Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

June 2004

Europe

Macedonia

Macedonian workers will be allowed to set up individual retirement accounts administered by private asset managers as a supplement to the current pay-as-you-go pension system beginning in mid-2005. Workers who first entered the labor force after January 2003 will be required to join the new system. Participation is voluntary for those employed before January 2003. Employees with contributions under the old system will only receive up to 5 years of credit under the new system, regardless of how long they had contributed.

Employer contributions under the current pay-as-you-go system total 20 percent of payroll. Under the new system, 7 percent of payroll would be redirected into individual accounts, with the remaining 13 percent supporting a residual pay-as-you-go benefit.

Participants in both the old and new systems will be eligible to set up separate, voluntary individual accounts. At retirement, workers will have the option of using both mandatory and voluntary individual account balances either to purchase an annuity from an insurance company or to receive programmed withdrawals scheduled to guarantee income over the worker's expected life span.

The reform also gradually increases the retirement age for women from 60 to 62 by 2007. The retirement age for men remains at 64.

Because Macedonia's capital markets are underdeveloped, a new Agency for Supervision of Fully Funded Pension Insurance will license only two asset managers for the system's first 10 years of operation. The World Bank will provide a Social Protection Implementation Loan of US$9.8 million to help carry out the reform.

Although relatively youthful compared with other European countries, Macedonia's shift toward a system of partially funded pensions is being prompted by adverse demographic trends. The United Nations estimates that by 2050 there will be just 2.6 persons, aged 20–59, for each person over the age of 60—down from nearly 6 workers today.

Sources: *Investments & Pensions Europe*, April 30, 2004; International Social Security Association, *Complementary and Private Pensions, 2003*; U.S. State Department Press Release, May 13, 2004; SeeNews, May 26, 2004; Macedonia's pension reform Web site at http://www.penziskareforma.org.mk, 2004; United Nations, *World Population Prospects: The 2002 Revision*.

The Americas

Mexico

Beginning in December, Mexican workers under the age of 56 will have a choice of two pension funds for their mandatory individual account—one that will invest solely in fixed-income securities and one that will combine fixed-income securities and certain types of equities. (See also the October 2003 issue of *International Update*.)

Currently, each pension fund management company is limited to offering one fund for mandatory contributions and another for additional voluntary contributions. The mandatory individual accounts are financed by employees' contributions of 1.125 percent earnings and employers' contributions of 3.15 percent of payroll and are supplemented by government contributions of 10.14 percent of total employer contributions. The government also finances the guaranteed minimum pension for workers with 1,250 weeks of contributions, whose accounts will not yield the minimum pension. Employees may also make unlimited voluntary contributions to their accounts.

Total assets of the mandatory individual account system presently represent about 5.6 percent of gross domestic product. Most of these funds, 82 percent, are invested in federal government bonds; 15 percent in domestic corporate bonds; and 3 percent in a mix of municipal and state government bonds and state-owned companies, such as PEMEX (Mexican Petroleum). Starting in December 2004, each pension fund management company will be permitted to invest 15 percent of its assets in various approved equity indices and 20 percent in foreign debt.

Sources: Dow Jones International News, May 3, 2004; IBIS, May 2004; JP Morgan Emerging Markets Today, May 5, 2004; AIOS, June 2003; Social Security Administration, *Social Security Programs Throughout the World: The Americas, 2003*; International Social Security Association, *Complementary and Private Pensions Throughout the World, 2003*.

Asia and the Pacific

Australia

Government-backed legislation in Australia would create new incentives for voluntary individual account contributions by low- and middle-income workers under the Superannuation Guarantee pension system. The bill, currently awaiting final passage by parliament, will also reduce a tax surcharge for upper-income wage earners.

Superannuation Guarantee is a mandatory retirement savings program covering most Australian workers except the self-employed. Employers are required to deposit 9 percent of wages into an approved savings vehicle for each employee. Individuals may also contribute voluntarily on a tax-advantaged basis. (See also the December 2003 issue of *International Update*.)

