Public Pension Reform and Old-age Protection

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Preface

Since the Bill on Revision of the National Pension Scheme was submitted to the National Assembly in October 2003, which mainly focused on its financial stability, there have been many different voices on the direction of the NPS reform among various interest groups, including political parties, academics, labor unions and civic groups. Among others, some have insisted that as Korea have a relatively short history of introducing a public pension system, NPS reform should be focused on securing pension benefits rather than financial stability of the NPS. On the contrary, it is also a highly convincing opinion that because Korea have been experiencing its population ageing at the fastest pace among OECD countries and because it is expected that the pension system would enter a matured stage in a relatively short period of time, the reform should concentrate on the financial stability of NPS in order to alleviate future generations' financial burdens.

These recent debates on the NPS reform have led to a gradual shift in the discussion's key agenda from financial stability to securing current aged people's pension incomes. When it comes to addressing the pension income security of the current old-age people, there stand two conflicting opinions. On the one side, some insist that we should introduce the Basic Pension Scheme of universal coverage, which would provide all the aged people with pension benefits financed by general tax revenue. On the other side, there is an argument that once we reach a matured stage of the NPS, the old-age protection issue would be significantly relieved, and thus rather than imposing grave burdens on future generations with a universal coverage pension scheme, to prepare for the coming super-aged society, we should introduce a public assistance type, old-age protection system, which would selectively secure the incomes of the aged people with poverty.

In this situation, in order to build a social consensus on the right direction of the reform, from August 2006 there had been a series of meetings, under the Office of Prime Minister, on policy responses to low-fertility and ageing society with special focus on the reform with participations from various interest groups, but they had failed to reach a consensus. As such, we now understand that a social consensus on public pension reform is hard to achieve not just in Korea; it is also difficult in many advanced countries as well.

This study articulates that debates on the NPS reform, as they have ended up in futile attempts, have left the public with distrust on it. This is alarming given that the main purpose of the reform, initially, was to rebuild the NPS into a more secure, reliable system for the public through forging financial stability.

In this regard, the study aims to draw meaningful implications from other countries' experiences who, under similar situations to Korea, have successfully resolved the reform issue or have been trying to build a roadmap to solve it. In this respect, the paper approaches the issue in two separate research themes. Chapter 1 examines how advanced nations deal with old-age income insecurity issues that would be caused by the pension reform under which the amount of benefits is reduced. The chapter includes case studies of a number of countries: Japan by Dr. Junichi Sakamoto from Nomura Research Institute; Australia by Professor Hazel Bateman from New South Wales University; U.S. by Columbia University's Professor Robert Lieberman; and, lastly, Korea by Dr. Yun Suk-myung from KIHASA.

Meanwhile, in Chapter 2, which deals with the issue of achieving social consensus during the process of pension reforms, Professor Karen Anderson at Netherland Radboud University examines the European nations' cases, such as Sweden and Germany, while Professor Kent Weaver from Georgetown University summarizes overall topics related to pension reform's social agreement achievement. The Chapter

2 also includes studies by Professor Thomas Klassen of York University on Canada's efforts for building social consensus and by Dr. Yun Suk-myung from KIHASA which analyzes the reason why in Korea, with time, social consensus is getting harder to achieve by using the method of Median Voter Model.

I sincerely hope that this study, as a reference, will be helpful to policy decisions on reforms and their social consensus building of NPS and Special Occupational Pension plans, including Civil Service Pension Scheme. I also wish that this paper will be used as a framework for international scholars and organizations to learn about special features of Korea's public pension reforms.

December, 2006

Yong-Moon Kim
President, KIHASA

PART 1

Public Pension Reform and Old-age Protection

1. The Recent Development of the Social Security Pension Schemes and Old-age Income protection in Japan

Junichi Sakamoto

1.1 Introduction

The last two decades with Japan can be characterized, as in many countries in the world, by steady improvement of mortality and sharp decline of fertility, both surpassing the projections. This has forced us to repeat pension reforms, lowering the benefit level and increasing the contribution rates. The repetition of pension reforms has had negative effects on the public minds. There has grown a sort of distrust in the social security pension schemes among the public. They have come to have the impression that the government always said that the reform would restore the financial equilibrium and stabilize the schemes and always betrayed them afterwards. The 2004 reform took place under such circumstances.

Reflecting such atmosphere, the government judged that the traditional way for reform would not be applicable to the new reform when the up-dated population projection was published in January 2002, showing better mortality and less fertility than had been projected in the previous projection in 1997. By the traditional way for reform, the author means a reform in which the benefit provisions such as the benefit level, the pensionable age, etc. are first to be reviewed and then the contribution programme is to be determined. Such a reform always has to go through the Diet deliberations and is exposed to political battle. Thus the government started to seek for a set of measures that, once it was enacted, would not necessitate the repetition of submitting the reform bill every time the up-dated population projection shows better mortality and less fertility than was assumed in the previous reform. It was a set of measures which would automatically restore the financial equilibrium even in such a case that the government sought for.

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Under such circumstances, the government studied the reform Sweden carried out in 1990's. From this it obtained the idea of fixing the contribution programme and introducing a mechanism that, based on a fixed rule, automatically and gradually reduces the benefit level to restore the financial balance eventually over time if the pension scheme is financially imbalanced.

The mechanism that was actually introduced in the 2004 reform is a modified indexation. The principal indexation, that was already functioning before the 2004 reform, is that the benefit amount is indexed to the increase of per-capita disposable income of the active employees until the age of 65 and is indexed to the Consumer Price Index (CPI) after the age of 65. The modified indexation modifies this principal indexation, until the financial equilibrium is attained, by subtracting the modifier from the principal index. The modifier is the sum of the decrease rate of the total number of active participants in the social security pension schemes and the increase rate of the life expectancy at age 65. In other words, the modified indexation curtails the increase of benefit that would have been realized through the principal indexation. Thus the benefit level would gradually go down in comparison with the per-capita disposable income until the financial equilibrium is attained.

According to the 2004 actuarial valuation, it is projected that, in the case of the Employees' Pension Insurance (EPI) Scheme that covers the private employees, the modified indexation would last until 2023 and the benefit level represented by the replacement ratio[1] would gradually be reduced to 50.2% from the current level of 59.3% in the case of best estimate case. It is also projected that after 2023 the indexation would be able to return to the principal one because the financial equilibrium would be attained in 2023 and so the replacement ratio would remain 50.2% afterwards.

This sort of automatic balancing mechanism has been introduced in some countries so far. Italy is the first country that has switched its indexation basis from per-capita wage increase to GDP increase. Sweden has introduced elaborate automatic balancing mechanism, changing the scheme framework to the notional defined-

[1] The replacement ratio is the ratio of the total annual amount of old-age pensions that a couple would receive from the social security pension schemes in the year when they reach age of 65 to the average annual amount of disposable income of the active employees in the same year. The couple here is composed of a husband who has worked from the age 20 to 59 with the earnings always in the average and a wife who is of the same age as her husband and has always been a non-working dependent housewife from the age 20 to 59.

contribution system that only provides old-age benefits. Germany also introduced, in 2004, a modified indexation that resembles the Japanese one as a great coincidence.

The automatic balancing mechanism has a great advantage of enabling us to avoid political arguments even if the population becomes more aged than was projected and the financial balance has to be restored. It may also mitigate the fear of the active population that the contribution rates would increase to an unsustainable level in the future. It should, however, be noted that the automatic balancing has disadvantages as well. Since the benefit level is automatically reduced under the mechanism, it may go down to such a low level that the benefits the social security pension schemes provide can no longer prevent majority of people of full length of coverage with average savings from being impoverished. In such a case, the social security pension schemes would lose their reason for existence. Such a situation should be avoided. The benefit level should be monitored. Another disadvantage is that the people may have the impression that their benefits would infinitely be reduced. The government should be careful enough to avoid such situation.

How to prevent the disadvantages of the automatic balancing mechanism from becoming real problems may partly be solved by introducing a lower limit of the benefit level. When the benefit level threatens to go below the lower limit in a few years' time, the scheme should stop modifying the indexation or automatic balancing and drastically review the whole scheme. By drastic review, the author means review of pensionable age, contribution programme, etc. It may even include review of the lower limit if it is judged to have some allowance and to be able to still provide adequate pensions due to socio-economic changes even if it is reduced to the reviewed lower limit. In fact the 2004 reform introduced such lower limit of benefits[2].

The current old-age benefits that the EPI scheme provides can be deemed to cover most of the consumption expenditure of the couple with the husband aged 65 and over and the wife aged 60 and over. According to the National Survey of Family Income and Expenditure in 1999, the average expenditure of such couples was about JPY 245,000, including the expenditure for cultural events and entertainments of JPY 31,000 and the expenditure for reunions

[2] It is expressed in terms of replacement ratio. If it threatens to go below 50% by the next actuarial valuation, the law requires the government to stop the modified indexation and to set about reviewing of the whole scheme.

and funerals of JPY 31,000 while the couples whose husbands have worked for 40 years with the career average of his revalued salary equal to the average salary of the current active male employees may expect, in 2006, old-age EPI benefit of JPY 236,000. Between 1999 and 2006 the salary decreased and the CPI dropped. So the benefit level the EPI scheme provides would manage to be adequate even after the modified indexation though it should be monitored. The benefit level for a couple of employee husband and his wife would maintain adequacy under the 2004 reform.

We also have to look into the benefit level for the self-employed people. A couple of the self-employed are receiving the monthly basic pension benefit of JPY 132,000 as a household if both the husband and the wife have contributed to the National Pension (NP) Scheme for 40 years. According to the National Survey of Family Income and Expenditure in 2004, the average monthly basic expenditure[3] of a couple with the husband aged 65 and over and the wife aged 60 and over is JPY 118,000. This shows that the basic pensions provide benefits adequate enough to cover the basic expenditure of such couples at the moment. There is also allowance as well. The government, therefore, judged that the level of basic pension benefits would be adequate after the modified indexation. The basic expenditure can be one of the measurements that tell whether the basic pensions are adequate or not, but the government should continue to monitor the level of basic pension benefits from as many angles as possible.

The final section of this paper discusses the relationship between the basic pension benefits and the social assistance benefits. The author believes that the two benefits are totally different from each other. The basic pensions play the role of enabling people from being impoverished. They are provided in virtue of a definite legal right without stigma irrespective of one's current earnings or property.

The social assistance benefits, on the other hand, play the role of saving the impoverished people. They are provided after one has depleted one's property. They are from time to time accompanied by stigma.

Taking account of such difference in their respective roles, the level of basic pension benefits should not necessarily be linked to that of the social assistance benefits. In fact, the amount of social

[3] The basic expenditure is composed of expenditure for food, housing expenditure, fuel charge, light charge, water charge, expenditure for furniture and household utensils and clothes and footwear.

assistance benefits in FY 2005 for a couple of a husband aged 68 and a wife aged 65 is JPY 135,000 if the couple lives in a large city centre, and is JPY 124,000 if the couple lives in a local city, and is JPY 108,000 if the couple lives in a rural area. If we take account of the tax and the social insurance contributions, the benefit level of the social assistance benefits for a couple living in a large city centre is fairly greater than that of the basic pensions. It should, however, be noted that the social assistance benefits are only provided after one has depleted one's property. Very few people would not mind losing their dignity.

It should, however, be noted as well that the government should monitor the level of the basic pension benefits and avoid such situation where many of the households receiving the full amount of the basic pensions threaten to be impoverished and become social assistance beneficiaries. The government should not overlook the falling of the benefit level of basic pensions to such extent.

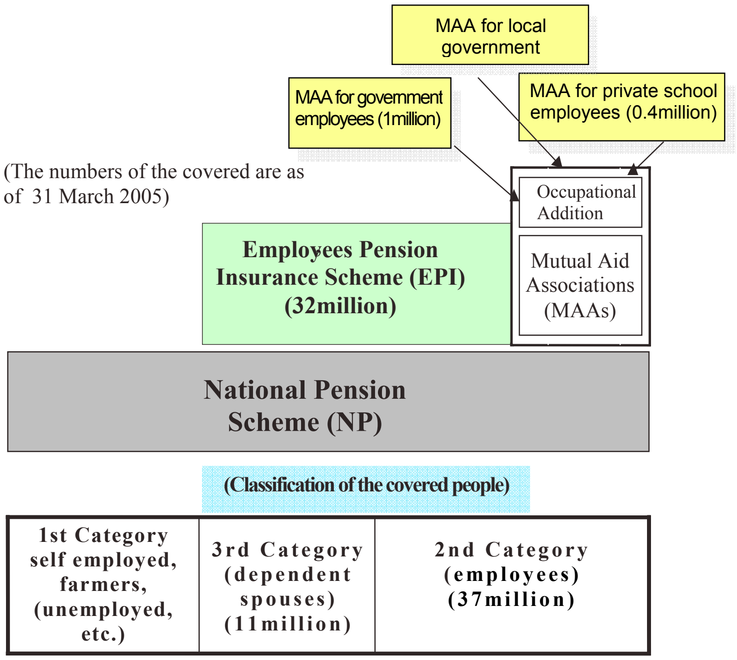
1.2 Social security pension schemes in Japan

Before we start the description of the recent pension reforms in Japan, we will briefly describe the outline of our social security pension schemes to give a proper framework for the discussion.

1.2.1 Coverage

Every resident of Japan aged between 20 and 60 is compulsorily covered by the National Pension (NP) scheme. If he/she is an employee in the private sector, he/she is covered by the Employees' Pension Insurance (EPI) scheme as well. This coverage is also compulsory. If he/she is an employee in the public sector like the national government, the local governments, etc., he/she is compulsorily covered by one of the mutual aid associations (MAA's). There are three MAA's: MAA for government employees, MAA for local government employees, and MAA for private school employees. <Fig. 1-1> shows the structure of coverage of the social security pension schemes in Japan.

<Fig. 1-1> Social Security Pension Schemes in Japan



The active people covered by the NP scheme are classified into three categories. Self-employed people, farmers, fishermen, etc. belong to the first category. Their dependent spouses are also included in this group. Those covered by the EPI or one of the MAA's are classified as in the second category. Their dependent spouses form the third category.

1.2.2 Benefits

The NP scheme provides flat-rate basic pensions; the annual amount of benefit is proportionate to the ratio of the number of covered months to 480 months (1 at the maximum), irrespective of what his/her income has been. The current annual amount for a beneficiary of 480 months of contribution is JPY 778,600 as of 1 April 2006[4].

[4] Strictly speaking, it is provisionally JPY 792,100 because, for FY 1999, FY 2000 and FY 2001, the amount was not indexed in spite of the deflation of 1.7%, but this amount is not to be indexed until the CPI increases by more than 1.7% from the 2004 average level. (If deflation happens again, this amount is to be indexed downward.)

The EPI and MAA schemes provide earnings-related pensions; the annual amount of benefit is 5.481‰ of the average of the pensionable remunerations during the covered period multiplied by the number of covered months. The average of the pensionable remunerations is defined to be the sum of the average of the monthly pensionable remunerations and the average of pensionable bonuses. The average of the pensionable bonuses is the sum of the pensionable bonuses divided by the number of the covered months. <Fig. 1-2> shows the formula to calculate the benefit amount of the old-age earnings-related pension benefit of the EPI scheme.

<Fig. 1-2> Benefit Formula for Earnings-related Part

$$\boxed{\text{The annual amount of benefit Earnings related pensions}} = \boxed{\text{The average of pensionable Remunerations (Revalued)}} \times \frac{5.481}{1000} \times \boxed{\text{The number of Covered months}}$$

The monthly pensionable remunerations and the pensionable bonuses are revalued according to the increase of disposable income of the active workers so that the benefit is indexed to the improvement of the active workers' disposable income level up until the beneficiary reaches the age of 65. After the age of 65, the benefit is indexed to the increase of the Consumer Price Index (CPI).

The social security pension schemes in Japan are thus composed of two layers for employees, providing flat-rate benefits and earnings-related benefits respectively. The self-employed people are, on the other hand, provided only with flat-rate benefits.

The benefit level the social security pension schemes are providing now may be measured in various ways. One measurement the MHLW has often utilized is a replacing rate[5] for a household where the husband has been covered by the EPI scheme from the age of 20 to the age of 59 and the wife is the same age as

[5] In section 4 (4), we define a more specific replacing rate and we call it the replacement ratio in this paper. It is a replacing rate of a household where the husband has earned the average salary the entire life. Furthermore the denominator of the replacement ratio is the average annual disposable income of the active male workers and is different from that of the replacing rate though it happens to be equivalent to that of the replacing rate.

her husband and has been dependent the entire life. The replacing rate is the ratio of the sum of the annual amount of the old-age benefits the couple is to receive at the age of 65 to the amount of the career average disposable income[6] of the husband. For this calculation, it is assumed that the gross annual income is twelve times monthly pensionable remunerations plus 3.6 times monthly pensionable remunerations (the latter is the average level of bonuses) and that the annual disposable income is 84% of the gross annual income. For a household where the husband has earned the average salary the entire life[7], the current benefit amount at age 65 is about JPY 233,000 per month and the replacing rate is 59.3%. For a household where the husband's career average of revalued monthly pensionable remunerations is JPY 200,000, the benefit amount at age 65 is about JPY 188,000 per month and the replacing rate is 86.3%. For a household where the husband's career average of revalued monthly pensionable remunerations is JPY 600,000, the benefit amount at age 65 is about JPY 301,000 per month and the replacing rate is 45.9%. The more you have earned, the less the replacing rate will be though the benefit amount will be larger. It is due to the redistributive nature of the flat-rate basic pension benefits.

The pensionable age is now 60 for the earnings-related part whereas it is 65 for the old-age basic pension benefit. It is, however, to be raised gradually to 65 for the earnings-related part by the year of 2025 for men and 2030 for women.

1.2.3 Pensionable remunerations

An employee's monthly pensionable remuneration is the average of his/her monthly salary or wages paid in April, May and June. It is applied from September until August of the next year. If his/her monthly salary or wages is sharply changed, then his/her monthly pensionable remuneration is also changed. There is a lower limit and an upper limit for the monthly pensionable remunerations. They are JPY 98,000 and JPY 620,000 respectively. The pensionable bonus is the amount of bonus with the upper limit of JPY 1,500,000.

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[6] The disposable income is the amount of the gross income minus tax and social security contributions.

[7] In this case the career average of revalued monthly pensionable remunerations is about JPY 360,000.

1.2.4 Contributions

The insured people of the first category pay flat-rate contributions to the NP scheme. The present contribution rate for this group is \13,860 per month[8]. The insured people of the first category with low income or no income at all may be exempted from paying their contributions with benefits for such periods calculated at one third of the normal benefit level. Those who are beneficiaries of social assistance or of disability pensions are totally exempted. Those whose annual earnings are below the amount calculated by the following formula are also totally exempted:

> (the number of dependants + 1) x (JPY 350,000) + (JPY 220,000)

Furthermore, a partial exemption is allowed. If one's income is above the total exemption level but below the amount calculated by the following formula, one only has to pay 1/4 of the normal contribution rate (currently JPY 3,470):

> (JPY 780,000) + (tax deductible amount for dependants) + (tax deductible amount for social insurance contributions)

The benefit in this case is 1/2 of the normal level. This case is called the 3/4 exemption case.

If one's income is above the 3/4 exemption level but below the amount calculated by the following formula, one only has to pay 1/2 of the normal contribution rate (currently JPY 6,930):

> (JPY 1,180,000) + (tax deductible amount for dependants) + (tax deductible amount for social insurance contributions)

The benefit in this case is 2/3 of the normal level. This case is called the 1/2 exemption case.

If one's income is above the 1/2 exemption level but below the amount calculated by the following formula, one only has to pay 3/4 of the normal contribution rate (currently JPY 10,400):

[8] It was JPY 13,330 just before the new NP contribution programme became effective on 1 April 2005.

(JPY 1,580,000) + (tax deductible amount for dependants) + (tax deductible amount for social insurance contributions)

The benefit in this case is 5/6 of the normal level. This case is called the 1/4exemption case.

The insured people of the second category pay contributions proportionate to their pensionable remunerations to either the EPI scheme or one of the MAA's. The present contribution rate of the EPI scheme is 14.642% as of 1 September 2006[9].

The insured people of the third category, namely dependent spouses of employees, do not have to pay contributions though each insured month as a category 3 person is considered to be a month in which he/she has paid the contribution of the NP scheme. Accordingly a person with 40 years covered by the NP scheme totally as category 3 can receive his/her old-age basic pension benefit of full amount though he/she has never paid the contributions. As seen in the following paragraph, the contributions are effectively made for them by the schemes which cover their spouses.

1.2.5 Financing the basic pension expenditure

The benefit expenditure of the basic pensions is managed by the Basic Pension Sub-account of the National Pension Special Account. It is financed by transferring the designated amount of money from each of the schemes to the Sub-account. <Fig. 1-3> shows the flow of the financial resources for the basic pension expenditure. The designated amount of money for a scheme is the total amount of annual expenditure of the basic pensions multiplied by the ratio of the number of the active people aged between 20 and 59 covered by the scheme plus the number of their dependent spouses aged between 20 and 59 to the total number of active people aged between 20 and 59 throughout the schemes plus the number of their dependent spouses aged between 20 and 59. In other words, the total amount of annual expenditure of basic pensions is shared by each of the schemes proportionately to the number of active people aged between 20 and 59 covered by the scheme and their dependent spouses aged between 20 and 59.

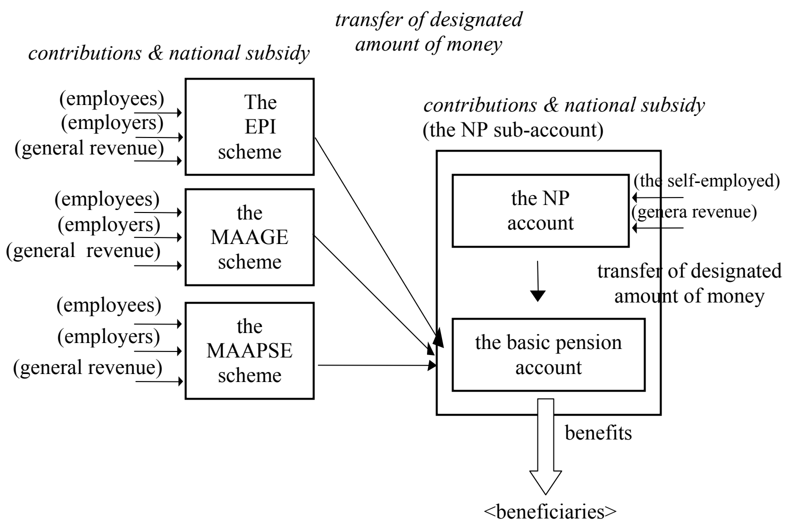
In calculating the designated amount of money, the insured people of the first category are deemed to form one group and the

[9] It was 13.58% just before the new EPI contribution programme became effective on 1 October 2004.

National Pension Sub-account of the National Pension Special Account transfers the designated amount of money to the Basic Pension Sub-account. The National Pension Sub-account collects contributions from the insured people of the first category.

In this way, the financing of the basic pension benefits is immune to changes in the industrial structure though it is still dependent on the demographic structure. When the designated amount of money is transferred from each scheme to the basic pension account, one third of the amount is subsidized from the general revenue for each scheme. This is shown in <Fig. 1-3> as each scheme has the national subsidy from the general revenues as well as the contributions from employers and employees. As a result, one third of the benefit expenditure of basic pensions is subsidized by the general budget.

<Fig. 1-3> Financing the Basic Pension Benefits



1.3 Evolution of social security pension schemes in Japan

The pension reform that took place in 2004 was carried out under the historical constraints of the repeated social security pension reforms. In order to facilitate the readers' understanding of the situation, we briefly summarize, in this section, the historical evolution of the social security pension schemes in Japan. The history can be split into two parts: the first part can be characterized as the period when the benefits were improved, and the second part can be characterized as the period when the scheme were repeatedly forced to adjust themselves to the changing socio-economic conditions.

1.3.1 Until the end of the 1970's

The Employees' Pension Insurance (EPI) scheme was introduced in 1942. It was the first general social security pension scheme in Japan covering male blue-collar employees in private companies with no less than 10 employees. Until then there only existed pension schemes covering some specific occupational groups like government employees and seamen.

Two years later the coverage was extended to male and female employees, including white-collar employees, in private companies with no less than 5 employees.

The benefit was earning-related without the flat-rate part and the coverage was limited to employees of manufacturing and mining companies. Employees in the servicing industry like construction, mass media, hospital, education, and research were excluded from the coverage.

In 1954 the benefit formula was reviewed and changed into the one consisting of two parts: flat-rate part and earnings-related part. Thus the EPI scheme started to play the income redistribution function. The benefit level was, however, very modest and the public had the impression that it was hardly reliable. At this reform the EPI coverage was extended further to the employees in almost all industry including the above-mentioned servicing industry.

In 1961 the National Pension (NP) scheme was introduced to extend the coverage of the social security pensions to the rest of the population, i.e. the farmers, the self-employed people and the non-employed people. The NP scheme also covered employees in the private companies with less than 5 employees. Since the precise grasp by the government of the income of the self-employed people and the farmers was judged to be very difficult and the imprecise grasp was deemed to cause unfair treatment between the employees and the self-employees in respect of the income redistribution function of the EPI scheme, the government gave up extending the coverage of the EPI scheme to these people. Instead it introduced the NP scheme that provided flat-rate benefits for flat-rate contributions. The NP benefit level was, roughly speaking, almost the same as the benefit level of the flat-rate part of the EPI scheme.

In the 1960's and the first half of the 1970's, Japan experienced the great economic growth and the living standard was rapidly improved. In line with this the benefit levels of the EPI scheme as well as of the NP scheme were increased rapidly. The benefit increase on an ad hoc basis culminated, in 1973, in the introduction of the indexation of the benefit amount to the per-capita gross wage increase.

The social security pension reforms until the end of the 1970's were concerned mainly with the benefit improvement and rarely with the benefit reduction. The only exception was that the 1954 reform stipulated the raising of the pensionable age for men of the EPI scheme from 55 to 60. It was due to the fact that the prolongation of the life expectancy was already felt and projected to continue to improve in the future.

1.3.2 The 1973 reform

As stated above, the 1973 reform introduced the indexation of the benefit amount to the per-capita gross wage increase. It was done through revaluing the past wage to the present level based on the per-capita gross wage increase rate in the meantime. It should, however, be noted that the several reforms before 1973 increased the benefit level on an ad hoc basis by increasing the multiple that appears in the benefit formula shown in <Fig. 1-2> and by increasing the amount of the flat-rate part. In fact the multiple was increased from 5/1000 to 6/1000 in 1960 and to 10/1000 in 1965. The annual amount of the flat-rate part was fixed at JPY 24,000 in 1954, but was raised in 1965 to the amount equal to JPY 250 multiplied by the number of insured months.

These benefit increases realized through increasing the multiple contained the element of indexing the benefit amount. The multiple should, therefore, have been reduced if the duplicated increase of benefit level had been to be avoided when the indexation by revaluing the past pensionable remunerations to the present level was introduced. Actually it was not reduced and the benefit level became too generous by the 1973 reform. Later this became one of the main causes for reforms for sustainability of the scheme. The reforms after the 1980's would have been less severe if the duplication of the benefit increase had been avoided.

1.3.3 1985 reform

In the 1980's the socio-economic environment in Japan greatly changed. The economic growth slowed down to the ordinary level and the mortality improvement did not fade. Furthermore the decline of fertility rate came to be recognized as a persistent trend in late 80's. The number of farmers continued to decrease due to further advance of industrialization.

The socio-economic change had great impact on the social security pension schemes in Japan. First it gave rise to the gloomy future financial prospect of the NP scheme because the rapid decrease of the number of farmers resulted in the projection that the number of the active participants in the NP scheme would soon start to decrease in the near future and the contribution rates would soar to an unsustainable level.

In order to cope with the problem, the Ministry of Health and Welfare proposed a reform plan that would extend the coverage of the NP scheme to the whole nation. By doing so the ministry expected that the financial basis of the NP scheme would be invulnerable to this sort of industrial change. At the same time the ministry proposed to change the EPI scheme and the MAA's into schemes that would only provide earnings-related part of the benefits with the flat-rate part replaced by the benefits provided by the NP scheme. The proposals were accepted and the reform bill passed the Diet. On 1 April 1986, the new law became effective and the NP scheme started to cover the whole nation. At the same time the flat-rate benefits provided by the NP scheme came to be called basic pensions[10].

The 1985 reform also reduced the benefit level by 25% of the earnings-related benefits the EPI scheme provided[11]. The reasons for the reduction were the excessively generous benefit level of the EPI scheme and the mortality improvement. The financial projections on 1980 actuarial valuation of the EPI scheme had shown that the future contribution level would go up to an unsustainable level. The mortality continued to improve even after the 1980 actuarial valuation. Thus the ministry proposed the benefit reduction.

The proposals to extend the coverage of the NP scheme to the whole nation including employees and to reduce the benefit level

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[10] Strictly speaking, the NP scheme also provides flat-rate benefits only for the self-employed people, the farmers and the non-employed people and not for the employees. But the size of the benefits is very small compared to the size of the basic pension benefits and they are paid out of the National Pension Sub-account of the National Pension Special Account instead of the Basic Pension Sub-account <see Fig. 1-3>.

[11] Until the reform, the MAA's had provided the final-pay benefits. They changed the benefit design and started to provide career average benefits like those of the EPI scheme by this reform.

for the future beneficiaries gave rise to fierce arguments between the ruling Liberal Democratic Party and the opposition parties. It took more than a year for the bill to pass the Diet. In the end the opposition parties agreed to vote and the bill passed the Diet though most of the opposition parties voted against the bill.

One of the driving forces that made the opposition parties agree to vote was the financial crisis of the MAA for the National Railway Company employees. It was suffering from the rapid decrease of the number of active employees due to the development of motorways that shifted the primary means of goods transportation from railways to lorries. It had redundancies and it could not help reducing the number of active employees. The extension of coverage of the NP scheme and the benefit reduction were expected to relieve the financial situation of the MAA even if it was only temporary. Behind the scene the trade unions could not neglect this fact.

The 1985 reform was essentially the first reform in the history of social security pension schemes in Japan in which the active population were asked for several sacrifices. They believed that, although they were going to suffer from some sacrifices, they would be able to consolidate the financial basis of the schemes by the reform. Very few people thought that this sort of reform would be necessary again in the future.

It should be noted that, in the 1985 reform, there was little awareness among people concerned of the fertility decline though the Total Fertility Rate (TFR) had already decreased from 2.05 in 1974 to 1.80 in 1983. Most people thought it was just fluctuating and possibly going back to 2.00. It was quite natural that very few people paid attention to this decline after the discussion of 'demographic explosion[12]' a decade before.

It was the 1992 population projection that assumed that the ultimate TFR would be 1.80 that was less than 2.00 for the first time.

1.3.4 Reforms in the last decade

As noted above, the 1992 population projection assumed the ultimate cohort TFR to be 1.80 that was below 2.00 for the first time. Together with the mortality improvement, this aggravated the

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[12] The word 'demographic explosion' refers to the prediction that, if the status quo continued, the population in Japan would rapidly increase to the extent in which the economy would not be able to sustain the whole population. The prediction prevailed in the 1960's.

financial basis of the social security pension schemes that was thought to have been consolidated by the 1985 reform. The 1994 pension reform, therefore, aimed at restoring their financial soundness again. It raised the contribution rate and changed the indexation basis from per-capita gross earnings to the per-capita net earnings. It raised the pensionable age of the flat-rate part of the Employees' Pension Insurance (EPI) scheme benefit from 60 to 65 as well. These changes were, in a sense, something that required sacrifice on the part of the active participants as well as pensioners. In any case, most people that had studied the topic thought that the schemes had attained the financial sustainability and would not be changed for a fairly long time.

Contrary to their expectations, the 1997 population projection[13] mercilessly worsened the future financial conditions of the schemes. It lead to the 2000 reform in which the indexation basis for pensioners aged 65 and over was changed from net earnings to the Consumer Price Index (CPI) though there was no proposal to raise the contribution rate due to the lingering economic recession. It also raised the pensionable age of the whole of the EPI scheme benefit from 60 to 65, lowered the level of the earnings-related benefits by 5% and extended the coverage of the EPI scheme to employees aged between 65 and 69. The reform law also stipulated an increase in the rate of national subsidy to the basic pensions from 1/3 to 1/2 by the year 2004 by securing the financial resources. These changes were thought to have narrowly achieved financial sustainability if indeed the increase in the national subsidy was implemented in 2004. However, securing the budget resources was a highly political problem and appeared to be difficult to achieve.

In the 1994 reform, raising the pensionable age of the EPI scheme was a hotly debated issue. The trade unions strongly opposed it and demanded the connection of employment with pensions without break. In those days most of the companies set the mandatory retirement age at 60. The government eventually gave up the idea of raising the pensionable age for both flat-rate part and the earnings-related part, opting instead to raise it only for the flat-rate part. The trade unions, however, never accepted the proposal. The bill passed the Diet by vote, but the conflict between the trade unions and the government lingered on even after the passage of the reform bill.

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[13] Its ultimate cohort TFR was 1.61. Its mortality was smaller than the one assumed in the 1992 projection.

In the 2000 reform, the trade unions declared that they would never accept changing the benefit provisions nor raising the contribution rates. They insisted that, according to their calculations, the same level of contribution rate would be applicable to the EPI scheme if the basic pensions were to be converted into a non-contributory scheme. They did not, however, elaborate the financial resources for the conversion. The government insisted that the benefit provisions should be changed in order to keep the ultimate contribution rate within a sustainable level and also warned them of the shortcomings of non-contributory schemes. The government was fiercely confronted by the trade unions. Likewise, the government parties were also confronted with the opposition parties backed by the trade unions. In the end, the government parties decided to put the reform bill to a vote. The opposition parties resisted, but the bill passed the Diet.

1.3.5 2002 population projection and need for reform

When the 2002 population projection[14] was published, the Pension Bureau of the MHLW evaluated its cost effects on the EPI scheme and the National Pension (NP) scheme[15]. The result was that the EPI scheme would ultimately need to raise its contribution rate to as high as 25.9% and the NP scheme to JPY 29,500 in FY 2004 value. These levels of contribution were judged to be far from sustainable. Again the expectations that, through the 2000 reform, the schemes had financially been stabilized were smashed.

Although we had to work out measures to recover sustainability, we strongly felt that we would not be able to repeat what we had done in the former reforms. Since we repeated changes that would contain benefits, people's distrust of the schemes had grown[16]. Some people had come to feel anxiety about the future contribution level. Other people had started to have obscure fears that they would not be able to receive their pensions when they retired. To simply repeat raising the pensionable age or lowering the benefit level was sure to increase distrust. We had to find measures that would remove people's anxiety or fear and recover their trust. In

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[14] Its ultimate cohort TFR was 1.39. Its mortality was smaller than the one assumed in the 1997 projection.

[15] Strictly speaking, it is the cost effect on the National Pension Sub-account to which the 1st-kind insured people of the NP scheme pay contributions that are flat-rate.

[16] There is no survey for this, but this was felt mainly through the conversation with the legislators who told the government about what the constituents had told them.

other words, we had to find out reasonable measures that would gradually recover sustainability without immediately imposing too much pain on particular generations, and, at the same time, would make it unnecessary to repeat reforms every time the demographic conditions worsened.

1.4. The 2004 reform

As we have seen in the above chapter, the 2002 population projection destroyed the financial stability of the social security pension schemes that the 2000 reform had been expected to bring about. We had to start another round of reform discussion. It was, however, almost impossible to repeat the same process we had followed in the preceding reforms.

In the preceding reforms we first fixed the reform items concerned with the benefit provisions and then we worked out the contribution programme that could be expected to secure contributions enough to finance the benefits. If the contribution programme was judged to be unsustainable, we reviewed the benefit provisions again. Then we worked out the contribution programme again that could be deemed to be enough to finance the benefits. If we had followed the same process, the mass media or the opposition parties would have denounced the proposals as the mirage in the desert that was sure to betray people. They were fed up with the proposals that were alleged to restore financial balance of the schemes if such and such benefit reductions were to be accepted. Thus we had to work out a set of proposals that should satisfy the following conditions:

(i) It clearly states the future contribution level that is within the sustainable level.

(ii) It is equipped with a mechanism that will automatically restore financial balance of the schemes, enabling us to avoid political battles even if the socio-economic environment change worsens the financial basis of the schemes.

In search of the new strategy for reform, the Swedish reform in the 1990’s gave us a lot of hints. The Swedish reform could be characterized as fixing the contribution rate and introducing an automatic balancing mechanism that was to automatically reduce the benefit amount if the financial imbalance came out. Since our scheme structure was quite different from the Swedish one, we could not directly apply the method to our scheme[17], but from this we worked out a set of proposals for the 2004 reform. It was essentially composed of fixing the contribution programme and modifying the indexation[18] until the financial balance was attained. It also contained a proposal that the national subsidy rate should be raised from 1/3 to 1/2.

These proposals were finally submitted to the Diet in February 2004 as the 2004 reform bill. During the Diet deliberations, however, there were very few discussions on the modified indexation, but mostly on scandals and irrelevant details. For example, it should have been a great issue whether the modified indexation was suitable to the purpose of social security pension schemes or not. The opposition parties did not raise such subjects. The Upper House election was to be held in July 2004 and they were making every effort to give faulty image of the government parties to the public. At the same time they submitted their own pension reform bill that proposed to introduce a single scheme that would cover both the employees and the self-employed people, providing earnings-related benefits to them. They declared that any bill that did not propose to unify all the social security pension schemes into a single scheme could not be regarded as aiming to achieve drastic reform. In a sense they took a showy stance for the election. In the end the government parties decided to put the reform bill to a vote, neglecting the assertion of the opposition parties that the bill should not be put to a vote. The bill passed the Diet in June 2004.

In the following we briefly describe the contribution programme, modified indexation and the national subsidy that were stipulated in the law by the 2004 reform.

1.4.1 Fixing the contribution programme

The 2004 reform has stipulated the contribution programme in the law. The finalized contribution programme of the EPI scheme is <see Fig. 4-1>:

- First, the current rate of 13.58% is to be raised to 13.934%

[17] The ageing of the population was much faster in our case than in Swedish case. This was another reason why we could not apply the Swedish automatic balancing mechanism to our schemes.

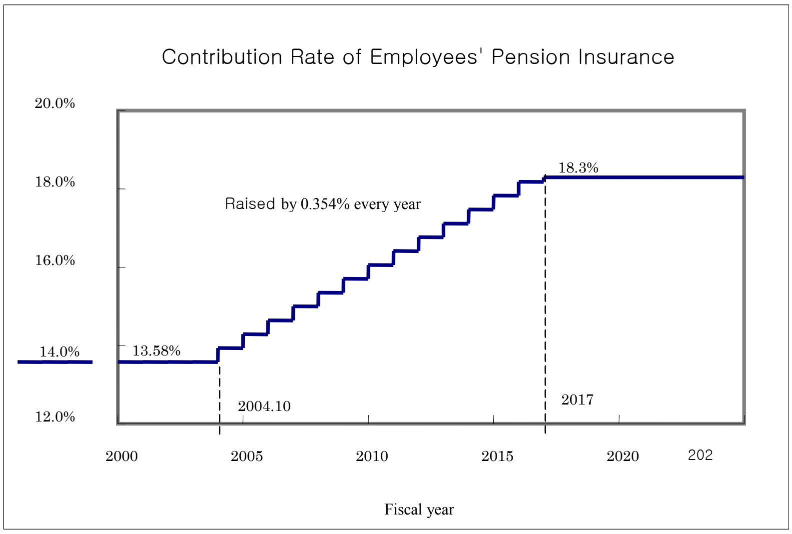
[18] The Swedish automatic balancing mechanism can be deemed to be consequently modifying the indexation. This became a hint for our case.

in October 2004.
- Then it is to be raised by 0.354% in September every year.
- In September 2017 it is raised to the ultimate rate of 18.3% and the contribution rate is fixed at 18.3% afterwards.

When the MHLW published its proposals for reform in November 2003, the ultimate rate of the contribution programme was set at 20%. It was projected that the ultimate benefit level expressed as the replacement ratio [19] under the contribution programme with the 95-year period of financial equilibrium would be 54.7% in the best estimate case.

The government parties, however, under the pressure by the employers, started to argue about the ultimate contribution rate. The employers insisted that such a high rate as 20% would undermine Japan's economy and be, in the end, harmful to the nation's life. After a long series of debate, the government parties finally decided to set it at 18.3% in February 2004.It was the rate by which the benefit level was narrowly kept above 50%.

<Fig. 1-4> Contribution Rate of Employees' Pension Insurance



[19] See the section (2) of this chapter.

Likewise the contribution programme for the people covered by the NP scheme as the first category, i.e. the self-employed people, farmers, fishermen, etc., has been stipulated in the law. It is to be raised by JPY 280 every fiscal year from JPY 13,300 per month in FY 2004 to JPY 16,900 per month in FY 2017. These rates are expressed in terms of the FY 2004 value and are indexed to per-capita gross wage increase.

1.4.2 Modified indexation

Since we decided to fix the contribution programme, we had to work out a measure that would restore financial equilibrium under the fixed contribution programme even if the socio-economic change affected the financial basis of the scheme. First we paid attention to the fact that, for the EPI scheme, the total amount of the wages that the active employees receive every year represents the capacity to sustain the benefit expenditure. Since the total amount of wages can be decomposed of the per-capita average wage multiplied by the number of active employees, we hit on the idea that the financial equilibrium might be attained if we reduced the index for the benefit indexation by the decrease rate of the active employees for some time. We made projections and confirmed that it would be workable in most cases. We published a consultation document including the financial projections to propose this method in December 2002 and obtained many reactions.

Most of the reactions were affirmative on its introduction, but stressed needs for improvement. Their comments were provided at the committee meetings of the Pension Subcommittee of the Social Security Council[20], in the direct conversation with the Director-General of the Pension Bureau, or in other ways. Summing up, the following two opinions for improving the modified indexation were forwarded:

- In order to minimize the difference of benefits and contributions among generations, the modifying should be accelerated as much as possible. The modification should also take account of the improvement of life expectancy at age 65 because it increases the cost unless adjusted. It helps hasten the modifying as well.
- The projected size of the accumulated reserve fund is too large. It should be reduced. The government should not control such a huge amount of money because the

[20] It is an advisory organ to the Minister of Health, Labour and Welfare.

government is apt to make bad use of the fund.

Taking account of these opinions, we decided to change the modifying method and defined the modifier as follows:

modifier = (the decrease rate of the number of the active participants covered by all of the schemes[21]) + (the increase rate of the life expectancy at age 65)

The modified index is obtained by subtracting the modifier from the normal index[22] based on either the increase rate of per-capita disposable income for beneficiaries aged below 65 or the CPI increase rate for beneficiaries aged 65 and over.

If we apply the modified index to the benefit amount in place of the principal indexation, the benefit level will be gradually reduced. We can, therefore, expect that, at a certain point in the future, the financial equilibrium will be attained if we continue to apply it instead of the principal indexation[23].

It should be noted here that the modified indexation is only a temporary measure and we go back to the principal indexation after the financial equilibrium is attained. After returning to the principal indexation, we may restart to apply the modified indexation if the financial equilibrium is destroyed afterwards.

The second term of the modifier has been added because many people insisted that the increase of life expectancy at age 65 should be taken account of because the longer the life expectancy is, the larger the total amount received will be if the amount remains unmodified. In the law, it is fixed at 0.3% based on the average of the projected annual increase rate of life expectancy at age 65 during the period 2000-2025 of the 2002 population projection. It is fixed in order to avoid fluctuations due to epidemics, etc. Awareness of the necessity to speed up the modification for the purpose of minimizing the intergenerational difference was also a motivation.

Whether we should take account of the increase rate of the number of the newly awarded or not was not discussed. If it had been included, our modifier would have perfectly coincided with

[21] In this case, MAAs are included as well.

[22] In the following we call this way of indexing the principal indexation.

[23] Theoretically there are cases where financial equilibrium cannot be attained even if we continue to apply the modified indexation to the benefits. Sakamoto (2006) gives a necessary and sufficient condition for the modified indexation to recover financial equilibrium.

the German case as will be explained later. As we have seen above, the approach may well have considered the element of the number of the newly awarded, but somehow it was neglected. Perhaps many people may have thought that it was obvious that if we had included the increase rate of the newly awarded, the modifier would have been very large, perhaps too large to be realistic given that the baby boomers will soon retire.

We should here note that, even under the modified indexation, the nominal amount is guaranteed. In other words, if the modifier is larger than the increase rate of per-capita disposable income or of the CPI, then the modified index is considered to be zero. Moreover, if the increase rate of per-capita disposable income or the CPI itself is negative, then we do not apply the modification to the indexation.

<Table 1-1> shows the projected decrease rate of the number of active participants covered by all of the schemes. The average projected decrease rate is about 0.6% for the period 2005-2025. Since the increase rate of the life expectancy at age 65 is fixed at 0.3%, it can be said that the average rate of the projected modifier for the period 2005-2025 is 0.9%.

<Table 1-1> Projected Decrease Rate of the Number of Active Participants of All the Social Security Pension Schemes

Year	Active participants (in million)	Decrease rate (%)
2005	70.0	-0.4
2006	69.9	-0.3
2007	69.4	-0.2
2008	68.7	-0.2
2009	68.0	-0.5
2010	67.3	-0.8
2015	64.9	-0.8
2020	63.3	-0.5
2025	61.8	-0.5
2030	59.3	-0.8
2040	52.0	-1.3
2050	46.2	-1.1

1.4.3 Period of financial equilibrium

We have so far used the word ‘financial equilibrium’ without clear definition. The 2004 reform has introduced its definition.

In section (2) we have referred to the two opinions that were forwarded after we published a consultation document about the modified indexation. One of the opinions was that the projected size of the accumulated reserve fund was too large; it was several times as large as the annual expenditure. They said that the government should not have such a huge fund because it was apt to make bad use of it through poor investment or through political pressure.

We examined the reason why such a size of fund would accumulate and found that it was attributable to the fact that, under the contribution programme, the ultimate contribution rate was to be reached long before the ratio of the number of beneficiaries to the number of active participants became stable. The ultimate contribution rate was smaller than the future PAYGO rate because it was fixed at an early stage of the ageing process of the scheme. To compensate the gap between the ultimate contribution rate and the PAYGO rate in the future, the investment return was called upon and the requirement for financial equilibrium gave birth to the accumulation of the reserve fund under the fixed contribution programme.

Furthermore, the reason why the PAYGO rate in the future was larger than the ultimate contribution rate was that we assumed more aged demography of the scheme in the far distant future than the demography at around 2020 when the ultimate contribution rate was reached. The 2002 population projection of the NIPSSR extends to 2100, but, since we had taken it for granted that the financial equilibrium should be considered in perpetuity, we had to make assumptions for the years after 2100. So we assumed that the demography of the scheme in 2090's would be repeated after the year of 2100. The old-age dependency ratio [24] of the 2002 population projection shows that 2090 is more aged than 2020. So the assumption had the effect of placing more emphasis on the aged stage of our country.

The method was reconsidered with the perspective that the government wanted to consider the whole future period for the financial management of the schemes. It also had the merit that the financial management would be stable if everything went in line with the assumptions. The criticism that the government was apt to make bad use of the reserve fund was rather journalistically exaggerated. If we used up all or most part of the reserve fund, it

[24] It is the ratio of the population aged 65 and over to the population aged between 15 and 64.

would simply lower the ultimate level of benefits or augment the ultimate contribution rate.

At the same time, it was a reasonable criticism that the assumption that the demography of the scheme in 2090's would be repeated after 2100 was very rough and baseless. It was also reasonable to add that it might mislead the judgment of the financial status when too much emphasis was put on the period after 2100.

We looked for a method that would reconcile the good points of the current method with the criticisms, and, at this time, the US example gave us hints.

Every year in the United States the Board of Trustees of the OASI Trust Fund and the DI Trust Fund publishes its annual report and provides the basic information on the OASDI's financial status. Its financial projections cover the next 75 years, but not the longer period. To evaluate the financial adequacy of the OASDI programme, it essentially compares the adjusted summarized cost rate and the adjusted summarized income rate for the next 75 years[25]. Here, the adjusted summarized cost rate means the ratio of the present value of the cost of the programme for the next 75 years plus the present value of the one-year cost of the last year of the 75-year period to the present value of the taxable payroll for the next 75 years. The adjusted summarized income rate means the ratio of the present value of the scheduled tax income (payroll tax revenue plus taxation of benefits) for the next 75 years plus the amount of assets on hand at the beginning of the 75-year period to the present value of the taxable payroll for the next 75 years. If the adjusted summarized cost rate is larger than the adjusted summarized income rate (which is the usual case), the difference represents the rate by which the current contribution rate should be raised to attain financial equilibrium for the next 75 years.

We paid attention to the fact that the Board of Trustees, in principle, looks into the financial status of the OASDI programme not in perpetuity but for the period of the next 75 years. We also paid attention to the target trust fund level of one year's cost at the end of the projection period.

What we thought was that, if we applied to our case this idea of finite period of financial equilibrium with the target fund at the end of the period being one year's cost, we would be able to get rid of the criticisms that the assumptions after 2100 were baseless and that the accumulated reserve fund would be too large.

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[25] Strictly speaking, it calculates several other measurements to test the long-range financial adequacy of the programme.

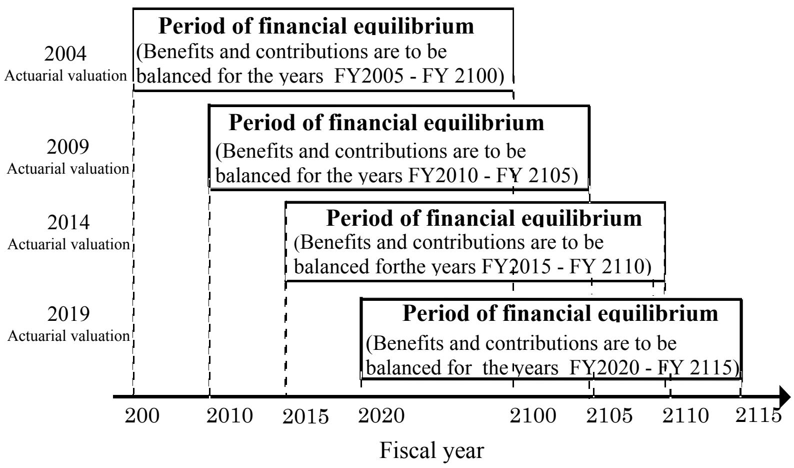
Furthermore, as we would fix the length of period of financial equilibrium, we would, in the end, take any year in the future into account, so the government's sense of responsibility that all the years in the future should be taken into account for the financial management would be more or less maintained.

The only shortcoming of this method would be that the difference between the adjusted summarized cost and the adjusted summarized income could be different, or, under the modified indexation, the ultimate benefit level could be different on the next valuation even if the socio-economic conditions remained the same. This is because the years leaving out of the period can be of nature different from the years coming into the period. The fluctuation can, however, be smaller if we take into account a long enough period.

In the wake of these considerations, we have concluded that we should adopt finite period of financial equilibrium with target fund at the end of the period being one year's cost. We have also decided that the length of the period should be 95 years. It is the length of time during which almost all of the people already born at the beginning of the period will cease to receive benefits, and the current government can be said to have taken financial responsibility to take account of these people if the financial equilibrium is confirmed for the period.

<Fig. 1-5> summarizes the discussion. When we review the financial projections every five years, we take 95-year period of financial equilibrium. This period should not be shorter.

<Fig. 1-5> Period of Financial Equilibrium



1.4.4 Measurement of benefit level (replacement ratio)

Since the modified indexation gradually reduces the benefit level, we need a measurement that properly indicates the level of benefit. Without it we would not be able to know whether the benefit level is still adequate or not. Adequacy of benefits is essential to social security pension schemes. Even if the financial equilibrium is maintained, social security pension schemes would lose their reason for existence if their benefits are not adequate enough to support the beneficiaries' core income.

The 2004 reform has introduced such a measurement called the replacement ratio of the EPI scheme. By replacement ratio, we mean the ratio of the benefit amount that the household of the following conditions receives, at age 65, as a couple to the average disposable income of the active participants at the time:

- The husband has been covered by the EPI scheme for 40 years with the salary always equal to the average salary of the active participants.
- The wife, whose age is the same as her husband's, has always been a dependent, non-working housewife.

