Rapid Ageing and Old-Age Income Security in Korea

Sukmyung Yun*

Abstract

The Korean old-age income support system is at a crossroads. The population is ageing rapidly and the public pension schemes are facing bankruptcy. Proposals to downsize the National Pension Scheme have been held up in the National Assembly by political parties who have argued for multi pillar arrangements as advocated by the OECD and the World Bank. However, with the recent passing of legislation to allow the conversion of retirement allowances to private pensions, many commentators believe that a better approach would be to covert the current National Pension Scheme from a 'low contribution-high benefit' scheme to an 'adequate contribution-adequate benefit scheme. For the future of the nation, reform of the pension system is urgent and inevitable.

1. Introduction

Over the next few decades, Korea is expected to undergo a rapid demographic transition that will make its elderly dependency ratio one of the highest in the world. In the meantime, following rapid economic growth and demographic change, reliance on inter-family transfers for support

* Director, Office of Research Coordination, National Pension Research Centre, National Pension Corporation.

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during old age has given way to formal pension arrangements, mostly mandated by the government.

Publicly mandated old age income security in Korea consists of public pension schemes and retirement allowance programs. The public pension schemes are divided into two groups: one is the Special Occupational Pension Schemes (SOPS) for civil servants, military personnel and private school teachers and employees, and the other is the National Pension System (NPS) for the rest of the population. Legislation has recently been passed that will see the partial conversion of retirement allowances into funded private pensions.

The rapid demographic transition will lead to higher costs associated with the maintenance of current public pension systems. Both the SOPS and NPS have been facing serious problems of financial sustainability arising from a structural imbalance between low contributions and overly generous benefits. The SOPS is already running deficits and depletion of the fund reserves is looming. Although the NPS is still in the start-up phase, it is faced with an overriding challenge of accumulating a huge stock of funds before the reserve begins to shrink from mid-2030. As the NPS has the characteristics of a partially funded system, it is particularly vulnerable during economic downturns and to rapidly ageing populations. Meanwhile, mandatory employer-based, retirement benefits (retirement allowance programs) are effectively unfunded and unregulated.

The design of a pension system which will be sustainable in the long term is an urgent problem for Korea. While existing formal pension schemes are financially unstable and impose a large burden on future taxpayers, the new pension system must be fiscally sustainable and fair to future generations.

The aim of this paper is to examine the recent reform initiatives of public and private pension schemes in Korea. To attain this goal, the paper is structured as follows. The changing social environment and demographic issues facing the public pension schemes are presented in section 2. In section 3 the features of the current Korean pension arrangements are described and the associated economic and financial issues are highlighted. Section 4 summarizes recent reforms and outstanding issues, while the current reform initiatives for both public pensions and retirement allowances are presented in section 5. Section 6 concludes.

2. Overview of the Social Environment in Korea: Changes in Population and Family Structure

Since the 1960s, Korea has experienced rapid social change, characterized by the emergence of the nuclear family and the dissolution of the traditional extended family system. These changes have resulted from high economic growth, and the extension of life expectancy due higher incomes. At the same time, the total fertility rate has been declining drastically, due largely to the increasing participation of women in the ever-growing labor market. An implication of the increased labor market participation by women is a reduction in the number of traditional carers who used to look after the old, while the number of elderly has increased significantly. These factors have resulted in substantial changes in family structure.

Changes in Population Structure

The population growth rate has been declining since the 1960s thanks to the successful implementation of family planning, an increased income level, improved education and better health. Since the 1980s, the total fertility rate has fallen so low that even sustaining the population at the current level has been threatened. The total fertility rate has fallen from 6 live births in 1960s to 2 in 1980s, and 1.48 births in 1998. The drop in 1998 was attributed to the economic downturn in the wake of the Asian financial crisis and its negative impact on family planning. In 2002, the fertility rate reached a record-low level of 1.17 (see Table 1) and Korea's total fertility rate is currently lower than that of most advanced countries. The fertility drop in Korea has been accompanied by rising marriage and childbearing ages. A very important change coincidental with the fertility drop is the rapid increase in the educational level of Korean women. Accordingly, this change in childbirth timing alone can explain a significant part of the drop in the total fertility rate. These facts suggest that policy initiatives directed at increasing fertility would not be very significant in the medium term.

