

Global Aging and the Sustainability of Public Pension Systems

An Assessment of Reform Efforts in
Twelve Developed Countries

A Report of the Aging Vulnerability Index Project

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INTRODUCTION

The essays in this volume chronicle the efforts of twelve developed countries to prepare for their coming age waves—and in particular, to reform their public pension systems. They contrast and compare retirement systems in different countries, discuss recent reforms, and evaluate likely developments.

If the essays had been written a decade ago, the dominant story almost everywhere would have been about political gridlock and the seeming inability of democratically elected governments to make far-sighted resource tradeoffs between older and younger generations. But over the past few years, many governments have begun to grapple seriously with the challenge.

Germany, Japan, and Sweden have all indexed their public pension systems, at least partially, to their changing demographics. Instead of building in automatic cost-escalation, indexing formulas now build in automatic cost-restraint. Many countries are also moving aggressively to boost funded retirement savings. Australia, the world reform leader, now has a large and near universal system of mandatory funded employer pensions. Sweden, Europe's quintessential welfare state, has introduced a mandatory system of personal retirement accounts. Canada, taking a different course, is investing the public pension system's reserve fund in private markets. Other countries, including Germany, Italy, and Spain, are trying to jump start voluntary private pension systems. Meanwhile, almost everywhere, countries are cutting back on expensive early retirement options.

Progress, to be sure, has been uneven, and no country, with the possible exception of Australia, can legitimately claim to have solved its old-age support problem. Despite recent reforms, public benefit systems in most developed countries remain fiscally unsustainable—and even where long-term costs have been controlled, serious concerns remain. The United Kingdom, having stabilized future pension spending as a share of GDP, is now worried that it has done so at the risk of impoverishing the future elderly. As for the United States, reform appears to be on indefinite hold. America enjoys many advantages in confronting the age wave, from its relatively youthful demographics to its large funded private pension system. Yet its failure to engage entitlement reform could in the end leave it no better off than many European countries facing far larger demographic challenges.

I am grateful to Jim Capretta for researching and writing the pension profiles in this volume. You will not find a clearer and more insightful analysis of reform efforts in the major developed countries. I would also like to thank Neil Howe, a senior associate with the CSIS Global Aging Initiative, for his many thoughtful suggestions, and Keisuke Nakashima, a research associate with the program, for his assistance in editing and fact-checking the profiles. The project was supported in part by a generous grant from the Richard M. Fairbanks Foundation.

The pension reform profiles presented here are intended as a supplement to the CSIS Aging Vulnerability Index, or AVI. The AVI represents the first attempt to develop a comprehensive measure of the aging challenge that is consistent across the developed countries. Readers who are interested in a more quantitative assessment of where the countries discussed in this volume stand are urged to consult it. Released in March 2003 at a joint CSIS–European Commission conference in Brussels, the AVI is now being thoroughly revised and updated to reflect new developments—demographic, economic, and programmatic. The first edition can be downloaded from the Global Aging Initiative's website at <http://www.csis.org/gai/avi/>. The new edition will be available later this year.

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AUSTRALIA

Introduction

Australian pension reform over the past two decades has successfully improved retirement income prospects for workers while increasing national savings and, at least potentially, lowering long-term government costs. Many experts now point to Australia and its mandatory system of funded pensions as a model for other countries to study. Australia's main remaining challenges include providing stronger incentives for longer working lives and establishing withdrawal rules that encourage workers to rely less on means-tested public benefits.

Background

Unlike most other developed nations, Australia never established an earnings-related public pension system. Instead, until the mid-1980s, it relied exclusively on means-tested public pensions, voluntary employer plans, and personal retirement savings.

The Age Pension, which was first introduced in 1909, is financed out of general revenue and pays benefits to Australians with 10 years of residency who qualify under a means test. Men can collect benefits starting at age 65, women at age 62 and $\frac{1}{2}$. (The eligibility age for women is being raised in stages to age 65 in 2014). The maximum pension payment is set at 25 percent of average biweekly earnings for male workers, or A\$488.90 as of September 2005. Couples collect a benefit equal to about 160 percent of the individual pension payment. The full benefit is payable to individuals with biweekly incomes below A\$124 in 2005 and is phased out at a rate of 40 cents for each additional dollar of income until it falls to zero for persons with bi-weekly incomes of A\$1360.75, or roughly 70 percent of the average wage. Beneficiaries must also pass an asset test to qualify.

Over the years, as the pension law was liberalized, more and more Australians qualified for means-tested benefits. By the mid-1980s, some 85 percent of the population aged 65 and over was receiving a full or partial Age Pension. Labor unions and the Labor party government elected in 1983 became increasingly concerned that workers were relying too heavily on public benefits, leaving their retirement income vulnerable to the fiscal pressures expected as Australia ages.

During wage bargaining negotiations in 1985 and 1986, the labor unions secured, with government cooperation, a contractual agreement that all covered employers contribute 3 percent of total wages to a pension plan—called a “superannuation fund” in Australia—on behalf of their employees. By July 1991, some 75 percent of Australian workers had superannuation coverage.

The non-governmental nature of the obligation, however, left gaps in coverage. At the same time, the 3 percent employer contribution rate was viewed as inadequate to support retirement income—and increasing it would have been difficult through voluntary employer-employee negotiations. In 1992, the Labor government successfully passed legislation imposing the “superannuation guarantee,” or SG, which requires all Australian employers to contribute a percentage of a worker's earnings, up to a maximum of about 2.5 times average earnings, to an employer-sponsored superannuation fund. The SG increased this mandatory employer contribution gradually over a decade, until it reached 9 percent in 2002. Self-employed Australians are not required to make superannuation contributions.

The withdrawal rules for the new system, which Australians affectionately call “Super,” are quite flexible and have drawn some criticism from pension experts for not properly assuring retirement income protection. One issue is the early age at which withdrawals are permitted. Australian workers may begin to withdraw funds from their Super accounts at any age past the

“preservation age,” now 55 but scheduled to increase to 60 between 2015 and 2025. The low preservation age—together with a rule that, until recently, required workers to leave the labor force to access funds—creates a strong incentive to retire early and may put workers at risk of inadequate income late in life.

Another issue is the lack of any annuitization requirement. About 75 percent of retiring workers take lump sum payments from their accounts. Some experts worry that workers may thus be “wasting” their Super balances. This concern may be misplaced, since lump sum withdrawals are generally “saved” in one fashion or another. About two-thirds of the assets are reinvested in new funds, deferred annuities, or other savings vehicles.¹ Most of the rest are used to pay off debts.

A more valid concern is that pension system rules allow many Australian workers to dispose of their lump sum withdrawals in ways that help them qualify for the Age Pension—the so-called double-dipping problem. For instance, if workers use their Super balances to pay off a home mortgage, they can evade both the Age Pension income and asset tests, since housing wealth is exempt, whereas if they convert account balances into an annuity income stream they might fail to qualify.

These caveats notwithstanding, there is little question that Super will result in a substantial improvement in the retirement income prospects of most Australian workers. According to government projections, the overall pension system—the Age Pension and Super combined—is expected to provide a replacement rate of 82 percent in 2042 for an average-earning worker with 40 years of contributions,² far above the typical replacement rate today for the Age Pension alone and well above the replacement rates provided by public pension schemes in most other developed countries.

The existence of a large funded pension system may in turn make it politically easier to reduce the future budget cost of means-tested benefits. To realize substantial savings, however, Australia will first have to solve the double-dipping problem. Under current rules, the percentage of the elderly population getting a full-rate Age Pension is expected to drop from over half today to around one-third by 2050, while the percentage getting no Age Pension will increase from 18 to 25 percent and the percentage getting a partial benefit will increase from 28 to 40 percent.³ Overall, the government projects that Age Pension spending in 2050 will be only about 6 percent lower with Super than it would have been without it.⁴

Recent Developments

Although put in place by a Labor government, Super now enjoys broad support across the political spectrum. Since assuming power in the 1996 general election, the Liberal party, led by Prime Minister John Howard, has made only targeted reforms to the pension system.

In 1998, the government introduced Retirement Savings Accounts, or individual superannuation funds, as an alternative to employer funds. In 2000, it eased the phase-out rate for the Age Pension, allowing more retirees with slightly higher incomes to become eligible for a

¹ Hazel Bateman and John Piggott, “Australia’s Mandatory Retirement Saving Policy: A View from the New Millennium,” Social Protection Discussion Paper Series no. 0108 (Washington, D.C.: World Bank, March 2001), p. 12; and Association of British Insurers, *UK Pension Reform: Lessons from Abroad?: Pensions in Australia, New Zealand, Sweden, and the USA* (London: Association of British Insurers, April 2005), p. 26.

² Australian Commonwealth Treasury, “Inquiry into Superannuation and Standards of Living in Retirement,” paper submitted to the Australian Senate Select Committee on Superannuation, July 2002, p. 4.

³ Australian Commonwealth Treasury, *op. cit.*, p. 10.

⁴ Australian Commonwealth Treasury (George P. Rothman), “Projections of Key Aggregates for Australia’s Aged,” paper presented at the Sixth Colloquium of Superannuation Researchers, Melbourne, Australia, July 9-10, 1998, pp. 9 and 13.

partial benefit, and thus improving incentives for voluntary savings. And, beginning in 2003, it introduced “co-contributions,” matching payments from the government to superannuation accounts for middle- and low-income workers who make voluntary contributions themselves.

The Howard government has also addressed two long-standing concerns about Super: portability and consumer choice. Until recently, superannuation savings was not fully portable, which meant that many workers ended up with multiple accounts (three per person, on average), and hence higher than necessary administrative costs. Beginning in 2004, workers whose accounts have received no superannuation contributions for at least six months may transfer their assets to an alternative account. In 2004, the government also secured “Choice of Funds” legislation—a reform to Super that the Liberal party had been seeking since coming to power in 1996. Effective July 2005, employees can direct their employer’s superannuation contributions to a fund of their choice, although employers will continue to choose a default fund for employees not making an active election.

In May 2005, the government announced a plan to establish a “Future Fund” to finance the unfunded liabilities of government employee pension plans. These defined benefit retirement schemes, now closed to new entrants, predate the 1992 SG and have been financed on a pay-as-you-go basis. The unfunded liability for the schemes stands at A\$91 billion, or 11 percent of GDP.⁵ The Future Fund would be cordoned off from the rest of the government budget and governed by an independent board, which would invest the assets in a diversified portfolio.

Finally, the Howard government is trying to reduce incentives for early lump sum withdrawals and double-dipping. New regulations regarding the “transition to retirement” became effective July 1, 2005 that allow workers reaching the preservation age to access the balances in their superannuation accounts without having to retire permanently from the workforce. The regulations, however, continue to prohibit full lump sum withdrawals while a worker remains in the labor force. The government hopes the new regulations will encourage more workers to remain employed, at least part time, while gradually withdrawing their superannuation savings.

Environment and Outlook

Australian political leaders have demonstrated far-sighted initiative in preparing for population aging. With the superannuation guarantee, Australia has a near universal, fully funded, privately administered, and, as of 2005, individually controlled and portable, retirement savings program. Today, over 90 percent of workers have superannuation coverage, and superannuation assets are growing rapidly, from 14 percent of GDP in 1983 to 75 percent of GDP in 2004, with the Australian Treasury projecting that they will reach 110 percent of GDP by 2020.⁶

With both a near-term budget surplus and a long-term old-age dependency burden that is manageable by international standards, Australia is unlikely to enact additional large-scale changes to its pension system anytime soon. Nonetheless, political leaders will continue to explore incremental reforms to correct the system’s flaws, especially the incentives for early retirement and double-dipping. If the government fails to make progress on this front, it may be forced to consider mandatory annuitization of superannuation balances, despite its unpopularity with Australian workers.

⁵ Australian Parliamentary Library, “The Future Fund,” *Research Note* no. 43 (Canberra: Australian Parliamentary Library, April 4, 2005); and Office of the Treasurer and Minister for Finance and Administration, Commonwealth of Australia, “Future Fund,” Joint Press Release no. 055, May 10, 2005. Available at <http://www.treasurer.gov.au/tsr/content/pressreleases/2005/055.asp>.

⁶ Australian Prudential Regulation Authority, *Superannuation Trends* (Sydney: Australian Prudential Regulation Authority, September 2004), p. 26; and George P. Rothman, *op. cit.*, p. 24.

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BELGIUM

Introduction

Belgium has been more reluctant than most European countries to pursue reform of its public pension system—and indeed, of its welfare state in general. With a large pay-as-you-go public pension system, the lowest effective retirement ages in Western Europe, and virtually no funded private pension savings, there is much reform that could occur. So far, however, Belgium’s only significant response to the aging challenge has been to initiate a program of government debt retirement. Sustained budget surpluses over the next two decades are supposed to make room for the sustained budget deficits projected to occur in following years as the population ages and pension and health-care costs rise. Missed fiscal targets in the early years of this undertaking have already exposed the vulnerability of relying exclusively on an approach with so many uncontrollable variables.

Background

Belgium’s modern public pension system had its origins in the midst of World War II. Employers and workers, who had joined together to resist the Nazi occupation, forged a decree on “social solidarity” that was signed by Prince Karel (King Leopold was in exile in London) in December 1944—on the same day the Germans launched the Ardennes Offensive against Allied forces in Belgium. The decree formed the basis for the Belgian welfare state that emerged in the postwar era.

While Belgium has an unusual political culture (there are significant regional differences among subpopulations defined by their languages—Dutch or Flemish, French or Walloon, and German), the country’s social insurance system is familiar in its typically European design. Separate pension schemes cover private-sector wage earners, the self-employed, and public-sector employees. All of the schemes are traditional, pay-as-you-go, defined benefit arrangements.

The primary scheme, for wage earners, replaces 60 percent of average lifetime earnings for single persons and 75 percent for married couples. Full benefits for men are payable at age 65 with 45 years of earnings. Until recently, women qualified for full benefits at age 63 with 43 years of earnings, but the rules for women are now being harmonized with those for men. The scheme is financed with a payroll tax, set at 7.5 percent of earnings for employees and 8.86 percent for employers. General government revenues subsidize roughly 10 percent of annual costs.¹ As in many other European countries, the separate scheme for public-sector employees is considerably more generous.

