Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

July 2007

The Americas

Brazil

Brazil's National Monetary Council (NMC), the government's highest ranking economic policy body, relaxed investment rules for voluntary private pension funds. These new rules, adopted May 30, allow private pension funds to pursue higher returns while assuming greater risks.

According to the government, declining interest rates prompted this new policy intended to give pension plans more flexibility to diversify investments by broadening some investment categories and risk limits. Domestic interest rates have fallen steadily from the peak in 2005 of nearly 20 percent to the current 12 percent.

The changes introduced by the NMC will allow private pension funds to:

- invest for the first time up to 3 percent of their managed assets in multimarket funds whose portfolios include investments in stocks and government and corporate bonds.
- increase investment limits on securities backed by mortgages and company accounts receivable from 10 percent to 20 percent and on bank credit notes from 5 percent to 10 percent.
- invest in derivative instruments provided that the amount invested is matched by an equal amount invested in government-issued securities.
- invest in securities issued in the domestic market by international lending institutions, such as the World Bank. Investment in these securities would come under the existing fund portfolio limit of 80 percent for fixed-income exposure.

Voluntary private pension funds offer defined contribution, defined benefit, or combination (hybrid) plans to companies and individuals. "Closed funds" can be created for employees of the same company or financial group; employees in affiliated companies; or employees in the same profession, union, or other affiliation. In Brazil, there are 364 closed pension funds covering 2.4 million participants. "Open funds" are insurance products offered to individuals and companies by authorized insurance companies and insurance subsidiaries of banks. Open funds manage 7.8 million individual accounts.

According to industry sources, Brazil's pension funds held 388 billion reais (US$190 billion) in assets under management at the end of the first quarter of 2007. This is equivalent to 16.7 percent of the country's gross domestic product. Pension experts expect private pension funds to manage 460 billion reais (US$240 billion) in assets by the end of 2007 and 600 billion reais in 2010 (US$314 billion in 2007).

For private-sector workers, Brazil has a two-tiered retirement system: voluntary private pensions and the country's mandatory pay-as-you-go public pension system. Special pension systems cover public-sector workers and military personnel. (See also the March 2007 issue of *International Update*.)

Sources: Secretaria de Previdência Complementar (Gabinete), July 2004; *Mercer*, September 1, 2005, and June 21, 2007; "Pension Reform in Brazil: the Challenge of Labor Inclusion," International Social Security Association, March 5–7, 2007; Mapfre Seguros Brazil, 2006; Dow Jones Commodities Service, April 26, 2007; AE Brazil, May 30, 2007; Dow Jones International News, May 30, 2007; *Business News Americas*, May 31, 2007.

Asia and the Pacific

New Zealand

New Zealand employers must enroll new workers aged 18 or older in a KiwiSaver plan, a voluntary defined contribution retirement savings plan. Beginning July 1, all individuals under age 65, including anyone not in the labor force, are permitted to set up a KiwiSaver account with any provider. However, workers automatically enrolled in a KiwiSaver can opt out of the plan between the second and the eighth week of their employment. (See also the October 2006 issue of *International Update*.)

Workers may select a monthly KiwiSaver contribution rate of either 4 percent (the required minimum and the default) or 8 percent of gross earnings. Workers may increase their contribution to the maximum 8 percent rate at any time. Those who have been automatically enrolled and do not select a registered provider will be assigned to one of seven default providers chosen by the Ministry of Economic Development (which also approves all KiwiSaver providers and issues provider and plan regulations).

While the default providers will offer only plans with a conservative investment portfolio, all other registered providers will be permitted to provide a variety of investment portfolios such as conservative, balanced, or growth. KiwiSaver accounts are portable, and members may switch plans and investment risk portfolios at any time. Although there are no government guarantees for the funds in KiwiSaver accounts, the government provides account holders with a number of subsidies deposited directly into their accounts. The subsidies consist of the following:

- a tax credit of up to NZ$20 (US$15) a week and up to NZ$1,040 (US$793) a year,
- a one-time tax-free payment of NZ$1,000 (US$763), and
- an annual subsidy of NZ$40 (US$31) for administrative fees.

