

Pension reforms

Early birds and laggards



Reforming pensions has loomed large over the policy agenda of OECD countries. It is often said in the United States and elsewhere that reforming public pensions is the “third rail” of politics: touch it and you die. Pension policy involves long-term decisions in the face of numerous short-term pressures. Before the long-term benefits of reform appear, most governments will have left office.

Nevertheless, much has been done since the early 1990s to make pension systems fit for the future; often, more than governments are given credit for. Nearly all the 30 OECD countries have made at least some changes to their pension systems in that period. In 16 of them, there have been major reforms that will significantly affect future benefits.

Which countries reformed?

Six of the ten countries with the *highest* public expenditures on pensions as a percentage of national income in 1990 – Austria, France, Germany, Italy, Sweden and Finland (ordered from highest to lowest spenders) – have undertaken major pension reforms since 1990. These reforms have cut benefits and will lead to lower pension spending in the future.

However, the ten OECD countries with the *lowest* pension expenditures in 1990 were almost equally active. This group of reformers, which includes Australia, Japan, Korea, Mexico and Turkey, currently has a low level of pension expenditure. Nevertheless, these countries will face significant financial challenges in the future which they are aiming to ease by acting now.

In Japan, the need for change to the pension system is driven by the pace and scale of population ageing. Pension expenditure in Japan almost doubled from

5% of gross domestic product (GDP) in 1990 to 9.3% in 2003.

In Korea, Mexico and Turkey, pension systems are less mature and populations in these countries are currently younger than in other OECD economies. There are still relatively few recipients of old-age pensions and so public pension spending is low. However, Korea is undergoing particularly rapid demographic change, moving from one of the youngest to one of the oldest populations in the OECD in the space of only one generation.



This media briefing is one of a pair prepared for the launch of the second edition of *OECD Pensions at a Glance* in Paris on 7 June 2007.

Reform in Mexico and Turkey was driven more by the unrealistically high level of promised pension benefits, which their governments have recognised as unaffordable in the longer term.

What did countries do?

Most countries' pension reforms were packages comprising a number of different measures, as shown in Table 1. Some of these changes, such as increases in pension ages, are highly visible and often politically controversial. Others, such as changes in the way in which earnings are measured when calculating benefits, are more technical and less transparent. Some countries maintained the structure of the pension system, modifying only parameters and some of the rules, while others overhauled the entire system. Table 1 distinguishes these "parametric" and "systemic" reforms.

Changes in pension age are the most common feature of reform packages. The

rationale for these changes is clear: starting in the 1960s, life expectancy started growing rapidly, but many countries cut their retirement ages. The average age at which full-career workers can first draw their pension in OECD countries for men fell from 64.5 years in 1958 to 62.2 years in 1993 and for women from 61.8 to 60.7 years.

Recent reforms have reversed the trend to lower pension ages, with seven countries introducing gradual increases in pension ages for both men and women and a further five countries increasing pension ages for women alone. When these reforms are complete, most OECD countries will have a standard retirement age of 65 years, although in Denmark, Germany, Iceland, Norway, the United Kingdom and the United States, the pension age is or will be 67 or more. Only France, Hungary and the Czech and Slovak Republic plan to have pension ages below 65; in four more countries, only women can retire on a full benefit before 65.

Table 1. What did countries do?

The main elements of pension reform packages in selected OECD countries

	Parametric						Systemic		
	Pension age		Retirement incentives	Calculation		Indexation	DC	NDC	Life Expectancy
	M	F		measure	revaluing				
Austria	•	•	•	•					
Finland			•	•	•			•	
France			•	•	•			•	
Germany			•					•	
Hungary	•	•	•	•		•			
Italy	•	•	•				•		
Japan	•	•		•					
Korea	•	•							
Mexico						•			
NZ	•	•							
Poland			•	•		•	•		
Portugal		•	•	•	•			•	
Slovakia	•	•		•		•			
Sweden				•		•	•		
Turkey	•	•							
UK		•	•						

Note: Includes only 16 countries that have had major reforms since 1990.

