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Recent trends in reforming the pension system in Israel

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RECENT TRENDS IN REFORMING THE PENSION SYSTEM IN ISRAEL

by

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S U M M A R Y

In Israel, as in other Western countries, pension-related issues have gained high priority on socio-economic policy-making agendas over the past decade. The occupational pension system has undergone several reforms aimed at (a) reducing the actuarial deficits accumulating in pension funds; (b) eliminating cross-subsidy elements within the system in order to enhance the actuarial fairness and the relation between pension payments and premiums; (c) integrating new workers joining the public sector into the funding pension scheme rather than in the budgetary scheme. These reforms tackled some of the problems, yet further reexamination is called for. The current debate is whether to enact a mandatory pension law so as to overcome the problem of partial coverage in the occupational pension.

I. Introduction

In Israel, as in other Western countries, pension-related issues have gained high priority on socio-economic policy-making agendas over the past decade. The factors motivating reforms of national and occupational pension systems are common to all countries: population aging, a decrease in labor force participation, a rise in the incidence of early retirement, and a changing attitude towards the role played by the government in the pension system.

Demographic forecasts for OECD countries indicate that the dependency ratio (i.e., the ratio between the old-age population and the labor force) will rise by a quarter to one third between 2000 and 2020 and will, more or less, double between 2000 and 2050. In 2020, the dependency ratio among EU countries is expected to range between 25 percent (Ireland) and 40 percent (Italy), as compared to 19 and 29 percent in 2000, respectively. In 2050 the ratio is predicted to reach about 65 percent in countries such as Italy, Spain, Greece and Japan (as compared to 27-29 percent in 2000) and 38-46 percent in the United States, Canada, the United Kingdom and northern Europe (as compared to 21-29 percent in 2000).¹

In 2000, public expenditure for pensions in EU countries reached a weighted average of some 10 percent of the GDP. Variation among these countries is relatively high, ranging from 4.5-5 percent for the United Kingdom and Ireland to 14.5 percent for Austria and Italy, with all others in between with ratios between 8 and 12 percent. The forecast for 2050 indicates that these figures will rise to an average of 13 percent, ranging from 4 percent for the United Kingdom to 17.5 percent for Spain. Consequently, financing pension payments will require an increase in the tax burden or diversion of resources from alternative uses, especially in countries where pensions are primarily financed on a pay-as-you-go (PAYG) system.²

In certain respects, Israel is in a better position than many other Western countries. First, its population is relatively young: 9.8 percent are aged 65 and up, with a dependency ratio of 15.8 percent. The forecast for 2020 predicts that these figures will rise to 12 and 19 percent, respectively. Second, the PAYG public pension system in Israel, that includes National Insurance Institute (NII) benefits and a budgetary pension for the public sector is not as dominant as it is in many European countries. In 2000, the public expenditure on pension payments was about 5 percent of the GDP – a low percentage from an international perspective. Israel's rather well-developed earnings-related occupational pension scheme is largely based on a funding system, even though the major part of the pension funds reserves is invested in earmarked government bonds. However, in a certain respect Israel is in an inferior position than Western countries because of its lower labor force participation rates, which erodes the country's demographic advantage. Considering the *economic* dependency ratio, which perceives as dependents not just the elderly but also non-participants of working age and the unemployed, one finds that the gap between Israel and European countries is narrower than the gap in the demographic dependency ratio.

