Longevity Challenges in Korea:

Lessons for the Asian Countries

Wonshik Kim

Konkuk University

2017. 9. 22

The 13th International Longevity Risk and Capital Market Solutions Conference
Taipei, Taiwan

건국대학교
KONKUK UNIVERSITY

Contents

I. Introduction

Pension in Aging Society

- Bismark's Paradox
  - German Life expectanacy: 45 (1889)
  - German Pension age: 65 (1889)
  - How many people received pension in 1889?
    - Then, what should be the pension age if live expectancy is 80?
- Public Pension's Paradox
  - Does the poor get more benefits from public pension than the rich?
    - The rich lives longer with more pension benefit than the poor.
    - The effective contribution rate of the rich is lower than that of the poor because of tax preferences such as income tax deduction and income tax credit.
- How is the pension benefit used?
  - Healthcare or long-term care cost

건국대학교 KONKUK UNIVERSITY

Pension in Korea

- The poverty rate of the aged: 49.6% (2015)
  - The asset value of the aged is higher compared with the aged in OECD countries (12.4%).
  - Traditional family care disappeared with a rapid urbanization.
  - Most aged spend their savings for retirement on private education of their children and health care, and payback of large loans.
- Suicide rate of the aged in Korea is the highest among OECD countries.
- Korea established multi-pillar pension system faster than any other countries; national pension, individual pension, corporate pension, and basic pension.
  - Long-term care is another program for the aged to consider with pension.

II. Facts

Life Cycle of Korea

- Economic Bio of average Koreans
  - Start working: at the age of 30
  - Retire from the regular work place at the age of 50
  - Start receiving public pension at the age of 65 (pension age)
  - Retire from work completely at the age of 70
  - Start to get sick at the age of 70 (health expectancy)
  - Die at the age of 81 (life expectancy)

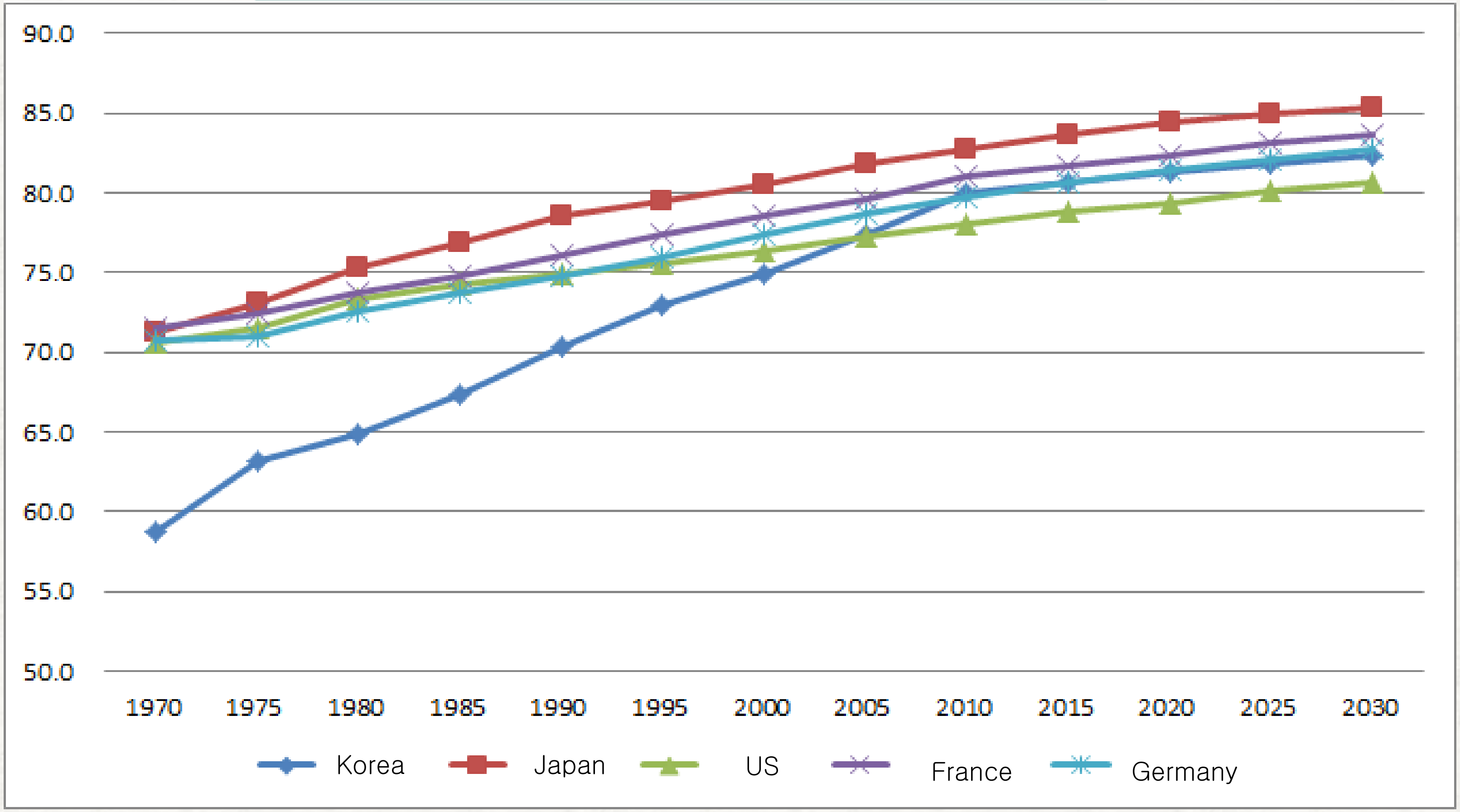
- Earn for about 20 years as a regular worker, spend savings for about 30 years.
  - Overall, they end life in a deficit.
  - Who will fill up the deficit?

