Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

November 2015

Europe

Ireland: Abolishes Pension Levy by the End of the Year

In an October budget speech, the Minister for Finance announced that the pension levy will be abolished at the end of 2015 because the levy has accomplished its goal of improved public finances. The levy applies to voluntary private-sector pension plans—defined benefit (DB) and defined contribution occupational and personal plans—as well as to voluntary personal retirement savings accounts; it is assessed each year on the market value of pension assets. To date, the total revenue received from the levy since 2011 has amounted to nearly 2.4 billion euros (US$2.6 billion).

The levy was introduced in 2011 for a 4-year period to fund (1) a new jobs initiative at a time when registered unemployment reached 14.3 percent, and (2) a decrease in the value-added tax for the hospitality sector. When it was first introduced, the levy rate was set at 0.6 percent of an individual's pension assets. However, an additional levy of 0.15 percent was implemented in 2013 for a 2-year period. The government justified the second levy at the time to prefund potential liabilities it assumed for the Waterford Crystal's DB pension fund following the company's insolvency. Consequently, the overall levy reached 0.75 percent of managed private pension assets in 2014 before declining to 0.15 percent in 2015. The second levy, with its 2-year timetable extending beyond the initial levy period of 2014, generated controversy because the government had previously presented the levy as a temporary measure that would expire in 2014.

In addition to voluntary private-sector pensions, covering approximately half the working-age population, Ireland has a public pension system that includes an earnings-related contributory benefit paid at age 66 (gradually increasing to age 68 by 2028) and a non-contributory means-tested benefit for residents aged 66 or older ineligible for the contributory benefit.

Sources: "Ireland," *International Update,* U.S. Social Security Administration, May 2013 and November 2014; "Irish Government Confirms End of Multi-Billion Pensions Levy," *Investment & Pension Europe*, October 14, 2015; "Noonan Scraps Controversial Pension Levy," *Irish Independent*, October 14, 2015.

Poland: Constitutional Tribunal Releases Ruling on 2014 Pension Reform Law

On November 4, the Constitutional Tribunal released its ruling on parts of a 2014 pension reform law that made second-pillar individual accounts voluntary for all new entrants to the workforce; allowed current participants to opt out of the second pillar; and transferred all government bond investments held by the second-pillar open pension funds (OFEs) to the first pillar, which is managed by Poland's social insurance institution (ZUS). The Tribunal evaluated the constitutionality of various measures of the law and found that the most significant changes were legal—specifically, the transfer of approximately 153 billion zloty (US$39.5 billion) in government bond investments from OFEs to ZUS and the prohibition of future OFE investments in government bonds. However, the Tribunal ruled against the law's ban on OFE advertising during periods when fund members may leave the second pillar.

When the previous government implemented the second-pillar reforms in February 2014, it argued that the changes would ensure that workers have a stable source of income in retirement while also reducing the country's public debt. The government estimated that the transfer of all government bond assets—which accounted for around 51.5 percent of all assets held by the OFEs—would reduce public debt by around 9.3 percent of gross domestic product (GDP) in 2014. (According to more recent figures, the law reduced the public debt by about 8 percent of GDP.) As of the end of October 2015, OFE assets under management totaled 147.5 billion zloty (US$38.1 billion).

Poland's pension system consists of the first-pillar notional defined contribution (NDC) program, voluntary second-pillar individual accounts, and voluntary third-pillar retirement savings accounts. Workers participating in the second pillar contribute 6.84 percent of covered earnings to the NDC program and 2.92 percent of earnings (plus up to 1.75 percent of contributions for annual administrative fees) to individual accounts; employers contribute an additional 9.76 percent to the NDC program only. (Employees who opt out of the second pillar contribute the full 9.76 percent to the NDC program.) The normal retirement age for workers born before January 1, 1949 is age 65 (men) and 60 (women); for workers born after December 31, 1948, the retirement age is gradually increasing until it reaches age 67 in 2020 (men) and 2040 (women).

Sources: "Poland," *International Update,* U.S. Social Security Administration, May 2011, July 2013, and March 2014; *Social Security Programs Throughout the World: Europe, 2014*, U.S. Social Security Administration, August 2014; "Poland's Public Debt May Rise If Court Rules Against Pension Reform," *Reuters*, November 4, 2015; "Polish Pension Reform 'Largely Legal,' Constitutional Tribunal Rules," *IPE.com*, November 5, 2015; "Poland—Retirement Pensions," European Commission, Employment, Social Affairs, & Inclusion.