II. Major Problems of the Pension System in Israel

The two-tier pension system in Israel – the basic flat-rate mandatory NII benefit and the occupational pension – suffers from several problems which hamper its ability to insure income to all retirees at present and in the future. The reform in the occupational pension introduced in the second half of the 1990's tackled some of the problems, yet further reexamination regarding the necessary changes in the structure and functioning of the system is called for. The two major problems still lacking a satisfying solution after the implementation of the reform are:

-) א) *Uncertainty regarding the ability to avoid a fall in the living standard of the elderly population*: the need to allocate increasing resources to the financing of pension payments, at the time when the size of the active population in the labor market shrinks as well as the amount of collected contributions, is causing an exacerbating financial imbalance. The rise in longevity, on the one hand, which is expected to continue in the future, and the decrease in labor force participation, and particularly the expansion of early retirement, on the other hand, is leading to a fall in the ratio between the number of years of work to years of retirement. Furthermore, the new immigrants, many of whom arrived in Israel at a relatively advanced age, therefore becoming eligible for the basic NII pension immediately after their arrival or after a short work period in Israel, impose an additional burden on the system. These developments have resulted in an accumulated actuarial deficit in the pension funds. The reforms that have already been implemented will contribute to reducing the deficit, although not sufficiently, given that the above developments are expected to continue in the future.
-) ב) *Partial coverage of the occupational pension*: About 40 percent of the working population are not covered by any pension plan. Coverage rates are especially low among low-wage earners and among employees in traditional and non-organized industries. This same holds for the self-employed. The developments in the labor market, mainly the expansion of non-traditional and temporary employment arrangements and the competition of foreign workers for low-wage jobs might exacerbate this problem. The inequity embodied in the partial coverage will be translated in the future to greater income inequality and poverty among the elderly, which are already high.

In view of these problems, which do not characterize only Israel but also many other countries, policy makers are seeking solutions in several directions:

- Expansion of pension coverage.
- Reducing pension funds deficit by one or more of the following: tying the pension level more closely with the individual accrued amount, increasing premiums and raising the pension age, strengthening incentives for labor force participation and introducing disincentives for early retirement.

3. The Pension System in Israel

Israel's pension system comprises two tiers: the state tier, guaranteeing a basic pension to nearly all elderly persons and the occupational earnings-related tier, provided by pension funds or by the state for civil servants. The first tier, administered by the NII, fulfills an important role in the redistribution of income and in reducing poverty among the elderly, while occupational pensions prevent substantive decline in standard of living among elderly persons following retirement from work.

3.1 NII Pensions

The NII old-age and survivors' insurance plan guarantees a basic pension to elderly persons who meet its eligibility criteria. The plan is applied almost universally: benefits are uniform, independent of earnings during work period and only partly dependent on the number of years the beneficiary has been insured.

Besides the basic benefits, supplements are provided for dependents, seniority and deferred retirement. The amount is determined as a percentage of the national average wage and is updated according to changes therein. Elderly persons eligible for both old-age and survivors' benefits receive the full amount of the former and half that of the latter. Benefits for persons of *conditional age* (60-65 for women and 65-70 for men) are subject to an earnings-test, but benefits remitted to those of *absolute age* (women 65+ and men 70+) are independent of earned income. The plan is financed primarily by premiums paid by the insured population and the employers, with government participation (15 percent of amount collected). The NII pension scheme is not purely a PAYG one, as it is backed by assets sufficient to finance 3-6 years of expenditure. Surpluses are invested in government bonds with a guaranteed yield of 5 percent, on average.

Elderly persons who do not meet the eligibility criteria, primarily new immigrants, receive special old-age pensions through the NII. Furthermore, the Income Support Law entitles low-income elderly to income support benefits, guaranteeing them a minimum income for subsistence as determined by law. The special pensions as well as the supplementary benefits are financed by general revenue.

In 2001, benefits were paid to 90 percent of the elderly in Israel: About one third of the beneficiaries were entitled to income support (16 percent of PAYG pension recipients and 95 percent of those receiving special pensions). Payments for old-age and survivors' pensions account for one-third of all NII benefit payments, amounting to 3 percent of the GDP. PAYG pensions constitute 80 percent of all pensions remitted to the elderly.

