

Private pensions



A growing role

Private pensions play an important and growing role in providing for old age in OECD countries. In 11 of them – Australia, Denmark, Hungary, Iceland, Mexico, Norway, Poland, the Slovak Republic, Sweden, Switzerland and the United Kingdom – the private sector delivers part of the *mandatory* provision for income in old age. In addition, *voluntary* private pensions have broad coverage in a number of OECD economies.

Three kinds of policy have increased the role of private pensions. First, Hungary, Mexico, Poland, the Slovak Republic and Sweden have recently introduced mandatory private pensions as a substitute for part of the public pension provision. Secondly, Australia and Norway have added a mandate for a private pension on top of existing public plans. Finally, many countries have scaled back their public pensions, leaving a greater role for voluntary, private savings. These include – most notably – Germany and Japan.

Who has a private pension?

Data on coverage of private pensions, unfortunately, can be very difficult to obtain and are often difficult to compare between countries due to institutional differences in the markets for long-term savings. Table 1 draws on a number of sources; the OECD is working to improve these preliminary data.

Table 1 shows coverage by type of scheme – personal or occupational – and by whether plans are voluntary or mandatory.

Coverage is naturally higher when private pensions are *mandatory* (Australia, Iceland, Norway, Switzerland). In Hungary, Poland and the Slovak Republic, coverage of private pensions is only mandatory for younger workers and/or new labour-market entrants, whilst others had a choice as to whether to

take out a private pension. Hence, coverage of these programmes is between 45% and 60% of the current workforce, but this will rise over time to the whole labour force. Broad industrial-relations agreements ensure high coverage in some countries (Denmark, Netherlands, Sweden) and so can be thought of as “quasi-mandatory”.

This briefing focuses on *voluntary* private pension provision: voluntary in the sense that either employers do not have to provide an occupational plan or that individuals do not have to join a personal plan.



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.

Table 1. Coverage of private pension plans

Mandatory personal	Coverage	Voluntary occupational	Coverage
Denmark	>90%	Austria	35%
Hungary	58%	Belgium	40-50%
Mexico	31%	Canada	39%
Poland	49%	Finland	7%
Slovak Republic	45%	France	10%
Sweden	>90%	Germany	57%
		Ireland	50%
Mandatory occupational		Italy	8%
Australia	>90%	Japan	45%
Denmark	>80%	Luxembourg	20%
Iceland	>90%	New Zealand	20%
Netherlands	>90%	Norway	45%
Norway	>90%	Portugal	4%
Sweden	>90%	Spain	10%
Switzerland	>90%	United Kingdom	43%
		United States	47%

Source: OECD *Pensions at a Glance*; OECD private pension statistics

Voluntary occupational pension plans have long had broad coverage in English-speaking countries, such as Canada, Ireland, the United Kingdom and the United States, where it currently reaches 40% or more of employees. Belgium, Germany, Japan and Norway also achieve this degree of coverage. At the other end of the spectrum, 10% or fewer workers are covered by voluntary, occupational, private pensions in Finland, France, Italy, Portugal and Spain.

The pension gap

In countries with relatively small public pensions, individuals will need to make extra, voluntary, private savings to ensure that their living standards do not decline sharply as they move into retirement.

Figure 1 shows the gross replacement rate – pension in retirement relative to earnings when working – for average earners in OECD countries. The projected gross replacement rate from mandatory pension schemes for the average earner with a full career ranges from 31% of individual earnings in the United Kingdom to 96% in Greece.

The 11 countries at the bottom of the chart, which have below-average mandatory replacement rates, are the focus of this

