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NOTES

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Executive Summary:

Britain's Answer for Future Retirement Income: Possible Lessons for the United States

- ***Similarities and differences in U.K–U.S. retirement problems*—**Both the United Kingdom and the United States face similar budget pressures over their national retirement programs, shortfalls in individual savings, and a rapid decline of traditional private defined benefit pension plans. Although Congress is not about to overhaul U.S. retirement policy, Britain has very significant changes on the table, with the prospect of action later this year: The government is moving to raise the eligibility age for state pensions, create a new mandatory system of private savings accounts, and require both employer and worker contributions to the accounts.
- ***U.K. presentation in Washington*—**John Hutton, British secretary of state for work and pensions, outlined the British proposal for pension reform at a June 14 meeting in Washington organized by Retirement Security Project. This article summarizes his presentation and initial reaction by U.S. experts.
- ***Affordability, employer mandates big issues*—**In both the U.K. and the U.S., major stumbling blocks to reform have been whether the government can afford the changes and how employers might be hurt by a national mandate to contribute to their workers' retirement accounts.

An American Perspective on the Chinese Pension System

- ***China's underfunded retirement system a potential weakness*—**For all its rapid economic and military growth, China may have a crucial weakness in its grossly underfunded retirement system for the largest national population on earth. Currently, the implicit pension debt in China is around $1.5 trillion, a liability that primarily rests on the country's 31 provinces.
- ***China's worker/retiree ratio worse than here*—**In the U.S., the ratio of workers to retirees is declining from 6 to 1 in 1960 to 2 to 1 in 2040. China, which generally limits each family to one child, the decline is much faster: from 6 to 1 in 2000 to 2 to 1 in 2040. Only 50 percent of urban workers and 11 percent of rural workers are actually paying into the current Chinese social security system.
- ***A break on growth?*—**Unless China implements reform, it runs a serious risk that inadequate funding of retirement benefits will constrain its high rate of economic growth, as the government will begin to devote a much larger percentage of its GDP to paying retirement benefits, and workers will have to save a large part of their income to finance their retirement.

Britain's Answer for Future Retirement Income: Possible Lessons for the United States

by John A. MacDonald, EBRI

The Bush administration and Congress have been working on issues of private retirement income and savings for years. All the changes that have been under consideration have been incremental when it comes to workers, and discussions on adjustments to Social Security are currently off the table. Recent reports from the Congressional Budget Office and the Government Accountability Office, however, make it clear that future Congresses will have to make significant changes in Social Security, Medicare, and Medicaid—either by cutting benefits or increasing taxes—because the programs are not sustainable for the long term. A widespread consensus also exists that current workers will need to save a lot more than they have to date if they are going to have comfortable retirements.

Across the Atlantic, Great Britain has very significant changes on the table, with the prospect of action later this year. The government is moving to raise the eligibility age for state pensions and create a new mandatory system of private savings accounts. Both countries face similar budget pressures over their national retirement programs, shortfalls in individual savings, and a rapid decline of traditional private defined benefit pension plans. Britain's response may have some valuable lessons for the United States.

In the United States, the eligibility age for full Social Security benefits is currently in the process of increasing from 65 to 67. The British plan takes the eligibility age for a state pension—the equivalent of Social Security—a year further, to 68. The changes reflect increased longevity in both countries.

Policymakers in the United States flirted this year with a plan the Bush administration supported to carve individual accounts out of the existing Social Security program, but then put the issue on ice until at least 2007 because of political opposition. The British proposal for individual accounts, which is designed to increase personal savings, would be different in two ways from the Bush-backed plan:

- It would automatically enroll all workers unless they specifically opted out. Bush's plan was totally voluntary.
- It would be an *addition* to the British state pension, not like the controversial partial Social Security *carve-out* that Bush supported in this country.

Less than a month after he presented the plan to the House of Commons, John Hutton, the British secretary of state for work and pensions, outlined the proposal at a June 14 meeting in Washington organized by the Retirement Security Project, a nonpartisan group that is working to make it easier for middle- and lower-income Americans to save for a financially secure retirement.