The current replacement ratio is about 59%. The modified indexation will reduce it slowly until the financial equilibrium is attained.

After the financial equilibrium is attained, the indexation is to return to the principal indexation based on the increase of the per-capita disposable income or the rate of increase of the CPI. It is the same indexation as the one currently implemented and maintains the replacement ratio of the newly awarded person afterwards.

1.4.5 Financial projections

Now that the contribution programme has been fixed, modifying method of indexation has been decided, and the period of financial equilibrium has been defined, we can make projections for several cases. <Table 1-2> summarizes the result of these simulations.

In the best estimate case, the ultimate benefit level is projected to be 50.2%. It is to be reached in 2023. In other words, if the benefit level is lowered to 50.2% through the modified indexation until 2023, the EPI scheme will be financially balanced for years until 2100 if we restart the principal indexation in 2024.

In the case where the economic conditions are better and the decline of the ultimate cohort TFR is milder to be 1.52, the ultimate benefit level is projected to be 52.4% and the period of modified indexation to end in 2019.

In the case where the economic conditions are worse and the ultimate cohort TFR drops to as low as 1.10, the modified indexation is projected to last until 2033 and the ultimate benefit level to be 45.3%.

<Table 1-2> Ultimate Replacement Ratio and Period of Modification of the EPI Scheme

	Present replacement ratio	Ultimate replacement ratio	Modification replacement ratio
(best estimate case) *population projection: intermediate variant *economic assumptions: intermediate case	59.3%	50.2%	FY2023
(low-birthrate & low-growth case) *population projection: low variant *economic assumptions: pessimistic case	59.3%	45.3%	FY2033
(high-birthrate & optimistic-growth case) *population projection: 1.52 variant *economic assumptions: optimistic case	59.3%	52.4%	FY2019

1. Economic assumptions:

	wage increase	net earning increase	CPI increase	rate of investment return
*intermediate case:	2.1%	19%until2017	1.0%	3.2%
*pessimistic case:	1.8%	1.6%until2017	1.0%	3.1%
*optimistic case:	2.5%	23%until2017	1.0%	3.3%

2. The 1.52 variant means the population projection with the ultimate cohort TFR being 1.52 that is situated halfway between the high variant and the intermediate variant. It just corresponds to the case where the average number of children married couples would give birth to is assumed to is assumed to be the same as before.

Source: Ministry of Health, Labor and Welfare

We have also made financial projections of the EPI scheme[26] and the NP scheme for the best estimate case. <Table 1-3> and <Table 1-4> show them respectively. According to it, the EPI scheme is projected to be in deficits for the first several years and then turn into surplus until around 2050. After that it is projected to be in deficits again, using the reserve fund to compensate for the deficits, and at the end of the period of financial equilibrium, the size of the reserve fund is almost equal to the size of the annual expenditure. The same tendency can be found in the projection for the NP scheme though the size of the reserve fund is much smaller than that of the EPI scheme.

<Table 1-3> Financial Projection for the EPI Scheme (2004 Actuarial Valuation)

Fiscal year	Contribution rate (monthly flat-rate amount in FY 2004 value) (JPY)	Annual income (①) (JPY in trillion)	Contributions (JPY in trillion)	investment return (JPY in trillion)	Annual expenditure (②) (JPY in trillion)	Difference (①-②) (JPY in trillion)	Accumulated reserve fund at the end of FY (③) (JPY in trillion)	Accumulated reserve fund at the end of FY (in FY2004 value) (JPY in trillion)	Fund ratio (③/②)
2005	13,580	4.0	2.1	0.2	4.2	-0.2	10.8	10.8	2.6
2006	13,860	4.3	2.2	0.2	4.5	-0.2	10.6	10.6	2.4
2007	14,140	4.6	2.4	0.3	4.8	-0.2	10.4	10.3	2.2
2008	14,420	4.8	2.5	0.3	5.0	-0.2	10.1	9.9	2.1
2009	14,980	5.4	2.5	0.3	5.0	0.3	10.5	10.0	2.0
2010	16,380	5.6	2.6	0.3	5.1	0.5	11.0	10.2	2.1
2015	16,900	6.5	3.0	0.4	5.9	0.7	13.8	11.7	2.2
2020	16,900	7.3	3.4	0.6	6.4	0.9	17.9	13.6	2.6
2025	16,900	8.1	3.7	0.7	7.0	1.1	23.2	15.9	3.2
2030	16,900	9.2	4.0	0.9	8.0	1.2	29.2	18.1	3.5
2040	16,900	11.2	4.3	1.2	10.6	0.6	38.7	19.4	3.6
2050	16,900	13.1	4.7	1.3	13.0	0.1	42.0	17.2	3.2
2060	16,900	14.7	5.3	1.3	14.8	-0.1	41.9	13.9	2.8
2070	16,900	16.1	5.8	1.3	16.5	-0.3	39.7	10.7	2.4
2080	16,900	17.7	6.5	1.1	18.2	-0.5	35.2	7.7	2.0
2090	16,900	19.5	7.5	0.9	20.2	-0.7	29.0	5.2	1.5
2100	16,900	21.6	8.6	0.7	22.4	-0.8	21.6	3.1	1.0

1. Long-term economic assumptions after FY2009 are as follows:
rate of wage increase 2.1%
rate of the CPI increase 1.0%
rate of investment return 3.2%
rate of disposable income increase 2.1%(until FY 2017 it is 1.9%)
2. The FY2004 value means the value discounted by the rate of wage increase.
Source: Ministry of Health, Labor and Welfare

[26] It includes the portion of the old-age benefits substituted by the Employees' Pension Funds. So the amount of the reserve fund is greater than the amount managed by the Pension Sub-account of the Social Insurance Special Account.

<Table 1-4> Financial Projection for the NP Scheme (2004 Actuarial Valuation)

Fiscal year	Contribution rate (monthly flat-rate amount in FY 2004 value) (JPY)	Annual income			Annual expenditure		Difference (①−②) (JPY in trillion)	Accumulated reserve fund at the end of FY (③) (JPY in trillion)	Accumulated reserve fund at the end of FY (in FY2004 value) (JPY in trillion)	Fund ratio (③/②)
		(①) (JPY in trillion)	Contributions (JPY in trillion)	investment return (JPY in trillion)	(②) (JPY in trillion)	transfer to the Basic Pension Sub-account (JPY in trillion)				
2005	14,288	28.3	20.8	3.0	31.9	11.1	-3.6	163.9	163.9	5.2
2006	14,642	29.8	21.6	3.5	32.9	11.3	-3.1	160.8	161.1	5.0
2007	14,996	31.2	22.6	4.0	33.8	11.5	-2.5	158.3	157.8	4.8
2008	15,350	33.0	23.5	4.7	34.9	12.0	-1.9	156.4	153.1	4.5
2009	15,704	36.1	24.5	4.9	36.5	12.6	-0.4	156.0	149.2	4.3
2010	16,058	37.6	25.5	4.9	37.5	13.0	0.0	156.0	145.3	4.2
2015	17,828	44.0	30.8	5.1	41.4	15.1	2.6	162.5	137.3	3.9
2020	18.30	49.2	34.8	5.8	43.3	16.5	5.9	186.3	141.8	4.2
2025	18.30	53.7	37.7	6.9	45.5	17.7	8.2	223.1	153.1	4.7
2030	18.30	58.2	40.0	8.3	49.5	19.4	8.7	266.6	164.9	5.2
2040	18.30	66.2	43.1	10.3	62.9	25.4	3.3	330.1	165.8	5.2
2050	18.30	73.5	47.2	10.6	74.8	31.4	-1.3	335.0	136.7	4.5
2060	18.30	80.6	52.8	9.9	82.9	35.5	-2.4	314.4	104.2	3.8
2070	18.30	87.0	58.4	9.0	90.8	39.3	-3.7	284.4	76.6	3.2
2080	18.30	94.2	65.0	7.6	99.6	43.4	-5.4	237.9	52.1	2.4
2090	18.30	103.6	73.9	5.7	109.8	48.0	-6.2	178.4	31.7	1.7
2100	18.30	115.1	84.8	3.7	121.5	53.3	-6.4	115.1	16.6	1.0

1. Long-term economic assumptions after FY2009 are as follows:
 rate of wage increase 2.1%
 rate of the CPI increase 1.0%
 rate of investment return 3.2%
 rate of disposable income increase 2.1%(until FY2017 it is 1.9%
2. The FY2004 value means the value discounted by the rate of wage increase.
3. The projection includes the benefits substituted by the Employees' Pension Funds.
Source: Ministry of Health, Labor and Welfare

1.4.6 The minimum replacement ratio

As the modified indexation gave the impression that it would continually lower the benefit level until the financial equilibrium was attained, the MHLW proposals in November 2003 included the provision that the government should review the scheme urgently if the benefit level of the newly awarded people threatened to drop below 50% by the next actuarial valuation[27]. This sort of minimum

[27] The government parties' discussion on the level of the ultimate contribution rate was also conscious of this proposal though the meaning of 50% was different from the minimum benefit level provision.

benefit level should be added to the compulsory income security programme. Otherwise the scheme itself would lose its reason for existence. This was supported and has become a provision in the law.

Since the actual effect of the decline of birth rate on the labour force starts in about 20 years' time, a scenario in which the benefit level of the newly awarded pensions falls below 50% in a few years' time is not likely to happen for the next 10 to 15 years as long as unusual things like death of a considerable portion of the labour force does not take place over several years. This means that there is time to work out comprehensive measures to remove the causes of the low birth rate.

The rate of 50% itself has been set by taking account of the ratio of the average consumption of the households of aged couples to the average amount of disposable income of the active labour force. It may change as the socio-economic environment changes. We have to continue to watch the environment carefully and to review the rate.

1.4.7 National subsidy

The 2004 pension reform has introduced another important change in the scheme financing. It has raised the national subsidy rate from 1/3 to 1/2. It has stipulated in the law that the raising of the national subsidy rate should be realized no later than 1 April 2009. As of FY 2006 the rate has been raised to 1/3 + 25/1000. As to the financial resources for the raising, however, there is no definite provision in the law. It may necessitate the amendments in the tax law. We have to decide them in two years' time. Given this fact, it should be all the more noted that the financial projections have been made, assuming that the national subsidy rate after FY 2009 is 1/2.

1.5 Automatic balancing mechanism in foreign countries

As we have seen in chapter 4. our idea of modified indexation was derived from the Swedish automatic balancing mechanism introduced in the 1990's. There are several other countries that have adopted a sort of automatic balancing mechanism for their social security pension schemes. In this chapter we summarize the mechanisms of Swedish and German cases.

1.5.1 Swedish mechanism

The Swedish reform undertaken in 1990's consists of several elements. From the financial and actuarial point of view, the introduction of automatic balancing mechanism with the fixed contribution rate is most conspicuous.

First, it declares that the contribution rate for the state pension scheme is fixed at 18.5%, which is supposed to eliminate the anxiety of younger generations that the contribution rate would go up to an unsustainable level in the future. The contributions corresponding to 2.5% out of the 18.5% goes to the mandatory, privately-managed individual DC accounts, so the contributions corresponding to 16% goes to the pay-as-you-go earnings-related part.

Second, it reorganized the scheme framework to concentrate itself on providing the old-age benefits. Disability pensions and survivors' pensions were removed from the social security pension framework and put in the general budget. At the same time it has introduced notional individual accounts in the new state scheme where each person's contribution is recorded and the interest is put on it. The interest rate is equal to the per-capita gross wage increase rate. The sum of the principal and the interest accumulated in a person's account at his/her age 65 is divided by a divisor[28] to calculate the annual amount of old-age benefit.

Third, it has incorporated an automatic balancing mechanism into the scheme. It defines the concept of turnover duration as being the difference between the average age of pensioners and the average age of the active participants weighted respectively by the pension amount and by the salary amount. At the end of each fiscal year, the scheme calculates the turnover duration and compares the following two amounts:

(i) (the yearly contribution income) x (the turnover duration) + (the amount of the reserve fund)
(ii) the present value of the benefits corresponding to the period up to the end of the fiscal year

[28] The divisor is the present value of a life annuity at age 65 that provides unit amount. The mortality is based on the latest experience and the discount rate is 1.6%. The old-age benefit is indexed to per-capita gross wage increase, and so, if the real per-capita wage increase is 1.6%, then the actual indexation is virtually the same as the CPI indexing.

<Fig. 1-6> illustrates what are compared. If the (i) is not less than (ii), the scheme is considered to be financially balanced. If the (i) is less than (ii), the scheme is considered to be financially imbalanced, and the amount of all of the benefits gained up to the end of the fiscal year is reduced by being multiplied by the ratio of (i)/(ii) together with the per-capita gross wage increase. The reduction obviously renders the scheme balanced according to the definition stated above. Thus this process automatically gives financial balance to the scheme, and so it is called the automatic balancing mechanism.

For example, at the end of 2003, (i) was SEK 6,042,011 million and (ii) was 5,984,199 million, so the scheme was considered to be financially balanced. In this case, the turnover duration was calculated to be 32.39887 years, the yearly contribution income was SEK 168,681 and the reserve fund was SEK 576,937.

The reason why the comparison of (i) with (ii) can be the indicator of the financial balance is that, under the scheme that only provides old-age benefits in the same manner as the NDC does, the present value of the benefits corresponding to the past period is equal to the yearly contribution income multiplied by the turnover duration if the demographic structure of the scheme is stationary[29].

<Fig. 1-6> Automatic balancing in the Swedish reform

<table>
<tr><th>(i)</th><th>(ii)</th></tr>
<tr><td>Contribution asset
(= (annual income of contribution)
X (turnover duration))</td><td rowspan="2">Present value of benefits corresponding to the past period</td></tr>
<tr><td>Reserve fund</td></tr>
</table>

1.5.2 German reform in 2004

In Germany the pension reform bill passed the Parliament in March 2004. It aims to make the social security pension schemes sustainable by limiting the indexation of the benefit. The method to realize it is surprisingly similar to our modified indexation. So it can be said that Germany and Japan were simultaneously discussing

[29] See Ole Settergren, Bogslaw D. Mikula (2001)

the same sort of reform by chance. In the following, we would like to compare the German method with our modified indexation.

The German indexation basis has been the average disposable income of the active workers. The new law has added a factor called the sustainability factor to contain the normal indexation. A beneficiary's benefit amount for a year is obtained by multiplying the amount for the last year by the disposable-income-based indexation and by the sustainability factor[30].

The sustainability factor is defined as follows:

(sustainability factor) = $(1 - ID)\alpha + 1$

where ID = the ratio of the dependency ratio a year ago to the dependency ratio 2 years ago,

and (dependency ratio)

= (the number of pensioners[31]) / (the number of contributors plus the number of the unemployed[32])

and α is a positive number not greater than 1 and is to play an adjusting role to what extent the ageing degree is reflected in the modification of the indexation.

If we denote by b the increase rate of the number of pensioners from 2 years ago to a year ago and by c the decrease rate of the total of the number of contributors and the number of the unemployed, then we can rewrite the sustainability factor as follows:

$$
\begin{aligned}
\text{(sustainability factor)} &= (1 - ID)\alpha + 1 \\
&= \{1 - (1 + b)/(1-c)\}\alpha + 1 \\
&\fallingdotseq \{1 - (1 + b + c)\}\alpha + 1 \\
&= 1 - \alpha(b + c)
\end{aligned}
$$

If $\alpha = 1$, then the sustainability factor is $1 - (b + c)$. When many years have already passed since the social security pension schemes were introduced and the only factor that increases the number of beneficiaries is the improvement of mortality, b represents the

[30] The amount of social security pensions in Germany is calculated by multiplying the unit amount by the points earned. So, actually, the sustainability factor is applied to the unit amount last year to obtain the unit amount this year.

[31] It is adjusted for beneficiaries with low benefit. The number of contributors is also adjusted for low earners.

[32] The reason why the number of the unemployed has been added is that it is to exclude cyclical effects on the dependency ratio.

increase of life expectancy at the pensionable age. The c is, roughly speaking, the decrease rate of the labour force. It can, therefore, be said that b + c is almost equivalent to the modifier of the 2004 Japanese reform. What an interesting coincidence! The modified indexation is not an innovation peculiar to Japan but rather applicable throughout the world. As has been seen in 4. (2), if our case had taken account of the increase rate of the number of newly awarded, our modified indexation would have completely been identical with the German sustainability factor.

The 2004 German reform has another factor of α that can adjust the degree to which the increase of life expectancy and the decrease of labour force are reflected in the modification of indexation. The 2004 German reform law has set $\alpha = 1/4$. With this sustainability factor it is projected that the contribution rate is a little bit lower than 23% in 2030.

The 2001 German reform law stipulates that the contribution rate must be below 20% until 2020 and be below 22% until 2030 while the net replacement rate must stay above 67% with the Riester DC pension added. The 2004 reform has not attained this target. In the 2003 reform proposals by the Rűrup Commission, there was a proposal to raise the pensionable age from 65 to 67, but it has not been realized in the 2004 reform law. It has just been proposed to the Congress as a reform bill by the grand coalition administration of Merkel. The German reform is still in progress as is true in most countries.

1.6 Automatic balancing mechanism

As we have seen in chapter 4. the automatic balancing mechanism through the modified indexation has been introduced in the social security pension schemes in Japan. It has been introduced with the intention to enable us to avoid political battle every time socio-economic changes affect the financial basis of the schemes. It automatically restores the financial balance and so there is no need to pass reform legislation, enabling us to avert political arguments.

Furthermore it is combined with the fixed contribution programme that may mitigate people's fear that the future contribution rates might increase without limit. This is another great advantage of the automatic balancing mechanism.

It should, however, be noted that the automatic balancing mechanism realizes the above- mentioned advantages at the sacrifice of benefit level. It may lower the benefits to inadequate level. Furthermore, as time passes, people will be aware that the benefit level is being gradually reduced. This may give them the impression that their income in retirement is not so secure. These are the weaknesses of the automatic balancing mechanism.

Taking account of the fact that the adequacy of benefits is one of the essential conditions for the existence of the social security pension schemes, we have to overcome or at least mitigate the weaknesses of the automatic balancing mechanism. One solution may be to introduce the floor of the benefit level. The 2004 reform has introduced the provision of minimum replacement ratio, or the minimum benefit level. According to the provision, if the replacement ratio defined in 4. (6) is projected to go below 50% in 5 years' time, the scheme should stop modifying the indexation and return to the principal indexation. The scheme should also be reviewed drastically again in this case. In such a case the ultimate contribution rate might be increased, the pensionable age might be raised, the minimum replacement ratio might be reviewed, or these might be combined. By doing so we can check the adequacy of benefits the social security pension schemes provide.

1.7 Benefit level

The automatic balancing mechanism lowers the benefit level bit by bit. The monitoring of the benefit level is, therefore, all the more indispensable for maintaining the adequacy of the social security pension benefits. In this chapter we examine the prospect of the benefit level relative to the expenditure of the elderly household under the modified indexation.

The way to confirm whether the current benefit level is adequate for the life in retirement is not so simple. Daily life expenditure may vary from individual to individual. It depends on the type of the household. Those who are used to slightly fashionable lives might say the amount is not enough while those who are living austere lives might say it is more than enough even if the benefit amount is the same. Furthermore the cost of living depends on where you live. It is very difficult to set a comprehensive question whose answer gives us the proof of the adequacy or inadequacy of pension benefits.

Although the major type of household to which at least one elderly person belongs is changing in Japan, it is still the household where a husband is living with his wife. According to the Basic Survey of National Life in 2005, its share in all types of household can be estimated to be at least about 48 %[33]. So in this chapter we examine the average total amount of the social security pension benefits that can be expected in a household where the husband and the wife are both beneficiaries of old-age pension benefit. We compare it with the average family expenditure obtained by the National Survey of Family Income and Expenditure in 2004 in the case of employee household. We also compare it with the average basic family expenditure in the case of self-employed household.

1.7.1 Benefit level of employee household

When we discuss the average total amount of the social security pension benefits that can be expected in a household where the husband and the wife are both beneficiaries of old-age pension benefit, we consider a household where the husband has been covered by the EPI scheme for 40 years with the average of his revalued monthly pensionable remuneration being equal to the current average monthly remuneration of the active participants and the wife has always been dependent and non-working. The average monthly pensionable remuneration of male employees at the end of FY 2004 was about JPY 360,000, so his gross annual wage can be assumed to be JPY 5,616,000 (= 360,000 x 12 x 1.3) where his bonus is assumed to be equal to 3.6 times monthly pensionable remuneration. Since the adjustment rate for indexing to the per capita disposable income increase for the period from FY 1994 to FY 2004 is 0.98, his average of the revalued pensionable remuneration is JPY 458,640 (= 5,616,000 x 0.98 / 12) in the benefit formula for the EPI earnings-related benefit shown in <Fig. 1-2>. So the monthly amount of his EPI earnings-related benefit is about JPY 101,000. Since the monthly amount of the old-age basic pension that is provided to those who have contributed to the NP scheme for 40 years was about JPY 66,000 in FY 2004, the household receives the total amount of about 233,000 (= 101,000 + 66,000 x 2) every month.

<Table 1-5> shows the average family expenditure of households composed only of a husband aged 65 and over and a wife aged 60 and over based on the National Survey of Family Income and

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[33] Out of the 14.6 million households where the person representing household is aged 65 or over, 5.3 million are those composed of a husband and a wife and 1.7 million are those composed of a husband and a wife and their non- married children. The number of households of single elderly is 4.1million and its share is about 28%. Many of them may be deemed to be households of surviving wife. In such households many of them may be deemed to be receiving the survivor's pension.

Expenditure in 2004 conducted by the Statistics Bureau, the Ministry of Internal Affairs and Communications[34].

<Table 1-5> Average family expenditure of households composed only of a husband aged 65 and over and a wife aged 60 and over in 2004

(monthly amount in JPY)

items	Average expenditure
Food	61,313
Housing	19,697
Fuel, light and water charges	16,831
Furniture and household utensils	9,477
Clothes and footwear	10,556
Medical expense	16,342
Cransportation and communicatior	28,148
Education	12
Reading and recreation	32,111
Other living expenditure	66,358
total	260,846

According to the <Table 1-5>, the average family expenditure is greater than the amount of pension benefits. It should, however, be noted that other living expenditure contains allowances for grandchildren, funeral donations, fees for reunions, etc. The average for these expenses is about JPY 34,367 out of JPY 66,358. These may not be supported by the social security pension benefits. Reading and recreation expense of JPY 32,111 may not be covered by them, either. If we subtract these expenses from the total, the remaining expenses total about JPY 194,000. Therefore the current benefit level of JPY 233,000 can be judged to be adequate for the family expenditure of such households.

The 2004 actuarial valuation assumes that the real wage increase is 1.1%. Since the average rate of the modifier is 0.9%[35], the benefit level is to continue to rise relative to the CPI increase by 0.2%. It may, therefore, be said that, even after the modified indexation, the benefits will continue to maintain purchasing power. It should also

[34] The survey is carried out every five years.
[35] See 4. (2).

be noted that this is the situation at age 65. After the age 65 the benefits are indexed to the CPI increase if the modified indexation is finished. So it may still be said that the benefits will continue to maintain adequate purchasing power.

We have just seen that the current benefit level is adequate for major households composed of a husband aged 65 and over and a wife aged 60 and over. But we cannot predict what will happen in the future reality. Furthermore there are other types of households like those of single woman. We have to continue to monitor.

1.7.2 The benefit level of the self-employed households

The covered people in the first category of the NP scheme like the self-employed people, farmers, etc. are to pay the flat-rate contributions and receive flat-rate basic pension benefits. This is due to the fact that the grasping or even defining of their income is so difficult that we have given up the combination of the flat-rate benefits and the earnings-related benefits to avoid inequity that may happen in the course of income redistributive function. For this reason the benefit level of the self-employed households are usually compared with the basic family expenditure. By the basic family expenditure we mean the sum of the expenses for food, housing, fuel, light and water charges, furniture and household utensils and clothes and footwear. In other words they are expenses listed in the first five items in <Table 1-5>. In a sense the basic pension policy has almost explicitly aimed to provide basic pensions that compensate for the basic family expenditure.

From <Table 1-5>, we see that the average basic family expenditure of households composed only of a husband aged 65 and over and a wife aged 60 and over is about JPY 118, 000. The total amount of old-age basic pensions of such a household is JPY 132,000, and so the benefit level may be said to be adequate enough to compensate for the basic family expenditure. In the same manner as in the case of the employee households, we can say that, even under the modified indexation, the benefit will maintain its purchasing power for the basic family expenditure. At the same time we have to continue to monitor it.

1.8 Concluding remarks

We have seen that the social security pension schemes in Japan have struggled to cope with the continuous improvement of mortality and the incessant decline of fertility for the last three decades. Every time the updated population projection showed mortality and fertility smaller than those assumed in the previous projection, pension reform discussions were restarted and fierce and fruitless political battle was repeated. To avoid such non-productive energy consumption, the 2004 reform introduced an automatic balancing mechanism through modified indexation.

Since the modified indexation automatically reduces the benefit level, we have to continue careful monitoring of it. At the moment it keeps some adequate level, but the elderly household distribution by type is changing and we have to adapt the schemes to such a change. At the same time we have to work out a method that enables us to monitor the benefit level in a comprehensive manner.

To conclude this paper we would like to refer to the relationship between the basic pensions and the social assistance programme. Sometimes people compare the benefit level of basic pensions with that of social assistance. <Table 1-6> shows some examples of social assistance benefits for the elderly. Sometimes it is slightly higher than the level of basic pensions.

<Table 1-6> Examples of social assistance benefit level for aged household in FY 2005

(the husband aged 68 and the wife aged 65)

Area	Large city center	Local city	Rural area
Monthly amount (JPY)	134,940	123,960	107,990

It should, however, be pointed out that it is not a proper way to compare in this way. The policy objectives of both schemes are totally different from each other. The social security pension schemes aim to prevent people from being impoverished by some risks in life like loss of earnings due to retirement while the social assistance programme helps impoverished people continue to live the life guaranteed by the Constitution. The social security pension schemes provide benefits as a definite legal right irrespective of one’s assets or income while the social assistance benefits are provided only when one has depleted all his assets. There is no explicit relationship between the benefit levels of these two programmes.

Although we have just stated that there is no explicit relationship between the benefit level of the basic pensions and that of the social assistance programme, it may be said that it should not happen that the modified indexation will have reduced the benefit level of basic pensions so much that majority of the self-employed people who have contributed to the NP scheme for 40 years are impoverished and eventually become social assistance beneficiaries. In order to avoid such situation, we have to continue to monitor the benefit level of basic pensions under the modified indexation.

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2. Old Age Income Protection in Australia*

Hazel Bateman

2.1 Introduction

Over the next few decades the structure of Australia's population will undergo a major change. The population is ageing because people are living longer and birth rates have declined. Over the past 50 years the life expectancy (at birth) of Australian men and women has increased by ten years to 79 and 82 respectively. Under reasonable assumptions, the next 50 years will see life expectancies extended by a further four to six years. Coupled with this increasing longevity, has been a significant decrease in fertility. Over the past 50 years, the fertility rate in Australia has fallen from around 3.5 births to just 1.7. The net impact is both a growing number of older persons, and an increase in the age dependency ratio. The over 65s, which accounted for 12.8% of the population in 2003, will increase to 26.1% by 2045, while the age dependency ratio is projected to more than double from around 20 percent today to over 40 percent by the mid 2040s. As a result, there will be increasing numbers of old people to support and fewer people of working age to provide that support. The number of workers per aged dependent, has fallen from over 8 workers for each retired person 50 years ago, to just 5 workers for each retiree today and is projected to fall to less than 2.5 over the next 50 years.

The combination of an ageing population and increased life expectancy will see an increase in government expenditure on age pensions, health and aged care. Recent government estimates suggest that by 2045 these aged related expenses will lead to a gap of around 6.5% of GDP between total government revenue and expenditure. In large part this will be due to a projected increase in health expenditures from 4% to around 8% GDP, in age care expenses from 0.7% to around 1.8% GDP and age pension expenses from 3% to nearly 5% GDP. (Productivity Commission 2005)

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The government has responded to this demographic change with reforms to both public and private retirement incomes policies over the past 20 years. This paper investigates after retirement income support in Australia with a focus on adequacy and sustainability in the event of population ageing. It is set out as follows: the next section describes the evolution of retirement income provision in Australia and summarizes current retirement income arrangements. Section 3 describes the characteristics and adequacy of incomes in retirement – both currently and in the future. In section 4 the policies and reforms introduced in Australia to alleviate the impacts of an ageing population and ensure retirement income adequacy are explained. Section 5 concludes with a discussion of outstanding policy issues and a menu of lessons for other countries contemplating reform of public and/or private pensions.

2.2 Retirement Income Provision in Australia [36]

2.2.1 Evolution of retirement income provision

Over the past 100 years retirement income provision in Australia has evolved into a multi-pillar arrangement comprising a public pension (called the Age Pension), mandatory private retirement saving (the Superannuation Guarantee), voluntary private retirement saving (voluntary superannuation) and other long term saving through property, shares and managed funds.

For most of the 1900s Australian retirement income policy comprised only two components (or pillars) – the means tested Age Pension and voluntary (but tax preferred) private retirement saving (superannuation). Superannuation saving has been tax preferred since 1914 when tax concessions were introduced for employer contributions and fund earnings (establishing an EET framework). Tax concessions for retirement benefits followed in 1936. Superannuation was initially uncommon, until after the Second World War. However, as recent as the mid-1980s, less than 50% of full time employees were covered by superannuation: private sector coverage was only around 30%, coverage of full time females even lower at around 25% and coverage of part time and casual workers was minimal.

Unlike many other developed countries, Australia did not introduce OECD-style social insurance. The international trend had

[36] For more details see Bateman, Kingston and Piggott (2001), Bateman (2005) and CCH (2006).

been to commence with a targeted age pension (social assistance) and then expand this to contributory PAYG public pensions (social insurance). Australia's failure to follow this trend was more of a matter of historical and political accident than of any consistent policy as there were at least five unsuccessful attempts to introduce such a policy (in 1913, 1928, 1938, 1940s and 1970s).

However, there were ongoing concerns about retirement income adequacy. Current retirement income policy is framed by policy developments of the 1970s and 1980s, where the focus was to increase voluntary superannuation (rather than introduce earnings-related public pensions). Coincidentally these developments coincided with concerns by the trade union movement about the equity of access to superannuation benefits.

When a Labor Government was elected in March 1983, a major part of its economic strategy was a continuing contract with the union movement, known as the 'Accord'. The Accord, included the idea of building superannuation contributions into the national centralised wage decision. This materialised in 1986, when it was agreed that while the increase in compensation to employees should be 6%, to keep pace with inflation, half of the increase would accrue in the form of a 3% employer superannuation contribution, to be paid into an individual account in an industry fund. This was known as productivity award superannuation. While this fell short of mandatory private retirement saving, it was the genesis of the current Superannuation Guarantee.

The introduction of productivity award superannuation led to large increases in the coverage of occupational superannuation. Over the next three years, as individual industrial award agreements were negotiated and ratified under the umbrella of the 1986 national wage case decision, superannuation coverage increased markedly, particularly in the private sector and in industries dominated by women, part-time and casual workers. [37] Overall coverage of superannuation doubled from 40% to nearly 80%.

However, superannuation provided through industrial awards proved difficult to enforce and its implementation required that superannuation provisions be included in each and every industrial award. As a result, the government introduced the Superannuation Guarantee, which required all employers to make superannuation contributions of 9% earnings on behalf of their employees. Superannuation coverage has continued to grow, reaching over 90%

[37] Australia no longer has centralized wage fixation.

of employees (and close to 100% of full time employees) by the early years of the 21st century.[38]

2.2.2 Components of current retirement income provision

First Pillar: The Age Pension

The Age Pension was introduced in 1909 as a general-revenue financed, means tested, safety net payment for the retired. The Age Pension is universal to the extent that all residents of qualifying age are eligible, but targeted to the extent that it is subject to income and assets means tests.

For most of the period since its commencement in 1909 the Age Pension has served as the social welfare safety net for the elderly and, in the absence of a mandatory retirement savings pillar until the final decade of the 20th century, has been the main source of retirement income for most retired people. In 2006 around 80% of the retired of eligible age received some Age Pension – of which around two thirds were paid at the full rate (Department of Family and Community Services and Indigenous Affairs 2006).

The Age Pension is payable to elderly Australians who satisfy residency, age and means test requirements. Women can claim the age pension from age 63 years (increasing to 65 by 2014) and men from age 65 years. The Age Pension is means tested by either a person's income or assets - whichever determines the lower rate of pension. It is indexed to the greater of the growth of the Consumer Price Index (CPI) and male average earnings.

A higher rate of pension is payable to a single person than to each member of a married couple. In January 2007 the annual Age Pension will be $A13,314.60 for single persons (around 25% of average male earnings) and $A11,120.20 (around 20% of average male earnings) for each of a married couple. Net replacement rates are higher (closer to 40% for single retirees) as the Age Pension is exempt from income tax.

Eligibility for the Age Pension brings with it access to other payments and allowances, including: a pharmaceutical allowance, the pension concession card, rent assistance, remote area allowance, telephone allowance etc.

A recent initiative is the Pension Bonus scheme, which is designed to encourage persons of retirement age to defer claiming the Age Pension. Under the scheme a tax-free lump sum bonus is

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[38] A detailed discussion of the historical background can be found in Bateman and Piggott (1997) and Bateman and Piggott (1998).

available to those who defer claiming the Age Pension for a minimum of 12 months, up to a maximum of 5 years. When the person finally retires they receive the bonus and the Age Pension.[39]

Current means testing

As noted earlier, the Australian Age Pension is means tested by both income and assets. Under the current income test the Age Pension is withdrawn at the rate of 40 cents for each dollar of private income above a free area of $A64 per week (or $A114 per week for a pensioner couple). Private income includes: income from financial investments, cash, bank accounts, bonds, managed funds, shares, deferred annuities, business income, and income from trusts, property and superannuation. For simplification purposes, the income test applies to 'deemed' rather than actual income for many financial investments. Under the current rules no part pension is available under the income test once annual income exceeds $A36,991.50 pa for a single person (around two thirds of male average earnings) or $A61,906 pa for a couple.

The assets test reduces the Age Pension by $A1.50 per week for every $A1,000 of assets above statutory thresholds. Currently these are $A161,500 for a single homeowner, $A229,000 (married homeowner couple), $A278,500 (single non-homeowner) and $A346,000 (married homeowner couple). The retiree's own home is excluded. Assets included are home contents, cars, boats, rental properties, the capital value of investments, money in the bank, outstanding loans, the value of a business, and gifts in excess of $A10,000 in any financial year (or in excess of $A30,000 over a 5 year period). The test paying the lower rate of Age Pension applies.

A rationale for means testing

As noted earlier, the Australian public Age Pension has been means tested against both income and assets for nearly 100 years. However, means testing is often criticised on the basis that it results in high effective marginal tax rates, the intrusion and stigma associated with determining eligibility, and the possibility of a weakening of the political power of the poor. On the other hand, means tested public benefits are more sustainable, as less government revenue is required to finance poverty alleviation, and

[39] Eligibility for the Bonus Scheme includes a 20 hours a week work requirement. When paid the bonus is equal to 9.4% of the Age Pension for each year the Age Pension is deferred – eg single person eligible for full age pension and defer one year, bonus is $A1,135, 5 years - $A26,363.

may actually result in less overall distortions and less tax revenue is required to finance means tested as opposed to universal pensions (Mitchell *et al* 1994).

However, public policy design can reduce the impacts of means testing. For example, under the Australian Age Pension, the income and assets tests apply above thresholds, the income test taper is 40 cents per dollar of private income (not dollar for dollar) and the Age Pension is tax free (so the withdrawal of public benefits is not associated with simultaneous taxation of private benefits). In Australia, the maximum effective marginal tax rate for age pensioners is 40%.

Second Pillar: Mandatory Private Retirement Saving – The Superannuation Guarantee

The Superannuation Guarantee was introduced in 1992. Under the Superannuation Guarantee employers are required to make superannuation contributions of at least 9% of earnings on behalf of their employees to a superannuation fund. The arrangements apply to all employers and to almost all employees earning more than $A450 per month (around 10% of average male earnings).[40] The self-employed are not covered by the mandatory arrangements,, although tax concessions apply for voluntary contributions. The mandatory contributions are fully preserved until the statutory preservation age for access to benefits is reached – currently age 55, increasing to age 60 by 2024. Superannuation contributors can choose the superannuation fund into which there contributions are made, and many superannuation funds offer considerable choice of investment options and strategies. In this regard, the Australian superannuation industry is characterised by its diversity, with contributors able to choose between non profit and for profit funds; single employer, multi employer (industry) funds or funds offered in the retail sector; or may choose to manage their own superannuation fund. The current superannuation industry is summarised in Table 1 below.

[40] This decision was made largely on the grounds of high administration costs on small amount accounts.

<Table 2-1> The Australian superannuation industry at June 2006

	Assets($A billion)	Number of funds
Fund type		
- Corporate	54.3	557
- Industry	154.6	84
- Public sector	152.3	42
- Retail	294.6	187
Sub total (large funds)	**655.8**	**870**
Self managed *	258.1	326,962
Total	**913.9**	**327,832**

*Includes self managed superannuation funds and balance of life office statutory funds

Source: APRA Quarterly Superannuation Statistics, June 2006 – APRA (2006)

The superannuation funds are managed by boards or trustees who are subject to the prudent person rule. As a result, there is little regulation of fund investments (with the exception of a 5% maximum invested in in-house assets) and no rate of return requirements. The superannuation industry is supervised by the financial industry regulator – the Australian Prudential Regulatory Authority (APRA).

However, superannuation saving is subject to a complex tax regime whereby:

- ☐ Employer contributions are generally tax deductible, employee contributions are not tax deductible but may be eligible for tax concessions or government co-contributions, and special tax concessions apply for spouse contributions;
- ☐ Superannuation fund earnings are taxed, but at different rates depending upon the income type; and
- ☐ Until June 2007, benefits are taxed at different rates depending upon type of benefit, age of taxpayer and size of benefit, and an annuity rebate is available to offset tax on some retirement income streams. From July 2007, all superannuation benefits taken after age 60 will be free of tax.

Third Pillar: Voluntary Retirement Saving

Voluntary retirement saving includes voluntary occupational superannuation, personal superannuation and other forms of long term saving through property, shares, managed investments and home-ownership. Voluntary occupational superannuation is long standing and has been available to public sector workers and middle to high-income workers in the private sector for many decades. In the past benefits were based on defined benefits, but these are increasingly being replaced by defined contribution schemes. Voluntary superannuation is reasonably prevalent. In 2000 around 36% of employees made voluntary contributions to superannuation (ABS 2000a). Interestingly, coverage is higher for older than younger employees with around 7% of 15-19 year olds and 46% of 45-54 year olds making personal contributions. Other data suggests that around 27% of employees receive employer contributions greater than the Superannuation Guarantee level, while 20% of all employees make voluntary post-tax contributions (Bingham 2003). Homeownership is probably the most important non-superannuation asset for most Australians: in 2003, dwellings accounted for 65% of total Australian household assets, with around 85% of retirees owning their home.

For the self-employed, concessions under the capital gains tax exist to encourage rollover of the proceeds of the sale of a business into superannuation. However, the extent of take-up of this incentive is unclear.

2.2.3 Superannuation coverage in aggregate

In aggregate 90.4% of total employees have superannuation provided by their current employer, comprising around 96% of full time employees and 78% of part time employees – as detailed in Table 2. However, these broad aggregates hide some important trends. For example, of the part time workers, average superannuation coverage for males is 68% compared with 82% for females. As well, only 72% of casual workers (which may be part time or full time) are covered by superannuation (by their current employer and/or personal contributions). In other words 28% of casual workers remain uncovered by superannuation. As well, only 73% of the self employed are covered by superannuation (or 27% of the self employed remain uncovered by superannuation). Female coverage is higher than males across all categories, and public sector coverage is greater than private sector coverage for both full time and part time employees.

<Table 2-2> Superannuation provided by current employer (%), August 2005

	Males	Females	Total
Employees – total	**91.1**	**89.7**	**90.4**
Employees – full time	**95.0**	**96.7**	**95.6**
-Public sector	98.8	98.6	98.7
- Private sector	94.3	96.0	94.9
Employees – part time	**67.7**	**81.8**	**78.2**
- Public sector	84.7	95.8	93.9
- Private sector	65.8	78.7	75.1

Source: Employee Earnings, Benefits and Trade Union Membership, Australia, ABS 6310.0, Table 15. August 2005.

2.3 Incomes in Retirement

This section outlines the types of retirement benefits available in Australia, the take-up of these benefits and current and future retirement income prospects.

2.3.1 Types of retirement benefits

In retirement, elderly Australians are eligible for the means tested public Age Pension (from age 65 for males and 63 for females) and can access any superannuation accumulated under the Superannuation Guarantee or voluntary superannuation once the preservation age (currently age 55, increasing to age 60 by 2024) is reached. There is no mandatory requirement to take any part of the superannuation accumulation as an income stream, although until recently (before the May 2006 Budget) income streams were encouraged through tax concessions and the Age Pension means tests. In particular, indexed lifetime annuities or indexed term annuities for at least life expectancy were encouraged. However, it was unclear whether these incentives affected the long-term preference for lump sum benefits.

Because superannuation accumulations do not have to be taken as a particular type of income stream – and has generally been taken as a lump sum - a range of retirement income stream products have evolved. There are three main categories – superannuation pensions, annuities and allocated pensions.

- Superannuation pensions are lifetime income streams paid by superannuation funds, generally under defined benefit schemes. In recent years, most defined benefit schemes have been replaced by defined contributions arrangements.
- Annuities are sold by life insurance companies. Current products include fixed amount or indexed annuities for life or an agreed term (including life expectancy at retirement).
- Allocated pensions and annuities are effectively phased withdrawals from a retirement accumulation. Under current rules annual income payments must lie between statutory minimum and maximum amounts and choice of asset allocation is allowed. These products are offered by a range of financial institutions.
- Term allocated pensions have been available since September 2004. This product has features of both annuities and allocated pensions. It is similar to an allocated pension in that there is choice of asset allocation and payments are linked to the performance of underlying assets. However, like an annuity it is payable for a fixed term (of between life expectancy and life expectancy plus 5 years) and is non-commutable.

As noted earlier, under the Age Pension means tests, the Age Pension is withdrawn where private retirement income and assets exceed statutory thresholds. The Age Pension means tests do not distinguish between private mandatory retirement saving (the Superannuation Guarantee) and voluntary retirement saving. However, they do distinguish between the types of retirement benefit, although this distinction will be less pronounced when the Budget 2006 reforms take effect from July 2007.

Where a lump sum is taken and used to purchase financial assets, the capital value is assessed under the assets test and 'deemed' income is subject to the income test.[41] Where a retirement income stream is purchased, from July 2007, the assets test will apply to the capital value of the product, while actual income (adjusted for

[41] A lump sum that is taken and dissipated is not counted under the means tests.

return of capital) is subject to the income test. Prior to July 2007, the means tests apply differently depending on the product type. Products with a term of at least life expectancy receive greatest preference. The recent changes were made on the grounds of simplicity.

2.3.2 How do current retirees fund their retirement?

Nearly 80% of current retirees receive the Age Pension and two thirds of these receive the full rate of Age Pension. However, this is not really surprising. It is only in the last 15 years that superannuation coverage has exceeded 50% of workers, so it will be several decades before these workers retire with sufficient private savings. However, as noted earlier, the universal Age Pension ensures that all (single) elderly Australians are in receipt of a lifetime, indexed retirement benefit of at least 37% of male average earnings (or 49% of median male earnings) – and slightly less for each member of a retired married couple.

However, the superannuation accumulations of current retirees are quite small. APRA data for the June Quarter 2005, showed that the average size of a superannuation accumulation (for members of a standard superannuation fund) was $A25,800. On the assumption that each member has an average of 2.5 accounts, this suggests an average accumulation of around only $A64,500. Similarly, it has been estimated, that in 2006 the median superannuation balance of 55-60 year olds was only $A75,000, which if converted to a life annuity at age 65, would provide an income of only $A63 per week.[42] To put these numbers into context, a superannuation accumulation of around $A250,000 would be required to fund a retirement income equivalent to the public Age Pension.

It is noted, however that these low superannuation accumulations for current retirees are the product of previous policies, whereby less than 50% of workers were covered by voluntary superannuation and preservation of benefits to retirement was not mandatory.

t is therefore not surprising that the Age Pension is still the main source of income in retirement and that most superannuants take lump sum benefits. The Survey of Employment Arrangements and Superannuation conducted by the Australian Bureau of Statistics in 2000 showed that around 66% of retired people received only lump sum superannuation benefits, 21% received both a lump sum and an income stream and 13% received an income stream only (ABS

[42] Author's calculations, using information from RIM (2006).

2000b). Interestingly, this survey also showed that retirees used only around 50% of their lump sums for retirement income purposes. Of the lump sum recipients surveyed:

- 42% had used their lump sum to buy or pay off a home, make home improvements, pay off a car or settle outstanding debts;
- 23% had rolled the lump sum over or invested it in an approved deposit fund, annuity or another superannuation scheme; and
- 28% invested the lump sum elsewhere. (ABS 2000b).

Of those retirees who take retirement income streams, there is an overwhelming preference for allocated pensions or annuities. Table 3 summarises recent trends. In 2006 allocated products had the largest share of the market comprising around 91% of retirement income streams purchased with eligible termination payments. Lifetime annuities accounted for a very small proportion of total sales, as did the term allocated pensions introduced in 2004. However, in the first 3 months of 2006, sales of term allocated pensions increased by 16.4%, which offset the fall of around 15% in sales of term annuities (IFSA 2006).

<Table 2-3> Retirement Income Streams, Market Shares (March 2006)

Type of retirement income stream	Market share %	Sales in last 12 months, $A m	Average purchase price (in last 3 months), $
Allocated pensions	84	11,046	121,500
Allocated annuities	7	89	199,200
Term annuities	7	518	87,833
Lifetime annuities	1	11	103,900
Term allocated pensions	1	512	114,500
Total	**100**	**9,260**	**102,400**

Source: IFSA Retirement Income Streams Report (March 2006).

2.3.3 How will retirees fund their retirement in the future?

With almost all employees now covered by the Superannuation Guarantee, many workers with additional occupational or personal superannuation coverage and improvements in vesting, portability and preservation, the composition of retirement income, will change in future years as more Australians retire with a working life of superannuation contributions. The Treasury's Retirement Income Modelling Unit (RIM) estimate that a single male on median earnings with 34 years of Superannuation Guarantee contributions could expect to retire with a total (Age Pension plus superannuation) replacement rate of 76%. This would increase to 85% if contributions were made for 40 years. In both cases the total retirement income would comprise a part Age Pension and an income stream purchased from superannuation accumulation (RIM 2006). If these estimates were realized, by 2050, 25% of the retired would receive no Age Pension, 40% of the retired would receive a part pension and only 25% of the retired would receive a full pension (compared with nearly 55% currently. (Department of Family and Community Services 2002).

An indication of possible future net retirement replacement rates for workers with a full working life of mandatory superannuation is shown in <Fig. 2-1> below. In the absence of any superannuation, the net of taxes replacement rate associated with the full rate public Age Pension is 37% for a single male worker on average earnings and just under 50% for a single male worker on median earnings. These amounts are well in excess of any reasonable poverty. However replacement rates will increase, the greater is the amount of the superannuation accumulation at retirement. For example, 34 years of the 9% Superannuation Guarantee will generate a net total retirement replacement rate of 65% for a single male worker on average earnings or 76% the for median worker (RIM 2006). This will comprise both privately provided retirement benefits and a part public Age Pension.

<Fig. 2-1> Future retirement incomes –replacement rates for a single male after 34 years contributions

Source: Derived from RIM (2006)

2.4 Reforms to public and private pensions

The policy goals of the government in relation to retirement incomes are twofold. Firstly, to minimize aged-related expenditures on the publicly provided Age Pension, and secondly to increase the coverage and adequacy of incomes in retirement – specifically through superannuation.

In summary, the policy initiatives introduced to achieve these goals, can be summarized as policies to increase private saving for retirement, policies to increase the labour force participation of older workers, and policies to reduce public expenditure on the Age Pensions and associated benefits. These policy initiatives will be discussed first in terms of the reforms introduced before 2006, and then the policy reforms announced in the 2006 Budget.

2.4.1 Superannuation reforms before 2006

The centerpiece of the retirement income policy reforms was the introduction of the 9% Superannuation Guarantee in 1992. For those with a lifetime of superannuation contributions, the

Superannuation Guarantee will both increase retirement income adequacy, while reducing public expenditure on the Age Pension. Importantly the Superannuation Guarantee has had the effect of increasing the coverage of superannuation to around 96% of full time workers.

While there have been a wide range of reforms over the past 20 years or so, they are broadly unified to the extent that they provide a framework for additional contributions above and beyond the mandatory 9% floor – and therefore will work to increase adequacy of retirement incomes while reducing eligibility for the Age Pension. Specific policies introduced between 1992 and 2006 include [43]:

- The introduction of mandatory superannuation contributions (the Superannuation Guarantee) in 1992.
- Initiatives to provide greater choice in the nature and timing of voluntary employee and personal superannuation contributions, including the introduction of the government co-contribution in 2003, tax rebates for spouse contributions and the extension of the age for which contributions to superannuation can be made, to age 75 (subject to a work test).[44]
- Initiatives which remove (or lessen) the nexus between superannuation contributions and employment (and provide greater flexibility in labour force participation) by allowing any persons under 65 to make contributions to a superannuation fund, irrespective of their participation in the workforce (previous persons had to be employed to be able to make superannuation contributions); allowing the splitting of superannuation contributions with a spouse (since 2006); and providing tax rebates for contributions made on behalf of a low income or non working spouse.

[43] See Bateman (2006)..

[44] In particular, the government co-contribution provides significant incentives for low to middle income earners to make additional superannuation contributions by virtue of a government contribution equal to 150% of eligible personal contributions to a maximum of $A1,500 pa for employees with assessable incomes up to $A28,000 pa, and a part government contribution for those on incomes up to $A58,000.

- Initiatives to provide greater flexibility in the timing of retirement (and increase the labour force participation of older workers) by virtue of the policy, implemented from 2005, which allows superannuants to remain in the workforce, while receiving their superannuation benefits as a non commutable income stream.
- Previously superannuation benefits could only be accessed upon retirement.
- Policies to provide greater institutional and product choice for retirement savers including member choice of superannuation fund (from 2005) and legislative authority for a wider range of income streams. Income streams now supported by the legislative framework include allocated pensions and annuities; lifetime, life expectancy and other term annuities; and forms of variable annuities. It was anticipated that these initiatives would increase the take-up of retirement income streams.
- Policies to improve the regulation of the superannuation industry and the disclosure of financial products – and thereby support the increased institutional and product choice, including the operation of the Superannuation Industry Supervision Act (from 1993) which strengthened the regulation of the industry and the introduction of financial services regulatory regime by virtue of the Financial Services Reform (FSR) Act 2001 which imposed standards for product disclosure and for the licensing and conduct of financial services providers and financial markets.
- Policies to improve the sustainability of the Age Pension and address future expenditures on unfunded public sector superannuation benefits – including the introduction of a pension bonus scheme to defer retirement, and the establishment of the Future Fund to finance the 'unfunded' superannuation benefits of many public sector workers.
- Reforms to the Age Pension means tests to reduce the disincentive effects possibly associated with means testing. These include the adoption of a less steep taper under the incomes test, an increase in means test free thresholds, and the removal of income taxes on

the public Age Pension and tax concessions for superannuation benefits.