One of the hallmarks of the Belgian pension system is the generosity of its early retirement arrangements. Beginning in the 1980s, the government, in an effort to reduce high youth unemployment, began encouraging employers and unions to move employees into mandatory early retirement schemes as young as age 50. The pension schemes for both private- and public-sector employees now have in place “hold harmless” provisions that allow workers who retire without the required number of earnings years to receive full benefits anyway so long as they are in a qualifying status—that is, are eligible for unemployment, disability, or workers compensation benefits. Since special rules allow older workers to receive these benefits more easily than younger workers, access to subsidized early retirement is in effect nearly universal. The early

¹ Arnaud Dellis, Alain Joustien, and Sergio Perelman, “Micro-Modeling of Retirement in Belgium,” Discussion Paper Series no. 2795 (London: Centre for Economic Policy Research, May 2001), p. 4.

retirement arrangements for public-sector employees are especially generous and easy to access, with widespread use of a disability designation.

Belgium's generous early retirement provisions have saddled it with the lowest effective retirement ages in Western Europe. Among Belgians aged 55 to 64, only 36 percent remain in the workforce; among those aged 65 and over, just 1.4 percent do. The average retirement age for men in Belgium is 58.5, and for women it is 56.8.²

Despite widespread early retirement, Belgium's pension system is far from Europe's most expensive. One reason lies in the indexation rules used to calculate initial benefits. In the Belgian benefit formula, wage histories are brought forward for averaging based on price rather than wage growth, the latter being the usual practice in most countries, including the United States. This provision has the effect of gradually reducing per capita benefits relative to per capita wages over time. In fact, if Belgium's initial benefit formula used wage indexation, the projected increase in the total pension burden between 2000 and 2050 would be 2 percent of GDP higher.³

Over the years, Belgian workers have come to rely heavily on the public pension system for retirement income support. While many workers save something for retirement through life insurance schemes, funded employment-based and individually owned pension savings are virtually nonexistent. Fully funded private-sector pension assets amount to only 4 percent of GDP, while earned pension entitlements under the public pension system amount to about 250 percent of GDP.⁴

Recent Developments

In 2005, the Belgian government took some tentative steps toward reining in early retirement costs. Between 2008 and 2012, the minimum age required for so-called pre-pensions, one form of early labor force exit, is slated to rise from age 58 to 60. The government has also increased pension benefits for those aged 62 to 65 who remain in the workforce, while providing a new tax break on personal pension savings for those who wait until age 65 to retire.

Beyond this, the only significant "reform" development to date has been the creation of a budgetary trust fund that is supposed to prefund a portion of future pension costs. In 2001, the government promised to run sustained budget surpluses and deposit them in a new "Silver Fund," where they will be used to purchase outstanding government debt. The idea, which was inspired by a similar reform enacted a few years earlier in the Netherlands, is to reduce the debt-to-GDP burden in the near term, while Belgium's demographics are still favorable, leaving room for the government to run budget deficits as the population ages and pension and health-care costs rise.

Unfortunately, the reform amounts to little more than a political promise. Like the famous Social Security "lock box" that was much discussed in the United States in the late 1990s, the "Silver Fund" is a mere budgetary accounting device that in no way constrains the government's overall taxing and spending, and hence its borrowing balance with the public. Originally, the Belgian government's goal was to turn the projected budget deficit of 0.1 percent of GDP in 2001 into a surplus of 0.7 percent of GDP in 2005 and 1.5 percent of GDP in 2010 and

² Organization for Economic Cooperation and Development, "Key Statistics: Extending Opportunities: How Active Social Policy Can Benefit Us All," p. 3. Available at <http://www.oecd.org/dataoecd/31/16/34530748.pdf>.

³ International Monetary Fund, "Belgium: Selected Issues," IMF Country Report no. 03/50 (Washington, D.C.: International Monetary Fund, February 2003), p. 25.

⁴ Organization for Economic Cooperation and Development, *Financial Market Trends*, vol. 2006/1, no. 90 (Paris: Organization for Economic Cooperation and Development, April 2006), p. 212; and Arnaud Dellis, Alain Joustien, and Sergio Perelman, *op. cit.*, p. 3.

thereafter. Although some progress has been made toward this goal, primarily through spending restraint, the surplus targets have already been repeatedly missed and postponed.⁵

Environment and Outlook

Belgium's political leadership has placed great emphasis on the Silver Fund as the primary mechanism for managing the aging of its population. But for this prefunding approach to work, the government would have to show a high level of fiscal discipline over a period of decades—a discipline that few democratic governments have sustained even for a year or two.

Although it has made some progress, Belgium has yet to move toward a sustained budget surplus. Doing so without reforming pensions would require either progressively large reductions in other government spending or progressively large tax hikes. Yet there are few new proposals on the table to reduce other government spending—and many proposals to increase it in priority areas from education to health care. As for raising taxes, at nearly 50 percent of GDP Belgium already has one of the highest tax burdens in the world. Politicians of all political leanings generally agree that ensuring Belgium's competitiveness requires lowering taxes, not raising them.

Sooner or later, Belgium's political leaders will be forced to face what nearly every other European country is facing: significant reform of unsustainable public pension promises. Although the public has so far shown little appetite for reform, it may become more open to adjustments as budget pressures mount. The real question is when reform will happen—and whether it will be soon enough to avoid significant hardship for workers already in or near retirement.

⁵ The Belgian Administration of Treasury, *The Belgian Stability Programme, 2006-2009* (Brussels: The Belgian Administration of Treasury, 2005), p. 57.

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CANADA

Introduction

Although Canada's public pension system is relatively modest by international standards, its cost is projected to rise rapidly over the next few decades as Canada's unusually large postwar Baby Boom generation retires. While many other developed countries have recently made substantial cuts in future benefits to offset the projected cost of population aging, Canada is pursuing a different strategy. Beginning in the late 1990s, it raised the current contribution rate for the public pension system well above the current cost rate in order to build up a large trust-fund reserve. Canada's reserve is better insulated from the general government budget than similar government prefunding schemes in the United States and a number of European countries, and hence is more likely to raise national savings. The government's claim that Canada has effectively solved its long-term cost problem, however, is probably premature.

Background

Canada first established a public pension system in 1927 with the passage of the Old Age Pensions Act. The act provided federal subsidies to the Canadian provinces for a means-tested benefit to persons aged 70 and older. This original system was substantially revamped by the Old Age Security Act (OAS) of 1951, which eliminated the means test but kept the flat-rate benefit structure. In 1965, the eligibility age was lowered to 65.

The OAS remains the foundation of Canadian retirement security today. OAS benefits are based on years of Canadian residence, rather than earnings or contributions histories. The full OAS benefit is payable to persons who have lived at least 40 years in Canada after age 18, with proportionally reduced benefits payable to persons with fewer years of Canadian residence. Nearly all (over 98 percent) of Canadians aged 65 and over currently receive at least a partial monthly OAS pension.

Canada enhanced benefits for the low-income elderly with the Guaranteed Income Supplement (GIS) in 1967, followed by the Spouse Allowance in 1975. Although income-tested, there is no asset test for either the GIS or the Spouse Allowance. Twenty-seven percent of OAS-eligible men and 37 percent of OAS-eligible women received a GIS benefit in 2004, while the Spouse Allowance provided benefits to 10.5 percent of OAS-eligible women and 1 percent of OAS-eligible men. Participation rates in the GIS and Spouse Allowance are expected to fall in the coming years, as incomes rise faster than the inflation-adjusted income eligibility thresholds.¹

Since 1965, Canada has also had an earnings-related pension system. Unlike the federally run OAS/GIS/Spouse Allowance programs, Canada's earnings-related public pension—the Canadian Pension Plan, or CPP—involves substantial coordination with provincial governments. The consent of two-thirds of the provinces containing two-thirds of the population was necessary to establish the CPP in 1965, and this same super-majority is necessary for modifications to the program. To secure provincial support, Ottawa allowed the provinces to opt out of the CPP and set up their own pension plans. To date, only Quebec has chosen to run its own pension scheme, the Quebec Pension Plan, or QPP. The QPP, however, is virtually identical in its features to the CPP, and contributions and benefits under the two programs are completely integrated.

¹ Office of the Chief Actuary, *Actuarial Report (7^h) on the Old Age Security Program* (Ottawa: Office of the Superintendent of Financial Institutions Canada, May 4, 2005), pp. 44 and 68.

The CPP is a defined benefit program which, until recently, was effectively financed on a pay-as-you-go basis. Retirement pensions replace 25 percent of a worker's average lifetime earnings between a minimum and maximum threshold and are indexed annually for inflation. The retirement age, originally set at 68, is now 65, with actuarially reduced benefits for early retirement between age 60 and 64. Unlike the OAS/GIS/Spouse Allowance programs, which are financed from general revenues, the CPP is financed entirely from worker, employer, and self-employed contributions.

The Canadian public pension system provides relatively modest benefits by international standards. Taken together, the combined maximum OAS benefit and CPP pension replace roughly 40 percent of an average earner's wages in retirement²—comparable to the replacement rate for average earners in the U.S. Social Security system.

Beyond its public pension system, however, Canada also has an extensive voluntary private pension system. Registered Retirement Plans, or RRs—employer-based pensions that are regulated by the federal government and the provinces—cover about 40 percent of the workforce. In 1957, the Canadian government also established a personal retirement savings vehicle, the so-called Registered Retirement Savings Plans, or RRSPs. Initially aimed at the self-employed, RRSPs are now open to all Canadian workers on a voluntary basis. About 60 percent of Canadian households currently have assets in RRSPs.³

Recent Developments

In Canada, as in most developed countries, the scope and generosity of the public pension system was repeatedly expanded during the early postwar decades. And in Canada, as in most developed countries, this initial period of expansion came to an abrupt end in the 1980s.

The first attempt at reform was made by Canada's Conservative Party, which gained a large parliamentary majority in 1984. The reform was prompted in part by Canada's dire near-term fiscal situation—the federal government's deficit topped 8 percent of GDP in 1985—and in part by alarming projections of rising long-term pension costs as the population aged. In his first budget, Brian Mulroney, the Conservative prime minister, proposed limiting the growth in OAS costs by canceling cost-of-living adjustments unless inflation exceeded a 3 percent threshold. The proposal, however, met fierce resistance from opposition politicians, labor unions, and seniors groups, who successfully mobilized public opinion against it. The episode is widely remembered for the televised Parliament Hill steps confrontation between Mulroney and Solange Denis, an outraged near-retiree.

In 1988, the Conservatives made a second—and initially, more successful—attempt to scale back OAS benefits. The 1988 reform instituted an indirect income test called the “clawback” that imposes a special 15 percent tax on OAS benefits if the beneficiary's income exceeds a certain threshold, set at roughly C\$50,000 at the time of enactment. Although the clawback was estimated to affect only 4.3 percent of OAS beneficiaries initially, that percentage was expected to grow rapidly over time since the income threshold was not fully indexed to inflation. In 2000, however, a new Liberal government changed course and switched to full inflation indexing of the threshold. Current projections indicate that the number of beneficiaries affected by the clawback will increase only slightly, from 5.4 percent in 2005 to 8.5 percent in 2050.⁴

² Daniel Béland and John Myles, “Stasis Amidst Change: Canadian Pension Reform in an Age of Retrenchment,” *Social and Economic Dimensions of an Aging Population (SEDAP) Research Paper no. 111* (Hamilton, Canada: McMaster University, October 2003), p. 7.

³ Daniel Béland and John Myles, *op. cit.*, pp. 8-9.

⁴ Office of the Chief Actuary, *op. cit.*, May 5, 2005, p. 66.

Although the Liberals had opposed Conservative reform efforts, the ongoing deterioration in Canada's fiscal outlook, both near term and long term, forced them to take action of their own when they returned to power in 1993. In his 1996 budget, Jean Chrétien, the new Liberal prime minister, proposed replacing the OAS, GIS, and Spouse Allowance with a single income-tested program called the "Seniors Benefit." The Seniors Benefit would have reduced flat-rate old-age assistance for many more middle- and upper-income seniors than were hit by the clawback, while at the same time providing for a more gradual phase-out of income-tested benefits. Overall, the government estimated that the reform would reduce projected costs by about 10 percent by 2030.⁵

The Seniors Benefit proposal came under immediate fire from both the left (which was concerned that it based its means test on family income rather than individual income) and the right (which was concerned about disincentives to retirement savings in the benefit phase-out range). In the spring of 1998, as Canada's short-term budget crisis finally eased, the Liberals announced the withdrawal of the proposal.

At the same time, the Liberals had initiated a consultation process with the provinces on the long-term financing of the CPP/QPP. The resulting reform package, which was hammered out in 1997 and went into effect in 1998, included some modest reductions in benefits. The number of earnings years in the initial benefit formula was changed to the last five from the last three, the minimum earnings floor beneath which wages are exempt from contributions was frozen in nominal dollars, and death benefits were reduced. The centerpiece of the reform, however, was a large contribution hike. Between 1998 and 2003, the CPP/QPP contribution rate was raised in stages from 6.0 to 9.9 percent, well above the system's current cost rate.

According to government projections, the 9.9 percent contribution rate allows for the accumulation of a growing reserve fund (or rather funds, since the CPP and QPP have separate reserves) sufficient to indefinitely pay current-law benefits without additional contribution hikes.⁶ To help ensure that the "partial advance funding" results in genuine savings, the government created a fire wall between the general budget and fund administration. Investments are managed by the Canadian Pension Plan Investment Board (CPPIB), an independent agency whose twelve members are appointed by the Finance Minister. The CPPIB has a legislated mandate to invest assets solely in the interest of CPP beneficiaries. Prior to the 1997 reform, the CPP and QPP had nominal budgetary reserve funds whose assets were invested primarily in low-interest loans to the provincial governments, much like U.S. Social Security trust-fund surpluses are invested in special issue U.S. Treasury bonds. Since the reform, pension assets have been invested primarily in marketable securities. As of September 30, 2006 the CPP reserve totaled C\$103 billion, nearly two-thirds of which was invested in equities.⁷

The CPP reserve fund is projected to grow rapidly over the next few decades, accumulating assets of roughly C\$600 billion by 2030, or the equivalent of six years of benefits. Current contributions are expected to exceed annual benefit payments until 2022, after which investment income will be needed to finance an ever growing portion of annual program costs.⁸

⁵ R. Kent Weaver, "The Politics of Pension Reform in Canada and the United States," Center for Retirement Research Working Papers no. 1999-04 (Chestnut Hill, MA: Center for Retirement Research at Boston College, November 1999), p. 39.

⁶ Office of the Chief Actuary, *Actuarial Report (21st) on the Canadian Pension Plan* (Ottawa: Office of the Superintendent of Financial Institutions Canada, November 18, 2004), p. 11.