John Hutton, U.K. Secretary for Work and Pensions

"The challenge of how to support an ever-aging population poses fundamental questions for the future of welfare and pensions systems across the world," Hutton told his Washington audience. "Responding to such changes requires us to make difficult long-term decisions about the share of the burden between current and future generations; about the fundamental nature of the contract between the state and the individual; and the incentives and the support for individuals to save for their retirement."

Invited to offer reactions, three U.S. experts on retirement issues gave the British plan high marks. "I have not met an expert who is not impressed with your proposal," C. Eugene Steuerle, senior fellow at the Urban Institute, told Hutton. Other compliments came from Peter R. Orszag, director of the Retirement Security Project, and William G. Gale, senior fellow at the Brookings Institution.

Hutton said the plan, presented in what is known as a White Paper, was the result of nearly four years' of work, beginning with the establishment of a distinguished three-member commission in 2002 to examine changes needed to improve retirement prospects in the United Kingdom. Among other things, the commission concluded that Britons were not saving enough, that the current state pension system was unfair to women and overly complex, and that the country faced a 50 percent increase in the number of pensioners by 2050.

The government's proposals, which are subject to approval by Parliament, were extensively tested for public reaction in a series of eight pension debates held around the country before Hutton presented them to Parliament on May 25. Britons were told they had three basic options, Hutton said: Increasing taxes, cutting state pension benefits, or increasing the eligibility age for the state pension. The choice of Britons by far was to increase the eligibility age for government pensions, Hutton said in Washington.

As outlined by Hutton, the government's plan has four main components:

- Employees would be automatically enrolled in individual retirement savings accounts and required to contribute 4 percent of their earnings in the new accounts up to a maximum amount. Employers would contribute 3 percent of pay, and the government would provide an additional 1 percent in the form of tax relief. The accounts would be phased in over three years starting in 2012. Self-employed workers could opt into the plan. The government expects up to 10 million participants.
- The age when all Britons would be eligible for a state pension would rise in steps to 68 in 2046. The current state pension age is 65 for men and 60 for women. No one now over the age of 47 would be affected by the change. The number of working years needed to qualify for a full basic state pension would be reduced to 30 years for men and women; it is currently 39 years for women and 44 years for men. Under current U.S. law, the eligibility age for full Social Security benefits is gradually rising to 67 by 2027.
- The basic state pension would be re-linked to wage inflation starting in 2012. This would reverse a policy made during the tenure of former Prime Minister Margaret Thatcher to link pensions to price inflation, which is lower than wage inflation. By 2050, the basic state pension could be worth twice as much as it would if it had remained linked to prices, the government estimates.
- A series of changes would be introduced to make pensions fairer to women and others who provide care at home for children or the disabled. By 2040, this change would qualify 70 percent of women for a full basic pension compared with 30 percent today. Other changes are designed to protect the benefits of the poor and to streamline existing pension laws.

"I do believe it's a comprehensive, integrated set of reforms," Hutton said.

Some features of the plan were not final when Hutton spoke in Washington. For example, he said the government was still consulting with business in an attempt to minimize the burden of the 3 percent of wages that all employers will have to contribute to the new individual accounts. Hutton described employers' reaction to this part of the proposal as mixed, but a leading British business group expressed "deep disappointment" over the decision to go ahead with compulsory employer contributions.

In addition, the plan to re-link pensions to earnings is "subject to affordability and the fiscal position" of the nation in 2012. In effect, this means the proposed change could be delayed by future economic conditions. Hutton also said the government had yet to work out how to keep administrative fees low (30–40 basis points) for the new private accounts, which will be run by private financial managers, not the government.

Reaction in Washington to the British plan generally has been favorable. In addition to the three retirement experts who spoke to the Retirement Security Project meeting, David S. John, senior research fellow at the Heritage Foundation, said in an interview that while the plan was designed for the United Kingdom, the overall idea of focusing on retirement income was excellent. A key message of the plan is that individuals cannot rely solely on a government pension, he said. One feature that would not be well suited to the United States, John said, is the requirement that employers contribute to the new savings plan. Otherwise, he said, "there's a lot we can look at."

In Britain, many organizations have offered statements of overall support for the plan but some raised concerns about specific provisions. Sir Digby Jones, director general of the Confederation of British Industry, said the government proposal "provides a sustainable long-term settlement on pensions." But Jones also said his organization would seek government support for small businesses to help them meet the cost of the new savings program. "There will be anxiety amongst the business community that the government is forging ahead with compulsory employer pension contributions despite the potential damage it could inflict on firms, particularly smaller ones," he said.

