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PENSION INITIATIVES TO MEET GLOBAL DEMOGRAPHIC CHALLENGES

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Pension Initiatives to Meet Global Demographic Challenges

The timing and venue for the 2001 World Services Congress could not be more appropriate. Nations in this vast and dynamic region of the world, as elsewhere, are focusing ever more closely on their demographics and, in particular, on the aging of their *baby boom generations.* As former American Commerce Secretary Pete Peterson aptly observed a few years ago, *"the challenges of global aging, like a massive iceberg, looms ahead in the future of the largest and most affluent economies of the world."* This demographic and economic phenomena impacts as much on Hong Kong, China, India, Singapore or other nations of this region as it does on any country in North or South America or Europe.

I will briefly discuss public policy initiatives undertaken or contemplated by countries throughout the globe to effectively address the global aging challenge. I will also mention several important global pension reform features that are necessary if such reforms are to achieve their ultimate objectives.

In its assessment of private pensions in Asia, conducted for the OECD, the Public Policy Programme of the National University of Singapore notes that *"the main function of a social security system is to provide a substantial proportion of the current and future retirees a socially adequate replacement rate with a high degree of sustainability."* Yet, many governments in Asia and in other regions are ill prepared to meet this challenge.

The World Bank reports that public pension schemes are the largest fiscal program in many countries and most of them are in serious trouble. *"Declining fertility rates and increasing life expectancy has exerted economic pressures on traditional pay-as-you-go (PAYG) systems, making them nonsustainable in their present forms,"* a World Bank study reports. Ever so slowly countries in the Western Hemisphere, Europe, and Asia are moving away from PAYG governmental social safety nets that threaten to bankrupt them. Instead, they are exploring how public policy – including tax and economic policies – might be utilized to create viable, healthy private pension and retirement savings arrangements. They realize that governmental pension and retirement policy plays a vital role in the financial well being of their citizenry.

The global aging challenge was discussed at great length during the *OECD Conference on Private Pensions in Brazil* in March 2001. Pension and investment experts from Europe, Latin America, Australia, and the United States confirmed that personal pension plans *"…provided through pension funds and life insurance companies are playing an increasingly important role in mobilising national savings and financing retirement."* Several of these experts also confirmed the importance of favorable tax policies, including a *"…need to equalise tax treatment among financial vehicles providing retirement benefits in order to stimulate their respective growth."*

To further help put this discussion into some meaningful context, the Center for Strategic and International Studies (CSIS) Commission on Global Aging reports that *"…the challenges of global aging are fundamental, unprecedented, and potentially destabilizing to global prosperity."* In its report to world leaders, the Commission was unanimous in its finding that *"…demographic trends throughout the developed world have rendered current social insurance pension and health programs for the elderly unsustainable."*

Certainly no government has this dynamic more in mind than the People's Republic of China. With the strong support and leadership of Premier Zhu Rongji, China has undertaken a comprehensive examination of the burgeoning retirement needs of its enormous population, particularly in its transition from a planned to a market economy. Earlier this year Premier Zhu aptly commented to a group of provincial officials, as reported in *THE WALL STREET JOURNAL,* that *"the pension system is the lifeline of our workers."*

The World Bank reports that China's population of those over 60 years or age will rise from ten percent today to over double that percentage in 30 years. Although China adopted a modified private pension plan for certain enterprises a number of years ago, it must provide further direction for those private companies which will emerge from the privatized state-run enterprises in the future. At the end of 1996 total pension reserves were estimated at only 55 billion yuan, less than one percent of GDP. The World Bank also reports that virtually all incoming revenue is being used to pay current obligations of pensioners. While contributions reached some 120 billion yuan in that year, expenditures totaled 108 billion yuan.

The Ministry of Labor and Social Security (MOLSS) and the China Institute for Policy Studies, in particular, have devoted considerable attention to China's demographic and the need to provide supplemental retirement plans. As part of these analyses MOLSS and other government officials have met with a wide range of American, Australian, European, Latin American and Asian officials and the private sector to learn about their public and private pension initiatives. The Principal Financial Group has been among those global retirement savings and asset management firms that have worked closely with Chinese officials to help them learn about America's unique private, employer-sponsored defined benefit and defined contribution pension plans and the incentives provided through our tax laws. They have visited our offices in the United States, as well as in Chile, Australia and Hong Kong. MOLSS, CIRC (the insurance regulatory agency), CSRC (the securities regulatory body), and the State Council have thoroughly explored a variety of pension initiatives in order to gather a broad perspective on global private pension plans. This study will be further enhanced late next month when the OECD, in cooperation with MOLSS, hosts a workshop on occupational pension plans in Beijing, similar to its Rio pension conference in March.

A key element of China's exposure to private pensions schemes in the United States and elsewhere is the tax treatment of retirement plans. As the American experience has amply demonstrated, the success of private pensions and personal retirement schemes largely depends on their favorable tax treatment. While a politically sensitive issue in most countries, public policymakers cannot ignore it. Without question, tax incentives for employer-sponsored pensions and individual retirement plans constitute a key investment in a nation's economic infrastructure.

