Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

December 2003

Europe

United Kingdom

The United Kingdom's new legislative proposals related to private retirement pensions include the establishment of a Pension Protection Fund (PPF), similar to the Pension Benefit Guaranty Corporation in the United States. This fund will provide a bailout for under-funded defined benefit pension plans sponsored by failed businesses.

Current plans call for the PPF to be financed by employer contributions and to begin functioning by April 2005. Criticism has been directed at the proposal from both employer and employee representatives. Industry spokespersons object to placing the total burden for the PPF on employers. Consumer and union spokespersons object to the exclusion of employees affected by business closures in the past or between now and 2005.

Today, firms that go bankrupt must use accumulated pension assets to provide income for current retirees. However, some 40,000 to 60,000 current workers have lost accumulated retirement benefits during the past 5 years because they were still working when their employer went out of business. Details of how the fund will actually work will be revealed when regulations are issued, probably next year.

Sources: Financial Times, various articles throughout November 2003; The Guardian, November 27, 2003; The Express on Sunday, November 30, 2003; BBC News (http://news.bbc.co.uk).

Lithuania

Beginning in January 2004, Lithuanians will be able to allocate a portion of their social security contribution to a private pension instead of to the public pay-as-you-go system. The amount of the contribution, 2.5 percent of earnings in 2004, will be raised gradually (1 percent per year) until it reaches 5.5 percent in 2007. Workers are to have chosen a pension fund manager by December 1, 2003.

Nine pension fund management companies have been licensed thus far—four life insurance companies and five management companies. Each fund management company is permitted to provide up to three funds with different degrees of risk.

According to a market research poll in mid-October, only 8 percent of the eligible population had signed up, 39 percent do not intend to enroll, and more than half had not yet made a decision. While higher earners and younger workers are more likely to choose a private pension, most of those over age 50 are expected to stay with the pay-as-you-go system. About 19 percent of Lithuania's population is over age 60, somewhat lower than most Western European countries.

Sources: Baltic Business Daily, October 8, 2003, and November 12, 2003; FIAP Boletín, September 2003; United Nations, World Population Ageing 1950-2050.

Ukraine

Ukraine will set up a "three-pillar" pension system consisting of a modified public pay-as-you-go system with both mandatory and voluntary funded individual accounts. The measure, recently passed by Ukraine's parliament, includes the following provisions:

- Incentives to delay retirement for up to 10 years beyond age 60 (men) and 55 (women) will range from a benefit that is 3 percent higher for 1 additional year of work to a benefit that is 85 percent higher for 10 additional years.
- The mandatory contribution amounts may vary depending on the worker's age or the health status of the family breadwinner.

Experts believe that a successful reform will require close government monitoring of the pension funds, wider financial reform, incentives for setting up voluntary accounts, and a large portion of investments in foreign assets. The Japanese government has agreed to provide a grant of $880,000 to implement the program, and the World Bank is considering a $100 million loan to help with the reform process.

Ukraine has a relatively high dependency ratio. Of the 48 million Ukrainians, 20 million are in the labor force and 14 million are pensioners.

Sources: Pensions International, September 2003; Interfax Ukrainian News, October 14, 2003; Reuters News, October 14, 2003.

The Americas

El Salvador

The government will provide an extra subsidy to pensioners whose benefits under the new individual accounts program are lower than they would have been under the public pay-as-you-go system. The pay-as-you-go public pension system was closed to new entrants in 1998, and most insured workers—except men over age 55 and women over age 50—had to switch to an individual account. The government provided a transfer certificate, an indexed bond that represented the value of worker's rights accrued under the public system. At retirement, the worker combines the transfer certificate and the funds in an individual account to purchase an annuity or a deferred annuity or to make programmed withdrawals regulated to guarantee income for an expected lifespan.

Beginning in November 2003, pensioners who retire under the new program and whose retirement benefit is less than what they would have received if they had remained in the old public program will receive a monthly interest-bearing "complementary transfer certificate" funded by the government. The new subsidy is expected to increase a pension by an average of 35 percent.