2.4.2 Retirement income reforms announced in the May 2006 Budget

In its 2006 Budget, the Australian government included proposals to further modify the superannuation arrangements in its 'Plan to Simplify and Streamline Superannuation' (see Treasury 2006a and 2006b). These proposals represent a continuation of the shift in superannuation policies towards individual choice through their focus on reducing complexity while increasing flexibility. In brief, the proposals centred on the removal of all taxes on superannuation benefits (both lump sums and income streams), a simplification of the age pension means tests and of the tax rules providing tax deductibility for superannuation contributions, a further dilution of the nexus between superannuation and employment, and the removal of the differential taxation of superannuation contributions between employees and the self-employed.[45] As in recent years, the aim of these reforms was to increase (voluntary) superannuation coverage, and thereby increase the coverage and adequacy of private retirement saving. The main superannuation proposals announced in the 2006 Commonwealth Budget included:

- The removal of taxes on superannuation benefits. Since 1988, superannuation has been taxed at all three possible points – contributions, fund earnings and benefits – albeit at concessional rates. However, largely as a result of grandfathering arrangements, the current taxation of lump sums can include up to eight parts, taxed in seven different ways, while the taxation of income streams depends on the specific type of income stream, may include exempt components and may be subject to various tax rebates. The 2006 Budget announced a proposal to remove all taxes on superannuation benefits, both lump sums and income streams, for people aged 60 and over (with a lower rate of tax for benefits paid from an untaxed scheme).[46]

[45] For further details see Treasury (2006a, 2006b).

[46] Except benefits paid from a scheme for which contribution and earnings cannot be taxed for constitutional reasons (such as some public sector schemes).

- A simplification of the age pension means tests. The 2006 Budget proposals also include a reduction in the age pension assets test taper rate from $A3 to $A1.50 per fortnight, and the removal of asset test concessions for specific income streams. It is anticipated that these proposals will improve the adequacy of total retirement incomes, while complementing the simplification introduced by the exemption from taxation of all retirement benefits.
- A simplification of the tax rules relating to contributions to superannuation. The proposals to simplify the taxation of superannuation contributions include the unification of the tax treatment of superannuation contributions for employees and the self employed. This has resulted in increased incentives for the self employed to make superannuation contributions.

In terms of the adequacy and sustainability of retirement incomes, the above reforms are likely to lead to greater private retirement through superannuation (both in average amounts and in terms of coverage). Under a means tested Age Pension, this translates to lower government expenditures on the public Age Pension.

2.5 Discussion and lessons

The main lessons from the Australian arrangements for countries considering reform of their retirement income arrangements include:

- The ability of mandatory private retirement saving in Australia (the Superannuation Guarantee) to increase the coverage and amount of retirement benefits;
- The ability of tax concessions and labour market flexibility to increase voluntary retirement saving;
- The workings of a means-tested Age Pension which automatically reduce public expenditure on the Age Pension with increases in private retirement provision; and
- The design of the Age Pensions means tests so as to minimize the disincentives associated with means testing.

However, there are also a number of outstanding policy issues which need to be addressed to ensure the adequacy and sustainability of retirement incomes in Australia. These include: the failure to mandate retirement income streams, the increasing complexity of choices required to be made by individuals, the regressive impact of the recent reforms to the taxation of superannuation and issues associated with retirement income adequacy for workers with discontinuous labour force participation.

Failure to mandate income streams

Australian retirement income policy allows retirees to take their private retirement saving (superannuation) benefits as either a lump sum or an annuity. That is, there is no mandatory annuity purchase with any part of the retirement accumulation. As well, the incentives to take income streams in the tax system and under the Age Pension means tests were abolished in the 2006 Budget (in the name of simplicity). This is of particular concern as it exposes retirees to longevity and inflation risk in retirement if they do not invest their lump sum accumulation appropriately. As discussed earlier, only 10% of the total value of retirement benefits is used to purchase income streams and only 10% of this amount is used to purchase a lifetime, indexed annuity – the best source of insurance against longevity and inflation risk.

Moreover, it is often argued that the take-up of life annuities is low due to the high cost of annuity purchase (due to administrative loadings and adverse selection). Once of the ways of reducing adverse selection in the annuities market would be to mandate annuity purchase, with at least part of one's retirement accumulation.

Finally, failure to mandate retirement income streams, in conjunction with the design of the Age Pension means tests, can lead to moral hazard issues. That is, retirees may dissipate their lump sum benefits, or make inappropriate investments, and then become eligible for the public age pension. [47]

Increasing complexity of choices

The Australian private retirement saving (superannuation) requires individual retirement savers to undertake an increasing

[47] Analysis of the optimal asset allocation of retirement assets suggests that current retirees may be pursuing overly risky asset allocations for their allocated pensions, possibly due to the existence of the public age pension (Bateman, Kingston and Thorp 2006).

number of choices. These include, choice of pension (superannuation) fund; choice of investment strategy (which may include choosing from a menu of multi manager diversified and specialized options, specific investment managers and/or specific investment managers or asset classes); whether to make additional voluntary contributions; and choice of retirement benefit. All of these options are associated with different fees, charges and risk adjusted rates of return, and therefore have differing implications for retirement income adequacy. (Bateman and Mitchell 2004, Bateman and Thorp 2006). A particular challenge for Australian retirement income policy is to ensure that consumers (retirement savers) are able to make informed decisions. This raises questions in relation to the provision of financial education and the role of financial planning.

The regressive nature of the Budget 2006 superannuation tax initiatives

As noted earlier, Budget 2006 included an initiative to abolish all taxes on retirement benefits (for persons aged 60 and over). This changed the tax regime for superannuation from TTT to TTE and was justified by the government on the grounds of improving both simplicity and retirement income adequacy. However, there are concerns with this approach. First, it is likely that incentives to encourage voluntary superannuation contributions would be more effective were the tax on contributions, rather than benefits abolished. Second, the new tax regime still includes the taxation of superannuation fund earnings – which is detrimental to economic efficiency. Third, the taxation of retirement benefits was the only part of the superannuation tax regime which applied some form of progressivity to the taxation of retirement saving. Finally, it is unclear whether the non taxation of retirement benefits is sustainable in an economy that faces an estimated fiscal gap of 6.4% GDP by the year 2045. An alternative tax reform would be the EET regime. This would simplify the tax arrangements, provide a greater incentive for voluntary contributions and provide a source of tax revenue when the proportion of workers to retirees significantly increases.

Ongoing questions of retirement income adequacy

While all Australians of age pension age are eligible for the public Age Pension, the link between superannuation accumulations and labour force participation patterns raises questions about the adequacy of total retirement incomes. Those at risk of relatively low total retirement incomes include persons out of the labour force, or with discontinuous labour force participation and those on permanently low incomes. An ongoing policy question includes how to ensure equity in retirement incomes for such 'non standard' workers.

Overall, however, while there is room for improved policy design, the Australian retirement income arrangements are far more sustainable in the event of an ageing population than those of many other developed economies.

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3. Pensions and Pension Reform in the United States: A Historical Perspective on Social Security

Robert Lieberman

3.1 Pensions and Pension Reform in the United States: A Historical Perspective on Social Security

In recent years, the status and future of American public old-age pensions have been at the center of political controversy in the United States. Despite its apparent fiscal health and deep political support, Social Security has recently found itself at the center of a political firestorm. The coming retirement of the baby boom generation has led to dire warnings about the impending "bankruptcy" of the system and the potential collapse of this heretofore stable foundation of the American welfare state and the basic source of income security for older Americans. The confidence that Americans — especially younger Americans — once placed in Social Security as a prospective source of support in retirement has eroded (although not as much as the most alarmist analyses suggest).[48] During the 2000 presidential campaign, Texas Governor George W. Bush advanced a plan to establish a parallel system of private retirement investment accounts alongside Social Security's system of public pensions, while his opponent, Vice President Albert Gore defended the program's traditional structure, speaking cryptically in one of the televised debates of putting Social Security's funds into a "lockbox" as a way of safeguarding its future. Although Governor Bush won the election, his plan for Social Security reform has not been successful, and the challenge of securing the future of retirement pensions in the United States remains on the national agenda.

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48 Andrea Louise Campbell, *How Policies Make Citizens: Senior Political Activism and the American Welfare State* (Princeton: Princeton University Press, 2003), 97-98.

Despite the rhetoric of crisis that both Bush and Gore adopted in the 2000 campaign, the fiscal and political challenges facing Social Security are not new. Rather, such challenges are inherent in the program's very structure, and they form part of a chronological pattern of political development and policy adjustment that have characterized the entire history of Social Security. In this essay I survey that history and suggest that the current challenges of retirement income in the United States are neither extraordinary nor even particularly unusual. I begin by describing the political origins of Social Security in the Great Depression and the New Deal. I then show how the program's political and fiscal structure shaped its development and maturity, and I set the recent controversies in this context. I conclude with some reflections on the program's current and future prospects.

3.2 The Origins of Social Security

Compared with other advanced industrial countries, the United States was a latecomer to national public old-age pensions. Whereas European countries such as Germany and the United Kingdom had adopted old-age pensions of various kinds in the late nineteenth and early twentieth centuries, the movement for comparable pensions in the United States was not successful until the middle of the twentieth century. After the Civil War of 1861-1865, the United States enacted pensions for Civil War veterans of the Union (Northern) army that grew, over the late nineteenth century, into a large system of pension payments for a limited segment of the population. But these pensions were increasingly associated with the intense partisan politics and political corruption that characterized American politics in this period, and so never developed further into a more comprehensive system of universal workingmen's pensions that would cover those who were not eligible for Civil War pensions — such as Southerners and the growing number of working-class immigrants who had arrived in the United States too late to have fought in the war. During the Progressive Era of the early twentieth century, an extensive movement for the adoption of old-age pensions for workers failed to take hold, leaving the United States without a national system of old-age pensions at the beginning of the Great Depression of the 1930s.[49]

When President Franklin D. Roosevelt proposed what became the Social Security Act of 1935, he envisioned a comprehensive and coordinated program of economic security under the close direction of the federal government[50] As Roosevelt conceived of Social Security, it would promote what T. H. Marshall would later call the "social rights" of citizenship, ranging "from the right to a modicum of economic welfare and security to the right to share to the full in the social heritage and to live the life of a civilized being according to the standards prevailing in the society."[51] He wanted to build a program of public social provision that would protect Americans against the "hazards and vicissitudes of life," encompassing assistance for the elderly, the unemployed, the sick and disabled, and families and children. "I see no reason," he told his secretary of labor, Frances Perkins, "why everybody in the United States should not be covered" by such protections. "I see no reason why every child, from the day he is born, shouldn't be a member of the social security system. . . . And there is no reason why just the industrial workers should get the benefit of this. Everybody ought to be in on it — the farmer and his wife and his family. I don't see why not. . . . Cradle to the grave — from the cradle to the grave they ought to be in a social insurance system."[52]

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[49] Theda Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (Cambridge: Harvard University Press, 1992); Ann Shola Orloff, *The Politics of Pensions: A Comparative Analysis of Britain, Canada, and the United States, 1880-1940* (Madison: University of Wisconsin Press, 1993).

[50] Thomas H. Eliot, *Recollections of the New Deal: When the People Mattered* (Boston: Northeastern University Press, 1992), 110.

[51] T. H. Marshall, "Citizenship and Social Class," in *Class, Citizenship, and Social Development* (Garden City, N.Y.: Doubleday, 1964), 72.

[52] The "cradle to grave" formulation is most famously associated with the Beveridge Report, William Beveridge's 1942 planning document for postwar British social security policy, although the phrase does not appear in the report itself. Roosevelt did not use the phrase publicly until his 1943 state of the union message, where it was inserted by Social Security Board Chairman Arthur Altmeyer. Roosevelt, however, privately expressed irritation at the attribution to Beveridge. Franklin D. Roosevelt, "Message to the Congress Reviewing the Broad Objectives and Accomplishments of the Administration, June 8, 1934," in *The Public Papers and Addresses of Franklin D. Roosevelt,* ed. Samuel I. Rosenman (New York: Random House, 1938), 3: 291; Frances Perkins, *The Roosevelt I Knew* (New York: Viking, 1946), 282-84; *Social Insurance and Allied Services,* Cmd. 6404 (1942); Arthur J. Altmeyer, *The Formative Years of Social Security* (Madison: University of Wisconsin Press, 1968), 141-42;

Initially embedded in a broad economic security program that emphasized jobs for those who could work and relief for those who could not, the act was intended to complement programs such as the Works Progress Administration, which employed millions of people, and the National Labor Relations (Wagner) and Fair Labor Standards Acts, which extended labor rights and sought to create a reasonable standard of living for workers and their families. But the jobs component of the New Deal withered in the late 1930s and 1940s, leaving the Social Security Act as the key structural template of the modern American welfare state.[53]

Perhaps the central institutional principle that shaped the structure of the Social Security Act was federalism. Under the view of federalism that prevailed before the New Deal, the public welfare functions of the state were generally understood to be reserved exclusively for the states.[54] Many states had already adopted social provision policies in the early twentieth century — including pensions for single mothers and the elderly poor and workmen's compensation policies — although during the Depression states were largely unable to finance these benefits.[55] Some states had begun to develop unemployment insurance policies in the early 1930s and one, Wisconsin, had actually adopted unemployment insurance, before the passage of the Social Security Act[56] Although the Roosevelt administration understood that it was proposing dramatic expansion of the federal government's welfare responsibilities, it also recognized that it would have to accommodate the federalist structure of American politics. The Supreme Court, in particular, seemed to pose an obstacle to the

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Jonathan Alter, *The Defining Moment: FDR's Hundred Days and the Triumph of Hope* (New York: Simon and Schuster, 2006), 312.

[53] U.S. Committee on Economic Security, *Report to the President* (Washington: Government Printing Office, 1935), 3-4, 8-9; Edwin E. Witte, *The Development of the Social Security Act* (Madison: University of Wisconsin Press, 1962), 21, 27, 31, 128; Margaret Weir, *Politics and Jobs: The Boundaries of Employment Policy in the United States* (Princeton: Princeton University Press, 1992); Edwin Amenta, *Bold Relief: Institutional Politics and the Origins of Modern American Social Policy* (Princeton: Princeton University Press, 1998).

[54] William J. Novak, *The People's Welfare: Law and Regulation in Nineteenth-Century America* (Chapel Hill: University of North Carolina Press, 1996); Paul E. Peterson, *The Price of Federalism* (Washington: Brookings Institution, 1995).

[55] Skocpol, *Protecting Soldiers and Mothers;* Christopher Howard, "Workers' Compensation, Federalism, and the Heavy Hand of History," *Studies in American Political Development* 16 (2002): 28-47.

[56] Edwin Amenta, Elisabeth S. Clemens, Jefren Olsen, Sunita Parikh, and Theda Skocpol, "The Political Origins of Unemployment Insurance in Five American States," *Studies in American Political Development* 2 (1987): 137-82.

nationalization of social policy. The court's conservative majority had proved hostile to the expansion of national regulatory power in the early years of the New Deal, and Social Security's framers were tremendously anxious about the court's receptivity to a national program of social provision.[57] The court had, however, sanctioned federal grants to underwrite state programs in a variety of areas, such as highway construction, vocational education, and public health, and this cooperative approach was the model for most New Deal social policy.[58] Moreover, Congress would certainly not have passed legislation creating a fully national program of social security. From the 1930s to the 1970s, Congress was dominated by Southern Democrats, a diverse lot united primarily in their commitment to preserving white supremacy and segregation in the South. Southerners were especially wary of federal domination of domestic policy, especially in areas affecting civil rights and labor relations.[59]

But no state had yet contemplated a system of contributory old-age pensions like those in Europe.[60] Nevertheless, the architects of Social Security sought ways of devising a cooperative national-state system of old-age insurance in order to make it conform to the dominant federalist model of social welfare policy. Thomas Eliot, the act's chief legal draftsman, recounts that he spent "an awful lot of time . . . trying to figure out how . . . state old age insurance schemes could be encouraged" in lieu of constructing an entirely national program. "As I recall it," Eliot said in a 1966 interview, "the early part of fall 1934 I was drafting a lot of plans and talking with a great many people and getting ideas. There wasn't anything that anybody could dream up that made much sense."[61] In the end, it proved impossible to devise a state-by-state system of old-age

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[57] Arthur M. Schlesinger Jr., *The Politics of Upheaval* (Boston: Houghton Mifflin, 1960), 252-55, 275-80; Perkins, *The Roosevelt I Knew,* 286.

[58] V. O. Key Jr., *The Administration of Federal Grants to the States* (Chicago: Public Administration Service, 1937).

[59] Robert C. Lieberman, *Shifting the Color Line: Race and the American Welfare State* (Cambridge: Harvard University Press, 1998), 28; V. O. Key Jr., *Southern Politics in State and Nation* (New York: Alfred A. Knopf, 1949), 345-82; Ira Katznelson, Kim Geiger, and Daniel Kryder, "Limiting Liberalism: The Southern Veto in Congress, 1933-1950," *Political Science Quarterly* 108 (1993): 283-306; Ira Katznelson, *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth-Century America* (New York: W. W. Norton, 2005).

[60] Daniel T. Rodgers, *Atlantic Crossings: Social Politics in a Progressive Age* (Cambridge: Harvard University Press, 1998), chap. 6.

[61] Interview with Thomas H. Eliot, Oral History Collection, Columbia University, 29-30.

pensions, largely because of the enormous difficulty involved in tracking tens of millions of individual workers and their pensions contributions over long working careers in a highly mobile population. Consequently, the old-age pension system was the only fully national program created by the Social Security Act of 1935.

Institutionally, then, the Social Security Act constituted a critically important set of choices about how the American welfare state would subsequently be organized and how old-age pensions would fit into that structure. The welfare system that emerged from the New Deal embodied two distinct models of social provision. On one side were social insurance policies, which offered workers protection against certain predictable risks such as old age and unemployment. These protections promised benefits to workers in industrial and commercial jobs out of funds that pooled contributions from workers and their employers. Over thirty years, the categories of risk covered by social insurance expanded to include the surviving spouses and children of deceased workers (1939), disability (1956), and health (through Medicare, created in 1965). Over this same period, Social Security coverage expanded well beyond the industrial and commercial workers initially included in the scheme to include farmers and agricultural workers, government employees, and the self-employed, among other previously excluded groups, to become the closest thing to a universal social policy the United States has ever known. These social insurance programs shared a number of important institutional characteristics, above all their contributory structure, under which the right to benefits depended on contributions made either by individual workers or by employers on their behalf. In addition, social insurance programs were largely national programs with nationally determined eligibility rules and benefit structures and centralized administration. Thus these programs — principally Old-Age Insurance (known simply as Social Security) established strong claims for workers and their families on the national state.

On the other institutional side of the American welfare state were public assistance programs, means-tested benefits for the needy aged, blind, and families with dependent children. These policies were intended for those not covered by social insurance and who consequently did not acquire benefit rights through work. Public assistance programs, above all what was originally Aid to Dependent Children (after 1962 Aid to Families with Dependent Children, replaced in 1996 by Temporary Assistance to Needy Families), were not only noncontributory — meaning that benefits could not be claimed as rights based on prior contributions — but also decentralized. Partly funded by the federal government, they nevertheless delegated almost all policy and administrative control to state and local authorities.

The United States thus emerged from the Great Depression and World War II as one of the archetypes of what Gøsta Esping-Andersen has characterized as a liberal welfare state, in which relatively generous, work-based social insurance coexists with a wide range of means-tested categorical benefits for nonworkers (and state subsidies for private, work-related welfare schemes). [62] Moreover, while many European countries were reforming their welfare states in the immediate postwar era to create more universal regimes of social provision linked to interventionist economic policies aimed at maintaining full employment — the triumph of Keynesianism — the United States failed to implement similar reforms, rejecting proposals for national health insurance and expanded unemployment insurance and adopting a symbolic but ultimately toothless employment law.[63] As a result, American old-age pensions — Social Security — have long been distinctively politically isolated from other social policies, including public assistance, employment policy, and other policies that have elsewhere contributed to more comprehensive policy formulations.

3.3 The Development and Consolidation of Social Security

The structure of Social Security remains fundamentally the same as it was when it was established in 1935. Covered workers and their employer pay equal shares of a payroll tax on each employee's wages, up to an income ceiling, above which income is not taxed further. Payroll tax receipts are deposited in a segregated trust fund in the United States Treasury, from which benefits are also paid. Any surplus of payroll tax receipts over benefits paid must, by law, be invested in United States government securities. Benefits are

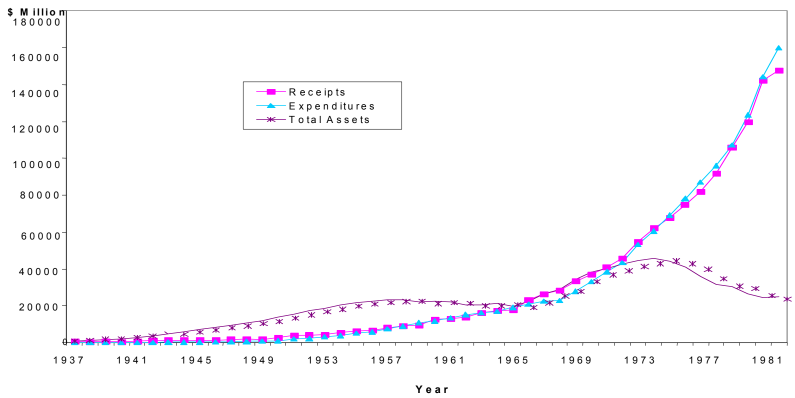
[62] Gøsta Esping Andersen, *The Three Worlds of Welfare Capitalism* (Princeton: Princeton University Press, 1990), 26-27.

[63] Robert C. Lieberman, *Shaping Race Policy: The United States in Comparative Perspective* (Princeton: Princeton University Press, 2005), 76-80; Claus Offe, *Contradictions of the Welfare State,* ed. John Keane (Cambridge: MIT Press, 1983); Peter A. Hall, ed., *The Political Power of Keynesian Ideas: Keynesianism Across Nations* (Princeton: Princeton University Press, 1989); Peter Baldwin, *The Politics of Social Solidarity: Class Bases of the European Welfare State, 1875-1975* (Cambridge: Cambridge University Press, 1990); Weir, *Politics and Jobs.*

payable to retired workers (and other beneficiaries, as provided for by subsequent amendments) according to a formula that relates an individual worker's benefits to his wage level during his working life. Spending from the Social Security Trust Fund to cover benefits payments is automatically authorized and not subject to the regular annual congressional budget process that is required for most other government spending.[64]

But although this basic structure has remained in place, the Social Security system has undergone many changes since its inception, many of them related to the program's fiscal structure. The program was designed to build up a large fiscal reserve in order to be effectively self-financing at least through 1980. The collection of payroll taxes began in 1937 but the payment of benefits was not originally scheduled to begin until 1942, allowing the fund to build up an initial reserve. Moreover, the payroll tax rate — initially set at one percent each on employees and employers — was initially scheduled to rise gradually to three percent each by 1949. As a consequence of this structure (and despite modifications over time, which I will detail below), the Social Security program has always had a substantial asset reserve, which grew steadily in the program's early decades, reaching $10 billion by the late 1940s and $20 billion by the mid-1950s <see Fig. 3-1>.[65]

<Fig. 3-1> Social Security Trust Fund, 1937-1982



[64] Eric M. Patashnik, *Putting Trust in the US Budget: Federal Trust Funds and the Politics of Commitment* (Cambridge: Cambridge University Press, 2000), chap. 4.
[65] Trust fund data are reported regularly by the Social Security Administration, Office of the Chief Actuary.

From the very beginning, this financing structure generated stiff opposition for a number of reasons. Some fiscal conservatives worried about the deflationary effects of the payroll tax and the building up of a large reserve fund in the treasury that was expected in 1935 to reach $47 billion by 1980. Others attacked the trust fund, which had to invest its annual surplus in government debt, as essentially a back-door means of running deficits in order to finance other government spending in support of the expanding scope and reach of the federal government under Roosevelt's New Deal. Finally, many conservatives worried that the existence of this reserve fund would generate political pressure to liberalize Social Security itself by increasing benefit levels beyond what the projected tax revenues could actuarially bear.[66]

In 1937, a group of Republican Senators led by Arthur Vandenberg of Michigan engineered the appointment of an advisory council to examine this and other issues and recommend amendments. This process resulted in an important amendment to Social Security in 1939, which made several significant changes to the program.[67] First, it adjusted the program's fiscal structure away from the financial reserve model that had been established in 1935 and toward a pay-as-you-go structure, in which the program would rely principally on current receipts to pay benefits. This was accomplished both by delaying the scheduled payroll tax increases and accelerating the beginning of benefit payments by two years. (On January 31, 1940, Ida May Fuller, a retired legal secretary from Vermont, received the first Social Security benefit check, for $22.54.) Second, the 1939 amendments also extended Social Security benefits to dependents of retired workers and the surviving dependents of Social Security-eligible workers who died, either before or after they retired.[68] These changes combined to shift the program's emphasis, at least incrementally, toward an increased standard of social adequacy, a direction that would continue with later amendments. Finally, the 1939 amendments began the gradual

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[66] Martha Derthick, *Policymaking for Social Security* (Washington: Brookings Institution, 1979), 232-35; Altmeyer, *Formative Years,* 88-91.

[67] Mark H. Leff, "Taxing the 'Forgotten Man': The Politics of Social Security Finance in the New Deal," *Journal of American History* 70 (1983): 359-81; Edward D. Berkowitz, "The First Advisory Council and the 1939 Amendments," in *Social Security After Fifty: Successes and Failures,* ed. Edward D. Berkowitz (Westport, Conn.: Greenwood Press, 1987); Patashnik, *Putting Trust in the US Budget,* 64-69.

[68] W. Andrew Achenbaum, *Social Security: Visions and Revisions* (Cambridge: Cambridge University Press, 1986), 32-33.

process of extending Social Security coverage to occupational categories that had, for a variety of reasons, been excluded from the program initially. Collectively, these amendments effectively (and rather ironically, since this was not the intention of the members of Congress who initiated the amendment) helped shore up the program's shaky political support — by accelerating benefits and limiting pressure to raise taxes quickly. But it also exposed the program to recurring political risks, particularly the prospect that its apparent self financing might become unsustainable and that general revenues might someday be necessary to cover benefit obligations.

During the 1940s, Social Security came under considerable political pressure from both the Left and the Right. On the Left, remnants of the populist Townsend movement, which had pushed for generous, universal, noncontributory old-age pensions during the 1930s, remained vocal and put considerable pressure on policymakers. But conservative opponents of the program were also lying in wait during the 1940s, and with the election of President Dwight Eisenhower along with Republican majorities in 1952, many thought they had their long-awaited opportunity to destroy the program. The House Ways and Means Committee created a special subcommittee on Social Security, chaired by Representative Carl T. Curtis of Nebraska, who had long been a vocal critic of the program. Curtis hoped to exploit a weakness in the program's structure that had been exposed by the 1939 switch to pay-as-you-go financing, namely the lack of a legally enforceable obligation for the payment of benefits, as would exist under a conventional private insurance contract. The highlight of the subcommittee's hearings in the fall of 1953 was Curtis's attempt to browbeat former Social Security commissioner Arthur Altmeyer (who had been replaced by the new Republican administration) into admitting that Social Security was not really "insurance" because no contract existed between an individual and the government. Altmeyer freely admitted that this was so and calmly explained the principle of social insurance and reviewed the program's history. Curtis became increasingly irate, and his chief counsel actually began shouting at Altmeyer at the top of his lungs. The hearings, intended to undermine public support for Social Security by exposing its precariousness, backfired on Curtis and the Republicans. Thanks to the program's political structure, which linked workers' contributions to the expectation of future benefits to create a broad coalition of stakeholders, their attempt to erode the program's political support failed and they were left with no choice but to support the contributory principle.[69]

Curtis's subcommittee adventure was connected to a proposal generated by the United States Chamber of Commerce, a leading national business association, to reorganize Social Security as a truly universal program under which pensions for all elderly citizens would be funded out of general revenues, rather than by a dedicated pension contribution that was deposited into a segregated trust fund. The Chamber's proposal would have discarded the most fundamental element of the program's fiscal structure — the network of linkages among wages, contributions, and benefits — and rendered benefits subject to annual congressional action, an arena in which the Chamber of Commerce believed it could better further its own interest in lower corporate taxes. Social Security supporters saw the proposal as a conservative scheme to do away with social insurance altogether. As if confirming their fears, the secretary of the new Department of Health, Education, and Welfare, Oveta Culp Hobby, convened a secret advisory group of outside Social Security "experts" that was stacked with businessmen who supported the Chamber's plan. When news of the group leaked to the press, which dubbed it the "Hobby Lobby," the administration was forced to quietly abandon the plan and eventually supported a further expansion of Social Security.[70]

This episode, in a way, represented the arrival of Social Security's political maturity. By the 1950s, Republicans (and some Democrats) had spent nearly twenty years waiting for the chance to reverse the expansive regulatory and social policies of the New Deal. When Republicans took unified control of Congress and the presidency in 1952, these anti-New Deal forces thought they finally had their chance. But in the case of Social Security, the program's conservative opponents did not reckon with the deep public entrenchment of the program, based primarily on its contributory fiscal structure. As Altmeyer explained to the Curtis subcommittee,

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[69] Edwin Amenta, *When Movements Matter: The Townsend Plan and the Rise of Social Security* (Princeton: Princeton University Press, 2006); Altmeyer, *Formative Years,* 221-35; Julian E. Zelizer, *Taxing America: Wilbur D. Mills, Congress, and the State, 1945-1975* (Cambridge: Cambridge University Press, 79-80. See also Robert M. Cover, "Social Security and Constitutional Entitlement," in *Social Security: Beyond the Rhetoric of Crisis,* ed. Theodore R. Marmor and Jerry L. Mashaw (Princeton: Princeton University Press, 1988).

[70] Altmeyer, *Formative Years,* 209-17; Derthick, *Policymaking for Social Security,* 144-57; Edward D. Berkowitz, *Mr. Social Security: The Life of Wilbur J. Cohen* (Lawrence: University Press of Kansas, 1995), 81-85;

Social Security should be regarded as a "statutory right," stronger than a contractual right "because you have a responsible legislative body, the Congress of the United States. You have at the present time [1953] about 90 million people who have accumulated wage credits. Now, it is inconceivable to me that the Congress of the United States would ever think of taking action to prejudice their rights that have developed under existing legislation."[71] Altmeyer understood that Social Security created an extremely strong expectation of future benefits in return for current obligations, an expectation that inexorably strengthened over time so that protecting Social Security benefits became a necessary position for politicians across partisan and ideological lines, even in the face of increasing budget deficits later in the centur. [72] President Eisenhower himself recognized the folly of attacking Social Security in the early 1950s. "Should any political party attempt to abolish social security," he wrote to his brother, Edgar, in 1954, "you would not hear of that party again in our political history." He added that there was "a tiny splinter group" who believed that this was advisable, but "their number is negligible and they are stupid."[73] This emerging consensus on Social Security in the 1950s — across parties, ideologies, and classes — seemed to vindicate Franklin Roosevelt's 1935 prediction that "with those taxes in there, no damn politician can ever scrap my social security program."[74]

This same structure that contributed to this political stability for Social Security by the 1950s also created a political process that led to the long-term expansion of Social Security to cover almost the entire American population. Initially, Social Security covered only

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[71] Altmeyer, *Formative Years,* 228.

[72] R. Kent Weaver, "Controlling Entitlements," in *The New Direction in American Politics,* ed. John E. Chubb and Paul E. Peterson (Washington: Brookings Institution, 1985); Paul E. Peterson, "The Rise and Fall of Special Interest Politics," *Political Science Quarterly* 105 (1990-1991): 545-46; Paul Pierson, "The Deficit and the Politics of Domestic Reform," in *The Social Divide: Political Parties and the Future of Activist Government,* ed. Margaret Weir (Washington: Brookings Institution; New York: Russell Sage Foundation, 1998); Patashnik, *Putting Trust in the US Budget.* On the legislative logic of partisanship and the time horizons of costs and benefits in American policymaking, see R. Douglas Arnold, *The Logic of Congressional Action* (New Haven: Yale University Press, 1990); and David R. Mayhew, *Divided We Govern: Party Control, Lawmaking, and Investigations, 1946-1990* (New Haven: Yale University Press, 1991).

[73] Quoted in Fred I. Greenstein, *The Hidden-Hand Presidency: Eisenhower as Leader* (New York: Basic Books, 1982), 50.

[74] Arthur M. Schlesinger Jr., *The Coming of the New Deal* (Boston: Houghton Mifflin, 1958), 308-9.

industrial and commercial workers; many categories of workers were excluded from coverage, meaning that they neither paid contributions nor acquired eligibility for pensions upon retirement. Among the largest and most politically significant occupations that were initially excluded from Social Security were farmers and farm workers (including tenant farmers and sharecroppers), domestic employees (household servants), government employees (at all levels — federal, state, and local), and the self-employed, among others. As a result, in the 1930s Social Security covered only approximately one-fourth of the American workforce.

But Social Security also created a new pattern of welfare politics. The linkage between taxes and benefits created a perpetual constituency for old-age pensions, which had an interest in low taxes and high benefits. In the early years many contributed and few received benefits, but as soon as benefit checks started flowing out, fiscal pressures mounted to gather enough revenue to meet benefit obligations. As long as the constituency was "incomplete" — as long as there were working Americans who did not contribute — those in the system had an incentive to bring new workers into the system in order to capture new sources of revenue for the trust fund, which could immediately be put to use to pay benefits to previous contributors. The fiscal alternatives, raising payroll tax rates or limiting the growth of benefits, were both politically unpalatable by comparison. A 1946 study by the National Planning Association (NPA) made this logic explicit. Expanding Social Security coverage to all workers, the NPA predicted, would more than double the program's revenue projections by 1950. At the same time, of course, projected benefit payments would increase by only sixty percent over the same period. Even extending these projections as far as 1980, the study still showed revenue increases from expanding coverage outstripping benefit increases.[75] This incentive created a powerful logic of expansion for Social Security, which it pursued through the decades after World War II.

The move toward a more inclusive, universal program began with the 1939 amendments, which added two small categories of workers who had been initially excluded. The major wave of coverage expansion occurred in the 1950s, with amendments in 1950, 1954, and 1956 that brought most self-employed workers, farmers and farm workers, and household employees into the Social Security system <see Table 3-1>. Significantly, these amendments

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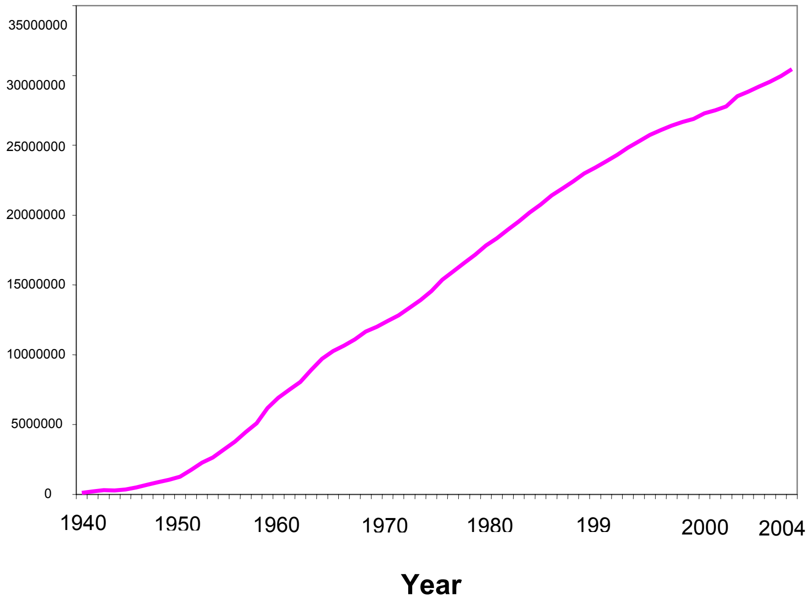
[75] Murray R. Benedict, *A Retirement System for Farmers,* Planning Pamphlet No. 49 (Washington: National Planning Association, 1946).

overcame one of the program's most severe inequities — the exclusion of a majority of country's African-American workers, who were disproportionately employed in agriculture and domestic service in the middle of the twentieth century. As a result, by 1960 Social Security was the closest thing the United States has ever had to a color-blind social policy.[76] Another wave of coverage expansion occurred in the 1980s, when employees of governments and nonprofit organizations were brought into the Social Security system. These occupational expansions of coverage resulted in increasing universalism in the program. As <Fig. 3-2> shows, the number of workers receiving benefits grew slowly during the 1940s, but that growth accelerated sharply during the 1950s as coverage expansions took effect and worked their way through the system. Since the 1960s, the program's growth has been very steady. In 2005, more than 30 million people received retirement benefits under Social Security. Perhaps more important, the share of the American working-age population that is covered by Social Security has grown dramatically, as depicted in <Fig. 3-2>.[77] When the program began paying benefits in 1940, only about one-fourth of the working-age population was insured by Social Security. Coverage increased sharply during World War II, as more of the working-age population moved into industrial employment to support the war effort, but after the war coverage remained below 40 percent. The coverage expansions of the 1950s dramatically increased the share of the working-age population covered, which reached 70 percent by 1950 and has gradually increased to nearly 90 percent since then.

[76] Lieberman, *Shifting the Color Line.*

[77] Data on covered workers are from data reported by the Social Security Administration Office of the Chief Actuary; they are compared with data on the working-age population as reported by the Bureau of Labor Statistics, U.S. Department of Labor.

<Fig. 3-2> Total Retirement Beneficiaries, 1940-2005



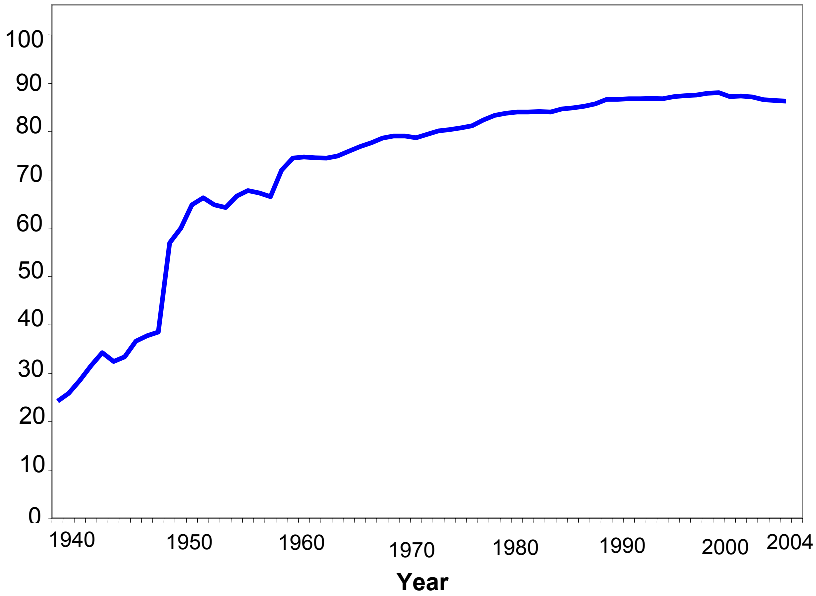
Because of the program's fiscal structure, this gradual expansion of coverage provided essentially an ongoing windfall of cash into the program's coffers. Under the pay-as-you-go financing structure, bringing in new workers meant increased revenue that was available immediately either to moderate payroll tax increases or to increase benefit levels, and policymakers did both. Over this same period, Congress acted repeatedly to increase the level of Social Security benefits. The first and most significant blow for more generous social insurance was struck in 1950, when the program was at risk of being engulfed by rapidly growing and popular public assistance programs for the elderly. In the Social Security amendments of that year, in addition to expanding coverage, raising payroll taxes, and ending the authorization to dip into general revenues to pay benefits, Congress increased Social Security benefits (which had not changed in ten years and whose real

<Table 3-1> Expansions (and Contractions) of Social Security Coverage

Year	Categories
1939	**Dependents and Survivors** Seamen Bank and loan-association employees (Agricultural processing workers excluded)
1948	(News and magazine vendors excluded)
1950	Non-farm self employed, excluding professionals Regularly employed agricultural workers Regularly employed domestic workers State and local government employees — voluntary Nonprofit employees — voluntary
1954	Self-employed farmers Most self-employed professionals — architects, funeral directors, accountants Remaining agricultural workers Remaining domestic workers Clergy — voluntary
1956	**Disability** Expanded self-employed professionals — lawyers, dentists, veterinarians, optometrists
1965	**Medicare** Doctors
1984	Nonprofit employees — compulsory
1986	Federal government employees
1990	State and local government employees — compulsory for those not covered by public pensions

Note: Bold type indicates program expansion; parentheses indicate exclusion of groups previously covered; all other entries indicate extension of coverage to groups not previously covered.

<Fig. 3-3> Percentage of Working-Age Population Covered by Social Security, 1940-2005



value had deteriorated badly) by 77 percent.[78] In addition to preparing the way for the ultimate political triumph of social insurance as the pension paradigm for American workers, the 1950 amendments set off a flurry of regular benefit increases that accelerated over the next two decades as Democrats in Congress and the White House learned the political virtues of generous and well-timed (they always seemed to arrive just in time for elections) Social Security benefit increases <see Table 3-2>. In 1972, President Richard Nixon, a Republican, sought to deprive Democrats of the perpetual political credit they were able to claim from regularly raising Social Security benefits. He proposed indexing benefits to inflation, a proposition the Democratic majority in Congress was unable to oppose, even though they recognized that it undercut a one of their clear political

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[78] Derthick, *Policymaking for Social Security,* 272-74; Zelizer, *Taxing America,* 66-81; Jerry R. Cates, *Insuring Inequality: Administrative Leadership in Social Security, 1935-54* (Ann Arbor: University of Michigan Press, 1983).

advantages.[79] This was a typically Nixonian political maneuver — co-opting a policy issue "owned" by the opposition in order either to neutralize the opposition's political advantage or divide the opposition's coalition.[80] Its success is further evidence of Social Security's political maturity.

<Table 3-2> Social Security Benefit Increases (before indexing)

Effective Date	Percent Increase
September 1950	77.0
September 1952	12.5
September 1954	13.0
January 1959	7.0
January 1965	7.0
February 1968	13.0
January 1970	15.0
January 1971	10.0
September 1972	20.0
March 1974	7.0

Source: Derthick, *Policymaking for Social Security,* 429-32; U.S. Social Security Administration, *A Brief History of Social Security,* SSA Publication No. 21-059 (2000).

<Fig. 3-4> depicts the change over time in the average value of Social Security benefits from 1940, when the first benefits were paid, to 1974, when inflation indexing began (a benefit increase adopted in 1974 was temporary; after May 1974 benefits reverted to their February 1974 levels, which became the base for automatic cost-of-living adjustments beginning in 1975).[81] The figure shows

[79] Zelizer, *Taxing America,* 317-43; Derthick, *Policymaking for Social Security,* 345-46; Joan Hoff, *Nixon Reconsidered* (New York: Basic Books, 1994), 135-36.
[80] See Stephen Skowronek, *The Politics Presidents Make: Leadership from John Adams to George Bush* (Cambridge: Harvard University Press, 1993); John David Skrentny, *The Ironies of Affirmative Action: Politics, Culture, and Justice in America* (Chicago: University of Chicago Press, 1996), 178-82.
[81] Cost-of-living adjustments (COLAs) are based on the annual increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) as

the value of a hypothetical $100 benefit in 1940 adjusted annually for inflation and periodically for legislative benefit increases. During the first decade, benefits lost more than 40 percent of their purchasing power, until the 1950 amendments — the dramatic first upward move in the figure — restored them to their original level. The 1954 amendment for the first time brought benefits to a substantially higher level, approximately 17 percent above the original baseline, and established a plateau that Congress maintained for the next fifteen years with periodic (and increasingly frequent) increases. Beginning the early 1970s, benefits took a sharp move upward, as the Democratic Congress and the Republican president very nearly fell over each other in their effort to claim credit for expanding Social Security.[82] But the mid-1970s, benefits were nearly 40 percent higher than in 1940, and they have since grown with inflation.[83] By 2006, the average monthly benefit for a retired worker was approximately $1,111, more than three times the real level of average benefits in 1940, as shown in <Fig. 3-5>, which depicts the average monthly retirement benefit (in constant dollars) over time.[84]

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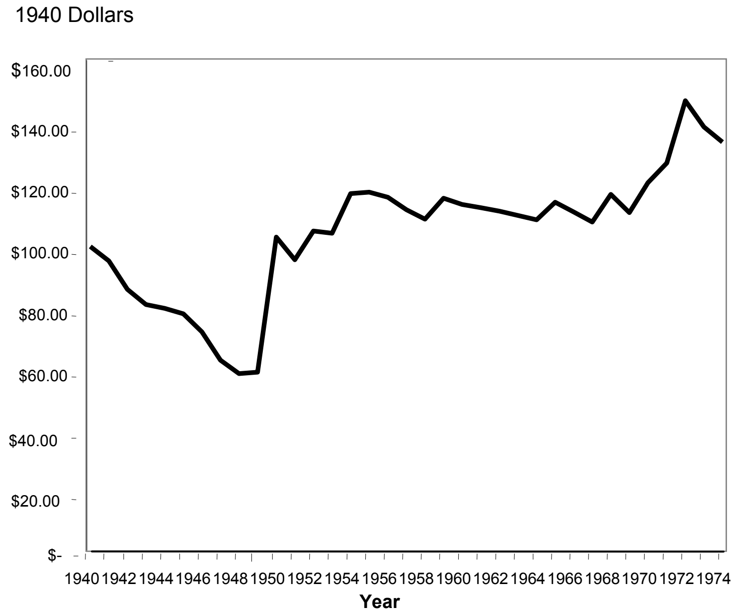
reported by the Bureau of Labor Statistics of the U.S. Department of Labor. From 1975 to 1982, COLAs were based on the increase in the CPI-W from the first quarter of one year to the first quarter of the next. Since 1983, COLAs have been based on the CPI-W increase from the third quarter of one year to the third quarter of the next.

[82] Derthick, *Policymaking for Social Security,* 345-46; Mayhew, *Divided We Govern,* 93, 107; Zelizer, *Taxing America,* 333-37; Herbert Stein, *Presidential Economics: The Making of Economic Policy from Roosevelt to Reagan and Beyond,* 2d. rev. ed. (Washington: American Enterprise Institute, 1988), 188.

[83] In fact, some economists believe, benefits since the 1970s may have grown faster than the cost of living because the Consumer Price Index may actually overstate inflation. See Weaver, "Controlling Entitlements"; Advisory Commission to Study the Consumer Price Index [Boskin Commission], "Toward a More Accurate Measure of the Cost of Living," Final Report to the Senate Finance Committee, 4 December 1996.

[84] Benefit data are reported annually by the Social Security Administration in the Annual Statistical Supplement to the *Social Security Bulletin.* Because of a computer error, benefit data are not available for 1981, accounting for the gap in Figure 5.

<Fig.3-4> Real Social Security Benefits (real value of $100 benefit in 1940)



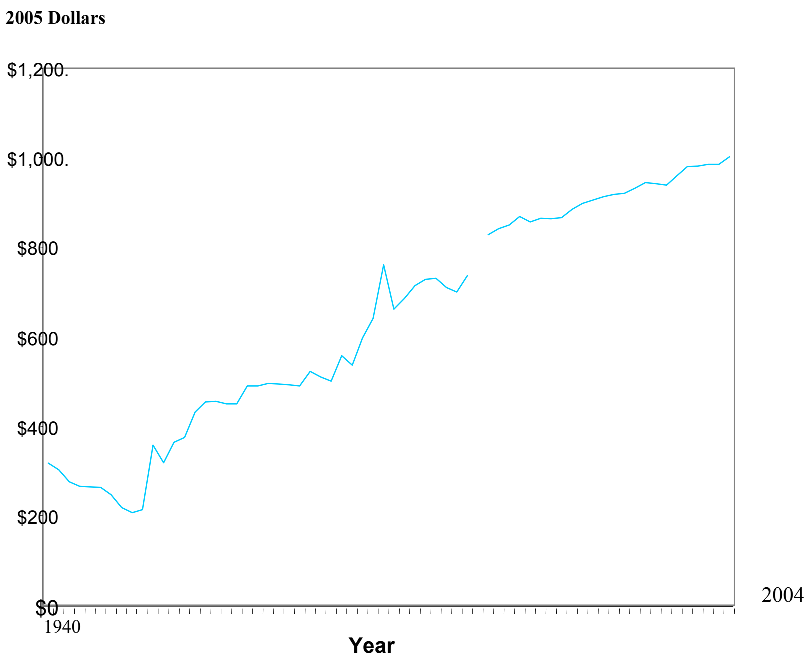
Social Security has historically been an important and effective poverty reducer for the elderly. Through the 1960s, Americans 65 years of age and older were substantially more likely to be poor than other age groups. But since the mid-1960s, poverty among the elderly has decreased substantially, and elderly Americans are now less likely to be poor than any other age group <see Fig. 3-6>.[85] There are many potential reasons for this shift, chief among them the creation of Medicare — public health insurance for the elderly — in 1965, this period also coincides with the period of the most dramatic increase in Social Security spending and benefit levels. Economists Gary Engelhardt and Jonathan Gruber have shown that increases in Social Security benefits since the 1960s are causally associated with a significant decrease in elderly poverty.[86] Moreover, the Center on Budget and Policy Priorities has estimated

[85] Carmen DeNavas-Walt, Bernadette D. Proctor, and Cheryl Hill Lee, *Income, Poverty, and Health Insurance Coverage in the United States: 2005,* Current Population Reports, P60-231 (Washington: U.S. Census Bureau, 2006), 52.

[86] Gary V. Engelhardt and Jonathan Gruber, "Social Security and the Evolution of Elderly Poverty," NBER Working Paper 10466 (National Bureau of Economic Research, 2004), available at http://www.nber.org/papers/w10466.

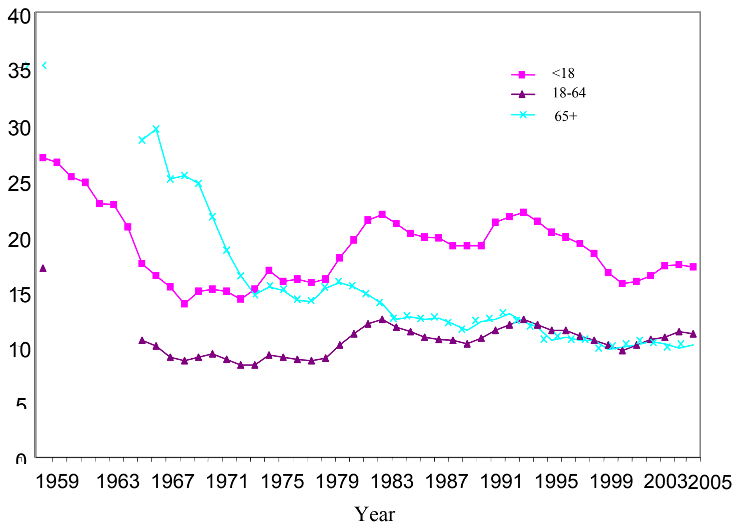
that Social Security benefits lift approximately 12.9 million elderly Americans out of poverty (based on data from 2000-2002). Excluding income from Social Security benefits, this analysis shows that the poverty rate among the elderly would be 46.8 percent. With benefits, however, elderly poverty is below 10 percent.[87]

<Fig. 3-5> Average Monthly Retirement Benefits, 1940-2004



[87] Arloc Sherman and Isaac Shapiro, "Social Security Lifts 13 Million Americans Above the Poverty Line: A State-by-State Analysis" (Washington: Center for Budget and Policy Priorities, 2005), available at http://www.cbpp.org/2-24-05socsec.pdf.

<Fig. 3-6> Poverty by Age Group, 1959-2005



3.4 The Maturity of Social Security: Fiscal Challenges and the Changing Political Environment

By the 1970s, Social Security was a mature social insurance program, in several respects. The program had existed for the equivalent of a full working life, so that retiring workers would have been contributing to the program for their entire working lives. Until the 1970s, most retirees would already have been in the middle of their careers when Social Security began in the 1930s; for these workers, the effective return on their contributions received in the form of post-retirement benefits was relatively high. By contrast, workers who began their working lives after Social Security came into existence and paid contributions over their entire working lives began retiring in the 1970s; for these workers the effective return on contributions was substantially lower. In this context, pressure grew to maintain reasonably generous benefits and low payroll taxes only intensified as the benefit-contribution ratio became less favorable for subsequent generations of retirees. At the same time, the expansion of coverage was virtually complete and nearly all of the potentially eligible workers in the country were by then insured under the program, with coverage levels reaching 90 percent of the total American working-age population. As a result, it was no longer possible to shore up the program's financing by expanding coverage to new categories of workers, further increasing the pressure on the other easily manipulable parameters in the Social Security equation — tax rates, benefit levels, and a new factor, retirement age.