No substantive changes were introduced in the NII old-age and survivors' pension plan over the past two decades except payment of old-age pensions to housewives (1995). Nevertheless, the system was affected by developments that took place in the labor market and in the occupational pension plans. First, the increase in the women's labor force participation rate led to a rise in the percentage of women entitled to pensions on their own right. This trend intensified on enactment of the Housewives Law, that entitles certain housewives to old-age pensions without requiring a minimal insurance period or premium payment. Second, as a result of the increased percentage of elderly persons retiring from work with occupational pensions or with income from savings and an increase in the percentage of women

receiving pensions on their own merits, the percentage of PAYG pensioners entitled to income support has declined drastically (from 36 percent in the early 1980s to 16 percent in 2001).³ Third, the percentage of deferred retirement increment recipients also declined because of early retirement (22 percent as compared to 14 percent, respectively and only 10 percent among new participants), primarily among men.

3.2 Occupational Pensions

The second tier consists of occupational pensions anchored in collective agreements (or individual contracts between employees and employers) and in State laws guaranteeing budgetary pensions for civil servants. The occupational pension system – excluding budgetary pension – is administered by pension funds, primarily those of the Histadrut (Israel General Federation of Labor), insurance firms and provident funds. Budgetary pensions are financed on a PAYG basis through general revenue, whereas other occupational pensions are provided on a funding basis. The latter are meant to be financed by premiums paid by employers and employees and by the yield on invested reserves. Pension funds and insurance firms are regulated and supervised by the Capital Market, Insurance and Savings Department in the Finance Ministry. Some of the bodies operating in the pension market also provide private savings plans.

Over the past few years, the occupational pension system has undergone several reforms aimed at (a) reducing the actuarial deficits accumulating in pension funds; (b) eliminating cross-subsidy elements within the system in order to enhance the actuarial fairness and the relation between pension payments and premiums; (c) integrating new workers joining the public sector into the funding pension scheme rather than in the budgetary scheme.

Pension reforms were instituted in 1995: Histadrut pension funds were closed to new members and new, competing funds were opened. The older funds continue to provide a DB (defined benefit) pension plan guaranteeing pension rights of 2 percent of the wage base for each year of seniority at work up to a maximum of 70 percent. The pension are adjusted to inflation. The determining wage for pension varies across pension funds: in some the pension is based on the average wage during the past three years, whereas in others – on the average wage during the best 25 years. The official age of eligibility for a full pension in keeping with accumulated rights is 65 for men and 60 for women. Women may begin receiving early pensions from age 55 and up and men from age 60 and up, but each year below the official pension age entails a 5 percent reduction in pension. One who has not accumulated maximal pension rights by age 65/60 may continue to do so until age 70/65. All premiums collected by the veteran pension funds are invested in earmarked government bonds bearing 5.57 percent interest annually. According to the reform agreed upon by the government and the Histadrut, the government undertook to maintain the rights of existing pensioners and fund members and not raise premiums. Furthermore, no decision was made regarding mechanisms for prevention of actuarial deficits.⁴

In contrast, the new funds, that also operate on a funding basis, seek to maintain actuarial balance at the fundwide level, guaranteeing pensions that combine elements of DB and DC (defined contribution) plans. The accrual of pension

rights in the new funds varies with gender, age and seniority in the fund (instead of fixed rate accrual for each year of insurance). Pension rights diminish with age, ranging (for men) from an annual pension coefficient of 7 at age 25 to 1.3 at age 65. The new table of pension rights accrual aims at eliminating the cross-subsidy between men and women and between those who joined at younger and more advanced ages, respectively. Furthermore, a ceiling on insured earnings equal to twice the average wage was set. Participants' rights are calculated according to average annual yield on invested premiums: 70 percent are invested in earmarked government bonds and 30 percent in the free market, subject to restrictions stipulated in the regulations.⁵ Pension rights on wages exceeding this ceiling are determined purely according to DC plan. In other words, participants receive a pension based on premiums paid and the yield on free market investment for the share of their wages that exceeds twice the average wage. Finally, the issue of actuarial balance mechanisms for the new funds – especially regarding adjustment of rights and premiums to changes in life expectancy – still arouses differences of opinion between the Histadrut and the Finance Ministry. A Cabinet decision concerning this reform indicated that the government will provide a safety net to cover yield risks and increased life expectancy. The respective parties maintain varying interpretations of this provision, however. Only in 2002 did the government succeed in forcing the pension funds to adjust the pension rights to updated mortality tables.

