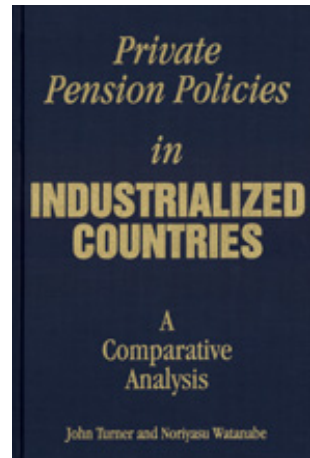

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The Trend Toward Private Pensions

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**Private Pension Policies in Industrialized Countries:
A Comparative Analysis**

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The Trend Toward Private Pensions

Economic insecurity among the elderly is a universal problem. Many industrialized countries have dealt with this problem by developing retirement income systems likened to a “three-legged stool.”¹ This image refers to the three primary sources of income for the nonworking elderly: government-provided social security, employer-provided pensions, and household-provided savings.² The three-legged stool, however, is more an ideal than a reality. In most countries that use this approach, only households with higher income—fewer than half of retirees—actually receive income from all three sources.

Pension systems are the result of cultural and economic forces and reflect different political philosophies concerning the relative roles of government, employers, and individuals in providing retirement income. In some countries, the ideas of national solidarity and communal responsibility are important, and government plays a major role in providing retirement income. In other countries, a high value is placed on individual responsibility and freedom of choice, and employers and workers play a larger role in determining retirement income. Historical experiences concerning inflation and the development of capital markets also influence the development of pension systems. The result is a diversity of systems among countries.

Regardless of the institutional arrangements of pension systems, population aging is a fundamental force that affects the way retirement income is provided. As populations age, the political power of the older generation increases, but so also does the cost of providing retirement benefits. The net effect is manifested in increasing payroll tax rates and cutbacks in benefit generosity. These changes reduce the rate of return on social security benefit programs, favoring the development of funded private pensions.

In addition to demographic changes, the shift towards private pensions may also be due to a move in many countries towards greater reliance on market institutions. This move has resulted in some countries from the fall of Communism. The trend has been more

widespread, however, with many countries seeking to reduce the role of government in economic life.

Pension retirement benefits provided by private-sector employers are an increasingly important source of retirement income in the United States, Japan, the United Kingdom, and Western Europe.³ Spain in 1987 (Ruano 1995) and Italy in 1993, for example, countries that have not had well-developed pension systems, have adopted comprehensive legislation to encourage and regulate private pension plans. Countries in Central and Eastern Europe are studying Western models to develop reforms of their retirement income systems. Countries in Latin America, following the lead of Chile, are moving towards private-sector pension systems. In 1993, Peru adopted a version of Chile's pension system, followed by Argentina in 1994 (Campbell 1994). Colombia has passed legislation calling for similar reforms. In the United States, there has been a long-run trend of employer-provided pensions providing a growing share of U.S. retirement income (Chen 1992).⁴ In short, these developments suggest that over the next decade, the growing importance of private pensions—the privatization of retirement income—will be worldwide.⁵

The primary purpose of private pensions traditionally has been to provide retirement income, a purpose sometimes called “welfare capitalism.” Private pension systems, however, are increasingly being called on to serve other functions. For example, the 1993 private pension legislation in Italy was a response to the government's declared aim of increasing savings and capital accumulation, supporting and enlarging the domestic financial market, and creating the capacity to absorb the large amount of assets to be sold during the process of privatizing public enterprises.

Pension Terminology

Pension terminology varies among English-speaking pension experts. While in many countries social security programs include a wide range of benefits, social security refers, in this book, to a government-provided retirement income program. Employer-provided pensions include those provided by private-sector employers and those

provided by public-sector employers for their employees. This book focuses on private pensions. A private pension plan is an employer-provided plan or an employee group-sponsored plan that provides retirement benefits for private-sector employees.