The 1970s also saw a dramatically different economic climate than had prevailed during Social Security's period of expansion and development. The decade's oil shocks and the resulting economic instability brought an end to thirty years of postwar growth and prosperity, resulting in increased pressure on government finances, including the Social Security system. The slowdown in economic growth in the 1970s resulted in revenues that were below projected levels. Benefits, however, were sensitive not to current economic conditions but to the past work and wage histories of retirees.

Consequently, benefits exceeded revenue during every year from 1975 to 1981, resulting in a substantial decline in the assets held by the Social Security Trust Fund. The fiscal challenges Social Security faced in the 1970s were exacerbated by an inadvertent mistake in the amendments of 1972 that indexed benefit increases to inflation. Under the terms of that amendment as it was adopted in 1972, retirees were overcompensated for inflation, resulting in an unexpectedly rapid growth in benefits and further draining the trust fund.[88] But even after a 1977 amendment corrected for this error and also increased both tax rates and the ceiling on taxable wages (which was also indexed to inflation), the program's fiscal problems continued. Slow wage growth and the declining ratio of workers to retirees (which fell from approximately 40:1 in the 1940s to 3.2:1 in the 1970s) remained the culprits.[89]

The 1970s also saw a proliferation of interest groups in American politics, particularly groups rooted in mass citizen mobilization, often growing out of the civil rights movement of the 1950s and 1960s. In particular, the 1970s saw the development of elderly Americans as an organized political force, through organizations such as the American Association for Retired Persons (now simply AARP). This development, which was largely a consequence of the entrenchment of Social Security as the foundation of American national old-age policy in the postwar era, profoundly influenced subsequent policy debates, providing even further political pressure

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[88] Patashnik, *Putting Trust in the US Budget,* 74.
[89] Achenbaum, *Social Security,* 62-63, 67-74.

to maintain high benefits, moderate taxes, and sound financing.[90] This pressure became particularly acute in the late 1970s and early 1980s, when the program's finances and future reliability seemed shaky.

In 1980 Ronald Reagan was elected president on a platform that included deep cuts in domestic spending, and in the spring of 1981 the Reagan administration proposed a package of reforms to address the continuing decline in Social Security's financial position. The Reagan proposal included substantial benefit reductions as a means of moderating the growth in the program's outlays and limiting its growth. The proposal ran headlong into tremendous resistance from both Democrats (who still had a majority in the House of Representatives) and newly empowered advocacy groups such as AARP, and Congress refused to pass the Reagan proposal.[91] Instead, a bipartisan commission on social security reform was formed, chaired by Alan Greenspan, who had been chairman of the Council on Economic Advisors under President Gerald Ford in the mid-1970s. The Greenspan Commission's report, issued in early 1983 and developed in cooperation with the Reagan White House, recommended a package of modifications including increased payroll taxes, delays in the upcoming cost-of-living adjustment to benefits, and a gradual increase in the retirement age (at which workers would become eligible for full retirement benefits) from 65 to 67 Congress quickly passed an amendment based on the commission's proposal, which came with the endorsement not only of the president but of leading members of both the House and Senate — including Senators Robert Dole, John Heinz, and Daniel Patrick Moynihan and Representatives William Archer, Barber Conable, and Claude Pepper — who had been among the commission's members. Significantly, the 1983 amendments also gained the support of AARP, which recognized the importance of supporting moderate and gradual current changes in order to preserve the program's fundamental structure.[92]

As a result of the 1983 amendments, helped along by the resumption of strong economic growth in the mid-1980s, Social

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[90] Jack L. Walker Jr., *Mobilizing Interest Groups in America: Patrons, Professions, and Social Movements* (Ann Arbor: University of Michigan Press, 1991), chap. 2; Campbell, *How Policies Make Citizens*.

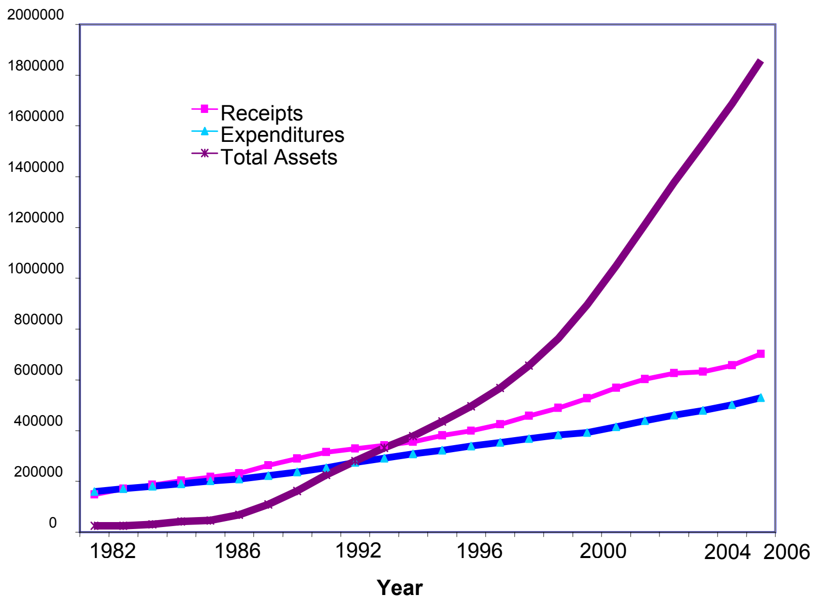
[91] Peterson, "Rise and Fall of Special Interest Politics."

[92] Campbell, *How Policies Make Citizens,* 104; Achenbaum, *Social Security,* 81-90; Paul Light, *Artful Work: The Politics of Social Security Reform* (New York: Random House, 1985).

Security's finances began to turn around. The total assets of the Social Security Trust Fund — the fiscal "reserve" that had been at the center of much of the controversy surrounding the program — had declined in the early 1980s to its lowest level in fifteen years. Between 1975 and 1981, expenditures had exceeded contributions by an average of $3 billion per year, cutting the fund's reserve holdings nearly in half <see Fig. 3-7>. After the 1983 amendments, the trust fund's finances almost immediately began to turn around.

Total assets began to grow, gradually at first but then with accelerating speed through the 1980s and 1990s and into the first decade of the new century, reaching $2 trillion by late 2006, as Figure shown in <Fig. 3-7>.

<Fig 3-7> Social Security Trust Fund,1982-2005



3.5 The Privatization Controversy

It is this growing surplus that has generated much of the recent controversy over the future of Social Security. Much of the ongoing surplus has been generated by the "baby boom" generation, the population bulge created by high birthrates in the two decades or so following World War II. The 1983 amendments coincided with the full entry of the baby boomers into the work force, allowing the system to maintain a stable ratio of workers to beneficiaries even as the number of retirees grew. But, as some analysts recognized at the time, the inevitable retirement of the baby boomers, beginning in the 2010s, would begin to drain these reserves as those workers stopped contributing and began collecting benefits to be funded by taxes paid by the smaller generations of workers that followed.[93] In their 2006 annual report, the trustees of the Social Security Trust fund estimated that, under a moderate set of economic and demographic projections and assuming no changes to the current parameters of the program (taxes, benefits, or retirement age), Social Security outlays will exceed payroll tax receipts beginning in approximately 2017 and the trust fund's assets will be exhausted in approximately 2040. Moreover, the ratio of workers to beneficiaries is project to decline from the current level (3.2:1) and approach 2:1 by the 2030s. (There is, however, a great deal of uncertainty around these projections. Under less favorable economic and demographic assumptions, the depletion of the trust fund is estimated to occur around 2030. Under more favorable assumptions, the feared reversal does not come, at least through 2080).[94]

In response to these growing anxieties about the apparent impending insolvency of Social Security, George W. Bush made social security reform a central issue of his first presidential campaign in 2000. In the campaign, Bush emphasized the limited investment return — projected to be approximately 2.7 percent after inflation in the coming years — that the trust fund gains from its exclusive, and statutorily required, investment in United States government bonds. By contrast with the rate of return on inherently riskier private investments such as stocks, which have historically produced somewhat higher returns, Social Security's investment approach undoubtedly limits the trust fund's growth. Shortly after

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[93] Achenbaum, *Social Security,* 180; Light, *Artful Work,* 90-91, 93-94.

[94] *2006 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Washington: Government Printing Office, 2006), 9, 11-12, 15.

assuming the presidency, Bush appointed a commission on Social Security reform, chaired by former Senator Daniel Patrick Moynihan and corporate executive Richard Parsons, to explore reforms that might address the program's long-range fiscal challenges and pursue Bush's political preference that Social Security follow some kind of private investment strategy. Later in 2001, Bush's commission proposed a variety of Social Security reform plans that all centered on a system of voluntary private accounts, under which each individual worker in the Social Security system would be allowed to divert some portion of her payroll tax contributions into an individual investment account, through which the individual could invest in a broader range of instruments — including stocks, bonds, and other investments — and over which she could exert some limited control. The remainder of her contributions would go into the Social Security trust fund, as under the current structure. Upon retirement, a worker with such a private account would receive a reduced public benefit, paid from the trust fund, as well as full access to the accumulated assets in her private investment account.[95]

This proposal has raised several important issues and occasioned a great deal of controversy. Critics have attacked it from a number of angles. One issue is the proposal's short-term impact on the trust fund. Currently, all of the money generated by the payroll tax (12.4%, evenly divided between employers and employees) goes directly into the trust fund. But under various versions of the Bush privatization plan, from 2% to 4% of payroll could be diverted from the trust fund to private retirement accounts, diverting nearly one-third of the system's receipts out of the pool of money and assets available to pay traditional, public Social Security benefits. This diversion of revenue would accelerate the depletion of the trust fund. Economists Peter Diamond of the Massachusetts Institute of Technology and Peter Orszag of the Brookings Institution have estimated that without some other source of revenue to make up for this loss, the trust fund would be depleted before 2030 under this scenario. The present value of the funds needed to make up for this shortfall — just to return the system to the trustees' current projection for depletion — is, they estimate, between \$2 trillion and \$3 trillion. Financing this shortfall would, they estimate, have a serious impact not only on Social Security's finances but also on

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[95] President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans* (2001), available at http://www.csss.gov/reports/Final_report.pdf.

the government's general fiscal health, since this shortfall would presumably have to be made up either through general revenues or increased debt, and on the long-term health of the American economy.[96] The Bush proposals, critics have argued, would also likely reduce the benefits that American retirees would be likely to receive as compared with traditional Social Security benefits, and also limit the program's capacity to insure Americans against other risks captured under the Social Security umbrella, such as disability or the death of a spouse or parent. As a result, critics charge, the privatization approach would expose Americans, particularly those at lower income levels, to increased risk of poverty in old age, because Social Security benefits would increasingly become dependent on individual investment decisions (which are likely to be poor), and the happenstance of the market's position when an individual retires, which can generate tremendous volatility in the value of investments and retirement income they can generate. Finally, critics have pointed to the dubious record of privatization of public pension systems elsewhere, which have had mixed success at maintaining solvency while extending coverage, maintaining adequate benefits, and preventing widespread poverty.[97]

The proposal to partially privatize Social Security was not completely disconnected from the history of American pension policy. The coexistence of public and private means of social provision has long been a distinctive hallmark of the American welfare state. In general, the United States is typically characterized as having a smaller welfare state than other advanced industrial countries. But when public and private welfare expenditures are combined, the United States no longer appears so unusual; its combined level of public and private social welfare expenditures, as a percentage of Gross Domestic Product, is comparable to the levels in other countries, such as Denmark and Sweden, that are generally

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[96] Peter A. Diamond and Peter R. Orszag, "Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security" (Center on Budget and Policy Priorities and The Century Foundation, 2002), available at http://www.tcf.org/Publications/RetirementSecurity/Diamond_Orszag.pdf.

[97] *Social Security Reform,* Revised 2005 Edition (New York: Century Foundation, 2005), available at http://www.tcf.org/Publications/RetirementSecurity/SocialSecurityBasicsRev2005.pdf; Indermit S. Gill, Truman Packard, Juan Yermo, *Keeping the Promise of Social Security in Latin America* (Palo Alto: Stanford University Press; Washington: World Bank, 2005); Paul Krugman, "Buying Into Failure," *New York Times,* 17 December 2004, A35;

considered to have much "larger" welfare states than the United States.[98] Moreover, the United States is quite distinctive in the level of private spending compared with other OECD countries — more than twice its nearest rival. This pattern of mixed public and private provision of social welfare — what the historian Michael Katz has called the "mixed economy of social welfare" in the United States — has long been a characteristic of American social welfare policy, particularly in the provision of old-age pensions.[99] Private pension plans provided by corporations for their employees emerged in late nineteenth and early twentieth centuries in the United States but have flourished primarily over the same period as Social Security — as a supplement to, rather than a substitute for, Social Security. Public policy, moreover, has encouraged and subsidized the growth of private pension systems through favorable tax treatment (particularly the deductibility of pension contributions from taxable income for both employers and employees), labor law, and regulatory policy. These policy developments ultimately resulted in the passage of the Employee Retirement Income Security Act of 1974 (ERISA), which established uniform standards for funding, benefits, and coverage of private corporate pension plans.[100]

Most early corporate pension plans were "defined-benefit" plans, which promise to pay pensions of a fixed, predetermined amount upon retirement, and for as long as the retiree lives. But since the mid-1970s — and, ironically, partly as a result of the new requirements on defined-benefit plans by ERISA — defined-benefit plans have largely been replaced by "defined-contribution" plans, in which contributions are made to an individual account, which is then invested. Upon retirement, the employee has access to the account, however large or small, to provide retirement income. Defined-contribution plans now dominate the private-pension landscape in the United States. They come under a variety of names — 401(k) plans (named after the subsection of the federal tax code

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[98] In 1995, for example, combined public and private welfare spending in the United States amounted to 24.5% of GDP, compared to 24.4% in Denmark, 25.0% in the Netherlands, 27.0% in Sweden, and 27.7% in Germany. Jacob S. Hacker, *The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States* (Cambridge: Cambridge University Press, 2002), 14-15.

[99] Michael B. Katz, *In the Shadow of the Poorhouse: A Social History of Welfare in America* (New York: Basic Books, 1986); Michael B. Katz and Christoph Sachße, eds., *The Mixed Economy of Social Welfare: Public/Private Relations in England, Germany, and the United States, the 1870s to the 1930s* (Baden-Baden: Nomos, 1996).

[100] Hacker, *Divided Welfare State,* part 2.

that authorizes them); Individual Retirement Accounts of various kinds; and Keogh plans for the self-employed — all of which differ in details but share the same basic characteristics: tax deductibility of contributions and interest accumulation, and penalties for pre-retirement withdrawal. The congressional Joint Committee on Taxation has estimated that effective federal subsidy for these plans in 2006, defined as the amount of tax revenue not collected because of the deductibility of contributions, was approximately $125 billion. Moreover, these tax provisions tend to benefit high earners more than low earners, because higher-income workers can generally afford higher pension contributions and are in higher marginal tax brackets, increasing the value of the effective subsidy through tax deductibility. Defined-contribution pensions thus tend to do a poorer job of redistributing income and pooling risk than either defined-benefit pensions or public social insurance.[101]

Thus Bush's Social Security proposal resonated with an increasingly familiar template for organizing retirement savings and seemed to offer a way around the program's fiscal challenges. But the plan was, of course, overwhelmed during his first term by other events and no reform has been adopted. Moreover, the early years of the 2000s were poor ones for the stock market, making the idea of diverting the nation's pension investments to stocks less politically appealing than it had been in the late 1990s, when investors were reaping the benefit of a tremendous run-up in stock prices. After his reelection in 2004, President Bush tried wanly to revive his Social Security reform proposal, but it fell on unreceptive ears, both in Washington and among the general public. AARP, the leading lobbying organization on behalf of older Americans and an important political broker on pension issues, took a firm stance in opposition to individual accounts. Nevertheless, the issue has created divisions among the American public along lines of age and income, with younger and more affluent Americans expressing stronger support for privatization than others, potentially threatening the historical political universalism that has long been one of Social Security's hallmark traits.[102]

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[101] Hacker, *Divide Welfare State;* Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton: Princeton University Press, 1997); U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010* (Washington: Government Printing Office, 2006), 40.

[102] Campbell, *How Policies Make Citizens,* 142-45.

3.6 Conclusion

Despite the apparent failure of Bush's privatization proposal the challenges facing Social Security in the medium and long term remain: the retirement of the baby boomers, the potential fiscal reversals of the coming century, the decline of retirement certainty and the expansion of risk for many American workers.[103] But as this survey of Social Security's history has shown, these challenges bear a striking resemblance to those the program has faced repeatedly over the course of more than seventy years.

Although it is difficult to predict what solution policymakers will adopt to address these issues, several paths seem possible. One possible future might involve some form of privatization, such as that proposed by President Bush and already adopted elsewhere.

Although the prospects for this approach current look bleak, especially after the election of Democratic majorities in both houses of Congress in 2006, the potential constituency for this policy direction remains in place: younger workers who seek higher returns on their pension contributions, conservatives who remain skeptical of state involvement in the economy and hope to promote what Bush has called the "ownership society," and the Wall Street firms who stand to make substantial profits managing millions of individual retirement accounts. Another alternative — doubtless more likely but hardly assured — is that policymakers will adjust, as they have when facing similar crises in the past, the system's manipulable parameters: payroll taxes, benefit levels, the retirement age, the taxability of benefits, and so forth. This approach, many analysts have suggested, could easily be undertaken to restore the system's fiscal balance well into the future.[104] Neither approach can be expected to change the fundamental American reliance on a mixture of public and private sources for funding retirement, although they certainly have different likely consequences for the distribution and redistribution of risk and inequality and for the

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[103] See Lawrence R. Jacobs and Theda Skocpol, eds., *Inequality and American Democracy: What We Know and What We Need to Learn* (New York: Russell Sage Foundation, 2005); Jacob S. Hacker, *The Great Risk Shift: The Assault on American Jobs, Families, Health Care, and Retirement and How You Can Fight Back* (New York: Oxford University Press, 2006).

[104] See the Century Foundation's *Social Security Reform.* For another alternative fiscal plan that avoids private accounts, see Robert M. Ball, *Meeting Social Security's Long-Range Shortfall* (New York: The Century Foundation, 2005), available at
http://www.tcf.org/Publications/RetirementSecurity/ballplan.pdf.

future politics of retirement security. Whatever approach the United States ultimately adopts to addressing the latest of Social Security's moments of fiscal adjustment, however, it seems certain that it will not be the last.

4. Aging Population and Public Pension - With Special Reference to Korean Characteristics -

Yun Suk-myung

4.1 Introduction

Korea joined the ranks of OECD (Organization for Economic Cooperation and Development) in the mid 1990s as a result of rapid industrialization achieved by a series of five-year economic development plans, after having experienced political upheaval such as the Korean War in the early 1950s and the April 19 Revolution in the early 1960s.

From the socio-demographic perspective, the country witnessed the population increase caused by the baby-boomers born after the Korean War from the mid 1950s through the mid 1960s, the collapse of traditional extended family system, and the nuclearization of family from the late 1960 due to rapid industrialization. Meanwhile, the necessity of public pension system that guarantees certain level of income for the aged people was raised as an important social issue because of the collapse of traditional inter-family income support system for the ensuing years.

Most of the OECD member countries experienced socio-demographic changes in the space of 50 to 100 years, but such changes proceeded just for two or three decades in Korea, which shows rapid paces in socio-demographic changes. Korea stands a distinguished position in the world in that it has both generality in terms of sharing similar experience with the most of OECD members on the issue of rapidly aging population and uniqueness in terms of achieving economic growth in such a short period of time.

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Due to the improvement of living standards which was bolstered by the rapid economic growth, the life expectancy increased by 20 years in just four decades. Meanwhile, the fertility rate, a basis to calculate the economically active population in the future, recorded merely 1.08 as of 2005, one of the lowest level in the world. The increased life expectancy and the drastic decrease of fertility rate have placed Korea as the fastest aging country in the world. While it took for European countries such as France to enter into the aged society for more than 100 years, Korea is likely to enter the aged society just in 18 years.

Korean war, military dictatorship, side-effects of intense economic growth during the past half century have produced a distrust sentiment in the Korean society--distrust on the government policy, in particular. As shown in the strong opposition against the recent real estate policy announced by the government, Koreans have rooted deeply the distrust toward the government's policy. Accordingly, Koreans strongly believe in themselves and their families--another feature Korean society has.

However, the government's efforts to cope with the collapse of traditional income guarantee system for the elderly, which was caused by the rapid nuclearization of family led to the introduction of the National Pension Scheme (NPS), a universal public pension system. The Welfare Pension Act which was scheduled to be introduced in 1972 was delayed in its adoption until 1988 due to the 1st Oil Shock all over the world. Despite such twisting in its initiation, the NPS had gradually expanded, and in April 1999, the era of universal NPS began.

Nominally, Korea is under the era of universal pension scheme. In practice, however, the country is faced with three major policy challenges in terms of securing a certain level of incomes for the elderly. First, the government should promote the participation of general public in the NPS as well as assuage the distrust of citizens against the government policy. Second, the government should reform the pension system in order to deal with a super-aged society in the near future. In other words, the public pension should be secured in a sustainable manner by building a multi-tier income support system. Third, the government should come up with measures for the potential blind spots (those who would not receive the pension), which would inevitably appear at the initial stage of introduction of the NPS. Focusing on these challenges, this paper will study the uniqueness and generality of the NPS reform in Korea.

4.2 Uniqueness and Generality from Socio-demographic Perspective

4.2.1 Population aging trends in Korea

According to the population forecast released by the "Committee on Development of National Pension Scheme", which, based on the population prediction through 2050 by the National Statistics Office, estimated the population trend to 2070, the current population (48 million as of 2008) will gradually decrease starting from the mid 2020s and shrink into 34 million in 2070. More serious problem than the demographic decrease, however, would be the composition of population. The proportion of the elderly, which marks approximately 13% at this point, will increase to a great extent: the proportion will increase into 24.5% in 2030, 34.4% in 2050, and 36.9% in 2070. Therefore, it is highly probable that the dynamics in our society as a whole will be remarkably weakened.

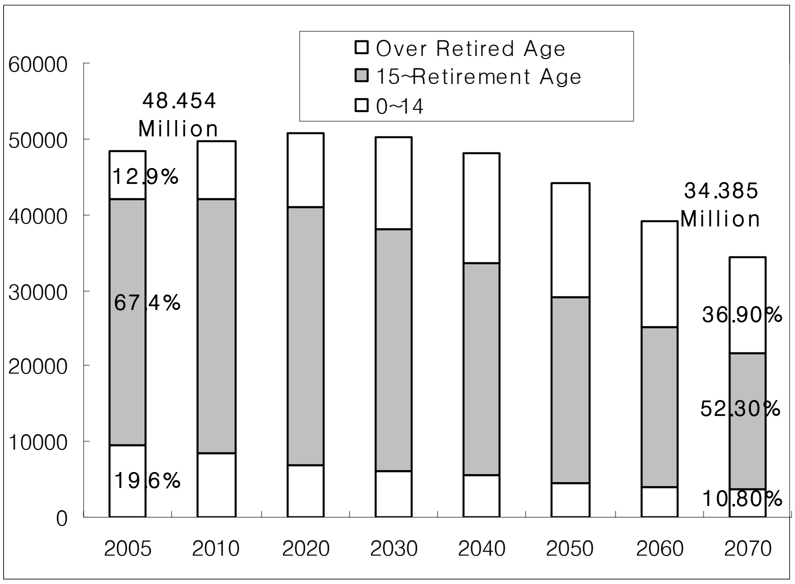
<Table 4-1> Total Population and Change of Demographic Structure under NSO's Estimation

(Unit: thousand, %)

NSO's Estimation	2005	2010	2020	2030	2040	2050	2060	2070
Total Population	48,454	49,584	50,620	50,275	48,075	44,156	39,214	34,385
Age 0 ~ 14	19.6	17.2	13.8	12.3	11.3	10.4	10.4	10.8
Age 15 ~ Retirement	67.4	67.7	67.1	63.2	58.7	55.3	53.7	52.3
Above Retired Age	12.9	15.1	19.2	24.5	30.0	34.4	35.9	36.9

Note: 1) Retired age refers to the initial age of receiving the pension (Age 61 in 2013 and 65 in 2033)
2) This population estimation was made using PROST model developed by World Bank. Hence, some differences were found in results despite having used the same presumptions used by the "Committee on Development of National Pension Scheme".

<Fig. 4-1> Change of Total Population and Demographic Structure under NSO's Estimation



4.2.2 Changes in family structure

The proportion of households composed of one generation has nearly doubled from 7.5% in 1960 to 14.2% in 2000 while the proportion of households composed of three generations has shrunk from 25.8% to 8.4% in the same period. The average number of family member is also on downward: it was 5.7 in 1960 but decreased to 3.1 in 2000.

<Table 4-2> Change in Family Structure

(Unit: %, persons)

Classification	1960	1970	1980	1990	1995	2000
Proportion of Family composed of 1 Generation	7.5	6.8	8.3	10.7	13.0	14.2
Proportion of Families with more than 3 Generations	28.5	23.2	17.0	12.5	10.1	8.4
Average Family Member	5.7	5.5	4.7	3.7	3.3	3.1

Source: National Statistics Office, Census, 2005.

4.2.3 Relations between population aging and National Pension

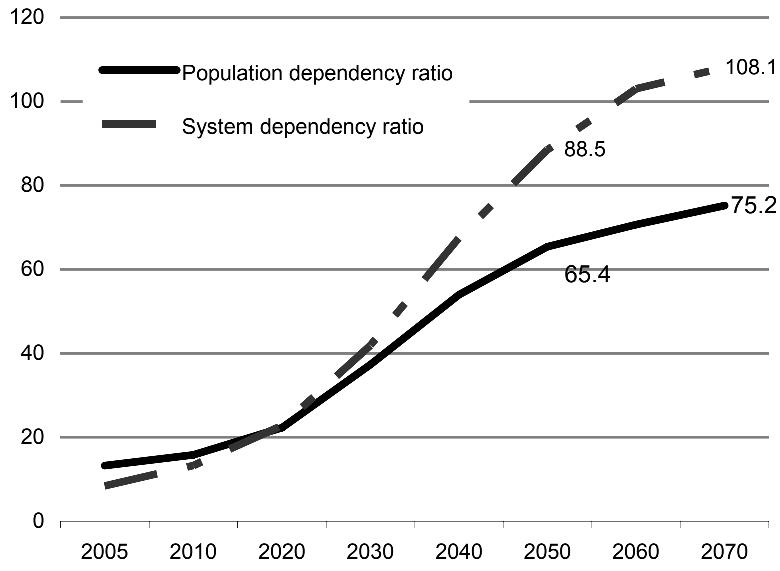
After the first introduction of the NPS in 1988, Korea opened the era of universal pension in 1999 with gradual expansion of the NPS. Apparently, it took only 11 years. However, on the other side of such a rapid implementation, the NPS has some side effects such as imminent financial burden when the babyboomers retire in earnest due to a "low-pay, high-receive" feature of the scheme. In particular, the rapid population aging will result in an unprecedented increase of financial burden to maintain the system, and the level of cost to care for the elderly caused by the change in demographic structure will be far greater in the long term. The worsened burdens for the pension system and care for the elderly insinuate that a public pension scheme with "low-pay, high-receive" feature, or a pure pay-as-you-go public pension system will be extremely hard to maintain in the long run.

<Table 4-3> Changing Trends of Cost of Care Caused by Changes of Total Population and Demographic Structure

Classification	2005	2010	2020	2030	2040	2050	2060	2070
Cost of Care for the Elderly	13.3%	15.8%	22.3%	37.3%	54.0%	65.4%	70.7%	75.2%
Cost of Keeping the Scheme	8.4%	13.3%	22.8%	41.9%	67.5%	88.5%	103.0%	108.1%

Note: 1) Cost of care for the elderly = 65+ / ages from 18 to 64
2) Cost of keeping the scheme (elderly) = elderly recipient / Insured

<Fig. 4-2> Changing Trends of Cost of Care Caused by Changes of Total Population and Demographic Structure



Source: Committee on Development of National Pension (2003).

4.3 Current Situation and Problems of Income Guarantee System for the Elderly

4.3.1 Current situation of the National Minimum Living Standard of Security System (NMLSS)

The National Minimum Living Standard of Security System (NMLSS) is a universal, ultimate safety net that enables those who lack the minimum living standards defined by the government to make living at a minimum level regardless of demographic features such as age and working capability rather than a special system designed only for the aged. As the economic crisis in 1998 put more difficulties on the low-income tiers and vulnerable families by layoffs and income reductions, the NMLSS was implemented from October 2000 to secure a basic level of living for those without working capability. As of March 2004, the number of elderly recipients whose age were more than 65 years old reached 349,000, accounting for 8.4% of the total aged people. Considering the economic vulnerability of the aged, approximately 25 to 30 percent of the recipients of the NMLSS is the elderly with the age of 65 or higher.

4.3.2 Current situation of the Elderly Pension System

The Elderly Pension System (EPS) was introduced in July 1998 to endow a chance to receive pension for those who could not have an opportunity to insure the public pension, and the EPS absorbed the age allowance that had been implemented for the elderly under the target of living protection from 1991. Therefore, the EPS can be regarded as a scheme that plays multiple roles: as a non-contribution pension for the elderly who were put outside of the public income security benefits; and as an additional payment for the elderly that receive the benefits of minimum living security. Current EPS will gradually lose its feature as a non-contribution pension that complements a public pension as the NPS is matured, and thus, the function of additional payment seems to be enhanced. As of December 2004, the number of EPS recipients was 618,000, 14.8% of the total aged people. Among them, 269,000 people received solely the EPS, accounting for 6.5% of the total elderly with the age of 65 or higher.

<Table 4-4> EPS Payment by Year

(Unit : Person, million KRW)

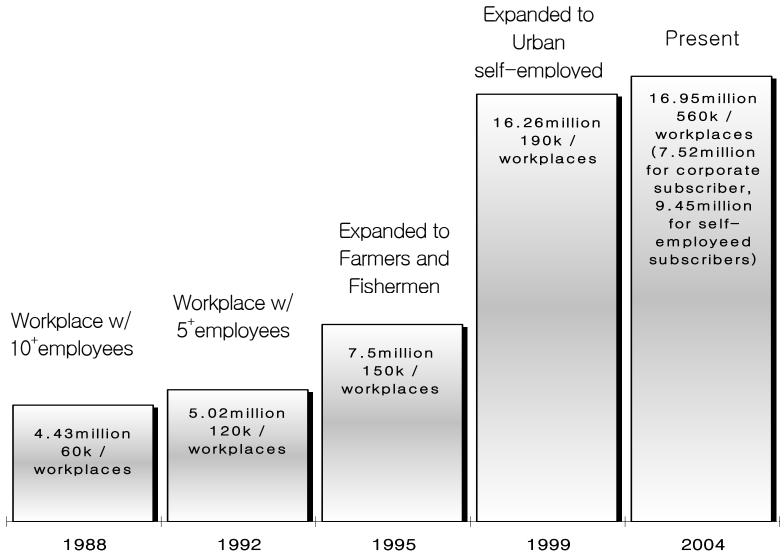
Classification	Dec. 99	Dec. 00	Dec. 01	Dec. 02	Dec. 03	Dec. 04
Total	574,700	587,684	565,031	616,343	619,206	618,531
Basic Recipients	288,303	327,928	334,175	333,526	344,413	360,360
Low-income Recipients	286,397	259,756	230,856	282,817	274,793	258,171

Source: Ministry of Health and Welfare (2005).

4.3.3 Current status of the NPS

The NPS was introduced in 1988 and expanded to the self-employed in urban area in April 1999. As such, the scheme has developed into a genuine universal NPS. Despite its external development, however, lots of citizens were categorized as an exemption for the payment, and merely a half of insured people actually paid the insurance. As a consequence, the blind spot of the NPS becomes regarded as one of the social issues. If current situation continues, and the self-employed do not pay their pension policy and remain outside of the NPS, the blind spot will inevitably expand.

<Fig. 4-3> Expansion of the NPS



<Table 4-5> Exemption of Payment by Reason (As of End of November 2005)

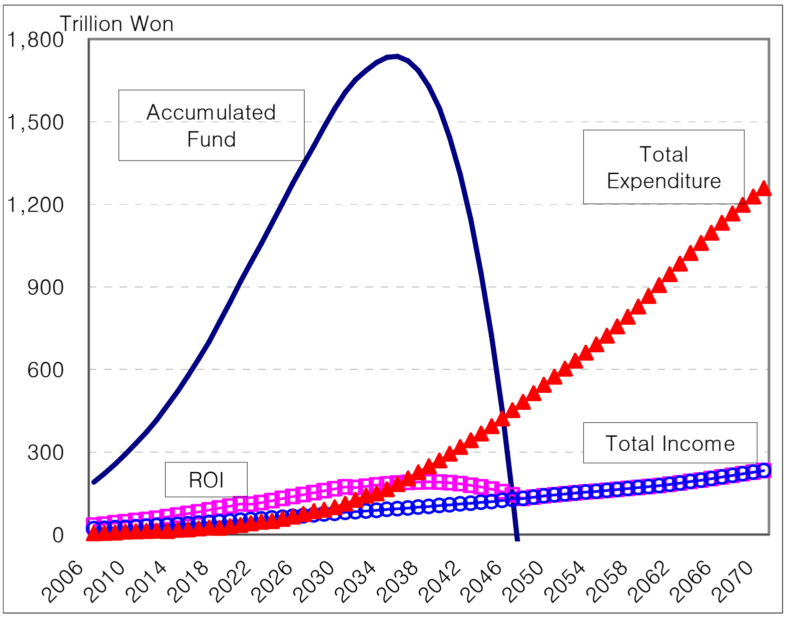
(Unit: Thousand persons, %)

Total	Unemployed	Cease of Biz	Living Difficulties	Unidentified Residence	Others
4,664	3,383 (72.5%)	424 (9.1%)	180 (3.9%)	524 (11.2%)	153

Note: Others include serving in military, studying, being rehabilitated or hospitalized, etc.
Source: National Pension Service, Internal document (February 2006).

Along with the issue of the blind spot that appears unavoidably due to its operational feature (i.e. run as a form of social insurance), unstable financial issue in the long term will be promptly addressed. At the end of 1998, the government already lowered the income replacement rate by 10% (from 70% to 60%). However, additional plans for securing financial security expected to be designed since the rapid population aging and the commencement of low economic growth will run dry the fund faster than predicted.

<Fig. 4-4> Long-range Projection of National Pension Program, under Current Scheme



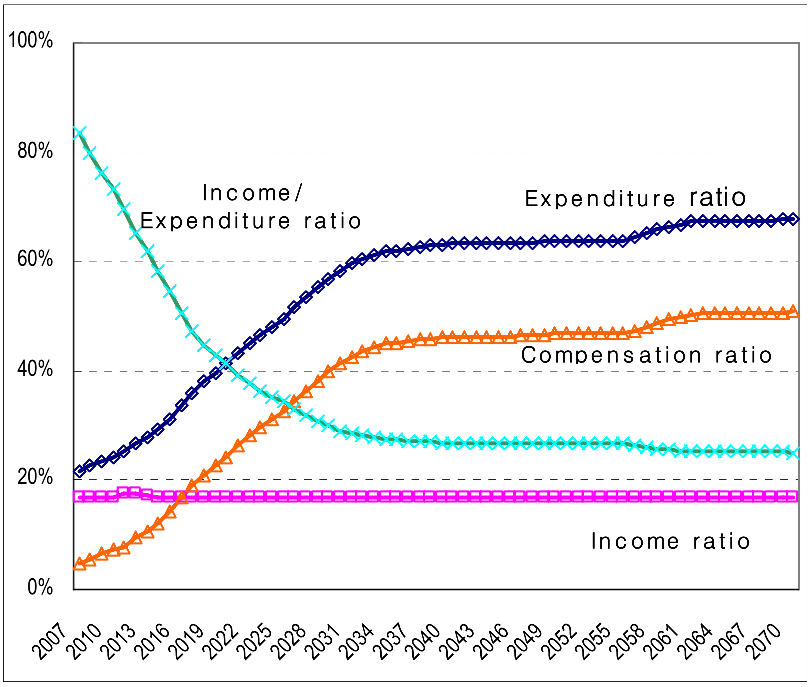
Source: Korea Institute for Health and Social Affairs, 2006.

3.4.4 Current situation of pensions for special occupations

Pensions for Special Occupations in Korea are divided into Government Employee Pension, Private School Teachers Pension and Military Personnel Pension. The special profession pension is paid when the person in charge for special duties retires or dies, or when the person suffers injury, disease or fatal disease in conducting his/her public duties. By providing a certain amount of payment in such cases, the special pension system serves to secure the living standards and welfare of the person in charge or his/her bereaved family. Therefore, the special profession pension can be dubbed as a comprehensive social security system that includes payment to secure income against retirement or death and compensation for injuries, diseases and fatal diseases. Also, it has a feature of compensation for the working and payment as assistance. Because of these features, the special pension guarantees higher level of payment than the NPS for the general public.

Despite the measures taken to stabilize its finance in 2000, the Government Employee Pension still has unsustainable burden and unbalanced benefit structure. As time goes by, the number of recipients will increase in an accumulated manner, and the size of annual deficit compensated by the government is expected to grow in an extremely rapid pace.

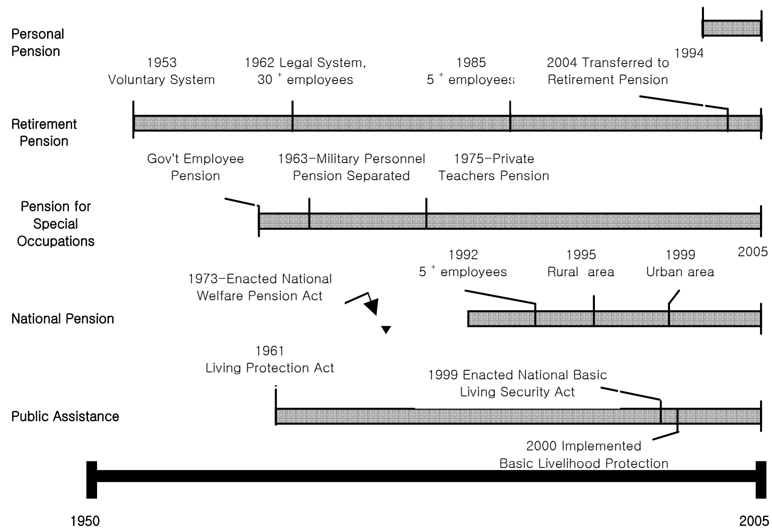
<Fig. 4-5> Financial Structure of Government Employee Pension



Note: Percentage of Expenditure=Expenditure on Payment/Total Amount of Payment, Percentage of Income=Earnings by Insurance Policy/Total Amount of Payment, Compensation Ratio=Amount to be Compensated by Government/Total Amount of Payment, Income/Expense Ratio=Earnings by Insurance Policy/Expenditure on Payment

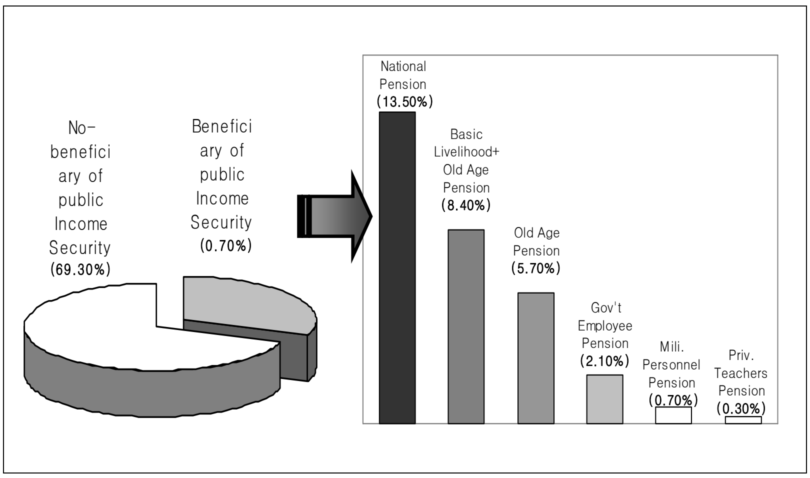
Source: Korea Institute for Health and Social Affairs, 2006.

<Fig. 4-6> Development Process of Income Security System for the Elderly in Korea



Source: Committee on Future Society, "*Implementation Plan for Income Security System for the Elderly against Aged Society*", 2005.

<Fig. 4-7> Percentage of Benefits on Public Income Security for the Elderly Over 65 Years Old (As of the end of 2005)



4.3.5 Retirement allowance system and retirement pension set by the law

When an employee works more than one year, employer will pay the retirement allowance, an amount equivalent to more than one-month salary per each working year. This system is applied to all workplaces that hire more than five employees. Initially, the retirement allowance was provided in workplace with more than 30 employees when it was introduced in 1961, but it expanded to workplace with more than 10 employees in 1987. Current system began in 1989. As of end of August 2003, approximately 6.2 million employees (around 48% of total employees) enjoy this retirement allowance system.

In 1997, both pre-payment and insurance system on the retirement allowances were introduced. The pre-payment of retirement allowances was adopted to reflect the demand of employees on the sizable returns and the burdens from corporate side on the lump-sum payment for the retirement allowances. In the meantime, the retirement insurance system was introduced to secure the individual benefit right of the employees and to mitigate the burdens of lump-sum payment from the employer.

However, the current retirement allowance system is paid in lump-sum only when an employee retires. Hence, the system lacks the function of income security for the elderly. Most of the allowances (53.1%) are used as basic living cost (Korea Labor Institute, 2000), and with the increase of non-regular workers, introduction of annual pay system, and increased workplace shift that has an effect to reduce the accumulated amount for retirement allowance, it is not sufficient to secure the income level after the retirement. These problems have led to the introduction of the Retirement Pension System in December 2005 after the legislation of Employee's Retirement Pension Security Act in December 2004 in an attempt to transfer the retirement allowances as an income source for the elderly. However, such transfer is possible only under the consent both from employees and employers. Therefore, the process of settling the retirement pension system as a genuine income security system for the elderly would take a lot of time under the current situation where the retirement allowances and retirement pension system exist separately.

<Table 4-6> Expansion of Retirement Allowance System

(Unit: Thousand persons, %)

Year	Size of Employees	Number of Beneficiaries	Proportion to Paid Employees	Proportion to Economically Active Population
1966	More than 30 employees	453	16.3	5.1
1975	More than 16 employees	1,448	30.5	11.9
1980	More than 16 employees	2,841	44.0	19.7
1985	More than 10 employees	3,786	46.7	24.3
1990	More than 5 employees	5,366	49.0	28.9
1995	More than 5 employees	6,168	48.2	29.6
2001	More than 5 employees	6,151	46.1	27.7

Source: Kim, et al., "Study on Multiple Income Security System for the Elderly", National Pension Institute, 2005.

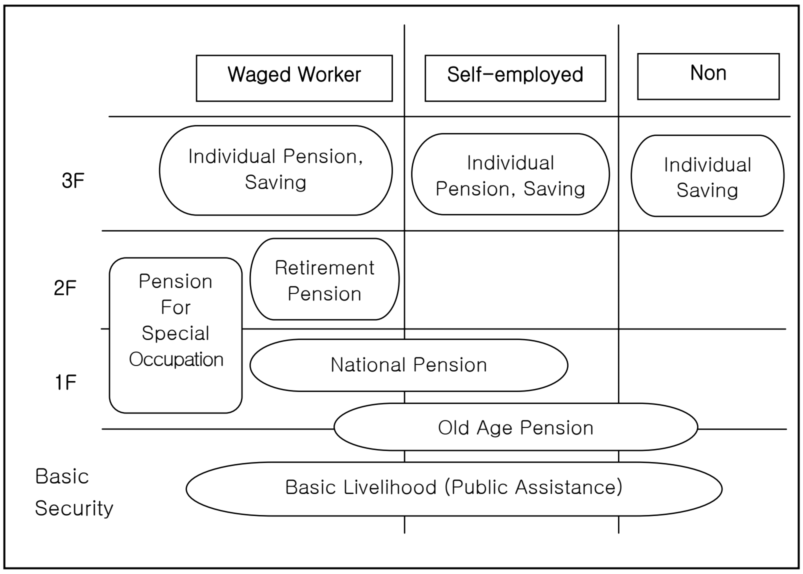
4.3.6 Personal pension system

The goal of the Personal(Individual) Pension System, which was introduced as a way of coping with the lowering domestic saving rate in 1994, was to prevent cash from flowing into the shadow economy by implementing the real-name financial transaction system and to strengthen the financial industry. Although it was introduced at the financial policy level, the personal pension system failed to carry out the function of securing income stability for the elderly since its saving feature was focused only to receive tax benefits. In this context, "tax-system preferred" individual pension system, introduced in 1994, was replaced by the new individual pension system in 2001. The new pension system offers a deduction up to 2.4 million KRW per year, and a tax exemption on its income from interest, but, according to the new system, a tax was imposed on the annual income. In other words, the new system can be dubbed as a "tax-deferred" individual pension system.

Despite such efforts, the individual pension system's biggest problem in terms of securing income for the elderly is the low enrollment and persistency rates. As of the end of 2001, the total enrollment number of was 3.73 million, accounting for 17.7% of the total employed. From 1994 to 2001, 11.58 million people bought the individual pension policy, but 7.85 million policy holders withdrew from the service, and the persistency rate was merely 33.2%. For example, 4.86 million bought the policy in 1994 but less and less people insured the individual pension system as time went by. In 2001, when the new individual pension system was introduced with distinguished features on taxation from the existing products, only 240,000 contracts were signed.

The schematized current situation of the income security system for the elderly in Korea is shown on the <Fig. 4-8> below.

<Fig. 4-8> Current Income Security System for the Elderly



4.4 Focusing on Uniqueness and Generality of Pension Reform in Korea

4.4.1 High poverty rate of the elderly and social pressure on the introduction of universal pension system

a. Income sources of the elderly

In Korea, the elderly has been traditionally dependent on their sons and daughters for income support within the framework of private income security system. However, with the advent of the era of nuclear family, which was caused by industrialization, the number of the elderly who live together with their sons and daughters as well as the parents' dependency on their offspring has been dramatically reduced. As shown in the <Table 4-7>, the economic support of the offspring for their parents has been sharply decreased just in 6 years to 44.3% in 1994 from 63.7% in 1988.

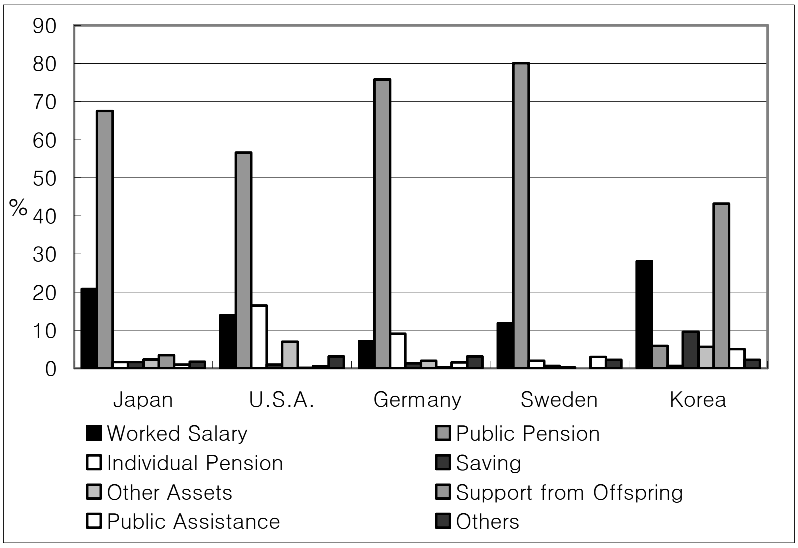
Comparing with the elderly in other OECD countries, who are dependent on various income sources including public pension as shown in <Fig. 4-9>, the Korean elderly have quite limited income sources because of the short history of public pension system, and Korea has extremely high rate of the elderly in poverty among the total aged people. Against this backdrop, social pressure on the necessity of preparing countermeasures to address poverty issue among the elderly who could not be endowed the chance of receiving the benefits of public pension system is increasing.

<Table 4-7> Comparison of Income Sources of the Korean Elderly at Different Points (Compared timing: 1988 and 1994)

Income Sources	Year	
	1988	**1994**
Public Pension	1.2	3.9
Individual Pension	0.0	0.0
Savings or Other Assets	6.8	6.9
Support from Offspring	63.7	44.3
Worked Salary	26.3	37.6
Public Assistance	1.8	3.5
Others	0.2	1.5
No Response	0.0	2.3
Total	**100.0**	**100.0**

Source: OECD, DEELSA/ELSA(2001) 6, 2001.

<Fig. 4-9> International Comparison of Income Sources among the Elderly over 65 Years Old



b. Social pressure on the needs to introduce a universal pension system

As mentioned above, the Korean National Pension Scheme is run in the form of social insurance that offers its service only to the insured who pay the insurance fee. Thus, the opportunity to buy the policy was offered to the elderly at the point of introducing the scheme, but those who could not pay the insurance fee were not eligible to secure the right of benefit, and, accordingly, the issue on the proper ways to guarantee the income security for the elderly who have no pension has become important nowadays.

If we employ the basic pension system based on taxes, which resembles the one that most of the advanced countries already introduced, the issue of income security for the elderly and the potential no-beneficiaries of the national pension will be automatically addressed. Opposition party and various interested parties, therefore, actively support the introduction of a tax-based, basic pension system.

However, the governmental ministries in charge of operating the pension system and a certain number of experts have negative positions on the introduction of the basic pension system since it might give excessive burdens to the future generations when the baby boomers retire in earnest starting from the mid 2020s although there can be a number of positive effects from its introduction, especially in terms of redressing the current blind spot issue. Those who have critical positions regarding the introduction of basic pension system see that if it is based on taxes, which means implementing a pure pay-as-you-go system instead of current NPS that is run by partial pay-as-you-go-system, then it might be a way backward to the international trends with strengthening the accumulative features of public pension system.

If a country has high proportion of public pension in the post-retirement income support system for the elderly both with matured pension system and aged population, and operates the existing public pension system by dividing into a basic pension system and a pension proportional to income system, the financial burden can be mitigated comparing to the existing public pension system. However, to a country like Korea, which is at the initial stage of aging population with rapid implementation of NPS system, the introduction of tax-based, basic pension prior to the progress of aging population can be resulted in outcomes opposite to the basic direction of pension reform to ease the burden of future generations.

<Table 4-8> Estimation of Cost, If Basic Pension System Proposed by the Grand National Party Is Introduced.

(Unit: Thousand persons, trillion KRW)

Year	Beneficiary (Population with more than 65 years old)	Total Cost			
		Current Cost		Fixed Cost (As of 2006)	
		100% Benefits	80% Benefits	100% Benefits	80% Benefits
2008	5,021	10.8	8.7	10.2	8.2
2010	5,354	14.4	11.5	12.8	10.3
2020	7,821	54.9	43.9	36.3	29.0
2030	11,899	178.3	142.6	87.7	70.2
2040	14,941	364.7	291.7	133.5	106.8
2050	15,793	627.9	502.3	171.0	136.8
2060	14,583	900.3	720.3	182.5	146.0
2070	12,925	1,239.2	991.4	186.9	149.5

Source: KIHASA (2006).