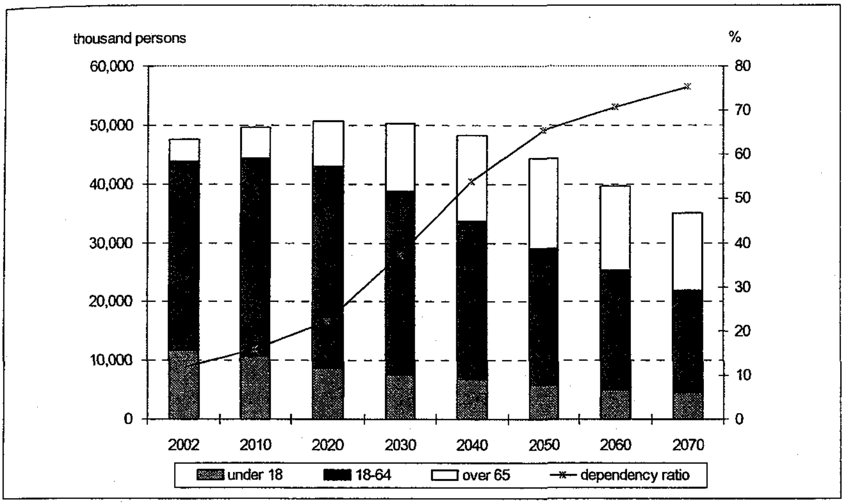
Table 1. Trends in the Total Fertility Rate (TFR)

Year	1960	1970	1975	1980	1985	1990	1995	2000	2002	2003
TFR	6.00	4.51	3.42	2.73	1.70	1.58	1.64	1.47	1.17	1.19

Source: National Statistical Office (2004).

The number of elderly aged over 65 has increased rapidly from 0.72 million in 1960 to 3.7 million in 2002, as shown in Figure 1 (see page 243). The National Statistical Office (NSO) population projections show that the number of elderly aged over 65 could be more than 11 million by

Figure 1. Long-term Projection of the Population and Dependency Ratio



Source: Using data from National Statistical Office (2003) and National Pension Research Centre (2003).

2030. The dependency ratio, which is the ratio of the number of elderly over 65 to the number of economically active persons (aged 18 to 64), which stood at 11.7% in 2002, is projected to increase to 37.3% in 2030 and further to 75.2% in 2070.

The United Nations defines an 'ageing society' as one in which the proportion of elderly over 65 exceeds 7%, and the 'aged society' as a society in which the proportion of elderly population exceeds 14%. Applying these definitions, Korea became an ageing society in 2000 when the share of elderly reached 7.13% and is projected to become an aged society in the 2019 when this ratio exceeds 14%.

The ageing process of a population is a common phenomenon and was experienced by all industrial countries during the period of rapid economic development after the Industrial Revolution (see Table 2, page 244). The problem being experienced in Korea with the ageing population is that, unlike the industrial countries, where the ageing of the population has been occurring gradually, the pace experienced by Korea has been extraordinarily fast. It took 115 years for France to become an aged society (old age share of 14%) from an ageing society (with a share of elderly of 7%), while the same process took 85 years for Sweden, and 47 years for the United Kingdom. In the case of Korea, this transformation process is expected to take only 19 years, if the current pace of ageing continues.[1]

Table 2. Transition from an Ageing to an Aged Society: Experiences of Advanced Countries and Korea

	Japan	U.S	U.K	France	Germany	Sweden	Korea
Aging Society	1970	1942	1929	1864	1932	1887	2000
Aged Society	1994	2013	1976	1979	1972	1972	2019
Years Taken	24	71	47	115	40	85	19

Source: OECD Economic Surveys: Korea (2001). For Korea, modified using the most recent estimates of National Statistical Office

Changes in Traditional Family Structure and Function

Following the substantial economic development and industrialization in Korea since the 1960s, there has been a large population inflow to urban centres from rural areas. As a result, the traditional extended family structure in rural areas crumbled in the midst of a large outflow of younger people to cities where they formed small or nuclear families.

The share of extended families (covering 3 generations in a household) has rapidly declined from 23.2% in 1970 to 11.1% in 1995 while the share of core (nuclear) families increased significantly from 6.8% in 1970 to 13% in 1995. The number of family members also declined from an average of 5.2 persons in 1970 to 3.3 in the mid-1990s.

Traditionally, Korea had an informal social protection system for the elderly who were supported by the members of their extended families. The eldest son was usually responsible for looking after the parents, and the family property was usually inherited through this line so that a kind of old age protection system operated. As the economy grew, young people left for the cities and women started to work, and the extended family system started to disintegrate, resulting in an end to this informal social protection system.

Since the Korean economy has been maturing and is now linked to the world economy, it has also been subject to worldwide economic fluctuations. This was particularly evident when it experienced a serious economic downturn caused by the recent Asian financial crisis. These events also disrupted the traditional lifetime employment system and mass unemployment has become a serious social issue.

Under these social and economic changes, the family-centered social protection system could no longer function.