Aging in Korea and the Demand for Safety Net

- Accelerated Population Aging in Korea
  - Very low fertility rate: from 1.654 (1993) to 1.172 (2016),
  - Rapidly increasing life expectancy:
    - from 62.3 (men: 58.7; women: 65.8) in 1970
    - to 82.1 (men: 79; women: 85.2) in 2015
- Strong Demand for Safety net: Major institutional changes in social insurances since the 1960s
  - Workers' compensation since 1963
  - Health insurance since 1980
  - National pension since 1988
  - Employment Insurance since 1994
  - Now, the above four social insurances cover all population
  - Long-term care Insurance since 2007

Life Expectancy

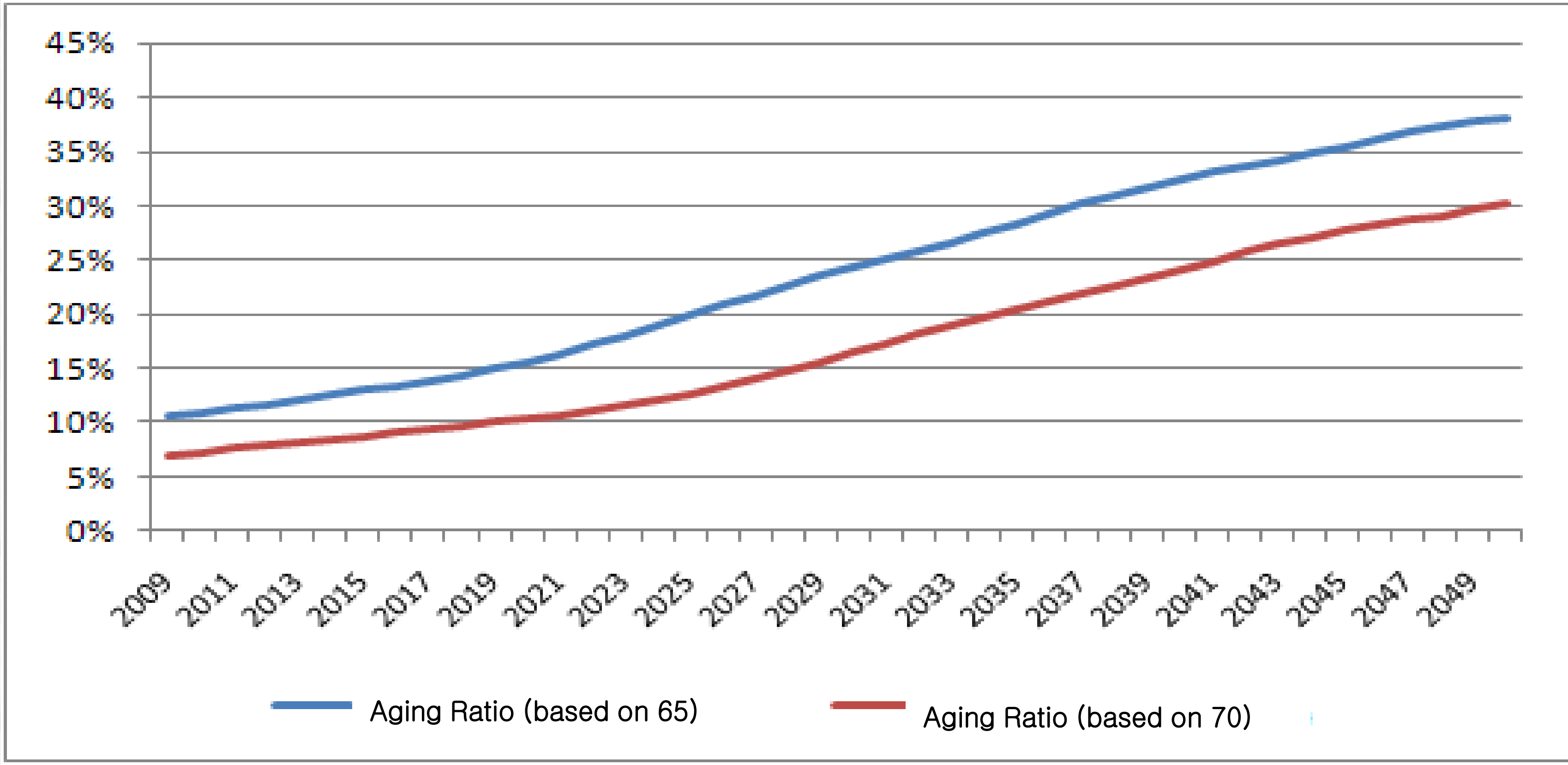
<Fig> National Trends of Life expectancy



- The life expectancy in Korea increased 5 months per year.
- Most frequently age at death increased to 90.

Share of Elderly Population

<Fig> National Trends of Life expectancy



- When the official age of the old increased from 65 to 70, the aging society would delayed from 2018 to 2027.
  - The labor market participation of the aged should be extended as much.

National Pension: Coverage and Contribution

- Coverage
  - Step-by-Step expansion of National Pension coverage
  - Implementation of National Pension to workplaces with more than 10 full-time employees in 1988
  - Expansion of the coverage to urban self-employed in 1999
    - Workplace-based insured: full time workers in a firm with more than one full-time employee and employer
    - Individual (e.g. self-employed) insured
    - Voluntarily insured
    - Voluntarily and continuously insured
