

The Multi-pillar system of old-age income security in Korea

: Its development, current status and issues

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<Abstract>

This paper is about the development and current status of the Korean multi-pillar system of old-age income security and some contentious issues. Taking the concept of multi-pillar system as its widest sense referring to risk dispersion via diversification of old-age income source, I analyze the whole formal old-age income security system including not only public, private pension but also different types of basic income security system encompassing allowance and public assistance.

This paper looks at the development of old-age income security system divided into three phases: initial phase until 1998, second phase from 1999 to 2003 and third phase from 2003 onward when talk about the second National Pension reform began. Finally, this paper analyzes the tasks of Korea's long-term multi-pillar old-age income security system. They can be summarized as reinforcing old-age basic income security by stabilizing basic old-age pension and lowering national pension benefit for the sake of fiscal stability and vitalization of private pension as a countermeasure.

Keyword : multi-pillar, old-age income security, National Pension, Retirement Pension, Individual Pension

I. Introduction

This paper is about the development and current status of the Korean multi-pillar system of old-age income security and some contentious issues. The multi-pillar system in its narrowest sense refers to the three-pillar system that the World Bank had proposed in 1994, namely the pillars consisting of public unfunded plan, private funded plan and voluntary private plan. Because there is criticism that viewing multi-pillar system only as the World Bank's three-pillar system is myopic interpretation, the Bank is recently moving in the direction of emphasizing flexible multi-pillar system design that is suitable for each nation's initial condition and context.

Another perspective is looking at multi-pillar system as a concept that differentiates the roles each public and private pension plays. According to this view, the multi-pillar system is in place to complement or replace public pension scheme with private scheme and to restrain the total

expenditure of the public pension. That is why there is much talk about how to reposition private pension within the multi-pillar framework and how to grow and strengthen it.

Equating multi-pillar system with public-private pension role division is a very good explanation of the multi-pillar system construction taking place in the direction of pension reform in the Western countries including Germany, UK and Sweden. The circumstances in Korea do not allow the direct application of this view, however, because this perspective is applicable only to societies where public pension has served as a sure mechanism to secure basic income. Only in such environments is it natural to focus on shifting the public pension's income adequacy function partially to private pension. In Korea, national public pension is not yet mature, and the low-income bracket's coverage ratio is substantially low, therefore failing to fulfill its due role as a basic income security system. Under such circumstances, it would not make sense to discuss the building of multi-pillar system focusing on differentiating the role between public and private pension because it is not relevant to building a complete old-age income security system.

Lastly, the multi-pillar system in its widest sense refers to risk dispersion via diversification of old-age income source. It gives consideration to the whole formal old-age income security system including not only public, private pension but also different types of basic income security system encompassing allowance and public assistance. Such a comprehensive viewpoint can also be found in the recent five-pillar model that the World Bank has proposed, stressing the need for zero pillar to reduce old-age poverty.

Old-age poverty is a prevalent issue in Korea, and it is most suitable to talk about building the multi-pillar system in Korea through the lens of the last comprehensive concept, in other words interpreting multi-pillar system as old-age income security system in several tiers. This perspective also best explains the actual discussion about the multi-pillar system development process.

In analyzing the Korean multi-pillar system, the paper mostly looks at the relationship between public and private pension and discusses how to strengthen the basic income security aspect of the scheme. Chapter II is about the history of the old-age income security system in Korea. Chapter III looks at the current old-age income security system and its characteristics, and Chapter IV rather than coming to a conclusion presents issues and challenges.

II. History of old-age income security system

This chapter looks at the development of old-age income security system divided into three phases: initial phase until 1998, second phase from 1999 to 2003 and third phase from 2003 onward when talk about the second National Pension reform began.

During the first phase, individual old-age income security systems were introduced without any relationship with one another. The external coverage of National Pension system was gradually expanded and first reform was complete. During the second phase, people began to have more awareness about the relevance among the different systems. However, the top agenda was the reform and development path of each system (or pillar) separately, and it was taken for granted that the government play a central and direct role in securing old-age income. People did not actively seek role division between public and private pension but rather took a critical stance.

The third phase invited a paradigm shift in National Pension reform dialogue. There was talk about introducing a separate system for basic income security during the course of national pension reform dialogue, and there was a move to legislate corporate retirement pension system; therefore, building the multi-pillar system on a long-term basis has been regarded as a prerequisite for reform and it naturally became an official topic.