Francis McGee, head of corporate affairs for the financial services company AEGON UK, said he was pleased the government is seeking more generous pensions for women and those who provide care to others. But McGee also had reservations. The government plan "seems to lack detail on the implications for existing pension schemes, so we need to beware of unintended consequences," he said. McGee added that he hoped there was still time for debate about the proposal because, in his opinion, it could increase unfunded government pension liabilities.

Stephen Haddrill, director general, Association of British Insurers, said the plan "points pensions' policy firmly in the right direction." But Haddrill also inserted a note of caution: "Now the hard work really begins, for the pensions and insurance industry as much as for the government," he said. "We all need the best possible understanding of consumers' needs and expectations."

The opposition Conservative Party welcomed key aspects of the government's plan, but called for a re-examination of others. Shadow Work and Pensions Secretary Philip Hammond expressed support for moves designed to restore the earnings link and to begin to improve pensions for women. But he said a provision enabling public-sector workers to retire at 60 should get closer review. Hammond also criticized the uncertainty caused by the government's declaration that the restoration of the earnings link in 2012 was subject to "affordability," and he said that the reforms affecting women did not go far enough.

The political systems in Britain and the United States are significantly different so making exact comparisons about the proposals involving social policy is difficult. However, members of the governing party in Britain traditionally have shown a higher degree of party discipline than is the case with the majority party in the U.S. Congress. Defections among Democrats helped kill President Clinton's plans for overhauling the U.S. health care system in the 1990s and reservations among Republicans have at least postponed (if not defeated) President Bush's proposal to carve individual accounts out of Social Security. Initial reports do not suggest that Prime Minister Tony Blair will face such defections within the Labor Party over the government's pension proposals.

However, Gordon Brown, chancellor of the exchequer and a prospective prime minister, did express some early concerns about the cost of re-linking state pensions to wage inflation. This concern prompted the proviso in the plan that the change would be subject to "affordability," but also introduced a note of uncertainty about the move. Exactly what the government will do to try to respond to business concerns remains to be decided. In the United States, business opposition to the "employer mandate" helped sink former President Clinton's national health care plan; in Britain, other special interests have indicated they also want to be heard on the pension reform plan.

No matter what side of the Atlantic, making major change in a significant social policy takes time—Britain has been at pension reform for four years—and is sure to prompt concerns about the details and results.

More Information about the UK Pension Plan:

- The Retirement Security Project has a complete copy of the government White Paper, "Security in Retirement: Towards a New Pensions System," and Secretary John Hutton's remarks statement in Washington, at www.retirementsecurityproject.org/
- The UK Department for Work and Pensions has additional information at: www.dwp.gov.uk/
- The Conservative Party statement is at: www.conservatives.com/
- Other organizations that have issued statements on the plan include: AEGON UK, the Association of British Insurers, the Confederation of British Industry, Deloitte & Touche LLP, the National Association of Pension Funds, and the Pensions Policy Institute.

An American Perspective on the Chinese Pension System

by Robert C. Pozen

Introduction

Americans and Europeans are increasingly concerned about China's surging thirst for energy resources, its tremendous impact on global trade flows, and its rapid rise as a military power. But everyone in the world may be overlooking a crucial weakness in China—a grossly underfunded retirement system for the largest national population on earth. Left unsolved, this may be the Achilles' heel that hobbles a seemingly unstoppable run of economic growth.

Robert Pozen
MFS Investment Mgmt.

Like Germany, Japan and other industrial societies, both China and the United States are facing a pension crisis. As life expectancies increase and fertility rates fall or flatten, the ratio of workers to retirees is declining in the United States—from 6 to 1 in 1960 to 2 to 1 in 2040. Though still an emerging market, China is facing a more serious pension crisis than the United States. Because China generally limits each family to one child, its ratio of workers to retirees is declining much faster—from 6 to 1 in 2000 to 2 to 1 in 2040.

Moreover, China is saddled with unfunded pensions from the era of the "iron rice bowl"—when industrial workers enjoyed a cradle-to-grave security system with little or no contributions on their part. As China began to restructure its state-owned enterprises (SOEs) in the 1990s, millions of SOE employees were laid off and allowed to retire early—some as early as age 40. The responsibility for paying these so-called legacy pension benefits was left with the 31 provinces of China.

