



July 2006

Europe

Denmark

On June 20, all of Denmark's major political parties endorsed the government's proposed welfare reform package including measures to increase labor force participation and reform the public pension system. The accord largely follows the proposals submitted last year by a government-appointed commission. (See the January 2006 issue of *International Update*.) The pension reform measures would be introduced beginning in 2019 and would affect only individuals younger than age 48 at the end of 2006. The reform legislation is expected to be approved by Parliament in October.

The pension reforms would reverse the 2004 decision that *lowered* the normal retirement age from age 67 to age 65 and shortened the duration of the generous voluntary early retirement program, known as VERB. (See also the February 2004 issue of *International Update*.)

Once adopted, the reform measures would:

- Gradually raise the eligibility age for the VERB program from age 60 to age 62 between 2019 and 2022. VERB benefits are paid until age 65 when eligibility for the old-age pension begins.
- Increase the required number of contribution years to qualify for early retirement VERB benefits from the current 25 years to 30 years in 2022.
- Gradually increase the normal retirement age for a universal flat-rate basic pension from age 65 to age 67 between 2024 and 2027.
- Index the retirement ages for VERB and the universal basic pension to average life expectancy of 60-year-olds beginning in 2025. This linkage to longevity would maintain constant the average number of years that Danes spent in retirement.

Between 2010 and 2040, the percentage of the Danish population older than age 60 is expected to grow from 23 percent to 29 percent. At the same time, life expectancy at birth is projected to rise from about 78 years to nearly 82 years of age. Recently, the Organisation for Economic Co-operation and Development (OECD)

reported that if participation rates remain unchanged the Danish labor force will contract by 10 percent over the next three decades, diminishing prospects for economic growth and the sustainability of publicly financed welfare programs. The proposed pension reforms are expected to reverse the decline in Denmark's labor force, which currently stands at 2.9 million workers.

Denmark has a multipillar retirement system. The first pillar consists of a government-financed universal benefit indexed to wages, a small earnings-related benefit (ATP), and a mandatory individual savings account (SP). (See also the March 2005 issue of *International Update*.) Funded occupational plans, largely mandatory and based on collective labor agreements, comprise the second pillar, while voluntary private pension savings form the third pillar.

Sources: "An Introduction to the Danish Pension System," Urban Institute, July 27, 2001; "Country Study: Denmark—Making Work Pay, Getting More People into Work," European Commission, October 2004; "Social and Health Policy," Danish Ministry of Foreign Affairs, December 2003; *World Population Prospects: The 2004 Revision*, United Nations on-line; "Policy Brief: Economic Survey of Denmark, 2006," Organisation for Economic Co-operation and Development, May 2006; "Factsheet on Denmark: Future Prosperity and Welfare," Ministry of Finance Denmark, June 2006; Agence France Presse, June 20 and 21, 2006; IPE.com, June 27, 2006; *World Factbook*, CIA, June 29, 2006; EurActiv.com, July 3, 2006; *Pension & Benefits Daily*, July 5, 2006; *Social Security Programs Throughout the World: Europe, 2006* (forthcoming).

Portugal

On May 1, Prime Minister José Socrates presented Congress with the government's plan for further reforms to maintain the solvency of the country's public pension system. The Organisation for Economic Co-operation and Development (OECD) reports that the average Portuguese public pension currently replaces about 80 percent of preretirement income. The government is discussing the proposed changes with various groups, including trade unions, the service sector, and employer federations. It expects the plan to be approved by Congress this year and become law in 2007.

The proposed reforms include:

- Accelerating the change in the benefit formula to earlier than 2017. According to a 2002 law, beginning in

2017 all new retirees will receive a benefit based on average adjusted lifetime earnings. Until then, at retirement, workers have a choice of a benefit based on whatever formula yields the highest benefit: the 10 best of the last 15 years of earnings, an entire working life, or a combination of the two.