Table 3. The Korean Pension System, 2004

Type	Private Sector Employees (52% labor force)	Self-Employed (41% labor force)	Government Employees (plus the military and private school teachers) (7% labor force)
Safety Net	Basic Livelihood Security (non-contributory old age pension) Funded from general revenue		
Mandatory Public	**National Pension Scheme (NPS)** Since 1988 Partially funded DB Contribution rate 9% (4.5% employee + 4.5% employer (9% from 2005) Benefits from age 60 Target replacement rate 60% after 40 years		**Special Occupational Pension Schemes (SOPS)** Since 1960 Partially funded DB Contribution rate 17% (8.5% employee, 8.55 government/ employer) Benefits from age 55 (increasing to 60) Target replacement rate 76% after 33 years
Mandatory Private	**Retirement Allowance* (RA)** Since 1961 Firms with >4 workers Min 1 month salary pa	n/a	n/a
Voluntary	**Personal Pensions** Since 1994, poorly developed market		

Source: Developed from Phang (2002). Note: * The Pension Reform Bill was passed in December 2004. This will see the partial conversion of retirement allowances to funded private pensions and an increase in coverage

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3. The Current State of Old-Age Income Security in Korea and Associated Problems

Old age income security in Korea comprises public pensions, retirement allowances and personal pensions. The current arrangements are summarized in Table 3 (page 245) and the coverage and design of each is detailed below.

Public Pensions

The first public pension scheme in Korea was the Civil Service Pension Scheme, launched in 1960. This was followed by the Military Pension Scheme in 1963, the Private School Teachers Pension Scheme founded in 1975 (collectively known as Special Occupational Pensions), and the National Pension System (NPS) introduced in 1988. The NPS, which initially covered all private sector workplaces employing more than 10 workers, extended its coverage gradually over the years and, by April 1999, became close to a universal pension system when coverage was extended to the urban self-employed.

The development of old age protection within the short time span of 40 years, was a remarkable achievement in Korea's social development. Despite this impressive development, however, the public pension system in Korea is facing serious problems of financial sustainability largely due to the inherent structural weakness of the system in which pension payment is overly generous compared to the contributions.

Special Occupational Pensions[2]

Introduced in January 1960 as the first public pension scheme in Korea, the Special Occupational Pension Scheme (SOPS) covers employees of the central and local governments, public school teachers and employees, the judiciary, the Office of the Public Prosecutors, and police officers. Its participants grew rapidly from some 230,000 in 1960 to about 967,000 at present. The scheme operates as a pay-as-you-go system whereby current contributions (from employees, government and other employers) fund current benefits.

The contribution rates have been gradually adjusted upward from 2.3% (for both employees and employers) in 1960, to 5.5% in 1970, 6.5% in 1996, 7.5% in 1999 and to 8.5% in 2001. That is, the current total contribution made by employees and employers is 17% of earnings. Maximum benefits after 33 years of contributions aim to provide a replacement rate equal to 76% of earnings, where earnings are defined as the weighted average of the last three years' salary of participants. In this respect, it is a typical pension system designed under the premise of a 'low contribution

-high pension' basis and its financial sustainability cannot be assured.

An early sign of financial instability of the Civil Servant Pension Scheme surfaced in 1995 when it ran into deficit for the first time in its history. The problem was aggravated again in 1998, due to the large number of civil servants who left the service as a consequence of structural reforms undertaken in the wake of the financial crisis. In sum, the Civil Servant Pension Scheme is facing serious financial instability.

National Pension Scheme

The law establishing a national pension scheme was passed in 1973 but its implementation was delayed by 15 years, owing to economic difficulties experienced in the 1970s. When the NPS finally commenced in 1988, its coverage was limited to workers in firms employing more than 10 people. In 1992, compulsory coverage was extended to cover firms with 5 or more employees. It was extended further in 1995 to farmers and fishermen as well as those employed by small workplaces (with less than 5 employees) and the self-employed in rural areas. Finally, in April 1999, the NPS was extended to cover the self-employed in urban areas, thereby establishing 'universal' coverage.

As of September 2004, a total of about 17.03 million persons, including 7.44 million employees and 9.5 million self-employed participants, were covered by the NPS. Out of the 9.5 million self-employed, 4.75 million or 50% declared their earnings while the remaining 50% were exempt from making contributions due to business closure, unemployment or declaring an underestimate of their income. As a result, the number of persons effectively making contributions to the NPS was only 12.28 million (or less than 75% of the target population).

The number of National Pension beneficiaries was around 1.4 million in 2004, 81.3% of whom received old-age pension benefits with the rest receiving a survivor's or disability pension. The National Pension Scheme, however, expects a substantial increase in the number of its beneficiaries and benefit expenditure after 2008 when payments of full benefits commence. The proportion of beneficiaries to participate in the NPS is expected to reach 13.3% in 2010, 41.9% in 2030, and 88.5% in 2050, compared to 7.8% in 2004. These figures clearly indicate that the NPS is still in a start-up phase.