Another stage in reforming the occupational pension system calls for transition of new civil servants from the budgetary scheme to funding pensions managed by the new funds, a policy that undoubtedly will be extended gradually to other public sector employees. The changes instituted in the pension funds and in the budgetary schemes created a “second generation” of participants with reduced pension rights who assume a greater burden of actuarial risks regarding life expectancy and rate of return entailed by investment in the free market. The effect of the reform on women's pension rights is stronger: not only do more women enter the labor force at an advanced age, but their working life is less continuous.

New funds still account for a relatively small share of all pensions. By the end of 2000, old and new pension fund assets totaled about 10 percent of the public financial asset portfolio, of which some 93 percent is concentrated in the older pension funds. The Histadrut funds now hold about 75 percent of new fund assets. Some 450,000 of the 550,000 participants in these new funds are insured with Histadrut funds.

3.3 Coverage under the Occupational Pension System

Little current information is available on the percentage of employees insured with pension funds in Israel. The Ministry of Finance publishes statistics on savings in new pension funds, but not on savings in other channels such as provident funds and executive insurance plans. Recently, two studies were published⁵ that estimated the percentage of employees and self-employed insured with pension funds (including the budgetary scheme, executive insurance and provident funds) according to income tax returns. Terkel and Spivak (2001) found that 61 percent of salaried employees save for pensions, as compared with 70 percent determined by Dahan (2002).⁶ Furthermore, Terkel and Spivak indicated that pension coverage is very low among the weaker population sectors: the

likelihood of an employee to be insured in any pension plan increases with the wage level, age, nationality (Jewish or not), and membership in unionized industries. While only 32 percent of employees in the lowest decile have pension insurance, the rate rises gradually to 82 percent in the upper deciles. Research in other countries has also revealed poor pension coverage among low wage earners. Akyeampong (1999),⁷ for example, discovered a similar phenomenon in Canada. In Israel, it was also found that pension coverage is low among young people (40 percent) rising to 70 percent among people of principal working ages. Coverage is higher for employees of well-organized industries with strong trade unions – such as electric and water companies – and lower for those in construction and agriculture. There is a broad gap in coverage rate between Jews and Arabs (64 percent and 43 percent, respectively). The pension coverage problem in economically weaker sectors is even more marked among the self-employed than among employees: Only 15-20 percent of the self-employed in the lowest quintile (of this population group) have any kind of pension insurance for which they are entitled to tax benefits.

3.4 The Economic Situation of the Elderly

The economic situation of retirees has improved over the past two decades. Between 1985 and 1997, the rate of the veteran (not new immigrant) elderly who received an old-age or survivors' NII benefit went up from 70 to 80 percent. Among men, this rate remained stable at a high level of about 94 percent, while increasing from 56 to 80 percent among women. An increase was also observed in the rate of those receiving occupational pension – from 31 to 42 percent – again with a higher rate of increase among women (from 21 to 33 percent) than among men (from 47 to 59 percent).⁸ This development resulted from the maturation of the pension system, including an expansion of coverage, accompanied by a growth in women's labor force participation.

The improvement is notable in the level of the occupational pensions as well, although the average level of the pension is still relatively low and the inequality in the distribution of pensions is still high. In 1997, 64 percent of occupational pension recipients had pensions which did not exceed half the average wage (as compared to 85 percent in 1985), while only 7 percent had pensions higher than the average wage (as compared to 2 percent in 1985). An additional trend revealed by the data is the decreasing rate of the elderly having income from work – from 16 percent to 11 percent, reflecting an increase in early retirement from work among men.