- Introducing a “sustainability factor” in the calculation of new pension benefits that links benefits to the average life expectancy of the population at the point when a worker retires. A worker could choose to retire with a lower benefit (about 5 percent less for those retiring within the next 10 years) or, to avoid a reduced benefit, either increase social security contributions or work longer (from about 5 months for those retiring within the next 10 years to about 20 months for those just entering the labor force).
- Allowing younger workers with three or more children to pay lower social security contributions than workers with fewer children. Contributions for those with two children would remain the same while contributions for workers with fewer than two would increase. The government is seeking to help raise the country’s birthrate, which has fallen from an average of 2.6 children per woman to 1.5 over the past 30 years.
- Adjusting benefits during retirement to a combination of growth in the country’s gross domestic product (GDP) and inflation instead of *just* the consumer price index.
- Encouraging workers to save more for retirement through employer-sponsored and individual pension plans. A recent Mercer survey of 12 European countries showed that Portugal has among the lowest per capita private and occupational pension fund assets under management.

Other changes were made recently to the public pension system including eliminating the provision for early retirement. (See also the October 2005 issue of *International Update*.) However, the government predicts that without additional reforms the public pension system’s deficit will reach 1.5 percent of GDP by 2020 and will rise to 3.5 percent of GDP by 2050. Today, 17 percent of the population is aged 65 or older and 67 percent are of working age; by 2050, those figures are expected to be 32 percent and 55 percent, respectively.

Sources: *International Social Security Review*, March 2006; Agencia EFE-Servicio Económico, April 27, 2006; Ministério do Trabalho e da Solidariedade Social, “Linhas Estratégicas da Reforma da Segurança Social,” 3 de maio de 2006; Watson Wyatt, *Global News Briefs*, May 2006; *Financial Times*, May 15, 2006; Agence France Presse, May 15, 2006; *Portuguese Business Digest*, June 14, 2006.

Spain

On July 13, the government signed an agreement with labor unions and the employers’ confederation on reforms to the public pension system. The agreed upon reforms were the result of almost 2 years of negotiation and must be approved by the Council of Ministers and then passed by both houses of Congress.

The agreement calls for:

- Encouraging longer labor force participation by increasing a full earnings-related pension by 2 percent for each year that a worker remains employed beyond the current normal retirement age of 65; and by 3 percent for workers with over 40 years of contributions, up to a limit of €600 (US\$768) per month above the maximum pension (currently €2,232, or US\$2,858, per month).
- Expanding subsidies to allow employers who hire workers aged 55 or older to pay lower social security contributions. Now the system subsidizes from 40 percent of the employer’s contribution if the worker is aged 60 or older to 90 percent if the worker is age 64.
- Gradually increasing the minimum number of years required for a full earnings-related pension from 12.8 years to 15 years, implemented over a 5-year period. Although 15 years of contributions are currently required to qualify for a full pension, in practice, salary bonuses count toward the calculation and effectively lower the number of required years to 12.8. The agreement gradually eliminates bonuses from the calculation.
- Raising the age of eligibility for a partial pension from age 60 to age 61. Workers below age 65 can now receive a partial pension beginning at age 60 and continue to work between 25 percent and 85 percent of a full-time position as long as the balance of the hours of the full-time position is filled by a registered unemployed person. The amount of a partial pension is calculated according to the reduction in working time.

According to the Organisation for Economic Co-operation and Development (OECD), today Spain provides the most generous public pension benefits among OECD member countries, with an average net replacement rate of about 88 percent of preretirement income. Most workers depend on the public pension system for their retirement income while only about 10 percent are enrolled in some type of employer-sponsored pension plan. If no changes are made to the current public system, pension expenditures are expected to rise from 7.8 percent of gross domestic product (GDP) in 2005 to 15.2 percent of GDP by 2050.

The Minister of Labor and Social Affairs has indicated that the agreed upon reforms will ensure the public pension system's solvency for the next 20 years. However, a June 2006 International Monetary Fund (IMF) report suggested the need for more extensive reforms because Spain is expected to experience one of the highest increases in age-related costs among European Union countries over the next 25 to 50 years. According to the Spanish National Statistics Institute, the percentage of the population aged 65 or older is now 17 percent and is expected to rise to 33.5 percent by 2050; at the same time, the ratio of the working-age population to retirees is projected to fall from the current 3.77 to 1 to 1.47 to 1.

