International Update

Recent Developments in Foreign Public and Private Pensions

January 2019

Europe

Germany Implements Pension Reforms Affecting Contribution Rates and Benefits

On January 1, Germany implemented a social insurance reform law that sets new minimum and maximum contribution rates, extends eligibility for reduced contributions, adjusts the target replacement rate for old-age pensions, modifies the benefit formula for disability pensions, and expands pension credits for certain caregivers of young children. The provisions are intended to improve benefit adequacy and to protect vulnerable populations from poverty. The government estimates the reforms will cost a total of €32 billion (US$36.64 billion) through 2025.

Key changes that came into effect on January 1 (unless otherwise noted) include:

- *New minimum and maximum social insurance contribution rates:* The law prevents the overall contribution rate (split equally between employers and employees) from rising above 20 percent of monthly covered earnings/payroll or falling below 18.6 percent of monthly covered earnings/payroll through 2025. (Contribution rates are adjusted annually.) Currently, the overall contribution rate is 18.6 percent and is projected to remain at this rate through 2023 before increasing to 19.9 percent in 2024 and to 20.3 percent in 2025 (thereby triggering the 20 percent cap). Under the previous law, the maximum contribution rate was set at 20 percent until 2020 and 22 percent from 2020 to 2030.
- *An increase in the number of workers who pay reduced contributions:* Effective July 1, employees with monthly earnings from €450 (US$515.25) up to €1,300 (US$1,488.50) will pay reduced social insurance contributions; the specific rate depends on an employee's earnings, with rates increasing progressively as earnings increase. Previously, reduced contributions were paid with earnings from €450 to €850 (US$973.25). (Employers continue to pay the full contribution rate regardless of the employee's earnings level.)
- *A new target replacement rate for old-age pensions:* The law sets the target replacement rate for old-age pensions at 48 percent of average wages (the current rate), through 2025. Under the previous law, the target replacement rate was set at 46 percent until 2020 and 43 percent from 2020 to 2030. (The target replacement rate is maintained through adjustments in the benefit formula.)
- *Benefit formula adjustments for disability pensions:* The law increases the number of years that an individual with a disability is credited as having worked and paid contributions (based on their average income before the disability began). Under the previous law, the period from the date of the reduction in earning capacity up to age 62 and 3 months (gradually increasing to age 65 by 2024) was taken into account in the pension calculation. The new law extends this period to age 65 and 8 months (gradually increasing to age 67 by 2031).
- *An increase in pension credits for certain parents:* For children born before 1992, the maximum number of individual earnings points credited to a parent who cared for a child up to age 3 increased from 2 to 2.5 earnings points. (For children born since 1992, a parent will continue to be credited with one earnings point for each year of care, up to 3 years.)

Germany's social insurance pension program covers employed persons; certain self-employed persons; military personnel; and, under certain conditions, caregivers and unemployment, sickness, and certain other benefit recipients. To qualify for an old-age pension, the insured must have reached the normal retirement age of 65 and 8 months (gradually rising to 67 by 2029) and have at least 5 years of contributions. (The normal retirement age may be lower under certain conditions.) Old-age and disability pensions are calculated as the product of: (1) total individual earnings points (individual lifetime earnings divided by average national earnings multiplied by a normal entry factor); (2) the pension factor (typically 1.0, but lower in certain cases such as early retirement); and (3) the pension value (the monthly benefit amount for one year of average covered earnings, adjusted according to changes in average national earnings).

Sources: "Germany to Harmonize Pension Provisions Across East and West," *International Update*, U.S. Social Security Administration, September 2017; *Social Security Programs Throughout the World: Europe, 2018*, U.S. Social Security Administration, September 2018; "RV-Leistungsverbesserungs- und-Stabilisierungsgesetz: Fragen & Antworten" and "Deutsche Rentenversicherung zum Rentenpakt," Deutsche Rentenversicherung, November 23, 2018.

