Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

November 2004

Europe

Finland

Finland will overhaul its private-sector, earnings-related pension system in January 2005 to encourage later retirement and to address demographic uncertainties. However, there is broad agreement that the reform will be insufficient to cope with rising pension costs brought on by low fertility rates and rising life expectancy.

Finland's old-age pension system is composed of the national pension and compulsory earnings-related pensions. The national pension guarantees a minimum income to residents who are not entitled to an earnings-related pension and to those who receive a relatively small earnings-related benefit.

The earnings-related pension system is a partially funded pay-as-you-go arrangement, with funds managed by a large number of private pension institutions. It is jointly financed by employer and employee contributions, and benefits are based on the number of years in employment, the accrual rate, and the pensionable wage. Voluntary pensions do not play a major role in providing retirement income in Finland.

The following new financial incentives and program changes will fully affect earnings-related pensions accruing from 2005:

- The normal retirement age, which is 65, will now become flexible, and the retirement age will range from 63 to 68. The qualifying age to receive an early old-age pension will rise from 60 to 62. For those retiring at the age of 62, the pension benefit will be reduced by 0.7 percent for each month of early retirement prior to the age of 63. Delaying retirement beyond the age of 68 will increase the pension received by 4.8 percent for each year postponed.
- Benefits will be calculated on an employee's entire working life, not just the last 10 years of earnings. The range of working years covered will be redefined as between the ages of 18 and 68 instead of between the ages of 23 and 65.
- Pension payouts will no longer be capped at 60 percent of monthly earned income.
- The rate at which pension benefits are earned will be increased to encourage longer employment. Currently, the accrual rate stands at 1.5 percent of pensionable earnings for each year credited to employees under the age of 60 and at 2.5 percent for employees who are older. Under the reform, the present accrual rate will continue for those under the age of 53, but the rate for workers between the ages of 53 and 62 will rise to 1.9 percent, and for workers older than 63, it will increase sharply, to 4.5 percent. Delaying retirement beyond the age of 68 will increase the pension as indicated above.
- The wage coefficient, which is used to adjust past earnings when computing the pension at the time of retirement, will be made more generous to ensure that wages earned at younger ages maintain their value in the benefit calculation. The new coefficient will be weighted 80:20 (wages to prices), up from the current 50:50 formula.
- A life-expectancy coefficient will adjust the pension level of each cohort in proportion to changes in life expectancy after 2009. If life expectancy rises, benefit payments will decline.
- The provisions for early retirement will be curtailed. The unemployment pension program will be gradually phased out between 2009 and 2014 and replaced with additional unemployment benefit days for the older unemployed until the age of 65. The minimum qualifying age to begin receiving unemployment benefits will be increased from 55 to 57, while the medical assessments required of workers aged 60 and older to receive an ordinary disability pension will be relaxed. The average age of retirement today in Finland is 59.
- Pension benefits earned for part-time work will be restricted. The minimum age for a part-time pension will be raised from 56 to 58, while the old-age pension rights accumulated during part-time retirement will be halved.

The Organisation of Economic Cooperation and Development (OECD) projects that Finland's old-age dependency ratio will rise faster than that of any other OECD country. The population aged 65 and older, as a proportion of the population aged between 20 and 64, is projected to increase from 23 percent to 45 percent in 2030 and thereafter to level off at slightly less than 50 percent during the decade 2040 to 2050. The OECD has recently reported that without reform, Finland's share of gross domestic product (GDP) devoted to old-age pensions will grow from 8 percent in 2000 to about 13 percent by 2050. Both the International Monetary Fund and the OECD have urged that additional reforms be taken.

Sources: International Benefits Information Service (IBIS), February 2003; Organisation for Economic Cooperation and Development (OECD), *Economic Survey—Finland 2003* (Paris: OECD, March 2003) and *Ageing and Employment Policies—Finland* (2004); Christina Lindell, "*Longevity Is Increasing. What About the Retirement Age?*" article for the 4th International Research Conference on Social Security (Geneva: International Social Security Association, May 2003); Heikki Niemelä and Kari Salminen, *Social Security in Finland* (Helsinki: Social Insurance Institution [Kela], the Finnish Centre for Pensions, and the Finnish Pension Alliance–TELA, 2003); International Social Security Association, *Trends in Social Security* (Geneva: ISSA, January 2004); World Economic Forum, *Pension Report 2004* (Washington, DC: Watson Wyatt Worldwide, January 2004); European Industrial Relations Observatory On-line (http://www.eiro.eurofound.ie), March 2004; Social Security Administration, *Social Security Programs Throughout the World: Europe, 2004* (Washington, DC: SSA, September 2004); *Investments & Pensions Europe*, October 11, 2004; and International Monetary Fund, *Finland—2004 Article IV Consultation* (Washington, DC: IMF, October 2004).

