OECD Pensions Outlook 2018
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The role of supplementary pension provision in retirement

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CHAPTER 7
Are survivor pensions still needed?
Reforms are making pension systems more robust and better placed to deliver pensions

People’s trust in pension systems is low. Population ageing, low returns on retirement savings, low growth, less stable employment careers and insufficient pension coverage among some groups of workers have been eroding the belief that all types of pension systems, pay-as-you-go or funded, will deliver on their promises once workers reach retirement age. This is supported by evidence in the recent OECD Risks that Matter survey. People are also concerned about whether the institutions managing their retirement savings in funded pension arrangements have their best interests at heart.

This mistrust may surprise some, given the wide range of pension policy reforms across OECD countries in recent decades. These reforms have improved the sustainability of pension systems, in particular of pay-as-you-go defined benefit public pensions. Many countries, for example, have introduced automatic mechanisms to adjust pension benefits to economic and demographic developments while taking measures to strengthen safety nets to prevent old-age poverty.

Regulators and policy makers have taken steps to make regulatory and supervisory frameworks for funded pension arrangements more robust. This includes improving pension fund governance, investment policies and strategies, and investment risk management, with the goal of ensuring a more solid focus on the best interest of members. Progress has also been made in better aligning the charges and fees individuals pay with the actual cost of providing funded pensions. Measures to improve transparency are essential, but they work best when supported by pricing regulations and structural solutions.

Policy makers have also implemented measures to improve the design of funded pension arrangements to address the challenges of insufficient financial knowledge and behavioural biases and assist people make better choices for their retirement. These include providing targeted financial incentives, including matching contributions; automatic mechanisms; default options; simplification of information and choice; and financial education initiatives.
All of these reforms have made pension systems more robust today and better placed to deliver pensions. However, people’s concerns are at least partially grounded in some remaining challenges. To ensure higher retirement income, people need to increase retirement savings, pension contributions, and/or the length of the contribution period in both pay as you go and funded pension arrangements. This is even more necessary as improvements in mortality and life expectancy lead to ever-longer periods in retirement.

Policy makers have a range of options, including linking the statutory retirement age to improvements in life expectancy, keeping in mind that there are large socio-economic differences in life expectancy in many countries. The interaction between different pension arrangements, old-age safety nets and the tax system may sometimes address the potentially regressive effect of increasing the retirement age, when this age is fixed for everybody. More flexibility around the age at which people can access their pension savings may help reduce this regressive feature. Financial service providers need to develop innovative products and approaches to manage longevity risk. In addition, higher funded retirement savings could be achieved both by linking increases in contributions over time to increases in real wages and through better designed financial incentives. Governments are also examining how to integrate workers in non-standard forms of work, such as those active in the platform and gig economy and those working as independent contractors, into public pensions and encourage them to save for retirement.

Finally, pension reforms need to be better communicated so that the rationale and effects of such reforms become clearer. People need a better understanding of what they themselves can do to secure their retirement incomes, why contributions to all types of pension arrangements are important, which vehicles are available for retirement saving, and how they are protected. These key steps could help to restore trust and confidence in pension systems.
Combining funded and PAYG pensions, automatic mechanisms, and a strong safety net for pensioners improves retirement outcomes

Countries encourage saving for retirement by taxing Policy makers designing pension systems should reflect on their objectives (poverty relief, redistribution, sustainability, and consumption-smoothing) and risks (demographic, social, labour, macroeconomic, and financial).

A robust safety net for pensioners, as well as a diversified and balanced pension system that incorporates a funded component is important, especially when promoting and reallocating national savings toward long-term investment is a policy goal. Additionally, well-designed pension systems need automatic mechanisms that align benefits with economic and demographic realities. Systems should be financially sustainable and provide some of the certainty conveyed by defined benefit arrangements.

Countries should introduce funded arrangements gradually when diversifying pension systems, especially when contributions will partially, or fully, replace an existing pay-as-you-go system. Policy makers should carefully assess the transition as it may put an additional, short-term, strain on public finances and increase risks for individuals.

KEY FINDINGS

Countries can improve the design of financial incentives to save for retirement

Tax and non-tax financial incentives can promote saving for retirement by providing an overall tax advantage to individuals through a reduction in total lifetime tax paid, although this has a fiscal cost. Incentive design should account for retirement saving needs and capacities for all income groups and, as a minimum requirement, provide for tax neutrality between consumption and savings.