An analysis of the income composition of elderly households shows differences between various groups. Elderly households in the lowest quintile had no occupational pensions and their income was derived solely from NII benefits. On the other hand, elderly households in the upper quintile had diversified income: 37 percent occupational pension, 36 percent income from work, 14 percent NII benefits, and 13 percent from other sources. The income of the upper quintile was almost 5 times as high as that of the lowest quintile. The new immigrant population subsisted on NII and other State benefits. The non-Jewish population too subsisted mainly on NII benefits, and only 12 percent of their income stemmed from occupational pensions.

NII data shows that poverty among the elderly is relatively high: about a quarter of all elderly households have net income lower than the poverty line, despite the relatively high contribution of transfer payments to reducing poverty among the elderly. The inequality of income distribution among the elderly too is higher than that characterizing the population as a whole.

4. Labor Force Participation and Early Retirement

As mentioned above, the need for changes in pension arrangements stems from the continuous increase in the number of non-working and retirement years relative to the number of working years. This issue has two aspects – economic and legal. Since there have been no changes in the laws regarding retirement or entitlement to pension in the past ten years, it follows that early retirement has been the consequence of economic and social factors only.

4.1. Explanations for early retirement⁹

The increase in early retirement occurred mostly among the low-educated population. Here a “scissors effect” took place: a reduction of demand for local workers to perform manual work, on the one hand, and a rise in social benefits, on the other.

The demand for low-educated local (not foreign) workers decreased mainly in construction, agriculture, traditional manufacture, and to a smaller extent in the personal services. This occurred as a result of a number of parallel processes: *first*, the rapid influx of an alternative labor force from outside sources – workers from the territories and especially foreign workers – who competed for low-skill jobs. The wages of the latter remained at a particularly low level due to their lack of mobility (among employers). As a result, the wages of local workers went down as well, especially in construction, agriculture and personal services. *Second*, the liberalization of imports in low-skilled labor-intensive industries (textiles, food, etc.) acted in the same direction. *Third*, the long-range trend of technological changes led to an ever-increasing preference for educated and skilled labor and to a gradual reduction in demand for low-skilled labor. A more detailed analysis reveals that the main factor accounting for the decrease in demand for low-educated workers is the liberalization of the import of merchandise and labor, and the less contributing factor – the technological changes. The reduction of demand has led to a lowering of wages, a growth in unemployment and an increase in labor force drop-out and early retirement.

At the same time, there was a rise in the relative weight of non-labor income among the low-educated population – particularly from disability and income support benefits. The changes in the formal rules of entitlement as well as in the level of benefits explain this development to a certain extent, especially in the case of income support. In the first half of the 1990’s, there was an increase in the level of the minimum income guaranteed to single-parent families and to adults aged 46 and over. The number of recipients of disability and income support benefits rose at a higher rate than that of the relevant population. Between 1985 and 2000 the number

of disability benefit recipients doubled (from 62,000 to 135,000) while the number of income support beneficiaries went up fivefold (from 25,000 to 128,000).

New immigrants who arrived in Israel after 1990 are over-represented among the income support beneficiaries (40% as compared to 16% in the total population). Beyond the influence of the immigration in 1992-1996, the rise in the number of income support recipients can be explained mainly by developments in the labor market – as described above – and to a lesser extent, by the extension of the policy to grant income support beneficiaries additional cash or in kind assistance in housing, health, transportation, and municipal tax. The income support benefit with the additional assistance ensures a substantial share of recipients an effective income higher than the minimum wage, even though minimum wage earners are also entitled to some of these additional benefits. In the context of early retirement, it should be noted that about a quarter of the income support recipients are aged 50 or over. Among new immigrants, this rate is about one third.

