Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

May 2004

Europe

Germany

On May 14, Germany's upper house of parliament (Bundesrat) rejected a bill passed in late April by the lower house (Bundestag) that would change pension taxation and eliminate the tax exemption for life insurance products. The measure now moves to a mediation committee that will rework the bill for resubmission to both houses probably before the summer break in July. (See the April 2004 *International Update*.)

As currently written, the legislation would begin taxing state pension benefits while phasing out taxes on workers' monthly contributions starting next year. The government estimates that the reduction in employee taxes would total €20 billion (US$24.5 billion) a year by 2025. The changes would be totally phased in by 2040. This latest reform is designed to bring Germany's tax system into compliance with a March 2002 ruling by the German Constitutional Court stating that existing laws inappropriately favored state pension benefits over civil servants' benefits, which already were subject to taxation.

The legislation also would eliminate the tax deductibility of premiums on life insurance contracts and make payouts fully taxable at personal income tax rates beginning January 1, 2005. Currently, payouts from savings products that are based on life insurance are exempt from taxation if the savings plan is held for at least 12 years and the payout period is at least 5 years. Plans pay either a lump sum or an annuity or a life insurance benefit in the event the holder dies before the end of the contract. The insurance industry is concerned that the change will undermine the attractiveness of these popular retirement products. For its part, the government argues that the savings plans are not being used primarily for retirement and therefore do not deserve tax privileges designed to encourage private pension savings. The legislation would also create a new class of private pension insurance, *Leibrentenversicherungen*, whose premiums would be tax deductible.

In a related development, the opposition party decided not to challenge the government's move to mandate unisex pension premium rates for men and women beginning in 2006. The matter instead will be taken up in planned European Union legislation. Two years ago, the government began granting tax breaks and subsidies for private pensions by introducing the "Riester" pension, named after the former labor minister who championed its passage. Thus far, the take-up rate for these products has been low, and industry analysts fear that the new legislation will make the plans even less popular among men, who will have to pay a higher premium rate.

Sources: Bloomberg, "German Lower House Backs Changes in Pension Taxation Rules," April 29, 2004; Dow Jones International News, April 27 and 29, 2004; *Investment & Pensions Europe*, http://www.IPE.com, May 4, 2004; Reuters News, April 28 and May 14, 2004; Dow Jones News Service, May 14, 2004.

Ireland

In late April, the National Pensions Reserve Fund reported a 2.7 percent rate of return for the first quarter of 2004. This followed a 12.8 percent return for the 2003 calendar year in which "equities were the real drivers of growth, achieving an investment return of 18.1 percent," according to the fund's chairman. At present the fund has a total value of €10.1 billion (US$12.4 billion).

The fund was established 3 years ago to provide partial prefunding for future costs of public pensions. Legislation establishing the reserve fund—financed by annual government payments equal to at least 1 percent of gross national product—stipulates that no withdrawals may be made before 2025 and that funds should continue to accumulate until at least 2055. The government estimates that pension outlays will roughly double as a share of gross national product by 2025 and nearly triple by 2056.

The fund is controlled and managed by a commission in accordance with specified guidelines "based on commercial principles and subject to prudent risk management." The commissioners have set a long-term investment strategy of 80 percent holdings in equity and other real assets and 20 percent investment in bonds. Currently, 76 percent of the fund is invested in world stock markets, split equally between eurozone and non-eurozone equities.

Ireland's pension system consists of two pillars. The first pillar is a combination of an Old Age Contributory Pension, for those who satisfy the Pay Related Social Insurance (PRSI) contribution conditions, and a means-tested Old Age Non-Contributory Pension, for those who do not. It is financed on a pay-as-you-go basis. The second includes civil service pay-as-you-go systems as well as funded occupational pensions and individual private pensions.

Sources: National Pensions Reserve Fund Commission, April 20, 2004; National Treasury Management Agency, Information Memorandum 2004; Donal J. Geaney, Statement to the Oireachtas Joint Committee on Finance and Public Service, January 28, 2004; *Irish Times*, January 2, 2004.

Switzerland

In a May 16 referendum, an overwhelming majority of Swiss voters rejected the government's latest attempt to reform the state pension system. The proposed pension reform, the eleventh in 7 years, would have increased the retirement age for women from 64 to 65 by 2009, gradually reduced benefits for widows, and changed the inflation adjustment of pensions from every 2 years to every 3 years. Annual savings under the measure were expected to total SFr787 million (US$612 million)—about half of what the government originally sought. (See the March 2004 *International Update*.)

