Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

December 2015

Europe

United Kingdom Introduces a New Voluntary "Top-Up" Benefit

On October 12, the government introduced a temporary program to help current pensioners and those nearing retirement to increase their weekly earnings-related State Pension benefit. The program—which allows for a new type of voluntary National Insurance contribution (NIC), known as Class 3A NICs—covers individuals who will not be eligible for the new more generous State Pension that will be introduced in April 2016. Government officials expect the program to be especially attractive to persons who have not contributed regularly over their working life—such as women (because of raising children and caregiving), who tend to live longer; and self-employed individuals, who are not eligible for the earnings-related benefit. (Self-employed persons are only eligible for the flat-rate Basic State Pension.) The government predicts that some 265,000 individuals will participate in this new program.

Until April 5, 2017, men born before April 6, 1951, and women born before April 6, 1953, may contribute a lump-sum payment equal to an additional £1 (US$1.51) up to £25 (US$37.66) per week in benefits. The amount depends on the individual's current age, life expectancy, and how much he or she wants (and can afford) to increase the old-age benefit—up to a maximum annual benefit of £1,300 (US$1,958.50). The top-up benefit will be increased according to changes in inflation, earnings, or by 2.5 percent, whichever is the highest. Analysts indicate that guaranteed indexation makes the benefit much higher than the same amount of money invested elsewhere. Also, at least 50 percent of the benefit can be provided to a surviving spouse or civil partner. For applicants who change their mind about participating in the new program, the lump-sum payment can be refunded to them within 90 days.

Another type of voluntary contribution, known as Class 3 NICs, is also available to help individuals fill in the gaps of missing contribution periods. Eligible persons are those reaching the State Pension age (currently 65 for men and 62 for women, gradually rising to age 65 by November 2018) but without the 30 years of paid or credited contributions required for a full pension; however, these additional contributions can only be applied to missed contributions in the 6 years prior to reaching pensionable age.

The public pension system in the United Kingdom includes the two-part (flat-rate and earnings-related) State Pension and a means-tested Pension Credit for low-income pensioners aged 62 or older. A single-tier State Pension will replace the two-part system in April 2016 and require a higher number of years of contributions to National Insurance (35 years compared with 30 years under the current program).

Sources: "Class 3A Voluntary National Insurance Policy Detail," Department for Work & Pensions, December 2013; "Boost Your Pension by £25 a Week Even If You're Already Retired," *Daily Mail*, January 26, 2014; "Why It's Not Always Best to Top Up Your State Pension," *The Independent*, February 1, 2014; "How a New State Pension Top-Up Could Treble Your Income: Women and Self-Employed Set to Benefit from Scheme," ThisisMoney .co.uk, August 18, 2015; "'Top-up Scheme' Allows Pensioners to Boost Retirement Income," *The Guardian*, October 11, 2015; "State Pension Top Up Calculator," November 26, 2015.

International

Global Aging Institute Releases Global Aging and Retirement Security in Emerging Markets

On November 18, the Global Aging Institute (GAI) released *Global Aging and Retirement Security in Emerging Markets: Reassessing the Role of Funded Pensions*, which examines the design of public old-age pension systems in developing countries. The report summarizes the current population-aging trends in developing countries, discusses the main advantages of the funded pension model in that demographic context, and reviews several important design considerations for implementing that model in developing countries. Although the report emphasizes that developing countries face great challenges in promoting old-age income security—for example, most of these countries do not have extensive and mature public pension programs to support their rapidly aging populations—it finds that these countries have an opportunity to design and implement new old-age income security programs going forward. The report argues that these countries should strongly consider a funded pension model (in the form of personal accounts) because that model may generate higher income replacement rates for future pensioners, reduce long-term pressures on government budgets, and accelerate the development of robust capital markets. The report notes that this is not necessarily an "either/or" choice because many countries have the option of building mixed pension systems that are composed of multiple pillars, which would incorporate both pay-as-you-go (PAYG) and funded programs.

The first section of the report provides an overview of key population-aging trends in a selection of developing countries. It finds that these countries have younger populations than their developed counterparts; however, dramatic declines in fertility rates and increases in life expectancies in most developing countries (particularly in East Asia, Eastern Europe, and Latin America) will lead to significant population aging over the next 50 years. This rapid population aging presents a major challenge, as large shares of those countries' populations are not presently covered by formal old-age pension systems. Although this situation could have many negative consequences in the long run, the report argues that it can also have some benefits in the near term. During the first stage of population aging, the ratio of working-age people to young and old dependents typically increases, which can in turn produce significant economic gains for the societies going through this transformation. If carefully crafted policies are in place to maximize this "demographic dividend," it can help dampen the long-term effects of population aging.

The second section of the report discusses the potential advantages of the funded pension model over the PAYG model for developing countries at different stages of economic development. According to the report, one of the main advantages of a funded system is that it can produce higher incomes for future pensioners according to different scenarios. The report presents several sets of projected income replacement rates for stylized funded and PAYG pension systems for three countries—India, Chile, and South Korea—using varying rates of real wage growth and real returns on capital. The three countries have modest, substantial, and very high projected rates of population aging, respectively. Based on its projections, the report finds the following:

- For India, a PAYG pension system is predicted to generate higher replacement rates than a funded pension system in most economic scenarios.
- For Chile, the funded pension model outperforms the PAYG model in all scenarios except those in which rates of real wage growth are high and rates of real return on capital are low.
- For South Korea, a funded pension system is projected to produce higher replacement rates than a PAYG pension system in all reasonable economic scenarios.