One of the most important ways private retirement savings aid a national economy is by providing a ready source of investment capital and, thus, an engine for economic growth. Pension assets do not lie idle. They provide investment funds for start-up operations and revitalization of national business enterprises. As Pinar Çebi of the American Council for Capital Formation, a Washington-based public policy think tank, writes in a soon-to-be published study, *"...saving makes possible the productivity-enhancing investments which in turn raise real wages for both skilled and unskilled workers. It is fundamental to the nation's competitive strength and standard of living, because economic growth depends on the availability of an adequate pool of savings to finance new investments."*

Regardless of the controversy or intellectual disagreements about the tax treatment of private pensions and retirement savings, it is important to bear in mind that tax incentives offered today to private or occupational pension schemes are, in most countries, tax <u>deferrals</u>, not tax <u>losses.</u> Today's pension tax expenditure creates a future tax base greater than the original contribution amount. In the United States alone it has been estimated that over US$750 billion in taxes on benefit payments will be paid during the next four decades as America's *baby boom generation* retires. Further, the tax deferral creates additional value over time as the contributions ar3e invested prudently and earnings increase the value of each pension plan participant's benefits or accounts.

In the United States funds in employer-sponsored pension plans – defined benefit and defined contribution – accounted for more than US$5 trillion in assets at the end of 1998. These pension plan assets represented 26 percent of all equity holds and 12 percent of taxable bond holds in the United States, according to the Employee Benefit Research Institute (EBRI). These figures compare with nine percent of equities and 14 percent of bonds in 1974, before the enactment in 1974 of the *Employee Retirement Income Security Act (ERISA),* America's primary private pension law, the introduction of *401(k)* plans in 1978, and the growth of *Individual Retirement Accounts (IRAs)* in the 1980's and 90's. Retirement funds have spurred the domestic economy in the United States and represent an important contribution to America's global competitiveness. According to EBRI and the Investment Company Institute (ICI) assets in IRAs, alone, amounted to US$2.47 trillion in 1999 – surpassing assets held in both private defined contribution and defined benefit plans.

Not to belabor the point but it is appropriate to observe that additional private retirement savings increase the pool of capital, thus permitting greater production of goods and services. These taxes encouraged private retirement savings also make possible additional productivity-enhancing investments by corporations, including small- and medium-size enterprises. And, depending on various national tax regimes, increased capital accumulation also generates additional corporate tax revenues.

There is ample empirical evidence from the American experience that confirms that targeted savings programs do, in fact, increase personal retirement savings. And it is especially important to note that middle-income workers are most likely to avail themselves of such targeted retirement savings programs.

But America need not serve as the only model. Consider Chile's experience. Nearly two decades ago that nation replaced its government-managed pension system with privately administered *Pension Savings Accounts (AFPs*, in Spanish). After 15 years of operation, the AFPs are 50 to 100 percent higher than they were under the former PAYG system. As of last year, Chilean AFPs grew to US$39 billion – 47 percent of the country's GNP. The system has also been running fiscal budget surpluses.

Particularly timely for this discussion is the exciting initiative taken by Japan. Within the past few months Japan has successfully completed two of three stages in a comprehensive reform of its pension system. Building on public pension reforms of March 2000, the Diet approved both a new corporate or defined benefit pension reform law in early June, followed shortly thereafter by a defined contribution pension measure. A third phase is to be adoption in 2002 of a hybrid cash-balance pension system that includes elements of both defined benefit and defined contribution plans.

The recently approved Japanese pension reforms, to become effective next month, should increase income security as well as pension and labor portability. The defined contribution plan removed restrictions barring pension plans from offering anything but a predetermined retirement benefit. As a colleague in Tokyo said soon after the Diet acted, *"the timing of the Japanese government's opening of this new retirement market is exactly right. In this way, many Japanese businesses and employees will see their retirement savings grow safely, efficiently, and quickly, to help them meet their future retirement needs."*

Under capable political and regulatory leadership, India will soon propose significant private pension legislation. The legislation will build on the proposals developed by the Old Age Social & Income Security (OASIS) Commission. This initiative could include creating an independent regulatory and supervisory entity to help ensure that the enormous long-term savings potential inherent in India's retirement and pension sector for both salaried and self-employed workers is fully deployed to the benefit of India's internal savings and capital market needs.

We might also consider similar experiences with Australia's *superannuation guarantee* program, Sweden's *premium pension* plan, Hong Kong's *mandatory provident funds,* Mexico's *AFOREs,* or Singapore's *supplementary retirement scheme.* The point is that it is highly imprudent for many governments around the globe to defer making hard choices about enacting tax incentives to encourage supplemental employer-sponsored or personal retirement arrangements simply because of political expediency or temerity. There are those – including in the United States – who claim that tax revenues will be foregone or lost or that tax incented retirement savings amounts to corporate welfare. What about when these workers retire and pay tax on some or all of their retirement income? Or, consider the advantage of providing tax incentives today to encourage private retirement savings instead of facing even higher economic and social costs associated with funding bankrupt state-sponsored retirement plans.