⁷ Canada Pension Plan Investment Board, "Financial Highlights," p. 1. Available at http://www.cppib.ca/Results/Financial_Highlights/default.html.

⁸ Office of the Chief Actuary, *op. cit.*, November 18, 2004, p. 10.

Environment and Outlook

Over the years, many countries, including the United States, have tried to partially pre-fund public pension systems by building up government trust-fund reserves. Few if any of these efforts have met the most basic litmus test of success—raising national savings.

Canada may well prove to be an exception. The firewall separating the operations of the CPP/QPP reserve funds from the general budget so far seems to be functioning effectively. Investment decisions appear to be made by the CPPIB with minimal if any political interference. The federal government, moreover, has run uninterrupted budget surpluses since the late 1990s excluding CPP/QPP operations.⁹

The long-term success of Canada's pre-funding strategy nonetheless remains problematic. When the next fiscal crisis hits, perhaps during a sustained economic slowdown, elected officials may be tempted to take advantage of the existence of large public pension reserves to finance higher, short-term government spending. In the end, the success of government pre-funding depends as much on political will as procedural safeguards. The problem is that so long as government owns the savings, it can spend it, borrow against it, or otherwise nullify it.

There is also some cause for concern that the assumptions underlying Canada's long-term public pension projections may be too optimistic. The projections rest on the expectation that current high levels of net immigration will indefinitely continue to offset Canada's feeble fertility rate, slowing the aging of its population. They also assume that reserve fund assets will continue to earn long-term historical rates of return, which may be unrealistic as rates of growth in the workforce and economy slow in the decades ahead along with population aging.

For the moment, however, these issues are simply not on radar of politicians or the public. Most Canadians seem content to allow their experiment in partial pre-funding to mature, making large-scale adjustments to the CPP/QPP unlikely in the near term. Meanwhile, politicians—having witnessed the political turmoil for the Conservatives in the 1980s and the Liberals in the 1990s—are unlikely to revisit the OAS/GIS scheme unless large fiscal imbalances reemerge.

⁹ Department of Finance Canada, *The Economic and Fiscal Update: Annexes to the Presentation* (Ottawa: Department of Finance Canada, November 16, 2004), pp. 10 and 24.

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FRANCE

Introduction

The French have long supported an expansive public sector, and France's public pension system is indeed generous and costly. The unusual degree of operational fragmentation and administrative control delegated to the "social partners" has also made it particularly resistant to reform. Over the last 15 years, pension reform proposals have repeatedly triggered political turmoil. Although the government has made some real progress in scaling back the pension system's projected long-term cost, large imbalances remain—leaving French political leaders to face the difficult task of convincing voters that much more sacrifice is needed, and relatively soon.

Background

Prior to World War II, France initiated a public pension system on two occasions, first in 1910 and again in 1930. Neither attempt proved enduring. In each case the schemes, which were designed to be fully funded, were depleted due to high wartime inflation—and in the end, the government converted them into means-tested support for the poor elderly.

In 1945, France abandoned the funded or *capitalisation* approach to public pensions and adopted a pay-as-you-go or *repartition* system. At the time, some employment sectors had voluntary schemes in place that employers and workers preferred to the emerging public pension system. Moreover, the self-employed were adamantly opposed to joining a pension scheme for "wage earners." The result was the establishment of a defined benefit pay-as-you-go scheme (the "Régime Général," or General Regime) for most private-sector workers, and retention of separate systems ("Régimes Spéciaux") for certain employment sectors and classes of workers, including civil servants, the military, the self-employed, and farmers. Today, 68 percent of the workforce is covered by private-sector schemes (with about 60 percent in the General Regime), while 21 percent are in the civil service pension system and 11 percent are in the self-employed schemes.

At the time the General Regime was being debated in France, managers and executives—the so-called *cadres*—did not want to be included. They formed a union and staged a national strike to pressure for their exclusion from the public pension law. In the end, the *cadres* were included in the General Regime, but given the authority to establish complementary pensions with contributions paid on earnings above the General Regime's contribution ceiling. In 1947, AGIRC ("Association Générale des Institutions de Retraite des Cadres") was established through a national collective bargaining agreement. In 1961, a second national collective bargaining agreement established ARRCO ("Association des Régimes de Retraites Complémentaire") for most private-sector workers not covered by AGIRC. In 1972, the French Parliament made complementary schemes mandatory for the small percentage of General Regime workers not already covered. Complementary pensions are not required for workers in the special schemes, since their generous replacement rates make them unnecessary.

AGIRC and ARRCO are unusual in several respects. They are ostensibly private employer pensions, yet form an integral part of the public pension system. They are also financed on a pay-as-you-go basis, yet are structured as defined contribution plans. Each year, workers earn pension value "points" based on their, and their employers', contributions in that year. Until recently, these points were indexed to wage growth to determine their value at retirement. In the 1990s, however, the indexing was changed to prices, significantly reducing the return on points earned in the system.

The General Regime is financed from a combination of payroll contributions and general tax revenue. Employers contribute 8.3 percent of wages and employees 6.65 percent of wages up to

a ceiling, plus, respectively, 1.6 and 0.1 percent of total wages. In addition, two separate income tax assessments equivalent to 8.0 percent of all household income are earmarked for the General Regime. Employers and employees pay additional payroll contributions for the complementary schemes organized through AGIRC and ARRCO at a combined rate of 7.5 percent of wages up to a ceiling and 20 percent of wages above the ceiling. The total cost of the French pension system, including the income tax assessments, is thus the equivalent of at least 32 percent of each worker's wages, among the highest cost rates in the world.¹

In 1956, France also instituted a minimum income guarantee ("Minimum Vieillesse") that supplements the income of persons aged 65 and older if their pensions are inadequate. About 30 percent of French pensioners get assistance from the minimum income guarantee, and more than 80 percent of the beneficiaries are women.²

During the early postwar decades, France, like many developed countries, repeatedly increased the generosity of its public pension system. In 1971, full benefits under the General Regime were raised from 40 to 50 percent of covered earnings, and in 1972 the earnings years included in the benefit formula were changed from the last 10 to the best 10. In 1976, the full-benefit retirement age was lowered from 65 to 60 for certain physically demanding occupations. And in 1982, the government passed legislation that lowered that age to 60 for all French workers.

By the end of the 1980s, however, it became clear to political leaders that these benefit liberalizations, in combination with the projected aging of the population, were pushing the French pension system toward insolvency. Projections at the time indicated that contributions would need to be nearly tripled to keep the system in balance through 2025.³

Following a decisive victory in 1993, the new conservative prime minister, Édouard Balladur, successfully initiated a series of reforms aimed at reducing the long-term cost of the General Regime. The reforms raised the number of years used to calculate pensions from 10 to 25, with a transition period ending in 2008, increased the number of working years necessary for a full-benefit pension at age 60 from 37.5 to 40 years, and indexed benefits in payment status to prices instead of wages.

In 1995, his successor, Alain Juppé, proposed reforming the full-benefit rules and indexing provisions of the special schemes, and in particular of civil service pensions, to bring them more in line with the recently reformed General Regime. Trade unions for civil servants and rail workers staged massive nationwide strikes in protest. Juppé was forced to withdraw the proposal in December 1995 and was subsequently defeated in the 1997 election.

Recent Developments

Between 1997 and 2002, Social Democratic Prime Minister Lionel Jospin steered clear of pension reform, even as a series of studies indicated large financing shortfalls on the near horizon. His only initiative was the establishment in 1999 of a government reserve fund for financing future pension costs, the "Fonds de Réserve pour les Retraites," or FRR. The FRR, which is credited with any pension scheme surpluses plus half of estate taxes, is projected to accumulate a reserve of

¹ Centre des Liaisons Européennes et Internationales de Sécurité Sociale, "The French Social Security System." Available at http://www.cleiss.fr/docs/regimes/regime_france/an_a2.html.

² Observatoire des Retraites, *Retirement Pensions: A Statistical Analysis* no. 3 (Paris: Observatoire des Retraites, January 2003), p. 59; and David Natali, "France: The Pension System," p. 1. Available at <http://www.ose.be/files/mocpension/FranceOMC.pdf>.

³ Bruno Palier, "Facing Pension Crisis in France," Oxford Institute of Ageing Working Papers no. WP302 (Oxford: Oxford Institute of Ageing, August 2002), p. 6.

€153 billion by 2020—or roughly the equivalent of 10 percent of GDP in 2002.⁴ Whether the FRR will ease France’s future pension financing shortfall, however, is open to question, since the transactions are internal to government and do not result in net new savings.

In June 2002, the conservatives returned to power under Prime Minister Jean-Pierre Raffarin and initiated a new round of reform. Raffarin’s proposals, which were essentially a repackaging of the Juppé plan, included increasing the number of years required for a full civil service pension from 37.5 to 40 by 2008, thus matching the 1993 reform of the General Regime, with a further increase to 41 by 2012; indexing civil service pension benefits in payment status to inflation instead of wages, again matching the 1993 reform of the General Regime; and reducing the credit toward the replacement rate for civil service pensions from 2.0 to 1.8 percent for each year of work by 2020. The reform also provided for a similar reduction in General Regime replacement rates for workers with less than 40 years of employment history to be phased in by 2008.

The announcement of the government’s proposals in April 2003 was greeted by a new wave of nationwide strikes that crippled public transportation. This time, however, the government was able to gain the support of two of the more moderate unions. The French public finally grew weary of the disruption, and the government managed to push the reforms through Parliament in August 2003.

Environment and Outlook

Of all the peoples in Europe, the French are perhaps most attached to generous pay-as-you-go pensions, which they view as the cornerstone of *solidarité sociale*—and the most hostile to funded alternatives, which they associate with “Anglo-Saxon” capitalism. The climate of public opinion has thus far precluded any debate about radical restructuring of the pension system. Indeed, even the “paradigmatic” reforms enacted to date have met with considerable public resistance.

The political challenge of pension reform is compounded by the unusual relationship of France’s pension regimes with the national government. Workers and pensioners are covered by scores of different retirement institutions based on employment sectors and professions. AGIRC is a federation of 45 different funds, while ARRCO has 90 funds in its association. Each of the separate funds is managed by representatives of the “social partners” (that is, employers and unions), not the government directly. Moreover, the pension regimes are not included in the regular state budget process, being, in effect, “extra-budgetary.” This fragmented and decentralized administrative structure has forced elected leaders to negotiate pension reforms with scores of employer and union representatives who, more than their counterparts in other countries, view themselves as “owning” the schemes.

Recent history indicates that progress can be made in pension reform, particularly if moderate unions can be brought into the effort. Whether France can make sufficiently bold reforms, however, is open to question. At some point, the reality of scaled-back pension promises will collide with the French expectation of an expansive welfare state, with unknown political consequences.

⁴ Bruno Palier, *op. cit.*, p. 10; and Andrew Burns and Alessandro Goglio, “Public Expenditure Management in France,” Economics Department Working Papers no. 409 (Paris: Organization for Economic Cooperation and Development, October 2004), p. 17.

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GERMANY

Introduction

Germany's public pension system is Europe's oldest and one of its most generous, with high replacement rates and early effective retirement ages. In recent years, however, a series of major reforms have begun to scale back the state largesse, while at the same time encouraging the development of funded private pensions. Although the reforms represent a major breakthrough, the planned transition from today's dominant, state-run, pay-as-you-go system to a less costly state system supplemented by funded retirement savings will not be easy to achieve. The scheduled cuts in public pension benefits, though large, fall well short of what's needed to ensure long-term solvency. Meanwhile, with just a fraction of eligible workers electing to participate, the new funded pension system is off to a rocky start.

Background

Germany's public pension system—the “Gesetzliche Rentenversicherung,” or GRV—was established by Chancellor Bismarck in 1889. As the first formal state system of old-age support in Europe, it has served as a model for many other countries' social insurance systems. In what is sometimes called the “Bismarkian paradigm,” public pensions are considered “retirement insurance,” and emphasize wage replacement for each worker in his or her retirement, rather than income redistribution among workers.

Over the years, the GRV evolved from a relatively inexpensive pension system paying modest benefits to the small fraction of workers lucky enough to survive to age 65 into one of the most generous and costly pension systems in the world. The era of benefit expansions culminated in the landmark 1972 reform, which set the net replacement rate for average earning workers at 70 percent and created various no-penalty early retirement options allowing them to collect full benefits beginning in their late 50s and early 60s.

The GRV is financed predominantly by payroll tax contributions. The current combined payroll contribution rate is 19.5 percent of wages up to a relatively high cap. Even this lofty contribution rate, however, is insufficient to cover annual benefit payments. About 30 percent of the GRV's cost is financed through general government revenues, including a dedicated percentage of the country's value added tax and a dedicated tax on fossil fuel.

By the late 1980s, with government projections indicating that rapid population aging would push the pension contribution rate past 40 percent by 2035, it became clear that the GRV was unsustainable in the long term.¹ Even the near-term cost outlook looked bleak, as reunification added millions of East German pensioners to the benefit rolls. In 1992, the Bundestag, led by Christian Democrat Helmut Kohl, enacted the first of a series of major public pension reforms. Prior to 1992, German pensions were indexed to gross wages, which had the perverse effect of increasing benefits more rapidly as pension contributions rose. The 1992 reform replaced gross wage indexing with net wage indexing—that is, indexing to wages net of worker payroll contributions. It also reduced incentives to retire early by providing for reductions in benefits for pensioners retiring before the official full benefit retirement age of 65.

¹ Axel H. Börsch-Supan and Christina B. Wilke, “Reforming the German Public Pension System,” paper presented at the American Economic Association Meetings, Boston, January 6, 2006, p. 4.

Recent Developments

Although the 1992 reform substantially reduced projected pension costs, it still left the system on an unsustainable trajectory. After defeating Kohl in 1998, newly elected Social Democratic Chancellor Gerhard Schröder appointed a blue ribbon pension commission chaired by Labor Minister Walter Riester. The commission was instructed to develop a reform package that would further reduce the GRV's long-term cost while at the same time providing overall retirement income support near the level that Germans had come to expect from the public pension system.

The commission proposed a series of complex changes to the GRV's initial benefit formula that were designed to hold the payroll tax rate to below 20 percent until 2020 and to below 22 percent until 2030—the Schröder government's announced goal. At the same time, to offset the reductions in public benefits, it proposed setting up a new voluntary system of fully funded, defined contribution retirement savings plans. The so-called “Riester-Renten,” or Riester Pensions, to which workers can elect to contribute 4 percent of wages, can be either employment-based or individual arrangements. Either way, fund balances must be largely annuitized upon retirement in order to substitute for the lower public pension benefits.

