

## Closing the Pensions Gap: The Role of Private Pensions

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### Introduction

Have you chosen the best pension scheme for you? And how can you be sure it will provide a secure income when you actually retire? Pension reform has been a key issue for governments in recent years as they grappled with the challenge of ageing populations or unsustainably generous public pension systems. Raising retirement ages and keeping older workers in jobs is only part of the solution – the bottom line is that as people are living longer, they will have to save more during their working years to ensure financial security in retirement. Private pensions play an important and growing role in providing for old age in OECD countries.

Three kinds of policy have increased the role of private pensions. In 11 OECD countries, mandatory private pensions operate as a substitute for part of the public pension provision. Two other countries have added mandatory private pension saving on top of existing public plans. And many countries have scaled back their public pensions, leaving a greater role for voluntary, private savings.

Voluntary occupational pension plans have long had broad coverage in English-speaking OECD countries such as Canada, Ireland, the United Kingdom and the United States, where they currently reach 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.

In nearly all OECD countries today's workers will have to do more on their own to prepare for tomorrow's retirement, even if they save throughout their entire career. If young workers miss out on the first 10 or 15 years of their career because of other demands on their budget, reaching a sufficient pension level will become even more difficult.

This *Policy Brief* looks at how the pension landscape is changing, and how voluntary private pensions can contribute to ensuring financial security in retirement. ■

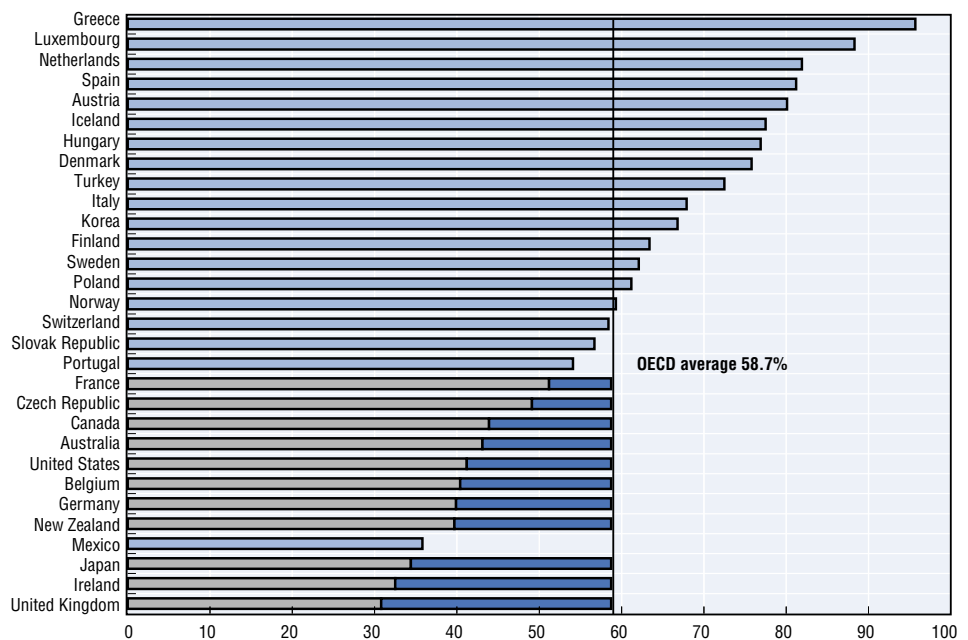
How big is the pension gap?

It is clear that 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. But how big is the problem, and which countries face the largest challenge? On current mandatory pension contributions, an average earner with a full career in an OECD country can expect to receive a retirement pension equivalent to 58.7% of earnings while working – this indicator is known as the “replacement rate”. But this is the OECD average; the actual replacement rate in individual countries varies enormously, from 96% of earnings in Greece to 31% in the United Kingdom (see Figure 1).

The 11 OECD countries at the bottom of the chart have mandatory replacement rates substantially below the OECD average, and these countries are the focus of this Policy Brief. (Mexico also has a low replacement rate but it is not considered here; the Mexican pension system is based entirely on individual retirement saving accounts and there is still a guarantee that the benefit will be at least at the level offered by the pre-reform system, so the retirement savings issue is not comparable with that of other countries.)

What level of voluntary, private pension savings would be needed to bridge the “pensions gap” and bring the average pension relative to earnings in the 11 countries at least up to the OECD average of 59%? This is obviously an arbitrary target but it can help measure the scale of the problem, and provide a benchmark relative to all OECD countries, including those with mainly mandatory retirement provision.

