SOCIETY OF ACTUARIES

Article from:

The Actuary

April 1989 – Volume 23, No. 4

Pensions viewed from upside down

by Charles Barry H. Watson

Retirement benefits have become a seamless worldwide web. Thus actuaries who go to war in the international arena are painfully aware of the impact of U.S. technology on the battlefield. The debut of that awesome (awful) weapon, ERISA, and all its derivatives has persuaded many countries to adopt counterparts – none, perhaps, with the same degree of sophisticated indifference to the purpose of pensions but still adequately perverse for the local scene. But this, of course, is one area where U.S. technology still leads the world – laws and regulations.

If, as many suspect, ERISA-style regulations prove to be the HIV for defined-benefit pension plans, then the United States will be the source of contagion.

There is, however, free trade in retirement benefits (epidemics know no boundaries), and seminal developments recently have flowed to this country. A good example is the privatization of social security. Personal choice as to the type and mesh of the pension safety net and deregulation of safety standards is a thought to warm Reagan's heart and those of his supply-side advisers, regardless of consequences.

This is an import, though. "Personal Pensions" to replace part of social security have been introduced in England, with untested and questionable success, under the aegis of Reagan's leading exemplar, Maggie Thatcher.

However, she was able to draw upon the splendid example of Chile, where President Pinochet (well-known as a friend of the disadvantaged) has indeed privatized social security. The employee contributes to a private account invested by a licensed institution (e.g., bank or insurer), which he has selected; the initial cost of his contributions was covered by a mandatory pay increase. Thus far, the system has worked plausibly well, at least in comparison with what preceded it, and it may serve as a lodestone for the Chicago school of economists who have advised Chile, pulling us in the same direction here.

It is not easy, politically, to tamper with social security. Another foreign extravaganza that has just burst upon the heavens may prove a more attractive import, as it deals with everyone's pet peeve – taxes.

As we all know, retirement benefits are tax driven. (Even if they are not, we suspect them of being so. Look at all the trouble taken to reduce benefits for everyone, just because Congress and, especially, the IRS thought that a few entrepreneurs were feathering their own nests at the expense of their employees.)

An excellent example of the power of taxes is seen in the popularity of lump sum retirement benefits in Australia (and to a lesser degree New Zealand). The reason for this is that, in upside-down land, lump sum benefits up to a generous maximum are largely tax-free; yes, taxes are waived, not just deferred. So any retiree would be a fool not to take his benefit as a lump sum; if he wants a pension, he can rush down the street to his friendly neighborhood insurer to buy an annuity, which is taxable only on the interest portion. This is clear discrimination, rooted in history. (Lump sums are popular in many other countries, especially developing ones, for a variety of social and economic reasons.)

Well, the new bombshell, also from the antipodes, will deal with this discrimination. It does many other things, too.

Put simply, Australia and New Zealand have now proposed separately (but one suspects that Messrs. Hawke and Lange, socialist prime ministers of the capitalist school, have chatted) that tax on retirement plans should be brought forward from the retirement period to the present. The details vary between the two countries, but the following is generally true:

- Employer contributions (previously tax-deductible) are now currently taxable to the fund at what amounts to the corporate tax rate.
- Employee contributions (previously tax-deductible within limits) are included in the employee's taxable income, and so made out of after-tax income.
- Fund income (previously not subject to tax, at least immediately) is taxable to the fund as earned.
- In return, retirement benefits – pensions, as well as lump sums – are to be tax-free to the retiree when received. (This of course eliminates the discrimination between the two types of benefits, but at the cost of chaos!)

It is important to note that all this will be part of a general revamping of taxes in both countries, based on the concept that "a dollar is a dollar," no matter when or how it is earned. (This is actually an old idea, dating back to a famous – unadopted – "green paper" in Canada of many years ago.)

The proposal, which will be put into final form in both countries this year, presents certain obvious problems to be resolved:

- The change in benefit form emphasis, from lump sums to pensions (even a level playing field changes the game), will dramatically alter retirement strategies and the capital markets.
- Unless the amounts of benefits are changed, the retiree will get a better deal (no tax!), which will be paid for by the employer. To handle this, both governments (New Zealand's with vigor, Australia's more tentatively) have said that the benefit package is to be renegotiated downwards between the employer and employees (unions). Good luck!
- The ultimate impact will depend on how tax rates change in the future. Presently, they are at historic lows, and tax increases will tend to hurt employers and help retirees.
- On the other hand, no bargain is forever, and a future government could resort to "double taxation" by introducing a tax on benefit payments.
- The advance of tax benefits, from the never-never of retirement to the cold reality of today, will have a varying absolute impact, depending

Continued on page 7 column 1