The Current Pension System

In response to the growing pension burden, the Chinese government established a new pension system in 1997 for urban workers based on combined payroll taxes of 28 percent—with normal retirement at age 60 for men and 50–55 for women. Employers now pay approximately 20 percent of the wages of all their employees toward a specified schedule of benefits. In addition, employees now pay 8 percent of their wages into personal accounts, which are supposed to be invested in government bonds and bank deposits.

In the United States, by contrast, the combined payroll taxes for Social Security are lower than 28 percent—a total of 12.4 percent, with the employee and the employer each contributing 6.2 percent of wages up to a specified maximum. In the United States, the total 12.4 percent in payroll taxes goes to finance a guaranteed schedule of retirement benefits, with normal retirement age rising from 65 to 67 by 2027 for both American men and women.

It is ironic that a communist country like China already has personal accounts as part of its Social Security system, while personal accounts have not become part of the Social Security system in the United States. However, the Chinese experience shows what happens if personal accounts are not actually funded with investments for the retirement years. The 8 percent payroll taxes paid by Chinese employees have often been "borrowed" by the provinces to help pay the legacy benefits due to retired workers from the pre-1997 era. The Chinese provinces also have tended to "borrow" the 20 percent in payroll taxes contributed by employers to help finance legacy benefits. This type of "borrowing" is similar to the manner in which current payroll taxes are used to meet current benefit payments of Social Security in the United States—thereby building up an implicit pension debt of the U.S. Treasury to the Social Security Trust Fund. The implicit pension debt in the United States is now close to $4 trillion; the implicit debt in China is around $1.5 trillion, according to the latest World Bank estimates. Thus, if personal accounts became part of any plan to reform Social Security in the United States, those accounts should be promptly and fully invested in a conservative mix of stocks and bonds to ensure they are not diverted for other government needs.

In both countries, the national government could finance the implicit pension debt out of general tax revenues—which would allow current payroll taxes to be invested and used only to pay benefits of those currently contributing into the system. This would be difficult to do in the United States because the implicit pension deficit is so large and the 12.4 percent payroll tax would not be sufficient to finance the current schedule of Social Security benefits for all current workers. The implicit pension deficit in China is much smaller than in the United States. Moreover, most of China's implicit pension debt is attributable to retirement benefits for pre-1997 workers who are not currently employed and never contributed payroll taxes to the system.

Indeed, the World Bank has estimated that, if legacy pensions in China were absorbed by the national government, their social security system for current workers could be sustained by a combined rate of payroll taxes below 20 percent—much closer to the level in countries like Germany and Japan. Such a reduced payroll tax in China would encourage employers to hire more workers, and to increase their participation in the retirement system. At present, the urban participation rate in the Chinese social security system is approximately 50 percent, although social security is supposed to be a mandatory system for urban workers. This system is avoided by many urban employers who believe the combined rate is too burdensome and/or do not want to pay for pre-1997 pension promises.

So far, the efforts of the central Chinese government to absorb the costs of legacy pensions have been modest. In 2000, it created the National Social Security Fund, which receives monies from state-run lotteries as well as 10 percent of the proceeds of initial public offerings of certain SOEs. The Fund has also run pilot programs where it helps provincial governments put actual assets, rather than "notional" credits, into personal accounts. Even in these provincial pilots, however, the personal accounts have been only partially funded. The total assets of the Fund for all purposes are less than $30 billion (U.S.).

So What Can Be Done?

Most importantly, the national Chinese government should finance all legacy benefits out of general tax revenues on a pay-as-you go basis. Paying these legacy benefits is part of the national cost of transitioning from a socialist to a market-based economy, and China can afford these transition costs given its high rate of economic growth. If legacy pension costs were absorbed in this manner, then payroll tax rates could be lowered and participation rates would be increased (as mentioned above). In addition, the current payroll taxes from employers could be invested through a separate trust, and the payroll taxes from employees could be actually deposited in their personal accounts.