**Figure 1.**  
**THE PENSIONS 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.

Mandatory national pension systems fall below the OECD average rate in all six mainly English-speaking members of the OECD – Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States – as well as in four continental European countries – Belgium, the Czech Republic, France and Germany – and in Japan. For these 11 countries as a whole, the replacement rate is 40.6% – in other words, the retirement pension is less than half earnings while working for average earners.

The gap is largest in the United Kingdom, where private savings would need to deliver a pension worth more than a quarter of earnings while working (28%) to bring the overall pension up to the OECD average. France has the smallest retirement savings gap of the 11 countries listed: 7.5%. ■

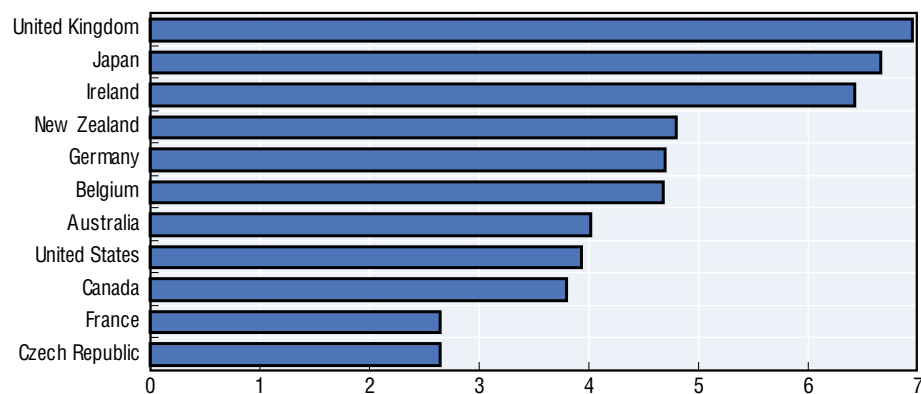
**How much saving is needed to fill the gap?**

The savings effort required to fill the pensions 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 the value of the pension, how long it is likely to be paid, and how much interest the savings earn. Life expectancy in France and Japan is much higher than in the Czech Republic, for example, and people retire at different ages in different countries. The normal pension age is age 65 in eight of the 11 “pension gap” countries, but is 60 in France, 62 in Hungary and will be 67 in the United States when the reform is fully effective.

The normal pension age also affects the number of years 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 the period is 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

**Figure 2.**  
**FILLING THE PENSIONS GAP**  
Contribution rate (% of earnings) required for full-career average earner to reach OECD average pension



Note: Assumes a real rate of return on investments of 3.5% per year.

Source: OECD, *Pensions at a Glance*.

of earnings that individuals would need to contribute to voluntary pensions to achieve an overall replacement rate equal to the OECD average of a retirement pension of close to 60% of earnings. The results are shown in Figure 2.

As might be expected, the United Kingdom has the highest required contribution rate – 6.9% of earnings – since it has the largest replacement-rate gap. Japan’s replacement-rate gap is four percentage points lower than in the United Kingdom, but because Japanese retirees live longer than older people in the United Kingdom, the required contribution rate is only two percentage points lower – 6.7% compared with 6.9% in the United Kingdom. France has the smallest replacement-rate gap, but a normal retirement age of 60 and life expectancy above the OECD average. This increases the required contribution rate compared with countries with normal retirement at 65 or more. The required contribution rate is 2.6% of earnings for both France and the Czech Republic. ■

### How many people save for retirement?

Do individuals respond to lower replacement rates from mandatory pensions by making additional voluntary, private provision for retirement? The answer varies widely between OECD countries, but they broadly fall into two groups.

The first group of countries has voluntary private pension coverage of less than 10% of the workforce. This group is made up of mainly Southern European countries – Greece, Italy, Portugal, Spain and Turkey – but also includes Finland and Poland. These nations have relatively high mandatory replacement rates for average earners so workers may see less need to make private provision for retirement. For these seven countries, the average retirement pension payment is 71% of gross earnings, compared with 59% for the OECD as a whole.

The second group 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% while around half of the workforce is covered by voluntary private pensions. ■

### How long do people need to save for retirement?

People are unlikely to spend their whole working lives contributing to 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 of 59%?

Obviously, the shorter the period over which an individual devotes part of his or her earnings to voluntary pension contributions, the greater the share of their earnings they will have to set aside during the years they do contribute. So in the United Kingdom, the contribution rate is 6.9% for a full career starting at age 20 and ending at national normal pension age. But if people delay starting their private pension until age 30, shortening the contribution period by 10 years, the contribution rises to nearly 10%, and with 20 missing years, contributions need to be nearly 15% to plug the retirement-savings gap.