In an international comparison of pension plans, the variety of benefit arrangements blurs the distinctions among different types. Plans providing cash benefits to older workers differ as to who sponsors them, who is covered by them, and what purposes they are used for. Pension plans for government-owned enterprises are plans in the private sector for enterprises that are owned by the government. Savings plans are employer-sponsored plans that may be used for retirement or for other purposes. Disability plans for older workers may allow a worker to retire with a pension, but require the worker to have a medical condition that affects the ability to work. Unemployment compensation plans for older workers may provide benefits that function as retirement benefits, but they require that the worker qualify as unemployed. Severance pay plans may provide retirement benefits for older workers, but they generally pay benefits regardless of the age at job separation. When discussing private pension plans, it is worth keeping in mind that other plans serve similar purposes.

A private pension plan may be voluntary or mandatory. This book considers the mandatory pension plans in France and Switzerland to be private pension plans because the assets of these plans remain under private-sector control. While some plans serve multiple purposes, plans used primarily for providing retirement income are considered in this book to be retirement plans.

Overview

Social security powerfully influences private pensions. Social security benefit expenditures have been growing in the developed countries of the Organisation for Economic Cooperation and Development (OECD).⁶ Social security expenditures as a percentage of Gross Domestic Product (GDP) are a measure of the public burden of providing old-age benefits. Table 1.1 shows that measure for the G7 countries—the major democratic, developed economies. Between 1960 and

1985, social security expenditures as a percentage of Gross Domestic Product doubled in France, nearly tripled in Italy, and quadrupled in Japan. In 1985, this percentage covered a fairly broad range, from a low of 5.3 percent in Japan, to a high of 15.6 percent in Italy. Expenditures as a percentage of GDP will continue to grow, due to the large increases in old-age dependency that will begin to occur early in the twenty-first century (table 1.2). Population aging will be a particularly serious problem in Japan. Because of long life expectancy, low fertility, and low immigration in Japan, the projected old-age dependency ratio (the ratio of the population aged 65 and older to the population aged 20 to 64) in the year 2025 will be nearly 50 percent higher than in the United States at that time. Increasing expenditures on social security have also been caused by a growth in the percentage of the aged who are beneficiaries (the maturing of social security systems), and by increases in benefit generosity in past years.

Table 1.1 Social Security Expenditures as a Percentage of Gross Domestic Product in Selected Countries, 1960-1985

Country	1960	1975	1980	1985
United States	4.1	6.7	6.9	7.2
Canada	2.8	3.7	4.4	5.4
France	6.0	10.1	11.5	12.7
Germany	9.7	12.6	12.1	11.8
Italy	5.5	10.4	12.0	15.6
Japan	1.3	2.6	4.4	5.3
United Kingdom	4.0	6.0	6.3	6.7

SOURCE: Mitchell (1993).

NOTES: The percentage is the ratio of annual public expenditure on pensions to current-year GDP. Public pensions in this table include both transfers through social programs and pension payments to retired government employees. Privately sponsored pensions are not included, nor are tax expenditures granted to private and/or public plan savings. Figures for Germany refer to the former West Germany.

With social security growing relative to the economy, a number of OECD countries are facing pressures to reduce their social security benefits. Future social security benefits have been lowered by legislation: in the United States in 1983, in Japan in 1985 and 1994, in the United Kingdom in 1980 and 1986, in Germany in 1989, in France and

Italy in 1993, and in Sweden in 1994. The United States, Germany, and Japan have scheduled increases in the age for full benefits and a higher reduction in benefits at early retirement. When the change is fully implemented in the United States in 2022, benefits at early retirement will be reduced by 12.5 percent below what they would have been had no reduction occurred.⁷

Table 1.2 Old-Age Dependency Ratio in Selected Countries, 1990, 2010, and 2025

Country	1990	2010	2025
United States	21	22	34
Canada	19	24	38
France	24	27	38
Germany	24	34	42
Italy	24	34	44
Japan	19	37	49
United Kingdom	27	29	39

SOURCE: U.S. Department of Commerce (1993, p. 122)

NOTE: The old-age dependency ratio is measured here as the number of persons 65 years and over per 100 persons 20 to 64 years.