When the Riester reform became law on May 11, 2001, the government confidently announced that it had solved Germany's long-term pension crisis. It soon became clear, however, that the reform had been oversold.

Participation in the new Riester pensions, which was expected to be nearly universal, came in far beneath projections. Of the 30 million Germans eligible for the new tax-favored personal savings accounts, only 4.2 million—or one in seven—had signed up by early 2005, despite generous subsidies.² There are many reasons for the disappointing take up, including overburdensome regulations, especially a “money-back” guarantee, that increase administrative costs and reduce returns. In the end, however, the most significant obstacle to voluntary retirement savings may simply be that the cost of paying twice for retirement—for themselves and for their parents—may be too high for many younger German workers.

At the same time, the scheduled cuts in public pension benefits were not large enough to meet the reform's payroll tax targets. Indeed, it appears that the commission's demographic and economic projections deliberately understated the size of the required savings in order to secure the buy in of Germany's powerful unions, a key part of the Social Democrats' governing coalition. Not long after the reform's passage, updated and more realistic projections concluded that the contribution rate would need to exceed the 20 percent threshold by 2014 and the 22 percent threshold by 2022.³

In November 2002, the Schroeder government was compelled to appoint a second commission. The new commission, headed by Professor Bert Rürup, recommended raising the full-benefit retirement age from 65 to 67 between 2011 and 2035, in effect further increasing penalties for early retirement. It also called for introducing a “sustainability factor” into the GRV benefit formula. The sustainability factor, which resembles similar mechanisms recently introduced in Sweden and Japan, automatically adjusts current pension payments to offset the deterioration in the dependency ratio of retired beneficiaries to contributing workers.

The German Bundestag, increasingly concerned that high payroll taxes were hurting Germany's economic performance, passed the sustainability factor on March 31, 2004. In principle, this reform should have immediately and permanently stabilized total GRV benefits relative to total contributions. As actually designed, however, the sustainability factor is weighted

² Jan Wagner, “Mandatory Pension Saving an Open Question,” *Investment and Pensions Europe*, March 7, 2005. Available at <http://www.ipe.com>.

³ Axel H. Börsch-Supan and Christina B. Wilke, *op. cit.*, 2006, p. 24.

so that it offsets just one-quarter of the projected deterioration in the system's dependency ratio, meaning that its cost rate will continue to rise. Although the proposed retirement age hike was not passed in 2004, the legislation contained a review clause that forces the Bundestag to revisit the provision.⁴ In November 2006, the new coalition government headed by Angela Merkel announced that it would implement the change.

Environment and Outlook

Recent reforms in Germany have attempted to pursue two goals that are difficult to reconcile—holding the line on payroll tax increases and preserving the living standards of retirees.

At least for the moment, the consensus in Germany seems to be that the goal of cost-containment must take priority, though there are dissenting voices among Germany's powerful trade unions. Unlike recent pension reforms in most countries, which have tended to defer any beneficiary sacrifice and grandfather current and near-retirees, Germany's reforms actually ask today's pensioners to give something up. In 2004 and again in 2005, the Schröder government issued ad hoc rulings that cancelled the annual benefit increase normally scheduled for July 1 in order to maintain the pension contribution rate at its current level of 19.5 percent. In future years, the Rürup reform's sustainability factor will make such cuts automatic.

The stress on cost-containment is being driven both by concerns about economic growth and generational equity. High payroll taxes are increasingly seen by the mainstream in both major parties as undermining German job growth and competitiveness. At the same time, there is growing resentment among younger Germans, who feel that they are being asked to pay for generous benefits for their elders that they themselves cannot hope to receive. In 2003, Philipp Missfelder, head of the youth wing of the Christian Democrats, leveled a widely quoted broadside against the intolerable burden that old-age benefits placed on the young in which he suggested that older Germans should pay for their own false teeth and hip replacements.⁵

The problem is that the government has failed to educate the public about the magnitude of the sacrifices that are being asked of future retirees. Together, the Riester and Rürup reforms will result in a nearly 20 percent cut in the replacement rate by 2040 for the typical retiree, on top of the cuts already enacted in the 1992 reform.⁶ To be sure, the official projections suggest that, once the new Riester pensions mature, pensioners will enjoy total retirement incomes comparable to today's levels. These projections, however, are based on the assumption that participation in the new funded system will be nearly universal. They also ignore the fact that additional cuts in public pension benefits, above and beyond what's already scheduled, will ultimately be required to keep contribution rates from rising.

It is possible that Germany will manage a smooth transition to a more sustainable and equitable pension system, with scaled-back pay-as-you-go public benefits supplemented by a growing funded private defined contribution system. On the current course, however, the road may be bumpier than leaders want to admit. To avoid a future crisis, Germany must somehow jump start its new funded pension system, which in turn may require making it mandatory. If it fails, the commitment to controlling payroll taxes may be derailed by disappointed retirement expectations.

⁴ Axel H. Börsch-Supan and Christina B. Wilke, *op. cit.*, 2006, p. 30.

⁵ Jack Ewing, "Revolt of the Young," *Business Week*, September 22, 2003, p. 48.

⁶ Axel H. Börsch-Supan, Anette Reil-Held, and Christina B. Wilke, "How to Make a Defined Benefit System Sustainable: The 'Sustainability Factor' in the German Benefit Indexation Formula," Mannheim Economics Department Discussion Papers no. 037-03 (Mannheim, Germany: Mannheim Institute for the Economics of Aging, October 2003), p. 8; and Axel H. Börsch-Supan and Christina B. Wilke, *op. cit.*, 2006, p. 29.

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ITALY

Introduction

Italy not only has one of Europe's fastest aging populations, but one of its most expensive public pension systems as well. The combination of generous benefits, powerful trade unions, and unstable governing coalitions has made reform perilous for Italian political leaders. Nonetheless, beginning in 1992, successive Italian governments have managed to pass a series of significant reforms that have substantially scaled back benefits. The long transition periods that largely insulate current and near-retirees from the changes, however, call into question their political durability.

Background

The evolution of Italy's public pension system is similar to that in many continental European countries. Originally established on a funded basis in 1919, the system was designed to provide modest retirement benefits to wage and salary workers in Italy's newly industrializing economy. After World War II, with reserves in its pension funds depleted, Italy followed the path of other continental European countries and shifted the pension system to a purely pay-as-you-go basis, while expanding coverage and liberalizing benefits.

The Italian public pension system is characterized by an unusual degree of fragmentation, with disparate rules for various employment sectors and scores of institutions serving different professions and regions. Although 50 different public pension schemes exist today, the vast majority of Italian workers are covered by schemes falling under the broad umbrella of the "Istituto Nazionale della Previdenza Sociale," or INPS. The primary INPS pension fund is the "Fondo Pensioni Lavoratori Dipendenti," or FPLD, which covers more than 90 percent of private-sector workers. Public-sector employees are covered by the "Istituto Nazionale di Previdenza per i Dipendenti dell'Amministrazione Pubblica," or INPDAP.

Italian pensions are generous even by European standards. Prior to the reforms of the 1990s, the normal or full-benefit retirement age for Italian workers was officially 60 for men and 55 for women. But under special rules for "pensioni di anzianità," or seniority pensions, Italian workers could actually retire from private-sector employment with no penalty after 35 years of contributions, no matter what their age. Public-sector employees could retire with full benefits even sooner—after 20 years of contributions if they were men and after just 15 if they were women. Moreover, benefits were based on earnings in just the last five years of employment for private-sector workers and just the final year for public-sector employees. In the INPS-FPLD, workers earned 2 percentage points toward their replacement rate for each year of work, up to a maximum replacement rate of 80 percent. Until the reforms of the 1990s, the annual cost of living adjustments for current retirees were based on wage growth, not inflation.

The extraordinary generosity of Italy's pension system is matched by its extraordinary cost. The current payroll tax rate is set at 32.7 percent, with employers contributing 23.81 percent of gross wages and employees 8.89 percent. And even this towering tax rate does not fully cover the system's costs. About 7 percent of expenditures are paid by Italy's general government budget.¹

The existence of Italy's generous public pension system—and the high cost of financing it—has stifled development of funded occupational pensions and individual retirement accounts. As

¹ Association of British Insurers, *European Pension Reform and Private Pensions: An Analysis of the EU's Six Largest Countries* (London: Association of British Insurers, May 2004), p. 26.

of 2001, only 10 percent of Italian workers participated in either an employer or individual pension scheme.² Private-sector workers, however, contribute 7.41 percent of wages to a severance pay fund, called the “Trattamento di Fine Rapporto,” or TFR. The severance fund, which accumulates as a bookkeeping entry on corporate balance sheets, is payable as a lump sum when the employee retires or otherwise separates from the firm.

By the early 1990s, it became clear to political leaders that the Italian public pension system was on an unsustainable path and that major adjustments would be required to avoid prohibitive payroll tax hikes as the population aged. Reform was given an added urgency by the 1992 Maastricht Treaty, which established a series of fiscal hurdles that candidate countries would have to meet in order to join the planned European Monetary Union, or EMU.

Italy enacted a first major reform in 1992 under the socialist government of Giuliano Amato. The Amato reform raised the normal retirement age for private-sector workers from 55 to 60 for women and from 60 to 65 for men, with the increases to be phased in over ten years. Although the reform retained seniority pensions, it tightened the eligibility criteria for public-sector employees by gradually raising the required number of contribution years to 35, the rule for private-sector workers. At the same time, the reform increased the number of wage years counted in the initial pension benefit formula from 5 to 10 for older workers with at least 15 years of contributions at the time of reform and to a career average for younger workers with less than 15 years of contributions. It also switched the annual indexing adjustment for pensions in payment status from the growth in wages to the growth in prices.

Although the Amato reform achieved substantial savings, it fell far short of a complete solution. With projections still showing that payroll tax rates would have to be raised, and soon, the newly elected center-right government of Prime Minister Silvio Berlusconi proposed a second round of pension reform in 1994. The Berlusconi proposal, however, was defeated in the wake of fierce protests by the Italian trade unions—and the resulting political firestorm contributed to the rapid dissolution of his first government.

It fell to Lamberto Dini, Berlusconi’s successor as prime minister, to more fundamentally restructure the pension system. In 1995, Dini managed to pass a second major reform which, after a long transition, will replace Italy’s traditional defined benefit pension system with a new system of “notional defined contribution” (NDC) accounts. The system’s financing remains entirely pay-as-you-go—hence the term “notional.” Benefits, however, are calculated based on a worker’s actual contributions to the system, with an administratively established rate of return formula applied to the contributions to determine a “balance” from which a retirement annuity is calculated. The annuity is adjusted according to the retirement age of the worker, which, under the Dini reform, could range from 57 to 65. At the same time, the reform eliminated seniority pensions for workers retiring under the new system, while establishing a minimum eligibility age of 57 for workers under the old system.

The Dini reform contains some features that will help to stabilize long-term pension costs. The rate of return to workers’ notional accounts is set equal to aggregate GDP growth rather than average wages, as is the case in a similar reform enacted in Sweden at about the same time. As the population ages and the workforce and payroll tax base grow more slowly, so will workers’ account balances. Annuities are also adjusted to reflect improvements in life expectancy, although the adjustment factors are to be revised only once every ten years—and even then the updates are not automatic, but will require legislative approval.

Even when fully phased in, however, the Dini reform will leave Italy with one of Europe’s most expensive pension systems—and the phase-in will take many decades to complete. The

² David Natali, “Italy: The Reformed Pension System,” 2004, p. 2. Available at <http://www.ose.be/files/mocpension/ItalyOMC.pdf>.

Dini reform completely grandfathered everyone over the age of about 40 at the time it was enacted. Workers with more than 18 years of employment at the end of 1995 remained in the old system, while those with less than 18 years will receive a hybrid pension. Only new workforce entrants in their early twenties were fully affected.

Recent Developments

Not surprisingly, pension reform was soon back on Italy's political agenda—and has remained there ever since. In 1997, in a final (and successful) bid to meet the Maastricht's treaty's fiscal targets, Prime Minister Romano Prodi's center-left government enacted a third round of more modest reforms. And in 2004, Berlusconi's second center-right government managed to push a fourth and more substantial reform package through Parliament.

The Berlusconi reform focused on achieving near-term savings by tightening eligibility rules for seniority pensions. Specifically, the reform established that the minimum eligibility age, now 57, will rise in stages beginning in 2008 until it reaches 62 in 2014. At the same time, it provided for a parallel increase in the allowable retirement age window for younger workers covered under the new NDC system. During the transition period, women will be allowed to receive a seniority pension at younger ages, but will have their pensions calculated fully under the less generous NDC benefit formula. To prevent a rush of retirements before the more stringent rules become effective in 2008, the new law provides deferment bonuses equal to 33 percent of salary per year for those workers who could retire but postpone doing so.

The Berlusconi reform also attempted to jump-start Italy's anemic funded pension system by directing TFR contributions to employer-based or individually controlled pension funds instead of traditional "book reserve" TFR corporate accounts. Although the switch is voluntary, contributions are to go automatically to the pension funds unless workers explicitly choose to remain under the old TFR system—a provision called "silent assent." The proposal initially encountered resistance from employers, who opposed fully funding benefit commitments, as well as from workers, many of whom preferred the old system of lump-sum payments. In the end, however, it was approved by Parliament. The government projects that if two-thirds of workers choose to shift their TFR payments to pension funds, pension fund assets would grow from just 3 percent of GDP in 2003 to 33 percent of GDP in 2050.³

Environment and Outlook

Over the years, pension reform in Italy has provoked repeated clashes between reform-minded governments and powerful trade unions—with the unions sometimes staging crippling nationwide strikes to protest government moves to scale back pension entitlements. In the face of such intense political opposition, and given the fragile nature of Italian political governing coalitions, it is not surprising that public pension reforms have largely protected the current and near-retiree population, with most of the burden of reform falling on younger generations.

The problem is that the future eventually becomes the present. Over the next few decades, the steep but deferred benefit cuts legislated during the 1990s will cause the retirement income prospects of younger Italians to fall far below those of their parents. The open question is whether, as future sacrifice becomes current sacrifice, Italy's political system can stay the course. In this respect, the 2005 Berlusconi reform, with its reductions in seniority pensions for the soon-to-retire, may be a hopeful sign. If so, it comes just in time.