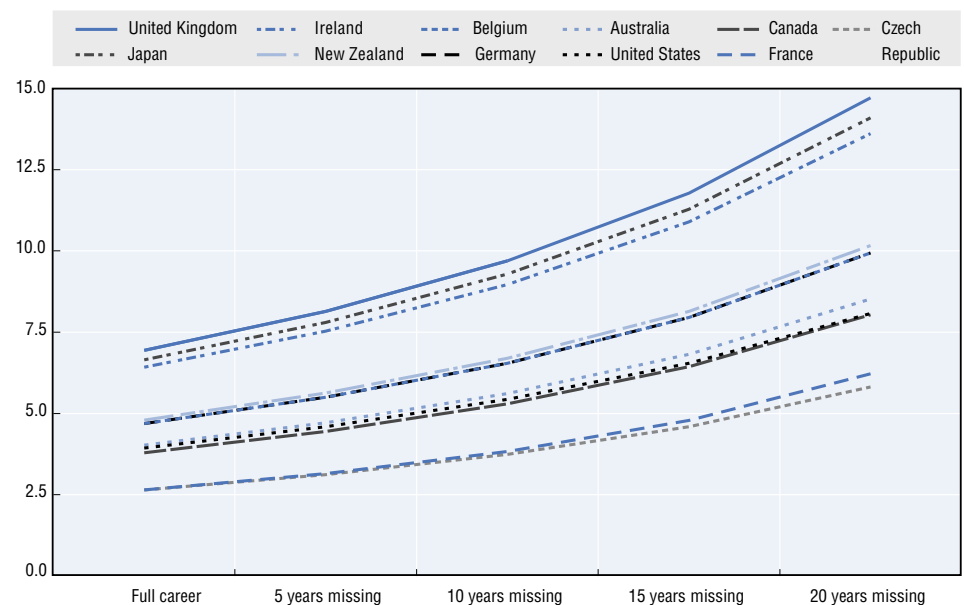
In Ireland and Japan, the necessary contribution rates are a little lower, but still rise significantly as contribution years are missed. In Belgium, Germany and New Zealand, the required contribution rate is around 4.6% for a full career, 6.7% with ten missing years and 10% with 20 missing years (see Figure 3). ■

**How much do investment returns matter?**

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 used here 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 of a 3.5% real annual return on investment. However, a lower rate of return would naturally mean that individuals would need to contribute more. If real returns on investment were only 2%, for example, the contribution rate in these

**Figure 3.**  
**YEARS OF CONTRIBUTIONS AND THE PENSIONS GAP**  
Contribution rate needed to reach OECD average replacement rate by years of contributions



Source: OECD, *Pensions at a Glance*.

three countries would need to be 9.5% to fill the retirement savings gap. In contrast, higher returns on investment of around 5% would lower 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. ■

### How to encourage greater pension savings?

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 – available evidence shows that about half of all employees contribute to private pensions. Yet data from such countries shows that coverage is uneven across population groups, with younger individuals, as well as low to mid-income and part-time or self-employed workers having particularly low coverage rates.

Data on average contribution rates are difficult to obtain but preliminary evidence shows that among those contributing to voluntary private pension schemes, the average contribution rates are 8.5% earnings in Canada, around 9% in the United Kingdom and United States and 10% in Ireland. These contribution rates would be sufficient to fill the pensions 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” of the situation at a particular moment in time, but it is lifetime coverage and contributions that ultimately determine an individual’s retirement income. It is often not possible, for example, to know whether a 50% coverage rate in a “snapshot” study of a private scheme implies that half the workforce contributes for every year of their working lives or the whole workforce contributes for half of their working lives. This is obviously important for governments seeking to increase pension savings, as the implications for pension policy are very different. If only half of workers are saving, more people need to be encouraged to save; if all workers are saving, but for only half of their careers, they need to be encouraged to contribute for longer. These different targets would require different policy approaches to achieve the desired result.

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 more than half of the workforce in any OECD country.

From the international experience, introducing mandatory 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”, which will require people to save unless they take action to 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. Other mechanisms that can be used to increase coverage of private pension plans include making more workers eligible for pension plans, providing financial education for workers and launching national awareness campaigns – issues for which the OECD is currently developing guidelines. Tax credits rather than tax deductions may provide more incentives for lower-income workers to contribute to voluntary pensions. ■

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### For further reading

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

OECD (2006), **The Importance of Financial Education**, Policy Brief, available at [www.oecd.org/publications/policybriefs](http://www.oecd.org/publications/policybriefs).

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), **Pension Reform: The Unfinished Agenda**, Policy Brief, available at [www.oecd.org/publications/policybriefs](http://www.oecd.org/publications/policybriefs).

Or visit [www.oecd.org/els/social/ageing](http://www.oecd.org/els/social/ageing); [www.oecd.org/daf/pensions](http://www.oecd.org/daf/pensions).

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