<Table 4-9> Estimation of Budget, If Introduced the Basic Pension System Proposed by Democratic Labor Party

(Unit: Thousand persons, trillion KRW)

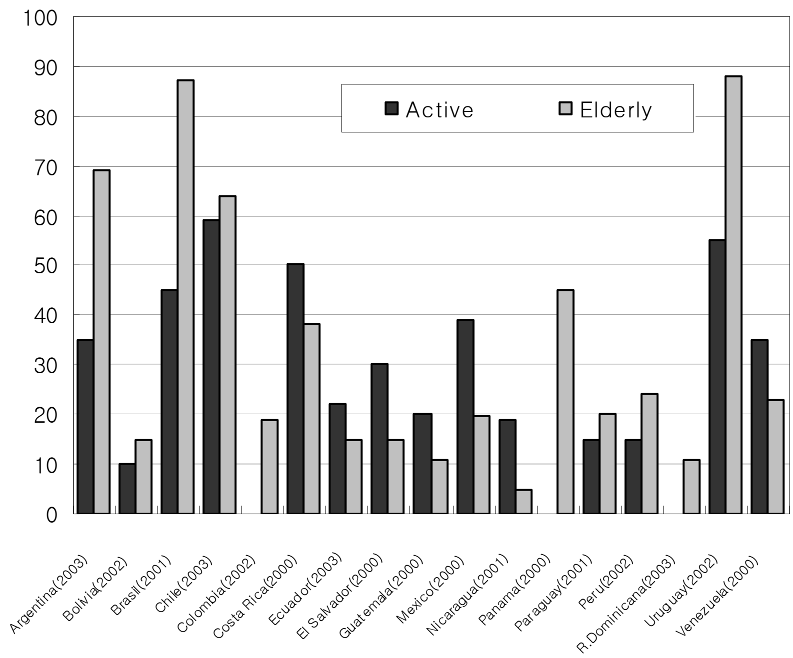
Year	Beneficiary	100% Benefits		Limits to Upper 20%	
		Current Cost	Fixed Cost (As of 2006)	Current Cost	Fixed Cost (As of 2006)
2008	5,021	5.2	4.9	4.1	3.9
2010	5,354	7.5	6.7	6.0	5.4
2020	7,821	36.6	24.2	29.3	19.4
2030	11,899	131.0	64.5	104.8	51.6
2040	14,941	273.2	100.0	218.6	80.0
2050	15,793	475.1	129.4	380.0	103.5
2060	14,583	690.9	140.0	552.8	112.0
2070	12,925	953.9	143.9	763.1	115.1

Note 1: Calculated based solely on the old age basic pension.
Note 2: Average income used in the above estimation was based on "Research on Basic Wage Structure (Monthly average wage was 1.75 million KRW as of 2004)" announced annually by the Ministry of Labor. If the standard above is used, the necessary cost to maintain the basic pension is higher in the long run. Based on such presumption, the Democratic Labor Party changed the standards for the National Pension into the average income(A) of the National Pension. In this case, the necessary resources decrease in a large scale.
Note 3: The basic pension plan based on taxes proposed by the Democratic Labor Party (DLP) has a characteristics of decreasing the necessary cost comparing to the draft proposed by the Grand National Party. However, DLP added NPS with 40% of replacement rate on top of the basic pension, suggesting a public pension system that requires significant level of costs in terms of total expenditure.
Source: KIHASA (2006).

As shown in the results of the estimations described above, the proposed basic pension scheme requires enormous financial burdens. Such alternatives are not suitable for the fundamental goal of pension reform - reducing the burden of future generation by coping with unsustainable budgets caused by low-birth rate and aging population. If the tax-based basic pension system is introduced now, the problem of the elderly in poverty can be resolved significantly, but in the long run, most of the budget will be allocated to the elderly, increasing further the burden to the future generation and raising the possibility of less focusing on the enhancement of national competitiveness.

Another issue frequently debated is on the low participation rate. To be sure, the size of blind spot from the NPS is quite large in absolute terms. But it is noteworthy that the participation rate in Korea is not so low comparing to the rate in countries with similar socioeconomic circumstances to Korea. As shown in <Fig. 4-10>, countries in Latin America have far longer history of NPS than Korea but their participation rates are quite low. In other words, if the comparison is made with developing countries, not with developed countries with extremely low proportion of self-employed, the participation rate of Korea is relatively high. In this regard, there are some cautionary voices on the introduction of basic pension system, which is based on taxes with weak links between pension contribution and payment.

<Fig. 4-10> Application of Pension System in Latin American Countries



Source: Rafael Rofman, "Social Security Coverage in Latin America", World Bank, 2005.

4.4.2 Necessity of pension reform and institutional differences of maturity among public pension systems

a. Difficulty in securing social support regarding unpopular financial stability plan for the NPS

Countries with longer history of introducing public pension system had opportunities to learn the positive aspects of such system throughout the previous generations that made living with the pension. Such experience has made it possible that the citizens' opposition against the "less-benefit, more-burden" scheme is relatively weaker than countries like Korea (though the intensity is so strong as to the collapse of a regime). This is because those countries are aware of the inseparable relationship between the pension system and the life in the elderly.

However, Koreans show very extreme reactions on the government's efforts to cope with unsustainable financial issue regarding the National Pension, raised in terms of long term perspective. At its initial stage, the system employed "low-burden, high-return" scheme: while the replacement rate of an insured with 40 years of enrollment was 70%, the insurance fee began with 3%. At the end of 1998, however, it was inevitable to come up with an additional plan for financial stability since the concerns over the long-term financial stability were raised in addition to a financial stability initiative (replacement rate was down by 10% to 60% while the insurance fee was up to 9%) that had been already taken. As a result, there were a series of plans in order to decrease the replacement rate to 50% while increase the insurance fee from 9% to 13% to 16%.

The reaction of Koreans against the government's budget plan has been quite cynical. They see with a consensus that the financial issue was caused by bad management of NPS by the government and the burdens were passed to the general public in an irresponsible manner. Many Koreans insist that rather than following the government's plan (pay more and receive less), it would be better to abolish the National Pension Scheme and receive all the insurance fees paid so far.[1] More specifically, many Koreans think that the increasing burden with decreasing benefits can be understood as a bankruptcy of the system itself even way before receiving any money.

This kind of extreme reactions may not disappear unless the beneficiaries of NPS increase and people learn a lesson that NPS could be a source of securing incomes for the elderly. However, it is not conceivable for the government and significant number of pension experts in Korea to postpone the reform until then. When Korea has a lot of pension beneficiaries, the compliance on the system might be enhanced, while its reform becomes more difficult due to the sharp increase in interested parties.

b. Conflicts between general public and specialized employees stemmed from the difference between the public pension systems

The first NPS was introduced to the workplace with more than 10 employees in 1988, and in April 1999 the scope was expanded to the urban self-employed. It means that Korea has less than 20 years of NPS history. In particular, the urban self-employed who shows a low compliance on the public pension system have less than 10 years of experience with NPS.

Meanwhile, pensions for special professions began earlier: Government Employees Pension system was introduced in 1960; Military Personnel Pension in 1961; and Private Teachers Pension in 1975. Hence, these pension systems are entering a maturity phase, not so much like the NPS. Among them, the Government Employees Pension has almost 50 years of history. The insecure budget of pensions for special professions has emerged as a practical issue. As a result, various discussions are under way regarding the reform of pensions for special professions.

Under the significant differences between NPS and pensions for special professions in terms of history and experience, only the necessity of reforming NPS is being stressed, and the reaction of general public is quite strong. Citizens opine that without reform of pensions for special professions, which have more serious budget issue than NPS, they will oppose the reform of NPS. In the meantime, employees at the special professions strongly oppose to such opinions since the public employees believe there is a significant difference between their pension schemes and NPS. For them, the very employer is government and hence, they believe that there will be difference in dealing with the pension issues between government and others. Furthermore, they cannot understand why the general public regard the Government Employee Pension, which includes retirement allowances, as the NPS.

Such debates which come from the difference in maturity and institution can be understood as one of the Korean characteristics.

4.4.3 High proportion of the self-employed and difficulty in estimating income level

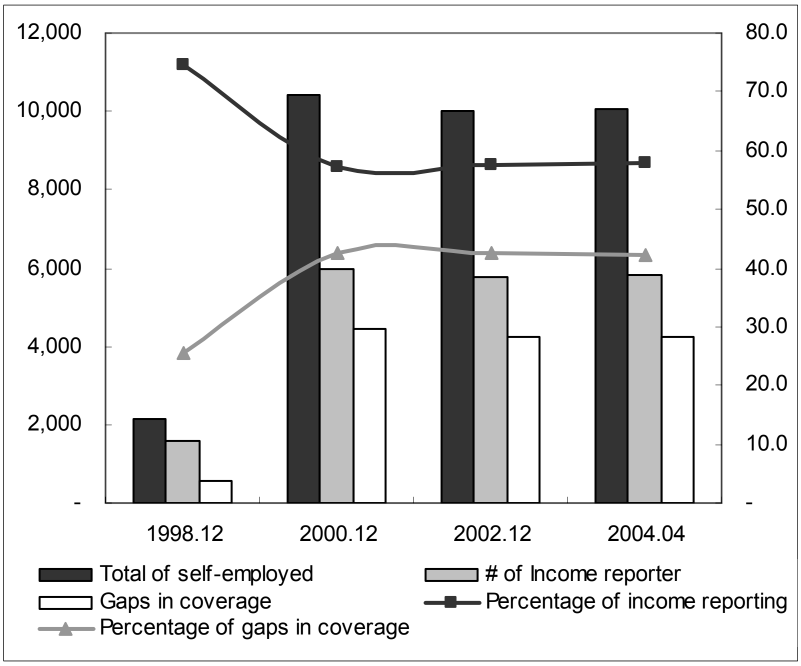
National Pension Scheme implicates the mechanism of income re-distribution within the generation. Hence, it is designed to function as the income re-distribution from the high-income earner to the low-income earner. Currently, "low-burden, high-return" structure makes the income re-distribution within the same generation not work properly, but once the government's plan for the budget security is implemented, such re-distribution function will work.

Different from other developed countries, Korea has a high portion of the self-employed among the public pension policy holders. Under this situation, an accurate income estimation is not possible, and most of them report their income lower than they actually earn. Thus, employees at workplace, whose income levels are open transparently, complain this situation.

In other words, complaints are raised since the same system is applied altogether at different levels of income transparency. Another reason for complaints made by employees at workplace is that the pensions for special professions are run by completely proportional to income.

Nominally, Korea employs the universal pension system. However, there are 4.5 million of exempted subscribers because of the high proportion of self-employed and distrust on the system, another feature of the Korean pension system has.

<Fig. 4-11> Situation of Exempted Persons for NPS Payment



Source: National Pension Service, Internal document.

4.4.4 Difference between replacement rate in theory (nominal) and real replacement rate in National Pension Scheme

As mentioned before, the history of National Pension Scheme is quite short, resulting in big difference between the replacement rate in theory and the real replacement rate. 60% of replacement rate for a subscriber for 40 years cannot be regarded as low in theory, by any international standards. However, if the real replacement rate is calculated with considering the history of introduction of NPS, the difference between nominal and real replacement rates becomes quite large. This feature comes from the fact that those who reached middle or senior ages in subscribing to NPS when it was first introduced, the longest insured period could not be longer than 15 years in practice.

<Table 4-10> Expected Income Replacement Rate by Insured Period and Income Level, If the Replacement Rate is Adjusted to 50% (Those Who Bought the Policy in 1999)

(Unit: %)

Insured Period	1/4 Q	2/4 Q	Average Income	3/4 Q	4/4 Q
10 Years	18.79	15.89	13.55	12.05	9.71
20 Years	36.93	31.23	26.62	23.67	19.06
30 Years	54.19	45.81	39.04	34.70	27.92
40 Years	71.55	60.47	51.51	45.77	36.81

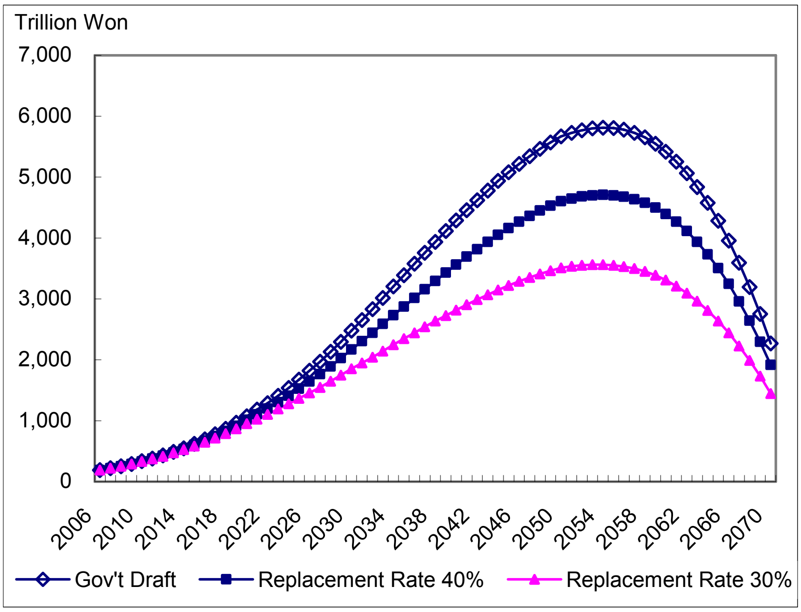
Note: Subscribers in 1999 was determined to be the criteria since the scope of NPS was expanded to the urban self-employed (who could not be covered in corporate pension) in April 1999. In other words, by analyzing the expected replacement rate of the relatively vulnerable group in the multiple income security system caused by the introduction of retirement(corporate) pension, it was possible to compare the adequacy of pension payment with alternatives to pension reform.

As shown in <Table 4-10>, those who joined the NPS in 1999 can expect 27% of replacement rate under 20 years of enrollment and approximately 40% with 30 years of enrollment. If we accept the fact that most of the NPS subscribers in 1999 cannot maintain it for more than 20 years (this is because a certain amount of the urban self-employed already entered the middle ages and seniors when first subscribing to the NPS), it is practically hard to promote downward adjustment of NPS to achieve the financial stability. In particular, since Korea is at the initial stage of NPS implementation, those who entered the middle ages or seniors cannot maintain their enrollment for more than 10 years, so as to result in 15 to 20% of replacement rate. It is also one of the Korean characteristics regarding the pension reform.

However, as NPS enters the maturity phase, the difference between the nominal and real replacement rates will be narrowed while the other pension systems might complement the decrease of replacement rate of NPS, and the additional decrease of NPS replacement rate (approximately 40%) can be condoned from the criteria of "adequacy of pension payment"[2)]. In particular, the retirement(corporate) pension system which was introduced at the end of 2005 will secure around 20% of additional retirement pension.

In this context, the replacement rate of national pension will be maintained at the level of 50% by 2028 (40th anniversary of the introduction of NPS). It will be the most realistic alternative in terms of adequacy of payment. But, after 2030, when NPS enters into the maturity phase, additional efforts to improve the system would be needed. If such presumption is reasonable, Korea might need a piecemeal reform rather than a systemic reform that shuffles the framework of National Pension Scheme, so that multiple income security system can be established in order to reflect the Korean characteristics.

<Fig. 4-12> Finance Forecast of NPS if Replacement Rate is Adjusted to 40% (or 30%) (50% of replacement rate will be maintained by 2027)



Note: Trends of accumulated fund under the presumption that "replacement rate necessary insurance premium policy" will meet the condition of financial soundness and that the funding ratio at the end of 2070 will be doubled.

<Table 4-11> Expected Replacement Rate by Insured Period and Income Level, if the Replacement Rate is Adjusted at 40% after 2028 (Based on the number of the insured in 1999, Replacement rate will be maintained at 50% by 2027)

(Unit : %)

Insured Period	1/4 Q	2/4 Q	Average Income	3/4 Q	4/4 Q
10 Years	18.46	15.62	13.32	11.85	9.54
20 Years	36.59	30.94	26.38	23.45	18.88
30 Years	53.50	45.23	38.54	34.26	27.57
40 Years	67.42	56.98	48.54	43.13	34.68

4.5 Discussion and Conclusion - Implementation Plan for Efficient Income Security for the Elderly in (Super) Aged Society

Korea has experienced an intense economic growth and its National Pension Scheme spread in extremely short period of time comparing to the major developed countries. Thus, it is very difficult to find an appropriate example in foreign countries to learn a lesson regarding the direction of improving the public pension system and the method to design the income security system for the elderly.

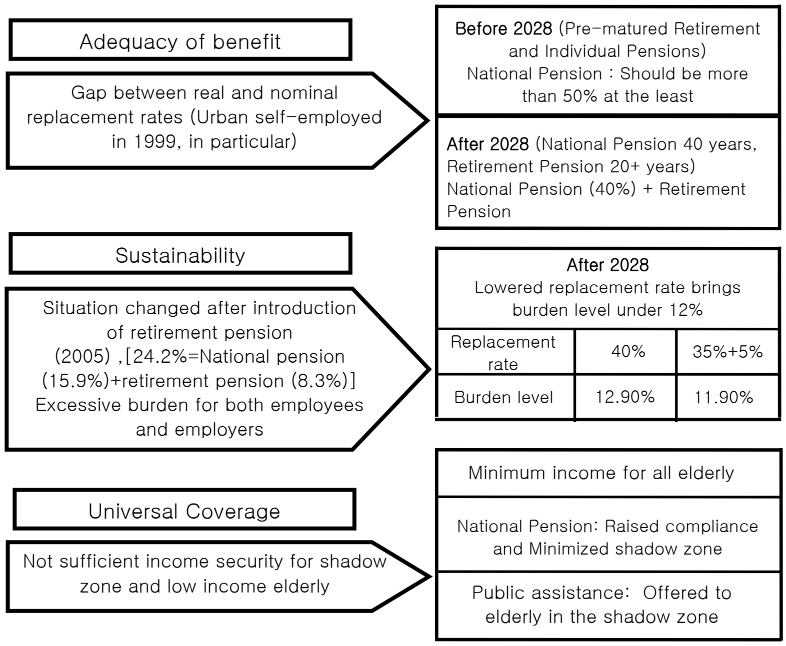
While other developed countries have expanded "low-pay, high-receive" pension scheme when the economy was growing intensively, Korea is likely to see the number of beneficiaries for the public pension increase greatly due to a situation where the pension system and the aging is proceeded simultaneously in a very short period of time with a drastic fall of birth rate. Taking this Korean situation into account, it is my judgment that Korea needs a gradual, piecemeal reform in dealing with the issue of pension reform. In particular, considering the uniqueness of Korean situation, replacement rate will be adjusted downward in a gradual manner since it will minimize the burdens for the future generations. Therefore, I believe that the gradual lowering of the replacement rate is the most desirable alternative.

This is somewhat contrary to an alternative that requires the introduction of basic pension system which is based on taxes, proposed by some experts with an aim to address the blind spot of the current NPS and the poverty issue among the current elderly, which inevitably have been caused by the characteristic of social insurance in the current NPS. It is my belief that a continuous, piecemeal reform will be the most efficient direction toward achieving the goal of pension reform in a systemic manner in the end. For example, Korea might adjust the current replacement rate (60%) to 50% (by 2027), and additionally, it might be lowered to 40 or 35% (after 2028). Then, the slimmed national pension can be placed as a de facto basic pension, and the lowered replacement rate of the national pension can be compensated by the retirement pension. We may also expect that, by adjusting the necessary insurance fee downward, individual pension scheme including retirement pension can be widely used.

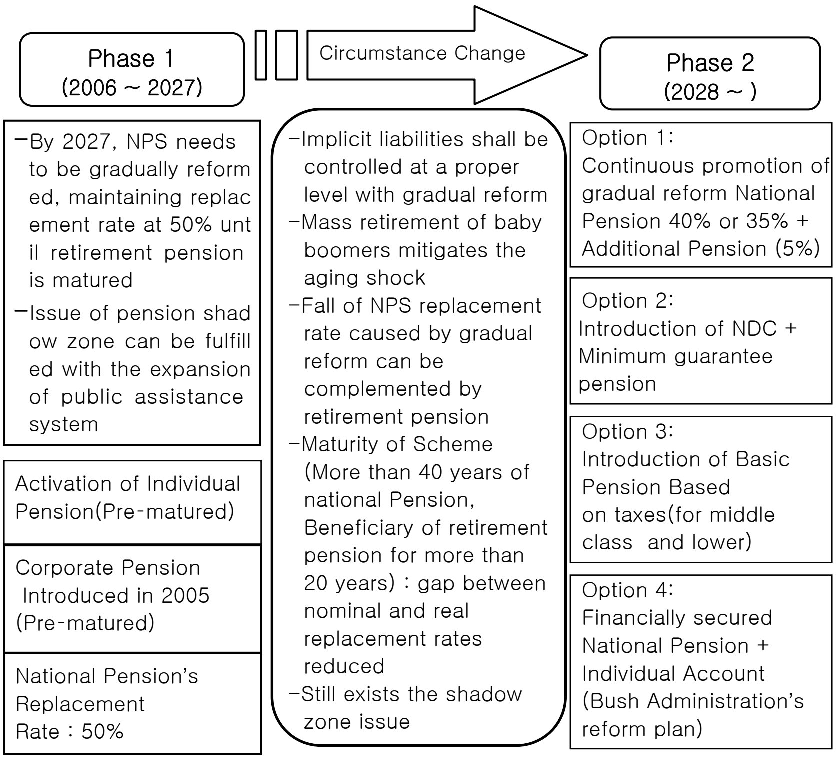
Despite gradual efforts for reform of public pension from the perspective of stabilizing finances, the socially vulnerable tier will still remain as a blind spot after their retirement. For such vulnerable tier, various types of social infrastructure will be prepared to raise the compliance to the system in order to minimize the size of the blind spot. For the group still remain in the spot after the retirement despite such efforts, proper level of income security for the elderly based on a thorough asset (or income) investigation might be ensured under the general revenue of the government, which can control a dramatic increase of fiscal expenditure by minimizing the size of support.

In summary, those who are able to prepare for their elderly life on their own will be incorporated into the sustainable income security scheme for the elderly even in the aged society. The government will focus on those who cannot be incorporated in such institution due to various reasons, in order to secure the sustainability of the system by separating the pension policy with the social insurance principle, and to minimize the government's expenditure on the aged with poverty tier. <Fig. 4-13> and <Fig. 4-14> show a basic framework regarding a desirable income security scheme for the elderly that will work even in the (super) aged society.

<Fig. 4-13> Gradual Improvement of System for (Super) Aged Society If Current System is Maintained



<Fig.4-14> Desirable Income Support System for the Elderly in (Super) Aged Society



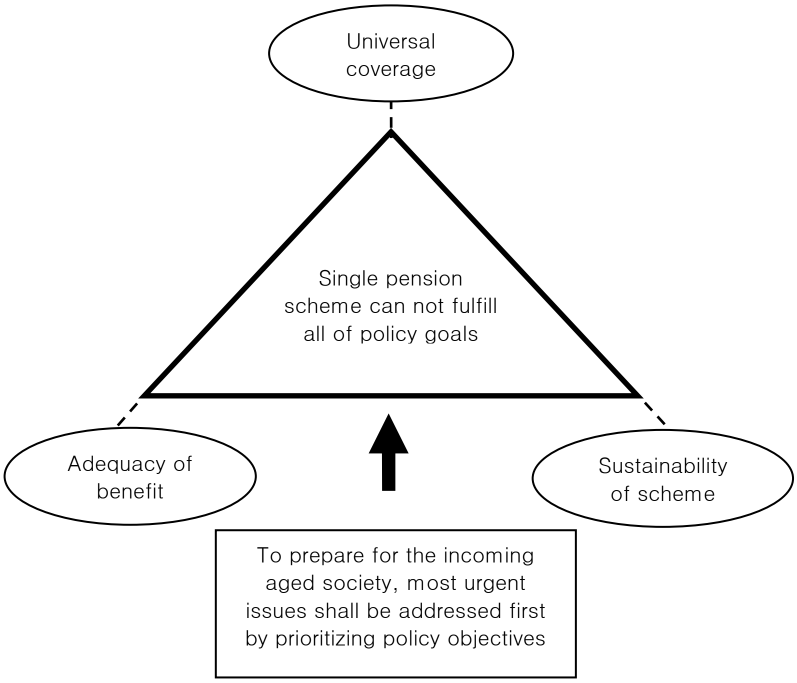
Meanwhile, different from the presumption that the current framework of NPS is maintained, Nominal Defined Contribution (NDC) pension scheme can be considered as an alternative to change the framework of current system in the long run. If NDC is effectively executed, sustainable financing for pension can be rooted within the institution. However, income assistant tool will be necessary for the low-income tier since their pension benefits are small, and to this goal, the introduction of minimum pension security system, which may be financed by general revenue, will be inevitable. However, I believe that the introduction of NDC into the current NPS is not desirable. If the measures to stabilize the revenues for the NPS are effectively carried out, implicit pension liabilities will remain within the controllable level, reducing the urgent needs first. But, more importantly, it will belong to the individual account as its scheme characteristics, with paying the pension in the form of defined contribution (DC). To a country with very short history of pension system and with the National Pension Scheme that reveals significant difference between the replacement rate in theory and the one in practice, transfer into the NDC system will be highly likely to increase the amount of pension to be paid by the policy holders with the minimum living cost.

In addition, the introduction of tax-based, basic pension scheme, which was proposed by the opposition party, can be considered as a long-term solution; since baby boomers--the largest portion of population composition--begin retiring, the basic pension scheme based on taxes might mitigate the shock incomparably to the present. However, in this case, a selective basic pension that enhances the characteristics of public assistance targeting only the low-income elderly will be introduced rather than a universal basic pension that offers benefits to all of the elderly. An example of selective scheme can be found and studied at the claw back system in Canada, which refunds the pension after the payment.

Furthermore, while promoting the stabilization of revenues regarding the existing social security system, the reform plan on the national pension which has been pursued by the Bush Administration in the U.S. can be reviewed in the long run, too. Currently, the social security contribution in the U.S. is 12.4%. Of 12.4%, according to the Bush Administration, the 8.4% is used to keep the function of income re-distribution by maintaining the OASDI in a sustainable social insurance, while the rest 4% is allowed to introduce individual account and is run on the basis of earning-related income. In case that the insured passes away without using all of the accumulated fund, it can be inherited to his/her spouse or children. This aspect can be effective in Korea since the inheritance idea fits well with the public sentiment in Korea. If such benefits are offered to policy holders, the compliance rate on the NPS will become higher than now. At the same time, the revenue sustainability of NPS would be secured. Therefore, it can be studied as an alternative of the pension reform in long-term perspective.

In summary, the unstable finances of public pension, the issue of blind spot in the pension system, and the payment level of pension are equally difficult and important issues. However, in order to efficiently cope with the advent of super-aged society, the prioritization process of policy is inevitable. In other words, addressing all the issues simultaneously by putting same weights on all of the policy tasks is not possible, and thus, a social consensus on this is urgently needed.

<Fig. 4-15> Policy Goals of Public Pension System



In this context, it is my personal opinion that the sustainability of pension scheme will be the first priority with regards to the reform of the NPS system in Korea. It needs to clarify that the sustainability here includes not only in terms of finances but in terms of political and social contexts. To this end, the compliance will be raised by redressing distrust among the general public towards the public pension system, and politicians need to distinguish the issue of public pension system from the populism. The current elderly tier and the potential blind spot of the elderly will be dealt with in a separate manner with a public assistance to ensure a minimum income security by adjusting relevant programs. It would be required to take into account that the proportion of beneficiaries of public assistance program will decrease along with the aging trends and maturity of pension system. If the income security system is designed reflecting this trend, the Korean NPS and related social insurance programs might secure the sustainability despite their fastest maturity paces.

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1) For example, after the government announced the financial stabilization plan for NPS in 2003, a document so called "8 Secrets of National Pension" was circulated on the Internet, increasing distrust of general public against the pension. The document insisted that the pension was merely another type of tax, has nothing to do with the elderly life and that, thus, NPS should be abolished
However, Korean journalists recognized the problems implicated in the public pension system through discussions with experts, and put significant number of articles that explained the government's efforts to change the institution. The Korean press critical to the current regime criticized the politicians that had passive attitude toward the NPS issue, and, thus made it discussed seriously among the politicians. It is a feature of Korean pension reform process.

2) Meanwhile, additional policy alternatives can be considered revealing socioeconomic changes. Now, women's participation in economic activities is relatively low and each household has only one pension. However, when the participation rate increases as much as that of men in 2030, such proportion will be quite lowered. Against this backdrop, the replacement rate can be adjusted to 35% level, but additional pension** will be paid (5%, for example) to mitigate the shock of "one-household, one-pension" family. Such payment system may exclude significant amount of payment with the increase of women's participation in the economic activities, leading to the budget savings in the long run. Therefore, it can be an efficient alternative.

** Additional pension is a kind of added payment with the characteristic of family allowance, which is offered to the person that makes living by the beneficiary at the time of acquiring the right to receive the pension by the subscriber of NPS.

PART 2.

Social Consensus and Pension Reform

5. Societal Consensus and Pension Reforms in Sweden, Germany, Italy and Denmark

Karen Anderson

This paper asks two questions. First, why are some countries more successful at reforming their pension systems than others? Second, what is the role of societal consensus in pension reform processes? The discussion will focus on recent pension reforms in Sweden, Italy, Denmark, and Germany.

One point I would like to emphasize in this paper is that societal consensus is not necessarily a precondition for successful reform. In Italy, societal consensus was important, as I discuss below. In contrast, the Swedish reforms were based more on elite party consensus than on societal consensus. In Germany, recent reforms have been conflictual, while Denmark is notable for the absence of major pension reforms. In Denmark, then, there is a silent consensus in favor of the status quo. I will return to these points later in this paper. The first section addresses the demographic, economic and political factors that influence pension reform trajectories. The second section briefly discusses the political difficulties associated with pension reforms. Section three discusses the ways in which existing pension policies influence reform processes and the prospects for consensual policy-making. Section four addresses the issue of stakeholders and the building of societal consensus. Section five briefly discusses Italy, Sweden, Germany, and Denmark in light of these issues.

5.1 The Pension "Problem"

The major challenge confronting public pension systems in Europe is some form of financial imbalance. Most public pension systems in Western Europe use pay as you go (PAYG) financing and rely on some version of payroll-tax financing that makes financial balance fairly easy to track.[105]

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[105] In Bismarckian pension systems, earmarked payroll taxes (or contributions) paid by both employers and employers finance current pensions. In many cases, the central government also provides a subsidy to the pension system that is financed from general taxation.

In many pension systems, the central government provides a subsidy to the pension system, either to compensate for revenue shortfalls or to finance the contributions of wage earners not currently in dependent employment because of unemployment, sickness, childrearing, and/or education. This setup is sensitive to the ratio of employed persons to retirees, and financial imbalance may be caused by declining birth rates, high unemployment, high levels of early retirement, and/or the accumulation of unfunded liabilities. Whatever the source of financial imbalance, most governments are no longer as willing or capable of increasing general revenue subsidies to make up for declining payroll tax revenues as a share of total pension spending. This means that restoring some semblance of financial balance usually requires payroll tax increases or benefit cuts, or a combination of both. To ease the pain of retrenchment, cuts and payroll contributions can be phased in for future workers/retirees. The essential point here is that when pension reform is a serious item on the political agenda, reform will entail losses for some groups and not others, so it is important to ask how political actors develop their policy preferences concerning these issues. Pension reform almost always produces some "losers" (people who are "worse off" in the reformed system) so the key to successful reform is to design a reform package that a)"justifies" the imposition of losses on some groups (to increase fairness, for example, as in Italy and Sweden) or b) appeals to groups to absorb some losses in exchange for "goods" such as increasing coverage to marginal groups or enhancing pension system solvency (as in Sweden and Italy) or c) provides incentives for workers to take up private or occupational provision in order to compensate for decreases in public provision (as in Italy and Germany).

5.1.1 Proposed Solutions

International and national pension experts have proposed a variety of solutions to the pension "problem."

1) nations should not strive to make *public* pension systems the monopoly pension system, but instead public pensions should guarantee minimum levels of support with private and occupational pensions providing supplementary tiers of pension coverage (privatization);
2) pension benefits should be more clearly linked to contributions in order to save money and in order to

slow pension expansion (actuarialization, or a movement from defined-benefit to defined-contribution systems);.

3) as a consequence of point 2, the privileged position of women within many pension systems has been called into question, with calls for reduction of differences in the treatment of men and women concerning privileges such as the minimum retirement age and the number of contribution years required for a pension. At the same time, pension rights for women's contributions to childrearing have been suggested (gender-neutral retirement age; pension rights for child-rearing);
4) in order to reduce future pension deficits and increase the financial sustainability of pension systems, advance funding should be introduced or increased, by moving from pay-as-you-go to partial or full funding, often in conjunction with an introduction of individual pension accounts.

Italy, Sweden, Germany and Denmark have used several of these strategies. See the case descriptions below as well as the appendix to this paper.

5.2 Why Pension Reform is Difficult

Recent contributions to the literature on welfare state change emphasize the difficulty of reforming mature welfare states even when fiscal and demographic pressures are substantial. Governments intent on adapting welfare state institutions to new economic and social conditions face considerable obstacles because of the popularity of existing social programs (Pierson 1994). As Weaver (1986) has shown, politicians try to "avoid blame" for unpopular policies, such as welfare state reforms that impose losses on important groups of voters. Public pensions are usually very popular with voters, so reforms that involve benefit cuts are almost always electorally risky. This does not mean that reforms do not happen; it only means that passing potentially unpopular reforms is difficult and often requires a political strategy based on compensating those negatively affected by the reform; dividing opponents; or hiding the negative effects of policy change.

Pierson (1994; 1998; 2001) argues that two key variables to explain the dynamics of pension policy change: policy legacies and the organizational and political capacities of important social policy stakeholders. Policy legacies constrain the range the options available to policymakers seeking reform, and the organizational resources of affected interests shape the extent to which politicians can mobilize support for their reform plans.

5.3 The Design of Existing Pension Schemes: Policy Legacies

Historical choices structure the menu of pension options available in reform discussions and past policy decisions shape the preferences of social groups (Pierson 1994, 2001; Myles and Pierson 2001). As Myles and Pierson (2001) argue, pensions are a classic case of path dependent change. Because pensions usually entail long-term, costly benefit commitments to large groups of voters, the structure of existing policies seriously constrains the prospects for reform. Moreover, the groups with a large stake in existing policies have an important impact on reform, not least because of the enormous political risks involved in scaling back and/or re-organizing pension arrangements (Pierson 1994; Weaver and Pierson 1993).

Myles and Pierson (2001) argue that the maturity of a public pension system is a critical variable influencing reform outcomes. The longer a country has had a pay-as-you-go (PAYG) pension system in place, the more difficult it is to reduce or privatize public pension commitments. The "double payment" problem makes it extremely difficult to reduce/privatize public pensions. Large, PAYG public pension schemes that cover all or most of the workforce generate commitments over many decades that are similar to property rights. In order for privatization to be possible, current workers would have to pay twice: once for current pensioners in the public scheme and a second time for their own private pensions. Because the political costs of such a strategy are extremely high, full-scale privatization of public PAYG pensions is nearly impossible, unless reformers can find a source of financing to fund the transition to a new partially privatized system. Sweden and Italy were able to do this, as the short discussions below will demonstrate.

For countries with mature, PAYG public pension schemes (Germany, Sweden, France, Italy, the Netherlands,[106] among others), past policies are highly constraining; policymakers and affected social interests make their policy choices in a context in which large scale privatization is nearly impossible. The main options available are "parametric" reforms that introduce changes within the existing public pension structure. For example, benefit formulae can be made less generous, contributions can be raised, partial privatization can be introduced to supplement public benefits, etc.

A second group of countries did not legislate earnings-related, PAYG public pensions during the decades immediately following World War II. This cluster includes Denmark, the Netherlands, Switzerland and the Southern European welfare states. Here there is usually a basic form of public provision, and earnings-related benefits are organized collectively, usually as occupational pensions negotiated as part of collective wage agreements (Myles and Pierson 2001). Although earnings-related pensions are organized by the market and not the state, the role of the state is still crucial in terms of *regulation*. However, the provisions of specific pension schemes (premiums; benefit formula, indexing, etc) are left to corporatist pension fund boards.

In both clusters of pension systems, organized labor plays a crucial role in decision-making about pension policy and in administration.

IV. Stakeholders and Mechanisms/strategies for promoting societal consensus

Unions as Stakeholders

A number of scholars trace differences in the willingness of key interest groups to accept reform to variations in policy feedback effects. This type of argument is an important amendment to Paul Pierson's "new politics" approach because it highlights the conditions under which key stakeholders are willing to accept retrenchment. Anderson (2001) compares the politics of welfare state retrenchment across different policy areas in Sweden in the 1990s—notably pensions and unemployment benefits—and argues that variation in the intensity of labor preferences concerning reform is an important variable for explaining differences in reform outcomes across policy sectors. Retrenchment in Sweden was possible only when important union groups supported reform, and

[106] The Netherlands is a difficult case to categorize because it has a fairly generous public flat-rate pension and quasi-mandatory private occupational pension schemes.

this pattern of support depended on how highly unions valued core features of the programs targeted for retrenchment. Differences in preference intensity are linked to different feedback processes generated by different types of social policies. The key insight here is that different types of social policies provide different types of benefits and resources to unions as organizations. Pensions can be conceptualized as "deferred wages," which helps explain the sources of union pension policy preferences. Seen this way, unions may be willing to accept modest cuts in future pensions that reduce privileges to well-protected groups if these reductions enhance the financial sustainability of the pension system and its capacity to deliver on its deferred wage promise. Specific aspects of program design also provide organizational resources to unions, particularly arrangements that give unions an institutionalized role in administration. This explains the resistance of Swedish unions to retrenchment in union-administered unemployment insurance at the same time that they accepted cuts in future pensions. Similarly, in other nations, self-administration may be a source of jobs for union officials, as in France (Bonoli and Palier 1997; Béland 2001), or provide union leaders with a power base for political influence, as well as a means of administrative influence, as in Germany (Ebbinghaus and Hassel 2000).

Finally, in line with the blame avoidance thesis, union cooperation and a conciliatory government stance towards unions may be a critical element in successful reforms. Italian policy-makers and politicians that cooperated with the unions in drafting reforms may have been more successful in bringing the legislative process to a successful close than those that pursued a combative course. More generally, Rhodes and Ferrera (2000) have pointed to the resurgence of "corporatism" in Southern Europe, with intensified union-government-employer cooperation through "social pacts."

The implication of these arguments about the centrality of labor for the politics of welfare state reform is clear. In the corporatist political economies of Western Europe, organized labor is still a major actor in the politics of welfare state reform, not least because of the effects of policy legacies. In many Western European countries, unions are still the main defenders of the pension policy status quo, even if they face competition from "new" interest groups like pensioners' organizations.

5.4 The Cases: Systems of Public Pension Dominance

5.4.1 Sweden[107]: Radical Reform in a Mature Pension System: Party Elite Consensus

Sweden stands out for its single comprehensive reform, one of the most radical undertaken in the OECD in the last two decades. Rather than incremental cuts, Swedish policymakers enacted a single reform explicitly designed to restore financial sustainability to the public pension system and obviate the need for incremental cuts in the future. An overarching objective of the pension reform is to separate "social insurance" (collective provision for risk) from "social policy" (objectives not based on shared risk), both in terms of program structure and financing. The new earnings-related scheme is autonomous and includes a notional defined contribution scheme (income pension) and funded individual accounts (premium pension). Contributions are divided between employers and employees, retirement age is flexible starting at 61, and the system has built-in automatic stabilizers to ensure that long-term pension liabilities do not exceed notional assets. Disability pensions and widow's pensions have been transferred to the government budget. The state is also responsible for basic security via the guarantee pension. The revamped pension also includes automatic stabilizers that ensure that (notional) pension liabilities and notional and funded assets remain in balance.

A particularly striking feature of the reform process is the five party coalition supporting it. The first phase of the reform (1994) was passed under a non-socialist minority government with Social Democratic support, and the subsequent provisions (1995-2003) were passed by Social Democratic minority governments with non-socialist support. The five parties backing the agreement pre-committed to keeping the pension reform out of electoral competition, and they managed to stick to the agreement during nearly ten years of negotiations. The reform process took ten years (1991-2001), and the cross-party coalition supporting the agreement has remained stable even through three election campaigns (1994, 1998, and 2001). No matter which parties were in government, representatives of the five parties behind the reform negotiated the details of legislation. The five parties kept the pension issue out of electoral competition by negotiating reform content in small working groups and sticking to their agreement to not let the

[107] See Anderson and Weaver (2003); Anderson (2003); and Anderson and Immergut (2007) for more detailed discussions.

pension reform become an election issue. This was especially tricky for the Social Democrats. Indeed, opposition from party rank and file nearly derailed the reform in 1996 and 1997.

The reform process was atypical by Swedish standards because interest groups, including unions, were explicitly excluded from the negotiations. The five political parties behind the compromise conducted their negotiations in a closed, parliamentary working group. Interest groups had access to most of the working group's materials and had the opportunity to comment on the group's proposals, but they had few opportunities to influence the content of the reform or the direction of the negotiations. Additionally, the political parties backing the agreement gave their negotiators unprecedented authority to negotiate without interference from the party rank and file. The exclusion of interest groups was part of the working group's strategy to de-politicize the reform, and it was a strategy that hurt TCO the most. The LO silently supported the reform. This is not to say that LO and TCO were unimportant. It is worth noting, however, that they did not set the terms of the reform debate and could not block proposals contrary to their interests they often did in the 1980s.

The Social Democratic party leadership and the blue collar unions advocated reform in response to financial and demographic pressures. In 1990, experts predicted that payroll taxes would have to increase to 33.1% of wages (the rate was 18.5% in 1990) by 2025 with an average economic growth rate of 1% (Ståhlberg 1990). In contrast to the widespread public protest that accompanies pension reforms in other European countries, the Swedish reform did not provoke widespread outcry, mainly because current pensioners were exempted from most cuts, and some groups of workers would actually get better benefits in the new system.

The Swedish reform is all the more remarkable when we consider that politicians faced a popular, universal, and nearly mature pension system. The "lock-in" effects of pension policy development dictated that reform would have to take place within the structure of the existing system. The non-socialist parties recognized this, but the large capital reserves in the AP Funds provided an opening for fundamental change. The role of the AP Funds in facilitating the transition to the new pension system can hardly be exaggerated. By 2004, the AP Funds had transferred SEK 350 billion (about € 38 billion) to the government budget to compensate the state for increased costs resulting from the reform. This made it possible to devote a larger share of contributions (16% of qualifying income) to income pensions, (compared to 12% of qualifying income in the old system) and to devote 2.5 percentage points to the new funded accounts. Thus the reform means that more resources are going to earnings-related pensions while the state takes over the non-insurance functions of the old pension system (basic security, survivor's pensions, disability pensions). The financial cushion provided by the AP Funds gave reformers a degree of maneuvering room that simply does not exist in other public pension systems.

The role of the AP Funds is important for another reason as well: as assets accumulate in the new premium reserve, it will eventually replace the AP funds as a source of investment capital. Although this aspect of the reform would not affect the level of benefits, it was a major victory for the non-socialist parties because they succeeded in the partial privatization of very large publicly controlled pension funds.

Finally, Anderson and Meyer (2003) argue that the reform was an opportunity for political actors to pursue a strategy of "rationalizing redistribution" (Myles and Pierson 2001) because the existing benefit formula (the 15/30 rule) was considered unjust. This feature of the old system was repeatedly criticized by reformers, and given the very high levels of female labor force participation, the rationale behind the old rules was hard to justify.

5.4.2 Italy: elite consensus with mechanisms for building grassroots support[108]

Until recent reforms, the Italian pension system was highly inefficient and inequitable. Different types of pension benefits, especially disability pensions and pensions for low-income pensioners were widely used for political patronage, as a substitute for unemployment benefits, and to ease social conflict (Franco 2000). Pensions also encouraged black market employment; there were huge incentives to retire early and then to work outside the regular market. The system was also segmented, with different systems for public and private sector workers, and the rules were not fully harmonized. Political parties could target benefits to specific groups, making reform difficult. The expansion of the pension system, generous rules, and the widespread occurrence of fraud meant huge expenditures. In fact, Italian pension spending dominates social expenditure, at 63% of social expenditure compared to 42% in the EU (1995).

[108] Unless otherwise noted, this section is based on Ferrera and Jesoula (2007).

In the 1990s, pension reform reached the top of the political agenda, for several reasons. First, the weaknesses of the pension system were well-known and there was widespread doubt that the pension system could meet its future obligations without massive increases in contributions. Demographic trends were predicted to increase spending from 14 percent of GDP in the early 1990s to 23 percent of GDP in 2040 (Ferrera and Gualimini 2001: 205). Second, the collapse of the party system in the wake of political scandals created a window of opportunity for reform. Finally, the deadlines for achieving the EMU convergence criteria created considerable pressure on the Italian authorities to reduce the budget deficit, and this would require substantial cuts in public spending.

The years 1992-1997 were a period of major pension reform. Reforms had three broad aims: cost containment, removing undesirable and inequitable program aspects, and reducing fraud and inefficiency. In 1992, the Amato government adopted the first major pension reform in decades. [109] The reform was aimed mostly at reducing pension expenditure. The reform increased the retirement age for men and women in the private sector by five years (to 60 for women and 65 for men), tightened rules for seniority pensions, increased the minimum contribution period from 15 to 20 years, introduced a more restrictive benefit formula (from five to ten years for the income reference period; for those with less than 15 years of contributions, the reference period was changed to lifetime earnings), introduced a shift from wage indexing to price indexing, and increased contributions. Most of these changes were phased in over several years. In addition, large temporary cuts were made by suspending the uprating of pensions and suspending new seniority pensions. The combined effect of all of these measures was the cancellation of at least one fourth of net pension liabilities. According to one estimate, accumulated pension liabilities decreased from 389% of GDP to 278% of GDP. The reform also included provisions for the gradual harmonization of public and private sector pensions, but it did not solve the problem of seniority pensions. These reforms were explicitly motivated by the desire to reduce budget deficits in order to meet the EMU convergence criteria.

In 1993, a new system for supplementary pensions was introduced. The new system included tax incentives designed to promote supplementary pensions and relieve the burden on the public system. Because of the substantial role and size of the public

[109] This section is based on Ferrera and Gualmini (2000) and Franco (2000).

system, funded private pensions were rather insignificant. Development of supplementary pensions has been slow, however, since the 1993 legislation.

After the Dini government replaced the Berlusconi government, another major package of reforms was adopted, which Ferrara and Gualmini (2000) call "revolutionary." The 1995 reform had more ambitious goals than mere cost containment. One goal was to stabilize pension spending as a proportion of GDP, remove labour market disincentives, and to reduce inequity. This included the switch from defined benefits to defined contributions (to take effect from 2013), the introduction of a flexible retirement age, standardization of public and private sector pension regulations, the gradual abolition of seniority pensions, and other changes aimed at controlling costs.

Most analyses argue that the 1992-1995 reforms were substantially influenced by the EMU process. Sbragia (2001) argues that "the misfit between Italian public finances and the Maastricht requirements was widely considered the most significant in the European Union." (80) Indeed, it was widely feared that Italy would not qualify for the first round of EMU. Because of the very high mass and elite support for Italian EMU participation, the adaptational pressures from EMU were "extraordinary." (Sbragia 2001). Other analysts confirm this argument. As Ferrera and Gualmini (2000) put it, "The deadlines fixed at Maastricht in February 1992 forced Italy to make an immediate and radical effort to reform and correct its public finances in order to halt the growth of public debt." (204). It is worth noting that successful reform depended on compromise with the social partners, and reform-minded governments had to modify several aspects of their plans in order to gain the approval of the unions and employers.

The success of reform hinged on two political factors. First, EMU pressure helped change interests, both among the governing elite and for the social partners.[110] The unions in particular were crucial players in the reform process, because their consent was essential for success. The desirability and potential benefits of Italian EMU participation (among other things) persuaded union leaders to accept reform, and internal union procedures helped persuade rank and file to accept reform (Baccaro 2002). Second, the collapse of party system created an opening for reform-minded politicians to overcome traditional parliamentary obstacles. Italian

[110] In 1993 the government budget deficit was 9.4% of GDP, well above the 3% Maastricht target. By 1997, the deficit had been reduced to 2.7% of GDP.

governments negotiated directly with the social partners and convinced the unions of the costs of non-adjustment. A growing debt burden would threaten not only EMU entry but also divert more and more resources from social insurance spending. Politicians convinced unions of the long-term advantages of sound finances, and the unions accepted pension cuts in order to reduce debt payments by the state. In sum, persuasion, supported by EMU, helped transform unions' narrow interests into encompassing interests. In addition, a more or less open and negotiated policy making style facilitated compromise and enabled political actors to overcome the electoral risks of pension reform.

In contrast to Sweden, the Italian reforms are remarkable for their reliance on union democracy in order to achieve societal consensus about pension reform. As Baccaro (2002) argues, "internal debate and procedural legitimacy were key" in generating worker acceptance of the 1995 pension reform. Union leaders consulted their members while they bargained with the Dini government, and once the deal was struck, the unions conducted internal consultations in order to explain and discuss the agreement. Confederal union leaders chose the strategy of deliberation because the proposed reform would disadvantage some categories of workers, and the leaders did not want to have to impose these losses from above. The plant-level delegates were key actors since they led the discussions at plant-level and arguably had the most influence on worker votes (Baccaro 2002). Plant-level discussions (42,000 assemblies were held) were followed by a secret ballot in 49,000 different locations (plants, union offices, etc.) on whether to accept the reform. Participation was not limited to union members; the unemployed, non-union workers, and pensioners were allowed to vote. 64% voted in favor of the reform, out of about 4.5 million participants. Two important groups, metalworkers and teachers, voted against the reform, but their votes were outweighed by the majority. Another round of internal union consultations and a referendum were held in conjunction with the Prodi reform of 1997.

Clearly, the desire to meet the Maastricht conversion criteria played a major role in generating union support and promoting societal consensus. In addition, the expansion of the second pillar was facilitated by the availability of the *Tfr* (*Trattamento di fine rapporto),* a severence pay scheme that could be converted into second pillar pension accumulation.[111]

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[111] The *Tfr* is financed through payroll taxes (6.91% of gross wages) and operates as a defined-benefit scheme, though it can only be paid in a lump-sum.

5.4.3 Germany[112]: Confrontation and Conflict

Germany is a prominent example of how politicians have adopted a series of incremental reforms largely in the absence of societal consensus. Beginning in the late 1990s, the German pension system has faced recurring financial problems, largely because of persistently high unemployment and the costs of German unification. German reforms have been more incremental than those passed in Italy, and especially, Sweden, but they add up to large-scale change in the German pension system. Moreover, governments attempts to build consensus behind pension reforms have largely failed. Most reforms have been adopted against the opposition of the unions and other stakeholders. Only the 2001 reform, passed under the Social Democratic-Green government headed by Gerhard Schröder included some weak incentives for union support. The German pension system is structured according to occupational status. The self-employed and professionals are covered by their own pension funds, civil servant pensions are tax-financed, while the statutory pension insurance (GRV, *Gesetzliche Rentenversicherung*) covers blue collar and white collar workers, about 70 per cent of the workforce. Statutory pensions are pay-as-you-go with social insurance contributions divided evenly between employers and employees and supplemented by general revenue grants.

By the mid 1990s, pension reform was on the agenda, but the cross-party consensus that had characterized earlier reforms had evaporated and the corporatist policy community that had dominated pension policy was weaker. In 1997, the Christian Democratic (CDU-CSU)-Liberal (FDP) coalition passed an unpopular pension reform that introduced modest cuts for future retirees. Although the proposed cuts were slated to affect future pensioners, the DGB (Confederation of German Unions) and sectoral unions opposed them, preferring instead to improve pension financing. Unmoved by these protests, the government went ahead with the reform and broke with the traditional pension consensus.

The 1998 election brought a Social Democratic (SPD)-Green Party coalition to power. Pensions were a major election issue, and the new government reversed some of the 1997 cuts. By early 1999, however, the government had changed course and announced reform plans that included more drastic cuts in future benefits than

[112] See Anderson and Meyer (2003); Jochem and Schulze (2007) and Lamping and Rüb for more detailed discussions.

the ones the government had just reversed. In 2001/2002 the Social Democratic/Green coalition government adopted a significant pension reform designed to slow the growth the pension spending and hold contributions below 22% of qualifying income. To achieve these goals, the reform includes modest benefit reductions for future pensioners and introduces a voluntary private investment scheme. For employers the reform reduces mandatory contributions but they are under no obligation to pay for the private pension schemes; however, employees have the right to demand that employers deduct contributions from their payroll to go directly into an occupational or private pension fund. Employers have to provide this saving opportunity, but are allowed to choose the type they want to offer.

Soon after the reform was passed, it was clear that the reform is not the long-term solution the coalition parties had hoped for. Initial take-up rates for the new private pensions were very low, but in 2005 and 2006 have increased significantly. In addition, despite the cost containment measures, towards the end of 2002 the reserves of the public pension funds again were too low, because of high unemployment. Thus, not long after a razor-thin victory of the SPD and the Greens in the general elections in September 2002 the government passed a "protection of contributions law" that raised pension contributions by 0.4 percentage points and increased the income threshold for contributions to public pensions by January 2003 (Bundestagdrucksache 15/28). At the same time a commission of experts and members of corporate bodies was set up whose mission it is to design a scheme for a complete overhaul of the social insurance systems. One of the results of the work of this commission is a recent law (December 2006) raising the statutory retirement age to 67.

