U.S.-KOREA BUSINESS COUNCIL

KOREA'S AGING SOCIETY CHALLENGE

PRIVATE SECTOR SOLUTIONS TO MEET RETIREMENT AND HEALTH NEEDS

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Introduction

Korea's rapid development over the past few decades has caught the attention of the world, registering advances across many industrial areas that are impressive by any measure. Korea's rapid economic growth also has made possible enormous gains in the wealth and health of the Korean people over a relatively short period of time.

Along with Korea's many successes comes a new kind of challenge – one that is driven by the demographic reality of a rapid increase in Korea's elderly population. Combined with Korea's low birthrate, Korea's workforce is projected to shrink significantly over the coming decades, placing tremendous strain on government finances dedicated to fund retirement and health benefits for retirees. Moreover, if left unaddressed, structural economic issues and other weaknesses in the national pension and health insurance systems also will put further stress on government spending for retirees.

For Korean policy makers, the need to successfully navigate these challenges and develop new approaches to help manage the retirement and health security needs of an aging population is quickly becoming a pressing priority. Maintaining a focus on policies that help sustain Korea's economic growth will remain critical to funding the needs of future generations.

However, growth alone will not be enough; the magnitude of the challenge that Korea faces requires new approaches and new thinking. If reforms are implemented in the near term, it can greatly improve Korea's trajectory in meeting this challenge, putting Korea on track to be able to provide for further improvements in the prosperity and health of Korean citizens for decades to come.

In particular, implementing reforms that provide greater opportunities and incentives for individuals to invest for their retirement, as well as improve their ability to plan for and manage retirement and health needs and challenges through diversified insurance products, will both lower the looming fiscal strain on government social security programs and provide individual citizens with greater choice and capacity to plan for their own future and retirement.

As Korea begins to face these important challenges, the U.S.-Korea Business Council (USKBC) offers the following policy recommendations in the belief that fresh approaches will enable Korea to successfully leapfrog over its various demographic and structural challenges and provide the Korean government greater fiscal freedom to ensure that all Korean retirees are able to benefit from a quality retirement and healthcare.

Korea's Aging Society Challenge

As is the case across many advanced economies today, Korea's policy makers will need to pursue new approaches to help meet the enormous fiscal challenge of fulfilling the financial and health needs of its aging society. Compared to most other OECD economies, however, Korea has much further to go to meet this challenge:

- **Korea's pension funds are underfunded**. The average ratio among OECD countries of assets in pension funds to national GDP totaled 84% in 2013 – yet Korea's ratio remains markedly low, standing at only 6.5%.

- **Returns on Korea's pension funds are not keeping pace**. Investment returns on pension funds in Korea grew only 1.1% annually on a real basis, on average, over the period 2008-2013. This is among the very lowest rates of return among OECD nations.

- **Koreans face a gap between their retirement needs and the capability of pensions to fund these needs.** Korean pensioners face an income replacement rate – the percentage of pension benefits as a percentage of pre-retirement earnings – that is well short of the OECD average. Korean median income retirees earn only 49% of their pre-retirement earnings from pensions, compared to the 69% average ratio among all OECD countries.

- **Koreans also face a gap in coverage for under the national health insurance system.** The "out-of-pocket" expense ratio for services covered under the national health insurance program is the highest among OECD nations, requiring individuals to pay an average of 37% of their healthcare costs.

Korea faces important choices in crafting policy responses to help fill these gaps, as well as to meet the enormous new fiscal strains of its aging society into the future. Increasing public financing or sharply reducing benefits of public social security programs are widely discussed as inevitable policy choices; neither, however, are desirable solutions.

But with careful planning and proactive steps today – before Korea's demographic realities evolve into an unsustainable crisis for public finances – Korea still has time to catch up and lead in this area by improving incentives and opportunities for its citizens to access a greater array of private sector services that help them meet their financial and healthcare needs in their retirement years.

