

Pension Reform into Multi-Pillar System

Yongha Kim

Professor of Economics, Finance, & Insurance
Soonchunhyang University

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1. Basic Direction To Improve Income Guarantee System

(1) Long-term Financial Stabilization Measures for Public Pension Schemes

All public pension schemes in Korea, including the National Pension scheme, civil servants pension scheme, private school teachers' pension scheme and the military pension scheme, are facing varying degrees of financial problems at present because of their weak and unstable financial bases, with the result that some of them have recorded deficits for some time and the others are expected to run deficits in the near future. This crisis in financial sustainability in public pension schemes is attributable to the structural weakness of the schemes which can be characterized as "high benefits, low contribution". It is estimated that the ratios of pension benefits to contributions amounted to 3 times for the civil service and private teachers pension schemes, and 2 times for the National Pension Scheme (NPS). This structural imbalance between pension benefits and contribution, coupled with low returns on investments of pension funds, further accelerated the financial deterioration of the public pension schemes.

In order to address the problem of financial sustainability, it is urgently necessary to correct the structural imbalance of "high benefit, low contribution" by gradually increasing level of contribution, taking into account the ageing of population and the expected change in retirement ages.

(2) Correction of Distortions in Income Redistribution Arising From Extension of National Pension Scheme

Since incomes reported by self-employed, farmers and fishermen are very difficult to assess and evaluate, their contributions to the national pension scheme tend to be much lower than actual. Therefore, the income redistribution impact of NPS coverage extension has become a controversial issue, as the admission of these large groups will cause a serious distortion of incomes of different groups.

The number of self-employed workers in urban areas in 2006, who participated newly in NPS after extension of its coverage, stood at 9 million which was larger than the number of total participants of NPS before coverage extension. Consequently, there appears to be a serious distortion in income distribution in favor of self-employed rural participants at the expense of urban institutional participants. It is, therefore, urgently necessary to devise some mechanism to measure and assess the incomes of new participants, especially the urban self-employed so that the distortion in income distribution could be minimized and eliminated eventually.

(3) Expansion of NPS Coverage

Despite the extension of NPS coverage to small and self-employed workers in 1999, there is still a group whose exclusion has been so conspicuously noted: the elderly citizen. The social protection for the elderly has become an important policy agenda which warrants

urgent attention. Furthermore, the fact that a large number of urban self-employed do not contribute to NPS at all is one of the major weaknesses of the present pension system. Another weakness of the system is that those participants retiring during the early phase of the pension scheme will receive a pension which is too low to support old age livelihood. Therefore, there is strong justification to introduce a new universal basic livelihood pension scheme to be established under the principle of “one pension for everybody”, which is expected to provide protection for the elderly, housewives and self-employed women who have been denied the pension benefits so far.

(4) Sounder Financial Provisions for Occupational Pension Schemes

There is a difference among the public occupational pension schemes with regard to replacement ratio, which varied widely from 70 per cent for the retiree with 30-years service in the public occupational pension schemes, in sharp contrast to a mere 45 per cent in the case of NPS. The retirement ages also vary among public pension scheme. It is 43-45 years in the military pension scheme, 54 years in both civil service and private teachers pension schemes and 60 years in NPS, respectively. (Even in occupational pension schemes, new participants who joined the schemes after 1 January 1996 will be retiring at age 60).

Another major shortcoming of the present pension system is the lack of pension portability between occupational pension schemes and NPS, which hampers job mobility. There are some people who are not entitled to a pension even after working for 20 years simply because of job changes and the lack of pension portability. It is also urgently needed to introduce portability among public occupational pension schemes.