The Americas

Canada Implements Canada Pension Plan Expansion

On January 1, Canada's federal government implemented a law that gradually expands the Canada Pension Plan (CPP), an earnings-related pension program that covers employed and self-employed workers in all provinces except Quebec. (The province of Quebec opted out of the CPP, but has a similar earnings-related pension program called the Quebec Pension Plan [QPP]; in February 2018, Quebec's government passed a QPP expansion law that largely follows the framework of the federal CPP expansion.) The law will be phased in gradually through 2025 and aims to improve the retirement security of future retirees; a worker with a full contribution history under the expanded CPP will receive a monthly old-age pension of around one-third of his or her average monthly career earnings, up from one-quarter of earnings prior to the reform.

Changes to the CPP that went into effect on January 1 include:

- *An increase in contribution rates:* The contribution rate for employers and employees increased from 4.95 percent to 5.10 percent of payroll and earnings, respectively, up to the annual earnings ceiling (the year's maximum pensionable earnings, or YMPE). (The YMPE for 2019 is C$57,400 [US$42,116.63].) The contribution rate will continue to increase gradually each year until reaching 5.95 percent for both employers and employees in 2023. In addition, in 2024 a second earnings ceiling (the year's additional maximum pensionable earnings, or YAMPE) will be introduced that will be set at 107 percent of the YMPE in 2024 and 114 percent of the YMPE in 2025 and thereafter. Employers and employees will each contribute 4 percent of payroll or earnings from the YMPE up to the YAMPE.
- *An increase in benefits:* Old-age, disability, and survivor pensions will increase based on how long a worker has contributed to the expanded CPP. As such, benefit increases will be modest for workers currently nearing retirement and larger for younger workers just entering the labor force. The first full old-age pensions under the expanded CPP will be paid in 2065.
- *A new tax benefit for low-income workers:* The government introduced a new refundable tax credit (the Canada Workers Benefit, or CWB) to supplement the earnings of low-income workers and encourage more people to join the labor force. The CWB replaces the Working Income Tax Benefit (WITB); compared with the WITB, the CWB provides higher maximum tax benefits and increases the income level at which benefits are phased out.

Canada's pension system consists of the public CPP, Old-Age Security (OAS), and Guaranteed Income Supplement (GIS) programs, and voluntary tax-advantaged private savings and employer-sponsored pension plans. The normal retirement age for a CPP old-age pension is 65 with at least one valid annual contribution; a reduced pension is possible from age 60 to 64, and a deferred pension (for an increased benefit) is possible up to age 70. OAS is a nearly universal pension paid to persons aged 65 or older and is financed through general revenue. To be eligible for an OAS pension, a person must be a legal resident of Canada for at least 10 years after reaching age 18. Low-income OAS pensioners are eligible for the income-tested GIS.

Sources: "Canada Reaches 'Agreement in Principle' on Expansion of the Canada Pension Plan," *International Update*, U.S. Social Security Administration, October 2016; "Backgrounder: Introducing the Canada Workers Benefit," Department of Finance Canada, 2018; "Québec (Canada) Adopts Law Expanding the Québec Pension Plan," *International Update*, U.S. Social Security Administration, March 2018; *Social Security Programs Throughout the World: The Americas, 2017*, U.S. Social Security Administration, March 2018; *29th Actuarial Report, Supplementing the 27th and 28th Actuarial Reports, on the Canada Pension Plan as at 31 December 2015*, Office of the Superintendent of Financial Institutions Canada, May 1, 2018; "Canada Pension Plan Enhancement," Government of Canada, January 9, 2019; "The Canada Pension Plan Enhancement—Businesses, Individuals and Self-Employed: What It Means For You," Canada Revenue Agency, January 10, 2019.

