Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

May 2005

Europe

Germany

The government announced in April that the level of social security benefits and the contribution rate of 19.5 percent will remain unchanged in 2005. This marks the second consecutive year that Germany's nearly 20 million pensioners will go without a benefit increase.

Sluggish economic growth, high unemployment, and worsening demographics are burdening Germany's public pay-as-you-go pension system, which currently claims monthly government expenditures of about €15 billion (US$19 billion). The Social Affairs Ministry estimates that the pension system will have a deficit this year of €1.5 billion (US$1.9 billion). Continued economic performance next year could result in not only a benefit freeze but additional actions being taken to fill the funding gap that the government estimates will reach €3.5 billion (US$4.5 billion) in 2006.

In the past, benefit levels were adjusted annually on July 1 in proportion to changes in earnings. Since January, however, benefits are indexed to wage growth and demographics, with the addition of a new element linking the pension benefit replacement rate to the system's dependency ratio. (See also the February 2004 and April 2004 issues of *International Update*.) This *sustainability factor* reduces the annual pension adjustment as the system's dependency ratio worsens. Effectively, the factor will slow pension increases by one-quarter of a percent for every percentage-point increase in the old-age dependency ratio, or about three-quarters of a percent of gross domestic product (GDP) in the long run, according to an analysis in 2004 by the International Monetary Fund.

Further evidence of Germany's pension problem is a dramatic decline of the fluctuation reserve, which is maintained to prevent temporary cash-flow problems. By law, the reserve must equal at least 20 percent of monthly pension expenditures. The reserve shrank to 9 percent in April, down from 32 percent in January. Officials are concerned that the reserve may be insufficient to cover estimated deficits for this year and 2006. To maintain the fluctuation reserve close to the legal limit and keep the level of contributions stable, the Social Affairs Ministry has suggested several budgetary options, including accelerating the payment of employer contributions by 2 weeks starting in January 2006.

Sources: International Benefits Information Service (IBIS), January, July, and November 2004 and April 2005; International Monetary Fund, *Germany: 2004 Article IV Consultation—Staff Report*, IMF Country Report No. 04/341 (Washington, DC: IMF, November 2004); Reuters News, April 2 and April 15, 2005; Dow Jones International News, April 4, 2005; Bloomberg.com, April 13, 2005; http://www.IPE.com (Web extension of *Investment & Pensions Europe*), April 19, April 29, and May 12, 2005.

The Americas

Costa Rica

In late April, the Costa Rican Social Insurance Fund Board (CCSS) approved major changes to the first-pillar public pension program by increasing the contribution rates and adjusting the benefit formula. The reforms, which resulted from more than a year of discussion by a group composed of technical representatives from CCSS, the National Institute of Women, labor unions, and cooperatives, are to be implemented within the next year. The new rules will apply to workers under the age of 45, and transitional rules will apply to workers between the ages of 45 and 54. Workers over 55 will not be affected. Alberto Sáenz, executive president of the CCSS, expects the reforms to guarantee the system's solvency until 2040; without the modifications, the system would collapse in 2028.

The changes to the system consist of

- raising the combined contribution rate from employees, employers, and the government from 7.5 percent of earnings to 10.5 percent gradually over a 30-year period;
- changing the basis for calculating the benefit from the highest 48 monthly contributions during the last 5 years of coverage to average earnings over the last 20 years, adjusted for inflation;

- increasing the minimum number of required monthly contributions from 240 to 300; and
- establishing a separate disability benefit—50 percent of the full disability benefit—for workers aged 48 and older with at least 5 years of contributions. Currently, a worker must have at least 10 years of contributions to receive a disability benefit.

The retirement age remains unchanged. Normal retirement is permitted at the age of 65, although early retirement is possible with additional months of contributions. The average age for retirement is 64.5 years.

Costa Rica established a second pillar of mandatory individual accounts in 2000 under which workers contribute 1 percent of earnings and employers 1.75 percent of payroll. Benefits at retirement may be taken as programmed periodic withdrawals or as an annuity. As of June 2004, second-pillar assets represented about 2 percent of GDP.

