Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

August 2006

Europe

Guernsey

On June 28, the government presented parliament with a proposal to reduce by half the public financing of the social security system by increasing employer contribution rates and the wage ceiling. Employer contributions would rise from 6 percent to 6.5 percent of payroll, and the wage ceiling would increase from £36,036 (US$67,200) to £60,000 (US$112,000). Employee contributions would remain at 6 percent of earnings.

Guernsey's public pension system provides a maximum flat-rate benefit of £7,618 (US$14,280) per year to men and women aged 65 or older who have approximately 42 years of contributions. Retirement benefits are financed from employee and employer contributions supplemented by general tax revenues. The government currently provides a subsidy of an additional 50 percent of the combined employee and employer contributions. All contributions also finance survivors' pensions, disability, long-term care, unemployment insurance, and some medical services.

Parliament is expected to vote on the proposed changes in early September, and if adopted, they would go into effect on January 1, 2007.

Sources: *Future Economic and Taxation Strategy*, Guernsey, Policy Council, June 28, 2006; *Social Security Programs Throughout the World: Europe, 2006* (forthcoming).

Norway

On June 16, Norway's parliament endorsed the government's proposal to abolish preferential tax treatment for all noncompulsory private pension savings. The government believes it is no longer necessary to provide tax advantages for supplementary pension plans because all workers must now save for retirement through mandatory occupational pension plans. (See also the January 2006 issue of *International Update*.)

Legislation passed in 2005 requires employers to provide their employees with a pension plan with certain minimum requirements. Since July, all employers must contribute annually a minimum of 2 percent of covered employee earnings—60,059 krone (US$9,708) to 720,708 krone (US$116,450)—to a defined contribution plan with a private asset manager or establish a defined benefit plan with comparable benefits. Employees have the option to match their employer's contribution to the defined contribution plan. Preferential tax treatment is granted to contributions to the mandatory private pension plan. Employer plans established before 2006 that satisfy the new minimum requirements will continue to receive favorable tax treatment.

Under the 2005 law, self-employed workers who purchase a retirement savings product from an insurance company qualify for a tax deduction equal to 2 percent of their earnings. The government now proposes to raise that limit from 2 percent to 4 percent of earnings to correspond to the minimum requirements established for employees in the new compulsory occupational defined contribution plans. Legislation will be submitted to parliament in October.

Sources: Press release, October 7, 2005, and "Mandatory Occupational Plans to be Introduced in 2006," January 2006, Norwegian Royal Ministry of Finance; "The Revised National Budget, 2006," Norwegian Ministry of Finance, May 12, 2006; Global Insight Daily Analysis, May 15, 2006; *Pension & Benefits Daily*, May 22, 2006; Hewitt Associates, *Global Retirement Update*, June 2006; personal communication, Counselor for Economic and Financial Affairs, Royal Norwegian Embassy, June and July 2006.

Serbia

In an effort to increase the labor force, the National Assembly passed, in July, a series of amendments to the Personal Income Tax Law that includes incentives for hiring both younger and older workers. In Serbia today, about 2 million workers support 1.4 million pensioners.

Beginning September 1, employers hiring new workers younger than age 30 will be exempt from paying social security contributions for those workers for up to 3 years. At the same time, employers who hire unemployed workers older than age 45 will pay only 20 percent of the employer's social security contribution (2.2 percent of payroll); and those who hire any new workers older than age 50 will pay no social security contribution for those workers. New hires older than age 45 will not be subject to income tax.

Serbia's pay-as-you-go public pension system is funded by 11 percent of earnings from both employers and employees to finance old-age, survivors, and disability insurance and work injury and medical benefits for pensioners. The minimum monthly earnings subject to contributions are 40 percent of the gross national wage and the maximum, five times the gross national wage. In November 2005, these figures were 10,951 dinars (US$154) and 136,890 dinars (US$1,927), respectively. Effective February 1, 2007, the minimum earnings subject to contributions will be lowered to 35 percent of the gross national wage (9,582 dinars (US$135) as of November 2005).

Old-age pensions are paid to men beginning at age 63 with at least 20 years of coverage and to women beginning at age 53 with at least 35 years of coverage. Workers with 45 years of coverage may retire at any age. Between 2008 and 2011 the retirement age will increase gradually by 6 months a year to age 65 for men and to age 60 for women, with 20 years of coverage required for both. (See also the November 2005 issue of *International Update*.)