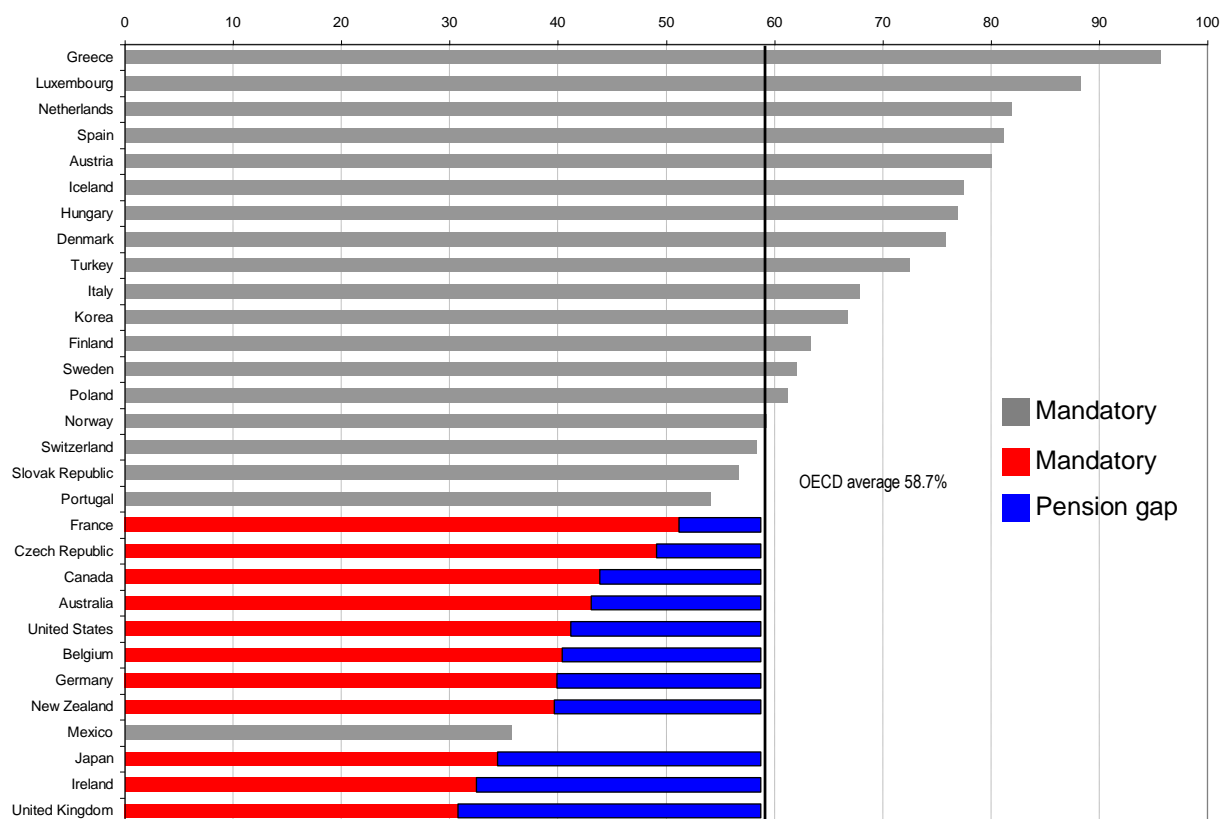
briefing. What level of voluntary, private pension savings would be needed to deliver an overall gross replacement rate in these countries that equalled the OECD average? This is obviously an arbitrary target but it is useful to set a benchmark relative to all OECD countries, including those with mainly mandatory retirement provision.

The difference between the national mandatory replacement rate and the OECD average is here called the “pension gap”. Along with all six of the mainly English-speaking members of the OECD – Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States – mandatory gross replacement rates are below the OECD average in four continental European countries – Belgium, the Czech Republic, France and Germany – and in Japan.

In the United Kingdom, private pension savings would need to deliver a replacement rate of 28% to bring the overall pension up to the level of the OECD average. France has the smallest retirement savings gap of the 11 countries analysed: 7.5%. For the 11 countries as a whole, the replacement rate from mandatory pensions is 40.6% for average earners, giving a retirement-savings gap of 18.2% on average.

Figure 1. The pension gap

Gross replacement rate for an average earner from mandatory pension schemes and difference from OECD average replacement rate