Source: OECD *Pensions at a Glance*

Nonetheless, effective retirement ages – the age at which people actually stop working – are lower on average than the standard pension age in most countries. A common policy response, adopted by nine countries, has been to encourage older workers to stay longer in their jobs.

The other changes to pension systems have been more technical and less visible. Two of these relate to the way that the earnings base for pension entitlements is calculated.

First, several OECD countries have extended the period over which earnings are taken into account instead of just basing the benefit on the last or one of the best salaries.

Secondly, many systems re-value past earnings to take account of changes in living standards between the time pension rights accrued and when they are claimed. Several countries have moved to a less generous adjustment. The final technical reform has been to the way that pensions in payment are adjusted or “indexed”. Many OECD countries have moved from adjusting pension benefits to earnings towards full or partial indexation to prices. All of these changes can have a strong effect on pension benefits.

A number of countries opted for wholesale or systemic reform. The most common policy has been to remove all or part of the public defined-benefit pension system and replace it with defined-contribution schemes, where the pension depends on contributions and interest earned on them. Hungary, Mexico, Poland, the Slovak Republic and Sweden have all introduced mandatory, privately managed individual accounts to replace part of the public pension. Australia and Norway added such schemes on top of existing provision.

Another kind of systemic change has been the shift in public pensions from defined-benefit plans to notional accounts. Again the pension depends on contributions but the

notional interest rate is set by government and often linked to wage or GDP growth. The schemes remain pay-as-you-go financed: no assets are accumulated.

The systemic reforms share one important feature: pensions will in future automatically adjust to changes in life expectancy. When pension capital is accumulated in an individual account it is usually transformed into a regular pension payment – an “annuity” – at retirement. Annuities will be lower the higher life expectancy is at the time of retirement because the pension will be paid for a longer time. Benefits from notional accounts are calculated in a similar way. But such automatic adjustments can also be built into systems which have not undergone systemic reform. Germany, Finland and Portugal have linked benefit levels to life expectancy. Denmark will increase the pension age and France will extend the years of contributions necessary for a full benefit as people live longer.

These different elements of pension-reform packages will have a number of effects on future pensioners. The first is a financial impact: how much smaller will benefits be for workers entering the labour market today compared with earlier generations. The second is a distributional impact: how will different groups – men and women, rich and poor – be affected?

How did reform happen?

Evolution rather than revolution has guided pension reform in OECD countries. Whilst a few – such as Hungary and Poland – introduced major changes in a single “big bang”, most have had a series of reforms. This latter group includes Finland, France, Germany, Japan and the United Kingdom.

Constructing a consensus about the need for and direction of reform is essential not only to make reform happen but also to build a stable and sustainable pension system.

Seeking to implement major reforms by stealth is almost certainly going to backfire. People need to understand the proposed changes, accept their rationale and adapt to the new systems. Consensus may also require a gradual phase-in of reforms in order to protect people close to retirement from large unexpected declines in their pensions.

A common way of trying to build broad agreement is by establishing reform commissions, such as those in Denmark, France, Germany, Ireland, Norway, the United Kingdom and the United States. But success is not guaranteed: for example, the Irish commission failed to agree on a conclusion. And very lengthy discussions with all political and social stakeholders can delay and water down much needed reforms.

Another policy that can maintain consensus is rules-based adjustments, such as the automatic link to life expectancy discussed above. This takes the pressure off policymakers to make periodic, discretionary benefit cuts. Reductions in pensions justified by longer life expectancy might also be perceived as fairer than discretionary changes. Still, some countries, such as Italy, have failed to apply the adjustment rules due to political pressures or electoral cycles.

Nevertheless, consensus is not always achieved. Some new governments have threatened to reverse reforms but there are few actual cases of this happening. Much more common, however, is to slow the transition to the new system; this happened for example in Hungary and Italy.