- Contribution is equally shared between employers and employees: 4.5% each
  - No income record for Small workplaces
    - Very poor accounting system, except in some professional officers
    - Avoid to pay contribution by the agreement between employee and employer

National Pension: benefit

- Benefit
  - Pension Benefit= 1.2* (A+B) * (1+0.05N)
    - A: Average monthly income of all workers
    - B: Average monthly income of the insured worker
    - N: Number of the insured years in excess of 20 years

  - Where, A is the redistributive components and B is a proportional component to individual worker's income
  - Normal replacement rate is 40% of 40-year contribution, average real replacement rate of beneficiaries is 25%.

National Pension: Financial Instability

- Lower participation leads to insufficient benefits for retirement and more government assistances to fill up the pension gap (= minimum living cost of aged – pension received)
- The financial instability of National Pension
  - Benefit-Contribution ratio is more than 1.4.
    - The ratio expected to increase with life expectancy
  - The break-even of cash follow is expected in 2036
    - 600B Dollars is accumulated as a pension fund.
    - 2,500B Dollars as a present value is expected in 2030s.
  - The depletion of pension fund is expected in 2060s.
    - Low contribution & high benefit structure
    - ROR on pension fund was 12-3% in 1990s.
      - 4.7% (2016), 5.4%(average of 2007-2016)
    - Average life expectancy of Korean was about 67 years in the late 1980s.
    - i.e. Financial market risk and longevity risk would further increase the deficit in the future.