The Americas

Mexico: Organisation for Economic Co-operation and Development (OECD) Releases Pensions Report

On October 15, the OECD released its Review of Pension Systems: Mexico*,* which evaluates the county's current pension system based on the OECD's best practices in pension design and makes recommendations for improving the system. According to the report, the individual account program has made progress in the 17 years it has been in operation: Financial stability has improved, total assets under management reached 14 percent of gross domestic product at the end of 2014, and the average annual real rate of return was 6.2 percent. However, the report notes that many challenges remain.

The report finds that one of the major issues confronting the pension system is the rule that allows transitional workers—those who were contributing to the public pension program (pay as you go [PAYG]) in 1997 when individual accounts were introduced—a choice of benefits from either program when they retire. Because the PAYG benefit is much higher than an individual account benefit, most workers are likely to choose the former. (From 2003 to 2014, less than 1 percent of transitional workers opted for an individual account benefit.) One reason for the switch to individual accounts was the strain on government finances for the cost of the PAYG program. Continuing to allow workers a choice of benefit prolongs and increases the financial burden because the PAYG benefits are financed mainly by general revenues.

A second challenge highlighted in the report is the low replacement rates under the individual account program compared with the PAYG program, in part because the contribution rates are too low. The report finds that once the transition has ended (in about 2042), the benefits based on individual accounts are projected to provide a much lower replacement rate, in part because the contribution rates are too low. Based on the current contribution rate (combined employer/employee) of 6.5 percent of earnings, the report estimates that an average worker who contributes during his or her entire working life could receive a benefit that replaces about 26 percent of that worker's final salary.

Another reason for the low replacement rates is the low density of contributions—the proportion of months that a worker contributes compared with the maximum number of months the worker could have contributed. According to the Mexican Social Security Institute, the average contribution density at the end of 2013 was 44 percent. (The report asserts that this issue is connected to the large informal sector and is beyond the scope of the report.)

A third challenge noted by the report is that Mexico's pension system is fragmented. Private-sector workers have a different individual account program than the more generous program for federal public-sector workers. There are also separate schemes for other groups of workers such as those employed by the state and by municipalities and universities. In addition, according to the report, the noncontributory benefit (paid to individuals aged 65 or older who do not receive an old-age or disability pension or a family allowance cash grant) is not adequate to significantly alleviate poverty.

Finally, the report finds that the rules relating to the pension fund management companies (AFOREs) at the accumulation stage and the insurance companies at the pay-out stage need to be modified. Among its specific findings are the following:

- The administrative fees the AFOREs charge their members are high according to international standards (an average of 1.17 percent of assets under management at the end of 2013), despite a number of measures introduced to reduce the fees. Even though only fees on assets under management are permitted, there is no cap on the amount of the fee.

- The type of allowable investments is very limited. At the end of 2014, nearly 50 percent of assets under management were invested in government securities, and 20 percent were invested in domestic fixed income.
- There is a lack of competition among the AFOREs. Relatively high fees are often an indicator of "a seller-dominated pension industry."
- Because most of the retirees are opting for the PAYG benefit, the market for annuities is limited. However, once the transition is over, the benefit will be based only on the individual account balance. Because insurance companies are only allowed to sell a single premium inflation-indexed annuity, often considered too expensive, individual accountholders are more likely to choose the programmed withdrawal option. As a result, given the country's increasing life expectancy, those accountholders are more likely to run out of money.

Based on those findings, the report made a number of recommendations, including—

- *Changing the rules for transitional workers.* Providing a two-part benefit: one part that guarantees the accrued rights under the PAYG program and a second part that is based on the individual account balance.
- *Increasing the contribution rates*. Achieving a replacement rate of 50 percent of a worker's final salary, by at least doubling the contribution rate (assuming 40 years of contributions). The increase in contribution rates should be gradual and pegged to wage increases to make sure that the take-home pay is not reduced.
- *Creating one unified pension system*. Harmonizing the different rules among the separate pension programs.
- *Raising the safety net levels*. Creating a new contributory minimum benefit that tops up the noncontributory benefit.
- *Introducing new measures that increase competition*. Using a tender process to determine which AFORE offers the lowest administrative fee. Workers who have not chosen an AFORE would be transferred to the AFORE that won the competition.
- *Broadening the pension fund investment limits*. Maintaining the life-cycle option (risk is automatically lowered as the accountholder ages) and expanding the types of investments with varying levels of risk.
- *Encouraging annuities.* Keeping with the OECD best practices in pension design and allowing insurance companies to offer a variety of annuity products, such as a combination of programmed withdrawals and a deferred annuity.

Source: *OECD Reviews of Pension Systems: Mexico 2015,* October 2015.

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