According to the report, another advantage of the funded pension model is that it involves fewer political risks and more economic benefits. Citing many examples of governments reducing the generosity of public PAYG pension benefits, the report states that funded pensions should be less vulnerable to this and other types of political interventions. In addition, by encouraging higher rates of saving and investment, funded pension systems are expected to help developing countries expand and deepen their domestic bond, stock, and insurance markets.

Finally, the report emphasizes the importance of creating well-designed funded systems, noting that funded pension systems can fail to deliver adequate and sustainable benefits if they are poorly designed. It recommends that countries—

- make participation in a contributory system mandatory,
- set the contribution rate at a level higher than 12.5 percent,
- assign control of pension funds to private managers,
- promote competition among investment managers to lower administrative fees,
- provide investment managers with a variety of investment options,
- limit the involvement of participants in making portfolio allocations,
- link the retirement age to life expectancy and make retirement voluntary,

- make annuitization of personal accounts mandatory at the time of retirement, and
- provide some type of noncontributory social pension.

Source: *Global Aging and Retirement Security in Emerging Markets: Reassessing the Role of Funded Pensions*, Global Aging Institute, November 2015.

Organisation for Economic Co-operation and Development Releases Pensions at a Glance 2015

On December 1, the Organisation for Economic Co-operation and Development (OECD) released *Pensions at a Glance 2015*, marking the 10th anniversary of the biennial report, which examines public and private pension systems in 34 OECD member countries and 8 nonmember G-20 countries. In addition to presenting statistics on a wide range of pension-related indicators, this year's edition provides an in-depth analysis of various issues, including recent pension reforms (enacted or legislated since September 2013); the role of basic pensions (not earnings related), minimum pensions, and social assistance programs in protecting vulnerable pensioners; and the effect of short work histories on future pension benefits.

According to the report, governments need to complete these reforms and enact new ones to ensure the sustainability of their pension systems in the face of rapid population aging and the long-term effects of the global economic crisis. From 1990 to 2011, average spending on old-age and survivors benefits across OECD countries increased from 6.2 percent of gross domestic product (GDP) to 7.9 percent of GDP; this spending is expected to continue increasing in 20 OECD countries and reach 10 percent of GDP in those countries by 2050.

The report presents a number of aging-related statistics for the OECD member countries, which include the following:

- In 32 of the 34 OECD member countries, the fertility rate is below the replacement level.
- Average life expectancy at age 65 in the 2010–2015 period is 21.8 additional years for women and 17.4 additional years for men and is expected to reach 25.8 years and 21.9 years, respectively, in the 2060–2065 period.
- The average number of expected years in retirement has increased from 11 for men and 15 for women in 1970 to 18 and 22, respectively, in 2014.
- The old-age dependency ratio (the population aged 65 or older divided by the population aged 20–64) is projected to nearly double from the current 28 older persons for every 100 working-age persons to 35 older persons by 2025 and to 55 older persons by 2075.
- The share of older workers aged 55–64 has risen from 48 percent in 2004 to 56 percent in 2014.
- The average effective age for leaving the labor market is 64.4 for men and 63.1 for women.

To counter these trends and the financial strain they put on public pension systems, the report notes that many countries have raised the statutory retirement age and introduced measures that discourage early retirement. By 2054, according to current legislation, 15 of the 34 OECD member countries will have retirement ages older than 65 (compared with 8 member countries in 2015). In addition, many countries provide incentives for older workers to remain in the labor force, for example, by increasing benefits for every year a worker delays retirement past the full retirement age. Although the report notes that such measures help strengthen the economy and provide adequate retirement benefits, it argues that individuals who cannot continue working could receive benefits that are inadequate and not sufficient to keep them out of poverty. Also, for persons working in arduous jobs, early retirement is not an efficient way to offset the impaired health and shorter life expectancy that often result from these physically demanding jobs. The report advises countries to make the workplace safer.

The report also examines changing work patterns in recent years and their effect on future pension benefits. Instead of having relatively stable jobs and long-term contracts, a worker entering the labor force today is more likely to have a temporary job and experience periods of unemployment; today's older workers often have long-term periods of unemployment. In addition, women often drop out of the formal labor force or reduce their working hours to care for family members. Recent changes in benefit formulas from those based on workers' highest earnings to lifetime earnings also have a negative effect on workers with shorter careers. Periods out of the labor force can lead to lower benefits because workers do not make regular contributions. The report indicates that pension credits and benefits that require residence in the country and shorter contribution periods help mitigate the effects of shorter careers on benefit levels.

According to the report, another group of workers that many countries need to better protect is made up of those who do not have enough contributions to qualify for a minimum pension. (About one-third of the OECD member countries provide a minimum pension and most provide a partial benefit with 20 years of contributions.) The report suggests that countries evaluate their social assistance programs as an alternative for this group. The safety net on average among OECD member countries is equal to 22 percent of average earnings (from 6 percent in Korea to 40 percent in New Zealand). However, some member countries have high rates of poverty among older adults, but provide low social assistance benefits (Chile, Korea, Mexico, Turkey, Switzerland, and the United States). The report advises these countries to consider raising the benefit levels.

Other findings of the report include the following:

- *The use of indexing benefits according to changes in prices.* Over time, the value of the benefits will decline in relation to wages. While this method is effective in lowering the cost of benefits for governments, the risk is poverty for pensioners.
- *The increasing importance of private pensions as public pension benefits decline.* The report warns that low interest rates—especially those that are due to changing economic conditions—and insufficient contributions can lead to inadequate benefits.

Finally, the report provides a variety of comparative indicators—on replacement rates, pension wealth, and old-age poverty, for example—and detailed country profiles on the public and private pension systems of the countries surveyed.

Source: *Pensions at a Glance 2015: OECD and G20 Indicators*, Organisation for Economic Co-operation and Development, December 2015.

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