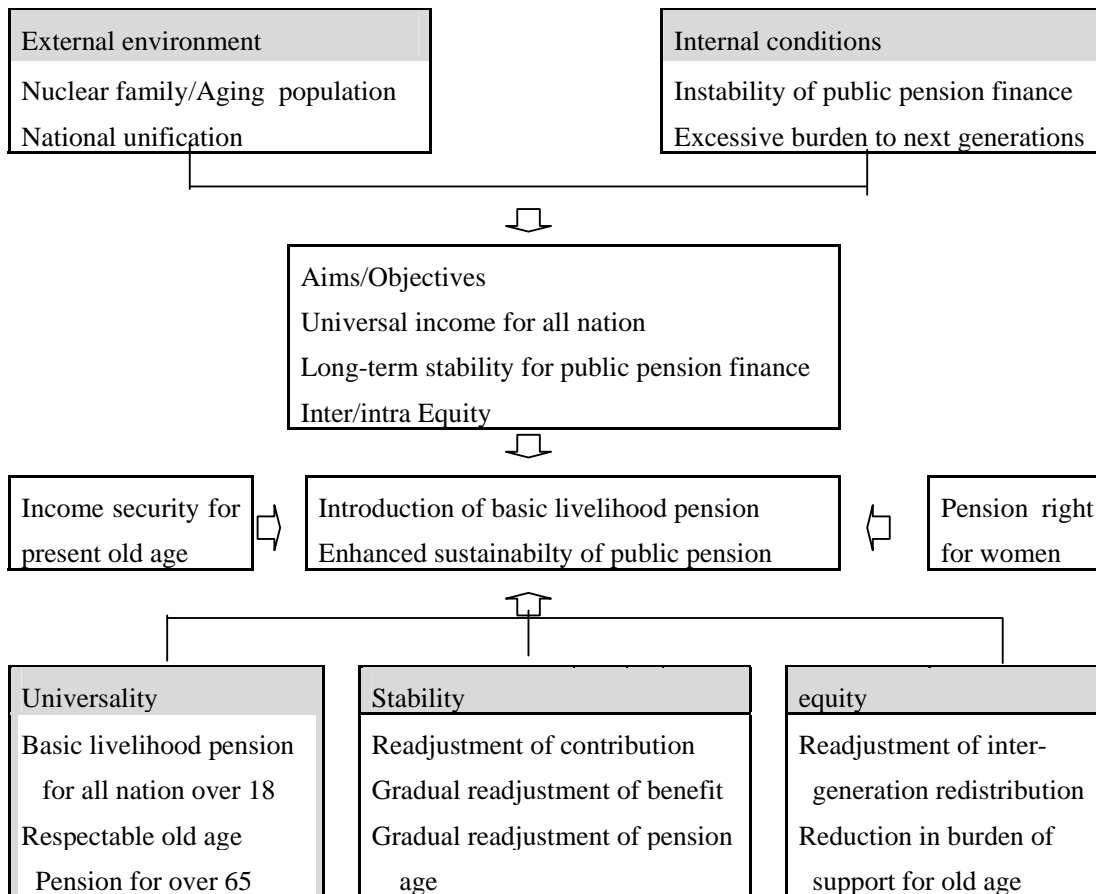
(5) Inter-generational and Intra-generational Equity

It is desirable to enhance inter-generational equity so as to ensure that future generations would not be unduly burdened to provide protection for the elderly. For the basic livelihood pension which is proposed to function to redistribute income among different groups, there is also need to introduce pension schemes which would be defined contribution type and be proportional to income so that an unnecessary burden shift to future generations could be prevented.

(6) Contingency Provisions for National Unification

Since a state-sponsored national pension covers all people in North Korea today, there will arise the pension rights issue of North Koreans in the event of unification of two Koreas. If unification does materialize, there will be a string of pension-related issues to be resolved, such as pensionable period for North Koreans and equity issues between North and South Koreans. In this regard, the reformed pension system should incorporate some contingency provisions under which North Korean pensioners could be accommodated without serious disruptions in the event of unification.

Figure 1: Improvement of Public Pension Scheme



2. Proposal to Establish New Old Age Income Protection System

It is proposed that, while maintaining the overall framework of the present pension system, a new basic livelihood pension (BLP) be established to provide old age protection for the elderly (pension rights for the elderly) and to enhance inter-generational equity. It is further proposed that the BLP cover all people (universal coverage) and that the target replacement rate be set at 20 per cent. While the present participants to NPS would participate in both NPS and BLP, those self-employed people whose income could not be readily assessed objectively or those who refuse to accept income criteria provided by the National pension Corporation (NPC) may participate in the BLP only.

It is also proposed that the current level of pension payments by NPC remain unchanged but some differentiation should be introduced for those households with a single income earner and those with two or more income earners. The current pension system may be supplemented by the reactivation of private corporate pension schemes.

The basic livelihood pension (BLP), designed to provide basic livelihood protection for everybody and to be redistributory in nature, would be operated as a pay as you go scheme in principle, while NPS would be functioning as a provider of pensions proportional to income. The BLP will be financed by taxes.