From the outset the reform process that produced the 2001 reform was characterized by acute conflict and latent tension among the central actors in the pension policy network. The government did not rely on coalition building behind the scenes but released a number of plans to the public that were heavily criticized and in response amended by the minister in charge. The SPD leadership clearly underestimated the opposition of unions to their reform plans. Likewise, the unions were surprised at the magnitude of the proposed cuts given that the SPD had just fought an election campaign on precisely this issue. The DGB's initial strategy was to try to block the reform, and when this failed, they joined with the VDR (Association of Public Pension Providers) and the left wing of the SPD in pressuring the government to modify its proposal. The

DGB's strategy was mostly defensive; it had no reform alternative of its own and pushed for smaller benefit cuts and a larger role for unions in the implementation of the private pension provisions. The VDR advocated a generation-neutral solution that would not threaten the long-term sustainability and legitimacy of the public pension system, and the SPD Left pressed for a reform that would not burden younger generations and would provide better entitlements for combining child rearing with part time work. Faced with such strong disapproval and an internal party revolt the government yielded and integrated the VDR's proposal into their bill. The reform was passed in parliament with the votes of the Social Democrats and the Greens in January 2001.

Thus, in the end the SPD-Green government adopted a reform solution influenced at the last minute by the combined pressures of the VDR, the unions and the left wing of the SPD. Even though the government side-stepped the pension policy network throughout the reform process, it could eventually only fashion a feasible reform with the help of these actors.

To summarize, the German reforms introduce major changes in existing pension policy. The public pension system no longer provides a pension in line with the standard of living achieved during employment. Voluntary private provision is encouraged by generous financial incentives, which will speed the growth of the second and third pension pillars. In other words, policy-makers are hoping that the growth of the second and third pillar will compensate for benefit cuts in the first pillar. These policy changes were legislated in a series of conflictual reform processes dominated by the cabinet and chancellor. Unions and other stakeholders were not much involved in the formulation of reform options, and the leaders of the governing parties have had to overcome considerable internal party opposition in order to gain parliamentary support for their reforms. Additionally, recent policy-making in Germany is characterized by the increasing use of expert commissions in which unions and other stakeholders are poorly represented.

Multi-Pillar Systems

5.4.4 Denmark[113]: consensual stalemate

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[113] Unless otherwise noted, this section is based on Green-Pedersen (2007); Ploug (2001); Esping-Andersen 1985; Plovsing (1997); and Ministry of Social Affairs (2001).

Unlike Italy, Sweden and Germany, Denmark is home to a multi-pillar pension system. A fairly generous basic pension was legislated early in the 1900s, but the path to public earnings-related pensions was blocked by decades of policy stalemate that facilitated the growth of collectively bargained earnings-related pensions. Thus the current pension regime in Denmark includes four parts: the income-tested basic pension; the modest ATP scheme; funded labour market pensions providing earnings-related pensions for nearly all employees; and voluntary private pension savings accounts. Assets in the latter three schemes are considerable: ATP assets equal 19% of GDP; capital in labour market pension funds totals 29% of GDP, and assets in private individual insurance accounts amount to 29% of GDP.

In contrast to Sweden, Italy and Germany, Denmark did not and does not face a severe pension "problem." The scope of basic pensions is generous, but tax financing ensures that public pension costs do not add to non-wage labor costs as they do in Italy, Sweden and Germany. The only real "problem" was the issue of how to extend earnings-related pension coverage to those without occupational pensions. In 1980, about 60% of Danish workers only had access to the basic pension. Despite the basic pension's generosity, it only provided a replacement rate of about 33% for many groups of workers in the early 1980s. This means that pension reforms since the 1980s have revolved around how to maintain the value of the basic pension and how to regulate the emerging occupational pensions negotiated as part of collective agreements.

Danish Social Democratic attempts to introduce public supplementary pensions in the 1960s were a notable failure. The Trade Union Confederation (LO) campaigned to introduce a Swedish-style earnings-related pension (ATP) in the early 1960s, but this resulted only in watered down legislation passed by the Social Democratic coalition in 1964. Unable to legislate substantial public supplementary pensions, the government opted for the small ATP and improvements in the basic pension in 1964. The ATP provides a flat rate benefit based on previous hours worked rather than income. Only wage earners pay contributions, and despite the small size of this program, accumulated assets equal more than 19% of GDP.

For many low wage earners, the basic pension and the modest ATP benefits provided adequate pension coverage. In contrast, higher income earners, like the metalworkers, experienced a significant drop in income after retirement because of the inadequacy of the basic pension and ATP in relation to previous wages. It was precisely this group that led the effort to improve earnings related pension coverage among private sector workers. However, the metalworkers would have to wait much longer than their counterparts in the public sector.

The vacuum left by the failure of ATP has been filled with a variety of labour market related pensions. In the early 1960s, when the political establishment could not agree on the introduction of supplementary pensions, such a scheme was introduced for wage earners in the public sector. As the welfare state expanded, supplementary pensions for teachers, nurses, and other professionals were a way to enhance the attractiveness of public sector employment. According to Ploug (2001), this move set a decisive precedent for the rest of the labour market twenty years later.

By the 1980s, the Social Democrats and Liberals had changed their positions regarding occupational pensions. One important economic factor was persistent deficits on the current account, caused by Denmark's low savings rate (among other things). The accumulation of pension savings was one way to address this. Another contributing factor was the demands of some LO unions for improved supplementary pension coverage, particularly the Metalworkers Union. At the time, however, wage bargaining negotiations were centralized, and this precluded the Metalworkers and other unions from negotiating supplementary pensions as part of wage contracts. Separate pension agreements could only be negotiated on a lower level and existing institutions ruled this out.

By the mid 1980s, the Metalworkers advocated a centralized solution to their pension concerns and demanded that LO work towards a legislated, centralized system. Other unions opposed the Metalworkers demands, however. The low wage unions in the LO, who were basically satisfied with the coverage of existing arrangements, feared that making occupational pensions the centerpiece of their bargaining with the non-socialist government would distract attention from other bargaining issues. In addition, the lower wage unions argued that occupational pensions would reinforce income inequality in retirement.

These divisions among the LO unions were mirrored with the Social Democratic Party. The party was already divided on the issue of occupational pensions because of fears similar to those of low wage LO unions: occupational pensions would reinforce income inequality in retirement. Despite these divisions, in 1985 the LO and Social Democratic Party agreed on a proposal for economy-wide, funded, supplementary pensions. Wage earner representatives would manage the fund capital.

The non-socialist government supported the expansion of occupational pensions, but the coalition opposed the LO-Social Democratic Plan, as did the employers. Despite what appeared to be a united LO-Social Democratic front, both the unions and the Social Democrats continued to be internally divided on the issue, and the proposal ultimately failed. Social Democratic opponents advocated further expansion of the basic pension instead. The non-socialist government, employers and unions finally agreed on the outlines of a decentralized system of occupational pensions in 1989. By now, Denmark's competitiveness position had deteriorated significantly and there was widespread support for wage moderation and higher savings to offset the current account deficit. The LO was now prepared to accept collectively bargained occupational pensions to improve coverage for its middle and higher income members. The Social Democrats remained opposed to the non-socialist government's plans for expanding labour market pensions, preferring a legislative solution. In order to increase the pressure on the Social Democrats to cooperate with the minority coalition to adopt occupational pension framework legislation, the LO began negotiations with the employers and the government. At first the strategy worked, and the government initiated negotiations with the Social Democrats, but the talks soon broke down. By now, the LO considered its alternatives to be exhausted and viewed decentralized labour marked pensions as the only remaining solution to its occupational pension problem (Green-Pedersen 2007).

The first steps toward this new model were taken in 1989 when unions for unskilled public sector workers negotiated a separate pension deal. Metalworkers took similar steps in 1991, setting a precedent for the rest of the private sector. Most occupational schemes are defined contribution. The coverage rate of occupational pensions was 84% in 1997, up from about one third in the late 1970s.

Why did unions finally accept the expansion of funded, decentralized labour market pensions as the solution to their pension dilemma? First, the unions wanted some control over pension fund governance, but this was precisely the issue on which the non-socialist government would not compromise. Similarly, the Social Democratic opposition was resolute in its resistance to decentralized pension funds. The distance between the government coalition and the Social Democratic opposition was too great to permit any sort of compromise on this issue. For the LO, participation in pension fund governance (with employers) was a second best option that it accepted in order to finally improve pension coverage for its middle and higher income members. Moreover, union participation in pension fund administration had advantages: influence over investment decisions and selective incentives for workers to join unions participating in pension plans (Green-Pedersen, 2003).

To summarize, Denmark can be described as a case of "societal consensus in favor of the status quo." The public basic pension is popular and no government would seriously consider major retrenchment. The only real pension-related conflicts in Denmark have concerned earnings-related pensions. Political stalemate prevented the adoption of a public, earnings-related scheme. When the Metalworkers Union pushed for the introduction of contractual earnings-related pensions in the 1980s, they faced resistance from low-wage unions who were satisfied with the status quo. The Metalworkers (backed by the Social Democrats) also faced resistance from the non-socialist parties who opposed plans for union control over pension capital. In the end, unions, employers and political parties compromised by agreeing to promote funded (defined contribution) occupational pensions as part of wage bargaining. Today, about 90% of Danish workers are covered by these occupational pensions.

5.5 Conclusion

In conclusion, I want to stress several points. First, societal consensus concerning pension reforms is not always a pre-condition for successful reform, as the German case shows. To be sure, there are considerable risks associated with a strategy of confrontation. The Social Democrats were punished at the polls for their retrenchment policies in both the 2002 and 2005 elections.[114] The Swedish case shows that party consensus is a potentially viable basis for reform. The five parties backing the 1994/98 Swedish reform represented more than 90% of Swedish voters, and the architects of the reform often reminded the unions of this fact.

Second, the Italian case shows the potential for using deliberative democracy in order to increase legitimacy and achieve consensus. The democratic procedures used by unions in the 1995 reform

[114] The Social Democrats remained in power with the Greens after the 2002 election, but they lost votes compared to the 1998 election.

process allowed pro-reform union leaders to overcome the opposition of specific groups of workers (i.e. teachers and metalworkers) who opposed the reform. By allowing all workers as well as pensions to take part in the referendum, vocal minorities could not block reform.

Third, there are several mechanisms for increasing the attractiveness of pension reforms that involve losses for some groups of workers. In Italy and Sweden, the availability of financial resources facilitated the transition from the old system to the reformed pension system. In Sweden, the AP Funds were used to finance the extra costs associated with the reform, including the introduction of the premium pension. In Italy, the Tfr could be converted to a new purpose: second pillar occupational pensions. In both cases, the availability of alternative sources of financing reduced the costs of switching to the new system.

Finally, unions and other stakeholders are more likely to accept pension reform if they are guaranteed a role in the new system. This is illustrated most clearly in the German and Swedish cases. One of the reasons the German unions reluctantly accepted the 2001 pension reform is that union-administered second pillar pensions receive favorable treatment as a form of voluntary private provision. In Sweden, union-administered pension funds are included within the new premium pension scheme.

<Appendix>

<Table 5.A.1> Sweden: Pension Reforms since 1980

Year	Name of reform	Reform process (chronology)	Reform measures
1987	Reform of widow's pension	• Pension Committee appointed 1984 Committee Report SOU 1987: 55 • law takes into effect January 1980	• widows' pension replaced by lower "adjustment pension" (*omställningspension*): 96% of the basic pension plus 20% of the deceased's ATP if children, 40% if not. Payable for 12 months. Means-tested additional allowance (*särskild efterlevandepension*) payable after twelve months; widows married before 1990 still eligible for widow's pension, as well as women born before 1930; existing widows' pensioners grandfathered in. child's pension: increased to 40% of the base amount and max benefit of 20% of the base amount plus 30% of the deceased's ATP, (slightly lower for siblings).
1992	"Crisis packages"	• November 1992 non-socialist government - SAP opposition agreement	• Pensions are calculated at 98% of the already reduced base amount, this rule was extended in 1993, 1994, 1995, 1996, 1997, and 1998.
1994	Pensions reform	• 1990 The Pensions Commission (*Pensionsberedningen*) Report SOU 1990: 76 November 1991 non-socialist government appoints parliamentary working group to negotiate reform • January 1994 working group final report SOU 1994: 20 -TCO (white collar unions) tries to pressure government to change some provisions and fails. -LO (blue collar unions) tacitly supportive. Metalworkers oppose; Municipal Workers support reform • Framework legislation adopted 8th June 1994	• 15/30 → lifetime earnings • Pension contributions 50:50 employers: employees. • 2.5% contribution to „premium reserve" (obligatory individual investment accounts). • guarantee pension replaced old basic pension (*folkpension*) and pension supplement (*pensionstillskott*) • recommendations: replace partial pension with flexible pension age from age 60; transfer disability pension scheme to sickness or work injury insurance system. • unresolved items: reduce guarantee pension for those with contractual occupational pensions?; construction of premium reserve; the swap in contributions; economic adjustment index; pension rights for students; automatic balancing

Year	Name of reform	Reform process (chronology)	Reform measures
1998	Pensions reformen	• 1994 The parties behind the 1994 reform appoint an „implementation group” (*genomförandegruppen*) to work out remaining details • 1994-98 ongoing negotiations between five parties supporting agreement -January 1996 grass-roots opposition to reform at SAP Extra Party Congress. -January 1997 The parties behind the reform agree on the contribution swap and the structure of the premium reserve -1997 grass roots opposition at SAP Regular Party Congress -January 1998 The parties behind the reform agree most remaining details • 2nd April 1998 The government propose two detailed bills one on the income pension and one on the guarantee pension • both bills passed easily the Riksdag on June 8, 1994	• income from the premium pension, private pensions and occupational pensions do not affect the level of the guarantee pension • increase in contribution to Premium Reserve from 2.0 to 2.5% of qualifying wages. -contribution to sickness insurance is transferred to pensions in order to achieve partity financing between employers and employees -Premium Pension Authority created -Default investment fund for those who do not choose a fund or who want the state to manage their premium pension account. -SEK 90 billion transferred from AP Funds to the state budget in 1999 and 2000 to cover tasks transferred to the government budget
2001	Buffer Funds	• 2001 The legislation passes	• SEK 170 billion transferred from AP Funds to state to cover transition costs. Total transfer is now SEK 258 billion.

<Table 5.A.2> ITALY: Pension reforms since 1980s

Year	Name of reform	Reform process (Chronology)	Reform measures
1992 -3	Amato Reform • emergency measures: laws 359/92 and 438/92 • structural reform: delegation law 421/92, then implemented through D.Lgs. 503/92 (reform of public pillar), D.Lgs. 124/93 (framework for supplementary pensions)	• June 1992: technocratic government supported by a four-party coalition • nomination of a pension committee • July 1992: emergency measures: presented bill C1287 to convert D.L.333/92; approved 7.8.92: law 359/92 presented bill S463 for structural reform • September 1992: Union strikes and demonstrations; tripartite negotiations. bill S463 revised. Emergency measures: bill C1581 to convert D.L.384/92 • 10 October 1992: bill S463 approved by the Chamber of Deputies (vote of confidence). pro 303 (gov. parties) - con. 3 (Greens,RC;LN,Pds) – abst. 11 (Msi,Pri); 22 October 1992: Senate approves (vote of confidence): pro 158 (gov. parties) - con. 4 – abst. 7: Law 421 • 12 November 1992: bill C1581 approved by Senate (vote of confidence): Law 438/92 • December 1992: D.Lgs. 503/92 • April 1993: D.Lgs. 124/93	Law 421/92 – D.Lgs. 503/92 • increase of retirement age from 55 to 60 for women and from 60 to 65 for men • extension of the period to assess reference earnings from last 5 years (for private sector) and last month (for public sector) to 10 years for those with at least 15 years of contributions and entire working career for new entrants in the labor market • phasing-out of seniority "baby pensions" for public employees: minimum qualifying period from 20 to 35 years • harmonization of the public sector seniority pension with private sector i.e. introduction of minimum qualifying period of 35 years • lengthening of minimum qualifying period for standard old-age pension from 15 to 20 years • change of indexation base from wages to prices • limitation of compatibility of pensions and income from work • lengthening of minimum qualifying period for seniority pension from 35 to 36 years → proposed but not enacted • reduction of the accrual rate for workers with higher wages law 438/92 • suspension of the option to retire with seniority pensions in 1993; reduction of pension indexation for 1993. D.Lgs. 124/93 • legal framework for open and closed pension funds in the second/third pillars . Possibility to use the *Tfr* to finance these funds

Year	Name of reform	Reform process (Chronology)	Reform measures
1994	Berlusconi Reform	• 1994: pension reform crucial issue in electoral campaign for the elections • government coalition between Forza Italia, Alleanza Nazionale, Lega Nord, Ccd-Cdu • September 1994 submission of government bill • Oct/Nov 1994 general strike and union protests • 1 December 1994: agreement between unions and government on few and temporary measures → original reform proposal drastically smoothened • 22 December 1994: resignation of the Berlusconi government	• Benefits reduction when retiring below standard retirement age of 60/65 years: 3% per each year below retirement age • reduction of the accrual rate from 2% to 1.75% for older workers • changing indexation from prices to projected inflation rate → reform failed (except for some minor changes: i.e. acceleration of the transition period to increase retirement age legislated in Amato reform)

Year	Name of reform	Reform process (Chronology)	Reform measures
1995	Dini Reform law 335/1995	• January 1995 : Investiture of a technocratic government under Dini supported by PDS, Popular Party , Lega Nord and some smaller center parties • 8 May 1995: agreement between government and unions; *Confindustria* refuses to sign • *Bill C2549* presented at the Chamber of Deputies • 3 August 1995: vote Senate: pro 175 (gov. parties)- con. 56 (AN,RC) - abst. 37 (FI,CCD) • 4 August 1995: vote Chamber of Deputies: pro 266 (gov. parties) – con. 92 (AN,RC) - abst. 125 (FI,CCD)	• Change of pension calculation formula from earnings-related system to contributions-related system i.e. benefits depend on amount of contributions actually paid, indexed with mean GDP growth rate of the last five years; very gradual phasing-in. • flexible retirement age: 57-65 years • introduction of factors into the benefit formula to take account of the age of retirement, economic trends and demographic dynamics • seniority pensions: gradual increase of minimum qualifying period from 35 to 40 years • introduction of child rearing credits • increase in contribution rates • replacement of *pensione sociale* with new means-tested benefits (*Assegno sociale*) • new scheme for workers with “atypical” contracts • extension of tax incentives for supplementary second pillar pensions (contributions are tax deductible up to 2% of annual income with an upper limit of € 1,291)
1997	Prodi Reform Law 449/97	• 1996: Prodi government supported by Olive tree and the external support of *Rifondazione Comunista* • establishment of a committee (*Commissione Onofri*) • 18 December 1997: vote Chamber of Deputies: pro 305 (gov. parties) - con. 188 (opposition) - abst. 3 • 23 December 1997: vote Senate: pro 161(gov. parties) – con. 40 (opp.) – abst. 0	Law 449/97 • tightening conditions for seniority pensions via harmonization between public and private sector • one-year freeze of pensions indexation • increase of basic pensions • restoration of partial compatibility of pensions and income from work proposed but not enacted • unification of different pension regimes • acceleration of the introduction of the new pension formula of the Dini reform introduction of automatic revisions of the conversion coefficients

Year	Name of reform	Reform process (Chronology)	Reform measures
2000	Lgs. 47/2000	• May 1999: law 133/99, government presents a bill to ask parliament a delegation of power to issue a decree on supplementary pensions • February 2000. government decree	• More generous tax incentives for supplementary pensions; contributions made deductible up to 12% of annual income with an upper limit of € 5,164)
2004-5	Berlusconi II Reform law 243/2004 D.Lgs. 252/2005	• 2001: Brambilla committee report • December 2001: government presents a bill (C2145) to ask parliament a delegation of power to reform pensions • 2002: debate and criticism by social l partners and experts • Oct/Dec. 2003 general strike and a big demonstration • January 2004: original draft bill substantially modified to take into consideration social partners' requests • 13 May 2004: vote Senate (vote of confidence): pro 153 (gov. parties) - con. 88 (opposition) - abst.0 • 28 July 2004: vote Chamber of Deputies (vote of confidence): pro 288 (gov. parties) – con.119(opp.) - abst. 0 • 2004-2005: debate starts on the new rules for the *Tfr* and supplementary pillars. Negotiations between the Minstry of Welfare and the unions; government divided. • 24 November 2005. Issued D.Lgs.252/2005	Law 243/2004 • introduction of bonus for deferred retirement despite eligibility to seniority pension • fixed and higher retirement age in the contributions-related system: 65 years for men, 60 for women • tightened conditions for seniority pensions in the transition period • compulsory transfer *of Tfr* into ension funds → Revised: transfer of the *Tfr* with the "silent assent" formula (to be confirmed by a government decree) • introduction of an extra 3% tax on very high pensions proposed but not enacted: • reduction of contribution rate to 5% for newly hired workers D.Lgs. 252/2005 (operative in 2008) • transfer of the *Tfr* with the "silent assent" formula • in the default option ("silence") the *Tfr* is automatically transferred to "closed" occupational funds; a residual fund, managed by INPS, is created to receive the Tfr if no pension funds are available. • compensatory measures for firms that "loose" the *Tfr* • revision of tax rules for supplementary pension funds

<Table 5.A.3> DENMARK: Pension reforms since 1980

Year	Name of reform	Reform process (chronology)	Reform measures
1990	Lov om satsreguleringsprocenter	• Alternative majority i.e. opposition parties push legislation through Parliament against the minority government's will	• Indexation changed from price increases to real wage increases; if annual increase exceeds 2% it is reduced by 0.3% which is used for the improvement of other cash benefits
1991	Collectively bargained pensions	• 1984 Metal Union demands occupational pensions through collective agreement • Fall 1985 union committee report • Spring 1986 opposition proposal to introduce occupational pensions with central fund • Fall 1987 tripartite negotiations: establishment of commission to investigate occupational pensions • intra-coalition conflict between Conservatives and Liberals with the Prime Minister leaning towards the Liberals who rejected any legislation on occupational pensions • Social Democrats' main interest was winning a parliamentary majority thus no interest in reaching agreement with government • failed negotiations → LO realizes that the only chance for occupational pensions is through collective agreement • 1991 most unions introduce occupational pensions	• Introduction of occupational pensions through collective agreements

Year	Name of reform	Reform process (chronology)	Reform measures
1993	*Konsekvenser af skatteform*	• Majority government passes bill without negotiating with the opposition	• Compensation for single pensioners for the abolition of their special tax exemption through a temporary supplement which has gradually been transferred to the pension supplement, implies greater income testing in the long run • reduction of basic pension but compensation by higher supplement
1996	Dobbelt ATP for folk på overførselsindkomster	1989 ATP-board suggests introducing contributions for recipients of sickness, maternity and unemployment benefits • Dec 1991 governmental bill for revision of ATP but without contributions for unemployed etc. • Spring 1992 amendment of the Labor Market Committee • change in government in 1993 (ditto) • budget agreement 1996: government suggests expanding ATP to include recipients of cash benefits	• Recipients of sickness, maternity, and unemployment benefits to get twice the normal ATP contribution, recipients of social assistance get the normal ATP contribution • no introduction of indexation of the ATP contributions, contrary to original proposal
1998	Special Pension Scheme (SP) (*særlig pensionsopsparing*)	• Fall 1997 government proposes introducing 1% contribution of work-related income to ATP • March 1998 elections • passage in Parliament	• Special pension scheme was made permanent and the benefit structure changed so that the value of the contributions would not matter for benefits as it did in the ATP scheme

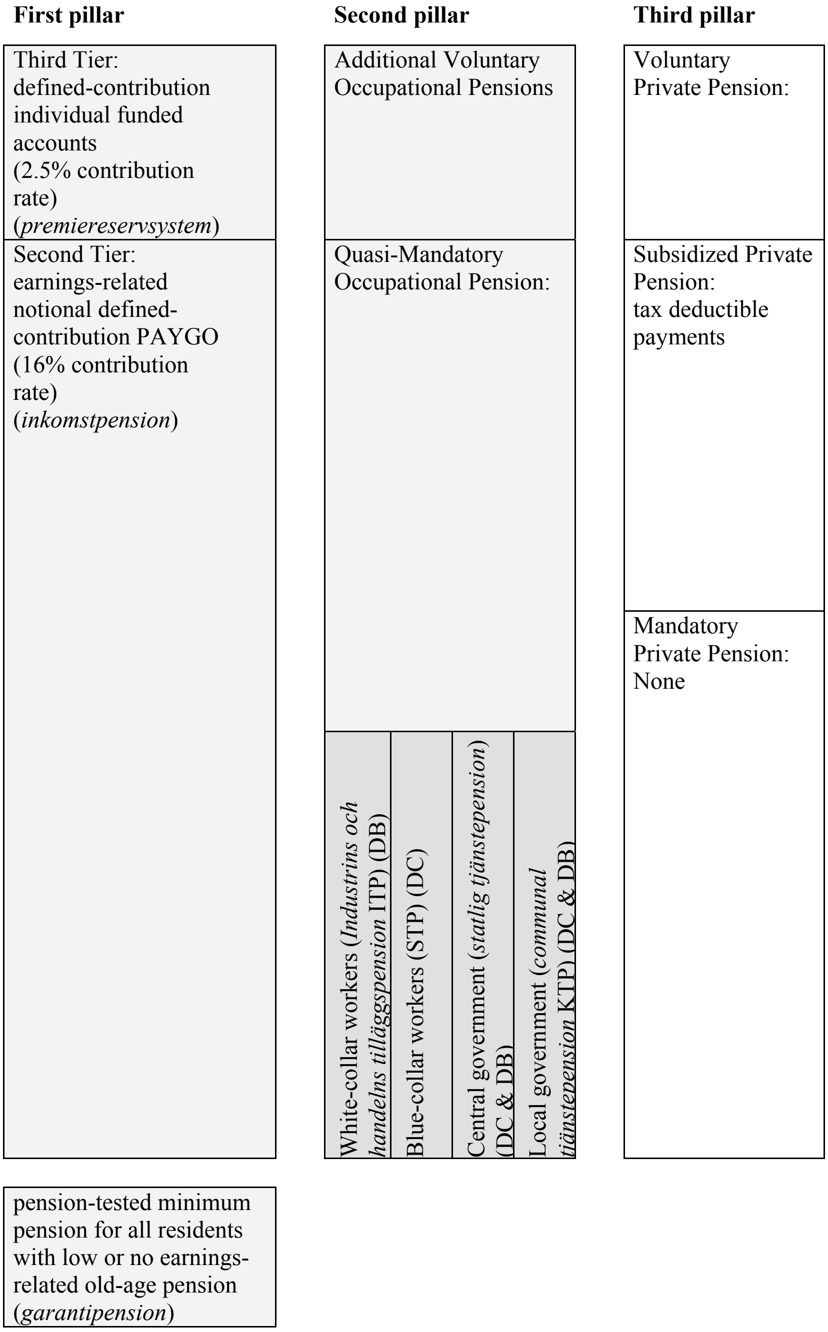
Year	Name of reform	Reform process (chronology)	Reform measures
2001	Førtidspensions reform	• Spring 2001 passage in Parliament by broad majority	• Introduction of ATP contributions for recipients of disability pensions financed 2/3 by the government and 1/3 by the recipient • establishment of voluntary pension scheme for disability pension recipients with contributions of 2% of average wage financed 2/3 by the government and 1/3 by the recipient.

<Table 5.A.4> GERMANY: Pension reforms since 1980

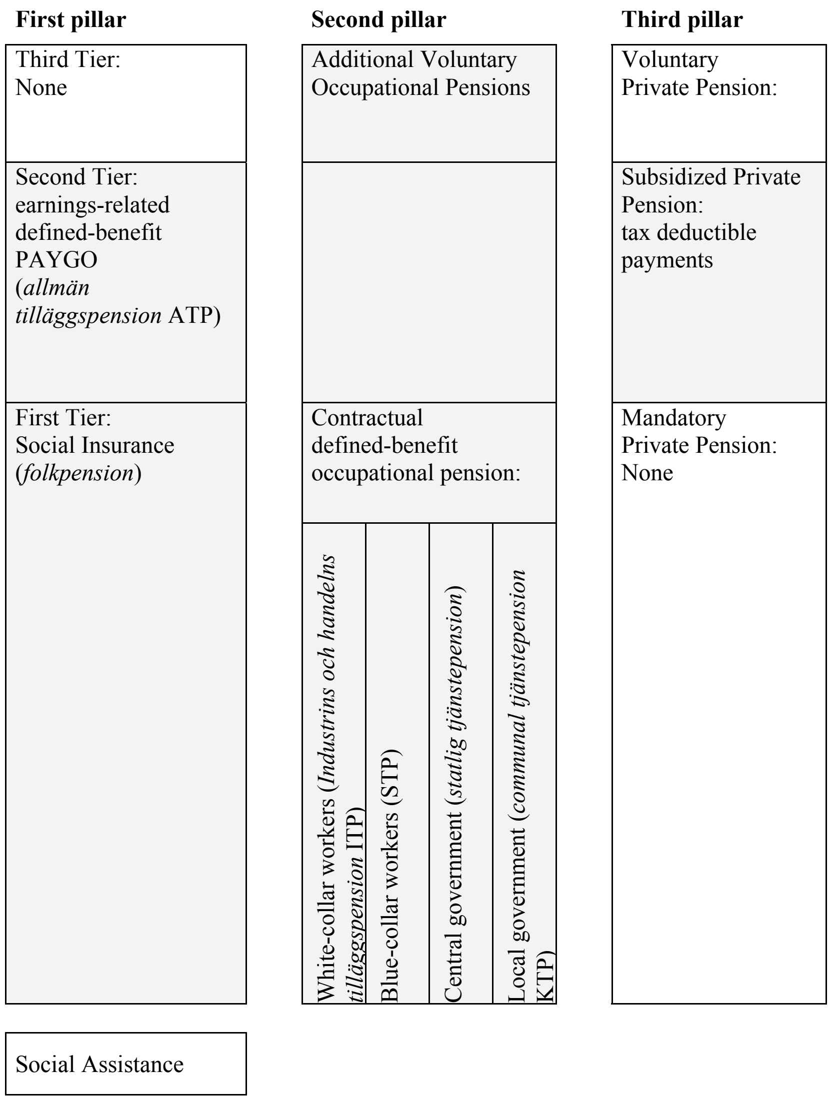
Year	Name of Reform	Reform Process (Chronology)	Reform Measures
1989	Blüm I Reform *Pension Reform Act 1992*	• February 1989 four-party agreement (CDU/CSU, FDP and SPD) • 7 March 1989 cross-party bill submitted to *Bundestag* • 9 November 1989 passage in *Bundestag* • 1 December passage in *Bundesrat*	• Change from gross- to net-wage indexation; • increase in retirement age for women, unemployed, disabled; • introduction of deductions for early retirement; • increase in child rearing period from one to three years
1997	Blüm II Reform *Pension Reform Act 1999*	• May 1996 Blüm Commission • 26 June 1997 submission to Parliament • 7 October 1997 submission of separate finance bill • 10 October 1997 passage of RRG 1999 in BT • 31 October 1997 passage of finance bill in BT • 7 and 28 November 1997 initiation of Mediation Committee • 28 November 1997 *Bundesrat* objection • 11 December 1997 *Bundestag* overrules BR-objection of RRG 1999 • 19 December 1997 passage of finance bill in *Bundesrat*	• Introduction of demographic factor in the pension indexation formula; • increase of child credits from 75% to 100% of average wage; • reduction in disability benefits of 0.3% per month of early retirement. limited to total of 10% of benefits; • increase in retirement age for disability pensions from 60 to 63; • increase in federal subsidy to pension system through 1 percentage point increase of VAT

2001	Riester Reform *AVmG* and *AVmEG*	• June 1999 Riester proposal • September 2000 ministerial draft (major changes compared to proposal of June 1999) • 14 November 2000 separation of private pension act (*AVmG*) from other reform measures (*AVmEG*) • 26 January 2001 passage of AvmEG in *Bundestag* • 16 February 2001 passage of AVmEG in *Bundesrat* • March 2001 Mediation Committee on *AVmG* • 11 May 2001 passage of *AVmG* in *Bundestag* • 11 May 2001 passage of *AVmG* in *Bundesrat*	• Introduction of voluntary, subsidized private pensions; • reduction of replacement rate of statutory pension system benefits from 70% to 64%; • fixation of upper contribution rate limit (20% up to 2020); • introduction of means-tested social assistance minimum pension; • reduction of survivor's pension from 60% to 55% of deceased's benefits
2004	Rürup Reform *RV-Nachhaltigkeits-gesetz*	• November 2002 establishment of Rürup Commission • 28 August 2003 Rürup Commission report • 30 September 2003 Herzog Commission report • 11 March 2004 passage in *Bundestag* • 2 April 2004 objection in *Bundesrat* and call of Mediation Committee • 16 June 2004 *Bundestag* overrules of *Bundesrat's* objection	• Introduction of *Nachhaltigkeitsfaktor* with loss limitation to 46% of one's former average wage; • change of assessment base for pension indexation to real contributory base; • suspension of pension adjustment for 2004; • abolition of credit points for periods of higher education; • increase in retirement age for unemployed and partial pension from 60 to 63; • change in lower limit of contingency reserve from 0.5 to 0.2 times monthly expenditure (*Nachhaltigkeitsrücklage*); Increase in retirement age from 65 to 67 → failed!
2004	*Alterseinkünfte-gesetz*	• 6 March 2002 BverfG verdict on taxation • 28 May 2004 passage in *Bundestag* • 11 June 2004 passage in *Bundesrat*	• Introduction of taxation of pension benefits; • introduction of gender-neutral benefits in Riester Rente (*Unisextarife*); • streamlining of criteria for certification of Riester-Rente products

<Figure 5.A.1> Pension system in Sweden post 1998



<Figure 5.A.2> Pension system in Sweden pre-1994

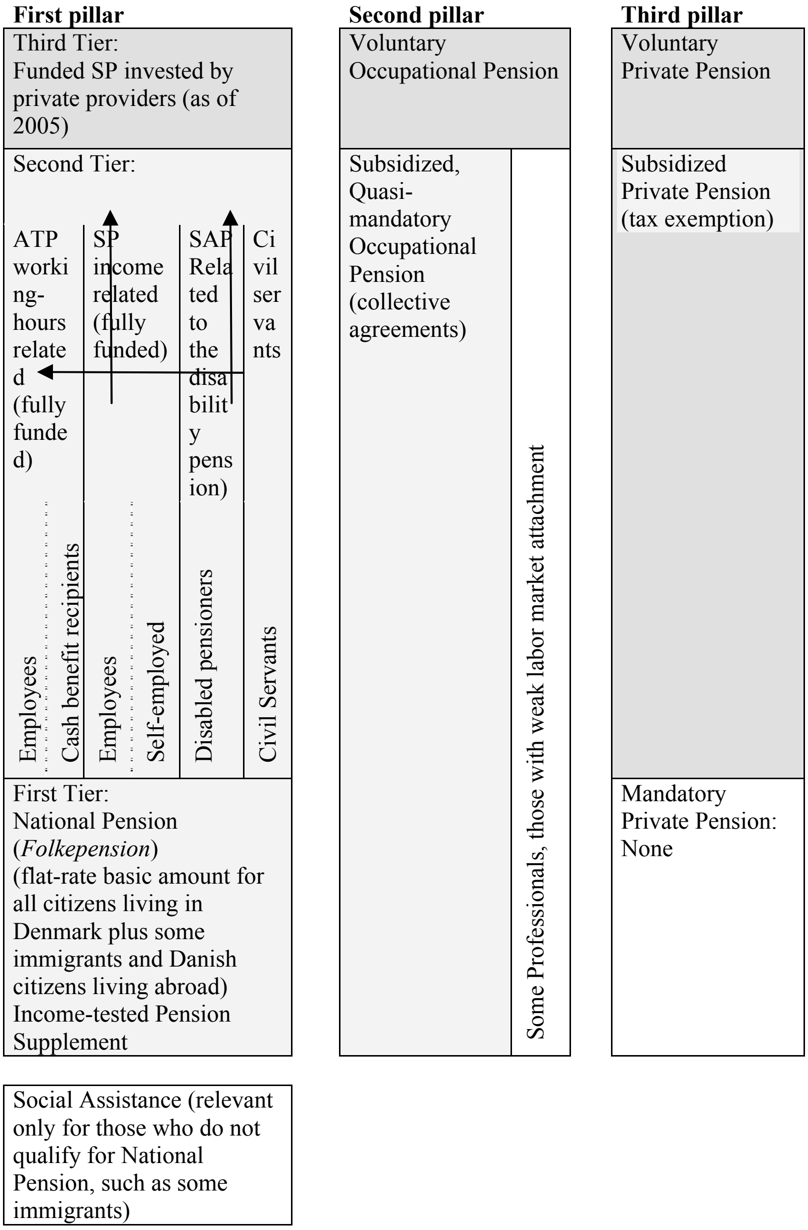


<Figure 5.A.3> Pension system in Italy

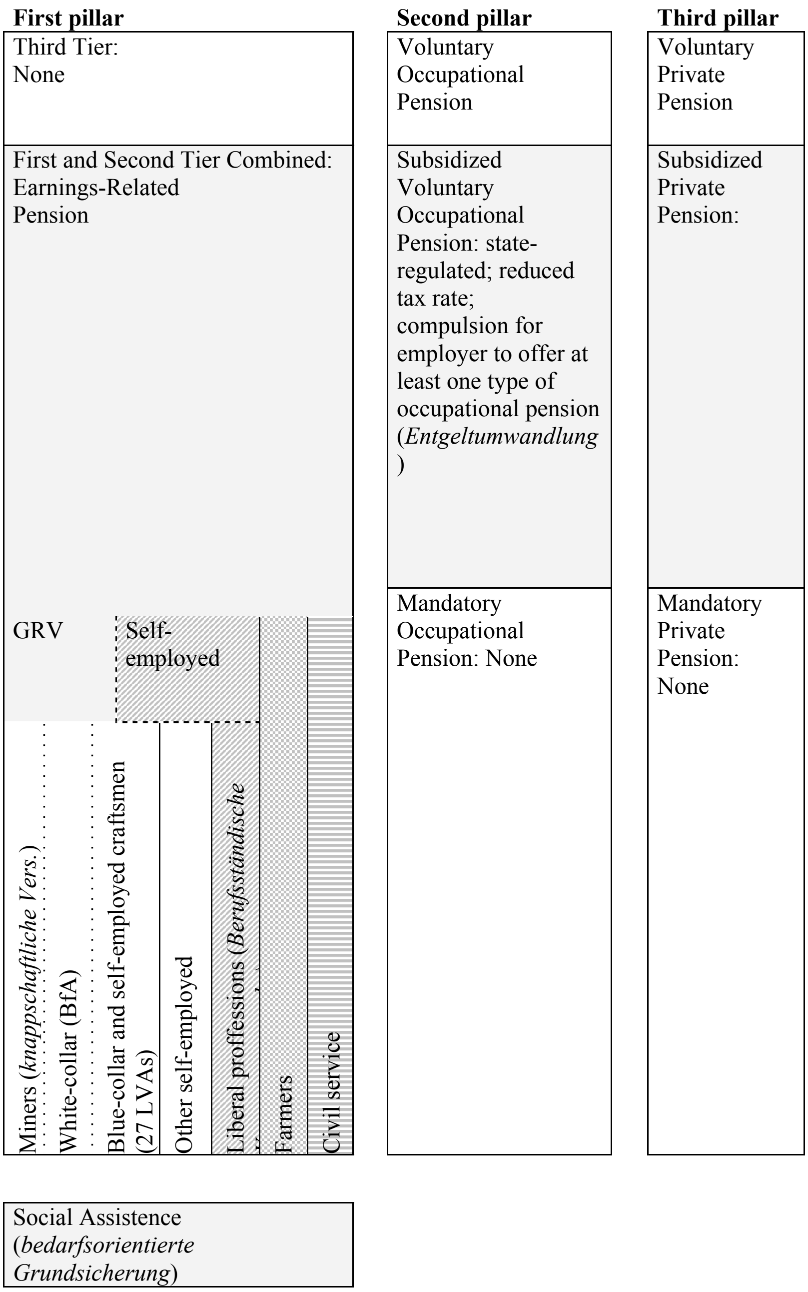
First pillar	**Second pillar**	**Third pillar**
Third tier: supplemental private investment: None	Voluntary occupational pension: none	Voluntary private pension: none
First and second tiers combined (INPS and INPDAP are the two biggest schemes, but many more funds exist)	Subsidized occupational pension -“Closed” pension funds; -“Open” pension funds in case of collective affiliation both tax subsidized (ETT)	Subsidized personal pension: -“Open” pension funds in case of individual affiliation -PIP (*Polizze individuali pensionistiche*)
INPS Self-employed INPDAP Employees (FPLD) Merchants Farmers Artisans Local government Central government	Mandatory occupational pension: none	Mandatory Personal Pension: none
Means-tested part (*Pensione sociale – Integrazione al minimo - Assegno Sociale*)	Mandatory severance payment/Quasi-pension scheme (private employees: *Trattamento di fine rapporto (TFR);* public employees: *Indennità di buonuscita*)	

Social Assistance: none

<Figure 5.A.4> Pension system in Denmark



<Figure 5.A.5> Pension system in Germany



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6. Reforming Public Pension Systems in an Era of Austerity: Is Social Consensus Possible?

Kent Weaver

Almost all industrialized and middle-income countries have made commitments to their public pension systems that are likely to be unsustainable in the medium to long-run, though there is immense variation in the degree of overcommitment.[115] And most of these countries have undertaken efforts over the past two decades to reform their pension systems, though the degree of success in doing so has varied widely.[116] The overall question addressed in this paper is whether something approximating social consensus is achievable as countries seek to reform their public pension systems, or must this process inevitably one that is highly conflictual and results in a majority--or even a procedurally-privileged minority—imposing its will on a recalcitrant and/or resentful minority? If pension reform is attempted without broad agreement, are such initiatives likely to fail? Or if reform occurs without widespread policy consensus, is that likely to lead to policy instability, either as a result of party turnover after elections or because governing parties, fearing electoral retribution, reverse course themselves?

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[115] See for example Bernard Casey, Howard Oxley, Edward Whitehouse, Pablo Antolin, Romain Duval and Willi Liebfritz, *Policies for An Aging Society: Recent Measures and Areas for Further Reform*, Paris: OECD Economics Department Working Papers No. 369, November 20, 2003.

[116] For overviews, see for example Karl Hinrichs, "Elephants on the Move: Patterns of Public Pension Reform in OECD Countries" *European Review*, vol. 8, no. 3, pp. 353-378, Paul D. Pierson, "The New Politics of the Welfare State," *World Politics*, 48 (January 1996) pp. 143-179, Mitchell A. Orenstein, "Mapping the Diffusion of Pension Innovation," pp. 171-193 in Robert Holzmann, Mitchell Orenstein and Michal Rutkowski, eds. *Pension Reform in Europe: Process and Progress*. Washington, D.C: The World Bank, 2003, John Myles and Paul Pierson "The Comparative Political Economy of Pension Reform," pp. 305-333 in Pierson, ed., *The New Politics of the Welfare State*, Oxford: Oxford University Press, 2001, and R.. Kent Weaver, "The Politics of Pension Reform: Lessons from Abroad," in R. Douglas Arnold, Michael Graetz, and Alicia Munnell, eds., *Framing the Social Security Debate: Values, Politics and Economics*, Washington, D.C.: Brookings Institution Press, 1998, pp. 183-229.

The first section of the paper outlines different stages of the reform process and major reform process options at the agenda-setting and problem definition, policy formulation, and modification and ratification stages. It also outlines some preliminary hypotheses to explain why countries are likely to differ in the reform processes they utilize. The second through fourth sections of the paper review the recent experiences of three English-speaking countries with very different pension systems: the United States, with a "Bismarckian Lite" public pension system, the United Kingdom's mixed pension system, and New Zealand's flat-rate pension regime. The final section of the paper asks why national experiences differ, and examines the question of what the implications of a lack of social consensus are for enacting public pension reform. In addition, it asks whether some reform processes work better than others, and whether there are "best practices" for pension reform processes that countries can learn from one another.

The central arguments of the paper are as follows. First, different countries are likely to employ different mechanisms and processes to enact pension reform. These differences are lagely based on variations in political institutions and norms of group inclusion or exclusion. But countries may in fact use different formulation and ratification processes at different points in time. For example, the United States has used both politically inclusive and exclusive processes to try to reform its Social Security system. Second, social consensus can rarely be generated for either incremental or parametric pension reform; the best that can be hoped for is elite agreement during the policy formulation process followed by social "acquiescence" during ratification. Third there are mechanisms available to build elite consensus and social acquiescence in pension reform, notably expert commissions and all-party or multi-party accords. But for both mechanisms, there are constraints that make elites reluctant to employ them and that may make their potential for promoting agreement fleeting at best.

6.1 The Pension Reform Process and Social Consensus

The process of pension reform can be broken down into several stages, which may be dominated by different political actors and different procedures for decisionmaking. For our purposes, we shall be concerned with whether some mechanisms are more likely than others to promote social consensus.

The first stage is agenda-setting and problem definition. While agenda-setting is inevitably a complex process that may involve several different "streams" (to use Kingdon's famous terminology[117]), several distinct possibilities may be noted:

- ☐ In many cases, government executives play a major role in agenda-setting, choosing some issues to emphasize over others as a focus for government's attention.
- ☐ Independent expert commissions (e.g., presidential commissions in the United States, Royal Commissions in Canada, commissions of inquiry in Sweden) may also help to put an issue on the agenda and help to build agreement both on the importance of addressing an issue and on particular approaches to addressing it.
- ☐ Politicians may put pension reform on the agenda as part of an election manifesto if they believe that it will be politically attractive, and/or as part of a post-election coalition agreement if one or more parties are strongly committed to it. This is presumably less likely when retrenchment and other painful options dominate pension policymaking than it was in an earlier era where expansion was the order of the day.
- ☐ A general fiscal crisis or programmatic funding crisis (e.g., exhaustion of the Social Security trust funds in the late 1970s and early 1980s in the US, the fiscal crisis in New Zealand in the early 1990s) may force politicians to act;
- ☐ A programmatic scandal (e.g., the pension mis-selling scandal in the U.K.) may cause an issue to make it onto government's agenda regardless of the wishes of politicians.

In general, we would expect that social consensus on pension reform is more likely when agenda-setting and problem definition takes place either through a broad process of consultation or through an expert rather than through a process that is dominated by the government executive or by a single political party. If opposition parties and social groups believe that governing elites are skewing problem definition in a way that benefits their partisan

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[117] See John Kingdon, *Agendas, Alternatives, and Public Policies*, 2nd ed., Reading, Mass.: Addison-Wesley, 1995.

and/or political interests, they are unlikely to cooperate at later stages of the policymaking process.

A second stage in the pension reform process concerns who formulates the proposed solution, and who is consulted in the development of that solution. There are several options at the policy formulation stage. The process may be Expert-led, notably through an independent commission that is appointed by government but retains policymaking autonomy. Second, it may be executive-led, that is, formulation occurs primarily within the executive branch, with a full-blown proposal emerging from the executive. It may also take place through an Inclusive (i.e., supermajority or all-party) Politician-led process, such as an all party-working group in the legislature or a politician-dominated commission representing all major parties.

A fourth option is an Exclusive (minimum winning coalition) Politician-led process, for example through the party manifesto of a party or a post-election coalition agreement among a group of parties. Finally, policy formulation may occur through a Group-inclusive process of consultation with employers, trade unions, and possibly organizations representing pensioners.

In considering these alternatives for policy formulation mechanisms, several initial hypotheses arise. First, given the high stakes of pension reform, truly Expert-led processes are likely to be (1) rare, and (2) prone to manipulation and interference from appointing governments. Second, Executive-led and Exclusive Politician-led processes will be common in Westminster-style parliamentary systems, where cross-party agreements are the exception rather than a frequent necessity. Third, Inclusive Politician-led and Group-inclusive processes will be especially common in (1) countries with PR systems, and (2) countries with strong corporatist norms and traditions.

Modification and ratification of pension policy proposals, like other stages of the pension policymaking process, may be more or less inclusive. We would expect that both fundamental restructuring and major retrenchment of pension policy are more likely when a country has few constitutional veto points and strong single party majority governments. However it is also likely that (1) even strong governments will be reluctant to undertake visible, cuts, especially in lead-up to elections, and (2) governments with few veto points may also be subject to some policy instability and reversal. Governing elites that want to ensure both broader social acceptance of their proposals and lower the probability that there will be a policy reversal after a change in party control of government may choose to make some concessions on policy during the ratification phase to achieve broader "buy in." But they are only likely to do so if they think that opposition groups bargaining in good faith—that is, that they will actually temper their opposition to the changes in both the short- and medium-term if concessions are made. Because pension policy changes in an era of budget austerity are usually unpopular, and thus an easy vehicle for a blame-generating opposition parties or groups, it is far from certain that concessions during the modification/ratification stage of policymaking will be offered or accepted in exchange for a share of the blame.

6.2 The United States: Policy Stalemate in a Bismarckian Lite System

The dominant tier in the public pension system in the United States is a contributory earnings-related Pay-As-You-Go (PAYG) program called Old Age and Survivors Insurance (OASI), commonly known as Social Security. Both replacement rates and payroll taxes for OASI remain much lower than in most of continental Europe, however--a distinctive policy regime that has been labeled "Bismarckian Lite."[118] The Social Security program is supplemented by a very small means-tested tier, the Supplemental Security Income (SSI) program, which contains severe income and asset tests.[119] Because there is no provision for general revenue financing for Social Security—it is financed by current payroll taxes and past surpluses (plus earnings on those surpluses) in the Social Security Trust fund, there is a potential action-forcing mechanism for retrenchment or restructuring in the program when the trust fund is running out of money.

The public pension system in the United States faces a distinctive set of policy challenges, incremental reform options, and regime transition opportunities. Demographically, the United States has a

[118] R. Kent Weaver, "Public Pension Policy in the United States," in Giuliano Bonoli and Toshimatsu Shinkawa, pp. 230-251 in *Ageing and Pension Reform Around the World: Evidence from Eleven Countries*, Cheltenham: Edward Elgar, 2005, and Weaver, "Public Pension Reform in an Age of Austerity," pp. 64-99 in Martin Levin and Martin Shapiro, eds. *Trans-Atlantic Policymaking*, Washington, D.C.: Georgetown University Press, 2005.

[119] Only 5.7 percent of those aged 65 and over received benefits from SSI in 1999. Arthur Jones, *Supplemental Security Income and Its Noninstitutional Recipients: July 1997 and 1999*, UIS Census Bureau Current Population Reports P70-90., August 2003.

lower elder-dependency ratio than many other advanced industrial countries and a higher fertility rate. Although Social Security expenditures have increased significantly as a share of the federal budget and of GDP in recent decades, in the near-term (as noted above), Social Security is running massive surpluses of revenue intake over expenditures, because the baby boom generation is in its peak earning and contributing years. In the longer term, however, Social Security faces a shortfall of around 2 percent of payroll over the 75 year projection period for the program. Clearly the absence of an immediate action-forcing mechanism makes action on pension reform in the United States less likely, despite the long-term funding problem.

To address Social Security's problems, several incremental reform options have been considered over the past few decades. On the benefit and eligibility side, options include a long-term lowering of benefit replacement rates, lowering inflation adjustments for current recipients, and increasing taxation of benefits for upper-income Social Security recipients. On the revenue side, increasing payroll taxes, which are low by most European standards, is also a possibility, but it is strongly opposed by Republican policymakers and by many powerful lobby groups, notably small business. In terms of more fundamental restructuring reforms, or regime transition opportunities, a shift to mixed system including individual defined contribution pension accounts is possible, but the PAYG nature of Social Security makes the transition very difficult unless new revenues are added to the system. A shift to a notional defined contribution (NDC) system on the Swedish model is also possible, but internal cross-subsidies within Social Security would make such a change very complicated and politically risky.