1. Phase 1 : Initial development of old-age income security system (until 1998)

The initial development of Korea's old-age income security system is characterized by the independent and separate introduction and growth of each system. The first system ever to be introduced was the severance allowance which is the predecessor to the current retirement pension system. It was introduced as early as in 1953 albeit on a voluntary basis, and it became legally mandatory in 1961. From then on, coverage grew incrementally by 2005.

The problem was that the severance pay system had been introduced when there was no other system in place for securing income in unemployment and retirement and had operated as part of 'comprehensive worker welfare' provided by the corporate. In other words, the retirement allowance system had been in place for a very long time positioned as one of the most important welfare systems in the workers' minds, but not necessarily as an old-age income security system.

National Pension system introduced in 1988 is considered to have been designed to serve as the sole system providing old-age income. The rationale behind such evaluation is that the benefit level of this single public instrument is 70% of the income level. The intent becomes clearer if one takes into consideration the fact that the national pension system was for companies with 5 or more employees, which is the same coverage for severance pay. It can be safely said that the national pension system was introduced not admitting the old-income security function of the severance pay system.

Such trend was still valid in 1998 when there was the first national pension reform to stabilize finance. The consensus was that the national pension's high level of income replacement needs to be maintained since it was the core old-age income security mechanism. That is why the argument to

lower the income replacement rate to 50% for the sake of fiscal stability lost ground, and compromise was reached at 60%.

In 1994, appropriate individual pension was introduced which was deemed not as an old-age income security system but as a savings instrument with tax benefits in the minds of the general public.

2. Phase 2 : Searching for individual development paths for each pillar (1999 ~ early 2003)

During this phase, earnest talk began about the long-term reform direction for National Pension system and Retirement allowance (or severance pay) system, and also the basic income security systems such as basic livelihood security system and old-age pension system were introduced. In seeking the right direction to develop each system, not much thought has been given to the interrelationship; but nevertheless there was heightened awareness about the need to consider the relationship between public and private pensions in seeking the right direction for the development of the pension system.

The first time people systematically reviewed the relationship between public and private pension was when the IBRD proposed 'integrated development and improvement measures of public pension system and private pension system' as an implementation condition to SAL II. This led to the establishment of 「Commission for Improving the Public and Private Pension Systems」 in December 1998. This Commission studied and reviewed the rational means to coordinate the roles between public pension and private pension and how to provide adequate old-age income security through reinforcing ties between the two types of pension.

And as a result, long-term fiscal instability, narrow coverage and inequality were raised as issues concerning the national pension system. There was not much opposition to the basic initiative of making the severance pay into a corporate pension system, but specific measures to introduce retirement pension were not brought to the table. As for Individual pension, high cancellation rate and weak old-age income security function were pointed out as main problems.

The Tripartite Commission of Korea took up the improvement of severance pay system and introduction of retirement pension system as an agenda, and discussions continued from July 2001 to July 2003. However, no consensus was reached on the specific process and model for converting to retirement pension. The talk ended delegating the issue to the government.

During this phase, the National Basic Livelihood Security System was introduced in 2000 as the core public assistance program for the whole population to replace livelihood protection system. While it became the zero-pillar to the elderly, its development path and benefit calculation logic was irrelevant to the old-age income security system.

Old-age pension, which is another public assistance-type benefit, provides benefit to the contemporary senior citizens who did not have the opportunity to join the national pension program. In that sense, it is the only scheme that was introduced giving deliberate and systematic thought to its relationship with the public pension.

3. Phase 3 : Talks about building the multi-pillar old-age income security system began (since 2003)

① From ‘pension’ reform to building ‘old-age income security system’: the second National Pension reform (2003~2005)

The fundamental difference between partial reform and structural reform lies in how to analyze the current system operation status and future outlook. But throughout the course of talking about reform, it was found that the conflicting point between the two sides was how to resolve the old-age poverty issue. As national pension grew more mature, income security for the elderly was going to become more obvious, but it seemed inevitable to devise another scheme besides the national pension system to resolve the poverty issue of the contemporary elderly who did not have the opportunity to join the national pension plan and to compensate for the low level of national pension due to its short history.

Discussion about reforming the national pension went beyond just talk about the pension and led naturally to building old-age income security system. Grand National Party’s proposal for pension reform through dual national pension itself means making the old-age income security system into multi-pillars.

