Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

August 2004

Europe

Austria

Austria began implementing the first of two major pension reforms in July. The current reforms, passed in June 2003, are designed to rein in the costs of one of the world's most generous and expensive systems, where benefits frequently surpass 80 percent of preretirement income. Another proposal now under consideration would harmonize separate public plans for private-sector employees, self-employed workers, farmers, civil servants, and other occupational groups.

A key provision of the 2003 reforms reduces benefits for private-sector employees by gradually increasing the number of years used to calculate initial pension benefit levels. Instead of the highest-paid 15 years, benefits will reflect a percentage of average income over 40 years, a full career. The calculation period will be increased annually by 1 year from the end of 2003 up to 2028. At the same time, accrual rates used to calculate the initial benefit will drop from an annual rate of 2 percent to 1.78 percent starting in 2009.

Until recently, workers with 35 years of contributions could retire 3.5 years before the statutory retirement ages of 65 for men and 60 for women. The new law raises the minimum retirement age for such workers: for men, the age will increase from 61.5 years to 65 years; for women, the age will rise from 56.5 years to 60 years. The increase will be phased in gradually beginning July 2004, and by 2017, early retirement will be eliminated. As part of an "equal treatment" agreement negotiated in 1992, the statutory retirement age for women will be increased gradually between 2019 and 2034 until it is unified with the retirement age for men at 65.

The reform discourages early retirement during the transition period by imposing larger penalties for those taking benefits before age 65. The initial benefit amount will be reduced by 4.2 percent a year, instead of the current 3.75 percent, up to a maximum reduction of 15 percent. At the same time, a bonus for later retirement will increase benefits by the same 4.2 percent per year up to a maximum of 10 percent.

The government also plans to present a proposal to parliament this fall designed to unify Austria's various pay-as-you-go public pension systems. After 22 rounds of negotiations with labor unions, the government announced a tentative agreement on July 12 calling for a unified system that assumes a harmonized base for contributions and a retirement age of 65 years. The new system would feature a flexible "corridor" between the ages of 62 and 68, during which workers could retire with deductions or additions to their pensions, depending upon when they take them.

Austria has a rapidly graying population. According to the United Nations, the ratio of the number of persons aged 65 or older to persons aged 15–64 is projected to more than double after 2030, rising from 0.24 in 2005, to 0.43 in 2030, and to 0.55 in 2050. Pension costs already total more than 14.5 percent of gross domestic product (GDP), compared with a European Union average of 10.4 percent. The government anticipates a savings of €2.2 billion (US$2.5 billion) in the first 4 years following implementation of provisions in the 2003 pension reform.

Sources: Leif L. Eskesen, *Population Aging and Long-Term Fiscal Sustainability in Austria*, IMF Working Paper WP/02/216, Washington, DC: International Monetary Fund, 2002; Agence France-Presse, June 1, 2003; APA News Service, June 11, 2003, March 30 and July 13, 2004; Associated Press Newswires, June 11, 2003; Watson Wyatt Worldwide, Global News Briefs, August 2003; *Investment & Pensions Europe*, September 17, 2003, June 2004, and August 6, 2004; Organization for Economic Co-operation and Development, *Economic Survey of Austria, 2003*, OECD Policy Brief, Paris: OECD, October 2003; *Austria Today*, May 7, 2004; World Economic Forum, 2004.

Italy

Prime Minister Berlusconi's pension reform won a vote of confidence in Italy's lower house of Parliament on July 29. The vote (333 to 148) was called to avert further delay in Italy's commitment to its European Union partners to institute long-term structural reform of its public pension system. Had the government lost the vote, Prime Minister Berlusconi would have been forced to resign.

The reform's centerpiece is an increase in the retirement age, beginning in 2008. Although currently a regular social security pension is payable to men at age

65 and to women at age 60, most Italians with comparatively long careers retire with "seniority pensions," whereby workers can retire at age 57 if they have made at least 35 years of pension contributions. The new law gradually increases the age and contribution conditions for payment of the seniority pension. Beginning in 2008, the following conditions will apply:

- Men will be able to retire only after 40 years of pension contributions (or after 35 years of contributions if they are at least 60 years of age). The minimum retirement age for men with only 35 years of contributions will rise to 61 in 2010 and to 62 in 2014.
- Women will be able to continue to retire at age 57 if they have at least 35 years of social security contributions. However, they will receive only 75 percent of their full pension until they reach the minimum age requirements set for men.
- Self-employed workers with a minimum of 35 years of contributions will be able to retire at the age of 61 in 2008, which rises to 62 in 2010 and 63 in 2013.