To boost voluntary superannuation contributions by low-income workers, the government proposes to increase its current dollar-for-dollar match of the first A$1,000 (US$706) contributed by an eligible worker. Under the proposal, eligible workers would receive a 150 percent match of their first A$1,000 contribution, resulting in a maximum match of A$1,500 (US$1,059). Currently, the eligibility threshold for the maximum match is A$27,500 (US$19,408). This amount would rise to A$28,000 (US$19,970), thus making more workers eligible. Above this amount, the government match would decline by 5 cents for each dollar of income and phase out completely at A$58,000 (US$40,933). Currently, the co-contribution phases out completely at A$40,000 (US$28,230).

Another feature of the bill would expand a planned reduction in the superannuation surcharge on higher-income workers. Unlike the United States, where retirement contributions are tax deferred, all Superannuation Guarantee contributions are taxed at 15 percent. However, "high-income" workers are charged an additional surcharge if their income exceeds A$115,000 (US$81,160). Under the proposal, the current surcharge rate of 14.5 percent would be reduced to 7.5 percent by fiscal year 2006. Currently, the rate is scheduled to fall to 12.5 percent in 2005. The government estimates the 4-year cost of these measures at A$2.7 billion (US$1.9 billion). Legislation combining the two budget provisions passed the House of Representatives on May 26 and will be taken up by the Senate later this year.

Sources: Australian Government, "Budget Speech 2004-05," May 11, 2004; *Australian Financial Review*, May 25, 2004; the Web site of the Parliament of Australia at http://www.aph.gov.au; Australian Embassy treasury officer.

China

In a spate of retirement reforms, China has passed the Enterprise Annuity Law, establishing a new system of voluntary retirement plans. Separately, government regulators approved the country's first "specialized pension insurance company." Both actions mark significant steps toward the government's efforts to promote a private pension market in China, where an aging population and significant unfunded pension liabilities in the shrinking state-owned enterprise sector weigh heavily on public budgets. (See also the April 2004 issue of *International Update*.)

The new regulations establish rules safeguarding account funds—a major weakness of past reforms—as well as corporate governance of pension funds. Government spokesmen predict that the first licenses to manage pension funds will be issued soon.

The law implies, but does not specify, a defined contribution plan design. Employee contributions are permitted but are not required. Similarly, there is no minimum vesting requirement. Specific features include the following:

- Pension payments may be made either monthly or distributed as a lump sum.
- Benefits may not be paid before retirement (age 60 for men and 55 for women), except in the case of death-in-service.
- Employer contributions may not exceed one-twelfth of the prior year's salaries of all staff, and combined employer–employee contributions may not exceed one-sixth of gross payroll from the previous year.

Although the law calls for contributions to be tax deductible and benefits to be tax exempt, actual policy in this area will be determined by provincial governments, which control tax legislation and collection in China.

The new pension fund rules permit Enterprise Annuity funds to be invested in domestic bonds, bank deposits, and securities. A key corporate governance rule provides that fund management must be overseen by either a committee within the company composed of at least one-third employees or an outside government-approved institution. Additional regulations are being drafted setting minimum capital requirements and other criteria for fund managers, custodians, and investment managers.

Since 1992, China has experimented with voluntary corporate pension plans as a supplement to social security, eventually including them as the second pillar in a multipillar pension reform framework spelled out in 1997. Companies that establish an Enterprise Annuity plan must also participate in the social security system, be up to date on contributions, appoint a trustee to oversee the plan, and manage annuity assets separately from the assets of the company and service providers.

Regulatory authorities recently approved Shanghai-based Taiping Life Insurance Company, one of China's oldest insurance companies, to set up Taiping Pension Insurance Co. Ltd. The fund is scheduled to start operations in August 2004. The new company will have a registered capital of 200 million yuan (US$24 million). Companies such as Taiping Pension may become custodians, asset managers, and recordkeepers to corporate pension funds. A pilot program is under way in three provinces of northeast China, where employers are being encouraged to set up tax-exempt annuities.

Although the corporate pension fund market is currently small, analysts expect it to grow rapidly in light of China's 40-percent household saving rate and a lack of safe investment alternatives to low-return bank deposits. As of year-end 2003, corporate pension fund assets amounted to about 35 billion yuan (US$4.2 billion) compared with private bank deposits of approximately US$1.6 trillion. China Insurance Regulatory Commission predicts asset growth of at least 100 billion yuan (US$12 billion) a year during this decade. The World Bank has estimated that corporate pension fund assets in China could total US$1.8 trillion by 2030.