Second, the Chinese government should promptly establish a mandatory social security plan for rural workers, not just those in the cities. Only 11 percent of China's more than 600 million rural workers participate in the current voluntary system for social security. Experience in other countries shows that near-universal coverage can be attained only by a mandatory system for social security. Of course, such a system in China would present serious administrative challenges, since the rural work force is so spread out. However, payroll taxes could be collected by rural branches of agricultural banks or insurance agencies, with benefits distributed by a national agency working together with local labor offices. Pilots for such arrangements are currently under consideration in China.

Third, over time, the national government should take over the administration of the new pension system from the provinces. With 31 provinces, the pension system is a maze of disparate rules. In the United States and other industrialized countries, it has proved more effective if payroll taxes are collected by a national agency supported by local tax authorities. Similarly, if pension benefits were calculated and distributed by one national agency, as they are in the United States, that would increase the portability of benefits so workers could move easily from one province to another. Although China has large differences in regional income that affect benefit payments, these differences can be taken into account by a national agency.

Fourth, over time, normal retirement age should be increased as the life expectancy of Chinese workers rises. Normal retirement age is increasing not only in the United States but also in Japan and Germany. In China, the life expectancy of women is now 74, compared with 71 for men. At the minimum, the normal retirement age for Chinese women should be gradually increased to 60—the same as for Chinese men.

Finally, the Chinese government should continue to develop other pension vehicles to help those workers with insufficient retirement benefits. The supplemental benefits provided by individual retirement accounts and employer-based plans have become critical to retirement planning in the United States. To augment social security benefits, Chinese firms were recently allowed to offer their employees "enterprise annuities"—like defined contribution plans in the United States—where employees choose payroll deductions during their careers and receive benefit payments at retirement. But few enterprise annuities have been offered because the regulatory and tax rules need to be clarified.

In contrast to the limited distribution of enterprise annuities, sales of life insurance products have been growing rapidly in China. These products are often bought by high-saving Chinese families outside of the government pension system. In rural areas, for example, better-off farmers buy insurance products in lieu of participating in the government's voluntary social security plans. In urban areas, some SOEs have bought group pension insurance to supplement the modest benefits from the government pension system.

If all these types of retirement programs were funded and invested, these would be important factors in deepening the Chinese capital markets. In turn, better capital markets would increase the returns to Chinese retirement programs. The investments from pension plans have played a key role in the development of American markets. Defined benefit plans have been purchasers of innovative products, and some have become activist shareholders. Through 401(k) and other types of defined contribution plans, many workers have become comfortable with investing in securities.

So far, China's National Social Security Fund has been allocated part of the cash proceeds from IPOs of SOEs listed overseas; it has not been allocated part of the proceeds of IPOs of SOEs launched in China because of concerns about the adverse impact of a large overhang of unsold government shares on the local market. These concerns could be alleviated if the Fund were allocated the unsold government shares from Chinese IPOs and then prohibited from selling such shares for 15 to 20 years. Under this approach, the Fund could become an activist shareholder of the former SOEs, and have an incentive to maximize their long-term value for the benefit of Chinese pensioners.

Conclusion

All of these recommendations to improve the Chinese pension system present difficult political challenges. However, if China does not rise to these challenges, it runs a serious risk that inadequate funding of retirement benefits will constitute a significant constraint on its currently high rate of economic growth. The Chinese government will begin to devote a much larger percentage of its GDP to paying retirement benefits, and workers (especially in rural areas) will have to save a large part of their income to finance their retirement. Although a high personal savings rate has many advantages, it will slow down the growth of consumer demand in China—which is critical to its transition from a global export engine to a more balanced economy.

As the economies of the world become more interdependent, how the United States and China deal with the financial security of their current and future retirees grows more and more important to other nations.

Robert C. Pozen is chairman of MFS Investment Management,® which manages more than $165 billion in assets for over five million investors worldwide. He was formerly vice chairman of Fidelity Investments and president of Fidelity Management & Research Company, the investment advisor to the Fidelity mutual funds. He served on President Bush's Commission to Strengthen Social Security from 2001–2002. This is an expanded version of a short article that appeared in Fortune magazine in June, 2006.