The NPS has been suffering from non-compliance, particularly among the urban self-employed, where the non-participation rate is almost 50%. Reasons for non-participation include unemployment, low wages, being economically inactive and not having confidence in the NPS. As a result, a large proportion of the self-employed, workers at small firms and women

Table 4. Financial Projection of the National Pension (current design), bill won

Year	Accumulated Reserves (current price)	Revenues	Expenditures	Balance	Funded Ratio	Contribution Rate (%)	Accumulated Reserves (Constant Price of Year 2000)
2005	160,396	29,687	4,219	25,468	32.0	9.00	136,897
2010	328,694	50,080	11,094	38,986	26.1	9.00	241,995
2020	908,028	109,073	35,010	74,064	23.8	9.00	497,441
2030	1,581,638	170,648	111,103	59,544	13.7	9.00	644,728
2036	1,702,972	189,069	201,456	-12,387	8.5	9.00	581,372
2040	1,447,808	191,224	289,188	-97,964	5.3	9.00	439,146
2047	-96,159	139,326	473,542	-334,216	0.5	9.00	-23,715
2050	-	154,610	561,966	-407,356	-	9.00	-
2060	-	201,822	895,032	-693,210	-	9.00	-
2070	-	271,210	1,286,469	-1,015,259	-	9.00	-

Source: National Pension Research Centre (2003).

are not actively participating or contributing to the NPS, resulting in a so-called 'pension hollow' problem. As well, it is suspected that many self-employed participants under-report their income. If this problem is not addressed in the near future, the redistributive design of the NPS will exacerbate intra-generational inequity between the employed and self-employed.

Under the present NPS scheme, with a 9% contribution rate and 60% replacement rate, the fund is expected to run deficits by 2036 and be bankrupt by around 2047 as indicated in Table 4 (opposite). The financial vulnerability of the NPS stems from its structural imbalance. The benefit level was initially set at 70 % of the lifetime average income for persons with 40 years of contributions, to be funded by a total contribution of 4.6% of earnings. However, this high level of benefit requires contribution rates of 25 %, which is far above the current level of 9 %.

Retirement Allowance Scheme

The Korean retirement allowance scheme was first introduced in 1953, as a way to 'guarantee income for the retired'. The scheme was voluntary at first and became mandatory in 1961. Since then the system has been functioning as a compulsory, legally-mandated program, applicable to workplaces with five or more employees.

The retirement allowance is provided only to persons who have worked at least one year in a firm. The base salary is calculated as an average of the salary for the three months before retirement (or leaving the firm) and the benefit level is one month's salary per year of service. This is equivalent to 8.3% of the employee's monthly salary. For an employee who has served forty years at a firm, the replacement rate of the retirement allowance would be around 25% if converted into annuity. The current retirement allowance scheme therefore favours relatively high-income workers with a long history of service at one workplace.[3]

Initially, the retirement allowance, which might be better described as a severance allowance, was a substitute for public pensions and unemployment insurance, which were not introduced until 1988 and 1995, respectively. Generally, the allowance is paid as a lump sum, but it can also take the form of an annuity (OECD 2001).

However, the retirement allowance scheme is subject to a number of deficiencies. These include limited coverage and insecurity of payment. Currently, only a quarter of the labour force receives a retirement allowance and, moreover, there are no penalties for using the retirement allowance for purposes other than retirement saving.

As the retirement allowance at each job change is paid in cash and job turnover is relatively high, the current retirement allowance is limited in the role of a retirement saving's vehicle. Moreover, a high proportion of retirement allowances are paid prior to retirement for workers facing major expenses, such as the marriage of children and house purchasing.

In addition, the funding of retirement allowances is insecure. Most firms only keep liability for retirement allowances as book records and do not keep reserves for their payment, thus leaving individuals vulnerable to the financial performance of firms. This vulnerability became reality in the wake of the financial crisis in the late 1990s when many firms could not pay their retirement allowance liabilities.

When the NPS was introduced in Korea in 1988, it challenged the traditional role of the retirement allowance as the focus of the retirement saving system. However, it is now becoming clear that the contributions associated with the NPS and the retirement allowance are considerable and the replacement rate of a full-term NPS contributor (under its current design) also receiving the retirement allowance (if converted into an annuity) would comprise a significant proportion of pre-retirement earnings. The generous replacement rates for full term contributors plus the considerable cost of these arrangements, leave little room for any additional private pension schemes.

4. Recent Reforms and Outstanding Issues

Despite their fairly recent introduction, the design of both the National Pension Scheme and the Special Occupational Pension Schemes has been questioned both within and outside Korea. Recent reforms and outstanding issues are discussed below.

The 1998 Reform of the National Pension Scheme

After only ten years of operation, the National Pension Reform Board (NPRB) was convened in 1988 to report on the sustainability of the NPS and propose possible reforms. After a year's consideration, the Board presented three reform proposals as follows.

1. Parametric reform: including lowering the existing benefit level and a gradual increase of contribution rates.
2. Systemic reform: involving dividing the scheme into a basic pension and an earnings-related pension, and sharply lowering the total benefit level from a replacement rate of 70% to 40%.
3. Reform towards a so-called Chilean pension system: replacing the social insurance program with an individual account-based defined contribution system.

