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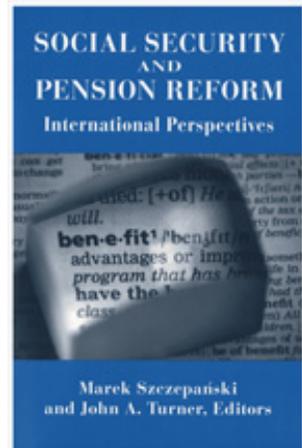
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# Social Security and Pension Reform: The Views of 16 Authors

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## **International Perspectives**

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Editors

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# 1

## **Social Security and Pension Reform**

### **The Views of 16 Authors**

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Countries around the world are reforming their social security and pension systems. International studies often focus on social security reforms in Europe and North America, and may include Latin America. Reforms, however, are also occurring in Asia and Africa, and include reforms of voluntary and employer-provided pensions as well as social security programs. This book discusses both social security and employer-provided pension reforms, as well as reforms in most regions of the world.

This chapter provides an overview of the book. Many of the chapters were originally presented at a conference of the European Network for Research on Supplementary Pensions (ENRSP) in Poznań, Poland, in 2012, that was organized by Marek Szczepański. Other chapters have been added to expand the range of countries covered.

### **OVERVIEW**

Part 1 of the book contains this introduction and a chapter written by John A. Turner and David Rajnes that examines social security and pension reforms around the world. It includes a survey of some of the

main points of chapters of this book, but has a considerably broader focus in terms of countries and issues. For example, an issue not touched on elsewhere is the trend in some countries toward adopting automatic adjustment mechanisms as a way of maintaining the solvency of their social security systems. In some countries, the level of social security benefits at retirement is automatically adjusted downward to reflect improvements over time in life expectancy. Turner and Rajnes's chapter also discusses the policy that a number of countries have adopted, which is raising the earliest age at which social security benefits can be received, and other policies to encourage workers to postpone retirement, which are ways of dealing with the added costs to pension systems due to increased life expectancy.

Turner and Rajnes discuss in Chapter 2 issues of concern in high-income countries, and also the problem that most workers around the world are not covered by social security or pension programs. Countries such as China and Kenya have developed innovative programs to attempt to deal with that issue. The programs in those two countries are discussed in greater depth in Chapters 10 and 11.

## **REFORMS IN EUROPE**

Part 2, which focuses on reforms of social security and pensions in Europe, is the largest section of the book. The authors discuss reforms in Ireland, Sweden, Norway, Portugal, Poland, and other countries in Central and Eastern Europe.

Chapter 3, by Gerard Hughes, discusses the reform in Ireland mandating that employers provide their employees the option to participate in an employer-provided pension plan, called a Personal Retirement Savings Account (PRSA). Although the reform requires employers who do not provide a pension plan for all their employees to designate a personal pension provider for their employees, less than half of the firms have done so. This may be in part because employees have shown limited interest, as no one is contributing to a PRSA in four-fifths of the firms that have designated a PRSA provider. Thus, the hopes that policy analysts had for this approach to extend pension coverage have not been realized. Requiring employers to offer pensions, but making the take-up

by employees voluntary, has not succeeded in significantly raising pension coverage in Ireland.

By comparison, the United Kingdom has adopted a policy that goes further: all private employers will be required to offer retirement plans meeting minimum requirements for their employees. Those plans can be defined benefit plans or defined contribution plans. In addition, going beyond the requirements in Ireland, employers will be required to automatically enroll their employees in the new system, with the employees having the option to withdraw. It is anticipated that this change will increase pension participation in the United Kingdom by 5–9 million workers (Segars 2012). An additional requirement is that mandatory contributions in the case of defined contribution plans will be made by employers, employees, and the government. When fully phased in, contributions will be 4 percent of pay for employees, 3 percent for employers, and a 1 percent government subsidy, making a total contribution of 8 percent of pay. Initially, contributions will start at a total of 2 percent of pay, reaching 8 percent by 2018.

The requirements apply to workers who earn more than minimum wage and are at least 22 years old; the maximum age for men is 65, with the maximum of 65 being phased in for women. The requirement for automatic enrollment into a qualifying pension plan was initially phased in on October 1, 2012, and will continue to be phased in through 2016. It will apply first to large companies, and over time to all others. Eventually automatic enrollment will apply to all employees who do not have another plan.

For companies that do not offer a qualifying plan, all money contributed to pension plans for employees will go into the National Employment Savings Trust (NEST), a jointly trustee investment vehicle that will offer a number of funds. Employees who use the NEST plan will have the option to choose investments or have a default investment chosen for them, which will be a retirement date fund based on what the employee indicates is his or her expected retirement date.

Chapter 4, by Gabriella Sjögren Lindquist and Eskil Wadensjö, focuses on low-income retirees in Sweden. The chapter begins with an outline of the Swedish system, which some countries have considered as a possible model for reform. The system includes a notional defined contribution system as the primary source of benefits and a mandatory individual account system, neither of which contain redistributive ele-

ments. Redistribution toward low-income pensioners occurs through other government programs, such as the guarantee pension, which is based on the level of other pension income a person receives, and a housing allowance. Women, the self-employed, immigrants, and persons at advanced ages are more likely to have low income in retirement than other groups.