EBRI periodically accepts articles for publications that it believes are both unique and of interest to our readers around the world, such as this article by Pozen. Comments on the article should be sent to blakely@ebri.org

New Publications and Internet Sites

Employee Benefits

U.S. Chamber of Commerce. *Employee Benefits Study: 2005*. U.S. Chamber of Commerce members, $75; nonmembers, $125. U.S. Chamber of Commerce, Publications Fulfillment, 1615 H St., NW, Washington, DC 20062, (800) 638-6582, fax: (202) 463-5608.

Health Insurance

Atlantic Information Services, Inc. *Consumer-Directed Health Care: Facts, Trends and Data 2005–2006*. $344. Atlantic Information Services, Inc., 1100 17th St., NW, Suite 300, Washington, DC 20036, (800) 521-4323, fax: (202) 331-9542, e-mail: customerserv@aispub.com, www.aishealth.com

Quadagno, Jill. *One Nation, Uninsured: Why the U.S. Has No National Health Insurance*. $28. Oxford University Press, Attn: Order Dept., 2001 Evans Rd., Cary, NC 27513-2010, (800) 451-7556, fax: (919) 677-1303, www.oup.com/us

U.S. Government Accountability Office. *Consumer-Directed Health Plans: Small but Growing Enrollment Fueled by Rising Cost of Health Care Coverage*. Order from GAO.

Pension Plans/Retirement

Hewitt Associates. *How Well Are Employees Saving and Investing in 401(k) Plans, 2006 Hewitt Universe Benchmarks*. $350. Hewitt Associates LLC, Attn: Hewitt Information Desk, 100 Half Day Rd., Lincolnshire, IL 60069, (847) 771-2500, e-mail: infodesk@hewitt.com, www.hewitt.com

McGhie, G. Neff, III. *Defined Benefit Answer Book*. Third Edition. $225. Aspen Publishers, 7201 McKinney Cir., P.O. Box 990, Frederick, MD 21705-9727, (800) 638-8437, www.aspenpublishers.com

Social Policy

Hacker, Jacob S. *The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States*. $24.99. Cambridge University Press, 100 Brook Hill Dr., West Nyack, NY 10994-2133, (845) 353-7500, fax: (845) 353-4141, www.cambridge.org

Web Documents

2004 Comparative Study of Major Public Employee Retirement Systems
www.legis.state.wi.us/lc/2_PUBLICATIONS/Other%20Publications/Reports%20By%20Subject/Employment%20and%20Occupations/04comparstudy.pdf

2005 US National Employer-Sponsored Health Plans Survey - Overview
http://mercerhr.com/ushealthplansurvey

2006 Segal Health Plan Cost Trend Survey
www.segalco.com/publications/surveysandstudies/2006trendsurvey.pdf

Access to and Participation in Employer-Provided Health Care Plans, Private Industry, 2005
www.bls.gov/opub/cwc/cm20060120ch01.htm

An Analysis of the Dynamics of Health Insurance Coverage and Implications for Employer-Mandated Insurance
www.epionline.org/studies/fairlie_01-2006.pdf

Aon Consulting's 2006 National Employee Benefits Trends Survey: Key Findings
www.aon.com/about/publications/pdf/issues/may_06_article3.pdf

Compensation Costs in State and Local Government
www.bls.gov/opub/ted/2006/jan/wk5/art04.htm

Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis
www.ifebp.org/PDF/webexclusive/06feb.pdf

The Factors Fueling Rising Healthcare Costs 2006
www.ahip.org/redirect/PwCCostOfHC2006.pdf

FAQs regarding Designated Roth Accounts
www.irs.gov/retirement/article/0,,id=152956,00.html

General Explanations of the Administration's Fiscal Year 2007 Revenue Proposals ["The Blue Book"]
www.treas.gov/offices/tax-policy/library/bluebk06.pdf

Other Postemployment Benefits: A Plain-Language Summary of GASB Statements No. 43 and No. 45
www.gasb.org/project_pages/opeb_summary.pdf

Pension Monitor: "The Latest Pension Articles and News from Around the World"
www.pensionmonitor.com/

President Bush's Fiscal Year 2007 Budget: Analysis of Key Health Care Provisions
www.familiesusa.org/assets/pdfs/Budget-Analysis-FY2007.pdf

Private Pension Plan Bulletin: Abstract of 2001 Form 5500 Annual Reports
www.dol.gov/ebsa/PDF/2001pensionplanbulletin.PDF

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