Tax rules should be straightforward, stable and consistent across all retirement savings plans. Tax credits, fixed-rate tax deductions or matching contributions can be used to provide an equivalent tax advantage across income groups. Countries using tax credits may consider making them refundable and paying them into pension accounts. Non-tax incentives, in particular fixed nominal subsidies, help to boost low-income earners’ savings. Countries with an “EET” tax regime should maintain the deferred taxation structure and all countries considering the introduction of financial incentives should examine their fiscal capacity and demographic trends.

Aligning charges levied with the cost of managing retirement savings requires better disclosure, pricing regulations and structural solutions

Providing pension services involves costs such as administration and investment activities which are paid for by members and employers. These costs can greatly affect the ultimate value of accumulated retirement savings. Some pension arrangements
can be also more expensive, such as those providing more choice.

Market mechanisms have often been insufficient to align charges with the actual cost to providers due to market failures, such as asymmetric information or behavioural biases.

Measures to improve transparency are essential, but are not enough to align costs and charges. They work best when supported by pricing regulations and structural solutions. To maximise net returns, policy makers and regulators can also use measures such as benchmarking and tying investment expenses more closely to portfolio performance.

The governance and investment approaches of nationally significant investment institutions provide useful guidelines to strengthen regulatory frameworks

Several nationally significant investment institutions have common features and provide evidence of good governance and investment approaches. They have regulatory and legal frameworks at arm’s length from government; clearly stated missions to guide investment policy; an oversight board that is accountable to the competent authorities and to members; and transparency about their governance arrangements and their investment and risk management to keep them accountable to different stakeholders.

These institutions express their performance objectives in terms of their mission and monitor performance against this long-term goal rather than against a market benchmark. Target date and lifecycle funds are the preferred strategy for institutions with individual accounts. Long-term return strategies may offer better returns, but at a higher risk that insufficient funds will be available to members at retirement.

Automatic features, default options, simple information and choice, financial incentives and financial education lead to better retirement outcomes

Low levels of financial knowledge and behavioural biases can lead people to make unsuitable decisions for retirement. Mechanisms such as automatic enrolment and escalation of contributions can harness inertia to make pension systems more inclusive and help increase contribution levels. People unable, or unwilling, to choose a contribution rate, a pension provider, an investment strategy or a post-retirement product, may benefit from default options.
There are also other tools to help with decision making, including: web applications, limiting options and making comparisons easier, and financial incentives. Pension statements can convey key information simply, while financial education seminars and financial advice can help people understand the information.

**Increased flexibility on retirement age and progressive public pensions and tax rules address financial disadvantages of populations groups with shorter life expectancy**

Individuals in low socioeconomic groups have a lower life expectancy than high socioeconomic groups. They may be financially disadvantaged if they spend a shorter time in retirement relative to their working life, receiving a lower “return” on contributions made towards their funded pension source. Public pensions and tax rules can help to offset some of this disadvantage.

Policies to improve the sustainability of pension systems in light of increases in life expectancy will need to consider how those in different socioeconomic and gender groups may be impacted. Generally, working for longer will be required, but not all groups will necessarily be able to. Increased flexibility around retirement age is key to improving pension outcomes for all groups and ensuring that lower socioeconomic groups are not penalised in retirement for having shorter life expectancies.

**Survivor pensions still play an important role, but should not limit incentives to work or redistribute from singles to couples**

Survivor pensions are still needed to smooth living standards after a partner’s death. However, recipients should not be eligible for a permanent survivor pension before retirement age. Instead, temporary benefits should be available to help adapt to the new situation.

The cost of survivor pensions should be internalised within each couple or, as a minimum, among all couples. In a budget-neutral reform, this means that the pension level of singles will be higher than someone living in a couple and benefiting from survivor pensions.

Partners from former unions should not be eligible as they have no current consumption to smooth. Splitting pension rights offers some advantages, although some countries favour the individual treatment of partners, including to promote gender equality.