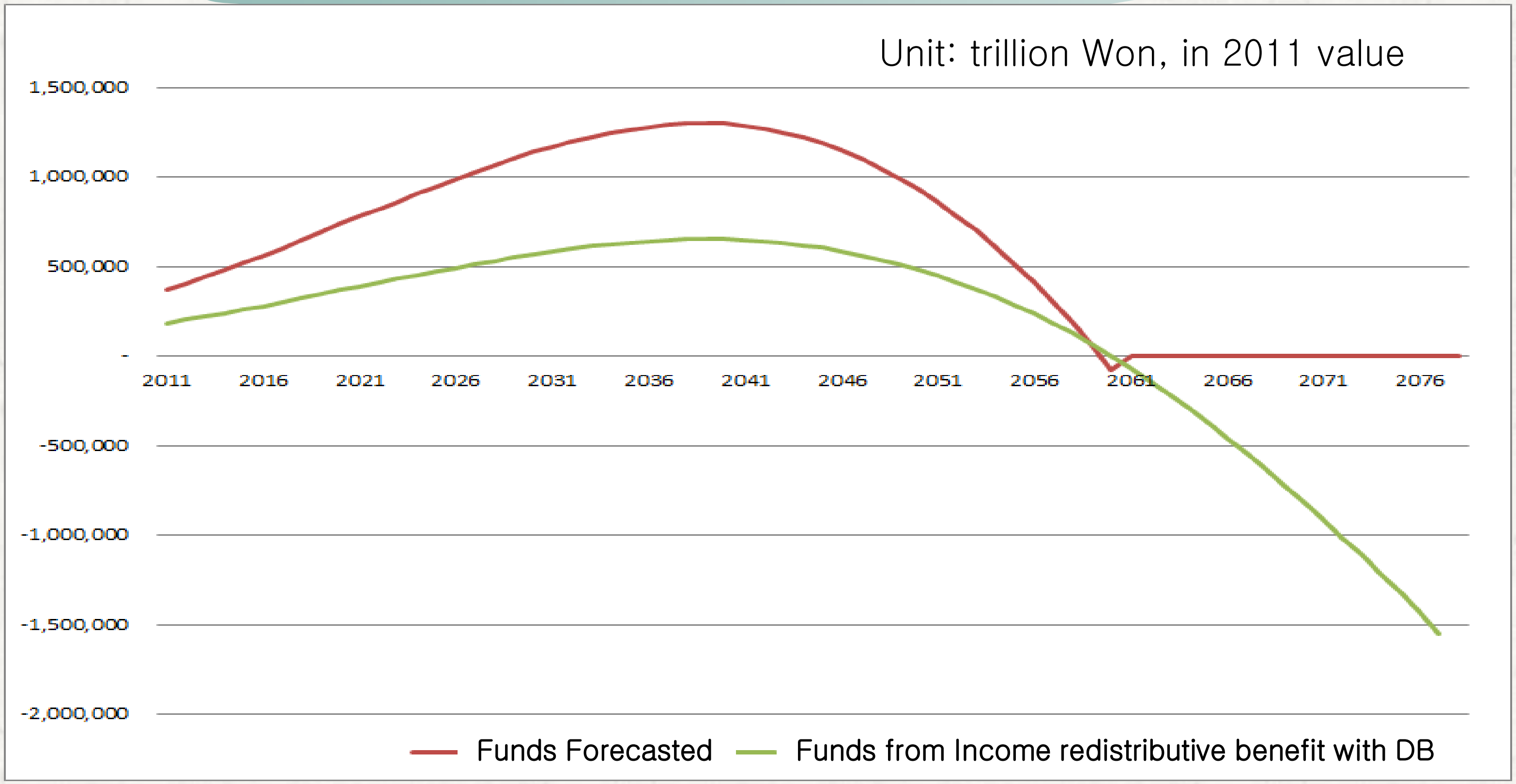
건국대학교
KONKUK UNIVERSITY

National Pension: Coverage of Individuals

- High compliance of workplace based insured and Low compliance of individual insured
  - Large share of informal sector in Korean labor market
    - 32.8% of employees are irregular workers (2016)
    - 27.4% of labor force are self-employed (2013)
  - Actually, large number of the poor are not covered or temporarily uninsured.

