Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

April 2004

Europe

Germany

On March 11, the German Parliament approved legislation that will change the way state pensions are calculated. The centerpiece of the legislation, which will go into effect on January 1, 2005, is the introduction of a "sustainability factor," a provision that will cause state pension payments to decline as the German population shrinks over the next 25 years. Beginning July 1, 2005, the level of retirement benefits will depend on the size of the workforce relative to the number of retirees.

Today, German workers outnumber retirees by a ratio of about four to one. However, Germany's very low fertility rate of 1.3 children per woman, coupled with increasing life expectancy, will dramatically change the country's age structure over the next 30 years. The average state pension currently replaces about 53 percent of a worker's final income, but under the new reform that percentage is expected to decline to 46 percent by 2020.

The government is also attempting to reduce the number of workers taking early retirement. Germany has a liberal early retirement policy that allows individuals to retire at age 60 if they have 15 years of contributions and have been unemployed for at least 1 year after age 58. Today, Germans are retiring at an average age of 60.2—well below the official full retirement age of 65. To address this situation, the statutory age for early retirement will gradually be raised from 60 to 63 by 2008. In addition, time spent in schools, universities, and polytechnics will no longer be counted as years worked.

Pension subsidies are rising faster than any other area of government spending. This year a third of the €251 billion (US$298 billion) budget will go to subsidize the pension fund.

Germany's rising unemployment rate and high labor costs have forestalled an increase in the current payroll tax rate of 19.5 percent. The Federal Labor Agency estimates that an increase of 1 percent in nonwage labor costs results in a loss of 100,000 jobs, and those costs reportedly rose to 41.7 percent of gross wages last year, up from 37.4 percent 10 years ago. Accordingly, the government has announced plans to keep the payroll tax below 20 percent until 2020 and below 22 percent until 2030.

Some experts, however, contend that maintaining a wage replacement level of 46 percent while limiting the contribution ceiling to 22 percent until 2030 is not possible without raising the retirement age to at least 67. The legislation does provide for a review of the pension system in 2008 to determine if further steps, such as raising the full retirement age, will be necessary. (For further information on Germany's recent reform measures, see the February 2004 issue of *International Update*.)

Sources: Bloomberg, March 11, 2004; Deutsche Welle, March 11, 2004; Associated Press, March 11, 2004; Global Action on Aging, *Pensions Sink with Workforce*, March 12, 2004.

Italy

Pension reform in Italy faces an uncertain future as unions orchestrate further demonstrations. A one-day strike was held on March 26 to protest the government's March 9 proposal to reform its state-run pension system—one of Europe's most generous. Italy's powerful labor unions have used similar tactics over the past year to block other reform attempts. (See the January 2004 issue of *International Update.*)

The key feature of the new proposal would raise the age of full pension eligibility to 60 for both men and women with 35 years of contributions beginning in 2008. Currently, Italians with 35 years of contributions may retire with full benefits at age 57. The government's original proposal would have increased the age of full benefit eligibility to 65 for men and 60 for women, or any age for workers who had made 40 years of contributions. (See the October 2003 issue of *International Update*.)

When fully implemented, this latest reform plan is expected to generate annual savings of about €9.0 billion (US$10.7 billion), or about 0.7 percent of gross domestic product. The government hopes that a draft bill can be approved by June.

Sources: International Pensions, Europe, http://www.IPE.com, March 11 and 22, 2004; *Financial Times*, March 10, 2004; Dow Jones International News, March 10, 2004; WMRC Daily Analysis, March 8, 2004; Pensions International, March 2004; Agence France-Presse, March 25, 2004; and International Business Information Service (IBIS) News, March 2004.

Asia and the Pacific

Australia

At the end of February, Treasurer of the Commonwealth Peter Costello outlined changes to the payout provisions of Australia's superannuation guarantee—a mandated system into which employers contribute 9 percent of wages for all employees except those earning less than A$450 (US$330) a month. The government's proposals are intended to "further broaden the availability of superannuation, provide more choices in financing retirement income, make superannuation more adaptable to changing work arrangements and improve the integrity of the system."

To boost savings, any one under age 65, even non-workers, will be eligible to contribute to the superannuation fund. At the same time, the contribution and distribution rules will be simplified for those aged 65 to 74. To encourage labor force participation by older workers, the government will amend the law to allow active workers who reach "preservation age" (currently 55, increasing to 60 by 2024) access to their superannuation funds. Currently, workers must retire in order to gain such access. The new rule allows workers at the preservation age to draw down superannuation funds as an income stream but not as a lump sum. To that end, the government announced that it will approve new market-linked income stream products that provide monthly benefits over a person's life expectancy. To the extent that Australians outlive their superannuation benefit stream, they could apply for means-tested state pensions.