Currently about 1,300 pensioners are entitled to receive this additional benefit (about 1,800 pensioners have retired under the new system compared with about 74,000 under the old pay-as-you-go system and a population of 538,000 over age 60). Ultimately, about 139,000 pensioners could be eligible if they do not take an early retirement. The government will provide the subsidy for 15 years.

Sources: Social Security Administration, 1999; The Fund Pro Latin America, November 18, 2003; Fundación Interamericana, October 9, 2003; Superintendencia de Pensiones, El Salvador, September 2003.

Peru

Peru has reduced the cost of survivors and disability insurance in its system of individual accounts and may increase the number of investment choices from one to three. The Peruvian system, set up in 1993 and modeled broadly on Chile's system, gives workers a choice of contributing to the publicly funded pay-as-you-go system or to an individual account managed by one of four pension fund management companies (AFPs). The pay-as-you-go system faces serious long-term funding problems due, in part, to the rapid aging of the Peruvian population.

Under the private option, workers contribute 8 percent of earnings to their account plus fees for survivors and disability insurance and administrative costs. Since November 2003, AFPs must use a competitive bidding process to select an insurance company to provide the survivors and disability insurance rather than the "no-bid process" they used in the past. The first-year savings to workers will be about 25 percent.

Since 1993, AFPs have been permitted to provide only one pension fund with strict asset allocations. The current fund's portfolio includes the following mix: 21 percent in government bonds, 7.5 percent in equities, 11 percent in private-sector bonds, 28 percent in the financial sector, and 8.5 percent in foreign securities. A law requiring AFPs to offer three different types of funds with varying degrees of risk was passed at the end of December and should become operational by the end of 2004. The second fund would invest mainly in fixed instruments, and the third fund in stocks.

Sources: El Comercio, October 10, 2003; The Fund Pro Latin America, October 28, 2003; FIAP, Boletín, September 2003; Superintendencia de Banca y Seguros, Boletín Informativo Semanal, November 1-7, 2003.

Asia and the Pacific

Australia

Recent changes to Australia's mandatory Superannuation (private retirement pensions) Guarantee will boost retirement savings for some low- and high-income workers. The mandatory superannuation law dates from 1992, when the Australian government built upon a 1986 national wage agreement that required employers to provide retirement accounts, in partial substitution for a wage increase, for workers covered by the agreement. Under the 2003 revisions, the government will match up to A$1,000 (US$777) of voluntary superannuation contributions from employees earning less than A$27,500 (US$21,370) a year and provide lesser co-contributions for those earning up to A$40,000 (US$31,084). Workers earning A$94,700 (US$73,590) and more will have their extra contribution tax (called the surcharge) reduced from 15.0 percent to 12.5 percent over the next 3 years.

By 1992, about 70 percent of all employees had superannuation accounts. Currently almost 90 percent of workers aged 18 to 65 have them. Employers are required to contribute 9 percent of salary into an approved savings vehicle for each employee. All superannuation contributions are taxed at 15 percent. Until recently, high-income contributors were charged an additional 15 percent, which now will be lowered to 12.5 percent.

Over the last four quarters, voluntary contributions from employers and workers made up 35 percent of total new contributions. While private pension benefits currently represent 2.5 percent of the country's gross domestic product, by 2040 they will represent an estimated 11 percent of GDP.

Sources: The Sydney Morning Herald, various articles in October 2003; The Australian, October 29, 2003; Australian Taxation Office web site (http://www.ato.gov.au) October 29, 2003; Center for Strategic and International Studies and Watson Wyatt Worldwide, The 2003 Aging Vulnerability Index, March 2003.

India

A new mandatory defined contribution pension system for civil servants will become operational on January 1, 2004, as part of a larger reform effort. An interim pension fund regulator, the Pension Fund Regulatory and Development Authority (PFRDA), which was set up in October 2003, will announce guidelines for the operation of new pension funds that may include existing mutual funds and insurance companies. Once pension funds are licensed and operational, the returns on individual accounts will be determined by the market. Portability will be assured through centralized record-keeping and administration, so all benefits can be transferred for workers who change jobs. Each pension fund management company will offer three types of investment risk options. Individuals will contribute into the retirement account until age 60, whereupon they will receive a minimum of 40 percent of their accumulated funds in the form of an annuity with the balance available as a lump sum.