³ Simone Ceccarelli, Enrico Mattioni, and Ambrogio I. Rinaldi, "Pension Reform and the Long-Run Growth of Pension Funds in Italy: A Simulation Model," (preliminary draft, March 10, 2005), pp. 18-19. Available at <http://www.dauphine.fr/eurosc/Ceccarelli-workshop2005.pdf>.

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JAPAN

Introduction

Fertility fell earlier in the postwar era in Japan than in other developed countries, while life spans have risen faster and further. The result is that Japan is now the world's oldest society—and a window into the near future for the rest of the developed world. To their credit, Japan's political leaders have addressed the public pension system's financing woes aggressively, even as demographic projections have become ever more pessimistic. The significant economic sacrifices scheduled for workers and retirees, however, have left Japanese voters uneasy, and it is possible that the reform process has not yet fully run its course.

Background

During the late-nineteenth century, Japan established state pensions for the military and government workers—and during World War II, it attempted to extend coverage to private-sector workers. The modern public pension system, however, only took shape in the 1950s and 1960s. Like the systems in a number of other developed countries, it has two tiers: a flat-rate benefit and an earnings-related benefit. Both tiers are primarily financed on a pay-as-you-go basis.

The first tier is the National Pension Program (NP), or “Kokumin Nenkin.” The NP, which covers all Japanese residents, provides a universal flat-rate benefit. Full benefits are payable at age 60 (rising to age 65 in stages) to persons with 40 years of contributions. Persons with at least 25 years of contributions are eligible to receive prorated benefits.

Except for the self-employed (who are exempt), all Japanese workers are also required to participate in the second-tier Employees' Pension Insurance Program (EPI)—or, in the case of government workers, Mutual Aid Associations (MAAs), which parallel the EPI. Since 1966, employers offering defined benefit pensions are allowed to contract out of the EPI if the pension is more generous than the EPI.

Both tiers of the Japanese pension system are financed with a payroll tax, which is set at 14.642 percent of taxable wages as of 2006 and is split evenly between employees and employers. Persons who are enrolled in the NP but not in the EPI make a flat-rate contribution to the NP system. In addition, the NP receives a substantial general revenue subsidy. Until 2004, the subsidy financed one-third of annual NP costs, but that share is now being raised to one-half. Although the Japanese public pension system is financed primarily on a pay-as-you-go basis, the NP and EPI programs have trust-fund reserves. Until recently, the assets were invested almost exclusively in public works projects, such as harbors, bridges, and housing loans—with the fund in effect serving as a source of low-cost financing for the postwar reconstruction effort.

Japanese public pensions are progressive due to the flat-rate structure of the NP. For the average-earning wage worker with a non-working spouse, the system currently provides a total combined (NP and EPI) replacement rate of 59 percent of net wages. For a lower-wage worker earning roughly 55 percent of average wages, the comparable replacement rate is 86 percent. For higher-wage workers earning 167 percent of the average wage, it is 46 percent.¹

The benefits offered average earners under Japan's public pension system are modest by European (though not American) standards. Most Japanese elderly, however, enjoy additional sources of income support. The majority of Japanese workers are covered by some form of

¹ Junichi Sakamoto, “Japan's Pension Reform,” Social Protection Discussion Paper Series no. 0541 (Washington, D.C.: World Bank, December 2005), pp. 15-16.

occupational retirement scheme, whether a pension plan or a severance pay plan. Many Japanese elderly also supplement their income through continued employment, often working in new positions (at lower pay) for their former employers after their formal retirement. Although labor-force participation rates have declined in recent years, a larger share of Japanese elderly (29 percent of men aged 65 and over) still work than in any other major developed country.

The Japanese government is required by law to assess the financial outlook for the NP and EPI schemes every five years and, if necessary, propose reforms. The review ordinarily occurs following Japan's quinquennial Census and the publication of new long-term demographic and actuarial cost projections. Over the past decade, more rapid than expected population aging (compounded by slower than expected economic growth) has led to a series of dramatic upward revisions in the cost projections for the NP and EPI—and forced a series of major reforms. In each case, the reforms substantially reduced the “ultimate” contribution rate needed to finance current-law benefits. And in each case, new and more pessimistic projections soon revealed that the system was again careening toward bankruptcy.

Recent Developments

A first round of reform occurred in 1994 after new projections revealed that the ultimate contribution rate for the Japanese pension system would have to rise to 26.8 percent of annual payroll, up from 11.2 percent at the time of reform. To bring long-term costs and contributions down, the 1994 reform switched the indexation of benefits in payment status from gross to net wages and increased the retirement age for the NP portion of the system from 60 to 65, with the increase to be phased in gradually between 2001 and 2013 for men and 2006 and 2018 for women. Together, these measures cut the system's ultimate contribution rate to 22.9 percent of payroll.²

The second round of reform occurred in 2000, when revised projections assuming lower fertility and higher longevity showed that the ultimate contribution rate would have to rise to 26.5 percent, right about where it stood on the eve of the 1994 reform. The 2000 reform extended the increase in the retirement age to the EPI portion of the system, with the phase-in to take place between 2013 and 2025 for men and 2018 and 2030 for women. It also lowered the EPI benefit accrual rate and further modified the indexing of pensions by switching from wage to price indexing for NP and EPI benefits in payment status. At the same time, the 2000 reform moved control of the NP and EPI pension reserves from the Ministry of Finance to the Ministry of Health, Labor and Welfare (MHLW). Rather than invest in “social overhead” projects, MHLW was henceforth directed to shift the reserve into investment-grade securities in order to raise returns. According to the government, the overall reform package ensured that the contribution rate would never have to rise above 20.0 percent of payroll.³

Yet once again, the long-term outlook soon deteriorated. In 2004, faced with new projections showing that the ultimate contribution rate had shot back up to 25.9 percent, the government enacted the third and latest round of reform.⁴

This time, Japanese political leaders took a different approach. To avoid the need for frequent ad hoc adjustments to benefits, the 2004 reform introduced a new mechanism, called the automatic stabilizer or “macroeconomic slide,” that automatically adjusts benefits to compensate for changing demographics. The stabilizer, which is similar to automatic adjustment mechanisms recently introduced in Germany and Sweden, adjusts the normal indexing formula

² Tetsuo Kabe, “Japan's Public Pension Reforms,” paper presented at the Urban Institute International Conference on Social Security Reform, Washington, D.C., February 24, 2006, p. 6.

³ Tetsuo Kabe, *op. cit.*, p. 7.

⁴ Tetsuo Kabe, *op. cit.*, p. 9.

applied to both new and current benefits by two factors—one designed to offset the decline in the number of contributing workers, the other to offset the increase in the life expectancy of beneficiaries. It is expected that the stabilizer, which is scheduled to remain in effect for twenty years, will cut annual indexation adjustments by an average of 0.9 percentage points each year between 2004 and 2023, at which point the replacement rate for an average wage earner would be 50 percent, down from 59 percent today.

The 2004 reform also called for raising new revenues. The EPI payroll tax rate is scheduled to rise by 0.354 percentage points each year until it reaches an ultimate rate of 18.3 percent in 2017. At the same time, the reform provided for increasing the general fund contribution to the NP scheme from one-third to one-half of annual NP costs. The new revenues serve in part to cover near-term pension system deficits, since combined NP and EPI benefits already exceed annual contributions by a wide margin. They are also supposed to result in a large long-term trust-fund build up that will be used to help defray rising benefit costs after the automatic stabilizer expires. By 2050 the reserve fund, together with the NP scheme's general revenue subsidy, will be covering roughly 40 percent of total annual pension costs.⁵

Environment and Outlook

In recent years, Japan has been able to move more aggressively to control long-term pension costs than most developed countries. Its success is attributable in part to the relatively low dependence on public benefits of the Japanese elderly, many of whom continue to work in retirement and/or live in extended families with their adult children. Another crucial factor has been Japan's renowned cultural capacity for forging social consensus around shared goals and shared sacrifice.

This capacity may be reaching its limits. Three rounds of major pension reform in ten years have left the Japanese public yearning for stability and uneasy about the significant economic sacrifices that lie ahead for both workers and retirees. Yet there is a good chance that additional reforms will be necessary.

Although the government claims that the 2004 reform will ensure the solvency of the pension system for the next 100 years, there are reasons to be skeptical. On the benefit side, the automatic stabilizer, though it will effectively control costs in the near term, is due to expire in 2023, after which the full pre-reform indexing formula will once again apply. Meanwhile, on the revenue side, the reform depends on large general revenue subsidies and a large trust-fund build up. To date, the Japanese government has identified only a small fraction of the new revenue required to fund the higher NP subsidy. As for the trust-fund reserve, the government, historically, has often failed to translate trust-fund surpluses into genuine economic savings. The 2000 reform of trust-fund financing attempts to create a more effective firewall between the trust fund and the rest of the budget. Still, for Japan's prefunding strategy to work, the government will have to show a degree of fiscal discipline that is not yet in evidence.

Complicating the landscape for Japan's political leaders is the rising rate of non-compliance with the payroll tax system. According to the government, there are about 630,000 Japanese residents who should be paying NP contributions, but do not. And, in 2004, it became known that powerful members of both the ruling government coalition and the opposition had failed to make proper pension contributions, a development that resulted in their resignations.

These revelations have contributed to the widespread sense among Japanese workers and pensioners that they are being asked to pay more even as a sizeable minority are cheating the system. Japanese voters have expressed their displeasure in recent elections, with parties in the

⁵ Junichi Sakamoto, *op. cit.*, p. 41.

government coalition losing parliamentary seats in 2003 and 2004. Surveys indicate that voter dissatisfaction with pension reform figured prominently in the government's poor showing at the polls.⁶

The next round of long-term projections is due out in 2007. If the new projections again show that Japan is aging more rapidly than the government's current projections anticipate, it may precipitate deeper than projected cuts in benefits under the automatic stabilizer. If the stabilizer were allowed to operate as intended, these cuts would occur without any need for further reform. But as it turns out, the 2004 reform includes a provision that may short-circuit the stabilizer. Although the reform provides for the automatic adjustment of benefits, it also stipulates that the replacement rate for average earners cannot fall below 50 percent.

It is too soon to tell when pension reform will be back on the agenda. What seems clear is that if politicians have to ask the public to accept another round of pension cuts and tax increases, they will encounter much more resistance than in the past.

⁶ Joseph Coleman, "Japanese Ruling Coalition Holds Majority in Parliament Vote, but Opposition Gains," *Associated Press*, July 11, 2004.

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NETHERLANDS

Introduction

Unlike most continental European countries, the Netherlands has a large, nearly universal, and fully funded occupational pension system that helps take pressure off government budgets. Its basic public pension system is relatively modest, though special early retirement programs greatly add to total costs. While the Netherlands has begun to cut back on access to early retirement benefits, it has yet to tackle pension reform head on. The government hopes to avoid politically difficult benefit cuts by running near-term budget surpluses in anticipation of greater government borrowing as its age wave rolls in. The Netherlands' recent fiscal record, however, raises serious questions about the efficacy of this strategy.

Background

The current Dutch pension system dates to the early postwar years. Immediately after World War II, the Parliament established a temporary public pension system. In 1956, the General Old-Age Act, or “Algemene Ouderdoms Wet” (AOW), made the system permanent, and the AOW remains the foundation of Dutch old-age security today.

The AOW pays a flat benefit to most Dutch residents aged 65 and older regardless of employment history. Residents earn an AOW credit of 2 percent for each year of residence in the Netherlands between the ages of 15 and 65. AOW pensions are tied to the nation's minimum wage, set by law at about 55 percent of the average wage. Single persons get a full-rate benefit equal to 70 percent of the minimum wage, while each member of a couple gets a benefit equal to 50 percent of the minimum wage. Since Dutch governments have kept the ratio of the minimum wage to the average wage relatively stable, AOW benefits are effectively indexed to wage growth. Persons aged 65 and older who do not have retirement incomes of at least 70 percent of the minimum wage receive means-tested social assistance to top up their incomes.

The AOW is payroll-tax financed on a pay-as-you-go basis. The contribution rate is currently set at 17.9 percent of earnings, up to a ceiling. Persons aged 65 and older are exempt from contributions.

At the time the AOW was put in place, Dutch employers were also rapidly establishing occupational pension schemes. Government caps on wage growth in the immediate postwar years had the effect of encouraging employers to compensate their employees with higher fringe benefits, including more generous pensions. Coverage was given a big additional boost by the Occupational Pensions Act of 1949. Under this law, employers and employees can ask the government to make a negotiated pension arrangement compulsory across a given industry if voluntary participation already covers at least 60 percent of the workforce. Employers can opt out of these industry-wide pension arrangements only if they can demonstrate that they are offering coverage that is at least as generous as the larger, industry-wide scheme. Once established, employer pensions are governed by the Pensions and Savings Fund Act, which, unlike regulations in many continental European countries, requires full funding of pension liabilities.

Occupational pensions have thus come to constitute a quasi-mandatory second tier to the Dutch pension system. Today, over 90 percent of Dutch workers are covered by 64 industry-wide and 866 single-employer schemes, with over 90 percent of these schemes providing defined benefit pensions.¹ As a rule, occupational pensions, together with the AOW, provide benefits

¹ Organization for Economic Cooperation and Development, *Pensions at a Glance: Public Policies Across OECD Countries* (Paris: Organization for Economic Cooperation and Development, 2005), p. 152.

equal to 70 percent of a full career worker's final salary, although replacement rates in some schemes are pegged to average career earnings. Occupational pensions are explicitly integrated with the public pension system through the "AOW franchise," which, like similar arrangements in some U.S. defined benefit schemes, allows private pension benefits to be offset by the amount of a retiree's public benefit. There is no law requiring indexation of occupational pensions, but most (60 percent) are indexed to wages, with 20 percent indexed to prices and the remaining 20 percent increased by other factors.²

Although the public and occupational pension systems are roughly equal in overall size, they do not play an equal role in income replacement for all workers. Benefits under employer plans go disproportionately to higher earners.³ While this is true of most occupational pension systems, the tilt is more pronounced in the Netherlands than in other countries. There are two reasons: On the one hand, the AOW is essentially a flat-rate benefit unrelated to earnings, while on the other Dutch regulations place no upper limit on creditable earnings under occupational pensions.