Nonetheless, poverty in Sweden is low compared to other European Union (EU) countries. It is defined on a relative basis as having an income below 60 percent of median income. Because Sweden is a high-income country, if poverty were defined alternatively as being below 60 percent of median income in the EU, the poverty rate would be even lower.

Chapter 5, by Maria Clara Murteira, discusses social security reform in Portugal and how the EU has affected it. The demand for macroeconomic budgetary reform has put pressure on countries to reform their social security programs. In addition, demand for fiscal austerity has put further pressure on pay-as-you-go (PAYG) financing of social security because of increased unemployment.

Murteira argues that while the social security reform of 2007 was presented as a technical reform, it in fact involved a fundamental change in principles and objectives for the social security program. By means of parametric changes, a structural reform was achieved. She criticizes the reform because it focused on the means of social policy (financing) and not on its goals (providing adequate retirement income). While PAYG financing was not replaced by funding, the overall logic of the system was changed. The goal of social security retirement pensions in Portugal is no longer to provide income maintenance. Instead, the goal now is to provide a modest level of income protection against old-age poverty. Murteira concludes that ultimately social security policy is about political choices, as it is influenced by the beliefs and ideas about the role of government in society.

Chapter 6, by Magdalena Mosionek-Schweda, describes the Norwegian Government Pension Fund, which is a sovereign wealth fund and is one of the largest pension funds in the world. The fund has two parts: one that is (Norway) is entirely invested in Scandinavia and another part (Global) that is entirely invested outside Norway. She focuses on the Global fund, which is financed by revenues from the extraction of oil in Norway. It currently is worth about \$120,000 per person in

Norway, and is expected to grow on a per capita basis before it is drawn on to help pay for retirement benefits. The fund does not have a legal liability for future pension benefits, but it is designed to be used for the purpose of helping to pay for these benefits. As discussed in Chapters 2 and 10, Ireland, China, and several other countries have similar funds. If the United States were to return to an era of budget surpluses, as it did during the Clinton administration, it could establish a similar fund.

Chapter 7, by Maciej Żukowski, describes social security reform in Central and Eastern Europe. This chapter provides a survey of a number of countries in Central and Eastern Europe, with a more detailed discussion of the reforms in Poland. While many aspects of the socialist economies in this region were not functioning well before the breakup of the Soviet Union in 1991, they did have functioning social security systems. However, starting in 1998, most of the countries in the region have had major reforms to their social security systems, introducing funded individual accounts as part of the systems. Of the 10 Central and Eastern European countries that are now members of the EU, all but Slovenia have adopted mandatory funded individual accounts as part of their social security systems, along with a reduced PAYG social security program (U.S. Social Security Administration 2012).

Because of the global financial crisis, since 2010, some of these countries have reduced the contributions to the funded individual accounts. They have encountered the double payment problem, which is needing to finance the PAYG systems while at the same time also contributing to a funded system. These countries did not adequately take into account this problem when they established their individual account systems. The European Union Stability and Growth Pact, which sets target limits on government debt and deficits, has influenced them to cut back on their individual account plan contributions. This issue is also discussed in Chapter 5, where EU policies are seen to have led to a reduction in the PAYG system in Portugal.

Chapter 8, by Marek Szczepański and Tomasz Brzęczek, discusses the risks in employer-provided pension plans in Poland. Like Sweden, Poland has a mandatory notional defined contribution system and a mandatory individual account system. However, unlike Sweden it has relatively few voluntary employer-provided pensions. Those pensions in Sweden cover most workers, in part due to widespread collective bargaining agreements. Szczepański and Brzęczek survey representa-

tives of businesses that provide pension plans, who indicate that the two most important risks facing pension plans are financial market risk and economic market risk. They find a high degree of mistrust by employers sponsoring pension plans of the advice provided by the pension plan managers. They also find that pension plans in Poland have invested in low-risk, low-return portfolios.

## **REFORMS IN AUSTRALIA, CHINA, EAST AFRICA, AND THE AMERICAS**

The following four chapters comprise Part 3 of the book and discuss pension and social security reform in Australia, China, East Africa, and the Americas.

Chapter 9, by Ross Clare, discusses the retirement income system in Australia and issues of equity or fairness. Recent reforms in Australia have reduced the extent of tax preferences going to high earners. He finds that less than 15 percent of the government assistance for pension contributions flows to those paying the top marginal tax rate. Government assistance includes tax preferences and a government matching contribution for low earners. This compares to the approximately 30 percent of aggregate personal income tax collections that is paid by that group of taxpayers. Thus, a far smaller percentage of tax preferences and government contribution assistance in Australia goes to upper-income persons than in the United States. A study in the United States finds that two-thirds of the benefits from pension tax preferences accrue to the top 20 percent of the income distribution (Orszag 2000).