France

The French government will accept a lump-sum payment of €7.7 billion (US$9.8 billion), or 0.4 percent of France's GDP, from the state-owned utility companies Electricité de France (EdF) and Gaz de France (GdF) in exchange for linking their largely unfunded pension plans to the national system. This payment will enable the French government to reduce its budget deficit from the current 3.8 percent of GDP to 2.9 percent of GDP in 2005.

Although the government's deal with the state-owned utilities may have improved its short-term financial situation, it may undermine its long-term fiscal outlook. Today, the country spends about €32.7 billion, or 27 percent of all public-service expenditures, on pensions. It is expected that France's aging population will cause a dramatic increase in pension outlays in the near future. Next year alone, public spending on pensions will increase by €2 billion.

EdF's 112,000 French employees have received very generous pension promises that the government will now have to cover. According to a special report in *The Economist*, the French parliament estimated that EdF's unfunded pension liabilities equaled €50 billion last year.

France is not alone in using pension assets from state-owned companies to reduce deficits. Last year Portugal assumed control of its underfunded postal pension fund and is currently considering taking over the assets and liabilities of three more state-owned companies: Caixa Geral de Depósitos, a financial institution, and Aeroportos de Portugal and Navegação Aérea de Portugal, both of which operate the country's airports. Similarly, Germany, which has been in violation for several years of the 3 percent cap on budget deficits established by the European Union's Stability and Growth Pact, has announced after much debate that it would assume control of the pension assets and liabilities of its state-owned companies, Deutsche Telekom and Deutsche Post.

Sources: *The Economist*, "A Very Big French Turn-off," July 3, 2004; Vincenzo Guzzo, "Euroland: Budgets—Only a Modest Tightening Bias in 2005, If Any," Global Economic Forum, http://www.MorganStanley.com, October 11, 2004; David Gauthier-Villars, "French Govt, Pension Body Agree Pact On EdF, GdF Pensions," Dow Jones Newswires, October 19, 2004; Rainer Buergin, "Germany Won't Assume Post, Telekom Pension Obligations for Cash," http://www.Bloomberg.com, October 26, 2004; Cecilia Valente, "Portugal Eyes State Firms' Pension Funds," http://www.IPE.com (Web extension of *Investment &Pensions Europe*), October 27, 2004; and Andrea Thomas and G. Thomas Sims, "Germany to Unveil Plan to Help Nation Stick to EU Budget Rules," *Wall Street Journal Europe*, November 4, 2004.

United Kingdom

The Pensions Commission, an independent body established to evaluate the national pension system and private savings in the United Kingdom, released its first report, *Pensions: Challenges and Choices*, on October 12. Although the Commission Chairman, Adair Turner, has pointedly avoided making any recommendations, the report suggests that the current pension system has contributed to extremely low levels of private savings and concludes that society and individuals will have to make unpleasant choices regarding the future of the country's retirement policies. The report concludes that, if retirees are not to be poorer on average in relation to the rest of society, either tax contributions must increase or savings must rise, or people will have to work longer.

The United Kingdom's retirement system is very complex. At its center is the basic state pension. For retirees whose retirement income falls below a certain level, a system of means-tested benefits provides additional income, not unlike Supplemental Security Income in the United States. In 1978, all employees, except the self-employed, were brought under a compulsory, wage-based pension system called the State Earnings-Related Pension Scheme (SERPS). In 2002, SERPS was replaced by the State Second Pension, which is more generous toward workers with low earnings. Employees may also contract out of the State Second Pension by contributing an equal amount to a funded pension system such as a defined benefit or defined contribution account. In an attempt to encourage private savings, in 1999 the government introduced tax-preferred individual savings accounts. However, the enormous variety of providers and plans, each with different governing rules, has hampered their popularity.