In some countries, rather than directly lowering social security benefits, changes have been made that indirectly have that effect. France, for example, has raised the qualifying period for full benefits from 37.5 years to 40 years, has raised the base earnings for computing benefits from 10 to 25 years, and has changed the indexing of the earnings used in computing the base from wage indexing to price indexing. These changes will reduce social security benefits by 8 percent. Similar changes have been made in Italy (Graham 1994). Thus, while social security expenditures are growing relative to the economies of a number of countries, legislative changes in place will cause the generosity of social security benefits to decline.

Effects of Shifting Towards Private Pension Systems

Government policy makers presumably base retirement income systems on the relative merits of private pensions and social security. There are important differences between the two: (1) private pensions generally do not cover the entire private-sector workforce, while social security generally does; (2) private pensions are at least partially funded through investments in the private sector, while social security generally is unfunded or has limited funding through holdings of government bonds; (3) social security frequently provides complete indexation for postretirement inflation, while private pensions provide partial or no indexation; and (4) social security benefits are fully portable between jobs, while private pension benefits in defined benefit plans generally are not.⁸ (When a pension benefit is fully portable between jobs, a job change causes no loss of future retirement benefits.)

Private pensions and social security may differ in how they affect workers and retirees. A reduction in social security could have the most serious consequences for low-income workers not covered by private pensions, who depend primarily on social security for their retirement income. Whether that effect occurs, with a consequent worsening of the income distribution, depends on how social security benefits are reduced. If social security is reduced across-the-board, as will happen in the United States in the next century, then it appears the shift towards private pensions would cause a worsening in the income distribution and an increase in poverty.⁹

Private pensions are at least partially funded in most OECD countries, while social security is generally unfunded. Thus, a shift away from social security toward private pension plans may increase national savings. A survey of studies suggests that a one-dollar increase in funding of a private pension plan increases aggregate savings on average by 40 cents and decreases nonpension savings by 60 cents (Pesando 1992). Researchers do not agree on the size of this effect, however, although most researchers have found at least a small positive effect. In the countries of Eastern Europe, which have poorly developed capital markets and thus fewer competing assets through which to save, the effect of private pensions on net savings would prob-

ably be greater than in countries with well-developed capital markets. Studies of the effect of social security on savings generally find a negative or insignificant effect (Feldstein 1974).

Because of differences in the degree and type of funding, social security and private pensions are subject to different risks. Funded private pension systems face financial market risks. Inflation risk is greater for private pension benefits than for social security benefits because private pension plans lack full inflation protection after retirement. Also, funded private pension systems are more at risk due to inflation than are unfunded public systems because of fixed rates of return on some investments. Unfunded systems depend on wage payments, which tend to keep pace with inflation better than do financial rates of return. Because defined benefit private pensions are generally not portable between jobs, they also have greater risk of benefit loss due to job change than does social security. Workers face risks associated with changeable political commitments to social security systems, but also face risks concerning changeable laws affecting private pensions.

Private pensions are more expensive to administer than social security systems because of the economies of scale in administering social security. On the other hand, private pensions offer greater flexibility because they can be tailored to the needs of small groups of workers.

Private Pension Systems and Policies

In developing pension policy, it may be useful to understand the experience of other countries with similar economies as they confront problems concerning retirement income. For example, many countries have legislated pension rules to protect workers against pension benefit loss at job change. All countries face the problems of demographic change and of inflation eroding the purchasing power of retirement benefits. All countries must decide on the tax treatment of their pension systems.