Who wins, who loses?

Despite the very different reform packages, future pension entitlements under the new systems for today's workers are generally below what they would have been without reforms. Figure 1 shows gross replacement rates: that is, the pension in retirement relative to earnings when working. The replacement

rates, which are for people with average earnings, are given both after reform and assuming that the reform did not take place (marked "before").

In New Zealand and the United Kingdom, replacement rates for average earners did not change. There was only a very small decline in Poland whilst in Hungary, gross replacement rates increased. (This, however, was accompanied by changes in the taxation of pensions, which offset much of this effect.) Austria, Finland, Korea and the Slovak Republic also cut the target gross replacement rate slightly.

At the other end of the spectrum are countries with large cuts. The largest was in Mexico, with the gross replacement rate halving to 36% through systemic reform. However, this overstates the short and medium-term effect, because all workers already covered under the old system are guaranteed to receive at least the same benefit as before the reform. Portugal and Turkey have also cut future benefits significantly: by more than 30%. Major reductions of between 15 and 25% will result from reforms in France, Germany, Italy, Japan and Sweden.

Figure 1 shows the replacement rate for average earners, but not all workers were affected equally by benefit cuts. Several countries moved towards greater targeting of benefits on poorer pensioners, especially Mexico, Portugal and the United Kingdom. But Austria, France, Germany and Sweden also protected low earners from the full effects of cuts in future benefits.

In other countries, however, recent reforms have worked in the opposite direction. Poland and the Slovak Republic, for example, have tightened the link between pension entitlements and earnings when working. Higher-income workers will get higher pension benefits and redistribution towards lower-income retirees is weakened or removed.

The rationale behind these reforms was to improve the incentives for workers to contribute to the pension system and to work longer. But for those who cannot work or move in and out of employment, there is an increased risk of poverty in old age.

Will being old mean being poor?

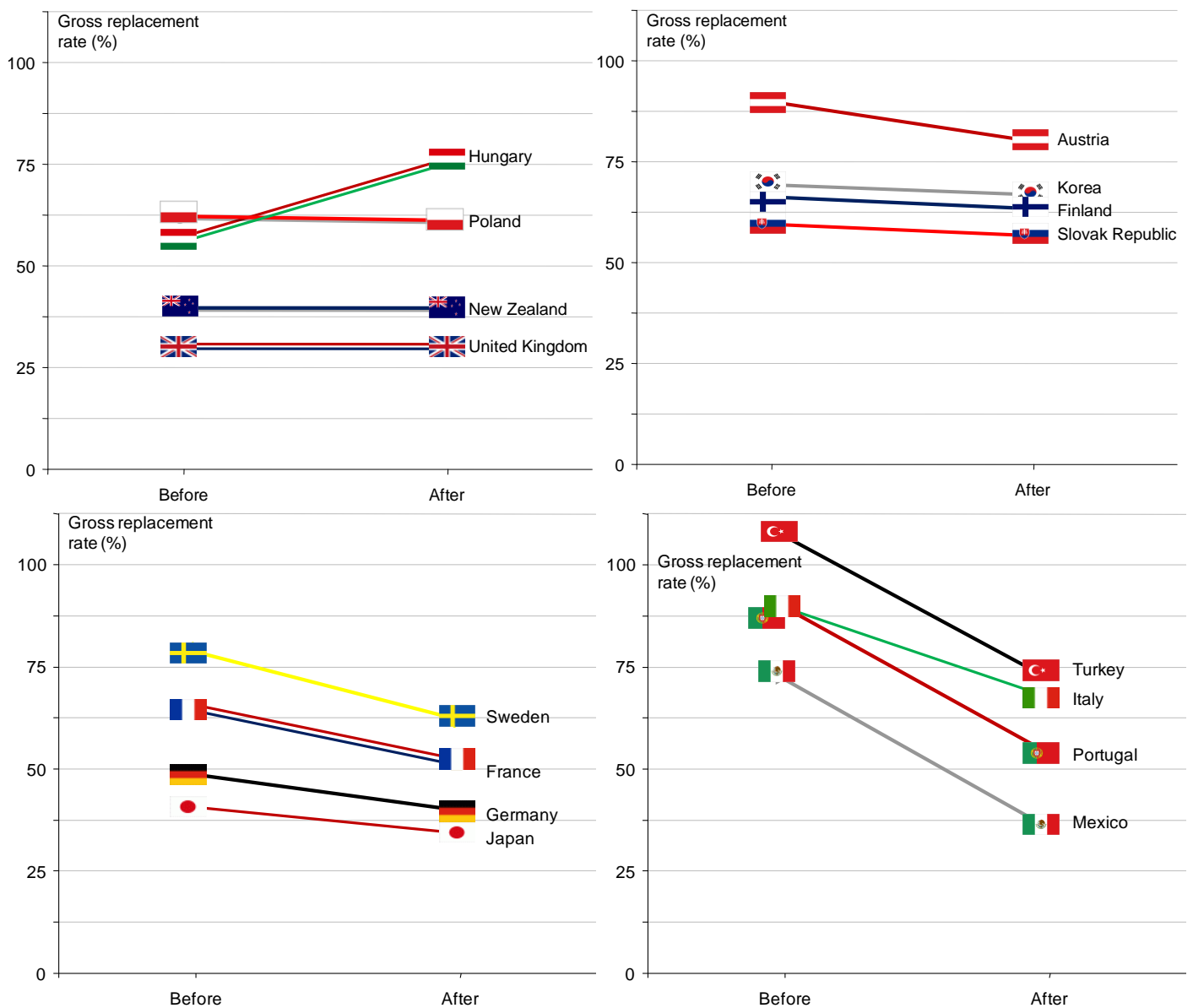
The reduction of old-age poverty in OECD countries during recent decades is one of the great success stories in social policy. Living