This retirement system has for many years been the envy of continental Europe, since public expenditures for pensions have been projected to decline as a percentage of GDP over the next 50 years. However, the Pensions Commission now suggests that the success of the United Kingdom's retirement system may have been exaggerated. Projections are low because they do not take into account the growing cost of the means-tested benefits or new data on the demographic projections for the United Kingdom.

The state pension benefits currently replace approximately 37 percent of an average earner's final salary compared with slightly more than 42 percent in the United States. Although the balance of retirement pensions in the United Kingdom had been provided by the State Second Pension or employer-based defined benefit pension plans, many of these plans have been underfunded, and an increasing number are now closed to new members. Some may soon close to current members, because of the winding up of plans. Employers are replacing defined benefit plans with less generous defined contribution plans.

The Pension Commission is in consultation with various experts and interest groups. It will release its recommendations next summer following parliamentary elections.

Sources: Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, DC: SSA, March 23, 2004); Nicholas Timmins, "Pensions Overhaul Expected After Election," *Financial Times*, October 11, 2004; and Pensions Commission, *Pensions: Challenges and Choices* (Norwich, United Kingdom: The Stationery Office, October 12, 2004).

The Americas

Argentina

Argentina's 11 private pension-fund management companies (AFJPs) have agreed to restructure the equivalent of US$16 billion of defaulted government bonds by swapping them for newly created inflation-linked bonds. President Kirchner signed a decree on October 7 after several failed attempts to come to an agreement during the past few years. However, since the country's other creditors have not yet accepted the latest offer by the AFJPs, the final status of the agreement between the government and the AFJPs is unclear.

Under the October agreement with the AFJPs, the government will issue higher-yield, short-term "Boden" bonds in exchange for US$2.3 billion in lower-yield treasury notes (Letes) that the AFJPs were forced to buy in 2001. The Boden bonds will mature between 2008 and 2014 and will begin semiannual payments in March 2011. Approximately US$13 billion in defaulted bonds will be swapped for new bonds with a 42-year maturity date. In addition, for at the least the next 5 years, the AFJPs will be allowed to set a higher than market value for their portfolios to protect them from major losses, especially for workers who are likely to retire in the next several years.

The defaulted bonds date back to Argentina's economic crisis that culminated in late 2001. At that time, in an effort to avoid defaulting on its foreign debt, the government required the AFJPs to swap their bond holdings for lower-yielding, longer-term bonds. The government also forced the pension funds to convert US$2.3 billion in certificates of deposit to treasury notes. In January 2002, the government defaulted on its debt and devalued its currency.

At the same time, to boost workers' take-home pay, the government temporarily reduced workers' mandatory contributions to an individual account from 11 percent of earnings to 5 percent. Currently the rate is 7 percent, but that is scheduled to be raised to 9 percent on July 1, 2005, and restored to 11 percent on October 1, 2005. Employers do not contribute to workers' individual accounts.

It is unclear how Argentina's system of some 9.8 million individual retirement accounts will be affected by the government's default and subsequent debt restructuring. However, it is assumed that the long-term effects will be negative because of the lowering of the contribution rate coupled with the lost value of the higher-yield bonds and the compound interest that would have been earned. The Argentine peso's appreciation over the past 2 years has raised individual account assets to about US$16 billion, or 13.5 percent of GDP, from US$11.5 billion, or 11.3 percent of GDP, in 2002. But, it is important to note that these figures represent book rather than actual market value.

The AFJP's defaulted debt represents about 16 percent of Argentina's US$100 billion total debt. President Kirchner believes that the agreement with the AFJPs will help convince the country's other creditors to accept a separate plan, but, to date, some 500,000 bondholders worldwide have not accepted Argentina's latest offer.

Sources: Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones (AIOS), *Boletín Estadístico AIOS*, Número 10 Diciembre 2003; IBIS, August 2004; La Superintendencia de Administradoras de Fondos de Jubilaciones y Pensiones (SAFJP), *Boletín Estadístico Mensual* 10(9) Septiembre 2004; http://www.Reuters.com, October 7, 2004; Dow Jones International News, October 8, 2004; Market News International, October 11, 2004; and World Bank Press Review, November 2, 2004 (Washington, DC: World Bank, External Affairs Department).

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