In addition, those who are entitled to retire between 2005 and the end of 2007 but who continue to work will receive a tax-free bonus of 32.7 percent of salary in the initial year—the equivalent of pension contributions normally paid toward state pensions—that will be annually indexed for inflation. Currently, those workers eligible for retirement who choose to remain in the workforce face an implicit tax rate of 79 percent on their earnings.

Italy faces a sharp rise in the cost of funding its state pension system in the coming decades because of low birth rates, increasing life expectancy, and low labor force participation. The support ratio is expected to deteriorate dramatically from the current 2.8 workers per retiree to 1.5 workers by 2050. Today, Italy spends about 14 percent of its GDP on pensions. Government economists predict the reform should save the equivalent of 0.7 percent of GDP each year from about 2012 to 2018 and 0.6 percent of GDP between 2018 and 2030.

Although the European Commission has welcomed the measures to address Italy's deteriorating public finances, many economists contend that the current reform does not go far enough. They predict that further changes will be necessary even before the current reforms can take effect. The recently approved reforms are not as far-reaching as those envisaged in an earlier draft approved by the cabinet in October 2003. (See the October 2003 issue of *International Update*.)

In recent years, trade unions have used intense lobbying and general strikes to oppose reform. (See the January and April 2004 issues of *International Update*.) The newly passed bill provides only a framework for reform. The implementation of the laws remains to be worked out, with negotiations between the government and unions expected to begin in September.

Sources: Associated Press, July 28, 2004; *Financial Times*, July 29, 2004; *Investment & Pensions Europe*, July 29, 2004; ANSA English Media Service, July 30, 2004; Bureau of National Affairs (BNA), *Pension & Benefits Daily*, July 30, 2004.

The Americas

Colombia

Colombian President Alvaro Uribe presented Congress with proposals to help fund the ailing public pay-as-you-go system in the legislative session that began on July 20. Despite a recent reform, which included an increase in contribution rates, the social security reserve is expected to be depleted in August. (See the January 2004 issue of *International Update*.) According to the Ministry of Finance, some US$352 million, or 3.8 percent of GDP, will be needed from general revenues to help fund pensions this year. By 2005, the pension deficit is projected to reach 5.5 percent of GDP.

The president proposes to establish a special 4 percent value-added tax (VAT) on goods and services that currently are not taxed, such as meat, eggs, rice, fruits, milk, and rental properties. The government anticipates that the new tax would generate $374 million in additional revenue in 2004.

President Uribe is also proposing a series of benefit cuts and a tax on higher benefits that would save an estimated 13 percent of GDP by 2035. These provisions include

- taxing pension benefits that are greater than four times the minimum wage, affecting about 5 percent of current pensioners;
- eliminating a year-end bonus payment equal to 1 month of benefits, for new retirees;
- accelerating from 2014 to 2008 the gradual increase in retirement ages for men (from 60 to 62 years of age) and for women (from 55 to 57);
- eliminating special "privileged" pensions for such groups as congressmen, judges, teachers, and oil workers, except for the military;
- establishing a guaranteed minimum pension equal to the minimum monthly wage, currently 358,000 pesos, or US$140; and

- phasing in a 50 percent cut in the maximum monthly pension—currently about 18 million pesos, or US$3,300.

Observers warn that President Uribe will face fierce opposition to the tax proposal since Congress has rejected recent attempts to impose a special VAT three times. Also, last year, Congress defeated a proposal to cut the privileged pensions.

Colombia's social security system, set up in 1993, allows workers a choice between the public pay-as-you-go program and an individual account managed by a private pension fund management company. Workers may switch from one system to the other every 3 years. The public system has about 5.6 million contributors, and about 5.3 million workers have individual accounts.

Sources: Economist Intelligence Unit ViewsWire, May 7, 2004; *Pensions International*, May 2004; OsterDowJones CommodityWire, June 23, 2004; World Markets Research Centre, June 30, 2004; Dow Jones en Español, June 30, 2004; FIAP Bulletin, June 2004; Latin American Andean Group Report, July 6, 2004; Latin American News Digest, July 9, 2004; Bloomberg.com, July 19, 2004; Dow Jones International News, July 21, 2004.

Ecuador

Ecuador's unicameral National Congress passed a bill in July to increase pension benefits after several thousand retirees staged a month-long protest and more than 50 held a 2-week hunger strike resulting in 16 deaths. At an annual cost of $68 million, or about 0.02 percent of GDP, the bill raises the average retirement pension by $30 a month for pensions totaling up to $200, by $25 a month for pensions between $201 and $300, and by $20 a month for those above $300. An average monthly pension today is $166, and the minimum pension is $42.