Nearly 80 percent of the 1.3 million individual account holders are under the age of 45. In 2000, only 8 percent of the population was over the age of 60, and 60 percent were of working age. By 2050, however, those figures are projected to be 22 percent and 58 percent, respectively.

Sources: Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones, *Boletín Estadístico AIOS*, Número 11, Junio de 2004; Central Intelligence Agency, *The World Factbook, 2005* (Washington, DC: CIA); Social Security Administration, *Social Security Programs Throughout the World: The Americas, 2003* (Washington, DC: SSA, March 2004); ANSA—Servicio Economía en Latinoamérica, April 15, 2005; *La Nación* (Costa Rica), April 15, 2005; Dow Jones en Español, April 29, 2005; Agencia EFE—Servicio Económico, April 29, 2005.

Mexico

Beginning in June, the self-employed will be permitted to set up an individual account with a pension fund management company (AFORE) of their choice. Mario Gabriel Budebo, president of CONSAR, the National Commission of the Retirement Saving System that oversees the program, estimates that some 12 million self-employed workers will be eligible. Under current rules, employees are required to contribute to an individual account, while public-sector employees, the military, and petroleum workers each have separate pension systems.

CONSAR has implemented a separate measure to stimulate greater competition among the AFOREs by allowing workers to switch to a company that charges lower administrative fees at any time, rather than just once a year. Mexico's 15 AFOREs now manage individual accounts for some 33.6 million workers. Assets of nearly US$45 billion are up from US$38 billion in mid-2004. Since December, each management company can offer two types of pension funds. (See also the June 2004 issue of *International Update*.) Workers under the age of 56 can choose between a fund that invests mainly in fixed-income securities and one that invests up to 15 percent of assets in approved equity indexes. Both types of funds may hold 20 percent of assets in foreign debt. According to recent press reports, most AFOREs have not yet made the switch to equities. Initially, fund managers felt the market was overpriced, and now they are waiting for stability following a recent downturn in stock prices.

Sources: CONSAR, Estadísticas, Marzo 2005, http://www.consar.gob.mx/consar.shtml; Corporate Mexico (newswire at Factiva.com), April 22, 2005; Servicio Universal de Noticias, April 24, 2005; Associated Press Newswires, April 25, 2005; *El Universal* (Mexico City), April 25, 2005; Agencia Mexicana de Noticias, NOTIMEX, May 2, 2005; CONSAR (Comisión Nacional del Sistema de Ahorro para el Retiro), "Boletín de Prensa 2 de mayo de 2005," http://www.consar.gob.mx/consar.shtml.

Asia & the Pacific

Australia

On May 10, Treasurer of the Commonwealth of Australia Peter Costello announced plans to establish a special Future Fund to ensure that the government's superannuation liabilities for public employees and the military are fully funded by 2020. The unfunded liabilities for these pension plans currently stand at AU$91 billion (US$69.7 billion) but are projected to reach AU$140 billion (US$107.2 billion) by 2020. It is expected that the fund will begin with an initial transfer of AU$16 billion (US$12.3 billion) and thereafter be financed by transfers from general budget surpluses. The fund's assets will be strictly segregated from the remainder of the budget. Legislation will be drawn up later this year to create a statutory agency, which will oversee the management of the fund, and an independent, government-appointed board of experts in investment and corporate governance.

Sources: Treasurer of the Commonwealth of Australia, Joint Press Release (Canberra, May 2, 2005), http://www.treasurer.gov.au/tsr/content/pressreleases/2005/055.asp; *Financial Times*, May 11, 2005.

Singapore

The government has withdrawn plans to introduce low-cost, voluntary private pension plans as a way to increase retirement savings. (See also the February 2004 issue of *International Update*.) The decision in March followed consultations with pension fund experts and the public about the lack of industry incentives and the potential for investment losses under the proposed system. The Manpower Ministry is now exploring other ways to boost the return on savings from the state-run Central Provident Fund (CPF).

Because the private pension plans would have waived fund distribution fees and set annual fees and expenses below the level of 2.5 percent (or more) that is typically charged, the financial services industry feared that it would be unable to achieve the necessary economies of scale to lower costs and attract clients. Concern was also expressed that many workers lack the necessary aptitude and sophistication to evaluate the various investment options.