standards of retirees have risen and poverty among the elderly has been all but eradicated in many countries.

This success, however, should not be taken for granted in the future. Recent data on income distribution and poverty have shown that this trend has stalled or even reversed since the mid-1990s: in some countries poverty rates of the elderly are on the rise again.

Figure 1. Winners and losers

Impact of pension reforms on gross replacement rates of average earners in selected OECD countries



Notes: Pension in retirement as a percentage of earnings when working. Includes only 16 countries that have had major reforms since 1990. Replacement rates differ for women in Austria, Hungary, Italy, Mexico and Turkey: the rates shown here are for men.

Source: OECD *Pensions at a Glance*

Figure 2 shows relative pension levels (the pension benefit as a share of economy-wide average earnings) net of taxes and social security contributions for low-income retirees before and after reform. Because the relative pension level shows how far away pensioners are from the average living standards of workers, it is a useful measure of benefit adequacy. It is also a good indicator of poverty risk for retirees.

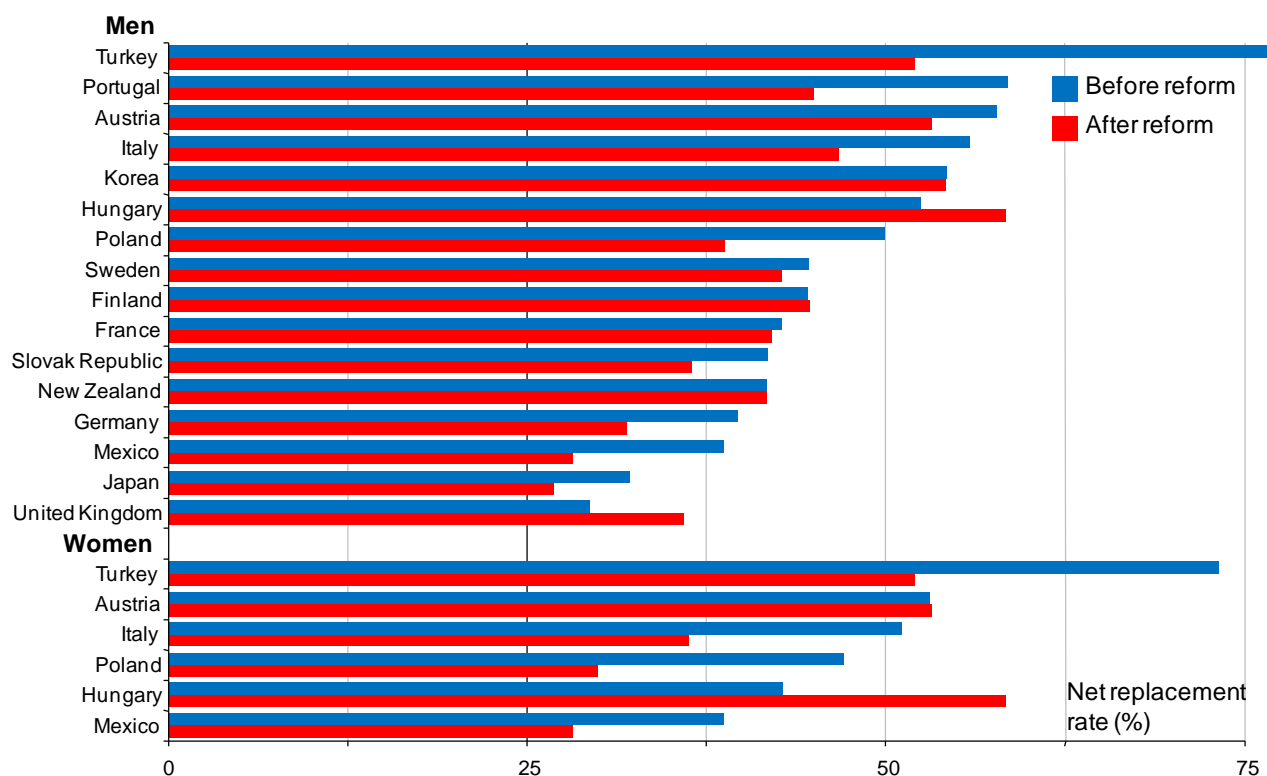
Only in two out of the 16 countries that had major reforms since 1990 did the income position of workers on half average earnings improve. In the United Kingdom, the benefit

for low earners rose from 29% to 36% of economy-wide average earnings because of the new pension credit and second state pension. In Hungary, low earners also gained from the reform, but with a larger relative increase for women.