Complicating either incremental or more fundamental restructuring initiatives in the United States are its political institutions. Separation of powers and multiple veto points within Congress make it easy for opponents of change to block any reform initiative. Divided government for almost all of the 1983-2002 period further increased gridlock potential. Candidate-centered elections and weak party discipline strengthen blame-avoiding incentives.

Table 1 provides a brief summary of Social Security reform initiatives since 1981. Social Security cuts were considered several times during the administration of Ronald Reagan (1981-1989). President Reagan had promised in the 1980 presidential campaign that Social Security would be exempt from cuts, and the new administration initially proposed only minor changes in Social

Security. But in the spring of 1981, spiraling deficit forecasts led David Stockman, Director of the Office of Management and Budget within the White House, to press for a Social Security reform package that contained a large dose of immediate political pain. Proposed cuts including a three month delay in cost-of-living adjustments a change in calculating future retirees' initial benefits that would eventually lower the percentage of a retiree's prior earnings replaced by Social Security benefits significantly, and a severe and almost immediate cut in benefits for future early retirees. The President initially backed the package, but after it generated widespread criticism from congressional Democrats and senior lobby groups, the White House quickly backed away; a relatively modest package of cuts was enacted in 1981.

Although the political dangers of proposing Social Security benefit cuts were evident, awareness of another looming Social Security trust fund crisis (the fund was expected to be exhausted in 1983) led the President and congressional Democrats to entrust Social Security's financial problems to a bipartisan commission that was to report after the 1982 elections. Although the commission almost came to an impasse, the threat that there soon would not be money in the trust funds to send out Social Security checks stimulated compromise. The commission provided a political cover allowing negotiators for the president and congressional Democrats to come to an agreement that was eventually approved, with some additions, by Congress, winning wide bipartisan majorities in both chambers.[120] Because both parties shared responsibility for reaching the agreement, the potential for blame was minimized, and the ability of the various participants to stick to the agreement was maximized.

The 1983 legislation made major changes in Social Security on both the tax and benefit sides. In the immediate term, the most important change was a small permanent benefit cut for current (but not future) recipients. In the longer term, the legislation imposed a gradual increase in the standard retirement age (the age at which full Social Security retirement benefits are received) from 65 to 67, phased in between the year 2000 and 2021. Although Republicans accepted an acceleration of previously scheduled payroll taxes as part of the rescue package, they adamantly (and successfully) opposed further increases in payroll tax rates. They also accepted

[120] See Paul Light, *Still Artful Work: he Continuing Politics of Social Security Reform*, New York: McGraw-Hill, 1995, chapters 16-17.

taxation of half of the value of Social Security benefits for middle and upper income recipients.

The absence of a short-term funding crisis in Social Security program acted as a fundamental brake on retrenchment initiatives after Bill Clinton assumed the presidency in 1993.[121] As shown in Table 1, the only significant exception was a provision adopted as part of President Clinton's 1993 budget package that made 85 percent of benefits taxable for beneficiaries at the upper end of the income scale. But this provision affected relatively few Social Security recipients.

Clearly politicians in the United States remain extremely reluctant to do anything that might leave their individual or party fingerprints on a bill that could later be portrayed by political opponents as a cut in Social Security. Policymakers could delegate decision-making to non-elected bodies and limit their own discretion to overturn the decisions of those bodies, as they have done in setting up special commissions to oversee closing of military bases. In practice, the president and Congress generally delegate real power to commissions--for example, saying that their recommendations go into effect automatically unless Congress can muster a majority against them--only an issues like military base closings and congressional pay where all the major actors in the legislative and executive branches are agreed on the broad outlines of a solution but need a political cover to work out the details and take the political heat.[122] But on Social Security, there is no such agreement on the basic dimensions of a solution, and thus not even a hint of willingness to submit its future to a commission with binding decision-making power.[123]

The story was initially the same after Republicans gained control of Congress in 1994. House Republicans, having learned from the

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[121] For a comprehensive view of Social Security policymaking during the Clinton administration, see Douglas W. Elmendorf, Jeffrey B. Leibman and David W. Wilcox (2002) "Fiscal Policy and Social Security Policy During the 1990s," pp. 63-119 in Jeffrey A. Frankel and Peter R. Orszag, eds., *American Economic Policy in the 1990s*, Cambridge, MA: MIT Press. See also R. Douglas Arnold, "The Politics of Social Security," *Political Science Quarterly*, vol. 111, no. 2 (1998) pp. 213-240.

[122] R. Kent Weaver "Is Congress Delegating Too Much Power to Commissions?," *Roll Call*, February 12, 1989.

[123] President Clinton did appoint a commission to study Social Security and other entitlement issues in 1993 (a price extracted by Senator Bob Kerrey for his vote in favor of Clinton's budget package), but the commission had only the power to make recommendations, and it ended up being so divided that it was unable even to agree on a package of recommendations.

Reagan experience with Social Security retrenchment initiatives, and seeking to avoid proposals that did not enjoy popular support, explicitly excluded Social Security cutbacks from their "Contract with America" campaign pledge in the 1994 congressional election.[124] Even when congressional Republicans endorsed very unpopular (and ultimately unsuccessful) Medicare and Medicaid cuts in the fall of 1995 in an effort to make their deficit and tax reduction promises "add up," they resisted Social Security cuts. The Clinton-Republican budget agreement of 1997 also excluded Social Security cuts.

Republicans and conservative critics have in recent years called for varying degrees of "privatization" of Social Security through mandatory or optional contributions to personal pensions.[125] But the last two presidential administrations in the United States have taken very different approaches to restructuring Social Security. In his January 1999 State of the Union, Clinton proposed to reserve 62 percent of the budget surplus that was then anticipated to occur over the next fifteen years to bolstering the Social Security (Old Age Survivors Insurance) trust fund. Approximately one-fifth of this amount would be invested in equities--collectively rather than individually--through a mechanism insulated from government influence. Thus returns on trust fund revenues would be raised at least modestly, but the size of the investment would also be modest enough to lessen fears about government control of the economy. In addition, another 11 percent of the anticipated surplus was to be reserved for government subsidies to new "Universal Savings (USA) Accounts"--new retirement savings accounts through which the federal government would match individual retirement savings accounts. Subsidies would be skewed toward low income workers. These accounts would help individuals prepare for retirement based on personal choice and individual accounts, as privatizers prefer. They had one fundamental difference from privatizers' plans, however: they would not have taken money out of existing payroll

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[124] Balz, Dan, and Ronald Brownstein (1996) *Storming the Gates: Protest Politics and the Republican Revival*, Boston, Little Brown.

[125] The Social Security Advisory Council's 1997 report also gave increased credence both to investing Social Security funds in equities and setting up individualized accounts over which workers would have some investment control. But nothing close to a consensus on a direction for reform emerged from the Advisory Council's 1997 report. The report contained three distinct proposals, none of which could command a majority of Council members.

[125] 1994-1996 Advisory Council on Social Security, *Report*, vol. 1: *Findings and Recommendations*, Washington, D.C.: The Council, 1997.

taxes or be part of the basic Social Security system. Thus they would not require cutting additional cuts in existing defined benefits of the OASI system, and government commitments to subsidize the new accounts could be scaled back when government budget surpluses shrink. Even with backing from President Clinton, the option of investment of Social Security trust funds in the stock market as a way to help finance Social Security was never seriously considered by Congress. It was blocked by strong opposition from congressional Republicans. Alan Greenspan, the powerful and widely-respected chairman of the Federal Reserve Board, was also a highly vocal critic of government investment in equities markets. Greenspan argued that no mechanisms to insulate investment managers from political pressures would be adequate.[126]

How and how much to restructure Social Security was an important issue in the 2000 presidential election campaign in the United States. Republican candidate George W. Bush proposed allowing workers to divert part of their Social Security payroll taxes to individual accounts, while his Democratic opponent, Al Gore, argued that doing so would further weaken the viability of the current Social Security system.[127] After the election, the new president decided to wait on Social Security until after his top priority, a tax cut, had made it through Congress. Instead, President Bush decided to appoint a commission on how best to implement an opt-out plan.[128]

Unlike the 1981-83 Social Security reform commission, however, President Bush appointed all of the members of the Commission, although members were drawn from both political parties. All appointees had to agree in advance to support a set of principles established by the White House, including no increase in Social Security payroll taxes, voluntary individual accounts, and no erosion of benefits for current retirees and near retirees. The commission eventually decided to present a menu of policy options rather than a single plan, in part to shield the administration from

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[126] For Greenspan's views, see for example Richard W. Stevenson, "Fed Chief Warns of Painful Choices on Social Security," *New York Times*, January 29, 1999, p. A1.

[127] See Kevin Sack, "Gore and Bush Trade Jabs on Pensions and Spending; Vice President Sees Threat to Future of Social Security," *New York Times*. November 2, 2000, p. A1.

[128] For a discussion, see Amy Goldstein, "Bush Plans Panel to Study Overhaul of Social Security," *Washington Post*, February 27, 2001, p. A1, and Sara Fritz, "Proof of Bush's Social Security Intentions Will Be in the Panel," *St. Petersburg Times*, April 2, 2001, p. 3A.

criticism over the benefit cuts that would be required to fund a Social Security opt-out.[129] Stock market declines in 2001 and 2002 also dampened, at least temporarily, support for partial privatization of Social Security. Perhaps most important, the quick post September 11 disappearance of federal budget surpluses made financing a transition to opt-out advance-funded individual accounts more difficult.[130] Indeed, Republican candidates in the 2002 congressional election were encouraged by the party to distance themselves from the notion of "privatization" because of its perceived political risks.[131]

An even more curious, and less productive, interlude occurred after George W. Bush's reelection in 2004. In early 2005, the President mounted a major public relations campaign touting the need for a major restructuring of Social Security. But after several months of presidential speeches, public opinion polls showed that the public had little appetite for Social Security reform, and little confidence in the Bush administration as a source of Social Security reform proposals. The presidential initiative was quietly dropped by the middle of 2005.[132]

Thus the United States remains, at the end of 2006, a country with a remarkably stable "Bismarckian Lite" public pension system. After a major parametric reform in 1983 and a minor reform in 1993, there has been no policy change for more than a decade. No consensus has emerged among political elites or among the broader public on the best direction for Social Security reform. Alternation of the Democrats and Republicans in the White House and almost perpetual divided government help to explain why the agenda for fundamental reforms has been broad: both parties have been able to put ideas broadly consistent with their political philosophies onto the discussion agenda.

American political institutions have clearly contributed to the absence of substantial Social Security reform in recent years. Short electoral cycles and candidate-centered elections give American

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[129] President's commission to Strengthen Social Security, *Strengthening Social Security and Creating Wealth for All Americans*, Washington, D.C.: The Commission, December 2001.

[130] Richard Morin and Claudia Deane, "Poll Shows New doubts on Economy; President's Tax Cut, Policy Are Questioned," *Washington Post*, March 27, 2001, p. A1.

[131] Jim Vanderhei and Juliet Eilperin, "Bush's Plan for Social Security Loses Favor," *Washington Post*, August 13, 2002, p. A1; Amy Goldstein, "Action on Social Security Debated," *Washington Post*, November 15, 2002, p. A16.

[132] See for example Jacob Weisberg, "The President Has Lost on Social Security, How Will He Handle It?," *Slate*, March 31, 2005.

politicians very little leeway for taking loss-imposing actions. Even in a period of united party control of the Executive and Congress, two initiatives by George W. Bush to get major restructuring reforms adopted collapsed without any congressional action. In addition, multiple veto points and almost continuous divided government made U.S. presidents reluctant to give a high priority to Social Security reform agendas that would likely fail to make it through Congress. Positions of the two parties' political bases are very polarized, and both parties see Social Security as an issue that may work to their electoral advantage. Thus the outlook for Social Security reform in the United States remains one in which continued blame-generating and continued stalemate rather than an elite-sponsored consensus on problem definition and specific solutions remain the order of the day.

6.3 New Zealand: Policy Reform in a Universalist Pension Regime

New Zealand has a pension system that, while once common, has become an anachronism in the industrialized world: a single-tier universal flat-rate pension paid from general revenues. In the absence of contributions and a trust-fund device, there is no action-forcing and legitimating mechanism for retrenchment that allows politicians to avoid blame for pension cutbacks. Flat-rate pensions also make it more difficult to impose retrenchment gradually by "grandfathering" current recipients and cutting benefits for later ones. Thus New Zealand has faced several unattractive incremental policy options as its pension spending burden increased: notably lowering (in real if not nominal terms) pension benefits for all recipients, at least relative to wages, creating a dedicated payroll tax to fund part or all of the financing burden, and/or increasing the age of eligibility for benefits.

In formulating and ratifying proposed policy changes, New Zealand's political institutions are extraordinary in the extent to which they concentrate power: no second legislative chamber, no independently-elected executive to veto legislation, no checks on the central government from provinces with autonomous spheres of jurisdiction, no judicial review of legislation, and (prior to 1996, when it switched from a system of single-member districts to a mixed member proportional electoral system) no coalition governments. Westminster minimum-winner governing traditions persisted even after onset of MMP, and are combined with short electoral cycles, and relatively close electoral competition which concentrate both governmental power and governmental accountability. This in turn means that: (1) it is difficult for politicians to avoid blame for pension cuts; (2) politicians have strong incentives to act quickly and with minimal consultation to try to embed policy before the next election and allow long-term gain to emerge from short-term pain before next election; (3) policies are neither embedded nor losses forgiven by next election; and (4) it is difficult to develop and maintain multi-party accords that can sustain policy stability even when party control of government changes. All of these patterns can be seen in New Zealand pension policy.

Beginning in the early-1970s, New Zealand entered into a prolonged period of policy instability characterized both by bidding wars between the major parties and partisan differences over how to provide supplemental, earnings-related pensions. A first move was made by New Zealand's third Labour Party government, which was elected in 1972 with a pledge to introduce earnings-related pensions. After a prolonged period of bureaucratic and legislative reformulation, the Labour government enacted legislation in 1974 to introduce an advance-funded, government-run contributory second-tier (universal pensions would remain in place) program. But the opposition National Party campaigned in the 1975 election on a pledge to scrap Labour's contributory scheme and move to a simple one-tier universal flat-rate pension payable out of general revenues at age 60 that would provide a married couple with a benefit equivalent to 80 percent of the average wage.[133] National won the election, and the new more generous flat rate pension went into effect.

New Zealand's almost exclusive reliance on a universal, flat rate public pension program financed from general revenues meant that pressures for retrenchment have been immediate, constant and intense. And it meant that targeting issues would be a core concern: should seniors with high incomes and substantial assets receive a full benefit? If not, how much should the universal pension be reduced? This issue came to a head in the mid 1980s: during the 1984 election campaign, Labour had pledged to leave National Superannuation untouched, but after winning office it imposed a

[133] Single benefits were set at sixty percent of the married amount. For a discussion of the setting of these amounts, see Booth, "The National Party's 1975 Superannuation Policy," pp. 123-124.

convoluted, mechanism to achieve the same result as an income-test: National Superannuation recipients with other income would be subject to an income tax surcharge (i.e., an increase in their income tax rate over the normal income tax rate) on that non-National Superannuation income above an exempt amount.

The surcharge was extremely unpopular among seniors, and the National Party promised during the 1990 election campaign a mixture of pleasure and pain: repeal the unpopular surcharge on other income of superannuitants in its first budget and an ironclad promise for pension indexation, along with a gradual increase in the pension age from 60 to 65.[134] But the new National government inherited an economy that was once again in crisis. The new government initially made relatively modest cuts in superannuation, but four months proposed an extraordinarily draconian set of cuts in superannuation including freezing pensions until 1993, a very rapid increase in the age for receiving superannuation, and replacement of the superannuation surcharge with a much stronger clawback regime.

After a storm of protest, the government in November 1991 enacted a more modest set of cuts, and appointed an independent task force (known as the Todd Task Force after its chairman) to provide advice on the best method for increasing retirement savings. The Task Force's went beyond the narrow mandate the government had authorized to stress the need for the establishment of a mechanism to build inter-party consensus on pensions policy to replace the cycle of electoral over-promising followed by ad hoc and unanticipated cutbacks that bedeviled New Zealand pensions policy.[135]

Heeding the Todd Task Force's call for a consensual approach, the governing National Party came together with representatives of the Labour Party and the Alliance (a coalition of smaller left wing and environmentalist parties) in August 1993 to sign an accord on retirement income policies that largely followed the substantive recommendations of the task force. The provisions of the Accord were quite explicit on benefit levels and income testing, although allowing some room for the differing policy preferences of its

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[134] On the evolution of this pledge, see the memoir of the Fourth National Government's first Finance Minister, Ruth Richardson, *Making a Difference*, chapter 8.

[135] Task Force on Private Provision for Retirement [Todd Task Force], *Private Provision for Retirement: The Way Forward, An Outline*, Wellington, The Task Force, December 1992. On the origins of the Todd Task Force, see St. John, "Superannuation in the 1990s," p. 284.

signatories.[136] The parties signing the Accord agreed that they would not "alter, or agree to alter, in a material way publicly provided retirement income, except as provided for in this Accord."[137]

The Accord had both policy and political purposes. In policy terms, it was intended to ensure that "retirement income policies are "stable, certain, and sustainable, so that people can plan properly for their retirement."[138] But the Accord also had a political purpose: to limit the scope of future debate and disagreement on superannuation and thus prevent costly pension bidding wars. Representatives from the signing parties met regularly to work out party differences.[139] In 1995 and 1996, for example, the Accord parties agreed to changes in the surcharge exemption amounts that were expected to lower the percentage of NZ Super recipients subject to the surcharge roughly in half, to 14 percent.[140] The latter cut was enacted just in time allow National to run on it prior to the 1996 election.[141]

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[136] The value of NZ Super benefits was to continue to be indexed to the Consumer Price Index; but benefits for a married couple would also remain within a band of between 65 and 72.5 percent of the after-tax value of the average weekly wage. The parties also agreed that benefits should be reduced for seniors with higher incomes, although neither the method (a surcharge or more progressive income taxation) nor the income level at which benefit reductions should take effect was specified, and that the current policy of moving eligibility for NZS to 65 should remain in effect, while making transitional arrangements for persons nearing retirement age.

[137] "Accord on Retirement Income Policies," section 2.7.2, August 25, 1993. The Accord is included as the First Schedule to the *Retirement Income Act, 1993*. The specific policy provisions are outlined in Sections 2.3 to 2.7.1. The Todd Task Force's final report (*The Way Forward: An Outline*, p. 3) had called for use of the surcharge as the mechanism for reducing benefits to upper income New Zealand Superannuation recipients, but the Accord included higher income tax rates as an alternative because the Alliance was opposed to the surcharge.

[138] "Accord on Retirement Income Policies," section 1.2.

[139] For a discussion, see Sir Geoffrey Palmer, "Review of the *Accord on Retirement Income Policies* for the 1997 Periodic Report Group on Retirement Income Policies," May 1997, http://www.govt.nz/prg/nzier/report6.htm.

[140] See Senior Citizens Unit, *Retirement Income*, Issue Paper for the Minister for Senior Citizens, October 1996, http://www.executive.govt.nz/96-99/minister/mcdonald/briefing/paper6.htm; Rt. Honorable Bill Birch, Minister of Finance, *Tax Reduction and Social Policy Programme—Details*, February 19, 1997, chapters 1 and 2.

[141] The 1996 surcharge cuts were not approved by the Alliance, and were filibustered in Parliament by New Zealand First in an effort to force the government to abolish the surcharge entirely. They were finally rammed through using urgency. See Michael Rentoul, "Super Surtax to Change Despite Alliance Concern," *The Press* (Christchurch), July 31, 1996, p. 6, and Michael Rentoul,

The Accord had serious limitations as a device to limit New Zealand's populist pension politics, however. It allowed a "band" within which Super benefits could be set, which left substantial room for election-time bidding wars, as did the lack of specificity on surcharge provisions. Moreover, there were no sanctions for non-compliance with the Accord, nor were there institutional hurdles (e.g., super-majority requirements in Parliament) to give it teeth. Thus signatory parties would be tempted to promise a more generous program when it was in their electoral interests to do so, and to make post-election cuts when it was economically desirable and politically tolerable.[142] An even more serious shortcoming of the Accord was the fact that it was not signed by all parties. In particular, it was rejected by New Zealand First, a new populist party headed by Winston Peters. Rejection of the Accord was not a major problem in the early days of the 1993 Accord, since Peters was one of only two NZ First MPs elected in the 1993 election (the last held under single-member plurality electoral rules). But as the 1996 election approached, Peters tried to win support from upper-income seniors by promising to abolish the NZS surcharge, put a higher floor on benefits, and introduce a second, earnings-related, pension tier to which contributions would be compulsory, but in which individuals would retain choice of their fund managers. Both elimination of the surcharge and a compulsory second-tier pension were major breaks with the 1993 Retirement Incomes Accord. Peters' opposition to the surcharge was particularly explosive: because it was widely unpopular, other parties were sorely tempted to break with the Accord and endorse its repeal as well during the election campaign. Eventually all major parties except National did so.[143]

The 1996 New Zealand election, the first held under the new MMP electoral system, resulted in an almost even split between a conservative bloc of parties headed by the National Party and a left bloc headed by Labour. The balance of power was held by Winston

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"NZ First Attempt to Block Debate Fails," *The Press* (Christchurch), August 29, 1996, p. 7.

[142] On the absence of institutional sanctions for breaches of the Accord, see Palmer, "Review of the *Accord on Retirement Income Policies*," paragraph 77. See also Susan St. John, "Superannuation in the 1990s: Where Angels Fear to Tread?," in Jonathan Boston, Paul Dalziel and Susan St. John, eds., *Redesigning the Welfare State in New Zealand: Problems, Policies, Prospects*, Auckland: Oxford University Press, 1999, at pp. 285-286, 295.

[143] See Policy Barometer: Where the Big Four Stand," *The Dominion* (Wellington), October 11, 1996, p. 15, and Brent Edwards, ""Super Surcharge Expected to Go," *The Evening Post,* (Wellington), October 16, 1996, p. 1.

Peters' New Zealand First. After a seven week bidding war between Labour and National, New Zealand First opted to go into coalition with National.[144] The new coalition had strong implications for superannuation policy: two of New Zealand First's primary election planks had been elimination of the superannuation surcharge and implementation of a new second-tier contributory earnings-related pension based on individual accounts. Elimination of the surcharge was included in the coalition agreement, assuring its adoption. On a compulsory retirement savings plan, the coalition partners agreed to hold a binding referendum in nine months. However, the coalition agreement did not specify that the plan considered in the referendum would be a second-tier plan (as New Zealand First had promised in its election platform), rather than a replacement for the current NZ Super. MPs of the coalition parties would be free to endorse or oppose its adoption, but if the public agreed to the proposal in the referendum, all coalition MPs would be required to back implementation of a plan by July 1998. From the outset, it was clear that National and New Zealand First would have trouble coming up with a workable proposal for an earnings-related pension. The superannuation plan unveiled by the government in July 1997 was very different from the one that NZ First had promoted in its 1996 election platform: rather than an earnings-related add-on to a basic, universal NZ Super benefit, the new plan, dubbed the Retirement Savings Scheme (RSS), would instead replace the universal Super benefit, which would gradually be phased out.

The referendum on the Retirement Savings Scheme in September 1997 was held under extraordinarily unfavorable conditions. Rather than a single-party majority government, contributory private pensions were pushed by the junior partner (New Zealand First) in a National Party-NZ First coalition government. The National Party-NZ First coalition held a slim majority in Parliament, and it was extraordinarily unpopular with, and little trusted by, the public. There was no clear electoral mandate for the reform. Nor was there a consensus within the coalition parties for the proposal. Moreover, the leader of the Alliance, Labour's left wing partner, said that even if the referendum passed, he would not honor it if he was part of the next government, threatening that the RSS could

[144] See Jonathan Boston, "Coalition Formation," pp. 94-107 in Raymond Miller, ed., *New Zealand Politics in Transition*, Auckland: Oxford University Press New Zealand, 1997

meet the fate of Labour's 1974 superannuation program.[145] A staggering 91.8 percent of New Zealanders voting in the September 1997 referendum rejected it.

After the collapse of the National-New Zealand First coalition government in August 1998, further skirmishing took place over benefit levels. The new National minority government used urgency procedures to limit debate on a proposal to lower the NZ Super floor. To prevent mobilization of negative publicity and interest group opposition, the legislation was enacted in a single extended session, less than 36 hours after it was announced. It passed by a vote of 61 to 59, the narrowest possible margin.[146] After the 1999 general election, which resulted in a Labour-Alliance minority government, the 1998 Superannuation cuts made by National were reversed almost immediately using urgency procedures.[147]

Two major changes in pension policy have taken place in New Zealand since the RSS referendum: the creation of a special superannuation fund to partially pre-fund the pensions of New Zealand's "baby boom" generation," and establishment of a voluntary retirement savings scheme known as "KiwiSaver." The former was originally proposed as part of Labour's platform in the run-up to the 1999 election in which Labour formed a minority government. But the plan provoked severe disagreements both among parties backing Labour and the opposition. After a series of compromises on the financing mechanism for the fund and the investment practices it would follow, it was enacted in October 2001 by the narrow parliamentary margin of 63 to 55.

The second major innovation is enactment of voluntary individual "KiwiSaver" accounts in 2005. Once again, the proposal originated in a Labour party election manifesto before the 2005 election, and was sold as a way to raise New Zealand's very low household savings rates. Under the plan, new employees

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[145] Michael Rentoul, "Battle Lines Drawn on Super Plan, *The Press* (Christchurch) July 8, 1997.

[146] *Social Welfare (Transitional Provisions) Amendment Act 1998*. See also Nick Venter, "ACT Abandons Nats Over Super Cuts," *The Press* (Christchurch), October 02, 1998.

[147] Because of a change in the way that Statistics New Zealand calculates the average wage, the increase--lifting the married could pension from 62.66 to 67 percent of the average wage—was equivalent only to an increse to 65 percent under the old wage measure. Matthew Brockett, "Pension Rise May Push Up Interest Rates," *The Press* (Christchurch), January 28, 2000; John Armstrong, "Government Delivers on Super Promise," *New Zealand Herald*, January 28, 2000.

automatically enrolled in new retirement savings accounts (withdrawals could also be made for a first home purchase), but can opt out; no employer match is required.

The story of New Zealand pensions is thus one of conflicting attributes—frequent pension policy change—and even policy reversal--and the absence of a fundamental transformation of pension policy. The flat-rate pension remains intact, with an optional "KiwiSaver" providing a modest potential for development of DC individual accounts. Efforts to create a stable multi-party accord that would limit blame-generating and create a basis for stable policy reform foundered on the shoals of partisan self-interest and party system change.

6.4 The United Kingdom: Policy Tinkering in a Mixed Pension System

Like New Zealand, pension policy in the U.K. has been characterized by frequent incremental changes and an absence of policy consensus. It begins from a very different policy base, however. The U.K. has a mixed pension system, with a quasi-universal flat-rate basic pension, an earnings-related second tier pension with an opt-out into occupational or personal pensions rather than as add-on to the state scheme, and substantial reliance on income- tested benefits among the elderly. This unique system—and in particular the opt-out second tier--has created an unusual set of policy challenges in the U.K. Because the state's role in pension provision is modest, the U.K. faces only a moderate pension affordability challenge in both the short run and the longer run. But the system is also administratively very costly, and the complex public-private mix, with many workers holding multiple pensions rights makes it difficult for many individuals to predict their pension levels or to make wise choices regarding their second-tier pensions. Thus lowering administrative costs and regulating private pension provision (especially insofar as those pensions function as state-approved substitutes for a state pension) have been important components of U.K. pension policy.

Political institutions in the U.K., like those in New Zealand, tend to facilitate loss imposition by governing parties, because there is no separation of executive and legislative power and extremely weak bicameralism. All governments since the mid 1970s have been single-part majority governments, frequently with very large majorities in the House of Commons.

The U.K. retirement system has been subjected to major restructuring and frequent tinkering. Margaret Thatcher's Conservative government came to power in 1979 with a strong determination both to reduce state expenditures and to roll back the role of the state more generally. The Thatcher government's initial move, in 1980, was to change the standard for indexing the basic state pension, from the higher of wages and prices to simply prices. The Thatcher government later proposed doing away entirely with the StateEarnings-Related Pension Scheme (SERPS), but eventually settled in 1996 for cutting back dramatically on SERPS benefits, generally in ways that preserved existing entitlements and pushed the most visible cuts fairly far into the future.Under Tony Blair, pensions policy increasingly has been driven heavily by the desire of Chancellor of the Exchequer (Treasury Minister) Gordon Brown and the Treasury to keep pensions costs down by concentrating increased expenditures down by use of means-tested benefits rather than increasing the Basic State Pension. The Blair government's initial pension legislation established a Minimum Income Guarantee for pensioners higher than both the level of means-tested Income Support available to pensioners and the Basic State Pension. Pensioners already enjoyed a higher means-tested Income Support level than other Britons, but the "re-badging" as a Minimum Income Guarantee was intended to address problems of low-take-up among seniors who did not want to accept means-tested benefits. In addition, Second, SERPS was to be phased out and replaced with a new State Second Pension (S2P), that was expected to provide substantially higher benefits to low-income workers when they retired. The third component of the government's proposals, "stakeholder pensions," was intended to deal with the problems of high (and frequently frontloaded and/or obscure) charges on personal pensions that made them a poor retirement savings vehicle for persons of modest earnings, and made moving savings from one fund to another even more problematic. A second round of legislation created the Pension Credit to address savings disincentives resulting from benefit withdrawal as income from retirement savings increases.

The most interesting and potentially dramatic reforms to emerge during the Blair government, however, did not originate in the Treasury-dominated process of policy formulation that has characterized most of the Blair proposals. They instead originated with the proposals of he Turner Commission, a government-appointed three-person body (one business leader, a trade union official and an academic), that in the course of three reports published between 2004 and 2006 carefully laid out the scope of the U.K.'s pensions problem, the narrow range of options to address that problem, and a specific and fairly dramatic set of proposals—including a gradual increase in the retirement age, a re-sorting of responsibilities among the state and pension providers, and a "quasi-mandatory" retirement savings plan—to address those problems. Although there has been some disagreement with the proposals, notably among some pensioner's organizations and small business interests, the Turner Commissions have also provoked a very substantial degree of assent, which almost certainly reflects the high quality of its work, the clear independence of its conclusions from either partisan or particular social interests, and the persuasive skills of its members and especially its chairman, Adair Turner. A series of government White Papers have followed the Commission's recommendations closely, and many of the Commission's recommendations are likely to be enacted into law. Overall, the U.K pension system today is still a mixed system in which private pensions and pension providers are closely intertwined with the public sector. As in New Zealand, the U.K. retirement system has been subjected to frequent tinkering with individual tiers, but there has been no fundamental change.

6.5. Conclusions

The country cases presented here suggest a number of conclusions about factors that affect the formulation of public pension reform initiatives, their prospects for achieving social consensus, enactment and policy stability.

First, the case studies clearly suggest that countries are likely to be constrained in the pension reform mechanisms and options available to them. The constraining factors are in particular political institutions and informal norms on cooperation and group inclusion or exclusion Multiple veto points in the U.S. help to explain both the absence of major policy change since 1983 and the reluctance of Presidents and legislative leaders to press hard for restructuring reforms that are unlikely to get enacted. Absence of veto points in U.K and New Zealand helps to explain frequency of incremental reform. Westminster political institutions mean that there are minimal veto points where dramatic policy change can be blocked: thus a government determined to cut can do so. But in New Zealand, short electoral cycles mean that government accountability as well as power is maximized. This political combination means that there is pressure on governments to put its plans in place quickly, even if they are not well thought out, in order to get them firmly imbedded before the next election. For unpopular actions, quick action also maximizes the distance between those policy changes and the election. But short electoral cycles also mean that many changes, notably Labour's 1974 contributory earnings-related scheme, are not deeply imbedded with a loyal constituency when there is a turnover in the party in power, and can therefore be dismantled more easily. Indeed, the fate of Labour's 1974 NZ Super scheme suggests how much more radically Margaret Thatcher might have transformed the State Earnings-Related Pension Scheme (SERPS) in the U.K. if the Conservative Party had come to power in 1976, a year after the creation of SERPS, rather than three years later. With respect to the question of whether public pension reform can be a consensual process, the short answer suggested by the three case studies presented here appears to be "no," at least when those reforms involve the benefit and eligibility cutbacks and payroll tax increases usually associated with pension reform in an age of "permanent austerity."

The cases do suggest that both expert commissions and multi-party accords can help to build broad coalitions for pension reform and a high degree of (1) public acquiescence and (2) policy stability, if not consensus. However, a basic political logic of Westminster systems in particular undermines the prospects for lasting multi-party or all-party accords that could limit the scope of pension conflict and promote elite consensus: governing parties always have a strong incentive to offer such accords when retrenchment is on the agenda as a way of spreading the blame, but parties in opposition always have a strong incentive to reject such a bid. As former New Zealand Finance Minister Ruth Richardson put it in discussing the Fourth National government's debate over whether to seek an all-party accord on superannuation after coming to power in 1990:

> National had been offered just such a chance of all-party talks when in Opposition: we had preferred to stand back, let Labour take the flak for imposing the [superannuation] surcharge, and outbid them at the electoral auction. Labour now had precisely the same incentive: to excoriate the government from the sideline for broken promises.[148]

[148] Richardson, *Making a Difference*, p. 87.

As the New Zealand case also illustrates, instability in the party system can also undermine a multi-party accord, if new entrants to the party system reject the accord or new leaders of established parties renounce it. Unlike treaties among sovereign states or contracts among companies, mechanisms for enforcing policy agreements among parties over time are extremely weak.

Finally, does the experience of these three countries suggest any lessons about how to reform public pension systems in a way that promotes public acquiescence and policy stability, if not public consensus, that can be transferred to other countries like Korea? Most of the lessons from the cases are in fact cautionary, suggesting that processes of problem definition, policy formulation and ratification is heavily influenced by a country's political institutions and by its informal norms on cooperation and group inclusion or exclusion. But they also suggest that countries do have choices, and that political elites who are willing to sacrifice to risk sacrificing control over outcomes and/or electoral advantage through devices like the multi-party 1981-83 Greenspan Commission in the United States or the Turner Commission in the United Kingdom can help to promote at least social acquiescence in major policy changes and help to prevent policy gridlock. Whether political elites will be willing to take those risks is another question entirely.

<Appendix>

<Table 6.A.1> Public Pension Reform Initiatives in the United States

Time Period	Agenda-setting and problem formulation	Policy formulation	Modification and ratification	Outcome
1981	Fiscal pressure and Executive led	Executive led	Executive proposals cut by Congress	Modest Social Security cuts enacted
1983	Program financing crisis and Executive-led	Bipartisan commission appointed by president and congressional leaders	Congressional legislation	Major non-paradigmatic changes including long-term increase in standard retirement age, taxation of benefits for upper-income recipients and
1993	Executive-led	Executive-led	Ratified by congressional legislation	Increase in taxation of benefits for highest-income recipients
1998-1999	Executive-led	Executive-led	Not considered by Congress	No change
2001-2002	Election manifesto	Led by presidentially-appointed commission with very specific mandate	Not considered by Congress	No change
2005	Election manifesto and Executive-led	Not applicable	Not considered by Congress	No change

<Table 6.A.2> Public Pension Reform Initiatives in New Zealand

Time Period	Agenda-setting and problem formulation	Policy formulation	Modification and ratification	Outcome
1972-74	Labour Party election platform	Proposal formulated by Treasury	Accepted by parliament	Contributory earnings-related pensions established
1975	National Party election platform	National Party election platform	Accepted by parliament	Contributory earnings-related pensions abolished; flat-rate pension made more generous
1984	Perceived financial crisis	Proposals formulated by Treasury and Cabinet	Accepted by parliament	Income tax surcharge imposed on NZ Superannuation
1990-1996	Election platform of National Party and perceived fiscal crisis	Proposals formulated by Treasury and Cabinet; 1996 surcharge cuts formulated by Superannuation Accord participating parties	Accepted by parliament	Multiple changes in level of flat-rate pension and claw back for upper income recipients; increase in eligibility age for flat-rate pension
1996-1997	Election platform of New Zealand First and NZ First-National coalition agreement	Election platform of New Zealand First	Accepted by parliament	Superannuation surcharge abolished
1996-1997	Election platform of New Zealand First and NZ First-National coalition agreement	Proposal formulated within Treasury	Overwhelmin g rejection in public referendum	No policy change
1998	Fiscal concerns	Proposal formulated within Treasury	Accepted by parliament	Superannuation rates gradually lowered below previous minimum
1999	Election platform of Labour Party	Election platform of Labour Party	Accepted by parliament	1998 changes reversed
1999-2001	Election platform of Labour Party	Proposal formulated within Treasury	Accepted by parliament	New Zealand Superannuation Fund established to "pre-fund" future pension expenditures
2005	Election platform of Labour Party	Executive-led	Enacted by legislature	Kiwi Saver program enacted to increase retirement savings

<Table 6.A.3> Public Pension Reform Initiatives in the United Kingdom

Time Period	Agenda-setting and problem formulation	Policy formulation	Modification and ratification	Outcome
1980	Executive-led	Executive-led	Approved by Parliament	Change in Basic Pension indexation from wages to prices
1986	Executive-led	Executive-led	Modified by government and approved by Parliament	Cut in SERPS replacement rates (rather than originally proposed phase-out of SERPS); opt-out from SERPS into personal pensions encouraged
2000	Executive-led	Executive-led	Approved by Parliament	Improved minimum benefit, flattening of benefits in state second-tier pension, introduction of low-cost "stakeholder" personal pension
2002	Executive-led	Executive-led	Approved by Parliament	Pension Credit increases incentives for retirement savings by low-earners
2003-present	Led by Expert Commission	Led by Expert Commission	Modification of proposals by Dept. of Work & Pensions and Treasury	Draft legislation has been prepared by Blair government to raise retirement age gradually and rationalize second tier pensions

7. Social Consensus in the Process of Pension Reform in Canada

Thomas Klassen

7.1 Introduction

Equality and freedom are the alternatives that divide citizens in capitalist democracies. The former choice (equality) means that government must intervene to reduce the inequalities and hazards that markets create.[149] The latter choice (freedom) implies allowing citizens to benefit, or suffer, from the market-based distribution of rewards. The welfare state is the tool that reconciles political equality with economic freedom by altering the distribution of income from what it would be in a notional free market.[150] The modern welfare state includes, among other elements: the tax structure, public health insurance, unemployment insurance, and public pensions.[151]

Social consensus is critical in reconciling equality and freedom, including the creation and on-going modification of the welfare state. Without sufficient consensus among the major societal groups and among citizens, reforms will not occur, or at least not last for long. This paper analyses the manner and extent to which social consensus has been attained in pension policy in Canada from 1980 to the present. It was during this time period that, due to chronic government deficits, changes in the labour market, and changing demographics, particularly dramatic reforms of pension programs were planned. These typically sought to restrict benefits and eligibility and/or increase contributions from individuals and employers, and therefore would require considerable social consensus in order to be implemented.

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[149] Alberto Alesina and Nouriel Rosenthal, *Partisan Politics, Divided Governments, and the Economy*, (Cambridge: Cambridge University Press, 1995).

[150] John Myles, *Old Age and the Welfare State*, (Boston: Little, Brown, 1984).

[151] This paragraph is drawn from Rodney Haddow and Thomas R. Klassen, *Partisanship, Globalization and Canadian Labour Market Policy,* (Toronto: University of Toronto Press, 2006).

Canada is the world's second largest nation, with a land mass 100 times that of South Korea, yet its population of 32.6 million results in an extremely low population density of three inhabitants per square kilometer, compared to 480 for South Korea. Its cultural diversity is reflected in a constitution that explicitly recognizes the official bilingualism and linguistic duality of the nation as well as the multicultural essence of the society. The two largest groups in Canada are Anglophones and Franco phones, with the latter group comprised of over six million people mainly residing in the province of Quebec. Individuals of Aboriginal descent represent nearly three and half percent of the population (1.1 million) overall but make up a significantly higher proportion in the western and northern regions of the nation. Immigrants form an important part of the country, as Canada accepts more immigrants per person than just about any nation in the world. In 2000, 18.5% of Canada's population was foreign-born, compared to only 10.5% in the United States of America.[152]

Demographic pressures in Canada are slightly less severe than those in many European nations. In 2000, 13% of the population was 65 years of age and older, compared to 18% in Italy and 16.4% in Germany. All the same, the Canadian change is now as rapid as that of European countries, and it will be more rapid once the large baby-boom generation move into retirement ages. Whereas in Canada just over one in ten people were over 65 in 1986, fifty years later, in 2036, projections are that about a quarter of the population will be over 65. Along with a median age of 45 years, and more than 12% of the population aged 75 and over, this will make an aged society.[153]

Canada is one of the most decentralized nations in the world, particularly when it comes to social and labour market policies. Its federal structure means that governmental powers and responsibilities are divided between the federal government and ten provinces (and three northern territories). Federal powers relate primarily to economic and financial policy, international affairs, defense, immigration, and criminal law. Provincial powers are expansive in comparison to most nations including responsibility

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[152] United States Census Bureau, *The U.S. Foreign Born Population*: *Census 2000*, Current Population Reports, Series P23-206, U.S. Government Printing Office, (Washington, DC).

[153] Don Kerr and Roderic Beaujot, "Demographic Change and Mandatory Retirement in Canada" in C. T Gillin, D. MacGregor and T. R. Klassen, eds. *Time's up: Mandatory Retirement in Canada*, (Toronto: James Lorimer & Company Ltd., Publishers, 2005), chapter 6.

for education, health, social assistance, the workplace, municipal institutions, and other fields. When the federal government began to establish a modern welfare state after the Second World War, the watertight division of responsibilities was broken, as the national government used its spending power (its right to disperse sums of money on any purpose) to influence policy-making in provincial jurisdiction. The provinces lack a comparable spending authority and therefore have less influence over national legislation, and they do not have direct representation in the federal parliament. Given these unique characteristics of Canada, achieving social consensus represents a particularly challenge.

The next section of the paper outlines the key elements of Canada's pension regime, followed by overview of major developments in the past 25 year (section three), and an analysis of social consensus inherent in these (section four). The last section of the paper discusses the applicability of the Canadian situation to South Korea, and draws conclusions. The focus of this paper is on public pensions, however private pensions are discussed to a lesser extent as they are a crucial component of Canada's income security system for older individuals.

7.2 Canada's Multipillar Pension Regime

Canada's pension regime conforms in many ways to the three pillar model advocated by the World Bank and some other organizations for the past decade.[154] The first pillar is a quasi-universal flat-rate pension financed from general tax revenues composed of three separate programs: The Old Age Security program, begun in 1951, provides a modest income beginning at age 65 for all citizens and permanent residents who have lived in Canada for at least 10 years since age 18.[155] The maximum monthly payment for 2006 was $492 (393,600 won), while the average was close to that amount at $463 (370,400 won). Individuals who have lived in Canada for less than 40 years receive a reduced pension, with each year of non-residency reducing the payment by 2.5%.

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[154] The World Bank, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, (New York, Oxford University Press, 1994)

[155] For a history of the Old Age Security program, and in particular the federal-provincial dynamics: James Struthers, "Building a culture of retirement: class, politics and pensions in post-World War II Ontario," *Journal of the Canadian Historical Association*, Vol. 8 (1997), pp. 259-282.

The program is quasi-universal in that individuals with net income above \$62,000 (49,600,000 won) do not receive the entire amount, while those with income above \$101,000 (80,800,000 won) do not receive any payment at all.

The second program – the Guaranteed Income Supplement – provides additional money, on top of the Old Age Security pension, to very low-income seniors. In 2006, the maximum monthly payment was \$600 (480,000 won), while the average payment was \$410 (328,000 won). The supplement is not paid once the annual income of an individual exceeds \$14,500 (11,600,000 won) annually, with a higher cut-off threshold for a couple.

The third and much smaller program – the Allowance – provides income support for those ages 60-64 whose spouse or partner receives the Old Age Security pension and the Guaranteed Income Supplement, or has died. The vast majority of the recipients of the Allowance are women. The Allowance is determined based on the annual income from the previous tax year. At age 65, most people who receive the Allowance have their benefit automatically changed to the Old Age Security Pension and, for those with low income, also the Guaranteed Income Supplement.

The Old Age Security, Guaranteed Income Supplement, and the Allowance are indexed to the consumer price index, and are adjusted several times each year. Old Age Security payments are taxable, but not the other two programs.

The second pillar of Canada's pension regime is composed of two earnings-related pension programs: the Canada Pension Plan and the Quebec Pension Plan. The Quebec Plan is almost identical to the Canada Pension Plan but applies only to those working in the province of Quebec (the Canada Pension Plan does not apply to those working in the province of Quebec). The provinces, other than Quebec, share constitutional responsibility for the Canada Pension Plan, with any change to the plan requiring approval from two-thirds of the provinces. The plans are not of the fully-funded type, but are closer to the pay-as-you-go model. Upon retirement, the pension plans provide monthly benefits based on an employee's average earnings, up to certain maximums. The pension is designed to replace about 25 percent of the earnings on which a person's contributions were based. The replacement rate has remained unchanged since the creating of the plans 40 years ago.

With very few exceptions, every person in Canada over 18 who earns more than the basic exempted amount of \$3,500 (2,800,000 won) in employment income must pay into one of the two pension plans. The contribution rate is 4.95% for the worker, and the same for the employer, for employment income between $3,500 and $42,100 (33,700,000 won) to a maximum annual contribution of $1,900 (1,520,000 won) for each party. The self-employed must pay both portions, namely 9.9% of income. The pension plans do not receive moneys from general taxes but rather are entirely funded from the payroll taxes.

The plans allow for retirement at age 60, unlike the Old Age Security program that is only available at age 65. However, for those accessing the Canada or Quebec pension plans early, payments are reduced permanently by 0.5% for each month prior to age 65. Individuals are also able to delay receiving pensions, in which case the amount paid is increased permanently by 0.5% for each month after age 65, up to age 70. These adjustments are considered actuarially neutral. The maximum monthly pension payment at age 65 in 2006 was $845 (675,000 won) while the average payment was considerably less at $463 (370,000 won). The pension benefits are adjusted annually to reflect increases in the cost of living as measured by the consumer price index. In addition to the retirement benefits described above, the pension plans also provide two other benefits: disability benefits (for contributors with a disability and their dependent children); and survivor benefits (including the death benefit, the survivor's pension and the children's benefit).

Private pension plans are the third pillar of Canada's income security regime for older persons. Two types of private arrangements exist: employer (occupational) pension plans and individual retirement savings plans. Although these plans are private, there is a substantial cost borne by the federal treasury for the plans in terms of lost tax revenues.

Other than the mandatory participation under the Canada or Quebec pension plans, employers in Canada are not required to establish or participate in any type of pension or savings arrangement for the benefit of their employees. Nevertheless, a number of employers have established pension plans. These plans must be registered with the appropriate federal or provincial regulatory authorities, and comply with tax and pension standards rules. The plans are funded through tax-deductible contributions by both employees and employer, while the investment income is tax-deferred.

In a unionized environment, the terms of a pension plan may be collectively negotiated, which may restrict an employer's ability to alter or amend the plan terms without union consent. However, there are few government regulations that protect contributors the plans: for example, employer plans need not be indexed. Furthermore, there is a wide variety of plans including defined benefit and defined contributions, with a range of benefits (such as early retirement) that might be available under a specific plan. Generally, the pension plans for public sector employees are the most comprehensive, while often those for private sector workers are much more modest.

Registered individual retirement savings plans are savings schemes for individuals, including the self-employed, that have been registered for the purposes under the federal *Income Tax Act*. Annual contribution limits to such an individual plan are based on earned in the previous year. The current the limit is 18% of income to a maximum of \$16,500 (13,200,000 won). Contributions from individuals are tax deductible, while the investment income is tax-deferred until funds are withdrawn from the plan. Contributions not made in one year may be carried forward to future years. Individuals may contribute until they reach age 69. The moneys in individual savings plans may be invested in a wide variety of ways, including cash and equivalents, fixed-income and equity investments.

The federal government introduced the individual plans in 1957 to encourage workers to save for retirement, as previously only those who belonged to employer pension plans could deduct pension contributions from their taxable income. Changes over the decades, such as increases in the amounts that could be deposited, the types of investment vehicles that could be purchased, as well as strong marketing by financial services companies, have encouraged contributions.

Workers who are members of an employer pension plan can also establish an individual retirement saving plan, but their contribution limit to their individual plan is reduced by the amount of a 'pension adjustment' that reflects contributions made by, and on behalf of, the employer pension plan. In other words, all workers in Canada are limited to contributing 18% of their income, to a maximum of \$16,500, towards employer or individual plans or some combination thereof.

Private pensions in Canada, as is the case with most nations, reproduce the inequalities of work life, with those in the primary labour market much more likely to be covered. In 2004, half of Canadians age 25 to 64 contributed to either an employer or individual pension plan. The percentage of workers covered by an employer plan was 39%, a decline from 45% a decade earlier. With regard to individual savings plans, 38% of workers made contributions in 2004, a percentage that has remained unchanged in the past decade. Not surprisingly, an individual's income affects both the likelihood of participating in an individual plan and the amount contributed. In 2004, just three percent of income earners aged 25 to 64 with incomes less than $10,000 (8,000,000 won) and eligible to contribute, in fact made contributions. This compares with 76% of workers with incomes of $80,000 (65,000,000 won) and over, who also made the highest average contribution: $9,500 per person (7,600,000 won).[156]

<Fig. 7-1> below, shows the pension savings of Canadians in 1993 and 2003, in constant dollars.

(millions 2003 $ Canadian)

	1993	2003
Canada and Quebec pension plans	66,556	80,397
Employer (occupational) pension plans	550,108	847,489
Individual retirement savings plans	208,008	403,218
Supplementary retirement income programs[ii]	421	7,117
Total accumulated assets	**825,093**	**1,338,221**

Notes: 1)As of December 31
2)Executive pension plans known as "retirement compensation arrangements".
Source: Statistics Canada, *Canada's Retirement Income Programs 2005*. Ottawa, 2006. Catalogue no. 74-507-XCB. .

7.3 Reform efforts since 1980

In the past 25 years there have been numerous efforts to reform components of the three pillars of Canada’s pension regime. The major proposals are analyzed below, while the next section of paper examines the role of social consensus in each of the reform attempts.

The Old Age Security program is by far the largest transfer government transfer to individuals in Canada representing 43% of all federal government transfer payments to persons. [157] Not

[156] Statistics Canada, The Daily, Tuesday, February 7, 2006, *Canada's retirement income programs,* http://www.statcan.ca/Daily/English/060207/d060207b.htm
[157] Calculated from Statistics Canada, *Government transfer payments to persons 2004*, CANSIM table 384-0009 and Catalogue no 13-213-XDB, 2006.

surprisingly given efforts to reduce government expenditures and balance the budget in the past decades, proposals to reduce government expenditures have twice focused on this program, in 1985 and again in 1996.

In 1985, shortly after gaining a large majority in the federal Parliament, the centre-right party – as a means to reduce the national deficit – proposed to partially de-index payment under the Old Age Security program. According to the government's proposal, in response to increases in the consumer price level, benefits would only be raised to a set maximum (three percent or less). This would decrease the value of benefits paid over time. However, this proposal was abandoned within weeks after an atypically – for Canada – potent negative reaction from nearly all stakeholders, which is analyzed in the next section.

In 1989 the same government successfully introduced a policy that limited Old Age Security payments to high income individuals and eliminated these altogether for those with very high income. Moreover, the income at which the benefits were reduced was only indexed to inflation in excess of three percent, such that over time more seniors would receive lower payments. However, in 2000 full indexation of the cut-off point was restored as the government achieved a series of budget surpluses. At present only five percent of seniors are affected by the income test, so that the program does remain almost universal in character.

In 1996, after the centre-right party assumed power, it proposed to eliminate the Old Age Security and Guaranteed Income Supplement program altogether and replace these with a new 'seniors benefit' that would be based on income and thus paid to those of low and middle-income. Additionally, the new benefit was to be paid based on family income, rather than individual income as was the case for the Old Age Security program. As in 1985, a powerful wave of grass-roots opposition arose and the government was forced to completely withdraw its proposal.