The government also provides tax incentives for employers who contribute to either an employee's KiwiSaver account or an employee's qualified occupational pension plan as long as the plan has the same requirements as the KiwiSaver: fully portable, full vesting, and "lock-in until retirement."

Even though employer contributions to employee retirement accounts are currently voluntary, the government intends to make employer contributions mandatory. A bill that is proceeding through Parliament would change the rules for employer contributions to an employee's KiwiSaver account or a qualified occupational pension plan. If the bill becomes law, beginning April 1, 2008, an employer will be required to contribute 1 percent of the employees' gross salary, increasing 1 percent each year until the mandatory employer contribution reaches 4 percent of gross salary by April 1, 2011. The government would provide a partial subsidy to employers for these mandatory contributions. The government calculates that by 2011, it would be matching the entire cost of employer contributions to a KiwiSaver plan or an occupational pension plan on employee earnings up to NZ$500 (US$381) a week.

After the first 12 months of membership, most account holders may take a "contribution holiday" for a minimum of 3 months, up to a maximum of 5 years. Members with a serious illness or experiencing a financial hardship may take a "contribution holiday" before the end of the first year. There is no limit to the number of contribution holidays that a member may take. Also, KiwiSaver plans and mortgage providers may allow plan members, after 12 months of membership, to divert up to half of their contribution to pay for their mortgage.

After the opt-out period expires, KiwiSaver participants may withdraw all their funds at age 65 or 5 years after they opened their account, whichever is later, and at any time in the event of serious illness. Participants may withdraw all their contributions and any vested employer contributions if they

- face significant financial hardship,
- leave the country permanently, or
- make a down payment on the purchase of a first home after at least 3 years of saving in a KiwiSaver account. Beginning in 2011, the government plans to provide an eligible first-time home buyer (subject to income and housing cost limits) with a home ownership subsidy of NZ$1,000 (US$ 793) per year, up to a maximum of NZ$5,000 (US$3,813) per person.

Sources: Personal communication, New Zealand Ministry of Social Development, Older People's Policy Office, May 2007 ; Michael Cullen, Budget 2007 Speech, May 17, 2007; New Zealand Inland Revenue Policy Advice Division, "Urgent legislation enacted," May 22, 2007; New Zealand government KiwiSaver Web site, http://www.kiwisaver.gov.nz; Budget 2007 Savers Fact Sheet, May 2007; *Sunday Star-Times*, June 24, 2007.

Reports and Studies

OECD

A recent report published by the Organisation for Economic Co-operation and Development (OECD) reveals that future public pension payments in OECD countries will cause a downward shift in living standards for a growing number of retirees. The report, *Pensions at a Glance*, was released on June 7, 2007, and is a follow-up to the 2005 report with the same name. It uses 2004 data from the OECD's 30 member states to underscore that while all OECD countries have enacted some form of pension reform since 1990, more needs to be done to maintain or improve the standard of living for tomorrow's retirees. The report also notes an increase

in the number of private and voluntary pensions among member states.

The report defines three types of pension reforms that are common among its member countries:

- mandatory private pensions as substitutes for part of the public pension (Hungary, Mexico, Poland, and Sweden),
- mandatory private pensions in addition to the public pension (Australia and Norway), and
- increases in voluntary private pensions due to reduced public pension benefits (Germany, Japan, and the United Kingdom).

The most common pension reform measure among OECD members is increasing the full-benefit retirement age. Most OECD countries now establish a retirement age of 65 years for workers to receive a full public pension benefit. However, the legal retirement age is 65 years in Denmark and the United Kingdom, 67 years in Iceland and Norway, and is increasing to 67 years in Germany (2011) and the United States (2027). In contrast, the Czech Republic, France, Hungary, and the Slovak Republic all have full-benefit retirement ages below 65.

Sixteen of the 30 OECD member states have undergone significant pension reforms in the past two decades. As a result, the new OECD average of pension spending is 7.7 percent of gross domestic product, up from 6.7 percent in 1990. Average member contribution rates across these nations have held constant—20.0 percent today and 19.9 percent in 1994.