In Finland, France, Korea and Sweden, low earners were protected from the effect of general benefit reductions. Finland increased the targeting of its national pension and Sweden replaced a basic pension with a targeted one. France introduced a new safety-net provision at a higher level than the previous benefit for low-income retirees.

Figure 2. Pension reforms and low earners

Net relative pension levels pre- and post-reform for low-income workers (50% of average earnings) in selected OECD countries



Notes: Pension levels net of taxes and social security contributions as a share of economy-wide average earnings. Low income is defined as half economy-wide average earnings. Includes only 16 countries with major reforms since 1990.

Source: OECD *Pensions at a Glance*

Reforms reduced retirement benefits for low earners in nine countries. Mexico, Poland, Portugal and Turkey will see the largest declines in relative pensions for low earners:

more than 10 percentage points. In Mexico and Portugal, this is due to major, across-the-board benefit cuts (although low earners lose proportionately less than higher earners). In

Poland, this reflects the abolition of the flat-rate, basic pension as the new system ties pensions more closely to earnings.

In most reforming countries, current pensioners were excluded from the reforms and the real effect of pension reform will only show once younger cohorts begin to retire. Given that cuts will start to bite later but old-age poverty is already rising, countries that cut benefits for low-income pensioners will have to pay special attention to those who are at risk of being poor in old age.

What remains to be done?

Despite the many, sometimes radical pension reforms in OECD countries there is no reason for complacency: the pension-reform agenda is far from finished.