Source: OECD *Pensions at a Glance*

Filling the pension gap

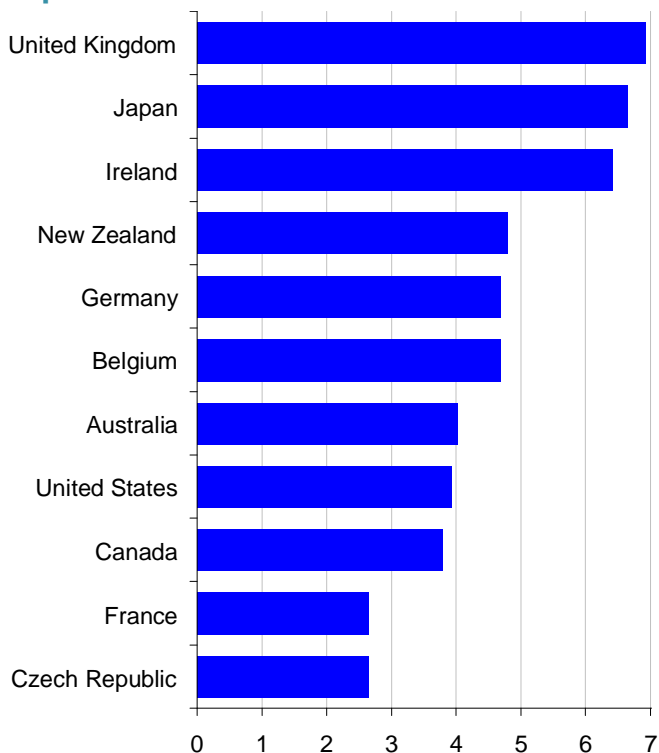
The savings effort required to fill the pension gap obviously varies with the size of the gap: contributions would need to be larger in the United Kingdom than in France, for example. But it also depends on how long the pension is likely to be paid, i.e. on life expectancy, as well as the value of the pension, which in turn is largely determined by investment returns on pension savings. Life expectancy in France and Japan is much higher than it is in the Czech Republic. The length of time over which the pension is paid also depends on the age of retirement. The normal pension age is age 65 in eight of the countries, but is 60 in France, 62 in Hungary and 67 in the United States.

The normal pension age also affects the duration over which contributions are made. On the baseline assumption of labour-market entry at age 20, individuals who contribute for a full career will pay into their pension funds for between 40 and 47 years, although in most cases this will be for 45 years.

Taking account of all these factors – differences in pension age, life expectancy and the pension gap – it is possible to calculate the percentage of earnings that individuals would need to contribute to achieve an overall – mandatory plus voluntary – replacement rate equal to the OECD average. The results are shown in Figure 2.

Figure 2. Filling the pension gap

Contribution rate required for average earner to reach average OECD replacement rate



Source: OECD *Pensions at a Glance*

The United Kingdom has the largest replacement-rate gap and the highest required contribution rate. Japan's replacement-rate gap is four percentage points lower than in the United Kingdom but life expectancy is longer. The required contribution rate in Japan is 6.7% compared with 6.9% in the United Kingdom.

France has the smallest replacement-rate gap, but normal retirement age of 60 and life expectancy above the OECD average together increase the required contribution rate compared with countries with normal retirement at 65 or more. The required contribution rate is just 2.6% in France and the Czech Republic.

How many people save for old age?

Do individuals respond to lower replacement rates from mandatory pensions by making voluntary, private provision for retirement? Figure 3 compares coverage of voluntary private pensions with the size of the mandatory (public and private) replacement rate. There are two clear clusters of countries.