My friend David Harris of Watson Wyatt has best summed up the foregoing. Speaking of the social security reform experience in his native Australia, Harris comments that it *"…demonstrates the ability for a nation to give its people a greater ability to craft our a sufficient and appropriate level of retirement wealth to meet expected future needs and demands."* Harris contends that no one nation's experiences in moving from a PAYG social security system to a private arrangement can be easily transported to another. But, the U.S., Australia and the other nations I have cited can demonstrate the key role played by the individual consumer in determining her or his own retirement savings needs. Certainly creating an entirely new pension structure, as in China or, last yeare, in Poland, is a challenging task.

A discussion of pension initiatives to address global demographic challenges would not be complete without a mention of the contributions made to public policy initiatives by the OECD. Under the aegis of its Directorate for Financial, Fiscal and Enterprise Affairs and its Insurance committee, the OECD has increased its focus on private pension issues as part of an extensive program on aging society. It has hosted groundbreaking private pension conferences in Rio de Janeiro, Brasil, and Sofia, Bulgaria. A similar workshop will be convened in Beijing next month in cooperation with Japan's Ministry of Finance and the US's International Pension Foundation and the Departments of Labor and Commerce.

The OECD Working Party on Private Pensions, on which I am honored to serve, has examined the growth of personal retirement arrangements, such as IRAs in the United States. To help encourage governmental policies providing appropriate regulation and supervision of private pensions, including the rights of pensioners and pension plan participants, OECD and member country experts have examined the asset management aspects of new pension plans, the administrative costs of new defined contributions plans and their regulation, the implications of recent pension reforms and liberalization of existing pension systems, and the investment regulation of defined contribution plans.

The OECD – most of whose 30 member nations and several other observer nations are represented at the World Services Congress – provides a convenient and constructive forum in which those nations who are restructuring and reforming their state pension systems are able to share experiences and to elicit suggestions from those countries which have already reformed their systems. It was very heartening that the June 2001 OECD Ministerial recognized this important subject and its unique role. The OECD Committee on Cooperation with Non-Members (CCNM) reported that *"private insurance and pension firms are essential in fostering emerging capital markets. Private pensions improve the balance and adequacy of pension systems."* The OECD Ministerial confirmed its intention to continue to *"promote the development of an adequate regulatory framework, key conditions for successful pensions reforms in emerging economies, and the development of open and sound markets."*

There is insufficient time for an exhaustive discussion of private pension reforms that have been successfully launched, are in process or are at least at the conceptual stage. However, I wish to briefly raise the issue of pension regulation and supervision. As nations in this region and elsewhere fashion new or improved system, it is useful to keep in mind that pensions and life insurance are totally different. They exist for different purposes and are managed in different ways. Virtually all countries regulate pensions and life insurance separately. This arrangement has worked well, is less cumbersome and more efficient, and best serves the needs and interests of the consumers.

As the World Bank, the OECD, regional development banks, and other global institutions consider the transition from outdated, costly government PAYG social security plans to private pension and retirement savings schemes, the pension and asset management business urges that pension funds have reasonable investment latitude. We understand the initial inclination of new pension systems to prefer investment in government securities. However, the risk of a nation requiring pension funds to be indefinitely held entirely or even significantly in government bonds and/or domestic investments leaves the pension system vulnerable to low returns and susceptibility to political meddling in pension fund management. In some countries government-managed pension funds have often produced negative real returns. Consideration should be given to instituting a *sunset* after five or ten years, after which investment regimes can be liberalized. A diversified pension portfolio can help protect against such risks – especially for the pension plan participants – if pension funds are invested outside the domestic market.

Equally important is the notion of pension portability. We live in an increasingly global economy with greater mobility, especially among the more highly skilled managerial and technical workforce. Yet, it is often difficult – if not impossible – to take one's pension from one employer to another, even within the same country much less among countries. So far most pension plans stop at national borders.

Finally, in developing pension initiatives to meet global demographic challenges we must consider activities to encourage personal retirement savings. Workers should be encouraged to put aside a set amount each month or pay period for their retirement. As part of this process workers should be helped to understand what their own retirement situation looks like today and what each one must do to properly prepare for their departure from the active workforce. As more nations create private pension arrangements, there is a growing need for consumers to receive timely, objective and useful guidance and information on their retirement savings investments. In the United States about 50 percent of 401(k) plan participants say they are uncomfortable making investment decisions about their retirement savings without some assistance. Only 16 percent of 401(k) participants have an investment advisory service available to them through their retirement plan. We have found that consumers want advice and guidance on how best to invest their pension funds to suit their own particular needs. Certainly an aggressive, articulate public education program on retirement savings and personal pension arrangements is needed to foster greater personal savings.

The challenges facing us are daunting but are not impossible to address in a responsible and meaningful way. In this era of globalization, our governments have the capacity to fashion public policies to provide adequate retirement savings and health coverage for our citizens. But, the demographic clock continues to tick. Nothing will reverse the global aging trends with which we are all familiar. Many countries have made an important start. Much more remains to be done.