Singapore's mandatory CPF has come under scrutiny in recent years for failing to provide adequate retirement income security. Contributions to the CPF are allocated to four accounts: a Medical Account, an Ordinary Account (OA) for preretirement withdrawals, a Special Account (SA) reserved for old age and related purposes that is available at the age of 55, and a Retirement Account that combines the remaining balances from the OA and the SA and provides an initial tax-exempt lump sum for funds above a required minimum balance at the age of 55 and a programmed withdrawal or annuity purchase from the age of 62. The combined CPF member savings pool was worth S$179 billion (US$108 billion) at the end of 2003.

Despite having one of the world's highest saving rates, many Singaporeans are expected to have insufficient savings in old age because of preretirement withdrawals for housing purchases, low returns on CPF account balances, and the tendency for many to stop working at relatively early ages. For example, the 3 million members of the CPF have placed S$110 billion (US$67.2 billion) of their savings into property but only S$29 billion (US$17.7 billion) into investments and insurance. Worsening demographics are compounding the problem. It is estimated that by 2030 the number of persons aged 65 and older will increase fourfold, with no corresponding growth in the working-age population to support them.

Sources: International Monetary Fund, *Singapore: Selected Issues*, IMF Staff Country Report No. 00/83 (Washington, DC: IMF, July 2000); International Benefits Information Service (IBIS), December 2002, February and November 2004; *Business Times Singapore*, October 8, 2004, and March 16, 2005; Dow Jones International News, March 10, 2005; *The Edge Singapore*, March 21, 2005; *Financial Times*, March 28, 2005; Reuters News, March 31, 2005.

Reports and Publications

Center for Strategic and International Studies (CSIS)

The CSIS Global Aging Initiative has released a report, *Projecting Immigration: A Survey of the Current State of Practice and Theory*. Net immigration rates in most developed countries have recently surged, and projections of immigration have become increasingly important in thinking strategically about long-term social challenges, from national security to retirement security. Prepared through the Social Security Administration's Retirement Research Consortium, this report assesses where projection-making agencies stand in their practice of immigration projection and explores how theoretical insights about immigration may help them improve projection practices.

Source: Center for Strategic and International Studies, Global Aging Initiative, *Projecting Immigration: A Survey of the Current State of Practice and Theory* (Washington, DC: CSIS, April 2005), available at http://www.csis.org/gai/0504_Howe_JacksonProjImmigration.pdf.

Organisation for Economic Co-operation and Development (OECD)

The OECD has recently released the following publications:

- ***Pensions at a Glance: Public Policies Across OECD Countries*** compares the mandatory public pension systems throughout the 30 OECD member countries from the vantage point of the pensioner—by providing a detailed description of how pensions are calculated, distributed, and taxed across different income levels.

  It reveals that among average earners in the OECD countries, Luxembourg provides the largest pension, replacing 101.9 percent of preretirement income—thus making retirement more lucrative than working. Other generous pension systems are in Turkey, Greece, Spain, and Italy, whose public pension system replaces 78.8 percent of preretirement income regardless of earnings.

  The United States ranked fifth among countries with the lowest replacement rates for average earners at 38.6 percent, followed by New Zealand (37.6 percent), United Kingdom (37.1 percent), Mexico (36.0 percent), and Ireland (30.6 percent). However, when benefits from voluntary pension vehicles such as individual retirement accounts and 401(k) plans are factored in, the replacement rate for those average earners in the United States rises to 77.7 percent.

- ***Private Pensions: OECD Classification and Glossary*** provides technical terms and expressions commonly used in the private pension industry. Its clear and consistent definitions should permit easier comparative analysis of private pension systems around the world and foster more effective communication on the complicated topic of pension reform.
- ***OECD Guidelines for Pension Fund Governance*** stresses the need for accountability and oversight in pension fund management.

Source: Organisation for Economic Co-operation and Development, *Private Pensions: OECD Guidelines for Pension Fund Governance* (Paris: OECD, April 27, 2005), available at http://www.oecd.org/dataoecd/18/52/34799965.pdf; *Pensions at a Glance: Public Policies Across OECD Countries* (Paris: OECD, May 2, 2005); *Private Pensions: OECD Classification and Glossary* (Paris: OECD, May 2005).

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