The pension reform was part of a package that also included SFr2 billion (US$1.6 billion) in federal tax breaks to stimulate economic growth and a 1.8 percent increase in the value-added tax. Voter turnout was slightly over 50 percent. In the final tally, 65.9 percent rejected the tax breaks, 67.9 percent opposed the pension reforms, and 68.6 percent opposed the increase in the value-added tax.

The votes were part of a running political battle between Switzerland's center-right and center-left parties. Although the Social Democrats and trade unions led the successful campaign against the tax breaks and pension reform measures, they were defeated in their attempt to increase the value-added tax. For its part, the government insists that tax and pension reform are still necessary.

Emanuel von Erlach, a political scientist at Bern University, characterized the referendum results as a triumph of centrism. "The cabinet and parliament might become a bit more modest in the way they present their aims in the future," he noted. "They have to realize that the electorate has a power of veto in the political process and that the Swiss favor compromise."

Sources: *Investments & Pensions Europe*, May 11 and 19, 2004; Swissinfo, *Neue Zürcher Zeitung*, May 17, 2004.

United Kingdom

After lengthy debate, the House of Commons, without opposition, approved the Pensions Bill on May 20. The bill now proceeds to the House of Lords for consideration. It was amended during the committee process to ameliorate some of the concerns expressed when it was introduced in February. (See March 2004 *International Update*.)

A potential loophole was blocked on April 27 when ministers took urgent action to prevent companies from dumping their pension obligations on the Pension Protection Fund (PPF). A clause was added to the bill that will allow the new pension regulator to require pension plan contributions from companies that have manipulated their finances to avoid liabilities retrospectively back to June 11, 2003, when creation of the PPF was first announced.

The PPF is the central feature of the Pensions Bill. Intended to protect retirees and current workers against total loss of accrued retirement benefits from underfunded pension plans of failed businesses, the legislation has been strongly criticized because of the absence of provision for employees affected by business closures in the past or between now and April 2005. As a result of a joint Labour/Tory amendment to the bill, on May 14 the government announced that it would set up a £400 million (US$735 million) fund to help the 60,000 workers whose pension savings have already been lost through failures of company plans. The assistance would be funded by public money in installments over 20 years, with the "possibility of further contributions from industry." Details are yet to be worked out, but the government has said that it will review the fund's operation in 3 years. Although the offer of compensation averted certain defeat of the bill in the Commons, critics on both sides of the aisle charge that the £400 million figure is inadequate. According to Dr. Ros Altmann of the London School of Economics, the £400 million figure would fall far short of her estimate of £2.3 billion (US$4.2 billion) over 30 years that is needed to fully compensate those workers.

Sources: Department for Work and Pensions, April 19, 2004; *BBC News*, April 20, 2004; *Citywire*, April 20, 2004; *Financial Times*, April 24 and 28 and May 5, 2004; *Independent*, May 19, 2004;"Pensions Bill—Passage through the House of Commons," Brief for Report Stage, House of Commons, May 18–20, 2004.

Asia

Japan

The lower house of parliament voted on May 11 to reform the national pension system by increasing employee contributions and reducing retiree benefits. The reform package has been sent to the upper house for further debate, but because the upper house has the power to only delay legislation, implementation of the reforms seems assured.

Japan's two-tiered pension system includes a flat-rate plan for all residents under the national pension program and an earnings-related plan under the employees' pension insurance program. The newly passed reforms will cause individuals' monthly premium for the national pension program to rise from ¥13,300 (US$120.00) to ¥16,900 (US$152.47) in increments of ¥280 (US$2.52) each year, beginning in April 2005 until 2017. In addition, the government will gradually increase its funding of the pension program from the present 33 percent to 50 percent by 2009.

The payroll tax for the employee pension insurance program will increase from the current 13.58 percent, which is shared equally by employees and employers, up to 18.3 percent by fiscal year 2017 in increments of 0.354 percent each year from October 2004. At the same time, pension benefits as a percentage of average salary will be lowered from the current 59.3 percent of take-home pay down to 50.2 percent by 2017.

The law further authorizes the government to cut pension benefits when changes in such variables as the working population and life expectancy warrant action to support financial solvency. In addition, a supplementary provision to the reform package directs the creation of a committee among the three major parties to develop a pension reform agenda, including the unification of the various pension systems. The committee must submit its report by March 2007.