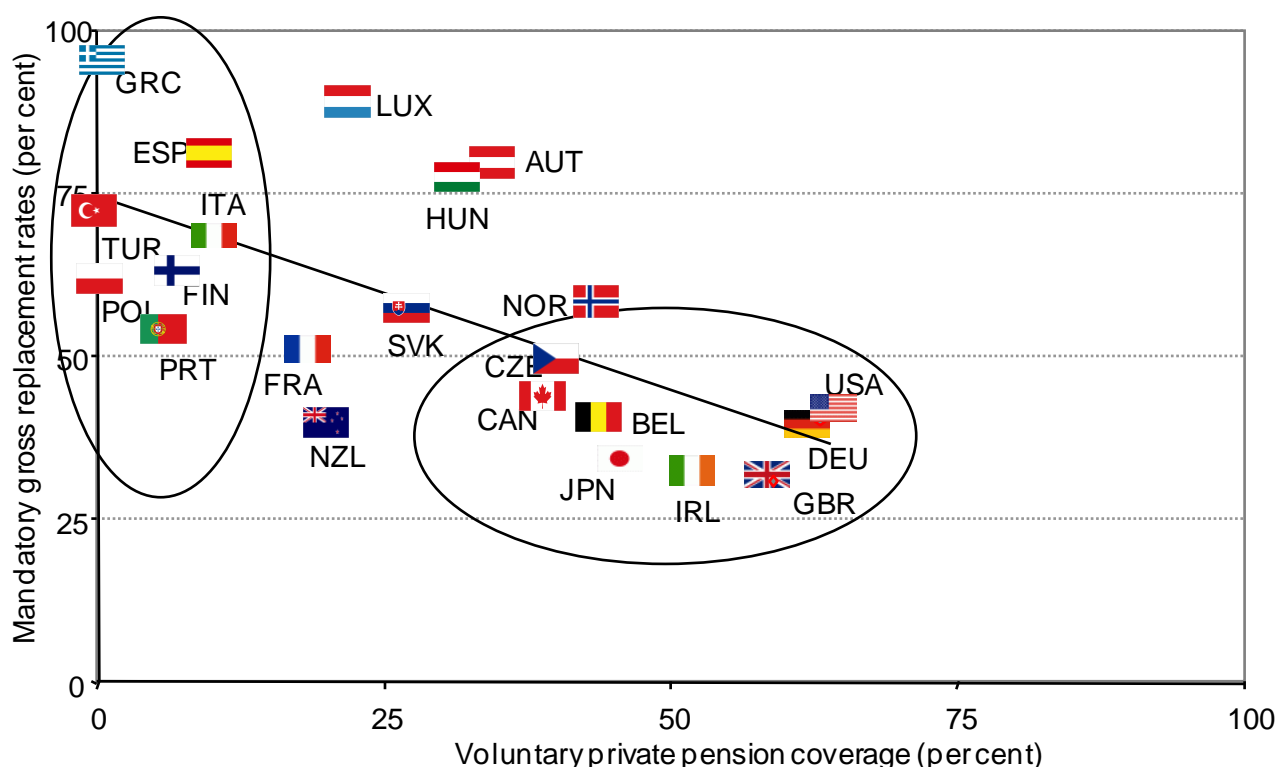
First, there is a range of mainly Southern European countries – Greece, Italy, Portugal, Spain and Turkey – but also including Finland and Poland, that have voluntary private pension coverage of less than 10%. These countries also have relatively high mandatory replacement rates for average earners. For these seven countries, the average gross replacement rate is 71% compared with 59% for the OECD as a whole.

The second cluster consists of eight countries with much lower mandatory replacement rates. Unsurprisingly, half of this group are from the mainly English-speaking countries – Canada, Ireland, the United Kingdom and the United States. However, Belgium, the Czech Republic, Germany and Japan show a similar relationship between private pension coverage and the scale of the mandatory pension system. In these eight countries, the mandatory replacement rate for the average earner is just 38%.

For how long should people save?

People are unlikely to spend their whole working lives covered by voluntary, private pensions precisely because they are voluntary. How does the number of years over which people contribute affect the contribution rate required to fill the pensions gap, that is, to deliver an overall – mandatory plus voluntary – replacement rate that equals the OECD average mandatory replacement rate? Figure 4 gives the answer.

Figure 3. Voluntary pensions fill the pension gap left by mandatory provision
Projected replacement rate from mandatory pensions for average earners versus coverage of voluntary private pensions



Source: OECD *Pensions at a Glance*; OECD private pension statistics

At the left-hand side of the chart is the required contribution rate with a full contribution history – from age 20 to national normal pension age. The next entry on the chart shows the situation with five years missing from the contribution history, i.e., assuming people delay starting their private pension until age 25.

With ten missing years – at the centre of the chart – the required contribution rate in the United Kingdom increases to nearly 10%, compared with 7% with a full career. With 20 missing years, contributions need to be nearly 15% to plug the retirement-savings gap.

In Ireland and Japan, the necessary contribution rates are a little below the rates for the United Kingdom. In Belgium, Germany and New Zealand, the required contribution rate is around 4.6% for a full career, 6.7% with

ten missing years and 10% with 20 missing years.