Sources: *Financial Times*, May 3 and July 5, 2004; Reuters News, June 7, 2004; *Asian Wall Street Journal*, April 12 and 27, 2004; Mercer Human Resource Consulting, April 16, 2004; Watson Wyatt, May 2004; *South China Morning Post*, April 6, 2004; Xinhua Financial Network (XFN) News, April 5, 2004; Hewitt Associates, June 2003; http://www.chinaview.cn, April 12 and May 15, 2004; Dow Jones International News, April 4, 2004; China Daily, June 17, 2004; and http://www.english.eastday.com, June 16, 2004.

South Korea

The South Korean government has approved long-term measures to stabilize the financing of the pay-as-you-go public pension system. The reform package is due to be submitted to the National Assembly in June. Under the proposal, implementation will begin in January 2005.

The reform guarantees current retirees the replacement rates promised at the time of their enrollment. However, the target income replacement rate for an average-wage worker contributing for 40 years will decline from the current 60 percent to 55 percent beginning in 2005 and to 50 percent in 2008. Meanwhile, the contribution rate will rise from 9 percent of the average wage today to 10.38 percent in 2010. This rate will continue to increase by 1.38 percentage points every 5 years until 2030, when it will level off at 15.9 percent.

The reforms are designed to respond to changing demographic and family trends. For example, to encourage individuals to remain in the workforce, those who work beyond retirement age will receive higher benefits, while those retiring before the statutory age of 60 will face reduced benefits. Divorced spouses will remain eligible to receive pensions even if they remarry. In addition, the reform package establishes a national pension policy council headed by the Prime Minister to oversee the development of measures covering the management of national pensions.

South Korea's population is aging rapidly because of a combination of below-replacement birthrates and rising life expectancy. In 2000, 7 percent of the population was aged 65 or older. By 2026, that share will exceed 20 percent. Projections by the Finance Ministry show that, under current law, the national pension fund—similar in structure to the U.S. Social Security trust funds—will begin running cash-flow deficits in 2036 and will be exhausted by 2047.

Although more than 17 million South Koreans are covered by the pension system, almost one-quarter—3.9 million—are in arrears in their contributions, including 1.8 million who are in default for over a year. Many of the latter have been unable to pay because of financial difficulties linked to the long economic downturn. In an effort to relieve the burden of financially troubled subscribers, the government has announced plans to ease contribution collections as well as to temporarily waive fines on some low-income workers.

Sources: *The Korea Times*, May 20 and 25 and June 3, 2004; *JoongAng Daily*, June 3, 2004; *The Korea Herald*, May 31 and June 3, 2004; and Reuters News, February 24, 2004.

Social Security Administration News

The Japanese Diet approved legislation on June 11 to implement a joint United States–Japan social security agreement that will benefit U.S. and

Japanese workers and employers. On February 19, Jo Anne Barnhart, Commissioner of Social Security, signed an agreement with Japanese Ambassador Ryozo Kato that will eliminate the requirement that U.S. citizens working for U.S. companies in Japan pay social security taxes to both countries. The agreement also will remove the double taxation requirement for Japanese citizens working for Japanese companies in the United States. "This agreement eliminates a serious and unnecessary impediment to American and Japanese businesses and their employees," stated Commissioner Barnhart. "Just as important, it promotes equity and fairness for workers who divide their careers between our two countries."

When the agreement takes effect, U.S. and Japanese employers and their employees will contribute to either the U.S. or Japanese social security systems, but not to both. Approximately 15,600 U.S. workers are affected. They and their employers will share tax savings of US$632 million over the first 5 years of the agreement, according to the Social Security Administration.

The agreement also will improve social security protection. Currently, some workers who have divided their careers between the United States and Japan fail to qualify for social security benefits from one or both countries because they do not meet minimum eligibility requirements. Under the agreement it will be possible for workers and their family members to qualify for prorated U.S. or Japanese benefits on the basis of combined credits from both countries. This will result in the vesting of 24,000 U.S. and Japanese workers within the first 5 years of the agreement.

The President will transmit the agreement to Congress, where it will be reviewed before taking effect. The United States has similar social security agreements with 20 other countries, including Australia, Canada, Chile, South Korea, and nearly every country in Western Europe. To find out more about agreements with other countries, go to http://www.socialsecurity.gov/international/.

Sources: *Nikkei Report*, June 11, 2004; Social Security Administration press office.

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