A combination of below-replacement fertility and dramatic gains in life expectancy has made Japan the world's oldest society. As a result of its low birthrate—just 1.3 children per woman in 2003—the population is expected to decline from a peak of 128 million in 2006 to 101 million by 2050. The share of the population aged 65 and over will rise from 17.4 percent in 2000 to nearly 29 percent in 2025 and 40 percent by 2050. The worker-to-retiree ratio is expected to decline from 3.6:1 today to 1.9:1 by 2025. At the same time, a 15 percent decline in the labor pool will exert substantial drag on economic growth. In the absence of corrective action, these trends will cause plan reserves to be depleted by fiscal year 2023, according to the Social Insurance Agency.

Sources: *Nikkei Report*, March 25, 2004; *Kyodo News*, November 18, 2003, and May 11, 2004; *Financial Times*, November 19, 2003; *Daily Yomiuri*, March 16, 2004; Economist Intelligence Unit (EIU) ViewsWire, March 17, 2004; *Irish Independent*, March 11, 2004; http://pensionsinternational.co.uk, March 2004; Jiji Press English News Service, February 9, 2004; International Business Information Service (IBIS), April 2004; *Asia Times*, May 12, 2004; Agence France-Presse, May 11, 2004; *Asahi Shimbun*, May 20, 2004.

Reports and Conferences

A recent Standard & Poor's report predicts that pressure on public finances caused by aging populations could increase by threefold the average debt ratio of 25 countries of the Organization for Economic Cooperation and Development and lead to member countries' credit ratings collapsing to noninvestment grade. According to Standard & Poor's credit analyst, Moritz Kraemer, some "sovereign ratings could come under strong pressure as early as the end of this decade unless governments start tackling this threat effectively."

The report, titled "The Western World Past Its Prime—Sovereign Rating Perspectives in the Context of Aging Populations," simulated fiscal trends over the next 45 years for 25 high-income nations around the world. It builds upon an earlier study in 2002 that covered the European Union (EU-15) countries. The report's scenario assumes that the governments will make no major structural reforms to counter the increase in their pension-age populations and concomitant decrease in their worker populations. Although the report stresses that the scenario is not a prediction, it does provide valuable insights into what might happen if governments resist reforming unfunded state-run social security systems.

The new report reflects the deterioration of Europe's fiscal position over the last 2 years, with the EU-15 debt projected to rise to 164 percent of gross domestic product (GDP) in 2050, up from 147 percent of GDP in the 2002 simulation. Countries such as Australia, Ireland, the U.K., and Sweden come out significantly better than average, however, with projected debt ratios of less than 70 percent of GDP by 2050. This outcome is mainly due to a mix of favorable demographics and pension reforms already undertaken. However, under the "auto-pilot" scenario, France, Germany, Portugal, Greece, Poland, and the Czech Republic would see their debt burdens rise to well above 250 percent of GDP by 2050. Owing to recent policy changes plus increases in the public debt since 2002, this year's report shows U.S. debt reaching 158 percent of GDP in 2050, nearly double the 83 percent projected 2 years ago. Japan, which has the most rapidly aging population, is predicted to have the highest debt burden, reaching an implausible 400 percent of GDP by 2030 and 700 percent by 2050.

The report notes that although some countries have embarked on structural reforms that are likely to mitigate the pressure on their financial deterioration, the "magnitude of the challenge…will require further decisive steps in almost all countries in the sample."

Sources: Standard & Poor's, "The Western World Past Its Prime—Sovereign Rating Perspectives in the Context of Aging Populations," March 31, 2004.

On May 17, the Social Security Administration's Office of Policy and the Michigan Retirement Research Center (MRRC) hosted a Global Aging Workshop at the Brookings Institution. The conference examined the effect of aging populations and shrinking labor forces—the product of below-replacement birthrates—on economic growth and investment returns in the increasingly globalized economy of the 21st century. The meeting featured a discussion of three papers:

- *Living Happily Ever After: The Economic Implications of Aging Societies*, by Sylvester Schieber and Steven Nyce of Watson Wyatt Worldwide;
- *Global Aging: Issues, Answers, More Questions*, by Axel Börsch-Supan of the University of Mannheim, Germany; and
- *The Impact of Aging on Financial Markets and the Economy: A Survey*, by Barry Bosworth, Ralph Bryant, and Gary Burtless of the Brookings Institution.

Proceedings from the workshop will be available in the near future on the MRRC Web site at http://www.mrrc.isr.umich.edu.

The U.S. Senate Special Committee on Aging held a hearing on *Strengthening Social Security: What Can We Learn from Other Nations?* on May 18. The hearing proceedings are available at http://aging.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=46.

International Update is a monthly publication of the Social Security Administration's Office of Policy.

Editor: Susan A. Carleson.

Writers/researchers: 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

SSA Publication No. 13-11712