Private pension systems and policies can be analyzed by comparing across pension systems, treating each country as an entire entity, or by comparing across countries on individual issues without discussing

entire pension systems. The first approach provides an understanding of the major issues as to how different countries structure their pension systems, but comparisons on individual policies are not as clearly drawn. The second approach provides a clearer international comparison on individual issues, but the major comparisons on system structure are lost. This book adopts the second approach because that approach is more useful for analyzing particular policy issues. It is designed for readers wishing to learn about how different countries address particular policy issues, rather than for those wishing an overview of pension systems in different countries. This decision reflects the availability of good country studies.¹⁰

A Selective Summary of Pension Trends

This book discusses issues that arise as countries adopt and expand private pension systems. In doing so, it identifies a number of international trends in various aspects of pension policy and systems. First, there is a trend towards greater privatization of retirement income. This is occurring through explicit privatization of social security and through legislative cutbacks in the generosity of social security benefits. Chile has almost entirely privatized its system of retirement income, and other countries have adopted partial versions of its system. The United Kingdom and Japan both allow for partial privatization of social security through “contracting out,” which is known in the United States (in the context of health care) as “pay or play.” Germany has a privatized system of pension benefit insurance.

Second, the aging of populations in developed countries is raising the cost of providing social security benefits, but it is also making the tax subsidies to support private pension systems more expensive. Presumably in response to this, a number of countries have reduced the generosity of the tax subsidies for private pension plans.

Third, in many countries there is a trend towards defined contribution plans. This is at least partly the result of increasing regulation of defined benefit plans. In some cases, it is the result of government policy mandating the provision of defined contribution plans.

Fourth, pension plans are investing increasingly in foreign securities. Regulations inhibiting foreign pension investments have been reduced or eliminated in some countries. In other countries, increased foreign investment seems to be driven by a realization of the financial benefits afforded by the greater diversification.

Fifth, many countries have reduced the loss of benefits suffered by workers who change jobs. Pension portability has been enhanced by reducing the years required for vesting and, in some countries, by indexing (up to a ceiling inflation rate) the benefits of workers leaving a job before retirement age.

Sixth, in most countries with pension systems the coverage rate of workers has increased over the past twenty years. In more recent years, this trend has stabilized or slightly reversed in some countries.

NOTES

1. Outside of the United States, the images of three pillars or three tiers are more commonly used.

2. Earnings, disability programs, unemployment insurance, and poverty programs also provide income for the elderly.

3. Reynaud (1994a) characterizes this analytical focus on the public/private division as an Anglo-Saxon approach. In France, analysis is based on whether a pension is a basic pension or a complementary pension. Reynaud also notes that when faced with the complexity of pension systems, analysts tend to practice ethnocentrism, applying a familiar analytical framework that does not always correspond to the logic of the pension system being analyzed.

4. Because of the declining generosity of social security starting in the year 2000, it can be expected that private pensions in the United States will provide a larger share of retirement income in the future.

5. These trends suggest that there will be a convergence of retirement income policies as many countries react to the changing demographic and political environment.

6. These countries include Japan, Canada, Australia, the United States, and the countries of Western Europe.

7. Generally, when referring to an aspect of social security or pension law where the primary source of the information is the law itself, secondary references are not given.

8. Multiemployer defined benefit plans are an exception. They allow unionized workers to change jobs within a single union and geographic area without losing benefits. For other exceptions see Turner (1993a).

9. This is the conclusion of Pestieau (1992).

10. Readers wishing to learn about particular countries should refer to the listing of countries in the index. In addition, readers wishing an overview of the pension systems in Canada, Japan, the Netherlands and the United Kingdom can refer to Turner and Dailey (1991). Readers wishing an in-depth analysis of the U.S. pension system can refer to Turner and Beller (1992). Additional country studies available include: Chile (Diamond and Valdes-Prieto 1994); Japan (Clark 1991b); Ireland (Hughes 1994); Germany (Bodie, Mitchell, and Turner 1995); France (Reynaud 1994b); and Mexico (Cross 1994). The World Bank (1994) discusses the overall structure of retirement income systems.