1-2014

Korea’s Pensive Pensioners Expect Expensive Expansion

Singapore Management University

Korea's pensive pensioners expect expensive expansion

Published: 22 Jan 2014.

Underneath South Korea's polished veneer of youth culture and high-tech companies are a widening income gap and increasing numbers of aged poor

When South Korean president Park Geun-Hye was forced in September to backtrack on her most important election pledge – a monthly 200,000-won (US$186) pension to all senior citizens over 65 regardless of income level – it led to inevitable political finger-pointing and popular criticism. Political opponents went as far as calling the move "an act of betrayal".

"We have to strike a balance between what we can afford and who needs the help most," says **Jun Kwang-Woo**, former Chairman and CEO of the National Pension Service (NPS) of Korea. "Otherwise, this projected additional cost of 40 trillion won over the next four years for this expanded basic old-age pension expenditure will put too much pressure on our economy."

The age old problem…or old age problem

The Basic Old Age Pension (BOAP) is a means-tested benefit that pays up to 94,600 won (US$90)to the lowest-income senior citizens. Park's plan for blanket coverage was perhaps overly optimistic given the population squeeze currently bedeviling policymakers in Korea and developed countries worldwide: a rapidly aging population and all-time low fertility rates.

"If the current demographic trend continues," Jun told *Perspectives@SMU* on the sidelines of the recent SMU SKBI event *Ageing in Asia: Trends, Issues and Policy implications – a Korean perspective*, "Korea's growth potential could be halved from 4 percent annually to 2 percent. Therefore, Korea needs to take aggressive action to generate income to support an aging population."

To that end, Jun had directed the fund managers at the NPS to diversify its investments. Where only 8 percent of the NPS's assets were put in overseas investments when Jun started his stint in 2009, that figure was 20 percent by the time he left in April 2013. Much of this reflects the change in the domestic macroeconomic situation, where Korean government bonds used to pay up to double-digit percentage returns.

"In the old days, the interest rates were very high in the domestic market," Jun recalls. "All we needed to do was put the money in the government bonds, and we can deliver the necessary returns. But things got tougher with the 2008 Financial Crisis and the excess liquidity and low interest rates."

Defining benefits

Another reason for the need to invest aggressively is the defined benefit nature of the NPS. Whereas Singapore's Central Provident Fund runs a defined contribution scheme with individual accounts, participants of the NPS will have access to a predetermined amount of money drawn from a common pool upon the end of the contribution period. The amount is arrived upon after taking into consideration the length of contribution and the participant's income level.

When the NPS was created in 1988, the initial benefit level – income replacement level – was set at 70 percent of lifetime average income with 40 years of contribution. While it accumulated funds in the beginning with a relative young population, things seemed rosy. As the population aged and fertility plummeted, it soon dawned on the NPS that it would require contribution rates of over 20 percent – far above the current 9 percent – to keep the NPS in the black.

The proportion of the population eligible for pension is forecasted to jump from 11 percent in 2010 to a staggering 37.4 percent in 2050. Even after repeated reforms, the NPS is expected to exhaust its funds by 2060 despite scaling back the income replacement level to the current 50 percent and an eventual 40 percent by 2028. The move is unpopular with those who are currently making contributions, but it does delay the inevitable eventuality of the pot being emptied and the government having to pay for pension out of its budget.

Does that put excessive pressure on NPS fund managers to maximise returns, perhaps even leading them to take excessive risks?

"The only additional stress that they may feel – because this is a public institution, and therefore subject to governmental inspection and review by the National Assembly – is that they need to be extra careful when they make non-standard investment choices," Jun explains. "Examples of such investments would be private equity or real estate deals. If this turns out to be not so profitable, then there will be pressure. However, we have to look at the average return because some deals make money, some lose money."

"Pension fund management is based on a long-term investment philosophy. If there is any pressure on the fund managers, it is to meet the long-term target rate of return. The NPS also has a yearly target. The short answer is: I don't think NPS fund managers are under undue stress or pressure."

Income disparity

The same cannot be said of the middle class in Korea, which now make up 67 percent of the population compared to over 75 percent in 1990. Additionally, the proportion of poor people rose from 7.1 percent to 12.5 percent in the same period.

The need to provide for the less fortunate is rising, but would the pressure be less if Korea had gone with a defined contribution scheme? Is it too late to do so?

"As Korea operates a defined benefits pension system, the burden to provide for an aging population is rising with longer life expectancy and lower fertility," says **Benedict Koh**, Professor of Finance at SMU and the Director of the Centre for Silver Security. "This pressure would have been lighter if Korea had adopted a defined contribution scheme which is practised in Singapore. Given that Korean policymakers are currently mulling over raising pension contribution rates, it may be opportune to introduce a hybrid defined contribution system so that Koreans can assume more responsibility for their retirement."

The middle class squeeze is a global phenomenon that is not unique to Korea, but the severity of it is amplified by the domination of the economy by a handful of family-run *Chaebols* or conglomerates. As globalisation concentrates resources in the hands of the wealthiest, its effects are more keenly felt in Korea. The increased number and visibility of the aged poor have led to calls for higher social spending, but Park's frustration in implementing her pension plans illustrate the difficulty of the task.

"Income polarisation can appear more profound in Korea because of the concentration of economic power in large conglomerates," says Jun. "To relieve this, it requires increased welfare-related expenditure to mitigate this gap and to help the most vulnerable groups in the society."

"However, spending on these expenditures out of budget is a formidable task. Sustaining fiscal soundness is a key policy goal for the future of this country. Any welfare programme we design has to be a sustainable welfare programme within the framework of economic growth."