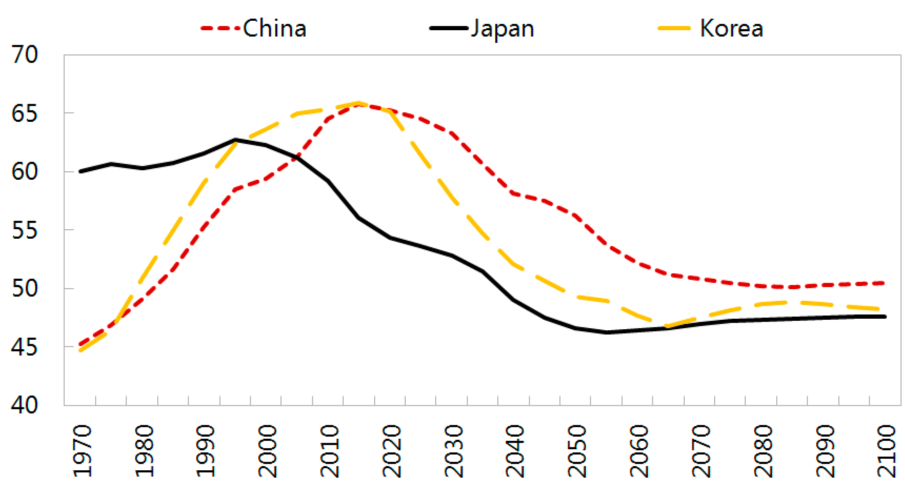
Some of the most significant challenges which are particularly acute in Korea's case, and which further underscore the need for swift and comprehensive action to adopt new policy approaches and solutions, include the following factors.

Demographic Challenges

Korea's society is aging particularly rapidly. Estimates from Korea's national statistics office indicate that more than 14% of the population – over 7 million people – will be over the age of 65 by 2017 (up from just 7% in 2000). United Nations estimates suggest that the 60-and-older age cohort will make up nearly 40% of the population by 2050, with the average age hitting 50 by 2045.

Complicating this trend is Korea's birthrate, which has plummeted in recent years and is currently the lowest in the OECD at 1.19 children per woman (OECD records show that Korea recorded its lowest ever birthrate of 1.08 births per woman in 2005). In 2013, Korea recorded just 8.6 births per 1,000 Koreans; in 1970, there were 31.2 babies born per 1,000 people. According to a study commissioned by the National Assembly Research Service, Korea's current population of about 50 million people will fall to 20 million by the end of the century if the current fertility rate stays constant – an unlikely, yet concerning, scenario.

Working-Age Population Ratio
(In percent of total population)



Source: The United Nations *World Population Prospects 2012.*
Note: Working age is 20-64.

An aging population coupled with a low birthrate creates a host of challenges for Korea. If current trends continue, Korea is set to become one of the oldest countries in the OECD by 2050. The dependency ratio – the ratio of people younger than 15 or older than 64 to the working-age population – is rapidly increasing. By 2050, the working-age population will have shrunk to roughly what it was in 1960, resulting in a wide deficit between the number of workers paying taxes and the number of pensioners reliant on social safety nets. Korea has already encountered difficulty providing financially for its existing elderly population, nearly half of whom live in poverty; given current estimates that Korea's workforce will begin shrinking as early as 2017, mounting pension obligations are likely to create a social security problem of major proportion.

Structural Economic Challenges

Korea's ability to overcome the challenges of financing its aging society is further compounded by the realities of slower economic growth. Compared to more rapid annual growth registering closer to 7 percent prior to the 1997 Asian financial crisis, Korean's economic growth has fallen over the past decade, registering around 3.5-4 percent per year on average. For 2015, the Central Bank of Korea and the International Monetary Fund (IMF) both have cut anticipated growth rates, predicting growth of only 2.8 and 3.3 percent, respectively.

