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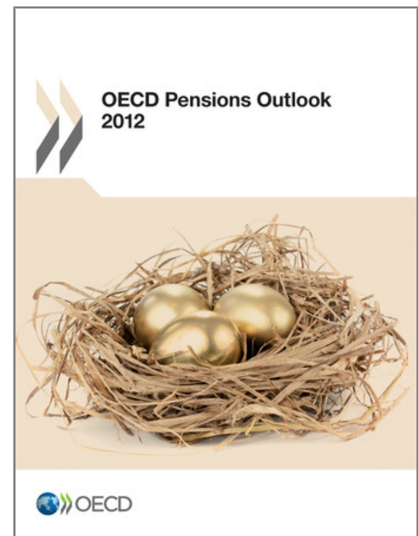
OECD Pensions Outlook 2012

Summary in English



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- This edition of the *OECD Pensions Outlook* examines the changing pensions landscape.
- It looks at pension reform during the crisis and beyond, the design of automatic adjustment mechanisms, reversals of systemic pension reforms in Central and Eastern Europe, coverage of private pension systems and guarantees indefined contribution pension systems.
- It closes with a policy roadmap for defined contribution pensions and a statistical annex.

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Pensions: Past, Present and Future

It may not feel like it, but today's retirees are living through what might prove to have been a golden age for pensions and pensioners. Far fewer older people live in poverty than in the past: about a quarter fewer than in the mid-1980s. They can expect to live longer: 65 year olds today are projected to live 3.5 years longer than their parent's generation.

Today's and tomorrow's workers, in contrast, will have to work longer before retiring and have smaller public pensions. Their private pensions are much more likely to be of the defined-contribution type, meaning that individuals are more directly exposed to investment risk and themselves bear the pension cost of living longer.

The financial shock of 2007-08 has reverberated during the succeeding years, with a profound impact on economies and the public finances in most OECD countries. Pension systems, already transformed by a wave of change over the previous decade, were further reformed, often under the pressure of fiscal consolidation and international financial markets. The most obvious change has been increases in pensionable age, adopted by more than half of OECD countries. In the long term, pension ages will be 67 or more in 13 countries, with a common age for both sexes in all but one country. Other, less visible measures to encourage people to work longer – tighter conditions for early retirement or greater rewards for continuing after the normal pension age – were implemented in 14 countries.

This is a welcome development for four reasons. First, working longer as people live longer improves the financial sustainability of pension systems, and in a less painful way compared with increasing taxes. Secondly, it ensures a fairer distribution of the costs of ageing across generations. And longer periods contributing can mitigate the impact of planned reductions in pension benefits on retirement incomes. Thirdly, it suggests a clear break with failed past policies of pushing older workers out of the labour market and into early retirement, through long-term sickness or disability as well as old-age pensions. The ostensible reason for the failed policy was that it would free up more job opportunities for youth. But the evidence shows that this is just another example of the "lump-of-labour" fallacy: keeping older workers in the labour force does not reduce job opportunities for the young. Fourthly, extending working lives in a situation of slowly growing or even declining workforces should provide an important boost to economic growth in ageing economies. Given these clear benefits, the trend to higher retirement ages – even beyond 67 – should be encouraged. One effective and transparent way to do so is to tie institutionally the retirement age to life expectancy, as in Denmark and Italy.

Pension reforms over the past decade have also led to a reduction in public pension promises in many countries, typically between a fifth and a quarter. Such cuts have been necessary to ensure the financial sustainability of pension systems for both current and future retirees. Since 2007, half of OECD countries took further steps to improve the sustainability of the public pension system, including changes to indexation requirements and benefit formulas.

On average in OECD countries, people starting work today can expect a net public pension of about half their net earnings if they retire after a full career at the official retirement age. This so-called "net replacement rate" from public benefits is less than 50% in half of OECD countries. In 13 of those countries, private pensions are mandatory. The law or social contracts require that all workers participate in such plans. As a result, total mandatory benefits – including these private schemes – offer a net replacement rate averaging about 69% on average in OECD countries.

Nevertheless, there is a large "pension gap" in a dozen OECD countries, with net replacement rates from mandatory schemes of less than 60%. In most of these countries private pensions are voluntary and rarely cover more than half of the workforce. A greater role for private pensions in these countries is inevitable to fill this pension gap. Even if further increases in retirement ages are implemented, private pension provision should be promoted to allow workers to draw on their savings in old age, complementing their working income and public pension benefits. This can be particularly attractive for those seeking flexible working conditions after a certain age or a phased retirement.

Making private pensions compulsory would be the ideal solution to eliminate the pension gap and ensure benefit adequacy. However, some countries have shied away from such a policy partly because of the concern that the contributions would be seen as a new tax. An alternative way to achieve a similar result is to enrol individuals into such plans automatically, while allowing them the possibility of opting-out within a certain time frame – so-called "auto-enrolment". By requiring people to opt out of rather than into retirement saving, it aims to use natural inertia to expand coverage. The first nationwide auto-enrolment retirement savings scheme in the OECD, the KiwiSaver introduced in New Zealand in 2007, has been highly effective in ensuring high participation rates among new employees, with opt-out rates as low as 20%. This kind of arrangement will be rolled out in the United Kingdom between 2012 and 2017, and other countries are likely to follow suit.

Another key policy that can be used to expand the role of private pensions is to provide financial incentives. The traditional way of encouraging people to save for their old age has been tax incentives. While some countries have recently extended tax incentives, Australia, Ireland, New Zealand and the United Kingdom have all moved to limit them to reduce the fiscal cost in the form of foregone tax revenues. Costs have been questioned elsewhere, including Germany.

The problem with the traditional design of tax incentives is that it benefits high earners most as they pay the highest marginal tax rates. Indeed, in most countries with voluntary pension systems, low-income workers are the least likely to participate in private pension plans. A more effective way to reach out to lower income individuals is to provide savers with flat subsidies and matching contributions, capped at a certain level to ensure greater progressivity. Such financial incentives can benefit low earners more, including those that pay no income tax or at a low rate. In Germany and New Zealand, two countries that have introduced such incentives for some of their retirement savings products, coverage rates are more similar across different income groups.

In addition to expanding private pensions coverage, policy makers need to act on three fronts to improve benefit adequacy. First, they should ensure that contributions to such plans are sufficient to meet retirement income goals. This is straightforward in mandatory systems, as in Australia, which recently announced an increase in the minimum contribution rate from 9% to 12% of wages. Secondly, they should limit leakage from such systems by restricting early withdrawals and lump-sum benefit payments. Thirdly, they should promote investment strategies and products that have low costs and mitigate risks during both the period of asset accumulation and retirement, when benefits are paid out. As they address these challenges, policy makers should pay great attention to the menu of investment and benefit options, to simplify and facilitate complex financial decisions. They should also improve the design of defaults for those who do not make active choices, so that they better meet individual needs and expectations.

"Which country has the best pension system?" is a question the OECD is often asked. But it is one that is very difficult to answer, despite the widespread appetite for rankings and league tables. The true response is that there is room for improvement in all countries' retirement-income provision. They all face at least some challenges: coverage of the pension system, adequacy of benefits, financial sustainability or the risks and uncertainties borne by individuals. The outlook for pensions in OECD countries is therefore one of continued – and necessary – change.

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