International

Organisation for Economic Co-operation and Development Releases OECD Pensions Outlook 2018

On December 3, the Organisation for Economic Co-operation and Development (OECD) released *OECD Pensions Outlook 2018*, the fourth edition of its biennial report on major policy issues facing public and private pension systems in the OECD's member countries. This year's report focuses on how certain financial incentives and regulatory measures can enhance pension fund performance. In particular, the report examines how policy changes in the following areas can produce better outcomes for retirement savers: the design of tax incentives and public subsidies for retirement savings, the regulation of administrative fees and pension disclosures, and the structure of automatic features and investment choices. In addition to these topics, the report analyzes how governments can reduce socioeconomic disparities in retirement and reform survivor pensions to meet current socioeconomic needs.

The report starts by providing an overview of the current pension landscape in the 36 OECD countries. It finds that public, defined benefit, pay-as-you-go (PAYG) pensions remain the most important source of retirement income for average earners in these countries. In 15 OECD countries, public PAYG pensions provide nearly all of the retirement income for average earners, with the total gross replacement rates of these pensions ranging from 32 percent (Poland) to 83 percent (Italy). Chile is the only OECD country where average earners can expect to receive all of their retirement income from funded pensions. The remaining 20 OECD countries, including the United States, have pension systems that combine public PAYG pensions with mandatory or voluntary supplemental funded pensions. The report contends that these mixed pension systems are preferable to purely PAYG or funded systems because they can better balance key pension risks and objectives (e.g., financial sustainability, poverty reduction, and consumption smoothing).

After highlighting the extensive use of funded pension arrangements in OECD countries, the report discusses several ways in which governments can improve these arrangements. The report's key recommendations include:

- *Standardize and simplify the tax treatment of funded pensions.* To reduce confusion about retirement savings, governments should apply similar tax rates and rules to all funded pension arrangements. The tax rates and rules should be easy to understand and relatively stable over time so that individuals can more confidently plan their retirement savings.
- *Provide a variety of financial incentives for retirement savings.* To promote retirement savings among individuals at all income levels, governments should offer a mix of tax deductions, tax credits, and direct subsidies. Governments can use fixed-rate tax deductions, matching contributions, refundable tax credits, and targeted national subsidies to incentivize retirement savings among low- and middle-income individuals. Governments should also configure entitlement programs and tax systems to avoid discouraging individuals from saving for retirement because doing so would significantly reduce their entitlement income or increase their tax liabilities.
- *Establish automatic features, simple investment choices, and default options.* Governments can increase participation and encourage savings in funded pensions by implementing automatic enrollment, auto-escalation of contributions, and other similar features. To encourage active participation among retirement savers, governments should support the development of consumer-friendly investment options and management tools. There should also be default contribution rates, plan providers, and investment strategies for individuals who are unable or unwilling to make their own choices.
- *Regulate pension disclosures and fees carefully.* Given that administrative fees can significantly affect the net returns of funded pensions, governments should create and enforce policies that help limit them. These policies could include strengthening investment and fee disclosure requirements, benchmarking the performance of every pension fund, imposing cost controls, or introducing a performance-based fee system (under which the fees a pension management company can charge are directly linked to its performance).

The report also makes several policy recommendations in its discussions of socioeconomic disparities and survivor pensions. Two of these recommendations are:

- *Expand protections for lower socioeconomic groups.* The negative effects of retirement age increases and other pension reforms often fall disproportionately on lower socioeconomic groups because they tend to have lower life expectancies than higher socioeconomic groups. To counteract these effects, governments should adopt more flexible retirement ages and more progressive public pension and tax systems.
- *Make survivor pensions temporary and budget neutral.* Survivor pensions are still needed to smooth living standards after the death of a partner, but they should not shift resources from single persons to couples or disincentivize work. Governments should therefore ensure that survivor pensions are funded entirely by covered couples and only provide temporary benefits when they are claimed before retirement.

Source: *OECD Pensions Outlook 2018*, Organisation for Economic Co-operation and Development, December 2018.

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