The present participants to the occupational pension schemes are expected to join BLP. Likewise, these participants will receive pension benefits from both BLP and the occupational pension schemes which will pay only the difference between the participants total entitlement minus payments made by BLP.

BASIC LIVELIHOOD PENSION (BLP)

The basic livelihood pension (BLP) is designed to provide basic livelihood protection to all people under the principle of “ one pension for everybody”.

The pension benefits to be provided under the BLP will include an old age pension, disability pension and non-contributory elderly pension. The level of pension benefits under BLP will be determined by the average income of all at the end of the preceding year and regardless of the income level of individual participants. Anybody who is 65 years or older will be entitled to the non-contributory elderly pension which amounts to 20 % of the average monthly salary of total NPS participants at the end of the preceding year. A disability pension will be paid to the eligible pensioners and the amount of pension will be determined by the basic pension entitlement under BLP. This formula and other details of BLP need to be further studied and adjusted, if necessary. The most important feature of the proposed scheme is that all Koreans, regardless of their income level or length of services, will be entitled to a minimum BLP pension, the average monthly salary of total NPS participants at the end of the previous year.

It is also worthwhile to consider generating resources for BLP by introducing a new social security tax. If such taxation method will be used, we can also seriously consider how this tax will be charged, whether this should be charged as a part of income tax or consumption tax. The advantage of this taxation method will be that it is very easy and economical to administer since no other income assessment is required. Moreover, if the tax is collected on the basis of expenditures rather than income, this will serve social equity objectives by eliminating equity issues between wage earners and self-employed. The most difficult problem of the taxation method will be the resistance from general public on creating a new tax since most pension participants in Korea consider their pension contribution as a kind of savings rather than tax.

Figure 2: New System for Old Age Protection

Individual protection	Personal pension, Personal savings			
	Severance pay	Corporate Pension		Occupational pension
Corporate protection	National Pension Scheme			
Social protection	Basic Livelihood Pension(One pension to everybody)			
Beneficiaries	Employed	Self-employed	Civil servants/ Soldiers/ Private school teachers	Poor without other means of income

(1) Pension Structure

Old Age Pension

Present formula: $0.15 \times (A + B) \times 0.05n + FP$
Proposed Formula: BLP: $0.20 \times A$
NPS: $0.20 \times B \times n/40$

Where A is the average monthly salary of the total BLP participant at the end of the previous year. Alternatively, we can consider a net concept, i.e., average salary minus tax and pension contribution; B is the average income of the whole service period, reevaluated at the end of the previous year; FP: The entitled pension amount; N: The number of service years.

(2) Pension Contribution Rates

Contribution Rates Adjustment NPS

Present Plan: 9%
Proposed Plan: 7%

Contribution Rate Formula for BLP

The cost for BLP will be financed by Tax.

3. Measures to Improve National Pension Scheme

It is proposed that the framework of NPS be transformed into an income-related pension scheme. NPS will be able to concentrate its operations with wage-indexed pensions. Since NPS would collect payroll taxes based on income. With NPS's concentration on income-indexed pension, it will become an almost fully-funded pension scheme.

The target replacement rate of income-indexed NPS will be 20 per cent of the average income for the retiree with 40-year service, a downward adjustment from the current level of 30%. However, their total replacement level remains unchanged at 60 % under the new system, as it will be composed of 20% from earnings-related NPS and 40% from BLP in the case of single income earning couple (20% for husband and 20% for wife). In the case of a working couple, the total replacement rate will be 80% since both will be entitled to 20% from BLP and 20% from NPS. At present, this couple is entitled to a replacement rate of 120%. The contribution rate of a working couple will be lowered to reflect the reduced replacement rate from the current 9% to 7.0 %. This lowering contribution for a working couple could be well justified by the fact that this measure would prevent excessive pension burden for a working couple and encourages a rational consumption and saving pattern.

The problem of false and low reporting of income may be addressed by denying these people from joining NPS. They may participate only in BLP in which pension benefits are at fixed amounts. These people may be allowed to participate in NPS if they accept the income criteria determined by the Ministry of Health and Welfare. It is proposed that the period covered before 2008 be recalculated on the basis of the laws and regulations which prevailed during that period but the recalculation be done with the main focus on the earnings-related pension in order to facilitate transition to the universal pension system. Under this system, all participants before 2008 will be adjusted by taking only 50% (for 40-year service retiree), 40% from salaries between 1999-2007 and 20% from those of 2008, respectively. All current pension recipients will continue to receive the same level of pension but the pension due from equity component will be paid by BLP.