While the Netherlands' extensive system of funded employer pensions gives it an important advantage in confronting the age wave, another distinctive feature of its pension system—the extraordinary generosity of early retirement arrangements—tends to push the other way. Although neither the public nor occupational pension system provides for regular early retirement benefits, most workers can take advantage of special programs. Indeed, until the mid-1990s, when the government began to tighten up on early retirement, the labor-force participation rate of workers in their late fifties and early sixties was among the very lowest in Europe.

Early retirement became commonplace beginning in the mid-1970s when the Dutch government, like many others in continental Europe, sought to "free up" jobs for younger workers facing high unemployment rates. Specifically, the government used tax incentives to encourage the addition of generous early retirement options ("vervroegde uittredingsregelingen," or VUTs) to collective bargaining agreements. The VUTs are pay-as-you-go schemes which typically offer workers 80 percent of their final salary for voluntary retirement as early as age 55, as well as ongoing credits toward their regular occupational pension. VUT benefits are not adjusted to reflect differences in ages among early retirees, effectively encouraging workers to take advantage of the benefits as soon as they are eligible.

Recent Developments

In 1998, the Dutch government announced that it would run annual budget surpluses of between 1.25 and 1.5 percent of GDP for a 25 year period, in effect prefunding much of the projected increase in public pension spending as the population ages. The idea was that, by substantially paying down the public debt in the near term, the government would have more room to borrow in the long term. According to the government, this policy, if sustained, would allow currently promised AOW benefits to be paid indefinitely without any increase in the system's contribution rate, which it promised to cap at 18.25 percent, or roughly today's level.⁴

The Dutch government, however, failed to establish a mechanism to ensure that the prefunding actually occurs. It did create something called the "AOW Savings Fund," but this is a mere budgetary

² David Carey, "Coping with Population Ageing in the Netherlands," Economics Department Working Papers no. 325 (Paris: Organization for Economic Cooperation and Development, March 2002), pp. 35-36.

³ Jan Nijssen, "Pensions in the Netherlands: A Balanced and Solid System Based on Solidarity," paper presented at the International Symposium on Pensions and Long-Term Care, Seoul, South Korea, November 25, 2004, p. 144.

⁴ Jan Nijssen, *op. cit.*, p. 147.

accounting device that in no way constrains the government's overall taxing and spending, and hence its borrowing balance with the public. For two years after 1998, the Dutch government ran budget surpluses as planned—but as soon as the economy weakened, the surpluses disappeared.

More promisingly, the Dutch government has taken concrete steps to reduce the generosity of its special early retirement programs, which not only add directly to Dutch pension costs, but impose a prohibitive “tax” on continued work. In the mid-1990s, the government began to phase out the old VUT system in favor of a new system of “pre-pensions” with fewer employment disincentives. Pre-pension benefits, unlike VUT benefits, are adjusted according to age, with the earliest retirees receiving smaller benefits. Beneficiaries under the new system, moreover, no longer receive continued credits toward their regular occupational pensions. In another major change, the pre-pension system is designed to be fully funded after a transition.

In February 2005, the Dutch government took additional steps to discourage early retirement. It passed legislation that will phase out the tax-favored treatment of employer-based early retirement programs. It also put in a place a new individual savings vehicle, called “levenslooplegeling.” Workers can contribute up to 12 percent of their wages to these personal accounts, and employers can also make contributions on behalf of workers. The balances may be tapped beginning at age 61 or during long periods of unemployment. The government hopes that the personal savings accounts will allow workers to make a phased transition from work to retirement by drawing on their savings while still remaining employed.

Environment and Outlook

As the Netherlands confronts its aging challenge, it enjoys the considerable advantage of a large, fully funded, and nearly universal occupational pension system. Dutch pension assets totaled an impressive 106 percent of GDP in 2004, far higher than the level in most European countries—and indeed, higher than the level in the United States (95 percent of GDP).⁵ In recent years, moreover, the Netherlands has made significant progress in scaling back its early retirement programs. Since the mid-1990s, the share of older workers collecting benefits from these schemes has steadily declined. Meanwhile, labor-force participation rates among older workers have risen, and now stand at about the European average.

Despite the progress, however, the Dutch pension system remains unsustainable. With over two-thirds of men (and over four-fifths of women) exiting the workforce by age 60, early retirement is still the norm. The basic AOW public pension system, moreover, remains entirely unreformed. Current government policy calls for defraying the long-term growth in benefit costs by running sustained near-term budget surpluses. The recent history of Dutch budget deficits—not to mention the failure of similar “save the surplus” policies in the United States and other countries—shows that this approach to financing population aging is unreliable.

In the coming years, the Dutch will have to face more difficult trade-offs in pension reform than they have so far been willing to contemplate. Although the size of the needed adjustments may be less than in Germany, France, Italy, and other continental European countries with more generous public pension systems, they are nonetheless significant—and can be expected to provoke the same kind of political clashes that have accompanied reform efforts elsewhere.

⁵ Organization for Economic Cooperation and Development, *Financial Market Trends*, vol. 2006/1, no. 90 (Paris: Organization for Economic Cooperation and Development, April 2006), p. 212.

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SPAIN

Introduction

Since the end of the Franco regime in 1975, Spanish political leaders have placed great emphasis on achieving consensus among the major political parties, employer associations, and trade unions. The result, even more than in other European countries, has been to limit progress in controlling the long-term cost of the public pension system. Indeed, recently enacted reforms have tended to expand, rather than roll back, existing benefit commitments. Despite a projected cost burden that is among the highest in the developed world, the current political environment appears unlikely to produce new reform momentum anytime soon.

Background

Spain first introduced mandatory state retirement insurance for private-sector workers in 1919, the same year as Italy. By the beginning of the Franco regime in the late 1930s, most Spanish workers enjoyed at least some sort of minimal pension coverage. In the ensuing years, the Franco government increased the generosity of pension benefits for employment sectors and trade unions with close ties to the regime. Perhaps the most significant liberalization occurred in 1963, when legislation created a large number of special schemes running parallel to the main old-age insurance program, the “Régimen General de la Seguridad Social,” or RGSS.

After the death of Franco in 1975 and the rapid transition to constitutional democracy, the government began to harmonize contribution and benefit rules among the various schemes. In 1977, a reform placed all of the public pension plans under the jurisdiction of one agency, the “Instituto Nacional de la Seguridad Social,” or INSS. Yet despite efforts at consolidation, the “Régimenes Especiales de la Seguridad Social,” or RESS, continue to operate for the self-employed, agricultural workers, seaman, domestic employees, and coal miners. As of 2000, just 47 percent of pensions were paid under the RGSS, while about 40 percent were paid from the special schemes. Pensions for civil servants and members of the armed forces, together with non-contributory means-tested benefits, accounted for the rest.

The RGSS, like all of Spain’s public pension schemes, is a traditional, defined benefit, pay-as-you-go system. About 65 percent of RGSS costs are financed by payroll contributions, with employers paying 23.6 percent and employees 4.7 percent of covered wages. The central government finances the remaining 35 percent of RGSS costs from general revenues.

Benefits under the RGSS are generous by any standard. Workers with the minimum 15 years of contributions who retire at age 65 receive a benefit equal to 50 percent of their average covered annual earnings. The replacement rate rises with each additional year of contributions until it reaches 100 percent for workers with at least 35 years of contributions. Early retirement with reduced benefits is allowed beginning at age 61 for workers with 30 years of contributions.

Spain also maintains a variety of minimum income provisions for the elderly. Retirees who have contributed to the RGSS for at least 15 years but have earned a pension below about 30 percent of the average wage are eligible for a “top up” payment. Participants in the special schemes enjoy a similar but more generous minimum pension guarantee. For persons who are not eligible for a pension at all, there is a minimum income payment equal to about 20 percent of the average wage.

Despite the liberal benefit provisions, pension spending per capita in Spain is currently among the lowest in Europe.¹ This surprising fact is attributable to several factors, including the relatively short work histories of most of today's female pensioners and the large number of today's pensioners, both male and female, whose careers were interrupted during the long periods of high unemployment that plagued the Spanish economy during the 1980s and 1990s. Another factor, perversely, is the generous minimum pension guarantee in the special schemes. As it turns out, many domestic, agricultural, and self-employed workers get a better deal on their lifetime contributions by working just long enough to qualify for the subsidized minimum pension—and no longer.² Although per capita benefits and overall costs are due to rise rapidly in the future as a new generation with longer work histories (and fewer domestic and agricultural workers) retires, the widespread perception that the system is stingy has become an obstacle to reform.

To date, the only significant cost-saving reform of the public pension system was adopted in 1985, during a period of Socialist Party control of Parliament. Prior to the 1985 reform, workers in the RGSS could receive benefits with just 10 years of contributions, and the benefits were calculated based on their final two years of earnings. The 1985 reform raised the minimum number of years necessary to receive a pension from 10 to 15, while increasing the number of years included in the initial pension calculation from 2 to 8. Although Spain's most powerful trade union, the UGT, broke ranks with the government and went on strike to protest the pension changes, the protest fizzled when other major unions supported the reform.

Recent Developments

Prompted by the deterioration of the public pension system's near-term finances following the 1993 recession, the Spanish government—now under center-right control—initiated a new round of reform. The negotiations with opposition leaders, employer representatives, and trade unions resulted in the Toledo Pact of 1995. The pact achieved some long-term savings by again increasing the number of years of earnings included in the initial benefit calculation, this time from 8 to 15. But it also provided for a number of benefit liberalizations, including more generous widows' benefits and smaller early retirement penalties for workers with long work histories, that offset the savings and left the long-term outlook essentially unchanged.³

Beyond these modest benefit changes, the Toledo pact also established a process for periodically reviewing the public pension system. As required by the pact, the Spanish Government initiated a first mandatory review in 2000. The resulting reform, which was passed in 2001, further liberalized early retirement provisions. Before the reform, only workers who had been in the workforce prior to 1967 were eligible to take advantage of early retirement, and their benefit replacement rate was reduced 7 percentage points for each year of retirement before age 65. The 2001 agreement removed the tenure restriction, provided that a worker is unemployed for at least six months before applying for early retirement. It also lowered the early retirement adjustment factor from 7 to 6 percent for workers with at least 40 years of contributions. The reform is expected to increase long-term Spanish pension costs, not reduce them.⁴

¹ Organization for Economic Cooperation and Development, *OECD Economic Surveys: Spain* (Paris: Organization for Economic Cooperation and Development, 2001), p. 111.

² OECD, *op. cit.*, 2001, p. 115; and Organization for Economic Cooperation and Development, *OECD Economic Surveys: Spain* (Paris: Organization for Economic Cooperation and Development, 2005), p. 145.

³ OECD, *op. cit.*, 2001, p. 168.

⁴ OECD, *op. cit.*, p. 108.

In contrast to the gridlock on public pension reform, Spain has recently made some progress in encouraging the development of funded occupational pension plans. New regulations require private-sector employers offering supplementary plans to transfer existing “book reserves” to external pension funds. Meanwhile, 2004 legislation authorized the establishment of supplementary funded schemes for government employees. Although rates of coverage remain low in the private sector, they are rising rapidly in the public sector.

Environment and Outlook

When it comes to reform of its public pension system, Spain seems to be in a state of collective denial. With a fertility rate of just 1.2, among the lowest in Europe, it faces a future of extreme demographic aging and soaring retirement costs. Yet Spain continues to defer reform—and hope that current pension arrangements will somehow prove affordable.

The recent and unexpected surge in immigration to Spain has improved the demographic outlook and put off the day of reckoning. Since 1998, net immigration to Spain has averaged 420,000 annually, roughly ten times the net annual inflow over the previous decade. The government has adjusted its official population projections accordingly, with a new assumption of 250,000 immigrants per year from 2010 on, compared with 60,000 in previous projections. Yet even if the higher level proves sustainable, it won’t do much to close Spain’s looming long-term pension deficits. Since immigrants tend to be young, they help pension finances in the near term by adding to the ranks of working-age contributors. In the long term, however, immigrants too grow old, and so also add to the ranks of retired beneficiaries.

It remains to be seen whether, as the fiscal and economic consequences of inaction become more visible in the years ahead, bolder leadership will emerge. For the moment, however, Spain’s political leaders show little inclination to disrupt the consensus-building approach to public pension reform that has produced only modest changes to date.

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SWEDEN

Introduction

In the late 1990s, Sweden enacted a major reform of its public pension system that the government projects has largely stabilized long-term costs. The reform, which replaced Sweden's old defined benefit pension system with a new system of "notional defined contribution" accounts supplemented by mandatory funded individual retirement accounts, leaves Sweden better positioned to confront the age wave than most European countries. The Swedes helped assure widespread support for the new system by seeking consensus among a broad coalition of political parties. That support could erode, however, if automatic indexing provisions reduce public benefits more than currently expected or if disappointing investment returns on individual accounts hurt retirement income prospects.

Background

Prior to the sweeping reform enacted in 1998, Sweden's public pension system was a traditional, defined benefit, pay-as-you-go program. The system consisted of two tiers: a small flat benefit (the "Folkpension," or FP), first introduced in 1913, that is payable to all Swedes meeting minimum residence requirements, and a larger earnings-related benefit (the "Allmän Tilläggspension," or ATP), which was added in 1960. The ATP replaces 60 percent of earnings for a full career worker, up to a ceiling. The Swedish full-benefit retirement age is 65, with the option of taking actuarially reduced early retirement benefits between ages 61 and 64 and actuarially increased deferred retirement benefits between ages 66 and 70.

The old Swedish pension system was financed primarily from employer and employee payroll taxes, set at a combined rate of nearly 19 percent in 1997, just before reform, with some general revenue financing for the FP portion of the system. The ATP was partially prefunded, with the payroll tax rate set higher than the current cost rate. The government invested the resulting surpluses through the National Pension Funds, or "buffer funds." Although most of the buffer-fund assets were used to purchase government bonds, in effect financing current government expenditures, a small portion—about 15 percent—were invested in domestic and foreign equities. At the time of reform, the National Pension Funds held total reserves equal to approximately five years of ATP benefit payments, or 40 percent of GDP.¹

Although benefits under Sweden's old public pension system were comparable to those offered by Europe's other expansive welfare states, less generous early retirement provisions helped moderate the system's total cost. Unlike in most other countries, adjustments for early and late retirement under Sweden's regular public pension system are more or less actuarially fair. Sweden also lacks most of the "back door" special early retirement schemes that are so common elsewhere. The result is that Sweden has one of the highest effective retirement ages in Europe. Fully two-thirds of Swedes aged 55-64 are still in the labor force—a figure roughly comparable to the United States. A well-developed occupational pension system covering roughly 80 percent of the workforce also helps take pressure off government budgets.²

Nonetheless, beginning in the mid-1980s, Swedish leaders from across the political spectrum became concerned that the aging of the population would soon lead to rapid growth in public

¹ Annika Sundén, "How Will Sweden's New Pension System Work?" *Issue in Brief* no. 3 (Chestnut Hill, MA: Center for Retirement Research at Boston College, March 2000), p.5.