There is also a factor that influences early retirement among high-educated workers in the civil service and the local authorities. In the 1990's, persons retiring at age 50 and over were offered improved pension conditions. These included an addition of pension rights – over and above the usual 2% – for every year of seniority, an extension of the “adaptation period” for which a salary is still paid after the termination of employment, and a promotion in wages before retirement. Finally, in the civil service one may purchase rights for the years for which pension was not paid, the payment being subsidized and financed by the employee in the form of a low-interest loan.

What caused these developments to occur in the 1990's and not before? They occurred mainly in the period of the massive wave of immigration from the former Soviet Union in the early 1990's, following the recession and the rise in unemployment during the late 1980's. With hundreds of thousands of immigrants entering the labor market in a period of recession, it is possible to justify the policy of encouraging older workers to retire in order to make more jobs available. The immigration apparently had another effect as well: the extensive system of social support set up for the new immigrants “overflowed” to the social support system of the population at large.

To what extent are the developments in the labor market and in the benefit system unique to the 1990's – and will be therefore less felt in the 2000's? Regarding the low-educated, it is possible that some of the factors of increased retirement will be weakened: the relative weight of the low-educated workers is decreasing, and a policy of reducing the number of foreign workers may be implemented. However, a turning point in the early retirement trend of the mid- and high-educated workers can occur only if the present policy changes.

4.2. Proposals for postponing the retirement age

In September 1997 the Ministers of Finance, Labor and Welfare set up a public committee to reexamine the retirement age issue. The committee was requested to express its opinion on the following questions:

1. Should the retirement age be anchored in law, or should it be left – as at present – to collective agreements? The committee recommended anchoring the age of retirement in law, since the scope of collective agreements was dwindling. Furthermore, anchoring the retirement age in law would prevent pressures of interest groups for an earlier retirement and would make the age of retirement in occupational pensions consistent with the age of retirement in NII old-age pension.
2. Should the age of compulsory retirement be raised (currently 65 for men and women) together with the standard age of entitlement to pension (the age in which the full pension can be obtained with no reductions)? The committee recommended gradually raising both ages to 67 for men as well as for women. The retirement age will be raised by one year every three years, a process to be completed in 6 years for men and in 21 years for women.
3. Should the entitlement age for NII old-age benefits be changed? The committee recommended that the conditional age for receiving NII benefits (subject to an earnings test) be gradually raised to 67 for both men and women and that the absolute age remain at 70 for men and be raised from 65 to 70 for women.
4. Should the age of early retirement be raised? The committee recommended that in the old pension funds early retirement will be 60, for both men and women (as compared to 65 and 60 today, respectively), and will be accompanied by a lower reduction rate in the pension level – 4.3 percent (as compared to 5 and 6 percent for men and women, respectively, today). Furthermore, the committee recommended setting up an expert committee to examine the possibility of early retirement before the age of 60 in certain occupations and in the civil service.

Beyond the above recommendations, the committee felt that the pension increment for deferred retirement should be increased. Today every year of deferred pension provides an additional 2% of the determining wage, up to a maximum of 70% of this salary (that is, 35 years of work). The committee recommended that those who delay retirement be able to accumulate up to 80% of the determining wage.

Not all the recommendations above were agreed upon by all members of the committee. The employers' and the trade unions' representatives objected to raising the retirement age beyond 65, and in particular, to making the retirement age compulsory and anchoring it in law, as this would interfere with collective agreements and labor market flexibility. The committee submitted its recommendations to the government in August 2001. To date, a discussion on the subject has not yet been held. However, as described in the first part of this section, most of the increase in early retirement did not stem from changes in laws or regulations, but is rather due to economic processes, mainly the liberalization of

imports, a significant increase in the influx of foreign workers and a notable extension of the social security net. It is very possible that a lengthening of the duration of participation in the labor force shall be influenced to a large extent by changes in policy in these spheres, and not only by changes in retirement rules.