Although it goes beyond the scope of this paper, there are some specific structural issues that underlie both the slower growth of the economy and the challenges of financing Korea's aging society needs. These include rising youth unemployment; the continued importance of the *chaebol* which generate relatively few jobs relative to their economic importance and output; and a lack of innovation and low productivity in Korea's service sector, which has lagged far behind Korea's rapid growth in manufacturing and heavy industries.[1]

To the considerable credit of President Park and her economic team, the Korean government has tried to tackle some of these difficult issues through the "creative economy" and other initiatives. Unless these issues are successfully addressed, Korea will not be able to generate the level of new revenue contributions that are critical to help sustain its social security programs. Moreover, even should it achieve a more optimal growth rate through structural economic reforms, Korea will still fall far short of overcoming the widening gap in meeting the pension and healthcare needs of Korea's rapidly aging society.

Shortfalls in the National Pension and Health Insurance Systems

Korea faces enormous challenges in meeting future pension obligations or health costs without major adjustments to the national pension and health insurance systems, which are already chronically and increasingly underfunded.

The National Pension Service (NPS) functions as Korea's most basic social security system for retirees, covering nearly 20 million people as of 2011. Since 2007, the NPS has provided a basic old age pension in the form of a tax-based, non-contributory benefit for 70 percent of the elderly. However, the NPS pension program offers relatively low benefit coverage to beneficiaries, paying out a maximum of only 700,000 won ($600.84) per month to single individuals and 1,120,000 won ($961.58) per month to couples as of 2010. The system is therefore not funding more than a fraction of the financial needs of Korea's senior citizens during their retirement. Corresponding to this low public pension support is a high poverty rate among Korean senior citizens – standing at 48.5 percent, the highest in the OECD.

[1] In 2014, the OECD estimated that Korea's service sector productivity is only approximately half of the level in its manufacturing sector. The productivity rankings of Korea's critical IT, finance, and insurance sectors, for example, are the lowest in the OECD.

Even with such low pension benefit payouts, the NPS nonetheless in recent years has tacitly acknowledged that it is still unprepared for the wave of pensioners that the next few decades will bring. In late 2012, the NPS announced plans to increase the eligibility age for the basic old age pension from 60 to 65 by 2033. A parliamentary report released around the same time indicated that the NPS could run out of money by 2053, overstretched by a shrinking workforce and a burgeoning population of recipients. While this may prove an extreme prediction, it is clear that Korea will not be able to meet future pension obligations or health costs without major adjustments.

Similarly, Korea's national healthcare system, which offers world-class medical services to its population, is also showing similar funding strains as it tries to keep up with Korea's aging population. The National Health Insurance (NHI) has provided universal coverage since 1989. One of the most pressing problems facing the NHI is its low contribution rate, which translates to low benefit coverage and high out-of-pocket (OOP) rates. As of 2011, the average employee contribution to health insurance amounted to 5.64 percent and, in turn, NHI coverage only met up to 62.5 percent of actual patient charges. Consequently, Korean OOP spending is the highest in the OECD at 37 percent, with average lifetime OOP expenditure averaging $100,000 per person. As Korean society ages, this will place additional and much heavier fiscal demands on the NHI to treat more costly and serious conditions, including dementia and stroke. Without adjustments, this will put further pressure on both the NHI and the elderly and their families to cover the resulting higher costs.

NHI is also chronically underfunded. Korea’s public expenditure on healthcare (as a percentage of total healthcare expenditure) is already low by OECD standards; average expenditure hovers around 55 percent, while the OECD average is around 72 percent. Korea’s sluggish economy and low youth employment rates could worsen the problem, as they will negatively impact both that amount of federal money available to allocate for healthcare and the number of beneficiaries that pay into the NHI. A spike in the elderly population and a sharp rise in medical spending will greatly strain the system even further.

Private Sector Solutions

As outlined above, Korea’s aging society challenge is as clear as it is pressing. Bold and comprehensive measures focused largely, but not entirely, around private sector solutions can make it a surmountable challenge. New steps can even help provide Korean retirees with higher levels of comfort and security than they experience today.

