In total, these measures are estimated to reduce expenditures by €8.1 billion (about US$9.2 billion).

Consideration of one of the key proposals from the Rürup Commission, to gradually raise the retirement age from 65 to 67 in 2025, will be suspended until 2010.

With a sluggish economy and unemployment at over 10 percent, Schröder has decided that the payroll tax is to remain at 19.5 percent, with half being paid by employers and half by employees. Experts had worried that the payroll tax rate, which had already increased from 19.1 percent at the beginning of the year, would have had to be raised to 20.5 percent if the budget gap had not been filled by other means.

The reform package is threatened from both right and left. On the right, Angela Merkel, leader of the main opposition party, has called for even sharper pension cuts. Since the governing coalition has only a minority in the upper-chamber, the Bundesrat, her support may be needed to secure final passage. In early November, the Bundesrat rejected two other components of Schröder's policy package: tax cuts and labor law changes.

On the left, the leaders of Germany's unions have expressed strong opposition. They threaten to "take the issue to the streets," as has been done on a large scale in France and Italy. However, turnout for protest strikes in the East several months ago was unimpressive, and union leaders have thus far avoided indicating whether and when they will call for large-scale protests.

According to government figures released in October, 24 percent of Germany's 82.5 million people—20.1 million—are aged 60 or older, and that number is projected to reach 37 percent by 2050.

Sources: Financial Times, October 20, 2003; International Herald Tribune Online, October 20, 2003; Reuters, October 17, 2003; The Independent (UK), October 21, 2003; Washington Post, October 19, 2003.

Romania

The Romanian cabinet has approved draft legislation allowing companies to set up voluntary employer-provided pension schemes that supplement the public pension system. According to the law, a bank or insurance company may set up a fund that has at least 100 participants and at least US$12 million in assets. Tax incentives of up to roughly US$200 per year will be provided for both employers and employees who contribute to the employee's individual account.

The Commission for Insurance Surveillance will oversee the program, which is totally separate from the public pension system. A strong regulatory organization is necessary to convince the Romanians of the merits of this new system because of skepticism resulting from recent banking and investment failures.

The government hopes to introduce additional legislation that sets up individual accounts as part of the public pension system.

Sources: Financial Times, October 14, 2003; BBC Monitoring European, October 13, 2003.

Russia

Administrative complications have delayed implementation of Russia's individual accounts program. The recent reform of Russia's social security system requires that a portion of the mandatory pension contribution be set aside in an individual account. A worker may choose between the government pension fund and a private company to manage the investments.

The government was required to send out a letter to each worker by August 2003 informing workers about their individual account and providing the documents needed to make a choice of fund managers; workers had about 2 months to decide. Due to problems with printing the letters and the documents and with the postal system, the deadlines for receiving the letter and for selecting a company have been extended to November 1 and December 31, respectively. The monies are expected to be transferred to the pension funds by April 2004.

Issues with both the public- and private-sector funds have further complicated the situation. Although 55 private fund management companies have been authorized to date, many of them have little or no experience managing public funds, and information about their past performance is not available. Of the 55, one already has been put up for sale, 26 are no more than 1 year old, and 9 are brand new. The state-run pension fund has appointed the state-owned Vnesheconombank (VNB) to manage the government pension fund. Since VNB has not provided any information about its performance and little is known about it or the 54 private managers, it will be difficult for Russians to make an informed decision about which fund to choose.

Sources: Benefits and Compensation International, June 2003; Financial Times, October 9, 2003; ft.com, September 7, 2003; ipe.com, September 22, 2003.

The Americas

Brazil

Brazil's social security reform bill is making its way through the legislature.

The proposals are aimed at decreasing the $20 billion annual pension deficit, which represents about 80 percent of Brazil's total annual budget deficit. Civil service pensions account for $15 billion of that total.

The bill mainly affects the public sector, where the average pension is more than 6 times that in the private sector. Provisions include raising the retirement age, trimming pension amounts, and taxing higher benefits. Although an earlier version of the bill applied to all public employees who have not yet retired, the current bill affects only new hires. The government expects that the reform measures will save only $16.3 billion over the next 20 years.

Full approval requires two more Senate votes. The government hopes for final passage by the end of the year.

Sources: Dow Jones International News, October 8, 2003; Bloomberg.com, August 14, 2003; Sun-Sentinel.com, October 2, 2003; FIAP, September 2003.

Chile

After nearly 10 years of discussion, a proposal to regulate fees charged for retirement annuities in Chile is closer to becoming law. Provisions of the bill before Congress include:

- A cap on the allowable fees for purchasing annuities, and
- A more comprehensive system for easily comparing different plans for workers about to retire.

At retirement, the savings from the worker's individual account may be used to purchase an annuity or a deferred annuity, or to make programmed withdrawals scheduled to guarantee income over the insured's expected life span. Annuities, the most popular form of retirement benefit in Chile, are purchased either directly from an insurance company or through an intermediary. Between 1995 and 2000, fees averaged about 5.6 percent of the value of the annuity. More recently, these average fees have declined to below 3 percent as competition increased and the insurance companies began to "self-regulate." The bill before Congress would cap the fees at 2.5 percent. Any change in this amount must be authorized by the Ministries of Labor and Treasury and remain in effect for 18 months. If the government does not approve a change in fee after 18 months, the prevailing rate will remain in effect for an additional 18 months.

Sources: Diario Financiero Online, August 2003 and October 2003; El Mercurio, October 1, 2003; The Fund Pro Latin America, October 16, 2003.