The new funded system will be mandatory for all new civilian employees of the central government. An individual will be able to operate two accounts—a mandatory tax-favored account for retirement and a voluntary account for savings with withdrawal privileges but no tax advantages. Employees will contribute 10 percent of salary into the mandatory retirement account, which will be matched by the government. The entire amount will be deposited with a pension fund management company selected by the civil servant. Employees in state government and the private sector will be permitted to join the new pension system voluntarily but will not receive a matching contribution from the central government.

The new defined contribution system replaces a defined benefit system, which currently operates on a pay-as-you-go basis without any contribution from the employee. Eliminating the central government's responsibility for providing pensions to new civil servants is expected to ease a fiscal burden from accumulated pension obligations estimated at 10 percent of the central fiscal deficit. State governments also face sizable pension liabilities. The combined expenditure of pension programs run by the central and state governments accounts for 1.5 percent of GDP and a quarter of the overall fiscal deficit equal to approximately $53 billion—nearly 11 percent of GDP.

As the government relaxes existing restrictions to allow investment of pension funds in the stock market, financial experts predict that pension funds will become the largest component of the financial sector. The current market in India could be as large as 3.5 trillion rupees (US$77 billion) and grow initially by nearly US$400 million annually.

According to a 2001 World Bank report, only one in ten Indian workers out of the nation's total labor force of 372 million currently participates in a pension system. Currently, fewer than 10 percent of the 72 million elderly (over age 60) receive pensions. Some analysts express doubt as to whether there will be enough subscribers for the new pension system from the pool of new central government civil servants and others. To provide the critical mass needed to make the new system sustainable, the government is considering phasing out the existing major retirement systems.

Sources: Business Line (The Hindu), November 26, 2003; The Economic Times, August 28, 2003, and November 24, 2003; ClariNews, October 12 and 15, 2003; Asher, May 2003; Shah, August 1, 2000; India Today, September 22, 2003; World Bank, 2001.

Turkey

Turkey has launched its new centrally run private pension system. Under a 2001 law that went into effect on October 27, 2003, the Pensions Supervisory Office is granting licenses to pension fund companies, among them subsidiaries of some of the larger Turkish banks and life insurance companies. This step is the latest in a series of measures to encourage the development of voluntary pension plans complementing the social security system.

Participation in the new defined contribution system is voluntary for both employees and employers. Monthly contributions will be accumulated and invested in an employee account and, along with the associated investment income earned during the accumulation phase, will be exempt from income tax. Employees will be allowed to diversify their accounts among at least three funds with varying degrees of risk and will be permitted to move their account to another pension fund company if they so choose. Owners of life insurance policies will be allowed to convert their policies into the new pension plans as well.

To attain retirement status, a participant will have to have been active in the system for at least 10 years and to have reached age 56. Only retirees will be allowed to withdraw funds from an account without incurring a penalty, and they will be able to request either a partial or lump sum payment or a monthly annuity payment purchased with the entire balance accumulated in the account.

It is expected that approximately 200,000 people will have taken out pension plans by the end of the first year of operation and that this number will grow to about 20 million over the next 10 years. With a population of about 70 million, including 50 percent below age 25, and a workforce of 24 million, some analysts claim that the Turkish pension sector could be worth as much as US$15 billion by 2014.

Sources: Mercer Human Resource Consulting, March 1, 2002, and April 15, 2002; PricewaterhouseCoopers, January 2003; Organization for Economic Cooperation and Development, May 27-28, 2003; Turkish Directorate General of Insurance, September 28, 2000; Economist Intelligence Unit, November 16, 2003; The Daily Star (Beirut, Lebanon), November 3, 2003.

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