② After retirement pension system was introduced (December 2005 ~ Present)

As such, the national pension reform in the fall of 2005 did not bear any fruit and was delayed once again. The Ministry of Labor instead submitted a bill for the 『Act of Workers’ Retirement Benefit Security』 , which was passed in the National Assembly without much opposition and was enacted in December 2005. According to this act, companies can convert the existing severance pay system to corporate retirement pension based on the employer’s and employees’ mutual agreement. At last, the multi-pillar system was born, albeit on the outer appearance.

With the introduction of the retirement pension system, it became inevitable to consider the development of Retirement Pension together in discussing pension reform. In other words, the dialogue about the pension reform which had centered on public old-age income security system was changed to accommodate the multi-pillar system including private pension.

Against this backdrop, in June 2006 the government wanted to have a breakthrough in reopening the dialogue for pension reform which had reached stalemate in a public forum. It presented a new reform direction as a baseline for political negotiation and long-term vision for old-age income security system. The new direction for reform was a compromise between maintaining the existing government's policy and accommodating the opposition party's request. The alternative for the areas not covered by old-age income security system was basic old-age pension, which was a cross between basic pension and current old-age pension. In order to gain both benefit adequacy and long-term fiscal stability the basic direction of downgrading national pension system in line with the maturity of the multi-pillar system was presented.

As such, it was the first time ever that an official government document dealt with the relationship between public and private pension and the direction of building multi-pillar old-age income security system. The precondition is that in order for the national pension to have long-term fiscal stability it is necessary to lower benefit than raise contribution, and the rationale behind this is that as the private pension grows mature, it will supplement public pension benefit. And by proposing basic old-age pension, which is a midway point between basic pension and the current old-age pension as a means to relieve old-age poverty with much greater coverage than the past, the government clearly stated institutional reinforcement to the zero pillar.

Since then, political parties negotiated and made compromises on different measures, which resulted in convergence among different plans and the following tentative agreement was reached. The National Pension maintained the premium rate of 9%, lowering the benefit level from the current 60% to 40%. As for the basic old-age pension, political compromise in line with the basic pension was reached at providing 5% of average income (to be adjusted upward to 10%) to 60% of the elderly population over the age of 65.

Finally, during the National Assembly session of April 2007, the Basic Old-age Pension Act was passed first, but National Pension reform bill for fiscal stability was pushed aside because other myriads of political matters intervened. In other words, National Pension and Basic Old-age Pension were dealt with as separate issues and the latter was introduced first without the reform of the former.

III. Current status and characteristics of the Korean multi-pillar system

Currently, old-age income support systems in Korea are categorized into public pension, private pension, public assistance and etc. The public pension scheme consists of the National Pension Scheme for the general public and special occupational pension schemes such as Government Employees Pension Scheme, Military Personnel Pension Scheme and Private School Teachers Pension Scheme.

Private pension consists of the Retirement Pension and appropriate Individual Pension Plan which was first introduced in 1994. Retirement Payment Scheme, with a lump-sum payment upon retirement, is expected to change into a selective retirement pension from 2005. Finally, there is the zero pillar which includes the Basic Old-age Pension introduced in this April and National Basic Living Security Scheme for the low-income household of all population.¹

<Table 1> Korea's Multi-pillar Scheme for Old-age Income Support

Pillar	C o v e r a g e			M a i n C r i t e r i a		
	Life-time poor	Infor-mal sector	Formal sector	C h a r a c t e r i s t i c s	Participation	Funding
0	X	X	x	Basic old-age pension(2007) National Basic Living Security Scheme	Residuary	Govt's general funding
1			X	National Pension Scheme and Special Public Pension Schemes (DB)	Mandatory	Contributions
2			X	Legal Retirement Payment Scheme (to be converted into a Retirement Pension) (DB or DC)	Mandatory	Employer contributions
3		X	X	Individual Pension Scheme	Voluntary	Individual contributions

Footnote: Marked X, X, x according to its importance. The above figure follows the Multi-pillar Pension Taxonomy format used by Holzmann et al (2005) Table 1.

Korea has a multi-pillar system on the outer appearance as <Table 1> shows, but a look at the elderly households' income composition reveals that the multi-pillar system is still at an immature stage.

Let us first take a look at Korea's old-age income source. Kim & Cho (2005) compared each nation's old-age income source concentrating on households headed by senior citizens aged 65-69.