Driving this change is a desire to limit spending on state pensions. The government recently estimated that growth in the working-age population will fall to zero by 2042 even as the elderly population surges. This situation points not only to a proportionately smaller tax base but also to an increased demand for pensions, nursing and in-home care for the aged, and health benefits.

Financial industry analysts and press commentary have responded positively to the intent and content of the proposed changes but add that a much more substantial overhaul of the superannuation system is required to accomplish stated objectives, the most important change being an increase in retirement savings. (See the December 2003 issue of *International Update*.)

Sources: Department of Treasury, *A More Flexible and Adaptable Retirement Income System*" and "*Australia's Demographic Challenges*, February 25, 2004; *Newcastle Herald*, February 25, 2004; Treasurer's Speech on Aging, February 25, 2004.

China

China plans to increase the proportion of its National Social Security Fund (NSSF) assets invested in the stock market to 25 percent this year—up from 5.1 percent in 2003. With hopes of obtaining higher investment returns for the financially troubled state-run pension system while reducing exposure to domestic market risks, China's Cabinet approved plans on February 9 to have the fund invest assets overseas. Currently, the Ministry of Finance and other relevant departments are drafting rules to implement this policy.

Under China's old planned economy, state-owned enterprises (SOEs) were responsible for providing their workers with pensions. However, this system began to crumble in the 1990s when the SOEs were downsized dramatically as part of China's modernization strategy. In the course of these reforms, many of the SOEs were eliminated, and others ended up with very high ratios of retirees to workers. The effect was to leave tens of millions of workers facing an uncertain retirement.

The government's initial response in 1997 was to institute a multi-tier arrangement—combining social insurance and individual accounts—under which provinces took over the responsibility for honoring the SOE's pension promises. This system, however, also proved unsustainable in provinces where SOEs were most concentrated. In the most affected provinces, payroll taxes already total 24 percent. High tax rates, in turn, have exacerbated the funding crisis by discouraging private businesses from joining the pension system. According to World Bank economists, maintaining solvency will require raising payroll taxes to 27 percent in 2005, 45 percent in 2030, and close to 60 percent in 2050.

The magnitude of this challenge led to the collapse of initial attempts to set up individual accounts. Under the 1997 reforms, each province was tasked with managing its own social security fund—collecting contributions from workers and employers, holding or investing the money, and disbursing benefits to retirees. However, as deficits mounted in the pay-as-you-go plans, provincial social security bureaus began to use individual account contributions to pay current benefits. In 2000, the central government responded by creating the National Social Security Fund, whose purpose is to help provinces meet the costs of transitioning to the new pension system. At the end of 2003, the fund's cash assets totaled 132.5 billion yuan (US$16 billion). Nearly 78 percent of those assets had been contributed by the central government, 17 percent came from the sale of state holdings in listed enterprises, and 5 percent was raised through lottery sales.

In a related move, China announced plans to launch a private voluntary funded pension system as early as the end of 2004. The new voluntary plans would resemble the employment-based and privately managed funds operating in Hong Kong's Mandatory Provident Fund System and the 401(k) savings plans in the United States. Employees would be permitted to contribute up to 4 percent of pretax salary into a professionally managed investment account owned by the worker. The measure could be formally adopted as early as this year.

Sources: Dow Jones International News, March 25, 2004; Reuters News, February 16, 2004, and March 26, 2004; *The Standard*, March 27, 2004; Xinhua Financial Network (XFN) News, February 17, 2004; *South China Morning Post*, February 17 and March 8, 2004; http://www.hewittasia.com, June 6, 2002; Xinhua News Agency, November 19, 2003; Center for Strategic and International Studies paper by R. Jackson and N. Howe, April 2004; *FIAP Bulletin*, January–February 2004.

The Americas

Canada

The Canada Pension Plan (CPP) investment fund recently reported a 13.9 percent rate of return for the first three quarters of fiscal year 2004, ending December 31, 2003. The CPP Investment Board's president and chief executive officer credited the "strong investment performance this fiscal year . . . [to the] diversification . . . into publicly-traded equities and strong equity markets." According to an analyst at the board, since its first full year of operation in 2000 the investment fund has realized a nominal annualized rate of return of 5.8 percent.

The CPP is a compulsory, earnings-related program providing retirement, disability, and survivors benefits for its members. It operates mainly on a pay-as-you-go basis and is financed by payroll tax contributions. The contributions are split evenly between employers and employees, and any contributions in excess of current program needs accumulate in a reserve fund.