The IMF report recommended additional reforms such as increasing the base period for calculating pensions (currently the last 15 years of work), establishing "actuarially fair incentives to prolong the effective working life," and encouraging participation in private pension plans.

Sources: *International Herald Tribune*, May 3 and July 21, 2005; *International Social Security Review*, March 2006; *European Pensions & Investment News*, April 10, 2006; *Gaceta de los Negocios*, April 11, 2006; Agencia EFE-Servicio General, August 4, 2005, and May 8, 2006; *El Pais*, May 31, 2006; *El Mundo*, May 31, 2006; Europa Press-Servicio Económico, July 25, 2005, February 12, 2006, May 31, 2006, and July 13, 2006; International Monetary Fund Country Report No. 06/211, June 2006; *La Vanguardia*, June 1, 2006; *ABC Sevilla*, June 2, 2006; Europa Press-Servicio Económico, July 5, 2006; *Social Security Programs Throughout the World: Europe, 2006* (forthcoming).

Sweden

Sweden's employers and unions agreed on April 25 to replace the supplementary occupational defined benefit (DB) pension plan for private-sector salaried employees, known as ITP, with a defined contribution (DC) plan. Negotiations over ITP have been ongoing since 1995, with the unions wanting to preserve the DB plan and employers wanting to move to a less costly DC design. The refusal by many new companies to enter into a collective agreement that included a DB pension provision eventually persuaded union leaders to agree that those now covered by ITP and born in 1978 or earlier will remain in the ITP defined benefit plan and, beginning July 1, 2007, all other eligible workers aged 25 or older will enter the new DC pension plan.

Currently, the ITP covers approximately 700,000 private-sector white-collar employees aged 28 or older. The plan provides old-age, survivor, and disability pensions that complement the social security system. The normal retirement age under the ITP defined benefit pension plan is age 65 with 30 years of employer contributions. Early retirement can be claimed from age 55 with a reduced benefit. Today, ITP's managed assets total around €40 billion (US\$51 billion).

The ITP defined benefit pension amount currently is based on an employee's final salary and is equal to the sum of the following: 10 percent of earnings up to 333,750 kronor (US\$46,230); 65 percent of earnings from 333,750 to 890,000 kronor (US\$123,190); and 32.5 percent of earnings from 890,000 to 1,335,000 kronor (US\$184,949). Employers make monthly contributions for the ITP retirement benefit equal to 5.25 percent of an employee's salary on annual earnings up to 333,750 kronor (US\$46,230) plus 50 percent of salary on earnings above that level up to an annual taxable income ceiling of 1,335,000 kronor (US\$184,949). A separate contribution structure applies to ITP survivor and disability pensions. Employer contributions are tax deductible provided they do not exceed 35 percent of an employee's covered annual salary.

Under the new ITP defined contribution plan, employers will make monthly contributions for employees aged 25 or older of 4.5 percent of an employee's salary up to annual earnings of 333,750 kronor (US\$46,230) plus 30 percent on any additional earnings. Several insurance providers will be selected to manage the new ITP individual accounts, and employees will be allowed to transfer their funds among providers. Employees will be required to invest at least half of their contributions into a qualified insurance fund with a guaranteed return; the balance may go into a variety of investment vehicles. High-income earners will be allowed to opt out of the new ITP defined contribution plan into their employer's DC plan, an option now available under the ITP defined benefit system for those earning above the annual taxable income ceiling. As early as age 55, employees will be able to decide the length of their benefit payout period, anywhere from 5 years to a life annuity.

Nearly all of Sweden's employees in both the public and private sectors are covered by supplemental occupational plans under nationwide collective bargaining agreements between unions and employer groups. ITP is the last major occupational pension plan to switch to a DC benefit structure.