Mexico

Unless reforms are enacted, by 2018 Mexico's separate social security system for government workers (ISSSTE) will have a fund imbalance equal to the country's current external debt (about 12 percent of GDP). One of the major reasons for the shortfall is the system's overly generous benefits. According to the Director of ISSSTE, Benjamin Gonzalez Roaro, a public employee can receive a full pension at age 46. When the system was set up in 1959, life expectancy was about 58 years, compared with about 67 years today.

Proposals for reform are on hold. One proposal would set a specific age for retirement (the current requirement is 30 years of service for men and 28 for women). Another proposal would incorporate ISSSTE's 10 million workers into the system of individual accounts that was set up in 1997 for workers in the private sector.

Sources: El Economista, October 16, 2003; The Fund Pro Latin America, October 16, 2003.

Asia and the Pacific

Japan

Defined contribution and cash balance pension plans are spreading as Japanese companies abandon conventional defined benefit (DB) pension plans. New pension plan designs, both defined contribution (DC) and cash balance varieties, have recently become available to employers, and a growing number of firms either have launched or are converting to a DC plan.

Following a decade of poor domestic equity returns, Japanese companies now face mounting unfunded liabilities in their employee pension funds that could threaten the financial health of plan sponsors. Declines in share prices have caused investment returns to be negative for 3 straight years, and pension fund asset balances have suffered as a consequence. According to a recent study by the Pension Fund Association, at least 70 percent of corporate DB pension funds do not have sufficient reserves set aside to match future pension obligations. Under these circumstances, the flight from conventional DB pension plans is expected to continue, recent surveys suggest. As of September 2003, only 1,522 companies had introduced DC plans for their employees in the 2 years since enabling legislation was passed in October 2001. However, the trend has quickened markedly in 2003. Press reports indicate that the number of company applications for the new plans has grown so quickly in 2003 that the Ministry of Health, Labor, and Welfare may be unable to process them all on a timely basis.

Firms favor the new DC plans, because they avoid accumulating unfunded pension obligations—a common experience of companies sponsoring traditional DB plans in Japan's dismal investment environment. Popularity in the new plans is also resulting from regulatory changes that have lowered plans' administrative costs. Less expensive, bundled DC plan designs have become available to cater to different sized firms. *Sogo-gata* plans, for example, allow small- and medium-sized firms to participate under a common structure that offers a predetermined selection of investment funds. By comparison, company sponsors under the earlier DC plan model had to search for investments and plan administrators on their own, making it a more expensive undertaking for each individual company. Another version of this model, the *rengo-gata*, has been designed expressly for conglomerates.

DC plans are available in two forms—one in which companies make contributions (corporate-type), and the other in which contributions are made by the employee (individual-type). Each program allows participants to tell their pension fund manager in which financial investment their contributions should be invested. Employees in a corporate-type plan are subject to a 3-year vesting rule: the amount in a participant's account is nonforfeitable after 3 years of service with an employer. Thereafter, the employee can roll over funds into a DC plan account with another employer. Accounts are portable, but only between DC plans: roll-over is possible between two corporate-type DC accounts, from a corporate-type DC account into an individual-type DC account and vice versa.

While some firms are moving to cash balance arrangements to reduce investment risk and administrative costs, the shift has been less dramatic than that for DC plans. In a cash balance plan, a virtual account is established for each employee; into this account employers contribute a percentage of salary toward a balance that is guaranteed at a specified rate of return. As of May 2003, Japan had 44 cash balance plans.

Sources: Jiji Press English News Service, April 8, 2003; Financial Times, September 9, 2003; Euromoney Institutional Investor, May 18, 2003; IBIS News, September 3, 2003; Jiji Press English News Service, October 24, 2003; Nikkei Report, October 20, 2003; Asia Pulse, October 28, 2003; H. Morito, "Reconsidering Japanese Corporate and Personal Pensions," OECD/INPRS Korea Conference on Private Pensions in Asia, October 23-25, 2002.

South Korea

South Korea is proposing social security reforms to address growing financial pressures on the system brought on by a combination of low birth rates and a rapidly aging society. An October 2003 report issued by the Korean Development Institute (KDI), a state-sponsored think tank, urged the government to overhaul the existing pension and medicare systems in order to cope with the aging population. At 1.4 children per woman, Korea has one of the lowest birth rates in Asia, which has accelerated the aging of the population. According to the Institute, the proportion of people older than 65 years, about 7 percent in 2000, will double to 14 percent in 2019. (By comparison, it took Japan and the United States 24 years and 72 years, respectively, for the same population segment to achieve that growth.) The KDI report said that the rising number of pensioners would cause the publicly managed defined benefit National Pension Scheme (NPS) to be exhausted by 2047. Contributing to this development is the expected decline in the working population. The Institute forecasts that the number of workers between the ages of 15 and 64 will fall by 10 million by 2050. The report's suggestions include raising the retirement age, boosting the birth rate, and increasing contributions.

The government announced proposals in August 2003 to revise the social security system, with some of the changes planned to begin in 2004. Although predating the KDI report by 2 months, the government proposal reflects reform ideas similar to those mentioned in the KDI report. It would reduce the average target replacement rate from the current 60 percent of final wage to 55 percent in 2004 and then gradually to 50 percent in 2008. A gradual hike in the contribution rate would begin in 2010: an immediate increase from 9 percent to 10.38 percent, with further increases of 1.38 percentage points every 5 years until the rate reached 15.9 percent in 2030. A 1998 reform had raised the contribution rate from 6 percent to 9 percent; it also introduced a gradual increase in the retirement age from 60 to 65. The change in retirement age, however, would not begin until 2013 and is to be phased in over the next 20 years.

Sources: IBIS News, September 2003; Asia Pulse, October 27, 2003; Joins.com, October 28, 2003.

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