Social Security

International Update: Recent Developments in Foreign Public and Private Pensions

December 2004

Europe

Netherlands

The Dutch government plans to end preferential tax treatment for current early retirement arrangements beginning in 2006 and introduce a voluntary career savings program. The legislation was recently passed by the lower house of parliament, although a second vote may be required because of a drafting error in the bill. It will also require approval by the upper house, perhaps as early as mid-February, before becoming law.

After many months of worker unrest over the proposed 2005 budget, the government reached an agreement with employer organizations and unions in early November. The unions pledged to restrain wages, including freezing civil servants' pay and social security payments at 2004 levels, and the government accepted smaller cuts in early retirement, disability, and unemployment benefits.

The Dutch pension system comprises three pillars: a basic, compulsory, pay-as-you-go public pension (OAW) financed by employee contributions that are levied as part of the income tax, with flat-rate benefits from the age of 65; funded occupational pensions, nearly all of which follow a defined benefit design, with contributions shared between employer and employee; and voluntary individual savings accounts that are typically taken as annuities through an insurance company.

At retirement, the basic OAW and occupational pension plans are integrated to allow a maximum benefit of 70 percent of final pay from both systems. Pension contributions and interest income for the second and third pillars are tax-exempt during accumulation, and pension benefits are taxed as normal income. Tax expenditures for the deduction of pension and annuity contributions cost the Dutch Treasury €9.6 billion (US$8.5 billion), or 2.1 percent of gross domestic product (GDP), in 2003—three times as much as in 1990.

Holland suffers from a low labor force participation rate in large part because of actions taken in the early 1980s that encouraged early retirement to free up jobs for younger workers. These early retirement schemes (*vervroegde uittredingsregelingen*, or VUTs) were very generous, providing benefits equal to 80 percent of a worker's final wage. In addition, even though the VUTs required complete withdrawal from the labor force, early retirees who were members of an occupational pension plan would continue to receive credit toward their plan until the age of 65.

The adverse effects of low labor participation became apparent in the 1990s, and the VUTs were mostly replaced by less generous, but still largely unfunded, early retirement arrangements known as prepensions. These plans allow employees to exit the labor force as early as age 55, but, unlike the VUTs, benefits vary with the age of retirement. In the late 1990s, about 27 percent of men between the ages of 60 and 65 were collecting early retirement benefits.

The main provisions of the new pension bill, which will go into effect January 1, 2006, include:

- Granting favorable tax treatment only to occupational pension plans with a normal retirement age of 65. Early retirement will be allowed provided that benefits received before the age of 65 are actuarially reduced.
- Abolishing tax advantages for prepension and VUT programs, except for persons who are aged 55 or older on January 1, 2005.
- Taxing as income accruals under early retirement and VUT plans for those retiring before age 55.
- Creating a voluntary lifecycle savings plan, or *levensloopregeling*. Employees will be allowed to save a maximum of 12 percent of pretax salary each year, up to a cumulative balance of 210 percent of final pay. Employers will be able to make tax-deductible contributions on behalf of their workers. The savings may be withdrawn during long leave periods or at early retirement (as early as age 61), with payments taxed as income.

After outperforming other European Union members in the 1990s, the Dutch economy is now one of the weakest in Europe, contracting 0.9 percent in 2003. The economy is expected to grow only 1 percent in 2005, and unemployment is projected to rise from today's 6.25

percent to 6.75 percent next year. Over the long term, low fertility rates and rising life expectancy will cause the old-age dependency ratio (the number of persons aged 65 and over as a percentage of people aged 20 to 64) to increase from 22 percent today to more than 43 percent in 2040. Total public spending on pensions stood at 7.9 percent of GDP in 2000 but is projected to grow to more than 14 percent in 2040.