4. Improvement for Civil Service and Other Occupational Pension Schemes

There are now heated debates among experts on the deficits of the civil servants pension scheme, since the pension scheme has shown deficits this year and its reserves might be exhausted soon.

Current debates are centered on the causes of the financial problem and who are responsible for this messy situation. Some people think that the problem of the civil servants pension is due to the structural weakness of the current scheme while others blame the mismanagement of its fund managers. Most of the participants and pension beneficiaries think that the Government and the managers of the civil servants pension are responsible for the mismanagement of the fund, while the Korea Development Institute (KDI) study found that the problem may be basically attributable to the systemic defect which is characterized by the imbalance between pension contributions and benefits.

Since the rights policy prescription cannot be made without proper diagnosis, it is essential to analyze and study the root causes of the problem so that the right policy direction could be prescribed.

Despite all the concerns and symptoms of financial problems looming over the civil servants pension scheme, the Government's attitude has been to pay attention to the public attention and did not take any action to address the problem. This attitude of the Government has aggravated the situation and has been the single major stumbling block for any reform initiative. Although the financial problem has been surfaced and the need to reform has been voiced since the 1980s, the Government failed to take any corrective measure out of fear that any reform effort might be resisted by the participants of the scheme.

This paper would like to analyze the root causes of the financial problems with a view to present a realistic policy direction to address this issue.

The financial problem facing the civil servants pension scheme is much more serious than perceived by the general public. Another problem is that the general public has an optimistic expectation that the crisis of the scheme would be resolved by the Government without difficulty. The scheme has almost exhausted its reserve funds despite the fact that it should have accumulated a huge reserve of Won 200 trillion (2005) and it has no capability to meet its pension liabilities in the future and its financial situation is deteriorating every year.

How could the civil servants pension scheme be reformed?

First, it is absolutely necessary to undertake an in-depth diagnosis of the financial health of the scheme as a matter of urgency. The core of this due diligence exercise will be focused on the level of its reserves to meet its obligations, as is being done in the Private Teachers Pension Scheme. Without correct assessment of the situation, no policy recommendation could be made.

Second, there is urgent need to determine the accounting standards applicable to pension obligations. Among many terms representing the pension obligations such as verified pension obligation(VBO), accumulated obligation(ABO), projected obligation (PBO) and indexed pension obligation (IBO), we think that IBO should be the most appropriate indicator to reflect pension obligation most correctly. In the U.S., the Financial Accounting Standard Board (FASB) was allowed to use both PBO and ABO for the evaluation of pension obligations under the FAS87 since there is no safeguard among corporate pension schemes to maintain the real value of pensions. Since there is such a safeguard in the civil servants pension scheme, it is necessary to use stricter accounting standards by adopting IBO in the case of the civil servants pension scheme.

Third, it is necessary to devise an effective mechanism that provides a link between contribution and benefit, which is missing in the Korean pension system. Some might argue that our system is partially funded but there is no clear definition or principle to support such terms. Ours is neither a pay-as-you-go (PAYGO) scheme nor a funded scheme. Under the current system, the pension contribution rate is being determined independently from that of pension benefits without due regard to the links between them. It is, therefore, necessary to devise a mechanism linking benefits to contributions and to redesign pension parameters using this mechanism effectively.

Fourth, it is essential to design the new pension system by incorporating the accounting standards for assessing pension obligations and the link mechanism between pension contributions and benefits. In this regard, it might be worthwhile to review the viability and rationale to retain several occupational pension schemes, including the civil servants pension scheme. Unless strongly justified by the review, continued maintenance of the current occupational schemes may be difficult to justify if they are to be sustained by budget supports.

Fifth, the accumulated contractual obligations of pension schemes should be gradually amortized by the concerned schemes. In undertaking this task, it should be clearly understood that the amortization of past obligation would be justified on the ground of inter-generation equity and burden sharing. That is the reason why I have proposed two different pension systems – one universal BLP and the other for occupational pension schemes.