Substantial reforms, effective in 1997, were made to help secure the CPP's long-range stability. To partially prefund future benefits by building up the reserve fund, the government increased the payroll tax rate, from 5.6 percent in 1996 to 9.9 percent in 2003. The CPP Investment Board was established as an independent investment organization to manage the reserve fund assets at arm's length from federal and provincial governments. Legislation instituting the reforms stipulated that the board invest "in a diversified portfolio of securities, in the best interest of contributors and beneficiaries."

Today, the investment fund holds assets of more than C$66 billion (US$48.9 billion), about three times the CPP's annual outlays. Nearly half of the fund is managed by the CPP Investment Board and is actively traded in equities and real estate. The remainder is held in long-term federal and provincial government bonds, which will be transferred to the board by 2006. Meanwhile, the value of assets available for active trading continues to grow because of both the current surplus of contributions over program needs and the funds released when government-held bonds mature and are not renewed.

Sources: CPP Investment Board, News Release, February 12, 2004; John MacNaughton, *The Challenge of Investing CPP Assets*, January 2004; *Business Wire*, February 12, 2004; *Financial Post*, March 2, 2004.

Chile

A new law expands survivors and disability coverage for the unemployed and makes it easier for young workers to qualify for a minimum survivors or disability pension. These provisions are part of the annuity law passed in February and reported in the March 2004 *International Update.*

According to the 1981 law setting up individual retirement accounts, survivors and disability benefits are provided by an insurance company through the worker's pension fund management company (AFP). In addition to the worker's monthly contribution of 10 percent of earnings to an individual account with an AFP of his or her choice, the worker now pays an average of 2.6 percent of earnings for survivors and disability insurance and administrative fees. The AFP then purchases an insurance policy for the worker from an insurance company. The government guarantees a minimum pension if a worker's benefit falls below the minimum established by law.

Under the new law, the unemployed will receive the same survivors and disability benefits as the employed. Beginning in August 2004, an unemployed worker who has paid at least 6 months of contributions in the year before death or becoming disabled will receive higher benefits: survivors and total disability pensions will be raised from 50 percent to 70 percent of average wages; partial disability pensions, from 35 percent to 50 percent of average wages. The association of AFPs estimates that increasing coverage for the unemployed will cost about US$8.4 million annually.

The new law will also aid young workers who have not had the opportunity to accumulate much in their individual accounts. Effective immediately, the government must provide a guaranteed minimum survivors or disability pension to workers who have paid at least 16 monthly contributions and die or become disabled less than 2 years after they first enter the labor force. Requirements for other workers will remain the same—either 2 years of contributions in the 5 years before death or disability or a total of 10 years of contributions.

Sources: AGAFP, "Mejor Cobertura del Seguro de Invalidez y Sobrevivencia Elevará Sus Costos," February 2004; SAFP, 2004.

Peru

The Congressional Social Security Commission has approved a controversial resolution called "free disassociation" that would allow workers in the individual account system to rejoin the public system. Workers most likely to take advantage of this proposal are those nearing retirement whose account balances are low. Because individual accounts were implemented in Peru in 1993, older workers would have, at most, 11 years of contributions plus a recognition bond—the value of their accrued rights under the public system. Currently, workers covered by the public system may switch to individual accounts at any time but may not return to the public system. Only workers entering the labor force have a choice between the private system of individual accounts and the public pay-as-you-go system.

Under the "free disassociation" proposal, workers could choose to return to the public system but would have to transfer the balance of their individual accounts plus any recognition bond to the consolidated reserve fund. In addition, since the contribution rate of 13 percent of earnings for the public system is higher than the average 11 percent rate for the individual account system, the worker would have to make up the difference.

Critics contend that allowing workers to transfer to the public system would further strain an already financially strapped program. The Ministry of Economy and Finance estimates the government's cost of the proposal at US$2 billion, or 4 percent of gross domestic product, if 120,000 workers (out of a total of 3 million eligible workers) choose to switch. The measure has been debated for months and must next be passed by the Congressional Economic Work Group before being taken up by Congress.

Sources: Fund Pro Latin America, March 11, 2004; *El Comercio*, February 26 and March 10, 2004; Goldman Sachs, Emerging Markets Daily Comment, March 9, 2004; Social Security Administration, *Social Security Programs Throughout the World: The Americas, 2003*, March 2004.

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Editor: Susan A. Carleson.

Writers/researchers: Rita DiSimone, Flan Fry, Barbara E. Kritzer, and David Rajnes.

Social Security Administration
Office of Policy
Office of Research, Evaluation, and Statistics
500 E Street, SW, 8th Floor
Washington, DC 20254

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