² N. Anders Klevmarcken, "Swedish Pension Reform in the 1990s," paper presented at the Fundacion Ramon Areces Conference on Pension Reform in Europe, Madrid, March 15-16, 2002, p. 1.

pension costs. The government projected that the buffer funds would be exhausted within 20 to 25 years, and that the payroll tax rate would need to rise to 24 percent by 2015.³ An advisory body was appointed in 1984 to study the problem. Although it met for six years and issued a large body of analysis, it did not develop a viable reform plan.

In 1991, with the country in a deep recession, the Social Democratic government was replaced by a multi-party, center-right minority coalition that placed pension reform high on the agenda. The coalition government established a small parliamentary “pension group,” headed by the minister of social policy, to negotiate a reform framework. The group included representatives from all of Sweden’s political parties supporting the reform effort, as well as a few selected experts. In 1994, its reform proposal was adopted “in principle” by the Riksdag, Sweden’s Parliament, shortly before elections returned the Social Democrats to power. The Riksdag passed implementing legislation in 1998, and the first benefit payments under the new rules began in 2001.

The 1998 reform replaced the ATP with the “Inkomstpension,” or Income Pension, which is a “notional defined contribution” (NDC) program. Although the Income Pension is financed on a pay-as-you-go basis, benefits are calculated based on a worker’s actual contributions, with a legislated rate of return determining the accumulated “balance” from which a retirement annuity is calculated. Persons born before 1938 remain under the old ATP system. Persons born in 1938 will receive 20 percent of their benefits under the new system and 80 percent under the old, with the proportion under the new system rising by 5 percentage points for each successive birth cohort until the new system is fully phased in for persons born after 1953.

Out of a total payroll tax of 18.5 percent, 16 percentage points are credited to workers’ Income Pension notional accounts. Contributions earn a rate of return equal to the growth in average wages in the economy. Workers can collect benefits at any age starting at age 61. The benefits are calculated by converting notional account balances into annuities at retirement, based on projected life expectancy for each cohort at age 65. By effectively indexing benefit payouts to improvements in longevity, this feature helps to stabilize total pension costs.

The remaining 2.5 percentage points of the payroll tax are directed to a new mandatory system of “Premium Pensions”—individually directed and fully funded personal retirement accounts that are administered by a new agency, the “Premiepensionsmyndigheten,” or PPM. This “carve out” of payroll contributions is financed in part by drawing down the old ATP buffer funds. Upon retirement, Premium Pension account balances must be converted into either variable or fixed annuities, which are administered by the PPM.

The Swedish Premium Pension combines a high degree of centralized administration with a high degree of individual choice in fund selection. Contributions are collected like payroll taxes and then transferred to the PPM, which invests the funds for workers, based on their fund selections, with any accredited investment fund wishing to participate. During the initial investment election period in the fall of 2000, Swedish workers were given over 400 options to choose from. Today, over 600 funds are available for investment through the PPM. The government manages a default fund for workers who make no active fund selection. The default fund is required to invest at least 80 percent of assets in equities.

Retirees with relatively low Income Pension benefits will receive a means-tested supplement, beginning at age 65, that is financed from general tax revenue. This new “Guaranteed Pension,” which replaces the FP, is quite generous, ensuring a minimum replacement rate equal to about one-third of the average wage.

³ Annika Sundén, “The Future of Retirement in Sweden,” Pension Research Council Working Paper no. 2004-16 (Philadelphia: Pension Research Council at the Wharton School, April 2004), p. 4.

Recent Developments

Although less than a decade old, Sweden's new pension system has already undergone an important modification. NDC systems like the one adopted in Sweden have certain inherent advantages. Most importantly, since lifetime benefits exactly reflect the magnitude and timing of lifetime contributions, they encourage work effort and reward later retirement. In and of itself, however, the NDC design does not ensure long-term financial sustainability. Since the system is still pay-as-you-go, its financing remains hostage to demographics.

In May 2001, Sweden added an "automatic balance" mechanism to the Income Pension system in order to ensure its long-term sustainability. The mechanism will reduce the annual rate of return to worker accounts, as well as the annual indexing factor applied to annuities, whenever the present value of system "liabilities" (i.e., projected benefits) exceeds the value of system "assets" (i.e., projected revenues). It is highly probable that the mechanism will be triggered at some point, perhaps soon, since the growth in payroll tax revenues is bound to lag the growth in benefits in the decades ahead as Sweden's population ages and its workforce grows more slowly.

There has also been considerable debate about the performance of the Premium Pension system. Sweden's new personal accounts were introduced with an emphasis on unlimited choice just as stock values reached a peak early in 2000. By the end of 2003, the average Swedish worker had lost roughly 30 percent of the value of his or her Premium Pension investments. After initial enthusiasm for active investment, newly enrolled Swedes have generally not selected an investment fund, instead allowing their contributions to go into the government's default fund.⁴

In October 2005, a government commission appointed to examine the structure and operations of the Premium Pension system recommended limiting available investment options to between 100 and 200 funds. It also recommended steps to reduce administrative costs and suggested converting the government's default fund into a life-cycle investment vehicle.⁵

Environment and Outlook

The long political negotiations in Sweden over pension reform centered on striking a balance between the retention of pay-as-you-go defined benefits, as favored by the Social Democrats, and the introduction of large, fully funded, defined contribution accounts, as favored by the center-right parties. In the end, the political compromise was to retain a largely pay-as-you-go system, but with benefits calculated along defined contributions lines, while adding a relatively small supplemental system of funded individual accounts. This compromise avoided much of the near-term transition cost associated with financing large individual accounts. But it did so at the expense of accepting a permanently higher long-term tax burden.

Whatever the shortcomings of the compromise, the new Swedish pension system has certainly altered the economic and political dynamics of pension financing in a positive direction. Although the public pension system's cost remains high, it has been largely stabilized. With the new NDC accounts, moreover, it is no longer possible for the government to close financing shortfalls that may emerge in the future through payroll tax increases, since this would also increase future benefit obligations. This was a conscious choice by Swedish political leaders, who viewed higher payroll taxes as an unacceptable solution to the aging challenge.⁶

⁴ Social Security Administration, *International Update: Recent Developments in Foreign Public and Private Pensions* (Washington, D.C.: Social Security Administration, September 2004).

⁵ Social Security Administration, *International Update: Recent Developments in Foreign Public and Private Pensions* (Washington, D.C.: Social Security Administration, December 2005).

⁶ Annika Sundén, *op. cit.*, p. 5.

The new system has so far enjoyed broad and stable political support, thanks in part to the process employed in developing it. From 1991 to 1998, as the reform was designed and implemented, the major political parties vested the “pension group” with the authority to negotiate consensus recommendations for consideration in Parliament. A remarkable 85 percent of Riksdag members supported the recommendations at each stage of the initial legislative process.⁷

It is too soon to tell whether the consensus will endure. The real test for the Swedish reform will come over the next few decades as the automatic balance mechanisms built into the new pension system inexorably cut per capita public benefits relative to per capita wages. If life expectancy rises faster than anticipated—or if the workforce grows more slowly—the cuts could be large enough to undermine popular support for the reform. The danger could grow if poor returns on Premium Pensions further erode retirement incomes. While there is little chance of a near-term course change, in the longer run Sweden could still find itself compelled to revisit pension reform.

⁷ Ole Settergren, “Two Thousand Five Hundred Words on the Swedish Pension Reform,” paper presented at the Urban Institute-German Embassy Workshop on “Social Security and Pension Reform in the United States: Lessons from Europe,” Washington, D.C., July 12, 2001, p. 2. Available at http://www.urban.org/pdfs/eu_event_sweden.pdf.

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UNITED KINGDOM

Introduction

The UK pension system, which has undergone nearly constant revision since the mid-1970s, provides an affordable public pension safety net supplemented by a large, funded employer-based pension system as well as personal pensions. But the interaction of public pensions with the voluntary “contracted out” employer and personal pensions is complex and has come under heavy criticism for leaving a growing number of British workers with uncertain retirement income prospects. Unlike other European countries, where recent reforms have focused on long-term cost containment, the focus in the UK has been on ensuring the adequacy of a system that has already been dramatically downsized. The May 2005 re-election of the Blair government set the stage for a new Labor-led reform effort that will likely result in an enhanced state role in assuring retirement incomes.

Background

The British Parliament first created a means-tested old age pension in 1908 to provide a minimum floor of protection for the growing numbers of elderly no longer able to support themselves in the industrialized economy. The system gradually evolved and expanded until, in 1946, the government established the Basic State Pension (BSP) for all workers. The BSP, the base pension for the UK’s elderly, pays a flat-rate (rather than means-tested) benefit, replacing about 15 percent of wages for an average-earning worker as of 2005.¹ Workers contributing less than the number of years required for a full BSP (44 years for men, 39 years for women) get a partial rate pension.

The floor of protection provided by the BSP was for many years the UK’s only public pension benefit. A large and growing share of the workforce, however, enjoyed supplemental coverage under employer-sponsored pension plans. The UK’s private pension system, whose origins date back to the late nineteenth and early twentieth centuries, originally covered white collar employees in large British industries. The scope of the system was greatly expanded during the early postwar decades as government tax preferences encouraged the establishment of new plans and unions pressed for better retirement protection. By the 1970s, employer pensions covered half of all workers and two-thirds of male workers.²

In 1975, the UK’s Labor government added a second tier to the public pension system—the State Earnings Related Pension Scheme, or SERPS. Designed to supplement the BSP for workers without employer pension coverage, SERPS was originally structured to provide a retirement benefit equal to 25 percent of a worker’s best 20 years of earnings plus a 100 percent spousal benefit. Employers who sponsored their own pension plans were allowed to “contract out” of SERPS, provided that the plans met minimum standards.

The election of Margaret Thatcher’s Conservative government in 1979 ushered in a series of reforms that dramatically downsized both the BSP and the new SERPS program. Alarmed by projections showing that the cost of the public pension system would soar as the UK’s population aged, the Conservatives switched the indexation of BSP benefits from wages to prices, increased the retirement age for women from 60 to 65 (to be phased in over a ten year period beginning in 2010),

¹ Pensions Commission, *A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission* (London: The Stationery Office, November 2005), p. 45.

² Steven A. Sass, “Reforming the UK Retirement System: Privatization Plus a Safety Net,” Global Issue Brief no. 3 (Chestnut Hill, MA: Center for Retirement Research at Boston College, June 2004), p. 4.

cut SERPS benefits to 20 percent of covered earnings over a full career from 25 percent of the 20 best earnings years, and reduced the SERPS spousal benefit from 100 to 50 percent. The reform was projected to reduce the value of the BSP from about 25 percent of average wages in the late 1970s to 10 percent by 2030. The projected reduction in the value of SERPS was similarly large.³

At the same time, the Conservative reform program initiated by Thatcher (and continued by her successor John Major) included new incentives designed to encourage the further expansion of funded private pension provision as a substitute for reduced public benefits. The key measure was the introduction of a new contracting out option that allowed workers to enroll in defined contribution personal pensions whether or not their employer sponsored a pension plan.

Although the Conservative reforms stabilized the long-term cost of the UK's public pension system, they were less successful at ensuring that all workers had adequate private substitutes. One early sign of trouble was the "miss-selling" scandal of the early 1990s, in which some 500,000 British workers who had already contracted out of SERPS were persuaded by an aggressive sales force to switch from employer-based defined benefit plans to personal pensions with much higher administrative costs and less generous benefit payouts. The scandal eventually found its way into litigation, with guilty companies paying £13.5 billion in compensation to date.⁴

Until the miss-selling scandal shook confidence in the private pension system, the UK had witnessed a steady increase in the number of workers contracting out of SERPS. Since 1995, however, workers have been migrating back to SERPS, with enrollment increasing from about 20 percent of the workforce in 1995 to 25 percent in 2000.⁵

Recent Developments

Tony Blair's "New Labor" government, first elected in 1997, embraced the twin goals of the Conservative reform—containing the overall cost of the public system while expanding the voluntary supplemental private pension system. At the same time, however, Labor introduced new redistributive features designed to shore up the retirement incomes of low-earning workers.

In 2002, Labor replaced SERPS with the more progressive State Second Pension (S2P). The S2P provides a replacement rate of 40 percent for lower-earning workers while keeping SERPS' 20 percent replacement rate for higher earners. Workers can contract out of S2P in the same fashion as SERPS, and have the option of enrolling in a new retirement savings vehicle called Stakeholder Pensions developed as a response to the miss-selling scandal. Stakeholder Pensions are personal pensions subject to special regulations, the most important being that administrative costs be below 1 percent of fund assets. This requirement is intended to force pooling of large numbers of individual account holders, like U.S.-style mutual funds, to achieve economies of scale. Employers with at least five employees but no pension plan must give their employees the option of participating in a Stakeholder Pension, though they need not contribute on their behalf.

In 2003, the Labor government established a new means-tested Pension Credit, which provides a guaranteed weekly income for those aged 60 and over of £105.40, currently about 20 percent higher than the full BSP. The credit, which is indexed to wages, is phased-out at a rate of £0.40 for every pound of non-credit income above the minimum guaranteed level. As the value of the BSP falls over time relative to wages, a growing share of the elderly will become eligible for the credit. Indeed, projections indicate that by 2050 roughly two-thirds of all

³ Steven A. Sass, *op. cit.*, p. 5; and Blake, David, "The United Kingdom Pension System: Key Issues," UBS Pensions Research Program Discussion Paper no.11 (London: London School of Economics, May 2003), p. 8.

⁴ David Blake, *op. cit.*, p. 4.

⁵ Pensions Commission, *Pensions—Challenges and Choices: The First Report of the Pensions Commission* (London: The Stationery Office, October 2004), p. 71.

pensioner households will be receiving it.⁶ While the BSP and S2P are financed through payroll taxes, the Pension Credit is financed from general government revenues.