(i) Parametric Reforms

First, pension receiving (retirement) age should be gradually increased; pensions should be indexed to CPI (consumer price index) rather than current index to wages; pension payments should be calculated based on average life-time earnings, rather than earnings of the last year; and salary increases should affect only future earnings, not the past earnings, though the rights of participants and pensioners will be fully recognized and protected.

Second, burden sharing structure should be reformed. Since the current civil servants pension has dual functions of pensions and retirement allowance, the Government's contribution should be higher than the civil servants to the extent of retirement allowance. Under the reformed pension system, the contribution rate of the scheme is estimated at 21% (the total contribution rate of the Government and participants), the additional contribution of Government would be quite substantial. Part of these additional resources would be earmarked for amortization of pension obligations of some occupational schemes.

(2) Reforms within the Public Occupational Pension Schemes

Apart from the civil servants pension scheme, all other public pension schemes are suffering from various financial problems: the military pension scheme needs an annual budget support of Won 1 trillion after depleting its reserves in 1975; the private teachers pension scheme is expected to suffer from a deficit from 2026. Therefore, comprehensive and simultaneous reforms are needed for all public pension schemes to maximize its impact. We can consider two different reform methods: the American-style reform and the Japanese-style reform.

In the **American style reform**, the current pension scheme for civil servants will be discontinued with the new participants served by NPS. With the participation in NPS, civil servants will be entitled to the retirement allowance like other workers and they might benefit from income redistribution between general workers and the self-employed. Under this reform method, the complex problem of civil servants pension scheme will become much

simpler and easy to resolve since its problem will be narrowed down to pensioners' entitlement and the pension obligation (past obligation only) of some civil servants. As retirement allowances are being transformed to a form of corporate pension scheme with the amendment of the Retirement Income Law (2005), it is also quite possible that a new pension scheme, which will be a kind of retirement allowance for civil services, might be established.

Under **the Japanese style reform**, there will be two-pillar pension schemes: the basic pension and the earnings-related pension. The basic pension is to promote inter-generation and intra-generation income distributions while the earnings-related pension will be designed to protect old age income for occupational groups. Under this reform, the special interests of some occupational groups such as the military, public employees and teachers would be better protected.

Under **the third alternative plan**, we can think of a reform within the framework of the public pension system. First, all participants of occupational schemes will be mandated to participate in the Basic Livelihood Pension (BLP). Second, the contribution rate will be adjusted upward to 21 %. Third, pension payments after 2008 will be adjusted downward while pension rights prior to 2008 will be guaranteed. Fourth, unfunded pension obligations of pension schemes will be amortized by the Government which will provide additional contribution for this purpose. Likewise, both military and private teachers pension schemes will be reformed.

5. Improvement in Retirement Allowances

(1) Introduction

Heated debates were on regarding the rationalization of the retirement allowance. Labor unions wanted to transform the allowance into a corporate pension scheme to ensure its benefit while employers would like to convert this mandatory retirement allowance to an optional one. Some insurance companies are already marketing some retirement pension products.

The conversion of retirement allowances into a corporate pension is not an easy job. Therefore, we have to come up with a workable proposal which is expected to provide a wide range of options to workers while addressing the problem of income security.

(2) Basic Direction for Improvement of Retirement Allowance

As the Korean economy matures and business culture stabilizes, we have introduced the national pension system, unemployment insurance and other social networks in order to provide stable social conditions. It is now time to review objectively the retirement allowance system to determine whether the current system needs to be maintained and how the system could be improved.

(a) Linking Retirement Allowance with Public Pension Schemes

The retirement allowance could be transformed into a separate system from NPS or some system linked with NPS or an independent system with links to NPS. In case of Japan, the qualified pension system is independent from the public pension system and developed as a contracting out model of a public pension system. We could consider establishing portability between public and private pension schemes, along the U.S. model.

Since the retirement allowance system in Korea has been evolved and developed as an independent legal requirement, I think it is difficult to provide a link with public pension

schemes. I personally believe that some kind of tax privileges could be provided to it like the qualified pension system in Japan.

(b) Converting Mandatory Retirement Allowance to an Optional Scheme

The proposal to convert the mandatory retirement allowance to an optional scheme, which was sponsored by employer groups, might face strong opposition from labor unions. The more important issue would be how we can build a social consensus to enhance welfare of workers while reducing the labor burden on businesses at the same time by adjusting taxation and the social security burden.