Sources: A. Lans Bovenberg and Lex Meijdam, "The Dutch Pension System," paper prepared for the Deutsches Institut für Altersvorsorge (DIA) Project *Vergleich alternativer Alterssicherungssysteme* (Cologne, March 1999); Erik De Gier, "The Future of the Dutch Pension System," article for the 4th International Research Conference on Social Security (Geneva: International Social Security Association, May 2003); David Natali, "The Netherlands: The Pension System," *L'Observatoire Social Européen*, 2004; K. Caminada and K.P. Goudswaard, "The Fiscal Subsidy on Pension Savings in the Netherlands," *Tax Notes International*, March 29, 2004; Peter Kooiman and colleagues, "Price and Income Incentives in Early Retirement: A Preliminary Analysis of a Dutch Pension Reform" (The Hague: CPB Netherlands Bureau for Economic Policy Analysis, June 2004); *Japan Times*, July 10, 2004; Dow Jones International News, October 11, 2004; Reuters News, November 6 and December 9, 2004; http://www.IPE.com (Web extension of *Investment & Pensions Europe*), November 8, December 3, and December 6, 2004; Mercer Human Resource Consulting, December 6, 2004; and International Benefits Information Service (IBIS), December 2004.

United Kingdom

The controversial Pensions Act was signed into law on November 18 and is scheduled to go into effect next April. The new law, which is intended to bolster employee confidence in the country's flagging private-sector occupational pension plans, has stirred heated debate over just how retirement security should be protected. Since the act was first published, it has taken on nearly 1,000 amendments and is twice its initial length, now at 400 pages. (See also the May 2004 issue of *International Update*.)

The Pensions Act appropriates £400 million (US$778 million) over 20 years for the Financial Assistance Scheme (FAS), which will help fund benefits for some 65,000 workers who have lost their pension savings because of employer insolvencies. However, in early December, Pension Minister Malcolm Wicks announced that the launch of FAS will be delayed by 6 months and that payments will not begin until late summer or autumn next year. There is also discussion of tying FAS assistance levels to age and setting a maximum aid ceiling of £12,000 (US$23,000) per year.

The key element of the legislation, the pension protection fund (PPF), will insure members of occupational pension plans against future insolvencies in much the same way that the Pension Benefit Guaranty Corporation does in the United States. Under much pressure, the government acceded to amending the act so that 80 percent of the rates charged employers by the PPF would be based on the risk that the employer might become insolvent instead of on the flat rate proposed initially. However, there is concern that the PPF will burden employers with heavy fees that could motivate more of them to close their defined benefit plans to new members—a situation that has already affected 47 percent of all defined benefit plans in the United Kingdom.

The act also creates a new Pensions Regulator that will have broad powers to police poorly funded plans and misadministration and fraud but will have little involvement with plans that are appropriately funded and managed.

The House of Lords failed in an attempt to amend the current requirement that retirees convert their pension savings into an annuity by no later than age 75. A coalition of Conservatives and Liberal Democrats objected to the principle of forcing people to invest in a financial product at a specific time when they might get a better return at a later date. The government promised to review the rules governing annuities next year after the release of the independent Pension Committee report. (See also the November 2004 issue of *International Update*.)

Sources: Nina Montagu-Smith, "Peers Force Delay to Pensions Bill," *Telegraph*, November 5, 2004; Christine Seib, "Pensions Bill Faces Rewrite in the Lords," *Times Online*, November 15, 2004; Jean Eaglesham, "Lords Goes into Battle over Annuities," *Financial Times*, November 17, 2004; Cecilia Valente, "UK's Wicks Eyes Public Sector and Pension Bill," *Investment & Pensions Europe*, November 18, 2004; Ben Hall, "Pensions Act Fails to Dispel Worry About the Rescue Plan: The New Law Has Arrived Despite Determined Opposition in the House of Lords," *Financial Times*, November 20, 2004; *Financial Times*, "Delay for Pension Assistance Scheme," December 3, 2004.

