Editorial
Three Solutions to the Pensions Paradox

Pension policy has always involved balancing the *adequacy* of benefits with their *affordability*. This balancing act has got harder as a result of the recent economic and financial crisis. It adds to the existing and much greater challenge to pension systems arising from population ageing. Despite these short-term problems, it is important to remember that pensions are a long-term issue.

In the first instance, there is an obvious trade off between adequacy and sustainability: higher public pensions deliver larger incomes in old age but cost more. However, if public pensions are at risk of being inadequate, there will be pressure for *ad hoc* increases in pensions or supplementary retirement benefits to prevent old-age poverty.

Similarly, pension benefits can be too high, rendering the system financially unsustainable. If governments delay reforms, then the scale of adjustment to benefits needed in the medium or long term will be more sudden and painful. Greece, Hungary and Ireland have all had to accept substantial pension reforms as part of the fiscal consolidation required for international bail-outs. Such sudden changes make it very difficult for individuals to change their work, retirement and savings decisions to reflect the new financial realities.

How can governments maintain retirement-income adequacy without endangering financial sustainability? There are three main routes out of the dilemma.

The first is longer working lives. Half of OECD countries are already increasing statutory pension ages or will do so in the coming decades. Pension eligibility ages for men currently average 63 and, for women, 62. These will increase to nearly 65 by 2050 for both sexes on current plans. However, in all but five OECD countries, projected gains in life expectancy over the next four decades will outstrip prospective increases in pension ages. Thus, financial sustainability is not guaranteed unless pension ages are increased beyond current plans in most of the OECD.

As an alternative to higher pension ages, seven countries have introduced an automatic link between pension levels and life expectancy. But their effect is different: benefits will fall as people live longer. While stabilising the finances of the pension system, the adequacy of benefits may be jeopardised in the long term. It is surprising that the alternative approach of linking pension ages to life expectancy has been adopted by just a few countries. This policy would have the advantage of providing a clear signal of the need to work longer. And it would allow annual benefits to be maintained at a higher level than if people continued to draw their pensions at the same age as life expectancy increases.

Countries have also dismantled many of the incentives to retire early provided by their pension systems. But we still need to recognise that older workers face a range of barriers in finding and retaining jobs. Pension reforms need to be bolstered by action from government and employers on age discrimination, training opportunities for older workers and working conditions. The ongoing jobs crisis should not be used as an excuse to revert to failed past policies of pushing older workers off the unemployment rolls and into *de facto* early retirement, especially through long-term sickness or disability benefits. Keeping older workers in the labour force does not reduce job opportunities for the young.

The second way of achieving both adequacy and sustainability is to concentrate the efforts of public retirement provision on the most vulnerable. For example, three of the countries with the lowest rates of income poverty in old age – Canada, the Netherlands and New Zealand – spend only 4-5% of their national income on public pensions, well below the OECD average. In contrast, more than one in five older people in Greece and Spain are poor while public pension expenditure is relatively high. The key to explaining this pattern is greater *redistribution* within public provisions of retirement incomes. Of course, some countries would need to change the philosophy underlying their pension systems if they were to move in this direction, because it involves a weakening of the link between individual contributions and benefits. But this link is already being powerfully tested by demographic realities, which require public schemes to pay low implicit rates of return on contributions to maintain financial sustainability.

Indeed, many countries' reforms have increased redistribution in their retirement-income systems. Finland, France and Sweden, for example, protected low earners from the full force of benefit cuts. Australia and the United Kingdom have used some of the fiscal space created by higher pension ages to increase benefit levels, and these increases have been targeted on low-income retirees. In contrast, Austria, Germany and Japan have cut benefits across the board, including for low earners. And Hungary, Italy, Poland and the Slovak Republic have tightened the link between contributions and benefits, eliminating all or most redistribution.

The third solution is to encourage people to save for their own retirement to make up for reductions in public benefits that are already in the pipeline or are likely to be required. There have been some significant successes in this area. The KiwiSaver scheme in New Zealand, which automatically enrols people in private pensions unless they opt out, has rapidly expanded coverage of private pensions. The United Kingdom will follow this approach in 2012. The Riester pensions in Germany have also been widely taken up, notably among the young and low earners, groups that other countries have found hard to reach (although these plans rely on relatively generous fiscal incentives rather than automatic enrolment).

Public benefits are the cornerstone of old-age income support in OECD countries, accounting for 60% of old-age incomes on average. The remaining 40% is divided almost equally between private pensions and other savings on the one hand and income from working on the other. The public sector's role in providing incomes in old age will remain very important, but will diminish. Working longer and private pensions will inevitably have to fill the gap.

However, the financial crisis has sapped confidence in private pensions' ability to provide a secure retirement income. In some countries that substituted private pensions for part of public provision, recuperating contribution revenues that should go to private pension plans has proved an attractive way out of short-term fiscal problems. But reversal of these pension reforms, which sought to encourage more private provision for retirement, would be regrettable. Taking the long view, a *diversified* pension system – mixing public and private provision, and pay-as-you-go and pre-funding as sources of finances – is not only the most realistic prospect but the best policy.

John P. Martin
Director
Employment, Labour and Social Affairs, OECD

Carolyn Ervin
Director
Financial and Enterprise Affairs, OECD

From:
Pensions at a Glance 2011
Retirement-income Systems in OECD and G20 Countries

Access the complete publication at:
https://doi.org/10.1787/pension_glance-2011-en

Please cite this chapter as:

Martin, John P. and Carolyn Ervin (2011), "Three Solutions to the Pensions Paradox", in OECD, *Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/pension_glance-2011-2-en

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