The majority of the NPRB advocated the second proposal. This recommendation, however, was not accepted. Instead, after public hearings, the ministry responsible for the NPS – the Ministry of Health and Welfare (MOHW) - presented an alternative reform proposal closer in design to the NPRB's first proposal. The subsequent amendments reflected this approach and were introduced in the context of improving the sustainability of the NPS.

The legislated changes included:

- A reduction of the average level of pension benefit from a replacement rate of 70% of lifetime income to 60%, for the retiree with 40 years service.
- An increase in the pensionable age from 60 years to 61 years in 2013, and thereafter, by one year every five years to reach a pensionable age of 65 years in 2033.
- Mandatory actuarial projections for the NPS conducted every 5 years.
- A reduction in the minimum eligibility period required for pension rights from 15 years service to 10 years, to strengthen pension rights.
- The introduction of a split pension benefit system for couples, to safeguard pension rights for surviving spouses.

Outstanding Issues with the NPS

Despite the 1998 reform, the NPS continues to face problems of sustainability, equity and coverage. Recent projections by the National Pension Research Centre indicate that if the current system remains unchanged, the NPS will run a deficit from 2036, and its fund reserve will be depleted by 2047 – see Table 5 (page 252). In order to avoid bankruptcy, the NPS contribution rate would need to be increased to 30.0% by 2050, and then 39.1% by 2070.

The financial instability associated with the NPS also raises questions of inter-generational equity. In future, the scheme as currently designed, will have insufficient contributions to fund its generous benefits. Addressing this issue will require increased contributions and reduced benefits for future generations – that is, an 'unfair' inter-generational transfer of financial resources.

Intra-generational inequity is also an issue, resulting from the redistributive element in the NPS benefit formula and the imbalance in effective contributions between sectors. Under current arrangements there is significant under-reporting of incomes by the self employed, leading to 'unfair' intra generational transfers from salaried workers to the self-employed.

Table 5. Projections of Total Taxable Income vs Total Pension Expenditure (bill won)

	Total taxable income in the NPS area (A)	Total pension expenditure (B)	B/A (%)
2010	342,633	10,921	3.2
2020	613,791	34,701	5.7
2030	967,960	110,576	11.4
2040	1,341,389	288,329	21.5
2050	1,869,968	560,567	30.0
2060	2,440,472	892,859	36.6
2070	3,280,327	1,283,095	39.1

Source: National Pension Research Centre (2003).

Finally, there is the issue of coverage. There are some pockets of income groups who remain outside the purview of the NPS. In particular, a large portion of the self-employed, workers at small firms, and women, are not actively participating nor contributing to the NPS.

The 2000 Reform of the Special Occupational Pension Schemes

As mentioned earlier, the Civil Servant Pension Scheme (as one of the Special Occupational Pension Schemes) is also facing serious financial instability, having moved into deficit in 1995. In order to partially address this, the government raised the contribution rate to 13% in 1996 and then to 15% in 1999. An additional short-term impact on the financial instability of the Special Occupational Pension Schemes (SOPS) came from the rapid increase in expenditure due to public sector restructuring following the Asian Financial Crisis in 1997. Before the 2000 reform, the replacement rate of the Civil Servant Pension Scheme was 76% of the final monthly wage of the retiree with 33 years of participation, a benefit level much higher than the National Pension Scheme and the civil servant pensions of other countries.

In 2000 the Government introduced reforms to resolve the growing problems in the Civil Servant Pension Scheme. These included, first, the introduction of a minimum pensionable age for civil servants with less than 20 years of contributions, whereby an eligible pensioner must be at least 50 years old or have at least 20 years of contributions as of 2001. In addition this minimum pensionable age is to increase gradually to 60 by the year 2020. Second, the earning base for calculation of benefits was changed from the final year's salary before retirement to the average of the final three year's salaries before retirement. Third, the method of benefit indexation was shifted from wages to price.[4]

Although these reforms eliminated the financial deficit of the SOPS in 2001, the schemes are facing future bankruptcy, largely due to the high income-replacement rate of the pension provided. It seems that more fundamental reform is inevitable in the near future.

5. Recent Pension Reform Initiatives

Given the systemic problems of financial instability, uneven effective coverage and issues associated with intra and inter generational equity, there has been a growing momentum for further reforms to Korea's retirement income arrangements. This was reinforced in the early 2000s when both the World Bank and the OECD entered the debate with reform proposals (World Bank 2000, OECD 2001). In 2003, proposals to reform both the National Pension Scheme and the retirement allowance scheme were announced.

The 2003 Reform Initiative of the NPS

It is generally accepted that under the NPS as currently designed, the rate of pension benefits is too high while the contributions are too low: salaried workers pay 9% of their income and the self-employed pay 8% in return for a lifetime pension with a potential replacement rate of 60% of average lifetime earnings.