The report also notes that the average replacement rate (the ratio between pension benefits received from mandatory systems and preretirement earnings) among OECD countries is 59 percent. Greece has the highest replacement rate at more than 95 percent, and the United Kingdom has the lowest replacement rate at around 30 percent. The average replacement rate for low earners (those who earn less than half of average pay) is 73 percent among OECD countries. Twenty of the 30 OECD countries have higher replacement rates for low earners than for average earners.

The report highlights that, despite reforms, current retirement savings in OECD countries are inadequate and workers will have to work longer and save more if they want to have the same level of pensions that their parents and grandparents had. As such, the report urges its member countries to take full and immediate action in several areas:

- overhaul public pension systems to provide adequate pension income,
- phase in pension reforms more quickly,
- evaluate the impact of added emphasis on voluntary retirement savings,
- close early retirement loopholes, and
- monitor or correct reforms that may adversely affect some workers.

Finally, the report states that the OECD will continue to monitor the effectiveness of both tax-based pension incentives and behavior-based incentives for private pension savings, such as automatic enrollment

Sources: *Pensions at a Glance and Highlights from Pensions at a Glance*, OECD, June 2007; BBC News, June 11, 2007; *Global Pensions*, June 11, 2007; International Pensions Europe, June 11, 2007; *Pensions and Benefits Daily*, June 11, 2007; *Pensions and Benefits Daily*, June 27, 2007 .

World Bank

The recent World Bank report, Informality: Exit and Exclusion, examines the causes and implications of the growing informal sector in Latin America and the Caribbean (LAC) and provides recommendations to reverse this trend. The report finds that the increase in the informal sector is restricting opportunities for economic growth in the region and hindering the social well-being of the workers. According to the report, the informal sector comprises a heterogeneous group of workers who are not registered with tax or social protection authorities and who account for 54 percent of the region's urban workforce. The study concludes that immediate reform actions should be undertaken to stop the increases in informal-sector employment and to move informal workers into the formal sector over the long run.

The report divides informal workers into two groups; "exit workers," those who work in the informal sector by choice; and "excluded workers," those who are excluded from the formal sector. Exit workers, about 24 percent of urban workers, include microfirm owners (10 employees or fewer) and self-employed professionals, artisans, handymen, construction workers, taxi drivers, and street vendors. Excluded workers, about 30 percent of urban workers, include domestic employees, unpaid family workers, microfirm workers (10 employees or fewer), and those who work in larger firms under informal labor arrangements. The report notes that the motivations for these two groups of workers to remain in the informal sector are diverse. Approximately two-thirds of the workers in the exit group entered their jobs voluntarily and value the nonfinancial benefits of the types of work in that group. The majority of the other group consists of workers who would prefer

to be in the formal sector but who are often excluded from jobs that provide social protection benefits because of their lack of education or their employer's decision not to offer benefits.

The report notes that a primary reason for the increase in the informal sector is poor design of the social protection systems in LAC, including

- the requirement of relatively high payroll taxes compared with the expected benefits and quality of services available, and
- the prevalence of "one-size fits all" approaches to mandated social security programs in which spouses and other household members who enter formal employment are required to pay an additional tax for benefits they would receive through a head of household employed in the formal sector.

Other factors that contribute to the increase in the informal sector are poor compliance and enforcement, weak labor and tax laws, and increasing participation of women, who are more likely to take informal temporary jobs, in the workforce.

The report suggests a mix of short- and longer-term solutions that will require changes in the structure of society, the laws, and the social protection programs. Specifically, the report suggests that LAC countries

- reform labor market policies to increase productivity of the formal and informal sectors through programs that reduce labor costs;
- change social protection to provide universal coverage rather than a benefit received through a labor contract;
- improve opportunities for workers in the formal sector by reducing barriers to business formalization and direct costs of participation in the formal sector;
- create a climate that stimulates investment in formal-sector businesses; and
- simplify tax laws, facilitate compliance, and strengthen enforcement through a focus on taxpayer registration, audits, and collection of taxes.

This report can be found at http://www.worldbankinfoshop.org/ecommerce/catalog/product?item_id=6532716.

Sources: The World Bank, press release and *Informality: Exit and Exclusion*, May 23, 2007; *Seattle Post-Intelligencer*, June 1, 2007.

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