Sources: Serbian Government Web site (http://www.srbija.sr.gov.yu), News, May 25, 2006; *Social Security Programs Throughout the World: Europe, 2006* (forthcoming); Mercer, *International Headlines*, August 2, 2006.

The Americas

Canada

On June 14, legislation was introduced in the Quebec National Assembly to replace the current rules governing the province's private defined benefit pension plans. The legislation, designed to improve the funding and governance of pension funds, exempts pension plans sponsored by universities, municipalities, and childcare centers.

The proposed legislation, Bill 30, contains the following measures:

- Employers would not be allowed to suspend contributing to their fund temporarily unless they had a funding surplus in an amount to be determined by future regulations.
- Annual actuarial valuations would be required unless the plan's actuary certifies that the pension plan was fully funded. Actuarial valuations are currently conducted every 3 years.
- A plan would be allowed to fund solvency obligations with a letter of credit of up to 15 percent of a plan's liabilities.
- A plan would have to be at least 90 percent solvent before benefit increases would be allowed unless the employer paid the full cost up front.
- Any surplus funds used for increased benefits would have to be fairly balanced between plan members and retired beneficiaries. Additionally, active or retired plan members could request arbitration to determine whether a benefit change was equitable.
- At retirement, plan participants could request that their pension fund purchase an annuity with an insurer that would provide a benefit equal to what would be received from the employer. The plan administrator would be required to purchase the annuity within 3 years of the worker's retirement.

A pension fund oversight committee would have the sole authority to choose delegates, representatives, and service providers for the pension fund, and those chosen would be held to the same fiduciary standard as oversight committee members. Also, oversight committees would be required to adopt and publish a set of internal fund operations and governance rules.

Bill 30, if enacted, will substantially change the current pension rules, which have been in place since the signing of the Supplemental Pension Plans Act in 1990. The proposed legislation is expected to be debated this fall; submitted for a vote at the end of the year; and, if passed, become effective January 1, 2010.

Sources: Watson Wyatt, *Global News Briefs*, June 2006; Mercer, Communiqué, June 21, 2006; Towers Perrin, Global Benefit and Compensation Issues, July 2006.

Peru

In July, the Superintendent of Banking, Insurance, and AFPs (SBS) released a preliminary report that included proposals to reform Peru's 13-year-old system of individual retirement accounts (SPP). The report describes the current state of the SPP and proposes increasing coverage, improving the operating efficiency of the pension fund management companies (AFPs), and raising benefits. The SBS, which oversees the SPP, plans to hear testimony from all sectors—the government, unions, academics, consultants, and account holders—between July and January 2007 before issuing a final report by March 2007.

According to the SBS:

- The SPP has been the main source for developing the country's capital markets. As of May 2006, the SPP's total assets reached almost US$11 billion, or 13.8 percent of gross domestic product.
- The system averaged an annual nominal rate of return of 10 percent for the first 12 years.
- Pension coverage is among the lowest in the region. About 11 percent of Peruvian workers regularly contribute to an individual account, compared with about 60 percent in Chile and 30 percent in Mexico.
- Since the SPP's account holders are young, there is strong potential for the individual accounts to grow. Of the nearly 3 million account holders, 35 percent are younger than age 30 and 46 percent are aged 30 to 44.
- With only a few AFPs, there has been little competitive pressure to lower pension fund administrative fees, which for account holders have remained high even though AFPs' earnings have been strong.

The SBS recommends expanding coverage by requiring the self-employed to establish and contribute to an individual account. Currently, participation for the self-employed is voluntary.

The report indicates that the AFPs could improve their operational efficiency by changing the structure of the administrative fee from a percentage of contributions to a percentage of account balances; allowing AFPs to contract out certain services; and establishing a centralized electronic process for collecting contributions.

The SBS also proposes closing the public pension system to new entrants. Currently, workers entering the labor force have a choice between the SPP and the public pay-as-you-go defined benefit system. While workers in the public system may switch to the SPP at any time, SPP account holders are not permitted to transfer to the public system, which today covers about 6 percent of the labor force.