To prepare for the first actuarial estimates and report on the financial stability of the NPS (as required under the 1998 reforms), the Ministry of Health and Welfare established the National Pension Scheme Development Committee (NPSDC) in March 2002 with the aim of drafting a reform proposal for the NPS. As a background to this task, the Committee set out a number of criteria around which to base their proposals.

- The NPS reserve fund should always be at least two times as much as needed to pay all expenditures in the year 2070;
- The benefit level of the average wage earner with an average number of years of contributions should be higher than the minimum living standard;
- The contribution rate should be capped at 18%.

Based on the above criteria, the NSPDC aim was to design an optimal contribution-benefit mix which could assure the NPS' financial stability. After collecting opinions of experts in various fields, the NPSDC presented three policy options in June 2003.[5]

Option 1: a 60% replacement rate with a contribution rate of 19.85%

The contribution rate, now 9% of income, would go up 2.17% every five years, from 2010 until 2030, and remain at 19.85% thereafter. While the pension premium would be some extent higher than the criteria of financial stability (18%), this would allow the potential pension benefit to remain at its current replacement rate of 60%.

Option 2: a 50% replacement rate with a contribution rate of 15.85%

The contribution rate, now 9% of income, would go up 1.37% every five years, from 2010 until 2030, and remain at 15.85% thereafter. While the targeted contribution rate is within the criteria, the potential pension benefit would be lowered to a replacement rate of 50% from 2004.

Option 3: a 40% replacement rate with a contribution rate of 11.85%

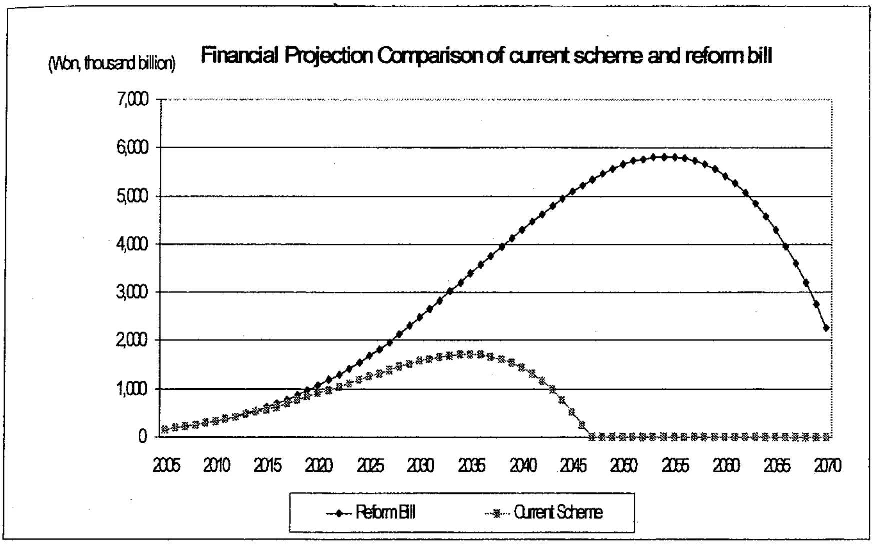
The contribution rate, now 9% of income, would go up 0.57% every five years, from 2010 until 2030, and remain at 11.85% thereafter. While the targeted contribution rate falls far short of the criteria, the benefit level would be sharply lowered to a replacement rate of 40% from 2004.

The majority members of the NPSDC favoured Option 2 and after having examined the NPSDC's proposals, the government and the ruling party announced a new proposal which was a slightly revised version of this option[6] – refer Figure 2 (page 255) and Table 6 (page 256).

The government submitted the Amendment Bill to the National Assembly in October 2003 with the aim of getting it passed before the end of the regular session. However, during this time the objections of both labor unions and business against the government-proposed revision of the National Pension Act were growing stronger. The gist of the revision is to pay more and get less. The labor unions were dissatisfied because retired persons will receive lower benefits, while management is upset because the insurance costs (that is, contributions), half of which are paid by the employers, will increase. Meanwhile, the ruling and opposition parties did not deal with the National Pension Law during the ordinary session of the National Assembly. As a result the draft Bill was automatically scrapped after being left unattended when the 16th National Assembly ended at the end of May 2004.

The 17th National Assembly began in June 2004, after the general

Figure 2. Long-term Financial Projection of the NPC



Source: National Pension Research Centre (2004).

election held in April 2004 and again the government submitted the NPS Amendment Bill to the National Assembly. The Amendment Bill is currently awaiting the decision of the reconstituted National Assembly.

2003 Reform Initiatives for the Retirement Allowance

At the same time as proposals for reform of the NPS were being considered, the Ministry of Labor (MOL) was working on a review of the retirement allowance scheme. In 2003 the MOL announced its proposed reforms and the resulting Retirement Pension Bill was passed in December 2004.