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**Figure 2. Tax treatment of retirement savings, 2018**

Notes: The three letters that categorise the tax treatment of retirement savings refer to contributions, returns on investment and withdrawals, each one being either taxed (“T”) or exempt from tax (“E”). Main pension plan in each country. “E” stands for “exempt” and “T” for “taxed”. Countries offering tax credits on contributions are considered as taxing contributions, as the tax credit may not cover the full amount of tax paid on those contributions.
Pensions intend to offer people economic security in old age, once they can no longer earn their living themselves. The public sector or the private sector could entirely, and in principle, provide economic security. Pensions could be financed by the state from general revenues or earmarked levies on a pay-as-you-go (PAYG) basis, or they could be fully funded through individual contributions and accumulated assets. Pension payments could be defined according to a formula (defined benefit, DB) or they may depend on the amount of assets accumulated (defined contribution, DC), (see Chapter 1, OECD Pensions Outlook 2016).

In practice, national pension systems combine PAYG and funded, DB and DC, and public and private elements. Public pensions have typically been DB in nature and financed on a PAYG basis. Increased longevity and the declining ratio of actively employed contributors to retired beneficiaries are threatening the financial sustainability of PAYG DB public systems. Reforms to ensure fiscal sustainability affect the adequacy of the pensions they can provide. Many countries have introduced supplementary pensions or are considering doing so in order to reduce the pressure on public finances and raise the overall level of benefits that a participating individual will receive. Typically, supplementary provision takes the form of funded, defined contribution pensions, managed by private institutions, pension funds.

The OECD encourages countries to diversify the sources of retirement income and to strengthen the degree of funding in the overall pension mix through a combination of PAYG and funded, public and private provision (see Chapter 1, OECD Pensions Outlook 2016). PAYG public and funded private pensions can be complementary. They offer different solutions for meeting the competing objectives of pension systems and have different capacities to cover the various types of risks that people face throughout their lives, both before and after retirement.

Objectives of pension systems include poverty relief, consumption smoothing, financial sustainability, redistribution, inter- and intra-generational equity, pension benefit adequacy, labour force participation, and coverage. Risks involved in saving for retirement include risks to the individual’s ability to contribute to both public and private pension arrangements (labour market and social risks); risks to the capacity of those contributions to fund an adequate retirement (macro-economic, financial market and operational risks) and the risk that an individual will outlive their assets (longevity risk).

To exploit the complementarity of funded pensions and enhance the resilience of the pension system, policy makers need to understand how their national system addresses the objectives and risks inherent to pension provision. They can then determine which features of pension design best support this role and
whether these design features should be implemented via PAYG public or funded private pensions. For example, consumption smoothing could be achieved through raising contributions to either PAYG public or funded private arrangements, and the choice between the two may come down to practical issues of implementation. Redistribution, on the other hand, is easier to achieve through a mandatory public PAYG system.

The primary design features that policy makers should consider when optimising the combination of public and private provision are whether participation in a pension scheme is mandatory or voluntary; whether benefits are backed by accumulated assets or paid from current contributions, and whether the scheme is defined benefit or defined contribution. A number of different outcomes are possible. Policy objectives, risk tolerances, legacy systems and institutions, and fiscal and demographic constraints all vary across countries. Pension systems interact with other policy areas (e.g. with the tax regime or labour markets) resulting in changed incentives and economic distortions.

Public and private arrangements can be used to introduce different elements of pension design – funded or PAYG, DC or DB –into the overall system. While public pensions are well equipped to achieve the objective of poverty relief, other objectives – especially consumption smoothing – can be addressed in a variety of different ways. The United States largely combines a PAYG system with voluntary DC, the Netherlands has a public basic pension plus mandatory funded DB, Australia and Chile have a means-tested basic pension plus mandatory DC, and France and Spain rely primarily on PAYG.

Most countries are increasing the role of funded pensions in meeting the objective of consumption smoothing. This raises the possibility that individuals will be exposed to more of the risks associated with building up savings over their working lives and ensuring that these are sufficient to last over their full lifetime in retirement. These risks are greatest for individuals saving into DC schemes.

Table 1 summarises the various objectives of pension systems, how different pension designs can help to achieve them, and the risks to which these designs are vulnerable. It can be seen that there are trade-offs involved in determining priorities and allocating responsibilities for pension provision, giving rise to a number of policy implications.