National Pension Fund

<Fig> Trend of National Pension Fund



- When the benefit separated as D/B based income redistributive benefit and D/C based income related benefit, government burden on the pension deficit would be halved.

Legal Corporate Pension

- Mandatory Severance Pay System (1963, by Labor Standard Law) changed to Legal Corporate Pension(named as Retirement Pension in Korea) in 2006.
  - Need for the re-establishment of the role of severance pay for the aging society as bridge pension for the period between retirement and pension age
  - For the safety of right of Severance pay as a workers' wealth, the fund is accumulated outside the firm.
    - Actually, another public pension that is managed by private financial institutions.
  - The coverage is expanded to most employees who have worked for more than a year.
  - Corporate pension can be rolled over at the individual account when the individual changes his workplace.

Legal Corporate Pension: Benefit

- Product type of Corporate pension provided by financial institutions
  - Defined Benefit Plan (DB)
  - Defined Contribution Plan (DC)
  - Mix of DB and DC

- Benefit
  - The value of pension benefit should be the same as that of severance pay
    - For DC, the contribution should be more than 30 days' wages
    - For DB, the benefit depends on the formula of severance pay: (the amount of final annual wage) x (number of service year)
  - Low rate of return is a problem.
  - 95% of benefit drawn as Lump-sum.