Under these reforms the existing retirement allowance scheme will be transformed into a retirement pension, with the overall aim of protecting workers' benefits and reducing labor market distortions. That is, employers and employees will be able to choose, via collective bargaining, to continue to take part in the retirement allowance system, or introduce a retirement pension (either of the defined contribution or defined benefit type). However, the proposed retirement pension must be at least equivalent to the current severance allowance in value (Hur 2003). Under the proposed reforms the retirement benefit will be payable from age 55 as an annuity with a term of at least five years. The proposal also includes the

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Table 6. Financial Projection of the National Pension Scheme (Under the Amendment Bill), bill won

Year	Accumulated Reserves (Current price)	Revenues	Expenditures	Balance	Funded Ratio	Contribution Rate(%)	Accumulated Reserves (Constant Price of Year 2000)
2005	160,467	29,690	4,168	25,522	32.4	9.00	136,958
2010	334,673	54,583	10,643	43,941	27.3	10.38	246,397
2020	1,077,199	142,365	32,361	110,004	29.9	13.14	590,117
2030	2,482,201	280,971	97,231	183,740	23.6	15.90	1,011,828
2040	4,294,137	421,396	247,642	173,755	16.6	15.90	1,302,487
2050	5,673,601	574,287	476,148	98,138	11.7	15.90	1,280,513
2054	5,819,629	587,085	574,355	12,730	10.1	15.90	1,167,002
2060	5,428,981	624,701	755,962	-131,261	7.4	15.90	911,741
2070	2,288,011	602,691	1,084,917	-482,227	2.6	15.90	285,916

Source: National Pension Research Centre (2004).

introduction of an Individual Retirement Account for workers who frequently change their job and for employees in small firms. This would enable the retirement pension to be portable and play a role in old-age income security. As well, coverage will be extended since every employee would be entitled to the severance allowance or retirement pension from their first month of employment.

With the passing of the Retirement Pension Bill, Korea has moved towards the multi-pillar system, as advocated by international bodies including the World Bank and the OECD and summarized in Appendix 1. In Korea's case this comprises, the publicly provided National Pension Scheme (and Special Occupational Pension Schemes), occupationally-based retirement pensions (or retirement allowances), and IRAs and voluntary personal pensions.

Under these arrangements, the potential aggregate replacement rate for an average Korean worker with 40 years of contributions will be around 75% (or 60-65% under more realistic working life assumptions of 30-35 years). However, with this comes an increased burden on employers and workers. The combined contribution rate of 17.3% (9% for the NPS and 8.3% for the retirement allowance scheme) would, under the current reforms proposed for the NPS, rise to around 24.2% by 2030. If we consider contribution rates of other forms of social insurance – such as health insurance, work injury and employment insurance - the burden borne by future generations would be much higher (see Table 7 page 258).

This poses the question of whether the contribution burden of future generations is appropriate and affordable. Maintaining the replacement rate as it is today for future generations means sharp rises in the NPS contribution rate for future working generations. Curbing the contribution burden of future working generations to an affordable level would require measures for reducing the replacement rate. All these issues are at the centre of attention at present.

6. Discussion and Concluding Remarks

During the next few decades, the population in Korea is expected to age rapidly. This ageing trend will incur high costs for the maintenance of the current National Pension Scheme. It is expected that the financial instability of the NPS will be inevitable without fundamental reform. In that sense, the old age income support system in Korea is at a crossroads. Naturally, the task of creating a sustainable system is all the more urgent because the NPS, despite its youth, would requirea doubling of contributions, a halving of benefits or a combination of the two to stabilize its finances and limit the burden on the next generation.

In 2002, the National Pension Scheme Development Committee (NPSDC) was created to deal with the emerging but inherent issues mainly relating to the sustainability of the NPS. After more than a year's consideration, the NPSDC produced a detailed report that included reform proposals for the NPS, involving lowering the benefit level while increasing the contribution rate. However, the discussion became entangled in politi-

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Table 7. Contribution Rates of Korean Social Insurance, as of 2003

	Employee	Employer	Total
Work Injury Insurance	-	0.4-31.9	1.49 (average)
Health Insurance	1.815	1.815	3.63
National Pension	4.5	4.5	9
Employment Insurance	0.4	0.7-1.3	1.4 (average)
Pay-Guarantee Fund	-	0.2	0.2
Severance Pay	-	8.3	8.3
Total	6.715	15.915-39.715	23.22 (average)

Source: Hur (2003).

cal disputes among interested parties and the reform did not materialize during the relevant term of the National Assembly. The proposals are now under review by the newly constituted National Assembly.

Instead of the reforms proposed by the NPSDC, some political parties prefer the proposals of international bodies such as the World Bank and the OECD. Both recommend a multi-pillar system, which they argue operates more efficiently than a system that relies heavily on any one pillar (as has been the reform direction in Korea). In particular, the reform proposal of the OECD suggests the conversion of the NPS into a flat-rate basic pension financed by general revenue and an earnings related defined-benefit pension, far less generous than the current NPS.