Policy implications

- As private, funded DC arrangements play an increasing role in pension provision the insurance against all risks will be lost. Policy makers may require that insurance is built into the funded system (e.g. through the purchase of individual or group insurance) or continue to provide insurance via a PAYG arrangement.
- Compulsion generally leads to higher coverage. Nevertheless, useful mechanisms exist to improve coverage in voluntary pension arrangements (see Chapter 5, OECD Pensions Outlook 2018).
- Higher retirement income may require higher savings, contributions, and longer contribution periods, especially in a context of low returns, low growth and improvements in mortality and life expectancy.
- Introducing a funded pension arrangement is intended to make pension systems more sustainable and to improve consumption smoothing. However the transition may put additional strain on the PAYG system or public finances while increasing the proportion of risks borne by individuals, if contributions to the new arrangements are made at the expense of the existing scheme. Such moves should therefore be introduced gradually.
- However, a pension system that includes both PAYG and funded arrangements is better able to achieve its various objectives and more resilient to the multiple risks to old-age financial security.
- DC pension arrangements are more sustainable than DB pension arrangements because DC pensions adjust automatically to any changes in the parameters (e.g. contributions, returns, longevity).
Table 1. Summary of pension designs, objectives and risks

<table>
<thead>
<tr>
<th></th>
<th>Public pension Non-contributory</th>
<th>Public pension Contributory PAYG</th>
<th>Public pension Contributory funded</th>
<th>Private funded pension Mandatory DB</th>
<th>Private funded pension Mandatory DC</th>
<th>Private funded pension Voluntary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty relief</td>
<td>General taxation is the most equitable and efficient way of providing poverty relief in a redistributive system. Provides backstop insurance against labour market, social and longevity risk. Depends on ability of tax base to support it.</td>
<td>May be used to determine eligibility for poverty relief and/or consumption smoothing. Covers longevity risk.</td>
<td>Covers longevity risk.</td>
<td>Safeguards required against resources being exhausted (longevity risk) – e.g. compulsory annuitisation.</td>
<td>Not suitable for poverty relief.</td>
<td></td>
</tr>
<tr>
<td>Consumption smoothing</td>
<td>May be primary vehicle for consumption smoothing for all individuals (e.g., France) or primarily for low earners (United Kingdom).</td>
<td>Contributes to consumption smoothing according to the parameters for contributions and benefits.</td>
<td>Employer and employee contributions ultimately come out of salaries therefore contributes to consumption smoothing.</td>
<td>Direct link between contributions and benefits. Where private DC is partially funded at the expense of public contributory arrangements, the impact on consumption smoothing will be reduced.</td>
<td>Contributes to consumption smoothing to the extent that savings into voluntary schemes do not just divert savings from other vehicles.</td>
<td></td>
</tr>
<tr>
<td>Financial sustainability</td>
<td>Depending on benefit level and entitlement, may conflict with other priorities for public expenditure. Can be vulnerable to macro-economic and demographic risks. Sustainability depends on benefit levels, retirement age, indexation. Transition to funded systems can worsen sustainability of PAYG systems.</td>
<td>Can be vulnerable to macro-economic and demographic risks. NDC may improve sustainability by closely linking benefits to contributions. Potential for operational risks. Transition from PAYG to partial funding can make the PAYG system less sustainable.</td>
<td>Vulnerable to demographic risks and low interest rates. Potential for operational risks.</td>
<td>Sustainability achieved by pushing more risk onto individuals – creates a requirement for a public system to provide some insurance.</td>
<td>Fully sustainable.</td>
<td></td>
</tr>
<tr>
<td>Redistribution</td>
<td>Part of progressive taxation. Means testing can increase redistribution effect. Can adjust parameters to increase redistribution e.g. link between contributions and benefits, floors and ceilings, accrual rates, indexation.</td>
<td>Can adjust parameters to increase redistribution e.g. link between contributions and benefits, floors and ceilings, accrual rates, indexation.</td>
<td>Not an objective of DB schemes. Tax incentives may be less progressive than overall tax system.</td>
<td>Not possible within individual DC schemes. Tax incentives may be less progressive than overall tax system.</td>
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<td></td>
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</tbody>
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Table 1. Summary of pension designs, objectives and risks cont...

