

Pension Reform: The Unfinished Agenda

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Introduction

Reforming pensions has loomed large over the policy agenda of OECD countries for several years as governments grappled with the challenge of ageing populations or unsustainably generous systems. It is often said in the United States that reforming public pensions is the “third rail” of politics: touch it and you die, but the phrase could well apply to all OECD countries. Pensions involve decisions for the long term, but most governments will have left office before the long-term benefits of any pension reform appear, so all they reap are criticisms in the short term of their reform efforts.

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. And 16 of them have made major reforms that will significantly affect future benefits.

Six of the ten countries with the *highest* public expenditures on pensions as a percentage of GDP in 1990 – Austria, France, Germany, Italy, Sweden and Finland – have undertaken major pension reforms since 1990. These reforms have cut benefits and will lead to lower pension spending in the future. But the ten OECD countries with the *lowest* pension expenditures in 1990 have been almost equally active. They will face significant financial challenges in the future, either because of population ageing or unsustainably high pension promises, which they are aiming to ease by acting now.

One thing is already clear. People in OECD countries will have to save more for their retirement as a result of the pension reforms carried out in recent years. But pension reform is far from being complete. This *Policy Brief* looks at what governments have done to reform pension systems in OECD countries, and what more they need to do to ensure sustainable pension systems in the longer term. ■

What have governments done?

Most countries' pension reforms were packages made up of a number of different measures. Some of these, such as increases in the age at which people can start drawing a pension, 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.

Changes in pension age are the most common feature of reform packages. The rationale for these changes is clear: life expectancy started growing rapidly in the 1960s, but many countries cut their retirement ages. The average pension age 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, while life expectancy grew from 68.5 years to 75.6 over the same period. At the same time, fertility rates have plummeted in many countries which means that there will be less active workers supporting a growing number of retirees. Pension systems, however, were drawn up when people lived relatively short periods in retirement. To keep the systems financially sustainable with population ageing, people will either have to work longer or retire on lower benefits.

Recent reforms have reversed the trend to lower pension ages, with seven OECD countries introducing gradual increases in pension ages for both men and women and a further five countries increasing pension ages for women, which had previously been lower than those for men. 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. Only France, Hungary and the Czech and Slovak Republic plan to have pension ages below 65; in four more countries, women can retire on a full benefit earlier than the male retirement age of 65 years. 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 salary, or one of the best salaries over a working lifetime. 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 are adjusted or “indexed” once people retire and start receiving benefits. Many OECD countries have moved from adjusting pensions to changes in earnings

towards using prices, at least in part, to determine pension adjustments. 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, where pensioners receive a set fraction of their previous earnings, and replace it with defined-contribution schemes, where the pension depends on contributions and interest earned on them during a working lifetime. 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 with a notional interest rate set by government and often linked to wage or GDP growth. The schemes remain pay-as-you-go financed: no assets are accumulated and the money used to pay pensioners comes from contributions by current workers.

The systemic reforms share one important feature: pensions will in future automatically adjust to changes in life expectancy, except in Italy where adjustments are supposed to take place every 10 years. 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 pensioners. The first is financial: how much smaller will benefits be for workers entering the labour market today compared with earlier generations? The second is distributional: 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.

Building 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 policy makers 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, *e.g.* 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. Table 1 shows the pension in retirement relative to earnings when working (known as the replacement rate), for people with average earnings. The calculations take into account reforms in 16 OECD countries that happened between 1990 and today results are shown after reform and for the hypothetical situation that there had been no reforms. In New Zealand and the United Kingdom, the situation did not change for average earners; their pension remained at the same level compared to their working income. There was only a very small decline in Poland whilst in Hungary pensions represented a greater share of earnings than before, although changes in the way pensions were taxed offset much of this effect. Austria, Finland, Korea and the Slovak Republic also slightly cut the target level of pensions relative to earnings.

But some other countries saw large cuts in pension rates compared to average earnings. 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.

These figures only apply to average earners; not all workers were affected equally by benefit cuts. Several countries moved towards greater targeting of benefits to poorer pensioners, especially Mexico, Portugal and the United Kingdom. Austria, France, Germany and Sweden also protected low earners.