To further limit the tax benefits accruing to high earners in Australia, a proposal is being considered that would reduce the amount of tax-preferenced contributions that could be made by persons with a pension account of A\$500,000 or more. (Australian dollars are roughly equal in value to U.S. dollars at 2013 exchange rates, although exchange rates fluctuate over time.) When viewing the Australian retirement income system in a broader framework, also taking into account the Age Pension, which is received by most persons but whose value declines with increases in personal income, the amount of government subsidy to the

retirement income system is fairly equal across deciles of the income distribution.

Chapter 10, by Tianhong Chen and John A. Turner, describes social security reform in China, which has roughly one-fifth of the world's population aged 60 and older. Also adding to the importance of understanding China's retirement income system, China is undergoing a period of important changes in its provision of old-age benefits. At the start of 2009, less than 30 percent of the adult population in China was covered by a social security old-age benefits program, but by 2012 that number had increased to 55 percent. Affecting its ability to provide old-age benefits, China is also undergoing important labor force changes—because of its one-child policy, the labor force declined in 2012 for the first time, and declines are projected to continue for many years.

China has a decentralized system of social security, where the central government establishes general guidelines, but subprovincial governments (county governments) have some discretion in establishing the programs, for example, in setting contribution rates. This feature alone would make the system complex. However, within that framework, there are separate systems for urban workers, rural workers, and rural workers working in urban areas. Each of these three systems has two parts—an individual account portion and a PAYG system. In addition, government employees have separate systems, and Hong Kong has a separate system.

An unusual feature of social security provision in China is that its new program for rural workers, which is voluntary, has been highly successful in attracting participants. Because voluntary programs generally fail to cover more than half of the eligible population in high-income countries, and a much lower portion in middle- and low-income countries, China's program may provide a model for other countries.

Chapter 11, by John A. Turner, describes social security and pension reform in the five countries of the East African Community—Kenya, Tanzania, Uganda, Burundi, and Rwanda. The chapter discusses social security and employer-provided pensions for both private and public sector workers. Many of the issues these countries face are similar to retirement income issues in other countries in sub-Saharan Africa. A different aspect, however, is that these five countries are attempting to

move toward greater economic integration, with the possibility of eventually having a single currency and a common market.

Most workers in the region and throughout sub-Saharan Africa—and in most middle- and lower-income countries—are not participating in social security or in another pension program. Therefore, extending social security or pension coverage to rural and informal sector workers is arguably the most important issue facing social security programs in most countries around the world.

Kenya has recently developed an innovative voluntary pension program that may hold promise for extending pension coverage to low-income workers in other parts of the world. In this system, workers can contribute small amounts, as little as \$0.25, using their cell phones and a mobile money system. Advances in cell phone technology have greatly reduced the cost of cell phones and usage rates so that even poor people in Kenya have cell phones, and so that small transactions are economically feasible. Many more people have cell phones than have bank accounts. This program is a promising development for extending pension coverage to poor people in other countries.

Chapter 12, by Denise Gómez-Hernández and Alberto M. Ramírez de Jurado Frías, analyzes defined contributions in a sample of countries from North, Central, and South America. Instead of using a replacement rate to measure the effectiveness of the defined contribution systems, they compare projected pension benefits to a measure of the basic market basket of goods. They find that differences in the level of fees charged to pensions across countries have an important effect on the outcomes of the pension systems.

## **REFORM ISSUES**

Part 4 contains the final two chapters, which discuss particular issues in social security and pension reform rather than focus on particular countries. Chapter 13, by Adam Samborski, discusses issues in pension fund governance, focusing on principal-agent problems in pension fund governance. In agency theory, agency relationships are understood as contracts under which a principal engages a third-party (agent) to perform certain actions on its behalf in dealing with a second

party, which is the provider of the service. The agent provides a managerial or advisory role. In pension arrangements, the plan participant is the principal, the plan sponsor is the agent, and the financial institution managing the pension funds is the second party. This implies the need for the principal to delegate specific powers to the agent to make certain decisions. However, both the agent and the second party may have conflicts of interest so that they are motivated to not act in the best interests of the pension participant.

Chapter 14, by John A. Turner and Dana M. Muir, discusses issues in financial literacy, financial education, and financial advice. A lack of financial literacy is widespread in countries around the world. This is particularly a problem in countries that rely on mandatory individual accounts and defined contribution pensions, where workers have added responsibility for financial decision making. Financial education has been considered as a remedy, but studies have shown that many workers lack interest in gaining the required knowledge. Financial education may be more successful if it is incorporated into school education programs for students. Financial advice has been recognized as another way of dealing with financial illiteracy. However, many financial advisers have conflicts of interest that cause the advice they provide to not be in the best interest of their clients. Because of the way financial advisers are compensated, the advice that provides them the highest income may also lead to pension participants and plan sponsors paying higher fees, but with no improvement in investment outcomes. Surveys have documented that persons receiving financial advice may receive lower rates of return net of fees than those not receiving advice.

## **CONCLUSION**

Many countries around the world are undertaking social security and pension reforms. These reforms are motivated in part by population aging, but they also are occurring in response to economic development in Africa, China, and elsewhere, and are due to changing views about how retirement income should be provided. Countries often look to international experience when considering reform options, and this book discusses social security and pension reform issues in different parts of the world.

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