The federal nature of Canada means that provinces are permitted to establish and operate their own pension plans, something that the province of Quebec has done. Both the Canada Pension Plan, which applies to the other nine provinces and three territories, and the Quebec Pension Plan become effective the same time in 1966 after many years of federal-provincial negotiation. The plans provided full benefits in 1977 following a ten year transition period, for those 65 and older.

In the negotiations to establish the plans, Quebec advocated a partially funded public mandatory contributory defined benefit scheme. One of the features that the province insisted on was the accumulation of a large pool of capital in the early years of the plan. Quebec eventually convinced the federal government and most other provinces of its plan's superiority, and created the Quebec Deposit and Investment Bank, to invest its pension funds. The pool of funds from the federal plan was lent to the provinces at very low rates to subsidize provincial debt.

Some reforms were made to the two pension plans in 1987, after extensive federal-provincial negotiation. The amendments extended benefits to those 60 years of age, rather than 65 as previously had been the case, payments for the disabled were increased, and premiums began to rise slowly from the 1.8% for employees and employers that had been in place since the start of the pension plans. However, by the early 1990s, it became more and more obvious that the pay-as-you-go structure of the plans was not sustainable at then current contribution levels, due to Canada's aging population and the longer life expectancy of Canadians. The impending crisis generated an extensive review by the federal and provincial governments including public consultations, academic studies and so forth.

The reforms that were proposed and implemented in 1998 were three-fold: 1) some modest reductions in benefits, 2) increases in contribution rates, and 3) changes to the pay-as-you-go model of the Canada Pension Plan. Each of these in discussed below.

The minor reductions included freezing the base level of income exempted from contributions at $3,500 (2,800,000 won) so that, due to inflation, over time a lower real level of income would be exempted from contributions to the plans, thereby raising effective average contribution rates. As well, the calculation for benefits was altered to the average of maximum pensionable earnings in the last five years, instead of three years. Disability pensions were reduced so that applicants must have worked an extra year or two to be eligible, while retirement pensions for disability beneficiaries was calculated using the average wage at the time of disablement instead of when the recipient turns 65. Lastly, the one-time death benefit paid to all plan recipients, was reduced slightly and fixed permanently at $2500 (2,000,000 won). The restrictions in disability benefits reduced the number of new beneficiaries by about 50 percent: from about one percent of the population to about 0.5 percent. As a result, the percentage of disability benefit recipients among older workers declined within a few years from about eight percent of the population to about six percent [158]

With regard to contribution rates, these were increased annually from three percent for both employees and employers in 1997 to 4.95% for each party by 2003, from which time the rate is to remain unchanged for the foreseeable future. The final element of the reforms was to move the plans further towards a hybrid structure to take advantage of investment earnings on accumulated assets. Instead of being a completely "pay-as-you-go" structure, the plans are expected to be 20% funded by 2017. The Quebec plan already had the Quebec Deposit and Investment Bank to actively manage its pension funds and thus was already operating more like a hybrid fund. The federal government created an arms-length body to do the same for the Canada Pension Plan: The Canada Pension Plan Investment Board.

Private pension plans – whether employer or individual – are regulated in a number of ways. Employer (or occupational) pensions are overseen by the provincial governments, although in a few sectors of the economy the federal government regulates employer pensions. The federal government also regulates all employer and individual plans as these must conform the income tax laws in order to qualify for favourable tax treatment. There are few inter-provincial differences in the regulation of employer pensions, however any adjustments do typically require consultation and discussion to ensure that tax, actuarial and accounting rules remain uniform across the 11 jurisdictions.

Developments over the past 25 years with respect to private pension plans are not the focus of this paper, however two important reforms to the individual plans are noted briefly below. First introduced in 1992, first time home buyers (those not having owned a home in the previous five years) are permitted to withdraw up to $20,000 as a loan from their individual plan to use as a down payment. The loan is not considered income and is not taxed as long as it is repaid within 15 years. Second, as of 1999, individuals are also permitted withdraw up to $20,000 toward the cost of full-time training or education for the individual or spouse, but not children. The funds must be repaid to the pension plan within 10 years after the completion of the educational program. The impact of these reforms on social consensus is discussed in the section below.

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[158] OECD, *Aging and Employment Policies: Canada*, (Paris: OECD, 2005), pp. 77-78.

7.4 Social Consensus

As noted at the beginning of this paper, social consensus is critical in ensuring the successful reform of a nation's pension regime. If sufficient consensus is not attained, reforms may not be possible at all, or may be dysfunctional in that actors may circumvent these or seek opportunities to reverse them in short order.

Canada's unique history, geography, economy and governance have created distinct routes to achieving social consensus. Unlike most other Anglo-Saxon nations, class voting in Canada has historically been weak "because the political parties are identified as representatives of regional, religious, and ethnic groupings, rather than as representatives of national class interests"[159] Not surprisingly, Canada diverges from the prediction that liberal political economies will posses two-party systems that are highly polarized along economic (class-related) lines.[160] Canada's socially fragmented landscape has resulted in brokerage style of politics, where success depends on a party's ability to aggregate support from a wide range of disparate interests. The main parties nevertheless also maintain close ties to business. The lack of policy and ideological focus among the main national parties in Canada is linked to their limited internal democratic accountability, electoral orientation and modest extra-parliamentary organizations.[161] As a result, reaching political consensus on income security policy is less problematic than in many other nations, as the platforms and ideologies of the major political parties diverge little with regard to this policy domain.

Veto points in the decision-making process in any nation are a critical nexus for consent to be reached or withheld. Canada's atypical arrangements, reflecting its history and political economy, have shaped a particular set of veto points. Both the federal government as well as the provinces have parliamentary regimes, with a Westminster-style combination of a first-past-the-post electoral system with single-party and executive-centered, prime-ministerial government. The first-past-the-post system – in other

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[159] Robert Alford, *Party and Society*, (Chicago: Rand McNally & Company, 1963), p. 251.

[160] Herbert Kitschelt, et al., "Convergence and Divergence in Advanced Capitalist Democracies," in Kitschelt, et al., eds., *Continuity and Change in Contemporary Capitalism.*

[161] William Cross, *Political Parties* (Vancouver: University of British Columbia Press, 2004), p. 33.

words, whichever candidate gets the largest number of votes is elected, even if his or her vote is less than half the total – means that most governments are majorities; while minority governments are rare. At the national level, but not at the provincial level, a second chamber – the Senate – exits, but as an appointed, rather than elected body, it does not represent a serious veto point. Elected representatives to the parliaments are subject to strong party discipline. Every province has a legislative assembly that is very similar to the House of Commons and transacts its business in much the same way.

The fusion of the legislative and executive branches – along with majority governments – results in the prime minister wielding extraordinary power. Once a decision is reached by his or her office, it is unlikely that either members of the governing party, or the legislature, will be able to block or reverse it. Issues requiring federal and provincial agreement or consensus, as described above, are typically decided after negotiation by the executive branches of the two levels of government, with often minimal involvement from the respective legislatures or other stakeholders. In summary, few impediments that face a governing party other than in policy domains requiring federal and provincial consensus. As such, grass-roots protests and/or highly organized coalitions of civil society groups are normally required to significantly alter government social policy proposals.

With regard to Old Age Security, a domain in which the provinces have no jurisdiction, in both 1985 and 1996 governing parties failed to reach sufficient consensus to reform the program. What explains this? In part, the reforms proposed were solely for the purposes of reducing the expenditures under the program. This, in and of itself, placed the governments in a precarious situation, as arguably those without the opportunity for income for employment will have the most difficultly in adjusting to lower transfer payments. This was the major argument made by the coalition of groups that arose to oppose the reforms. The partial de-indexation proposed in 1985 was seen as especially harsh since during the late 1970s and throughout the 1980s inflation had been high, with the consumer price index increasing at a rate of 10% for several of these years. Even groups that might not normally support income security programs for the elderly were convinced that targeting this group was unfair. The government's reforms in 1989 that limited Old Age Security payments for those with high incomes and eliminated it altogether for very high income earners saw little opposition as these impacted a very small group of people.

A critical factor in the mobilization of the fierce opposition to the 1985 proposal, including the mass protests in the national capital and other cities, were the many senior citizen and age-advocacy groups that had emerged or expanded during the 1970s and 1980s, such as the Canadian Council of Retirees. In some cases, these groups were launched with government grants during the 1970s aimed at creating senior citizen clubs and community organizations.[162] For the first and only time, a large number of these groups, along with other civil society organizations, united to influence pension policy.

The reforms planned in 1996 were more dramatic than those proposed in 1985 in that a relatively large pool of retirees would stop receiving Old Age Security payments. To avoid a backlash, the government wanted to exempt current Old Age Security and Guaranteed Income supplements recipients from the reform, as well as all those 60 and over, as well as their spouses. Nevertheless, the plan to abandon one quasi-universal program and one income-tested program was not acceptable to groups representing the interests of the elderly, but also professional associations, organized labour and investment firms.[163] Part of their argument was that the proposed ‘seniors benefit’ was not a benefit, but rather a tax that would discourage individual savings. Other groups – especially those representing women – opposed the scheme because it would be based on the income of a couple, rather than individual income as was the case for the Old Age Security program. Women feared that they might lose the seniors benefit, and their financial independence, if their spouse had a high income. In any case, the use of family income was atypical for income security programs in Canada, which tend to use individual income (other than programs for children) as one would expect in a liberal welfare state.

In both the 1985 and 1996, the governments did not follow the Canadian tradition of social-policy making; namely extensive consultation in advance of government announcements. Rather, the announcement of significant retrenchment came as a surprise to stakeholders, which served to engender the mass protests and rapid one-time coalition building. That the 1985 proposal had no policy

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[162] Henry J. Pratt, *Gray Agendas: Interest Groups and Public Pensions in Canada, Britain, and the United States*, (Ann Arbor, Michigan: The University of Michigan Press, 1993), pp. 147-169.

[163] Daniel Béland and John Myles, “Stasis Amidst Change: Canadian Pension Reform in an Age of Retrenchment”, in Bonoli and Shinkawa, eds. *Ageing and Pension Reform Around the World* (Cheltenham, UK: Edward Elgar, 2005), chapter 12.

rationale other than expenditure reduction, and was seen as engendering decreases in benefits 'by stealth' doomed it from the start. In 1996, the plan to abolish a long cherished program and universal program was unacceptable to its beneficiaries, especially when its planned replacement would be so different.

In developing proposals to reform the Canada and Quebec pension plans the governments did undertake the traditional and expected extensive public consultations with stakeholders and social partners, as well as academic and expert discussions across the country.[164] The federal and provincial governments decided not to make major cuts in pension benefits or to increase the age of eligibility for benefits, unlikely many nations that have done so when reforming their pay-as-you-go pension systems in the past decade.[165] The experience with attempting to shrink benefits under the Old Age Security program had convinced politicians that a gradual rise in the contribution rates would generate less resistance, especially when coupled with reforms on how accumulated assets would be invested.

That the Canada Pension Plan Investment Board would be fully independent, had a clear and simple investment-optimizing mandate, and would have diversified assets was essential in reassuring the business community of the policy reforms, especially given that payroll tax would increase significantly over a few years.[166] Indeed, the successful operation for several decades of the Quebec Deposit and Investment Bank provided a model for decision-makers in establishing the Canada Pension Plan Investment Board and reduced fears that this policy innovation might under-perform.[167]

Although some business groups and political parties advocated different policy directions, such a privatization of the plans, this was never a serious possibility. The province of Quebec would never agree to this, and in any case, the fact that the federal

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[164] Newman Lam, James Cutt and Michael Prince, "The Canada Pension Plan: Retrospect and Prospect," in Banting and Boadway, eds. *Reform of the Retirement Income System: International and Canadian Perspectives* (Kingston, Ontario: Queen's University, School of Policy Studies, 1997), pp. 105-134.

[165] For a review of major reforms in several European countries as well as the U.S.A. see: Vicenzo Galasso, *The Political Future of Social Security in Aging Societies*, (Cambridge, Massachusetts: The MIT Press, 2006).

[166] Michael Mendelson, *Financing the Canada and Quebec Pension Plans*, (Washington: AARP Public Policy Institute, December 2005),

[167] R. Kent Weaver, "Whose Money it is Anyhow? Governance and Social Investment in Collective Investment Funds" in Rein and Schmähl, eds., *Rethinking the Welfare State: The Political Economy of Pension Reform* (Cheltenham, UK: Edward Elgar, 2004), p. 296-303.

government and all provinces agreed on the reform directions – a rare situation in Canada on almost any matter – forestalled the further debate. By all measures, the Canada Pension Plan Investment Board has performed well, and there is no projected need to increase contributions or adjust benefits for quite some time. The changes made in 1998, especially its most radical aspect – the partial marketization of the Canada Pension Plan – have been summarized as "modest" but ones that received "relatively widespread support from labour, business and social policy groups outside Quebec. Typically, no group is entirely happy with the initiative… But most agree that the reform provides greater public confidence about the financial future of the scheme."[168]

With regard to private plans, the consensus in Canada – dating to the first employer plans in the late 19th century – has been that whether such a plan exists at all, and its provisions, are matter to be decided between employers and workers. In the same manner, the general consensus is that households are responsible for decisions about whether to establish individual plans, and the level of contributions to these. This conforms to what would be expected in a political economy where the welfare state seeks to maximize citizens' reliance upon, and loyalty to, the free market including the labour market, especially for working-age households. Individual plans have proven to be popular among Canadians, in part because of extensive advertising by the financial community. The option to borrow money for home ownership has been universally lauded; one third of first-time home-buyers utilize funds from their individual pension plans.

7.5 Discussion and Conclusions

The pension reforms undertaken in Canada during the past quarter century and role of social consensus are unique, reflecting the particular conditions and characteristics of the nation. Nevertheless, there are three insights that can be drawn that might be of value for South Korean policy makers and public administrators.

First, notwithstanding considerable economic restructuring in the past two decades – much of it the result of the Canada-United States Free Trade Agreement which came into effect in 1989 and

[168] Glenn Grover, Tilting Toward Marketization: Reforms of the Canada Pension Plan," *The Review of Policy Research*, Vol. 19, No. 3, (Fall 2002), p. 86.

the North American Free Trade Agreement which came into force in 1994 – as well as demographic changes, the pension regime has remained surprisingly unaltered. As a result, the existing pension regime has enjoys a degree of legitimacy and popularity that it might not, had a series of significant reforms indeed taken place and created a sense of uncertainty. In contrast, in South Korea, the national pension scheme remains "unpopular" and a source of "public mistrust".[169] The lesson is that frequent policy shifts or debates can undermine the necessary consensus and stability required for individuals, and organizations, to make longer term financial plans.

Second, the existence of the Canada and Quebec pension plans allow employers, particularly those of medium and small enterprises, to argue that there is no need to institute their own occupational plans. As thus, the Canada and Quebec pension plans have typically been supported by the business community, even as premiums were increased in the 1990s. At the same time, that the two plans provide only modest benefits has permitted the labour movement to press for more and improved occupational plans. Therefore, unions also, have supported the two public plans. The broad consensus of these two social partners about the public pension plans has been critical in protecting the integrity of the plans and reducing the number of policy shifts. The lesson from Canada is that a modest mandatory public plan will tend to draw widespread acceptance, at least within a liberal welfare state.

Third, the existence of three pillars of the Canadian pension regime, and that two of the pillars (the flat-rate pension and private pension) are composed of several components, means that most Canadians do not rely solely on any one component of the pension regime. Consequently, it may well be that social consensus can be reached more easily among the social partners and other stakeholders in under such conditions, compared to a nation with only one major pension program.[170]

The multi-pillar pension system means that most individuals depend on a combination of income from several public and private pension schemes for maintaining their standard of living in retirement. Although the nation has a Beveridgian tradition in

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[169] Gyu-Jin Hwang, *Pathways to State Welfare in Korea*, (Aldershot, England: Ashgate, 2006), p. 54. Chapter 4 "National Pensions: From an Instrument of Growth to Object of Distrust" further expands on this point.

[170] A number of observers have made this point as well. For example, Martin Schludi, *The Reform of Bismarckian Pension Systems*, (Amsterdam: Amsterdam University Press, 2005).

pension provisions (aimed at poverty prevention) the Canada and Quebec pension plans established in the 1960s moved the country towards the Bismarckian model by supplementing the basic pension scheme with a second public pillar. Social consensus has not been a major sustained issue in debates on pensions in Canada, notwithstanding that during the 1980s and 1990s the Canadian welfare state witnessed some retrenchment. This is partly because the retreat of the welfare state in Canada was not as dramatic as in other Western nations, and certainly not so with respect to pension policy.[171] To the extent that the Canadian welfare state has become more selective, there has not been the rise of the income polarization found in other Anglo-Saxon nations. Though broadly liberal, Canada's welfare state remains more robust than that of the United States due to the presence of universal elements in its social security system.[172] Although the two nations appear to be similar from a European perspective, the differences between their social programs are important "especially for the poor and for marginal social groups."[173]

As importantly in explaining the relative absence of intergenerational or class conflict is that the liberal market economy and liberal welfare state can – and perhaps must – operate without the need for a high degree of social consensus.[174] In other words, Canadians value individuality and freedom to a stronger extent than many European and Asian societies.[175] Solidarity, equity and social

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[171] Paul Pierson, "Coping with Austerity: Welfare State Retrenchment in Affluent Democracies," in Pierson, ed., *The New Politics of the Welfare State*, (Oxford: Oxford University Press, 2001), pp. 438-440.

[172] Rodney Haddow, *Poverty Reform in Canada, 1958-1978*, (Montreal: McGill-Queen's University Press, 1993), p. 14.

[173] Keith Banting, "The Social Policy Divide: the Welfare State in Canada and the United States," in Banting et al., eds., *Degrees of Freedom*, (Montreal: McGill-Queen's University Press, 1997), p. 268.

[174] Some analysts suggest that more debates on pension policies may occur in the near future. See; David K. Foot and Rosemary A. Venne, "Awakening to the Intergenerational Equity Debate in Canada," *Journal of Canadian Studies, Vol.* 39, No. 1 (Winter 2005), pp. 5-22.

[175] It is interesting to note, that other than the planned reforms to the Old Age Pension programs in 1985 and 1996, the issue that has been the most controversial for some groups with regard to income security policy is the equality of treatment for same-sex couples. In 2000, the federal government extended 'spousal' benefits to members of same-sex couples. This was the result of several decades of activism by the homosexual community.

cohesion are less important, while pluralism prevails.[176] The social consensus that is found in Korean society, including a tradition of an activist state – is foreign to the Canadian situation.

The planned reforms (reductions) to the eligibility and payments under the Old Age Security program were not implemented as social consensus was not reached. The proposed reforms did not fit with the model of income security that has come to dominate in Canada: namely, a minimum guaranteed level of support for all, with additional modest support for those in greater need, supplemented by a larger role for individual savings. The sense of economic or demographic crisis that might have caused sufficient solidarity to enact the proposed changes was never felt by the majority of the population, or even the major stakeholders. On the other hand, the adjustments to the Canada and Quebec pension plans, which increased benefits paid by workers and employers – but left the major other elements of the program untouched – saw considerable social consensus.

With regard to private plans, a primary policy objective in the past two decades has been to provide equitable tax assistance for retirement, regardless of whether a worker participates in an employer-sponsored plan or an individual plan.[177] That private plans are available to only the better off workers – and thus do nothing to reduce inequities – fits with the liberal welfare state of the nation, particularly given the existence of the other two (public) pillars of the pension regime.

In summary, Canada's pension system reflects the diversity and pluralism of the society. A number of distinct programs have been established over the years "in a fairly logical, ordered manner based on experience."[178] Social consensus, or at least social cohesion, has been forged and maintained with a set of programs geared to particular class and regional groups that as a whole balance equality and freedom.

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[176] For a current discussion of political consensus: John S. Dryzek and Simon Niemeyer, "Reconciling Pluralism and Consensus as Political Ideals," *American Journal of Political Science*, Vol. 50, Issue 3, July 2006, pp. 634-649.

[177] Martin Rein and John Turner, "How Societies Mix Public and Private Spheres in their Pension Systems" in Rein and Schmähl, eds., *Rethinking the Welfare State: The Political Economy of Pension Reform* (Cheltenham, UK: Edward Elgar, 2004), p. 263.

[178] Henry J. Pratt, *Gray Agendas: Interest Groups and Public Pensions in Canada, Britain, and the United States*, (Ann Arbor, Michigan: The University of Michigan Press, 1993), p. 149.

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8. Korea's Public Pension System at a Crossroads – Is the current public pension system sustainable in a rapidly aging society? -

Yun Suk-myung

8.1 Background

Korea has undergone huge political, economic, demographic, and social changes that most OECD member countries had experienced over 50 to 100 years within a relatively short period of 20 to 30 years. Better living conditions based on the rapid economic growth make the average life span of Koreans increase by 20 years in just 40 years, while the fertility rate stands at 1.08 (as of 2005), the lowest in the world, suggesting that the number of economically active people would decrease in the future. Increasing life expectancy and decreasing fertility rate make Korea the fastest aging country in the world.

Under the circumstances, the Korean government has made an effort to deal with the breakdown of traditional informal income system for the elderly caused by a sharp increase in the number of nuclear families. Such an effort has resulted in the National Pension Scheme(NPS), a public pension system for the general public. Since the NPS was first introduced in 1998, it had been gradually extended to become universal for all Koreans in April 1999.

Even though all Koreans can now be insured by the NPS, Korea is facing three policy challenges in relation to guaranteed income for the elderly. First, public acceptance of the NPS should be improved in these early stages of introduction, considering that Koreans have traditionally mistrusted government policy. Second, the scheme should be reformed to ensure financial substantiality and to develop a multi-pillar income support system for the elderly, in order to effectively respond to an incoming super-aged society. Third, measures should be taken to help ease poverty of the elderly, who are not able to benefit from the scheme of a social insurance type, and to help those who are currently excluded from the scheme and cannot benefit from the scheme in the future

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In October 2003, the Bill on Revision to the NPS, which pursued "more contributions and less benefits", was submitted to the National Assembly. However, there has been no even serious discussion on the bill for the last three years, as there are differences of opinions among interested parties about the urgency of the scheme reform, adequacy of benefits, and how to help those excluded from the NPS, which is managed as a social insurance type. While the Korean government has focused on financial stability of the NPS, the opposition has insisted that those excluded from the NPS should be first dealt with and then financial stability of the scheme should be gradually improved.

In the late half of 2006, the ruling party proposed to introduce the Basic Old-age Pension Scheme (BOPS) for the Elderly, a kind of public assistance, where 60% of senior citizens who are 65 years or older get 5 % of the average income of the contributors of the NPS (89,000 KRW as of 2008) in order to ease poverty among the elderly currently not covered by the NPS. However, the opposition parties did not give up the idea to introduce the Universal Basic Pension (UBP) using taxpayers' money. Under these circumstances, in the late March 2007, the Bill on Improving Financial Stability of the NPS (50% of income replacement rate and 12.9% of contribution) and the Bill on the BOPS were passed in the Steering Committee and Judiciary Committee of the National Assembly, increasing expectation of a passage of the Government's Reform Bill. However, 23 legislators who defected from the Our Open Party (OOP) abstained and members of the Grand National Party (GNP) and Democratic Labor Party (DLP) voted against the Reform Bill sponsored by the ruling party. As a result, the Reform Bill failed to be passed in the National Assembly. What's disturbing is that the BOPS negotiated as a political compromise in the first place in order to pass the Government's NPS Reform Bill was passed with an overwhelming majority. In other words, the National Assembly rejected the NPS reform Bill, which was not popular among the general public, while passing the populist BOPS, which would give taxpayers' money to 60% of those who are 65 years or older and have not paid any contributions at all in their life. Legislators passed only a bill that would put more burdens on the next-generations after quarrelling over the NPS for more than three years.

It should be noted that the opposition GNP, which is a conservative and market-economy oriented political party, gave up its NPS Reform Bill (basic state pension with 20% of the income replacement rate using taxpayers' money + state earning related pension scheme with 20% of the income replacement rate as a social insurance) and instead submitted the NPS Bill representing positions of the progressive opposition DLP, to the General Meeting of the National Assembly at a time when the ruling party submitted its own reform bill. The NPS Bill of the GNP and DLP also was not passed in the National Assembly. However, this bill has clearly showed that the GNP has disregarded its political platform and pursued short-term interest only in the discussion on the reform of the NPS.

Since 2006, the focus of the discussion on the reform of NPS has shifted to Special Occupational Pension plans (SOP) including the Civil Service Pension Scheme (CSPS), at a time when there was no agreement on how to reform the NPS. The contributors of the NPS and media have criticized that the Korean government is in hurry to reform the reform of NPS, which has a short history, while still maintaining SOP plans, which is a matured system with a long history and has clearly big problems caused by "less contributions and more benefits."

The NPS has a short history of less than 20 years. However, attempts are now being made to reform it in line with significant social, economic, and environmental changes over the past few years, even though the scheme was already reformed in the late 1998 to gain financial stability. In this sense, no one can deny the necessity that the CSPS should be also reformed to accommodate social, economic, and environmental changes, considering that it has a long history of more than 45 years.

The Korean government has recently made a proposal to financially stabilize the CSPS, which now shows serious financial problems after it was first introduced in 1960 (See Appendix). The government proposal based on the study conducted by the Korea Development Institute (KDI) has been reviewed by the CSPS Review Committee (CSPSRC) and submitted to the Government Administration and Home Affairs Minister. The proposal is designed to change the CSPS to ensure that civil servants pay more contributions and get less benefits in order to improve financial status of the pension system.

Interested parties have shown mixed responses to the reform proposal. Labor unions representing interests of civil servants claim that the proposal would make things worse, saying that it would lead to lower benefit of the incumbents and widening benefit gap between the incumbents and retirees. Civil society and the media representing the general public sharply criticize that the proposal is not for a reform in its real meaning, pointing out that measures in the proposal are too weak to financially stabilize the pension plan.

"As of 31 December 2006," politicians proposes populists measures for the NPS to gain more votes, while those with Special Occupations are strongly against the reform of SOP plans, which clearly show serious problems caused by a structure of "low burden and high benefits", saying that their occupations are different from those in the private sector.

Therefore, pension plan experts are deeply concerned about these circumstances and possible side-effects of delays in pension reforms. What's worse is political parties are not likely to actively push for pension reforms, which are not popular among the general public, because the presidential election is expected to be held in December 2007.

This paper examines background of public pension plans in Korea and explores the possibility of pension reforms through a democratic process using the Median Voter Model, which deals with pension reforms from the political and economic point of view. In other words, this paper analyzes whether Korea, which is the fastest aging society in the world, can implement successfully the much delayed pension reforms through a democratic process.

8.2 Review on the possibility of pension plan reforms through a democratic process in a super-aged society focusing on the Median Voter Model

Browning(1973) forecasted long ago that pay-as-you-go public pension plans would be inevitably expanded beyond the appropriate level in a democratic society. He noted that if pay-as-you-go public pension plans were managed in a democratic way and the shares of the young, middle-aged, and older in population were the same, the older, who were about to reach retirement, and the middle-aged, who had just a few years before retirement would want to maintain or expand a pension plan of "less contributions and more benefits," leading to a situation that the pension plan would be maintained or expanded despite opposition from the young. Based on the assumption that middle-aged and older people are increasingly resisting pension reforms in an aging society, this paper intends to explore the possibility of pension plan reforms through a democratic process in European countries using the Median Voter Model.

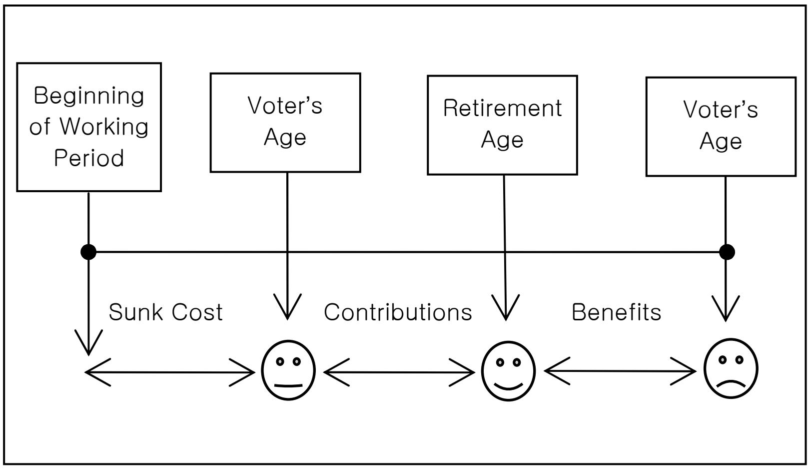
8.2.1 Overview of the Median Voter Model

In an aging society, the Median Voter Model has significant meanings for a democratic process for some types of public pension plans for several reasons. First of all, as for typical public pension plans based on "less contributions and more benefits," voters want to maintain the current pension plan, if they believe that they would get benefits stably after retirement and before they die, without consideration of financial burdens on future generations. In other words, the Median Voter Model is based on the assumption that voters strongly prefer to maintaining the current pension system, regardless of huge burdens on future generations, only if they are guaranteed with pension benefits while they live.

However, the young wants to reduce or abolish the pension plan of "less contributions and more benefits," as both fertility and economic growth rates would decrease in the long term, making the pay-as-you-go pension plan increasingly unprofitable and provide less benefits to beneficiaries in the future. In this case, the young people can get higher returns if they make an investment in financial products in the private sector, not in public pension plans. On the contrary, the elderly about to get benefits and middle-aged and older people who have paid contributions for a long time can expect high returns on their pension contributions, if a system of less contributions and more benefits is maintained. Therefore, they prefer to maintain the current pension system intact or strengthening a funded system.

In relation to pension plans determined through a democratic process in an aging society, the Median Voter Model suggests that PAGO public pension plans tend to expand in a rapidly aging society, because the age of the median voter continues to increases.

<Fig. 8-1> Median Voter Model Overview



Source: Galasso and Profeta, "Lessons for an ageing society: The Political sustainability of social security systems, CRR working Paper, 2004.

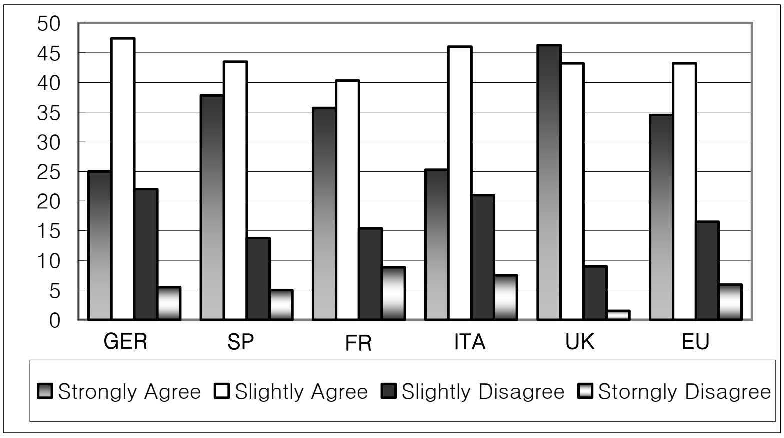
8.2.2 Examples of Median Voter Model application in other countries

The Median Voter Model can be useful in analyzing PAGO public pension plans, as it explains why problematic public pension plans of less contributions and more benefits are not rapidly changed into those of "proper contributions and proper benefits." In a democratic society, where a decision by majority is valued, politicians who want to win votes as many as possible tend to follow a majority decision. Therefore, if a public pension plan is not reformed before the age of the median voter significantly increases, it is virtually impossible for a democratic society to use a democratic process to change its public pension plan in a way to ensure that proper contributions are paid and proper benefits are given until financial resources of the public pension plan are totally exhausted.

<Fig. 8-2> shows that the overwhelming majority in the 15 European Union member countries do not want their benefits to be reduced, even if taxes or contributions are increased significantly. This suggests that the majority of people in a super-aged society of the European Union are willing to accept even a big increase in taxes or contributions to maintain the current public pension system. The problem with a democratic process to reform public pension plans is that the elderly shows far higher voting rate than the younger generation in an aged society. For example, in the U.S., the

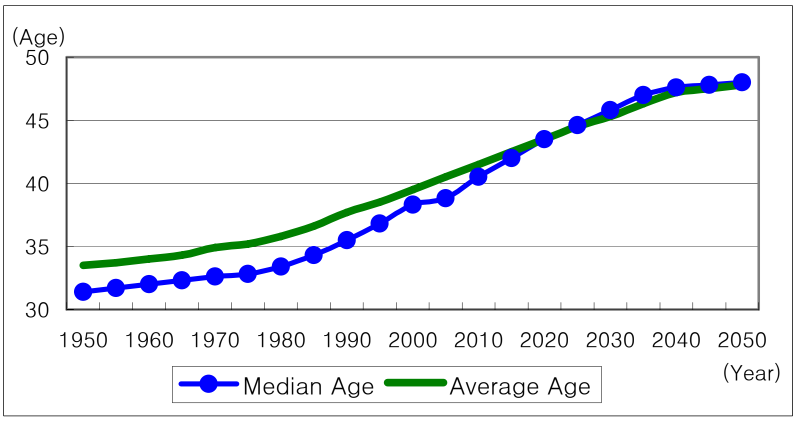
voting rate of those in their 60s is twice that of those in their 20s. Also, in France, those in their 60s have a 50% higher voting rate than those in their 20s (Galasso and Prota, 2004) .

<Fig. 8-2> Views on Public Pension Reform Directions of Citizens in the 15 EU Member Countries



Source: Galasso and Profeta, "Lessons for an ageing society: The Political sustainability of social security systems, CRR working Paper, 2004.

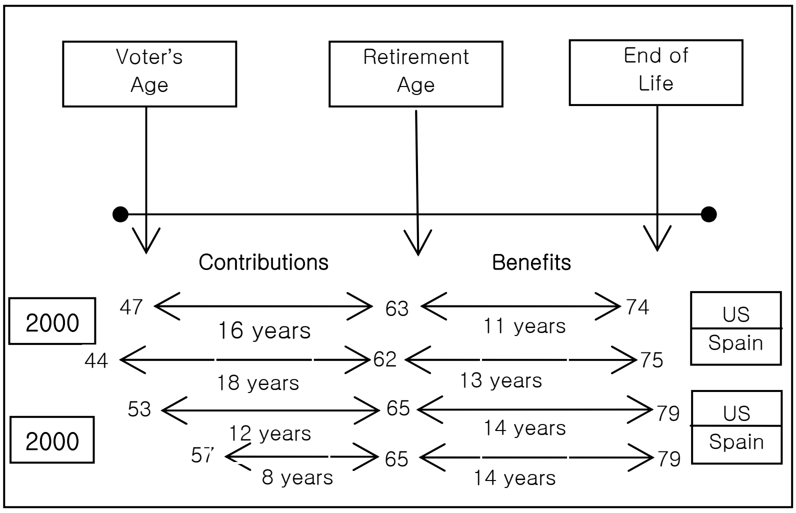
<Fig. 8-3> Changes in the Median Voter Age and Average Age in European Union.



Source: Commission of The European Communities, Green Paper "Confronting demographic change: a new solidarity between the generations", 2005.

The effects of a rapidly aging society on the democratic process for public pension plan reform discussed above can be found in cases of the U.S. and Spain. In the U.S., the contribution period of the median voter is expected to decrease from 18 years in 2000 to 12 years in 2050. In Spain, the contribution period is expected to decrease by 11 years in 2050. The Median Voter Model suggests that Spain is more likely to expand its public pension plan of "less contributions and more benefits," because Spain is expected to become a super-aged society earlier than the U.S. As the contribution period of the median voter before retirement is shorter, voters are more willing to maintain or expand the generous public pension system. This analysis is very significant for Korea, which is the world's fastest aging country.

<Fig. 8-4> Changes in the Median Voter Age in the U.S. and Spain Caused by an Aging Population



Galasso and Profeta, *ibid*.

8.3 Why is a pension reform so urgent for Korea?

The Median Voter Model suggests that it is more urgent for Korea to reform public pension schemes than for any other countries in the world, as it is rapidly aging and its public pension plans are matured. In fact, there are several reasons for Korea to reform its public pension plans as soon as possible.

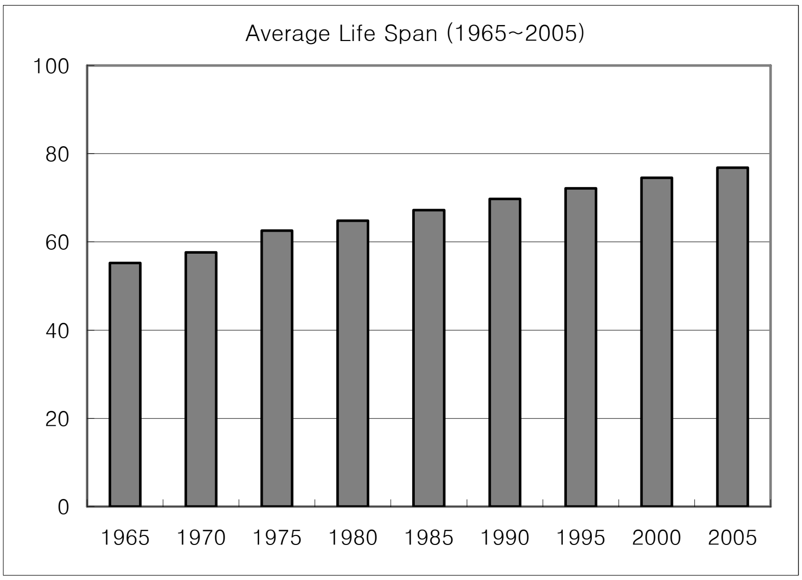
8.3.1 Rapid increase in the average life span

In the early 1960s, when the Civil Service Pension Scheme was first established, the average life span among Koreans was less than 60 years. However, in just 40 years since the establishment of the CSP System and 20 years since the introduction of the NPS, the average life span among Koreans increased by 20 years, causing a serious shortage of financial resources for the pension system.

It should be noted that in Germany, which was the first nation to introduce a public pension plan in the world, beneficiaries started to get benefits when they turn 60, at a time when the average life span of Germans was 40 years and life expectancy of those who had survived until the age of 60 was just 5 years. Germany's public pension plan was developed based on the assumption that beneficiaries could get benefits for just 5 years after retirement.

Today, advances in science and medicine have increased the average life span of Koreans by almost 20 years. As a result, the benefit period has significantly increased. Therefore, sticking to the old pension system would be not wise.

<Fig. 8-5> Increase in the Average Life Span of Koreans (unit: year)



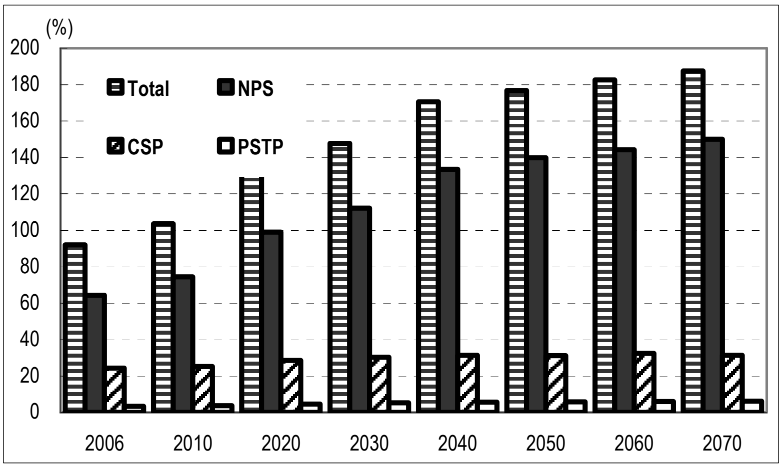
Source: National Statistics Office, Various years.

8.3.2 Rapid increase in unfunded liabilities caused by maturing public pension plans

As public pension plans of "less contributions and more benefits" mature, implicit pension liabilities, which occur when a promise is made to fund the pension plan in the future without setting aside money to cover those future payments, tend to sharply increase. According to the KIHASA's calculation, an actuarial fair contribution of the NPS would be around 24.98% while actual contribution rate of the NPS was just 9%.

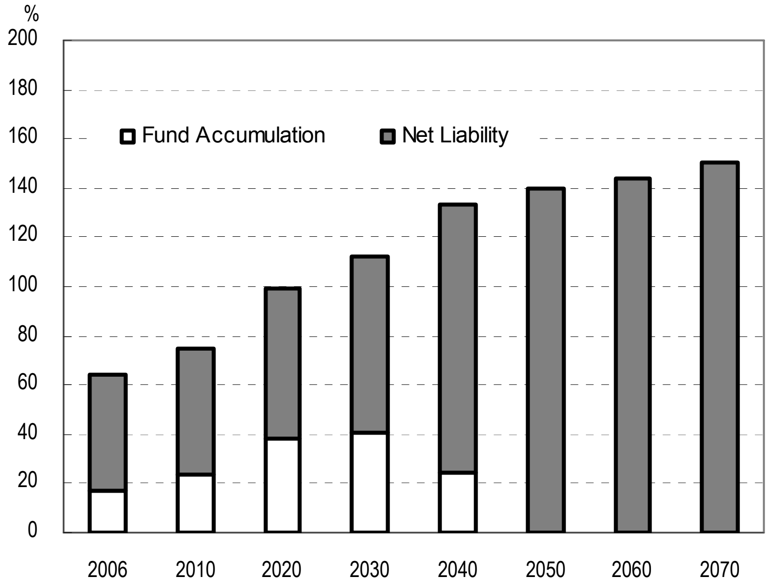
As of 2006, the ratio of implicit pension debts (IPD) to GDP was 92.1%. However, it is expected to significantly increase to 132% by 2020 and 170% by 2040, if public pension plans were not reformed and financially stabilized. In particular, in case of the NPS, the ratio of unfunded liabilities to GDP is expected to continue to increase to 140% in 2050 and 150% in 2070 from 46.9% in 2006. The concept of an unfunded liability is originally for the private sector. Therefore, it is not realistic to apply directly the concept to public pension plans and evaluate their financial soundness. Nevertheless, the Authority needs to find ways to stabilize public pension plans as soon as possible to reduce unfunded liabilities of public pension plans including the NPS.

<Fig. 8-6> Ratio of Implicit Pension Debts of Public Pension Plans to GDP



Note: NPS = National Pension Scheme, CSP = Civil Service Pension, PSTP = Private School Teachers' Pension
Source: KIHASA, 2006.

<Fig. 8-7> Ratio of Unfunded Liabilities of the NPS to GDP (=net debt + fund accumulation)



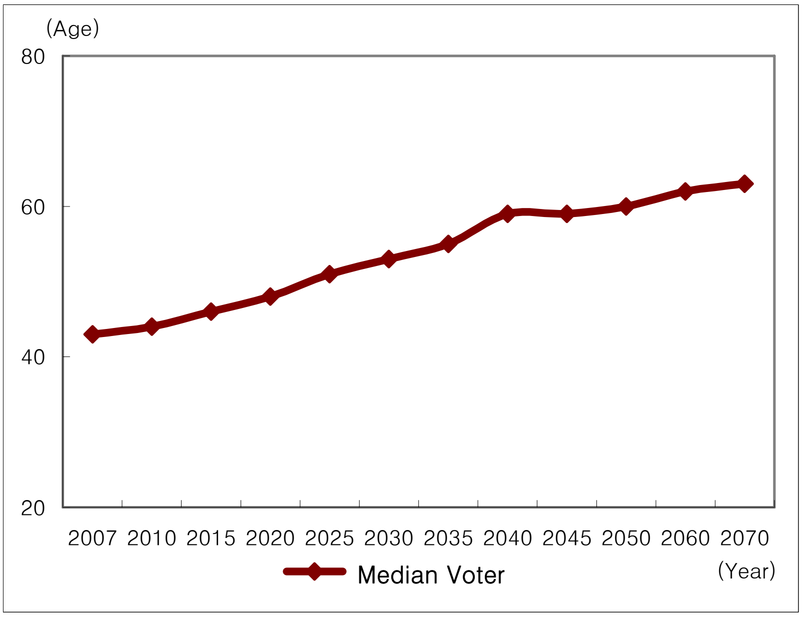
Source : KIHASA, 2006.

8.3.3 Rapid increase in the age of the median voter due to population aging

In Korea, which is the world's fastest aging country, the age of the median voter is also expected to increase at the fastest pace in the world. It is expected to reach 43 years by 2007, 48 years by 2020, 59 years by 2040, and 63 years by 2070. These figures suggest a gloomy picture that if Korea maintains the current public pension plans of “less contributions and more benefits” until it becomes a super-aged society, or introduce a 100% PAGO public pension system, public pension reform based on a democratic process would not be made until financial resources of the NPS is completely exhausted.

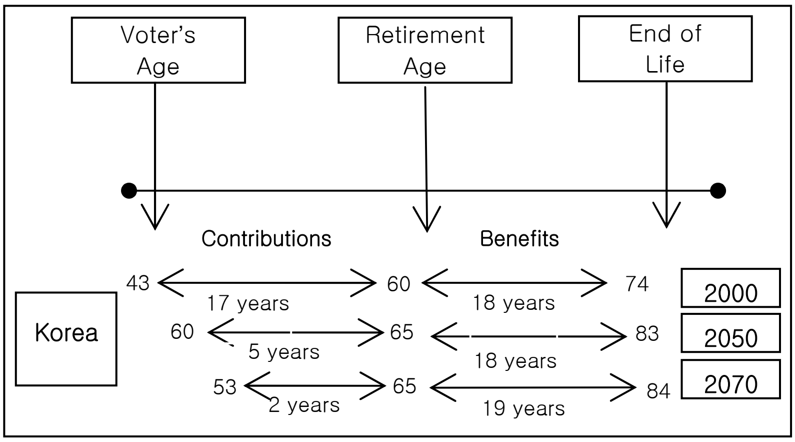
Considering the strong unity and high voting rate among the elderly, there is little time for Korea to push for a reform of the current pension system of "less contributions and more benefits" through a democratic process. The rapid increase in the age of the median voter suggests that Korea should reform the National Pension Scheme as soon as possible and Koreans should not regard the reform as a political issue.

<Fig. 8-8> Increase in the Age of the median voter in Korea



Note: The minimum voting age is 20 years.
Source: Author's Calculation

<Fig. 8-9> Changes in the Age of the Median Voter Caused by the Aging Population in Korea



Source: Author's Calculation

8.4 Discussion and Conclusion

Over the past three years since the Bill on Revision to the NPS to reform the current system of “less contributions and more benefits” was submitted to the National Assembly in October 2003, public agreement has not been made and things have gotten worse. While the government has been pushing for the Reform Bill to stabilize the NPS financially, the opposition parties have been focusing on providing benefits for those who are excluded from the National Pension Scheme.

The reason why the government has focused on financial stabilization in reforming the NPS is that securing financial resources is an essential matter. The NPS was introduced in the first place as a system of "low burden - high benefit" structure in order to encourage more people to contribute to the scheme. However, the government failed to change the scheme to a system of "proper contributions and proper benefits" in a timely manner due to political reasons, causing serious financial problems in the long term. In addition, as social and economic conditions such as economic growth rate, fertility rate, and life expectancy assumed at a time when the NPS was first designed have been significantly changed, reform of the NPS becomes imperative.

On the other hand, the media has reported almost every day that financial resources of the NPS will be exhausted. Koreans who have traditionally distrusted government policy are now very concerned that they would not be able to get benefits when they get older, even though they diligently pay their contributions for life. Therefore, the Korean government proposed the Reform Bill to financially stabilize the NPS and to eliminate the public concern about exhaustion of financial resources of the NPS in the longer term. Pension experts have also said that the Korean government should reform the NPS as soon as possible, because the number of interested parties will continue to increase, making it far more difficult for the government to improve the scheme over time, based on the lessons of pension reforms in other countries.

The current elder generation has been excluded from public pension plans, as they have had no opportunity to pay contributions for the NPS. Therefore, there are no dissent that a special old-age income protection program should be provided to the poor elderly using taxpayers' money. At issue is whether the income is given as a right to universal basic pension (financed by general tax revenue) or public assistance, considering financial burdens in a super-aged society in the future. However, I would like to ask politicians why they are now putting aside the urgent reform bill and wasting time in quarrelling over universal basic pension vs. public assistance, if they want to discuss ways to improve guaranteed income system to reduce poverty among the elderly and explore ways to provide income assistance to those excluded from pension plans.

Recently, Germany and Japan have already introduced a Swedish built-in stabilizer in their pension plans. These countries are well aware that there are no other options, considering changing social and economic conditions, even if they can reduce pension benefits. Therefore, it is not easy, at least in the perspective of financial soundness, to understand why Korean politicians struggle to introduce the out-of-date pension system that most developed countries have abandoned. In this regard, the Basic Old-age Pension Scheme for the Elderly (BOPS) (for 60% of those who are 65 years or older) that the ruling party has been proposing and the Universal Basic Pension (UBP) using taxpayers' money that the opposition parties have pushed for cannot be free from the criticism that these proposals have political intentions. The discussion on pension reforms designed to stabilize financially public pension plans has been losing its original purposes. Nowadays, politicians both in the ruling and opposition parties are discussing how to change pension plans in a way that more financial resources are required.

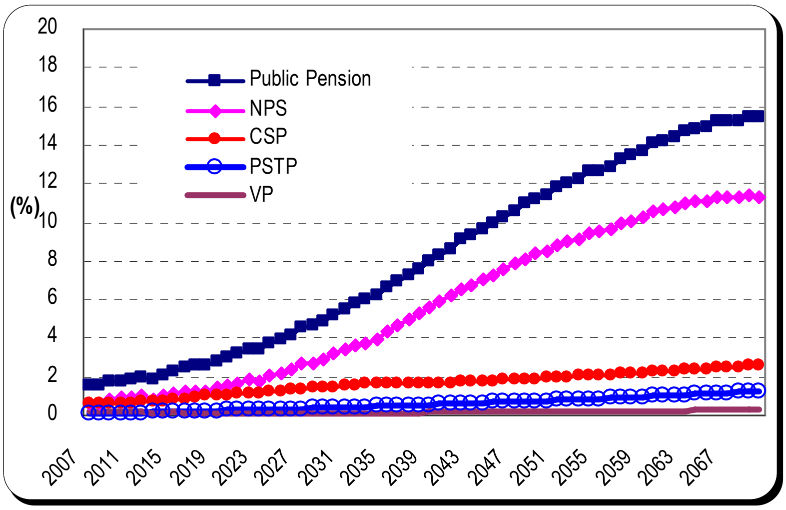
As for the BOPS for the Elderly, it will lose characteristics of public assistance type program, as the share of beneficiaries among total elderly is too high. Also, the introduction of the UBP using taxpayers' money also goes against these day's pension reform directions, where active aging is promoted and workers are encouraged to stay employed as long as possible to effectively meet the aged society. For instance, Finland has cut the number of beneficiaries of a universal basic pension by more than 40%, based on the pension test within a decade. As of 2005, beneficiaries of Full Basic Pension in Finland accounts for only 8% of the elderly. Korea should learn a lesson from Finland's pension reform before introducing a tax-financed universal basic pension program in its process to adapt to a super-aged society.

Countries that have successfully reformed their pension systems suggest that a desirable reform direction might be found, only when pension reform proposals do not involve political matters. Therefore, Korea needs to separate public pension plan reforms from political discourse and adopt a strategy of selection and concentration in improving the current system. The Korean government should now focus on securing financial resources for pension plans to help the disadvantaged live in a humane way by developing a pension system that can be sustained even in a super-aged society and reducing unnecessary expenditures as much as possible.

The analysis mentioned above suggests that there is little time available for Korea to reform the current pension system and develop a sustainable pension program. If it is so difficult for Korea to reform the current public pension system in the early stages, things would get worse and it would never be able to change the current system in the future. If belling the cat is difficult, belling the tiger would be impossible. Therefore, Korea needs to make the utmost efforts to design a sustainable pension system for the elderly that the current and future generations can share, instead of developing a monstrous pension plan that continuously wastes financial resources. The Median Voter Model mentioned above and huge increase in implicit pension liabilities of the NPS clearly indicate that Korea has little time to improve the current pension system through a democratic process.

<Appendix>

<Fig. 8.A.1> Long-range Projection of Public Pension Expenditures to GDP



Note: NPS = National Pension Scheme, CSP = Civil Service Pension, PSTP = Private School Teachers' Pension, VP = Veterans' Pension
Source: Korea Institute for Health and Social Affairs, 2006.

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