Disagreement between the president and Congress over how to fund the benefit increase for the 240,000 pensioners delayed the bill's passage. Congress passed the benefit increase to end the protests, even though the sources of funding had not yet been finalized. Thus far, an agreement has been reached to raise taxes on cigarettes and alcohol, except for beer. Deputy Economy Minister Ramiro Galarza stated that additional monies will probably come from the stabilization fund containing profits from the utility companies, plus unspecified budget cuts, if necessary.

The country's public pay-as-you-go system is administered by the Ecuadorean Social Security Institute (IESS), which by law covers 60 percent of the pension costs, (general revenues finance the remaining 40 percent). To date, a 2001 law setting up a system of individual accounts as a supplement to the public system has not been implemented.

Sources: Reuters News, July 26, 2004; Reuters-Noticias Latinoamericanas, July 26, 2004; EFE News Service, July 27, 2004; *El Comercio*, July 27, 2004; Dow Jones International News, July 27 and 28, 2004.

Nicaragua

The government announced on July 21 that it will postpone indefinitely implementation of the 2000 law creating individual accounts, scheduled to begin operation in July. According to the Minister of Finance and Public Credit Eduardo Montiel, a team working on setting up the "pension-saving system" concluded that the system would not work in Nicaragua as currently designed, because the country cannot finance the transition costs as the system is currently structured.

The Inter-American Development Bank stopped paying its US$10 million loan when difficulties in implementing the new system became apparent. Even though the World Bank provided an US$8 million loan to set up the system, Bank officials agree that the current pension reform design is not viable. Montiel proposed that the president name a commission to study the situation and make recommendations on needed legislative changes.

The pension-saving system is modeled on the Chilean system that closed the public pay-as-you-go program to new entrants in 1981 and set up a system of mandatory individual accounts. Workers younger than 43—some 260,000 workers representing 78 percent of current contributors to the Nicaraguan Social Security Institute (INSS)—would have been required to switch to the new system of individual accounts. The financially strapped INSS would continue paying pensions for current and future retirees, including those over the age of 43 who remain in the pay-as-you go system, as well as the cost of the transfer certificate that represents the value of accrued rights under the pay-as-you-go system for workers who switch to individual accounts. According to independent studies, the transition costs during the period 2005 to 2009 would total US$667 million, or 5.8 percent of GDP. The INSS holds no reserve funding for the transition.

Three pension fund management companies have been authorized by the Superintendent of Pensions, and each fund has already invested close to US$2.5 million in start-up costs. (See the October 2003 issue of *International Update*.) The government has not yet announced the status of these companies.

With a median age of only 19, Nicaragua has one of the youngest populations in the Western Hemisphere. According to the United Nations, only 4.6 percent of the population is over the age of 65; by 2050, however, that figure is projected to reach 16 percent.

Sources: United Nations, *World Population Ageing, 1950–2050*, New York: UN, Department of Economic and Social Affairs, Population Division, 2002; Agence France-Presse, July 17, 2004; Fund Pro Latin America, July 19 and 25, 2004; Agencia Mexicana de Noticias, July 21, 2004; Europa Press-Servicio Internacional, July 22, 2004; *El Nuevo Diario*, July 22, 2004; Central Intelligence Agency, *The World Factbook, 2004*, Washington, DC: CIA.

Reports and Studies

In a study released on July 22, the 30 member countries of the Organization of Economic Co-operation and Development (OECD) embraced full funding of occupational pensions. Other core principles outlined in the report include the need for independent asset management, enhanced compliance through supervision of pension funds and fund managers, and strict limitations on—or preferably the outright prohibition of—pension investment in one's own company. The report encouraged the adoption of pension portability and called for the removal of discriminatory practices, such as denial of participation in pension systems on the basis of gender, nationality, and age.

The OECD's recommendations reflect growing concern over the demographic aging of the industrialized economies and its impact on the long-term sustainability of occupational pensions. Although popular in the United States and the United Kingdom, funded employer pensions remain a rarity throughout most of the developed world, in which benefits typically are underwritten by a combination of publicly backed cross guarantees and company "book reserves."

Source: Organization for Economic Co-operation and Development, *OECD Recommendation on Core Principles of Occupational Pension Regulation*, Paris: OECD, July 22, 2004. The report can be found at http://www.oecd.org/dataoecd/14/46/33619987.pdf.

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