The Americas

Peru

On November 11, the Peruvian Congress approved a constitutional amendment that will reform the costly *cédula viva* (living decree) pension paid to some of Peru's highest earners, including former legislators. Once implemented, benefits for the 300,000 currently eligible retirees, about 4 percent of all pensioners, will be lowered gradually. The benefit will be eliminated for new retirees who instead will have a choice between the general public pay-as-you-go system and an individual account. (See also the July 2004 issue of *International Update*.)

Currently most *cédula viva* retirees receive monthly pensions between NS800 and NS5,000 (US$242 and US$1,515), and about 500 retirees receive NS8,000 (US$2,400). The amendment will cap all benefits at NS6,400 (US$1,940) and eliminate the provision of fully indexed benefits pegged to the current officeholder's present salary and full benefits paid to a spouse and any unmarried daughters at the retiree's death.

The savings from this reform, at least $90 million per year, or 0.15 percent of GDP, will be used to increase lower benefit levels in the general public pay-as-you-go system. Pensioners with monthly benefits between NS415 and NS750 (US$125 and US$227) will receive an additional monthly benefit NS100 (US$30), and those with benefits between NS750 and NS800 (US$227 and US$242) will receive an increase of NS50 (US$15) each month.

Sources: World Markets Research Centre (WMRC) Daily Analysis, November 15, 2004; Bureau of National Affairs, November 17, 2004; *El Comercio*, November 30, 2004.

International Agreements

Latin America

Paraguay ratified an agreement in November that clears the way for a multilateral social security totalization agreement among the member countries of *Mercosur* (*Mercado Común del Sur*), or Southern Common Market. The other member countries—Argentina, Brazil, and Uruguay—had given their approval several years ago. *Mercosur*, established in March 1991, is a free-trade zone and a customs union in which all members levy uniform tariffs on other member countries.

Social security totalization agreements serve two main functions by removing the burden of double taxation on citizens of one country working in another and by filling the gaps in social security protection for workers who have divided their careers among two or more countries.

According to the agreement, work performed in any of the member countries exceeding 12 months (except for diplomats and workers in international transportation) will count toward old-age, survivors, and disability benefits. The countries that have an individual account system (Argentina and Uruguay) must set up a special mechanism for transferring a worker's funds to the appropriate institution so that the worker can receive benefits. In addition, while employed in any of the four countries, workers and their dependents may also be eligible for health care benefits if their health care organization in their country of origin authorizes payment.

A permanent multilateral commission made up of three representatives from each of the member countries will oversee the implementation of the agreement and its administrative regulations.

Sources: "Acuerdo Multilateral de Seguridad Social Del Mercado Común del Sur," available at http://utal.org/segsocial/2.htm; *O Estado de São Paulo*, November 10, 2004.

International Reports

United Nations

On November 29, the UN Department of Economic and Social Affairs released its annual *World Economic and Social Survey*, which concluded that increased immigration will not solve Europe's pension woes. According to the report, if the original 15 countries of the European Union were to use immigration to maintain their 2003 ratio of retirees to workers, they would need to bring in a total of 13.5 million immigrants each year from now until 2050.

In much of the developed world, generous public retirement benefits will place tremendous pressure on government budgets as the ratios of retirees to taxpayers shrink. Limited attempts at pension reform, such as increasing retirement ages or scaling back benefits, have met with stiff public and political opposition in countries such as Germany, Italy, Greece, and France. With few options on hand, many governments are looking to the developing countries for a solution. Most of the developing countries in Southeast Asia, Africa, and the Middle East have large youthful populations and high unemployment. The report concludes, however, that despite the abundance of untapped labor in developing countries, the aging problem is far too large for immigration to reverse.

Although immigration clearly is not a panacea, the survey suggests that responsible migration policies can still be of benefit to both the destination and migrants' home countries. It concluded that temporary migrants could address the labor force deficiency without increasing social tensions or contributing to the fiscal burden of an already aging population. Such workers could also provide remittances to their home countries and upon return bring back valuable knowledge and skills.

Sources: United Nations Department of Economics and Social Affairs, *World Economic and Social Survey 2004* (New York: UN). The survey can be found at http://www.un.org/esa/policy/wess.

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