¹ Basic Old-age Pension will substitute current Old-age Pension Scheme which is designed to offer protection to the current generation of elderly people with low incomes and who are excluded from the National Pension Scheme

(<Table 2>) Although earned income is a still important income element in the Western nations after retirement, its dominance is a whopping 45.7% in Korea. First, this shows that Korea's old-age income security system including public and private pension is still immature or undeveloped. Second, it reveals the fact that more Korean elderly population live with their children compared to their Western peers.

The ratio of public transfer in the Western countries is as high as 41 to 70% but is very low in Korea at 14%. Corporate pension is big especially in Canada, the Netherlands, US and UK, but since the system was non-existent in Korea, this income source does not appear as relevant. While the elders' income source can be broken down to public transfer income and corporate pension, in Korea it is severely skewed toward earned income and private transfer.

<Table 2> Income packages on households headed by senior citizens aged 65-69.

	Earned income	Asset income	Public transfer	Employer-provided pensions	others (including private transfer)	Household poverty ratio
Australia 1994	24.1	17.9	44.5	11.0	2.5	29.6
Canada 1997	22.4	6.5	46.6	20.2	4.3	8.5
Germany 1994	17.2	3.3	70.0	9.5	0.2	7.8
Netherlands 1994	7.9	5.3	57.5	28.6	0.7	8.2
Norway 1995	33.5	5.5	43.8	16.2	1.0	6.6
Sweden 1995	16.1	5.0	62.0	16.4	0.5	2.2
Switzerland 1992	15.1	19.2	43.1	21.8	0.8	6.8
UK 1995	15.6	10.0	46.3	27.3	0.8	17.0
US 1997	28.8	12.2	41.3	17.4	0.3	24.7
Korea 2000	45.7	16.8	14.1	-	23.4	30.3

Source : Rein et al.(2004), for Korea, Kim & Cho (2005)

From a comparative perspective, Korean old-age income source is less dependent on the multi-pillar old-age income security system but is heavily dependent on the fourth pillar, namely earned income and asset income and private transfer. This results in high level of poverty rate of elderly households. In the future, when the multi-pillar system becomes more mature, that is, basic old-age pension is implemented and National Pension and Retirement Pension system also mature, only then will a more balanced portfolio be produced.

The characteristics of Korea's multi-pillar system can be summarized as follows depending on the characteristics and relationship of National Pension and Retirement Pension scheme. First, introducing the retirement pension plan was not a policy borne out of consistent decision making process among different government agencies under the framework of multi-pillar income security system. In 2004 the Labor Ministry proposed the retirement pension system and the Health and Welfare Ministry tabled the bill for reforming national pension for the sake of fiscal stability, which looks like a social policy package derived from policy coordination between the two government ministries to adjust downward the public pension benefit and build a multi-pillar system. But in actuality it was nothing more than standalone policies, not going through any consultation, coordination or consensus building.

Second, comparison of the roles retirement pension and national pension play respectively reveals that the former is not expected to replace the latter or play a vital role in the multi-pillar system but rather play a supplementary role to the latter. The proportion of the self-employed is high in Korea, and the fact that Retirement Pension only applies to the workers limits the role it can play within the multi-pillar context.

VI. Conclusion : Issues and Challenges

According to O'Higgins (1986)'s choice of words, Korea's multi-pillar system is 'un-integrated, un-coordinated welfare mix' where private pension grew without any close relationship with public pension. No consideration was given to systematic relationship building between public and private pension and the level of government's regulation and coordination to influence private pension to act as an old-age income security mechanism was not high. In discussing national pension reform, building a multi-pillar system is considered as a matter of course, but the government's intervention in multi-pillar old-age income security mostly stops at public pension.

Korea's multi-pillar system should be built with the two aims; fiscal stability taking into consideration the system's acceptability and old-age income security taking into consideration the possibility of fiscal burden. It is foremost to seek a rational balance amongst different objectives. At this point in time, if excessive focus is given to fiscal stability then this will undermine benefit adequacy or the contribution may be too high for the people to accept. At the other end of the spectrum is delayed reform, and if that happens then the burden may be excessively transferred to the younger generation. In order to achieve fiscal stability that is in line with both benefit adequacy and system's acceptability, then there needs to be incremental reform in a timely manner and establishment of a balance point in adequate contribution-benefit level.