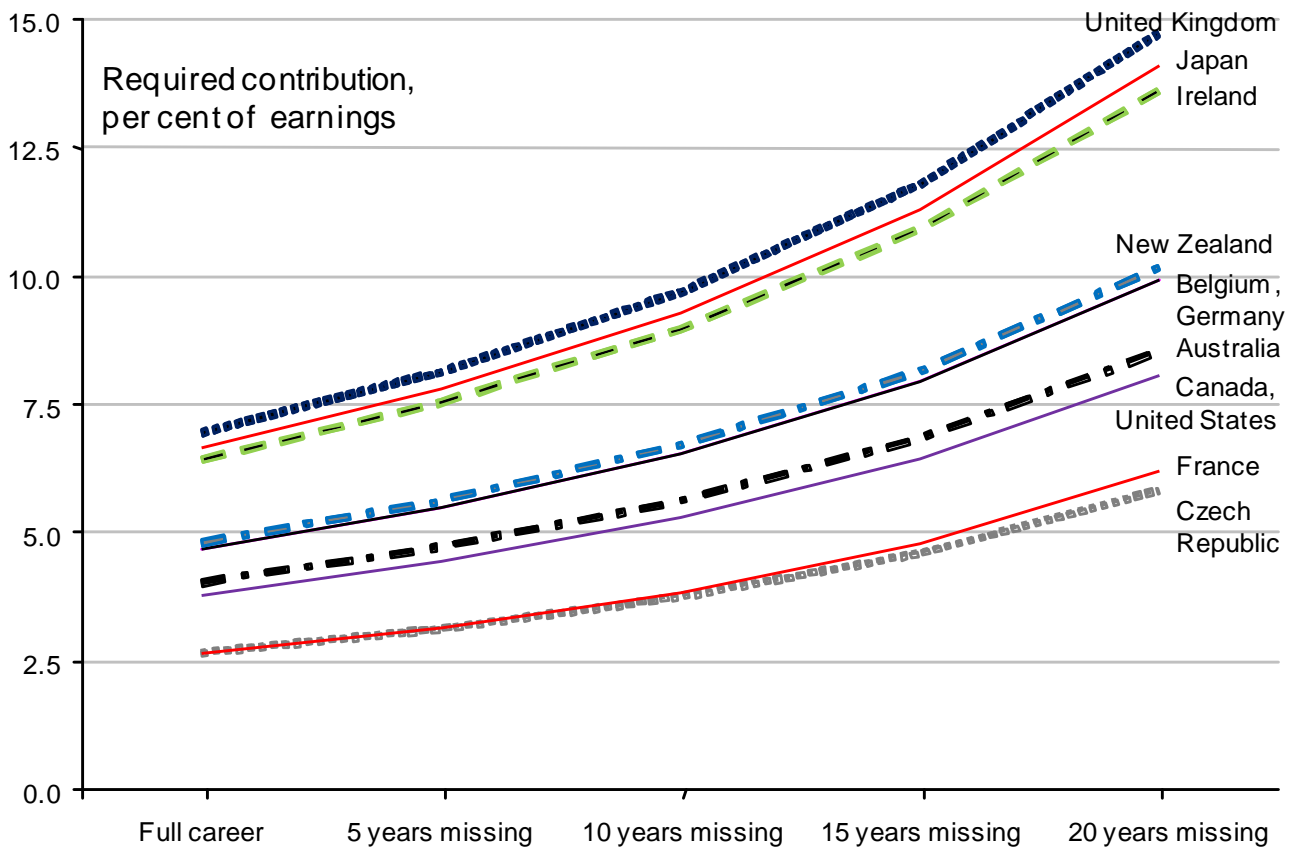
The role of investment returns

The value of defined-contribution pensions during retirement depends crucially on the rate of return on investments as well as on the amount contributed. The baseline assumption is a 3.5% real annual return. What happens when rates of return differ from this assumption?

Ireland, Japan and the United Kingdom have the largest retirement-savings gaps, averaging 6.7% on the baseline assumptions. However, a lower rate of return would naturally mean that individuals would need to contribute more. To fill the retirement savings gap these three countries would need a 9.5% contribution rate if real returns were only 2%.

Figure 4. How years of contributions affect the pension gap

Contribution rate needed to reach OECD average replacement rate for average earners by years of contributions



Source: OECD *Pensions at a Glance*

In contrast, higher returns would offset some of the requirement to contribute to the private pension plan, lowering the necessary contribution rate to only 4.5%.