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<th>Public pension</th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Non-contributory</td>
<td>Contributory PAYG</td>
<td>Contributory funded</td>
<td>Mandatory DB¹</td>
<td>Mandatory DC</td>
<td>Voluntary</td>
</tr>
<tr>
<td>Inter-generational equity</td>
<td>Within tax system</td>
<td>Demographic changes mean redistribution from current contributors to current retirees. This can be offset by adjusting benefit levels and accruals – this shifts part of macro-economic and longevity risk onto individuals</td>
<td>Demographic changes mean redistribution from current contributors to current retirees. This can be offset by adjusting benefit levels and accruals – this shifts part of macro-economic and longevity risk onto individuals</td>
<td>Longevity risk shared across generations. Risk sharing mechanisms can be introduced</td>
<td>Not possible within individual DC</td>
<td>Not possible within individual DC</td>
</tr>
<tr>
<td>Intra-generational equity</td>
<td>Can use compensatory mechanisms to offset missed contribution periods – therefore provides insurance against labour market and social risks. However this may be interpreted as a right so weakens incentive to contribute</td>
<td>Can use compensatory mechanisms to offset missed contribution periods – therefore provides insurance against labour market and social risks</td>
<td>Collective systems can provide insurance against labour market and social risks</td>
<td>Not possible within individual DC</td>
<td>Insurance against labour market and social risks can be purchased but at a higher cost than in a collective arrangement</td>
<td>Not possible within individual DC</td>
</tr>
<tr>
<td>Benefit adequacy/replacement rate</td>
<td>Can be set as minimum or target replacement rate for average earner (note potential fiscal implications)</td>
<td>Target replacement rate may vary by income level</td>
<td>Target replacement rate, though increasing move towards conditional indexation i.e. less protection against macro-economic risk</td>
<td>Vulnerable to macro-economic, financial market and operational risks. Investment strategy has significant impact on benefit levels.</td>
<td>Generally used to increase replacement rate for higher earners</td>
<td></td>
</tr>
<tr>
<td>Labour force participation</td>
<td>May weaken incentives</td>
<td>Incentive depends on link between contributions and benefits: close routes to early retirement and align age at which public and private benefits can be accessed</td>
<td>Uniform accrual rates penalise younger workers/those with less seniority – DB may be less adaptable to changing labour market conditions</td>
<td>Strong incentive</td>
<td>Limited incentive, unless no other savings vehicle available</td>
<td></td>
</tr>
<tr>
<td>Coverage</td>
<td>Universal</td>
<td>Excludes people who have never participated in formal economy</td>
<td>Can be extended to all workers within formal economy relatively easily</td>
<td>Tend to exclude the low-paid, part-time workers, self-employed</td>
<td>Tend to exclude the low-paid, part-time workers, self-employed</td>
<td>Generally used by higher earners. Incentives such as matching contributions can encourage more people to participate</td>
</tr>
</tbody>
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¹. Applies also to voluntary DB where applicable (e.g. Canada, United Kingdom).
Financial Incentives and Retirement Savings

Are tax incentives the best way to encourage people to save for retirement? This complementary publication assesses whether countries can improve the design of financial incentives to promote savings for retirement.

Chapter 1. Why countries provide tax and non-tax financial incentives for retirement savings

Chapter 2. The tax treatment of retirement savings in funded private pension arrangements

Chapter 3. Does the design of financial incentives provide a tax advantage when people save for retirement?

Chapter 4. Are financial incentives effective tools to increase participation in and contributions to retirement savings plans?

Chapter 5. The long-term fiscal cost of financial incentives to promote savings for retirement

Chapter 6. Assessing alternative approaches to designing financial incentives to promote savings for retirement

Chapter 7. Policy guidelines to improve the design of financial incentives to promote savings for retirement

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The 2018 edition of the OECD Pensions Outlook provides an analysis of
different pension policy issues in OECD countries covering both public and
private pension systems. It discusses policy options to help governments ensure
that people will get the most out of the pension system. This booklet reproduces
highlights from the 2018 edition of the Pensions Outlook. Covering both public and
private pension systems, the Outlook analyses the latest developments in pension
policies in OECD countries and assesses trends in retirement income systems.

www.oecd.org/pensions/oecd-pensions-outlook.htm