5. Approaches to the Structure of the Future Pension System

There are two central approaches to the desirable structure of the pension system in Israel:

- (a) Maintaining the existing structure, composed of a mandatory NII basic old-age and survivors' pension and a non-mandatory occupational pension, as designed in the 1995 reform;
- (b) Expanding the coverage of the occupational pension insurance to all workers – employees as well as self-employed – within the framework of a mandatory law.

Opponents to the mandatory pension legislation raise a number of arguments:

- Mandatory pension will raise labor costs, especially in industries where workers suffer from a relatively low coverage. Employment in these industries have been most affected by the structural changes in the labor market. Raising labor costs will further reduce employment.
- The role the government plays in the pension system should be focused on guaranteeing basic income to the elderly, in order to reduce poverty, rather than expanding its involvement in the supplementary pension.
- Mandatory pension imposes on individuals saving patterns which do not necessarily conform with their time preferences.
- As long as the pension funds continue to invest their reserves in earmarked government bonds which yield a guaranteed rate of return, the expansion of pension coverage following the enactment of a mandatory pension law will increase the scope of non-tradable bonds issued by the government, rather than channel the reserves to the capital market.

On the other hand, proponents of the mandatory pension legislation point out social justifications for enhancing government intervention in the area of pension insurance:

- Pension coverage is currently relatively low, especially among low wage-earners, and its expansion will reduce poverty and economic gaps among the elderly as well as government expenditure on income support for poor elderly.
- Employers' contributions to the pension funds are an integral part of the return to work and of the social rights granted to workers. Low wage and non-organized workers, whose bargaining power is relatively weak, are therefore discriminated against under the current system.

- Awareness of saving for retirement is relatively low among young workers, who might end up with pensions insufficient to avoid a drastic fall in their standard of living.

The controversy over the necessity of a mandatory occupational pension has significantly diminished in recent years. All parties involved – the government, the employers' association, and the trade unions – are currently discussing, although without commitment, the features of possible mandatory pension legislation. Furthermore, in 2002 the parliamentary Committee of Labor and Welfare intensively considered a number of private proposals for mandatory pension legislation. All proposals, whether raised by policy makers or experts, have several features in common:

- An obligation of the employer to insure his workers, and an obligation of the self-employed to insure himself, in one of the certified pension funds;
- A determination of the insurance premium rates imposed on the employee, employer, and the self-employed;
- The provision of pension insurance by private or non-profit providers under government regulation, as is currently the situation;
- The provision of pension plans which are more or less similar to those currently existing in the new funds. Pension rights accrual according to gender, age, and seniority in the fund up to a ceiling on insured wages which ranges, in the various proposals, between the average wage and twice the average wage. The actuarial balance will be maintained at the fund level rather than at the individual level. Pension rights on wages exceeding this ceiling will be determined purely according to a DC plan.

There are also a number of differences among the various proposals. Some proposals suggest that the actuarial balance at the fund level should be maintained by adjusting rights to the changes in life expectancy and to the return on the fund's investments. This means that all the fund's members are collectively bearing the risk of life expectancy and financial return. Other proposals advocate the adjustment of insurance premiums or structural adjustments (such as the postponement of the retirement age) as a means of maintaining actuarial balance. A controversy arises over the issue of investing fund reserves in earmarked government bonds.

Some proposals recommend a gradual movement towards investments in the capital markets, providing that the government guarantees a safety net for the financial risk, such as a minimum rate of return on premiums collected below the ceiling. Others prefer that the government continue to issue earmarked bonds, at least for 70 percent of the premiums accrued up to the average wage.

The discussions on the future of the pension system in Israel have focused on the mandatory pension law rather than on the first tier – the NII old-age and survivors' benefits – or on the integration of the two tiers. However, some proposals have also been raised in connection with the NII benefits. One proposal is to raise the level of the universal benefit or, at least, the minimum income guaranteed by the Income

Support Law, in order to enhance their re-distributional effects and to partially offset the growing uncertainty underlying the occupational pension level. A different proposal is to tax the NII benefits or to subject them to income tests.