At the other end of the scale, the contribution rates required in the Czech Republic and France would be 3.7% with low returns, 2.6% at the baseline and 1.8% with high returns.

Conclusions

In around a dozen OECD countries the target replacement rate from the mandatory (usually public) pension system is relatively low, leaving a large “space” for voluntary, private pension provision. In most of these

countries, coverage of private pensions is broad. Around one half of employees contribute to private pensions (on the best available evidence).

Data on average contribution rates are even more difficult to obtain than information on coverage. Preliminary evidence shows average (mean) contribution rates for those covered of 8.5% in Canada, around 9% in the United Kingdom and United States and 10% in Ireland. These contribution rates would be sufficient to fill the pension gap, but only if people contribute for most of their working lives at these rates.

A related concern for policymakers arises because private-pension coverage data are

a “snapshot” whereas lifetime coverage and contributions determine individual’s retirement incomes. It is often not possible, for example, to know whether snapshot coverage of 50% implies that half the workforce contributes for every year of their working lives or the whole workforce contributes for half of their working lives. The implications for pension policy are very different if the target is to get more people to contribute or to get the same people to contribute for more of their careers.

The “traditional” way of encouraging voluntary savings for retirement has been through tax incentives. However, these can be expensive and there is strong evidence that they are inefficient, in that much of the saving would have happened anyway without the incentive; tax incentives tend to be worth more to higher earners, for example. Moreover, voluntary private pension coverage does not reach much over 50% of the workforce in any OECD country. From the international experience, mandating private pensions appears to be the only way to have private pensions that cover significantly more than half the working-age population. But mandatory coverage has also its problems. People may resent being “forced” to save for retirement and may have good reasons not to: for example, because they are poor, their jobs are insecure or they have other reasons to save.

New approaches to encouraging private pension saving, which avoid having to resort to compulsion, rely on the insights of behavioural economics about people’s natural inertia. Such “soft compulsion”, requiring people to save unless they opt out, will be introduced at a national level, first, with the KiwiSaver plan in New Zealand. The United Kingdom aims to introduce a similar scheme and Ireland is debating the merits of going down this route.

Evidence from US surveys suggests that other mechanisms can also help increase coverage of private pension plans, such as simplifying plan rules for eligibility and enrolment and providing financial education for workers. Tax credits rather than tax deductions may provide more encouragement for low-income workers to sign up for private pensions while part-time and self-employed workers may be reached through the promotion of personal pension plans.

About Pensions at a Glance

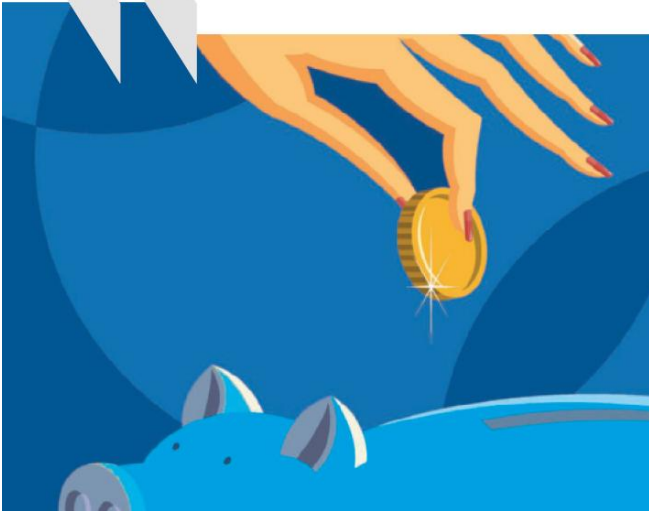
Government-mandated pension and retirement policies have changed dramatically during the past decade. Pensions at a Glance presents a consistent framework for comparing public pension policies across OECD countries, as well as reliable data. The report thus provides the basis for not only evaluating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

Please contact the OECD media division for more information:

telephone: + 33 1 45 24 97 00.
e-mail: news.contact@oecd.org

To discuss the OECD's work on pensions systems, please contact directly:

Monika Queisser

telephone: + 33 1 45 24 96 34
e-mail: Monika.Queisser@oecd.org

Edward Whitehouse

telephone: + 33 1 45 24 80 79
e-mail: Edward.Whitehouse@oecd.org

www.oecd.org/els/social/ageing/PAG