Environment and Outlook

The initial Blair government reforms failed to allay growing concern that the UK's downsized public pension system and patchwork private pension system were failing to provide adequate security for future generations of retirees. For many years, the UK was hailed by pension reformers worldwide as one of the only developed countries to have largely stabilized projected public pension expenditures as a share of its economy. Ironically, it now finds itself considering reforms whose net effect will almost certainly be to increase long-term costs.

In December 2002, the Blair government appointed a Pensions Commission, headed by Adair Turner, to review the adequacy of public pension benefits and assess whether it was necessary to move "beyond the voluntarist approach" in private pension provision. The Commission's preliminary report, released in October 2004, sketched a picture of a pension system in "crisis."

Although the UK has one of the largest funded occupational pension systems in the world, with assets totaling nearly two-thirds of GDP, the system is retrenching. The share of the workforce covered by occupational pension plans has declined over the past decade—and even for workers with coverage, plans may provide less retirement security than they used to. Employers are abandoning traditional defined benefit plans in favor of defined contribution schemes at a rapid rate. As of 2005, the number of workers in private-sector defined benefit plans that are open to new entrants had dropped to just 2.1 million, half what it was just five years before.⁷

In this context, the Commission argued that the UK's lean public pension system, though long seen as a significant strength from a government cost perspective, may also be a significant weakness from the viewpoint of retirement security. It leaves those workers not accruing employer pension rights with nothing but the BSP and SERPS/S2P to rely on in retirement. And, by international standards, these programs provide low benefits, replacing roughly a combined 35 percent (and falling) of an average worker's earnings.

In May 2006, the Pensions Commission issued a white paper offering a reform blueprint. The Commission recommended re-indexing the BSP to wages beginning in 2012 in order to shore up the public floor of protection. At the same time, it called for the introduction of a new personal pension system. All workers without employer pension coverage would be automatically enrolled in the new system, though they would have the option of dropping out. Unlike Stakeholder Pensions, moreover, employers would be required to make matching contributions. According to the Commission, the extra cost of the expanded BSP would be at least partially offset by an increase in the retirement age, as well as by savings in the Pension Credit, for which fewer workers would become eligible.

UK pension policy has undergone nearly constant adjustment since the mid-1970s, in part because the British parliamentary system allows the dominant political party of the day to rather easily re-orient the pension system in its own philosophical direction. The result has been the repeated stacking of new pension policies on top of old in a bewildering array of complexity that leaves many British workers confused about their retirement options and prospects.

It remains uncertain what elements of the Commission's proposed reform will ultimately be passed into law. What is clear is that the UK pension system is still a work in progress whose ultimate shape may not be determined for years to come.

⁶ Pensions Commission, *op. cit.*, October 2004, pp. 144-148.

⁷ UK Government Actuary's Department, *Occupational Pension Schemes: 2005* (London: UK Government Actuary's Department, June 2006), p. 29.

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UNITED STATES

Introduction

The United States should be the least vulnerable among the world's developed nations to the fiscal pressures arising from population aging. Due to its relatively high fertility rate and substantial net immigration, the ratio of workers to retirees will not erode as rapidly in the United States as it will in most other industrialized countries. Although it spends heavily on health care for the elderly, its public pension system, Social Security, is inexpensive by international standards. Moreover, the United States enjoys ownership of the world's largest pool of private fully funded retirement assets, which eases the pressure on government old-age spending. Yet despite its many advantages, a deeply polarized political environment and widely divergent visions for reform have made achieving consensus difficult—and left the United States facing a major long-term cost crisis.

Background

Prior to the 1930s, U.S. old-age support was limited to state-level assistance to the destitute elderly, with most older Americans relying on their extended families in their retirement years. The family-based support structure came under stress with industrialization and urbanization, and then collapsed as the Great Depression drove unemployment to levels never experienced before or since. With many elderly exposed to extreme poverty in their final years, political support grew for President Franklin D. Roosevelt's activist New Deal economic program. The most enduring legacy of that era is the nation's Social Security program of old-age assistance, enacted in 1935.

When Social Security was first set up, coverage was limited to nonagricultural wage and salary workers—and the only benefit was a modest retirement pension. Today, after many expansions, Social Security is a nearly universal social insurance program covering over 90 percent of the U.S. workforce and paying survivors and disability benefits in addition to retirement pensions. Social Security's full-benefit or "normal" retirement age was 65 for most of the program's history, but is now being raised in stages to 67. Workers, however, have the option of retiring as early as age 62 with actuarially reduced benefits.

From the beginning, Social Security's architects sought to balance two goals: providing wage replacement in retirement and income redistribution to low-wage workers. Today, the replacement rate for a lifetime average earner at normal retirement age is 43 percent. For low-wage workers earning 45 percent of the average wage, the replacement rate is 58 percent, while for high-wage workers earning the maximum covered wage throughout their careers, it is 30 percent.¹ Benefits are calculated at initial eligibility with earnings records indexed to average wage growth in the economy. Once in payment status, benefits are indexed to inflation.

Social Security is financed primarily with a payroll tax. Employers and employees currently pay 6.2 percent each on covered wages up to a maximum, set at \$94,200 in 2006. Social Security was initially conceived as a partially funded program, with a government-owned trust fund ultimately financing a substantial share of benefits. Within a few years, however, as benefit payments were started ahead of the original schedule, the program became purely pay-as-you-go.

¹ Social Security Administration, *The 2006 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Washington, D.C.: Social Security Administration, March 1, 2006), Table VI.F10, pp. 187-188.

Despite an attempted return to partial prefunding since the mid-1980s, it effectively remains so today.

In contrast to many European public pension systems, which replace most of a worker's pre-retirement income, Social Security was designed to provide a "floor of support." To supplement its relatively modest benefit levels, U.S. tax law has encouraged widespread adoption of employer-based pensions and Individual Retirement Accounts (IRAs). In 2004, 63.9 million American workers, or 42 percent of the total labor force, participated in some form of employer-based pension plan, while 23 million had one or more IRAs.² Overall, U.S. pension funds now hold two-thirds of the world's total funded pension investments.³

There is also a separate federal program, called Supplemental Security Income (SSI), that helps shore up the income of elders with inadequate Social Security benefits and virtually no other means of support. Established by Congress in 1972, SSI replaced the patchwork of state-based assistance programs, many dating back to before the Great Depression. SSI is means-tested and provides a maximum annual benefit of \$7,236 in 2006 for persons who are aged 65 and older or disabled.⁴

Congress periodically liberalized Social Security benefits until the early 1970s, when projections began to show large funding shortfalls. The deterioration in Social Security's finances was in part a long-term problem. As in other developed countries, the government actuaries suddenly woke up to the realization that falling fertility and rising longevity would ultimately lead to a dramatic aging of the population. But there was also a near-term problem triggered by the weak economy—and exacerbated by a mistake in a new automatic indexing formula introduced in 1972 that inflated benefits for new retirees. Although 1977 legislation corrected the "double indexing" mistake, the program continued to teeter on the verge of insolvency as a deep recession in 1981-82 depleted trust-fund reserves.

In an effort to avert a crisis, President Ronald Reagan appointed a bipartisan commission in December 1981 headed by Alan Greenspan (later to become Chairman of the Federal Reserve Board). The commission's recommendations formed the basis of the Social Security "rescue legislation" of 1983. The 1983 reform scheduled a gradual increase in the eligibility age for full benefits from 65 to 67, with the phase in to be completed in 2027. It also accelerated previously scheduled payroll tax increases and, for the first time, subjected a portion of Social Security benefits to income taxation above certain income thresholds. The purpose of the tax hikes was not just to shore up the system's near-term finances, but to build up a large trust-fund reserve in advance of the age wave that could later be drawn down to defray benefit costs.

Although the 1983 reform solved Social Security's near-term financial woes, it failed to put the program on a sustainable long-term footing. According to the latest government projections, annual Social Security benefit payments will exceed annual contributions by a widening margin beginning in 2017. In principle, the system's trust-fund reserve will allow current-law benefits to be paid in full all the way to 2040. It is doubtful, however, whether the reserve in any way eases the future burden of financing Social Security. The problem is that the 1983 reform failed to provide a mechanism to assure that the reserve would add to national savings, rather than allow the government to spend more than it otherwise would. The system's near-term surpluses, which

² Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2004," Issue Brief no. 286 (Washington, D.C.: Employee Benefit Research Institute, October 2005), p. 6; and Craig Copeland, "IRA and Keogh Assets and Contributions," *Notes* vol. 27, no. 1 (Washington, D.C.: Employee Benefit Research Institute, January 2006), pp. 6-7.

³ Organization for Economic Cooperation and Development, *Pension Markets in Focus* no. 1 (Paris: Organization for Economic Cooperation and Development, June 2005), p. 2.

⁴ Social Security Administration, "Fact Sheet: Social Security: 2006 Social Security Changes," October 2005. Available at <http://www.ssa.gov/pressoffice/factsheets/colafacts2006.pdf>.

Social Security has now been racking up for 23 straight years, are simply “lent” to the U.S. Treasury, with ambiguous economic implications. When Social Security presents its IOUs to Treasury for redemption, Congress will have to raise taxes, issue debt, or cut other government spending—just as if the trust fund had never existed.

Unlike the rest of the developed world, the United States never established a universal government health insurance program. Instead, it relies on voluntary, employer-based health insurance, with tax preferences to encourage widespread adoption. In the immediate postwar era, this employment-based system improved access to health care for most working Americans and their families, but the non-working elderly remained largely uninsured and vulnerable to high health-care expenses.

In 1965, President Lyndon Johnson successfully pushed for the creation of Medicare, a government health insurance program for the elderly and the disabled. Coverage was originally limited to hospital and physician services, but has recently been expanded to include prescription drugs. Medicare is currently financed through a combination of a 2.9 percent payroll tax on wages (without limit), beneficiary premiums, and large general revenue subsidies.

Although its price tag was initially quite modest, Medicare’s cost has grown explosively as on-going medical advances have interacted with its third-party payment structure to encourage more intensive use of health services. From 1970 to 2004, per capita Medicare spending on average grew 2.9 percent per year faster than per capita GDP growth.⁵ Official projections show the program’s total cost will rise from 3.2 percent of GDP in 2006 to 9.0 percent of GDP in 2050, surpassing Social Security as the most expensive U.S. government program by 2030.⁶

Recent Developments

After his re-election in 1996, President Bill Clinton briefly considered a new round of programmatic reform to close Social Security’s long-term financing gap. When his presidency was weakened by scandal, however, Clinton dropped this politically charged approach and instead emphasized the need to save Social Security’s existing surpluses. The idea was to create some sort of “lock box” to wall off the trust fund, and then to invest at least a portion of its assets in private securities. While the federal government ran sizeable overall budget surpluses in the late 1990s, in effect saving Social Security’s trust-fund surpluses, this proved to be a temporary phenomenon—and no consensus emerged on the idea of investing the trust fund in private markets.

President George W. Bush emphasized the need for Social Security reform in both his 2000 and 2004 election campaigns. His approach hinged on the creation of a new voluntary personal accounts component of Social Security that would give workers “ownership” of their retirement savings and improve the deteriorating “deal” that the program offers younger Americans by raising the rate of return on their contributions. Since the personal accounts were to be “carved out” of existing contributions, however, it is doubtful that they alone would have improved Social Security’s long-term finances. In 2005, after re-election, Bush attempted to jump-start the debate by offering a more detailed personal account plan together with a concrete proposal for reducing long-term costs by altering the indexing formula for higher-wage earners. Democratic

⁵ Congressional Budget Office, *The Long-Term Budget Outlook* (Washington, D.C.: Congressional Budget Office, December 2005), p. 7.

⁶ Centers for Medicare and Medicaid Services, *The 2006 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and the Federal Supplementary Medical Insurance Trust Funds* (Washington, D.C.: Centers for Medicare and Medicaid Services, May 1, 2006), Table III.A2, p. 33; and Social Security Administration, *The 2006 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, *op. cit.*, Table VI.F4, p. 173.

politicians, however, voiced nearly unanimous opposition to the personal accounts, while attacking the indexing change as a massive benefit cut. In the end, Republicans in Congress offered at best tepid support for the reform, leaving Bush with little to show for his effort.

While major Social Security reform has not occurred in more than two decades, political momentum began building in the late 1990s for Medicare reform. The reform effort, however, focused not on trimming Medicare, but on expanding it by adding a new prescription drug benefit. In 2003, Congress passed a controversial and expensive prescription drug plan that amounts to the biggest expansion in Medicare's history. Government projections indicate that the addition of the new benefit increased the program's unfunded liability by \$16.2 trillion.⁷

Environment and Outlook

Social Security—perhaps the most popular government program in U.S. history—has been called the “third rail” of American politics: Touch it, and your political career dies. Unfortunately, the 2005 Social Security debate only reinforced this perception. The failure of President Bush to gain broad support for his personal accounts proposal, which he had made his top domestic priority, hurt his political standing, and successful reform now appears as remote and risky as before.

The reform of old-age benefit systems—a difficult undertaking even in the most agreeable political climate—is made more difficult in the United States by deep ideological divisions over the role of government in providing social insurance. Most Republicans strongly favor moving toward defined contribution personal accounts in Social Security and intensifying market competition to control health-care costs, while most Democrats favor retaining Social Security's defined benefit structure and relying on government regulation to control health-care costs. Over the years, as politicians have adhered ever more rigidly to these opposing views, reaching a broad consensus in Congress over reform has become nearly impossible.

Although there has been some speculation about a possible “deal” on Social Security in the wake of the Democratic victory in the November 2006 mid-term elections, the current “reform paralysis” appears likely to endure. Unfortunately, a long delay before prudent reforms are adopted could leave the United States in no better fiscal position than many other industrialized countries, despite its demographic and economic advantages.

⁷ Centers for Medicare and Medicaid Services, *The 2006 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and the Federal Supplementary Medical Insurance Trust Funds*, *op. cit.*, Table III.C22, p. 116.

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The CSIS Global Aging Initiative (GAI) explores the fiscal, economic, social, and geopolitical implications of population aging and population decline. The Center for Strategic and International Studies established GAI in 1999 to raise awareness of the challenge and to encourage timely reform. Over the past seven years, GAI has pursued an ambitious educational agenda—undertaking cutting-edge research projects, publishing high-profile reports, and organizing international conferences in Beijing, Berlin, Brussels, Paris, Tokyo, Washington, and Zurich that have brought together world leaders to discuss common problems and explore common solutions. To learn more about the Global Aging Initiative, please visit its website at <http://www.csis.org/gai>.