If we pursue both fiscal stability and reinforcement of the government's basic income security system, then it is more desirable to lower the benefit level than to increase the contribution level. The reason is first, presently the raise in contribution would mean more financial burden to the self-employed population and possible non-compliance, lowering the system's acceptability. Second, by not increasing so much additional burden of national pension system, it is possible to expand and stabilize retirement pension on a mid- to long-term basis. In discussing local and overseas pension reform and also from the perspective of multi-pillar old-age income security system, the adequate contribution level of old-age income security is within 20% (retirement pension premium rate 8.3%, national pension premium rate 9%), and adequate benefit level is approximately 70~80% of income replacement rate. Given this, it is necessary to reduce the rate of national pension's income replacement by a greater margin than that of raising the contribution rate.

Also there needs to be supplementary measure in place to offset the downgrade of public pension benefit level. According to the current talk about pension reform, the plan is to reduce public pension benefit level based on the premise that private pension including retirement pension will be developed by 2030 and that multi-pillar system will be in place, but realistic measures to activate public pension are not implemented in a visible manner.

The current labor market situation and rather short period since the launch of the private pension plan limit our expectation that there will be automatic growth in retirement pension and private pension unless there is breakthrough policy implemented to vitalize private pension. Looking back on the past 1 year since the retirement pension system was introduced, we find that only 3.5% of the companies converted to the new scheme. According to the study by Kim & Kim (2007) about the take-up rate of private pension in Korea, if the current trend continues then by 2030 the percentage of 60+ elderly receiving Retirement Pension and Individual Pension benefits will remain at only 11.7% ~ 21.7%, 10% each. It means that the multi-pillar system will be built at a very slow pace.

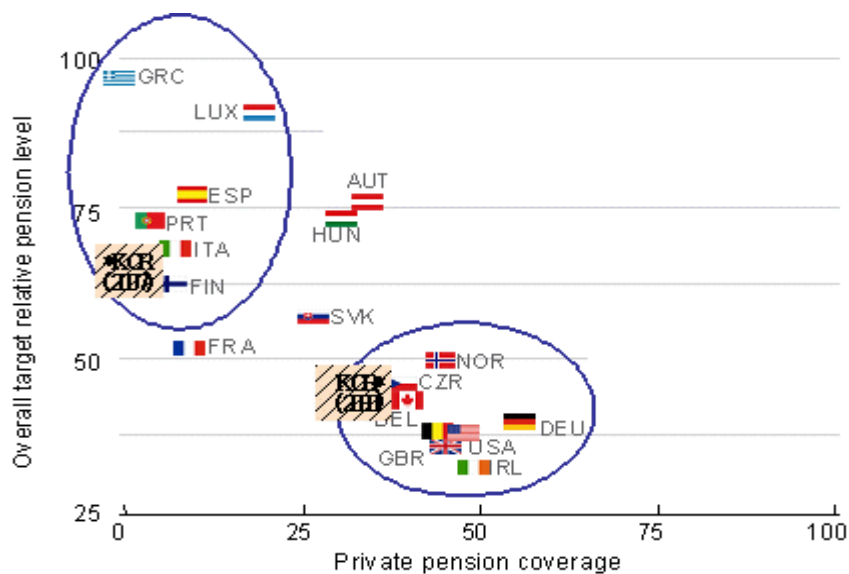
Therefore, in order to convert from public pension-dominated old-age income security to comprehensive income security under the multi-pillar old-age income security system, private pension needs to be vitalized; in other words, we have to enable private pension to play its due role in providing old-age income security. To this end, the government needs to encourage the companies to adopt the retirement pension scheme instead of their current severance pay system.

Third, there needs to be constant dialogue so that the basic old-age pension system introduced in April can position itself rightly vis-à-vis its relationship with the national pension system. Currently, 60% of the 65+ elderly population are entitled to 5% of their average income (approximately 90,000 Korean won), and the benefit level will rise to 10%. The current law intends to reduce the number of

basic old-age pension beneficiaries as those of national pension increase, but the talk is not conclusive yet.

In sum, Korea's long-term multi-pillar old-age income security system can be summarized as reinforcing old-age basic income security by stabilizing basic old-age pension and lowering national pension benefit for the sake of fiscal stability and vitalization of private pension as a countermeasure. Korea's multi-pillar system taking into consideration public and private pensions shall be positioned and deployed as follows.

<Figure 1> Mandatory pension level and private pension coverage



Source : OECD (2006). The 25th Social Policy Working Group Paper

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