

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

Summary in English

Recent years have seen a wave of pension reforms across OECD countries. These changes were motivated primarily by concerns about the *financial sustainability* of pension systems in the context of ageing populations. An in-depth look at pension systems reveals complex structures and rules, which make it difficult to compare retirement-income regimes. Nevertheless, sharing experience of pension reform and its impact provides valuable information for policy makers.

The report shows how large a pension people who start work now can expect to receive when they retire. This analysis answers a number of policy questions. Do retirement-income systems protect against poverty? Are they financially sustainable? How do they treat people who have low incomes or time out of employment? The report is the first in a series that will appear every two years. Future editions will also assess the impact of pension reforms.

This report shows the direction in which pension systems are heading. The cross-country comparisons reveal a diversity of pension provision in OECD countries. The analysis presented in this report covers all mandatory pension schemes — not only public pension systems, but also all compulsory private pensions. It also examines safety-nets for the elderly, and it takes account of differences in taxes, both across countries and between workers and pensioners. As such, this report provides a complete picture of the transfers across and within generations, and thus of the *social adequacy* of pension systems. Pension programmes have two main objectives. The first is redistribution of income towards low-income pensioners and prevention of destitution in old age. The second is helping workers maintain living standards during retirement by replacing income from work at an adequate level. Most countries pursue both goals in their overall pension policy, but there is large variation in the balance of emphasis between the two each objectives.

This report shows that workers on average earnings in OECD countries can expect their post-tax pension to be worth just under 70% of their earnings after tax. The countries with the lowest *net_replacement rate* are Ireland and New Zealand, which have just basic pension schemes and net replacement rates of less than 40%. The United Kingdom and the United States have slightly higher net replacement rates of around 50%.

Low-income workers in OECD countries on half of average earnings will receive a net replacement rate on average of about 85%. But pensions for poor workers are very low in some countries. In Germany, Mexico, the Slovak Republic and the United States, safety-net pensions for full-career workers are worth less than a quarter of economy-wide average earnings.

Some countries have aimed to *link contributions and benefits* more closely. In Italy, Poland and Hungary, for example, the redistributive features of pension systems have been all but eliminated. If the pension system does not redistribute to poorer people, then means-tested safety-net provisions will generally play a more prominent role in retirement incomes.

All OECD countries have some form of *safety-net* for older people. Usually, these are means-tested programmes. The average minimum retirement benefit for full-career workers across OECD countries is worth a little under 29% of average earnings.

This report reveals that the personal *tax system* plays an important role in old-age support. Pensioners often do not pay social security contributions and, as personal income taxes are progressive, the average tax rate on pension income is typically less than the tax rate on earned income. In addition, most income tax systems give preferential treatment either to pension incomes or to pensioners, by giving additional allowances or credits to older people.

Net replacement rates at average earnings are 22% larger than gross replacement rates (averaging across the OECD). However, the effect of taxes and contributions on low earners is more muted than on average because the former pay less in taxes and contribution than higher-income workers. The differential between gross and net replacement rates for low earners is 17% on average.

Most countries withdraw tax concessions from richer pensioners. However, Germany and the United States are two exceptions. They provide tax concessions across the income range (although this is changing in Germany).

The adjustment of pensions in payment to reflect changes in costs or standards of living — “*indexation*” — has long been central to the debate on the financial sustainability of pension systems. Nearly all OECD countries now link pensions to consumer prices. However, some still adjust pensions in line with average earnings, which may cost more than 20% more than if pensions were indexed to prices.

A related feature is “*valorisation*”: the adjustment of past earnings to account for changes in living standards between the time when pension rights are earned and when they are claimed. Until very recently, valorisation has received much less attention than indexation despite its powerful impact on pension benefits.

Most OECD countries revalue past earnings in line with economy-wide earnings growth. But there are several exceptions — Belgium, France, Korea, and Spain — where

past earnings are valorised with prices. Wages usually grow faster than prices, so price valorisation leads to substantially lower replacement rates than earnings valorisation. Price valorisation for a full-career could result in a pension 40% lower than under earnings valorisation.

Pension wealth — the present value of the future stream of pension payments — is the most comprehensive indicator of pension promises. It takes into account the level at which pensions are paid, the age at which people become eligible to receive a pension, people's life expectancy and how pensions are adjusted after retirement to reflect growth in wages or prices. Luxembourg has the highest pension wealth for a worker who earned average earnings, worth 18 times average earnings for men and nearly 22 times for women (due to higher female life expectancy). This is equivalent to USD 587 000 at the time of retirement, nearly treble the average for OECD countries. The lowest pension wealth for someone who has earned average earnings when working is found in Ireland, Mexico, New Zealand, the United Kingdom and the United States, where it is less than six times average earnings. Of course, people in these countries often contributed less to pension systems when they did work, so it can be misleading to refer to them as being less 'generous' than in other countries that promise higher pension wealth to retirees.

The *pension eligibility age* in most OECD countries is 65. Iceland and Norway have and the United States will have a normal pension age of 67. Pension eligibility ages are less than 65 in the Czech Republic, France, Hungary, Korea, the Slovak Republic and Turkey. France has gross replacement rates below the OECD average at earnings between 75 and 200% of the average. Pension wealth, however, exceeds the OECD average because the pension eligibility age of 60 is relatively low and life expectancy is relatively long.

The impact of differences in *life expectancy* on pension wealth is quite large. Other things being equal, the countries with low life expectancy — Hungary, Mexico, Poland, the Slovak Republic and Turkey — could afford to pay men a pension 10% higher than a country with OECD average mortality rates (Germany, Italy and the United Kingdom, for example). In contrast, longer life expectancies increase the burden on the pension system. For men, pension wealth is nearly 8% higher with the mortality of the five countries with the longest life expectancy, which are Japan, Iceland, Norway, Sweden and Switzerland.

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Fax: +33 (0)1 45 24 13 91

OECD Rights and Translation unit (PAC)
2 rue André-Pascal
75116 Paris
France

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