The status quo will not suffice, as simply maintaining current basic levels of support through a massive increase in government spending on social security means that retirees will continue to receive extremely limited benefits at the cost of rapidly increasing government debt. Moreover, placing ever greater burdens on a surging number of retirees by raising the official retirement age, cutting back on pension payments or healthcare coverage, or taking other similar steps is likely to only result in a significantly reduced quality of life for the elderly.

Higher government spending and reduced basic benefits may well both prove to be inevitable choices for policy makers. Yet the burden that each would inevitably create can be greatly mitigated by providing greater opportunities and incentives for Korean citizens to take advantage of private sector solutions to achieve true financial security.

In broad terms, public policies ideally should focus on enabling and encouraging Korean citizens both to more effectively save for their own retirement through a major expansion of incentives and choices for targeted retirement savings accounts, as well as to effectively convert their savings into an income stream that meets their lifetime retirement goals. These approaches should also be complemented by reforms that better enable individuals to manage pre- and post-retirement financial risks through greater access to private insurance products. These approaches will empower Koreans to access tailored coverage that meets their own future needs and fill the gap between the benefits offered by the government's social security programs and their goals for a comfortable and full retirement.

Embracing private sector solutions and services as new tools to help Korea successfully meet its aging society challenge also will require new thinking. It will require the establishment of a regulatory environment that allows innovative companies to compete to provide new products that either supplement or, in some cases, provide entirely new means of retirement and health coverage. It also requires a stronger emphasis on quality retirement education and planning, as well as access to information that empowers individuals to make the most informed choices.

Korea's policy makers can also look to successful private sector examples across many other advanced OECD countries, as well as to global best practices, that are enabling their citizens to supplement public programs with private sector financial and healthcare solutions that greatly improve their preparedness for retirement.

The following recommendations include a broad menu of measures and actions that will both modernize Korea's approach to this looming challenge and provide the degree of choice and know-how to help Koreans succeed in their retirement goals.

Policy Recommendations

1) **Encourage greater utilization of private retirement and health insurance products as a means to supplement existing public pension and health insurance system benefits**. Support should focus on encouraging individuals to save for retirement, secure steady income streams from their savings and pension during retirement, and mitigate financial risks that could undermine retirement planning. Concrete steps that will advance these objectives include the following:

    - Preserve and further expand tax and other incentives for long-term, retirement-targeted investments for individuals, including both savings and annuity investments, in both the accumulation (saving for retirement) and decumulation (collecting retirement benefits) stages. Specifically:

    - Consider roughly doubling the tax deduction currently provided on annuity savings products.

    - Consider implementing a similar, substantial increase in the tax deduction available for supplemental health insurance products, such as for cancer and dementia.

- To promote greater use of private retirement-focused investment products, reform and simplify new tax rules that currently discourage retirement-focused savings by creating complicated tax liabilities for investments held longer than 10 years.

- Enhance subsidies, tax benefits and tax incentives, including the use of means testing to determine the level of benefits and incentives, to encourage greater utilization of health and retirement savings and protection (insurance) products.

- Consider introducing a Korean model of "catch-up policies" that provide Korean citizens over the age of 50 with additional income deductions for their paid annuity premiums.

- Consider introducing aggressive new retirement savings programs, such as a Korean model of Germany's Reister pension system as a subsidy-supported mechanism for individuals to make matching defined contributions that will help them overcome Korea's serious "pension gap."

- Adopt new policies that help make private health insurance more widely available and attractive to consumers, including by providing tax breaks for all protection products and even higher tax breaks for individuals taking out coverage for high-cost conditions or major illness, such as cancer and stroke.

2) **Accelerate regulatory reforms that will give consumers greater choice and better options that meet their unique retirement needs.** Close oversight of financial institutions, combined with updated regulations that permit greater competition and service innovation for consumers, is an effective approach to ensure that the pressing needs of Korea's retirees are more adequately met.

    - Free-up a range of regulatory and other formal and informal limitations on products, price, and other restrictions currently imposed on financial service companies, including insurers, to allow more competition, innovation and better customization of insurance, retirement, and other products that meet the specific needs of Koreans at lower prices.