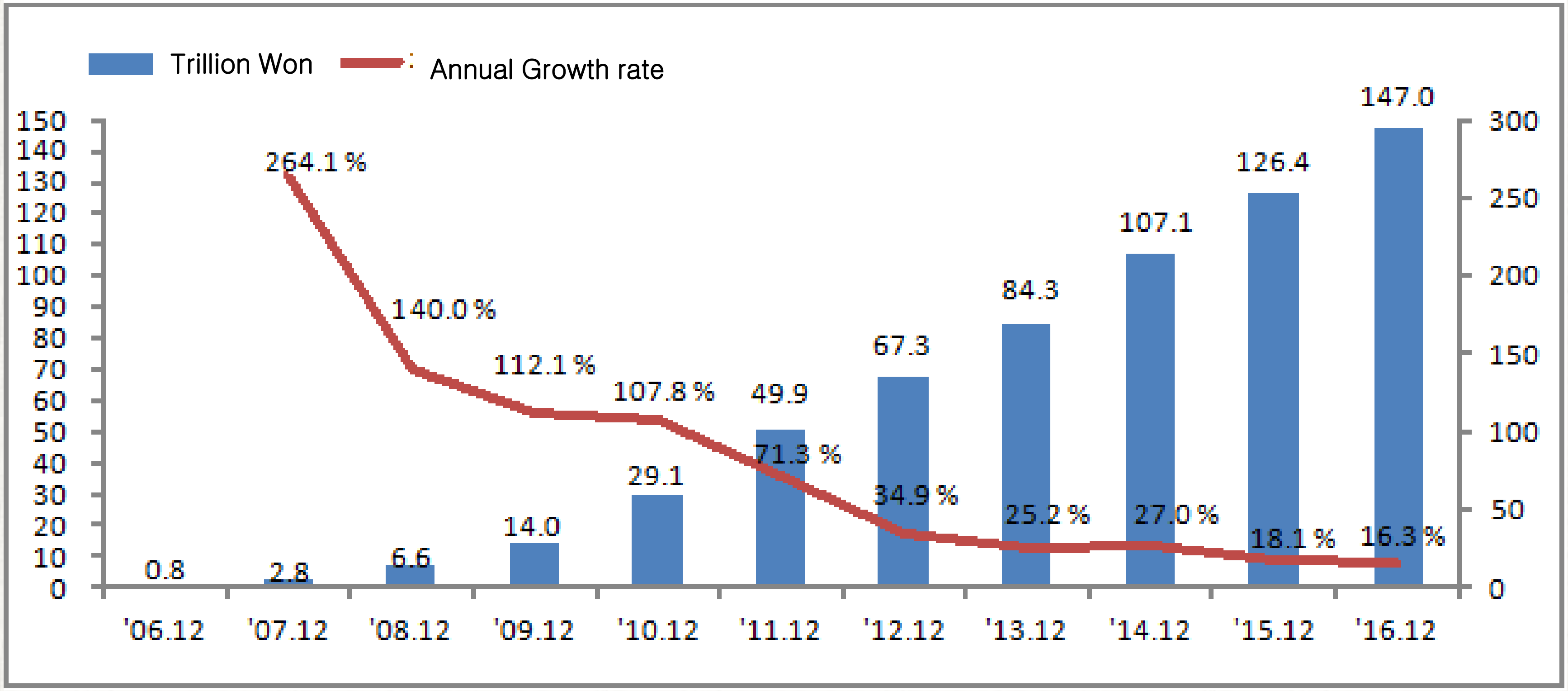
Legal Corporate Pension: Tax Benefits

- Tax system
  - Tax-free on investment return and when drawn after 55.
  - For Severance Pay

$$\frac{\text{Sevarance Pay - Dedcution}}{\text{Year of Service}} \text{ x tax rate of } \left[\frac{\text{Severance Pay - Deduction}}{\text{Year of Service}}\right] \text{ x Year of Service}$$

Legal Corporate Pension Fund

<Fig> Trends of Corporate Pension Fund



- DB:DC = 67.8:23.3
- Principal protected: Dividend = 89.0 : 6.8
- Annual rate of return: 1.58% (2016)
  - Principal protected: Dividend = 1.72% : - 0.23%

KONKUK UNIVERSITY

Individual Pension

- Introduced in 1994
- Qualification for the benefit
  - Deposit more than 5 years
  - Withdrawn after 55
  - Limit 7 million Won (7,000 USD/year) for tax advantage
    - Tax credit: 15% of the deposit
    - Apply special tax for pension
  - Penalty for early withdrawal

- 80% is invested at principal-protected funds with low return.
- Poor workers without income tax liability do not have the incentive to enroll individual pension.

건국대학교 KONKUK UNIVERSITY

Basic Pension

- Introduced in 2007
- Government pays 200,000 Won (200 USD) per month for the 70% of the aged over 65 by means test.
  - The amount will be increased to 300 USD in 2020.
- The government's burden would be too heavy in the future.

Multi-pillar Pension System

- Annuity tax
  - Separate annuity tax rate: 3-5% (varies with the age of payer after 2001)
    - Less than age of 70: 5%, Age of 70 to 80: 4%, Higher than age of 80: 3%
  - Deduction on annuity is applied from 350mil, … to 10% of above 1,400mil Won.
- Korea established a multi-pillar pension system already.
  - Sustainability is not guaranteed.
  - The system is not stable since the authority of the system is diversified.
    - National Pension and Basic Pension is under Department of Health and Social Affaires.
    - Corporate Pension is under Department of Labor.
    - Personal Pension is under Committee of Finance.

Multi-pillar Pension System

- As longevity increases, the deficit of the public pension which guarantees life time benefits would increase as well.
  - The deficit would be the burden of the next generations.
    - A start of Ponzi game

- The existing multi-pillar system is not enough to maintain a stable life after retirement.
  - The increase in retirement period can not be financed with the asset accumulated during working period.
  - During the retirement period, the aged should continue to work as long as they can.

III. Reform of Pension System

How to Reform: National and Corporate Pension

- Options for the stabilization of National Pension
  - Increase in contribution rate from 9% to 14-5%
  - The benefit should be divided into two and managed in different ways.
    - Income-redistributive benefit: DB and government guarantees
    - Income-dependent benefit: DC and benefit is decided according to the returns on the fund.
  - Pension age should be increased to 70 at least.