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 old-age poverty. ■

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 shows relative pension levels – the pension benefit as a share of economy-wide average earnings – net of taxes and social security

Table 1.
PRE- AND POST-REFORM GROSS REPLACEMENT RATES FOR WORKERS ON AVERAGE EARNINGS IN SELECTED OECD COUNTRIES¹
(percentage of individual earnings)

	Men		Women (where different)	
	Pre-reform	Post-reform	Pre-reform	Post-reform
Austria	90.0	80.1	80.0	80.1
Finland	66.3	63.4		
France	64.7	51.2		
Germany	48.7	39.9		
Hungary	57.7	76.9	52.7	76.9
Italy	90.0	67.9	80.0	52.8
Japan	40.7	34.4		
Korea	69.3	66.8		
Mexico	72.5	35.8	72.5	29.7
New Zealand	39.7	39.7		
Poland	62.2	61.2	57.3	44.5
Portugal	90.1	54.1		
Slovak Republic	59.5	56.7		
Sweden	78.9	62.1		
Turkey	107.6	72.5	102.8	72.5
United Kingdom	30.8	30.8		

1. OECD countries that have implemented significant pension reforms over the past decade.

Source: OECD pension models.

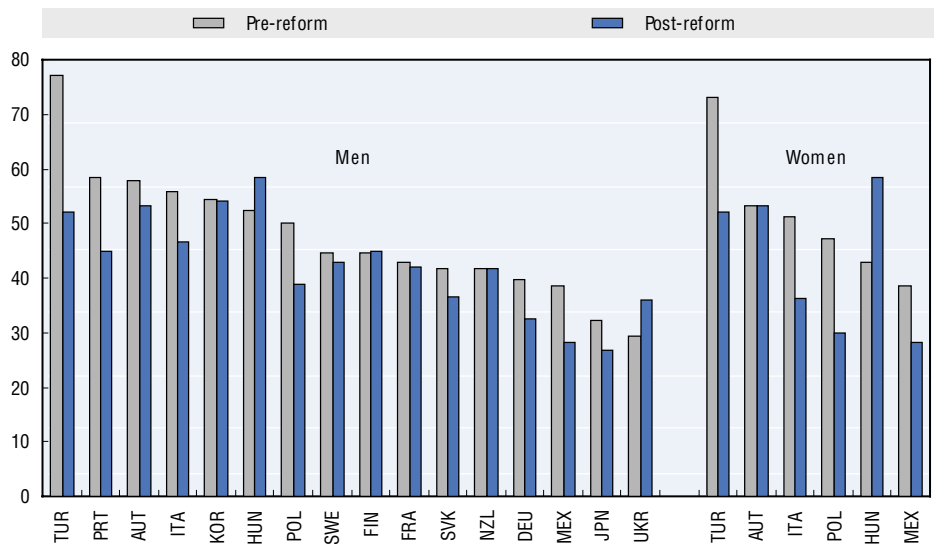
contributions for low-income retirees before and after reform. Because the relative pension level shows how far away pensioners are from the average living standards of workers, it is a useful measure of how adequate pension benefits are. It is also a good indicator of poverty risk for retirees.

Only in 2 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 a new pension credit and a second state pension. In Hungary, low earners also gained from the reform, but with a larger relative increase for women; this is due to a higher retirement age and thus a longer period over which women earn pension rights.

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.

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.

Figure 1.
NET RELATIVE PENSION LEVELS PRE- AND POST-REFORM FOR LOW-INCOME WORKERS (50% OF AVERAGE EARNINGS) IN SELECTED OECD COUNTRIES¹



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

Source: OECD Pensions at a Glance.

In most reforming countries, current pensioners were excluded from the reforms and the real effect of pension reform will only show once younger groups 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. ■

For further information

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For further reading

OECD (2007), **Pensions at a Glance: Public Policies across OECD Countries** (particularly Part II.1), ISBN 978-92-64-03214-9, € 30, 204 pages.

OECD (2007), **Closing the Pensions Gap: The Role of Private Pensions**, OECD Policy Brief, see www.oecd.org/publications/policybriefs.

OECD (2006), **Ageing and Employment Policies: Live Longer, Work Longer**, ISBN 978-92-64-03587-4, € 24, 146 pages.

Or visit www.oecd.org/els/social/ageing; www.oecd.org/daf/pensions.

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