First, some countries still need to make major reform efforts. For example, four of the countries with the highest pension spending in 1990 saw little or no change in their pension systems over the same period. This group comprises Greece, Luxembourg, Belgium and Spain; pension expenditures in 1990 in these countries averaged 9.5% of GDP, compared with 6.7% for the OECD as a whole. In all except Luxembourg, spending continued to increase between 1990 and 2003.

Secondly, the transition to the new rules is sometimes very slow, meaning that the impact is long deferred. This is the case in Austria, Italy, Mexico and Turkey. The Italian reform only affected workers who had been in the system for 18 years or less, so the new system will only be fully in place once labour market entrants of 1995 have retired (*i.e.*, from 2017 onwards). Under the proposed reform in Turkey, the new retirement age of 65 will only be reached for men retiring in 2043 and for women even later. In Austria, benefit cuts cannot exceed 10%.

Thirdly, early retirement and its costs are still a problem in many countries. The standard

retirement age has been increased to 65 in most OECD countries and, in some cases, even beyond. However, many routes for early exit from the labour market are still open. The average effective retirement age for men was below 60 in eight OECD countries – including Belgium, France, Hungary and Italy – over the period 1999-2004.

Reforming pension systems is undoubtedly challenging both politically and economically. But the obstacles to change can be overcome, as demonstrated by the recent experiences of the 16 OECD countries discussed here. Pension-reform laggards should take heart from this experience and press ahead. Further delay may perversely cause more hardship than faster reforms would have done.

About Pensions at a Glance

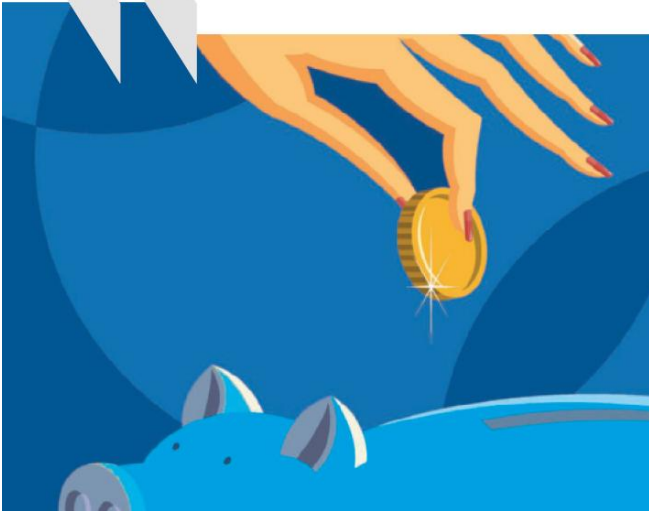
Government-mandated pension and retirement policies have changed dramatically during the past decade. *Pensions at a Glance* presents a consistent framework for comparing public pension policies across OECD countries, as well as reliable data. The report thus provides the basis for not only evaluating existing pension systems, but also designing and implementing future reforms.

The second edition updates in-depth information on the key features of mandatory pension systems – both public and private – in the 30 OECD countries, including projections of retirement income for today's workers.

Two new and important sections have been added to this edition: 1) description and analysis of pension reform in OECD countries during the past decade; and 2) a closer look at the complex range of private, voluntary retirement plans now playing a greater role in pension provision in many OECD countries, including an analysis of the private savings effort required to maintain standards of living during retirement.

Pensions at a Glance

PUBLIC POLICIES
ACROSS OECD COUNTRIES



About the first edition

"Pensions at a Glance deserves much more than a glance. It is a compendium of facts and analyses that should inform policymaking and public debate around the world for years to come. By providing in clear and easy-to-understand form a wealth of information about pension systems throughout the OECD, it will make it much harder for even the most insular to ignore the valuable lessons to be learned from the pension experience of other nations."

Henry J. Aaron
The Brookings Institution

Named one of 12 international "notable government documents" by the American Library Association.

Follow-up

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