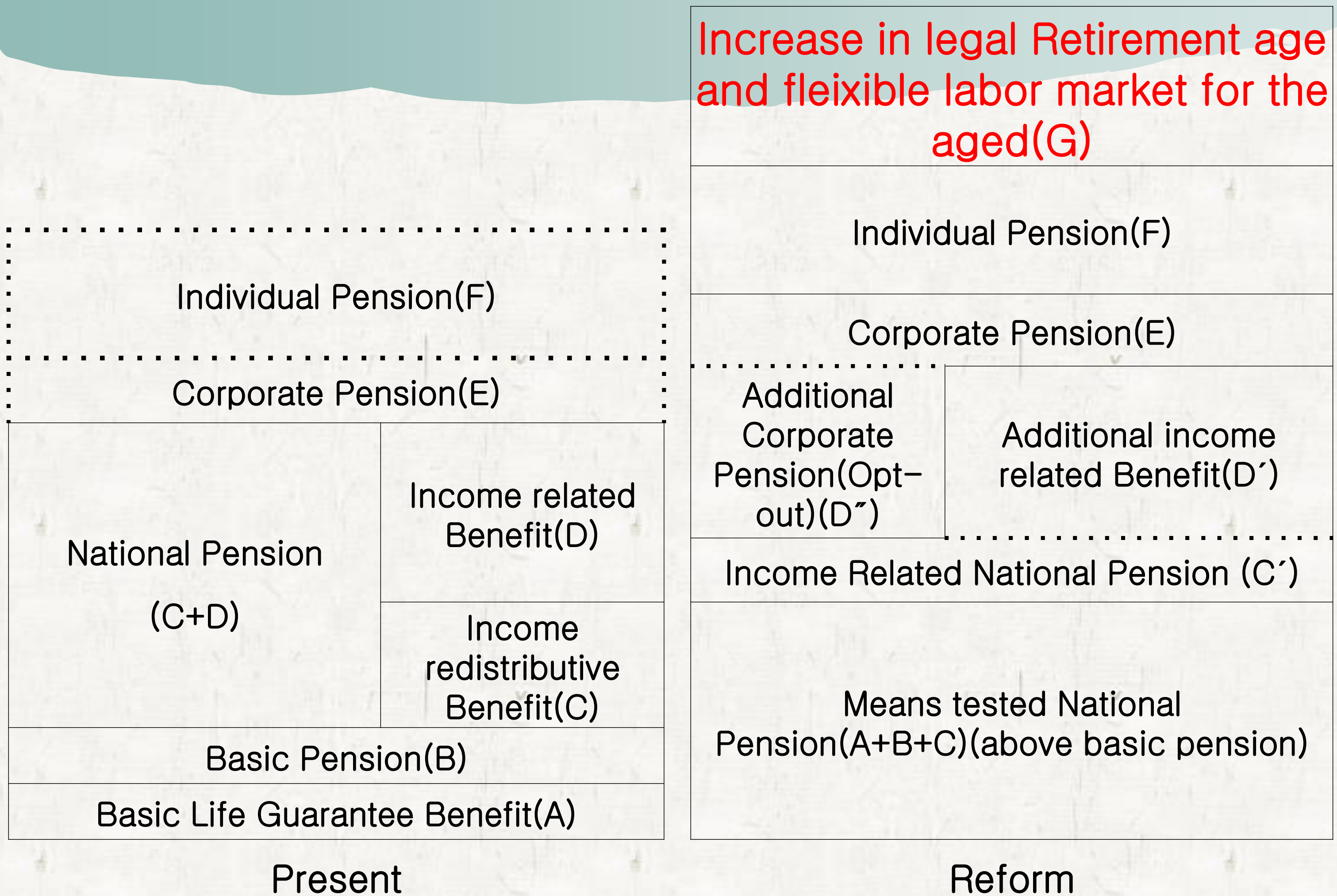
- Coordination between National pension and Corporate Pension
  - Contract-in/ Contract-out: The fund accumulated with national pension should compete with private pension fund.

How to Reform: Individual Pension

- Subsidy on individual pension
  - Negative income tax or German Reister Pension should be adopted.
  - The present tax preference on pension can not be applied to the poor workers.
  - It would save government expenditures on poor elderly population in the future a lot.

건국대학교 KONKUK UNIVERSITY

<Fig> Reform in a Nutshell



- The Multi-pillar Pension system under the Aging Society includes Basic Pension, Corporate Pension, Individual Pension, and extension of work.