Sources: *Insurope News*, October 2001; "Benefit Security Pension Fund Guarantee Schemes," Organisation for Economic Co-operation and Development, April 2005; *European Pensions & Investment News*, November 7, 2005; *European Institutional Market Place Overview: 2006*, Mercer, 2006; Watson Wyatt, *Global News Briefs: Europe-Sweden*, April 2006; IPE.com, September 1, 2005, and April 27, 2006; *Hewitt Global Report*, May 2006, and personal communication with Hewitt staff, June and July 2006; *Life & Pensions* (London), May 2006; Council for Negotiation and Cooperation (PTK), May 15, 2006; "Fiscal Implications of Income Security Reform in Sweden," *Social Security Programs and Retirement around the World: Fiscal Implications*, National Bureau of Economic Research (forthcoming).

Chile

On July 6, the Pension Advisory Commission presented to President Bachelet 70 proposals to reform the individual retirement accounts pension system established 25 years ago. The report calls for providing universal pension coverage, raising the level of benefits, increasing gender equity, and encouraging greater competition in the pension fund industry. Following a review with the Inter-Ministerial Committee for Pension Reform, the president expects to send pension reform legislation to Congress by the end of the year. (See also the March 2006 issue of *International Update*.)

The Commission calls for setting up a government-administered basic universal pension (PBU) for those individuals who do not qualify for an earnings-related pension. About 65 percent of individuals over age 65 would qualify for the PBU, which would replace the guaranteed minimum pension and the means-tested assistance pension. (See also the May 2006 issue of *International Update*.) A PBU for those with no account balance would be about 75,000 pesos (US\$145) a month, 67 percent higher than the poverty line and 68 percent of the current minimum salary. In addition, those workers whose pension from an individual account is less than 200,000 pesos (US\$387) a month would receive a proportional supplement.

The Commission's report also noted that mandatory participation in the individual accounts system would increase coverage. Currently, participation in the system is voluntary for the self-employed, who make up about 27 percent of Chile's labor force. At the end of the 1980s, 4.9 percent of the self-employed contributed to an individual account, but in 2005 the percentage had declined to 3.9 percent.

Other measures proposed by the Commission to raise the level of benefits and provide greater gender equity include:

- Providing a government subsidy to low-earning new entrants to the labor force of 50 percent of their monthly contribution for 24 months.
- Setting up a new voluntary retirement savings system to which both employers and employees would contribute.
- Increasing over a 10-year period the retirement age for women from age 60 to age 65 to match that for men.
- Providing a bonus to low-income women of 1 year of contributions for the birth of each child.

- Providing a survivor pension for widowers. Currently, only widows receive a benefit.
- Allowing a worker to make contributions to another person's individual account.
- Permitting assets in an individual account to be divided in the case of divorce or marriage annulment.

The Commission also seeks to improve the pension fund industry's "efficiency" by encouraging more competition and lowering the barriers for firms seeking to enter the pension market. Currently, two of the six pension fund management companies (AFPs) control 50 percent of all pension fund assets and have 66 percent of all accounts. Among the proposals are:

- Gradually eliminating the limits on foreign investment. Currently, only 30 percent of AFP assets may be invested abroad.
- Separating contribution collection, account administration, and branch office network functions from fund administration and management. Eliminating legal restrictions on contracting out some of the AFP duties.
- Allowing AFPs to offer discounted fees to workers for remaining with their AFP.

The Commission also proposes creating a financial education fund, financed by the AFPs and the government, to increase public awareness of the system and help workers make informed decisions. The 2002 and 2005 Social Protection Surveys revealed that between 70 percent and 80 percent of those surveyed were not familiar with how their retirement benefits were calculated or the relationship of their contributions to their pension.

Sources: Consejo Asesor Presidencial para la Reforma Previsional, "Informe del Consejo Asesor Presidencial para la Reforma del Sistema Previsional," July 2006, available at <http://www.consejoreformaprevisional.cl/view/informe.asp>; US Fed News, July 6, 2006; *La Tercera*, July 7, 2006.

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