(c) Enforced Transformation of Retirement Allowance into a Corporate Pension

Some argue that the current payment system of lump sum payments of retirement allowance be changed to an annuity payable over future year to protect old age livelihood. However, forced enforcement of this system is not desirable because it will result in an excessive burden of 8.3 % contribution to small and medium businesses, and also because this will seriously restrict the degree of freedom of workers and employers with respect to corporate pension. The most desired option is to maintain the overall framework of the current system but mandate employers to deposit the retirement allowances outside deposit banks by providing tax concessions, while the past practice of internal holdings within the company will be strongly discouraged by denying taxation privileges.

(3) Transformation of Retirement Allowance to Corporate Pension

The Government decided to convert the retirement allowance into an annuitized corporate pension scheme conditionally in 2005. But there are many issues to be addressed such as the role of corporate pensions, business groups to be applied, the issue of the self-employed in corporate pensions, pension rights and its transfer, appropriate levels of pension benefits and the indexation issue to protect pensions from inflation.

(a) Pension Rights and Its Transfer

The major weakness of corporate pensions is the issue of pension portability that guarantees free movement of pensioners from one to another without any cost to their pension rights. Since the transfer of pensions among different pension schemes is not possible without institutional arrangements to keep complete records and accounts on pension which is lacking at present.

(b) Financing Method and Burden Sharing

As pension financing methods classified into two broad categories of the pay-as-you-go (PAYGO) system and the funding system, I think that the PAYGO system would be better for corporate pension schemes in principle. Even under the PAYGO system, we can think of an array of different systems. Some may even assume the past pension obligations, allowing some degree of retroactivity. The funding system can be further classified into the fixed pension method which may be preferred by workers and the defined contribution method that suits better to employers and pension managers. I believe that the defined contribution system would be better from the points of longer-term financial sustainability and pension rights guarantee in the event of job changes.

(c) Guarantee of Pension Rights

One of the major problems in corporate pension systems would be the security of pension rights for the participants, since any pension system that takes a long time to mature

needs a strong financial base which is usually lacking for the fledgling private pension schemes.

In this respect, it is essential that some water-tight supervision mechanism and institutional safeguards to protect the pension rights of workers against the failures of the pension schemes or the employers should be in place before the operation of corporation pension schemes. It may be worthwhile to consider the feasibility of setting up the Corporate Pension Management Co.(tentative name) which will be mandated to supervise corporate pension funds and to protect pension rights, as is being done in the U.S.

(d) Level of Replacement Rate

A rational replacement is determined at the level which is sufficient to maintain the living standards of workers during their working years throughout the pension period. I believe that the replacement rate should be determined at a level which is much lower than the Western European countries.

(e) Tax Concessions and Support

It is a historical fact that pension systems in most countries evolved, matured and developed over many years with the strong support of the Government and tax concessions have been at the core of the Government support. There are three broad concessions for pension schemes: tax concessions on pension contributions made by employers and workers; tax concessions on pensions received by retirees; and tax privileges on investment incomes of pension funds. In Korea, both pension schemes and trust funds are enjoying tax concessions which cover employer’s contribution, worker’s contribution and pension income of retirees, which are considered to be more generous than other industrial countries.

(f) Considerations Needed for Self-Employed

While full time workers are given the benefit of pensions as well as the retirement allowance, the self-employed are not so well protected. Even though there are some individual pension schemes targeted for self-employed, its coverage and impact are not significant yet. For this reason, there is strong need to devise a pension scheme designed to provide pension benefits to the self-employed.

Table 1: Comparison of the Current and Proposed Systems

	Current system	Proposed reforms
Structure	Single pillar	NPS + BLP
Participants	Regular workers + self-Employed (19.5 million)	NPS: 12.5 million participants BLP: All Peoples
Beneficiary	Over 60 years olds(50%)	BLP: 100% of over 65 yrs. NPS: 50 % of over 60 yrs.
Contribution	3% → 6% →9% (adjusted every 5 years)	BLP: Tax NPS: 7%
Replacement	60% of average wage	NPS: 20% average income BLP: 20% lifetime income
Pension Age	Gradually raised to 65 yrs	Gradually raised to 65 yrs
Financing Fund Reserve	Revised funded system	BLP: pay-as-you-go NPS: funded system No fund depletion