It is contended here that creating a two tier system which includes unfunded benefits, would incur a greater economic and social burden on the incoming aged society, than the current arrangements. It would be more appropriate for Korea to reduce the benefit level of the National Pension so as to make it sustainable, rather than to introduce a basic pension as the World Bank, the OECD, and non-ruling parties recommend. Behind this view is the conviction that the World Bank's model of a 'social insurance type' basic pension would not help much in eliminating gaps in coverage. As well, the OECD and non-ruling parties' proposal of a tax-financed basic pension would require a staggering amount of financial support in its mature stage, although it may be more effective in eliminating gaps in coverage.

Therefore, what should be done now is parametric reform, with a view to making the National Pension financially stable, and establishing a multi-pillar income protection system by linking the National Pension Scheme to social assistance and the retirement pension arrangements (to be implemented in near future). With its elderly population growing at an unprecedented pace, Korea is in urgent need for an efficient post-retirement income protection system that provides adequate benefits in a sustainable way. In this regard, the contribution and benefit structure of the National Pension has to be converted from the current form of 'low-contribution-high-benefit' to an 'adequate-contribution-adequate-benefit' basis. The problem of inadequate benefits that may result from a reform of the National Pension may be dealt with by activating other means of post-retirement income protection, such as retirement pensions and private pensions.

There are many different ways of structuring a pension system. Obviously there is no single system which fits all circumstances, and the question of what is the most appropriate system has to be weighed against the other factors, in particular such as financial stability, universal coverage, and changing circumstances. This paper argues that the reform measures should be compatible with the ever-changing economic and social circumstances as well as being financially sustainable. In this context, the reform proposal of the NPSDC may be the best available, if not perfect, to prepare for the aged society.[8] In addition, efforts should be made for the elderly to remain in the labor market longer, to replace the reduced labor force. For that purpose, a part-time pension should be introduced for gradual retirement of the elderly. Also, the implementation of a bridge pension should be considered for involuntary early retirement.

As the World Bank and OECD pointed out, since the NPS does not begin paying full pensions until 2008, Korea has a window of opportunity to reform the current system. If Korea fails to reform the NPS now it will be 2008 before official actuarial estimates will be prepared again.[8] At this time the full pension will begin to be paid, so any amendments will become more difficult. For the future of the nation, reform of the pension system is urgent and inevitable.

Notes

1 Three factors contribute to Korea's rapid aging. First, the 'baby boomers' currently in their thirties and forties will join the elderly in twenty years. Second, the fertility rate is rapidly dropping. And lastly, life expectancy is extending.

2 The three special occupational pensions (Civil Servant, Private School Teacher, and Military Personnel) are very similar in their financial trends as well as the benefit and contribution levels. The following will focus on the Civil Servant Pension.

3 In Korea, many firms adopted progressive systems which pay more as years of employment increase.

4 The Private School Teachers Pension Scheme and the Military Personnel Pension Scheme also underwent similar reforms in 2000. However, the beneficiaries of these special occupational pension schemes were strongly against the reform. The government yielded to the pressure of the beneficiaries, resulting in an almost reversion of the old formula in the benefit indexation method. Under the law devised in December 2001, the indexation base of the occupational pension was changed to the weighted average of wages and prices, with more weight put on wages.

5 In its proposal, the NPSDC made it clear that all their policy proposals were devised based on the parametric reform of the NPS and any systemic reform would be left until the next 5-year projection (2008).

6 Under this revised (government) proposal, the potential benefit level would be lowered to a replacement rate of 50% in 2008, with a transitory rate of 55% to apply from 2004 to 2007

7 See Sukmyung Yun and Moonkil Kim (2004).

8 The next actuarial estimates of the NPS are due in 2008.

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Appendix 1 Alternative Pension Reform Proposals for Korea

World Bank

Pillar	Pension Type	Characteristics
1st pillar	Mandatory public pension	Target replacement rate is reduced to 30 % (DB type) Merging the Civil Servant's schemes with the NPS A relationship between contribution and benefit pension; only payable to the person who has his or her contribution history (social insurance)
2nd pillar	Corporate pension	Conversion of the retirement allowance Fully-funded defined-contribution scheme The self-employed are allowed to use this pathway to a privately managed personal plan similar to an IRA in the US
3rd pillar	Individual pension accounts	Tax incentives

Source: World Bank 2000

OECD

Pillar	Pension Type	Characteristics
1st pillar	Mandatory public pension	*1st Tier* ● A tax-financed universal welfare pension (social allowance) with a 20 % replacement rate *2nd Tier* ● An earnings-related defined-benefit pension with a 20% replacement rate
2nd pillar	Corporate pension	● Conversion of the retirement allowance ● Fully-funded defined-contribution scheme
3rd pillar	Individual pension accounts	● Tax incentives

Source: OECD 2001

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