- Undertake the necessary reforms and steps to provide financial service companies, including insurers, with much greater flexibility to develop, price, and offer new products that will help Koreans better insure their unique, personal risks. This will better enable individuals to target their savings toward retirement, housing, or other needs, instead of needing to save to cover potential catastrophic medical or other costs.

- Permit greater freedom for insurers to set and structure commissions for their salespeople.

- Provide consumers improved choice and access to new retirement investments and services by allowing greater utilization of banks as a distribution channel for insurance products through the easing of quantitative caps on individual insurers.

- Ensure data and digital technology rules provide greater efficiencies in the use of data within a secure environment for the development of new financial products.

- Promote critical labor market reforms that will provide businesses with more flexibility to right-size the workforce to increase productivity, efficiency, and competitiveness.

3) **Help lower costs and improve private sector retirement and health products and services by permitting greater flexibility for financial companies, including insurers, to more effectively manage and mitigate long-term risks.** Private companies are better positioned to reduce risk, lower fees and prices, and improve services for their customers where they are able to more efficiently manage assets across organizations, including internationally, as they are able in most industrialized countries. In addition, consumers can be better served by permitting the private sector greater freedom to develop, price, and offer new services that meet the differing needs of individuals seeking to generate retirement income.

- Allow for more methods for reinsurance, including financial reinsurance to affiliated entities, which will enable global financial companies to better control and manage risk.

- Allow for greater flexibility to more soundly and efficiently manage capital and mitigate risks for retirement investment products, including by:

    - Enabling financial institutions the freedom to hedge variable annuity assets outside of Korea to reduce overall single-market exposure.

    - Bringing variable annuity reserve calculations and capital requirements into line with the norms seen in advanced economies for the purposeful risk management of long-term liabilities inherent to retirement services.

    - Providing greater freedom for insurers to invest in a range of investment vehicles, both onshore and offshore, to help diversify investments and earn more attractive yields for consumer retirement funds.

- Phase out informal guidance that seriously limits the amount that private companies may return dividend surpluses to parent companies.

- Establish a new dialogue with insurance providers to discuss global best practices as a template for how to most effectively encourage development of attractive retirement income solutions in Korea.

4) Empower Koreans to better prepare and plan for their own retirement through better access to quality retirement and financial planning services and advice.

- Reform pending or existing regulations that may impede opportunities for face-to-face consultations directly with private sector providers. This will enable individuals who are retired or preparing for retirement to access the most professional retirement income planning advice.

- Encourage and permit creativity in programs offering retirement planning and advice that meet the needs and preferences of consumers seeking such advice. For example, online tools and "apps" can offer assistance to many people in preparing for retirement by combining financial education with the ability to utilize an online format that many find convenient, comfortable, and simple to navigate.

- Support awareness campaigns, including in partnership with the private sector, to highlight the importance of retirement savings and health planning to encourage action in preparing for retirement.

Conclusion

Following decades of economic expansion, Koreans are today well positioned to achieve financial security in their retirement years. To achieve this goal, while maintaining sustainable levels of public debt and spending on social security safety nets, new reforms that greatly encourage and expand the use of private sector services to help Koreans achieve their individual retirement objectives are a sound policy choice.

Placing a stronger emphasis on policies that help expand the role of the private sector in achieving retirement goals is a critical tool to help individuals supplement benefits from government-managed programs and fill their retirement-age pension income and healthcare cost gaps. This same approach also complements public social security programs by allowing individuals greater freedom to invest in tailored financial solutions for their own retirement through access to a broader array of range of savings and insurance services that the private sector can offer.

Creating the right regulatory environment that allows for expanded choices for consumers, implementing proven safeguards that most efficiently manage risk, expanding incentives that strongly encourage better preparedness for retirement, and expanded education and access to information to help individuals make informed choices as they plan for their retirement are all proven approaches that will fundamentally improve the financial security and well-being of Korea's aging population.