6. The New Policy (2002-2003)

The Israeli economy is currently in a deep recession, which is expected to aggravate in 2003. During 2002-2003, the government adopted a new economic policy which brought about a reduction in all NII benefit levels. While this policy has focused on income support, unemployment and child allowances programs, it led also to a reduction in old-age and survivors' benefits. The latter benefits have been reduced by 4 percent and have not been adjusted to changes in the average wage. In two years they lost 12 percent of their purchasing power. On March 2003, the Ministry of Finance submitted to the government a new package of policy measures, which included a proposal to freeze the old-age and survivors' benefits till the end of 2006 and from 2007 – to adjust the benefits according to inflation rather than to the average wage. This means a continuous erosion in the level of benefits in real terms and relative to the average wage, which is a common indicator of the standard of living in the population.

As regards the occupational pension, the Ministry of Finance proposed an additional reform which includes the following measures:

- Earmarked bonds for the pension funds will gradually cease to be issued (over the next 10 years). Deficits exceeding those calculated on the basis of a 4 percent rate of return on investments will be covered by the government
- Pension premiums will increase by three percentage-points: two additional points to be paid by the employee (an increase from 5.5 to 7.5 percent) and one point to be paid by the employer (from 12 to 13). In order to avoid an increase in labor costs, employers' participation in the finance of NII benefits will be reduced by one percentage-point.
- Employees covered by budgetary pension will begin paying 2 percent of their wage as premiums.
- The recommendation of the public committee on retirement age will be adopted: the retirement age will be gradually set at 67 for both men and women.
- Budgetary pensions and pensions paid by the old funds will be reduced, for current recipients, by two percent.

These proposed measures are not fully accepted by the Labor Union nor the Employers' Association. However, if approved by the government and parliament, they are bound to reduce the actuarial deficits of the old pension funds and future government expenditures on budgetary pensions. All this will be achieved at the price

of a lower and uncertain occupational pension level. At the same time, the erosion in the NII benefit, which will be stronger in the future if all the recommendations are accepted, will undoubtedly expand poverty among the elderly.

ENDNOTES

¹ John Chown, “The Pension Time Bomb and the Future of European Union”, paper presented at the Ninth International Research Seminar on “Issues in Social Security”, Sigtuna, Sweden, June 2002.

² Robert Fenge and Martin Werding, “Ageing and the Tax Implied in Public Pension Schemes: Simulations for Selected OECD Countries”, paper presented at the Ninth International Research Seminar on Issues in Social Security, Sigtuna, Sweden, June 2002.

³ The number of families eligible for income support benefits has also declined among recipients of survivors’ benefits (51% vs. 32%, respectively).

⁴ The principal change in calculating pensions in the older funds relates to limitation of the wage increase rate covered by pensions to 2% a year for rights already accumulated and 1.75% for future rights.

⁵ The effective guaranteed yield of special bonds is 5.05% per annum. It is assumed that the average long-range yield on investment of the remaining 30% will be 3.5% and that the consequent average yield on investment of pension premiums will be 4.6%

⁶ Eran Terkel and Avia Spivak, “Pension Coverage in Israel,” *Economic Quarterly*, October 2001 (in Hebrew); Mumi Dahan: “Mandatory Pensions: Estimated Special-Purpose Bond Increment,” April 2002 (Draft, in Hebrew).

⁷ Akyeamong, Ernest. “Saving for Retirement: RRSPs and RPPs,” *Statistics Canada* 75-001, Summer 1999.

⁸ Ramsees Gharrah, Brenda Morginstin, and Miriam Shmelzer, “Income of the Elderly in Israel”, Research Paper 77, Research and Planning Administration, National Insurance Institute, 2001 (in Hebrew).

⁹ Shmuel Amir and Ruth Klinov, “Changes in the Participation of Men in the Labor Market”, 2002 (Draft, in Hebrew).