

ANNEX I.3

Progressivity of Pension Benefit Formulae

The charts in Figure 5.1 of Chapter 5 show how the pattern of pension entitlements varies with earnings for different countries. This illustrates the very different philosophies of different pension systems, particularly in their relative emphasis on the insurance and redistributive roles of pension systems. The allocation of countries to six groups (Figures 5.1A to 5.1F) depends on the strength of the link between pre-retirement earnings and post-retirement pension entitlements. It is based on a single summary indicator, the calculation methodology and results of which are presented here.

Consider two benchmark regimes. The first is termed a “pure basic” scheme. It pays the same flat-rate amount to all pensioners regardless both of their earnings history and their other sources of income. Such a scheme is sometimes also called a “demogrant” or a “citizen’s pension”. The relative pension value is independent of earnings (as illustrated in Figure 5.1A for the flat-rate systems of Ireland and New Zealand) and the replacement rate declines with earnings.

At the other end of the spectrum of benefit design is a “pure insurance” scheme. This aims to pay the same replacement rate to all workers when they retire. The pension value obviously increases with earnings in a straight line, which is why these plans are often called “linear”. Defined-contribution plans typically conform to this pure-insurance model because the contribution rate is usually a constant proportion of earnings for all workers (the only exception is Mexico). Many earnings-related schemes (of the defined-benefit, points and notional-accounts varieties) are also linear: they offer the same accrual rate to most workers regardless of earnings, years of service or age.

These two benchmarks – pure-insurance and pure-basic schemes – underpin an “index of progressivity” constructed for cross-country comparison of pension benefit formulae. The index is designed so that a pure basic scheme would score 100% and a pure insurance scheme, zero. The former is maximally progressive; the latter is not progressive since the replacement rate is constant.

The calculation is based on the Gini coefficient, which is a measure of inequality and is widely used in studies of income distribution. The higher the Gini coefficient, the more unequal a distribution. Formally, the index of progressivity is calculated as 100 minus the ratio of the Gini coefficient of pension entitlements divided by the Gini coefficient of earnings (expressed as percentages). In each case, the Gini coefficients are calculated using the earnings distribution as the weight. Table I.3.1 shows the calculation both with national data (where available) and with the OECD average for the earnings distribution (see Figure 7.1 in Chapter 7).

Table I.3.1. Indicators of the progressivity of pension benefit formulae
Gini coefficient for pension entitlements and progressivity index for OECD average
and national earnings distributions

	Earnings distribution			
	OECD average		National	
	Gini	Index	Gini	Index
Australia	6.8	74.8	6.8	78.9
Austria	21.5	20.7		
Belgium	9.5	64.8		
Canada	3.7	86.5		
Czech Republic	7.8	71.1	7.5	76.8
Denmark	2.3	91.7		
Finland	25.3	6.7	22.6	29.9
France	14.6	46.4		
Germany	20.9	22.9	19.8	38.8
Greece	26.0	4.3		
Hungary	25.6	5.6		
Iceland	10.6	60.8		
Ireland	0.0	100.0	0.0	100
Italy	26.1	4.0	22.5	30.4
Japan	14.2	47.8	13.9	56.8
Korea	11.7	56.9	12.9	60
Luxembourg	22.5	17.2		
Mexico	23.4	13.7		
Netherlands	25.6	5.7	24.4	24.4
New Zealand	0.0	100.0	0.0	100
Norway	14.8	45.3	11.8	63.5
Poland	25.7	5.2	27.2	15.6
Portugal	18.7	31.1		
Slovak Republic	26.3	3.2		
Spain	23.6	13.0	26.7	17.3
Sweden	21.3	21.6	18.1	44
Switzerland	15.2	44.1		
Turkey	20.5	24.4		
United Kingdom	8.3	69.6	9.3	67.1
United States	16.1	40.6	19.4	40
OECD average	16.4	39.5	15.2	52.7

Source: OECD pension models.

The first column of Table I.3.1 shows the results for the Gini coefficient of gross pension benefits. The second column shows the index of progressivity of the benefit formula. In the flat-rate cases – Ireland and New Zealand – the index is, as explained above, 100. Other countries with highly progressive pension systems are Australia, Canada, the Czech Republic, Denmark and the United Kingdom where the index is above two thirds. These countries all have targeted or basic pensions that play a major role in retirement-income provision.

At the other end of the scale, Finland, Hungary, Italy, the Netherlands, Poland and the Slovak Republic have almost entirely proportional systems with very limited progressivity. The index is less than 10 in all these cases. This group includes two of the countries with notional accounts, which were deliberately designed to have a close link between contributions and benefits. Other countries lie between these two groups.

Note that these calculations are only based on the outcomes of the mandatory parts of the pension systems. In practice, countries that have a voluntary element for higher earners – for example the United Kingdom – will also have more extensive private occupational and personal pension provision. Taking these into account makes the overall distribution of pensioners' incomes wider than that based only on the mandatory pensions.

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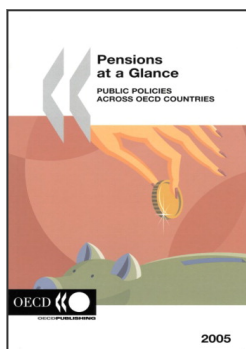
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From:
OECD Pensions at a Glance 2005
Public Policies across OECD Countries

Access the complete publication at:
https://doi.org/10.1787/pension_glance-2005-en

Please cite this chapter as:

OECD (2006), "Annex I.3. Progressivity of Pension Benefit Formulae", in *OECD Pensions at a Glance 2005: Public Policies across OECD Countries*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/pension_glance-2005-12-en

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