IV. Implications for Asian Countries

Implications for Asian Countires

- Public pension should be basic and less income related one.
  - The benefit of public pension is changed by the Law and politics.
  - When faced with economic crisis or longevity risk, the benefit is not guaranteed, in general.
- Private pension should be income related, and supported by strong tax preferences.
  - It would reduce government expenditure on the aged by 8-fold, compared to tax expenditure on private pension.
  - The incentive for private pension should include the poor workers.
  - German Reister pension should by applied.

Implications for Asian Countries

Tax Policy for the Private Pension in Korea

Wonshik Kim* · Woocheol Kim** ·
Sangbong Kim*** · Jaehyun Kim****

Recently, the advanced countries facing population aging are supporting private pension, under the assumption that the pay-as-you-go public pension will no longer be sustainable. In 2014, Korean government changed its tax program for individual pension from exemption to tax credit, decreasing the favorable tax terms for high earners and increasing them for low earners. The purpose of this change was to cut the total amount of tax expenditures, as well as lower inequality across workers. Our study shows that the tax expenditures made for the expansion of private pension saved government expenditure between 1.36 and 8.05 times of the tax expenditure in the long run, because the increased pension wealth reduces the number retirees in poverty. Therefore, the government should allow taxpayers to choose between exemption and tax credit for individual pension contribution. Also, various pension policies that subsidizes private pension directly for low-income families such as Riester pension of Germany and Lifetime ISA of U.K are recommended. The effect of tax expenditure for private pension on government expenditure is emerges in the long run. Therefore, the support for the private pension should be expanded as early as possible.

Korean Journal of Public Finance, Vol.9-4, pp.33-58

건국대학교 KONKUK UNIVERSITY

Implications for Asian Countries

- High-end qualitative financial system should be established for private pension.
  - Private Pension should maximize its return through the efficiency of financial market.
  - Because of the inefficient financial system, ROR on private pension fund is very low in Korea.
    - The development of investment bank is important.
- The Policy of Pension system should be linked with labor policy for the aged.
  - Active aging should be encouraged.

Implications for Asian Countries

International Comparison on Characteristics of Pension Taxation: Korea, U.S, and U.K

Wonshik Kim

The purpose of this paper is to compare the size of tax incentives for corporate pension among Korea, the United States, and the United Kingdom. The simulation based on the actual tax system of each country for its median income household shows that the net return on pension is smaller in Korea than that of the United States and the United Kingdom, when their fund is invested in the stock market. Korea provides tax incentives on corporate pension when collecting premium, but not when accumulating funds, as it is not considered to be capital gains on stocks. On the other hand, most other countries, including the United States and United Kingdom, give tax incentives on capital gains on stock, invested through corporate pension fund. This paper shows that under the current system, there is no tax benefits from investing in stocks, compared to investing in fixed income products. This may lead the workers to under-investment in corporate pension, than those in other countries. The rapid population aging increases the need for programs that guarantee retirement income. Therefore, the establishment of corporate pension, as well as the national pension, system is urgent. Capital gains and pension-related income tax reform can help retired workers to receive enough pension. In additional, I simulate the effective tax benefits across different income groups. The income group with the highest marginal tax rate receives six time higher tax benefit compared to that with the lowest marginal tax rate.

Korean Journal of Risk Management, Vol.26-3, pp.101-142.

V. Conclusion

Conclusions

- Pension Policy should be a part of labor market policy.
  - eg. Department of Labor and Pension in U.K

- The financial stability of public pension should be controlled though economic growth.

- the earlier the pension reform starts, the better.
  - Under aging society, the liability of the public pension continually increases.
  - Pension asset is not formulated in a minute.

- The earlier we start financial education for the young, the better.

Conclusions

- The Pension system in the Asian Countries is recommended to follow American style, rather than European style that guarantees' higher public pension.

- Public pension is not perfect!!!
  - Think about Chile, Italia, Greece, etc.
  - Public pension is not the best, but should be last resort, and final garreteer/insurance for the elderly.

- The degree of expansion of the private pension depends on the differences in the real net rate of return on pension products and general investment, that is, the comparative tax preferences.

Thank you!