The SBS cites a number of measures that have already been implemented to increase competition among the AFPs and lower costs. Since the end of 2004, the rules for workers transferring from one AFP to another have been eased and AFPs have been permitted to offer discounted fees to workers for remaining with their asset management company. (See also the March 2005 issue of *International Update*.) The first new AFP since 1993 was approved in 2005 when the SBS lowered the barriers for companies to enter the AFP market. After the new AFP announced its lower administrative fee structure, the other AFPs reduced theirs. (See also the September 2005 issue of *International Update*.) After the report was released, it was announced that two of the current five AFPs, Prima and Union, will merge. Their combined assets under management represent 28 percent of the system's total.

The report noted that the recent introduction of a choice of funds with varying degrees of risk has provided more efficiency in the investment process. (See also the January 2006 issue of *International Update*.) In addition, the SBS has improved the quality of the information provided to account holders by sending workers monthly reports that contain the net rate of return instead of just the gross rate.

Workers covered by the SPP contribute 10 percent of earnings each month to an individual account, an average of 0.91 percent for survivors and disability insurance, and 1.89 percent for administrative fees. Employers do not contribute to a worker's individual account.

Sources: SBS, *Boletín Mensual*, abril de 2006; SBS, "Evolución del Sistema Privado de Pensiones: Situación Actual y Lineamientos de la Reforma," julio de 2006; *El Comercio*, el 13 de junio y el 6 de julio de 2006; *Pensions and Benefits Daily*, July 26, 2006.

Africa

Kenya

On July 1, Kenya replaced its unfunded public employees' noncontributory defined benefit pension plan with a funded defined benefit plan. The government expects the change to lower the plan's estimated expenditure growth, which has increased annually by 15 percent over the past 10 years. Expenditures for the noncontributory plan accounted for 17.2 billion shillings (US$233.3 million) in 2005, and without the introduction of the new contributory plan they were projected to reach 80 billion shillings (US$1.1 billion) in 2016.

All new public employees will be required to participate in the new plan; current employees younger than age 50 have until June 30, 2007, to join voluntarily. All other public employees will remain in the noncontributory plan. Under the new funded plan:

- The government contributes 12.5 percent of the "basic salary," roughly 30 percent of total employee compensation, and employees contribute a mandatory 7.5 percent of their basic salary. Employees receive favorable tax treatment on their contributions of up to 20,000 shillings (US$270) a month or 30 percent of their basic salary, whichever is lower.

- Full retirement benefits are paid at age 55 and adjusted every 2 years for inflation as under the noncontributory pension plan. Plan participants who work for fewer than 5 years will forfeit the accumulated government contributions and receive a lump-sum payment equal to their contributions only plus interest at a rate determined by the Ministry of Treasury. Participants leaving the public sector before age 55 with more than 5 years of service will receive all accumulated funds in a lump sum.
- The new contributory plan is regulated by the Retirement Benefits Authority, which supervises all public and private pension plans in Kenya.

Since it gained independence in 1963, Kenya has operated a noncontributory defined benefit plan for public employees that is financed through general tax revenues. The plan, with a mandatory retirement age of 55, allows public employees to retire as early as age 50 with 10 years of continuous service. Retirement benefits equal 2.5 percent of the final basic salary for each year of service up to a maximum benefit of 100 percent of basic salary after 40 years of service.

Monthly pensions under the noncontributory plan generally range from 10,000 shillings (US$135) to 20,000 shillings (US$270), although minimum pensions start as low as 500 shillings (US$6.77). Even though minimum pensions were increased in 2005 between 20 percent and 30 percent, in many cases they have been inadequate to cover basic needs like food and shelter, according to a 2006 government report. Beginning August 1, the minimum monthly pension for public employees receiving less than 1,000 shillings (US$13.59) was increased to 2,000 shillings (US$27.10), and minimum monthly pensions above 2,000 shillings were increased by 3 percent.

Sources: "Public Expenditure Review," Republic of Kenya, Ministry of Planning and Development, July 2004; "Pay Policy for the Public Service," Republic of Kenya, Directorate of Personnel Management, January 2006; *The Nation* (Kenya), February 7 and July 17, 2006; Kenya Minister of State for Public Service, press release, June 27, 2006; Global Insight Daily Analysis, June 28, 2006; *Time News*, June 28, 2006; AllAfrica.com, June 28, July 17 and 20, 2006; Kenya Ministry of Finance, Retirement Benefits Authority, on-line FAQs.

International Update is a monthly publication of the Social Security Administration's Office of Policy. It reports on the latest developments in public and private pensions worldwide. The news summaries presented do not necessarily reflect the views of the Social Security Administration.

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SSA Publication No. 13-11712