Social pensions in high-income countries

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Introduction

Retirement-income provision in high-income countries is both diverse and complex. In low- and middle-income countries, social pensions are entirely separate from earnings-related plans. Retirees receive benefits either from the social pension or the earnings-related scheme, while in high-income countries most people who receive a social pension also receive at least some benefit from the earnings-related scheme. The result is that there are significant and complex overlaps and interactions between social and earnings-related pensions in high-income countries.

This paper looks at the 30 countries that are members of the Organisation for Economic Co-operation and Development (OECD), most of which, of course, fall into the 'high-income' category.

Background

Table 1 presents basic data for the 30 member countries of the OECD. As is well known, compared with the rest of the world, developed countries are currently older in their population structure. In half of them, over 15% of the total population is aged over 65. The oldest OECD countries are Germany, Italy and Japan.

High-income countries have relatively high life expectancy. For example, newly-born girls can expect to live into their 80s (with few exceptions). The average life expectancy at birth is 75 for boys and 81 for girls. This gap between the life expectancy of men and women has persisted. Although it has narrowed in some countries, in others, especially central and eastern Europe, it has grown. Life expectancy continues to increase rapidly, although the improvements in mortality are now tending to happen at older ages than in the past.

Generally, over 90% of the labour force contributes to the compulsory pension scheme, a much higher proportion than in most low- and middle-income countries. Furthermore, as a result of comparatively high rates of formal-sector employment, over 70% of the working-age population is covered. Moreover, this can understate the degree of coverage because most OECD countries have extensive systems of credits for people outside the labour force. This means that the unemployed, working-age students or people caring for children or older family members may also be covered even when they do not contribute.

TABLE 1 HERE

With such broad coverage of formal pension systems, informality in the labour market is less of a problem than in less-developed countries. Nevertheless, there are still many people who do not have full contribution records, for one reason or another, and who therefore do not get the 'target' or 'typical' replacement income in retirement that is usual in that country. Hence, systems in developed countries usually have 'floors' to old-age income of one sort or another which are equivalent in function to 'social pensions' as understood in the rest of the world.

What are social pensions?

A taxonomy of pension systems that has been widely used is shown in Figure 1 (OECD, 2004, 2005, 2007). This categorisation separates retirement-income provision that is mandatory from that which is voluntary. All voluntary schemes – meaning those that are not legally mandated – are put into the 'third-tier' of this taxonomy.

The great bulk retirement income support in most countries is provided through the second tier of pension systems. These comprise mandatory programmes, linked to the resources of individuals either through earnings-related schemes or individual accounts. These second-tier schemes can be managed in either the public or private sector.

It is the first tier of this taxonomy that is of most interest in this study. First-tier programmes are designed to address concerns about adequacy of incomes in retirement. They provide the floor below which pension incomes *generally* will not fall.

FIGURE 1 HERE

There are three main types of first-tier pensions:

- **Basic pensions**. A basic pension, in its purest form, is often called a 'demogrant'. It is paid at a single rate, regardless of people's other sources of income. However, countries with basic pensions usually have provisions, such as residency or contribution tests, which, for example, prevent new immigrants from benefiting in full.
- **Resource-tested programmes**. Resource-tested payments for old-age can either be separate programmes for older people or part of a general social-assistance scheme for people of all ages. The entitlement depends on income from other sources. Often, it can also depend on the value of assets held.

- **Minimum pensions**. Minimum pensions are similar to resource-tested pensions in that they are targeted at people with the lowest retirement incomes. The important difference is that only one source of income – income from the pension scheme – is taken into account when calculating entitlement to the minimum pension. If someone has a very low entitlement to pensions, then they may qualify for the minimum pension payment, even if they have high income from other sources.

We call all of these first-tier programmes ‘social pensions’ in what follows. However, there are a number of qualifications and clarifications that need to be taken into account when considering this framework.

The first is that minimum pensions and some basic schemes require contributions to have been paid for a specific number of years. Are these programmes really ‘social’ pensions? An important reason for thinking that they are is that most developed countries give credits towards these benefits for periods people spend out of the labour force: in unemployment, disability or caring for children or elderly relatives, helping to ensure that a minimum level of retirement income will be almost certainly be obtained.

Secondly, most OECD countries have social-assistance systems. In some countries, this is the social pension as analysed here. In many, social assistance is effectively a second safety-net, providing a floor on retirement incomes below the one in the pension system. Often, only a handful of people are in receipt of social assistance in old-age. It is included in what follows only when it plays a prominent role in retirement-income provision.

Which social pensions do OECD countries have?

Table 2 shows the types of social pensions that different countries have. Around half of them have only one kind of programme. In Germany and the United States, for example, there is only a resource-tested scheme. Japan, the Netherlands and New Zealand rely on basic pensions, while Finland and Sweden have only minimum pensions. In most countries, however, we find two of the three types and, in the United Kingdom, all three.

TABLE 2 HERE

How large are social pensions?

The existence of multiple social-pension programmes, often interacting and overlapping in complex ways, means that it does not make sense to analyse the different schemes independently. Figure 2 gives the value of the overall social-pension level. The calculations are carried out for people who have been covered by the formal pension system throughout their working lives, either because of their own contributions or through credits for unemployment, childcare, etc.

Social pensions are worth, on average across the OECD countries, 29% of national average earnings. Some 18 countries are bunched around this average, with social pensions worth 25-35% of average earnings. However, there are quite a few outliers. The basic pension in Japan will be worth just 16% of average earnings, once adjustments linked to the financial sustainability of the pension system are fully in place. The national pension in Finland and social assistance in Germany are also worth less than 20% of average earnings. The largest social pensions are the basic scheme in New Zealand and the minimum pension in Portugal, both of which are worth 40% or more of average earnings.

Although a social pension of 25-35% of average earnings is the norm in OECD countries, there are also considerable differences in some cases in the level of the retirement-income safety net.

FIGURE 2 HERE

How have recent reforms affected social pensions?

Around half of OECD countries have had major pension reforms in the past 15 years (see OECD, 2007, Part II.1 for a description). Table 3 aims to summarise the impact of these changes on the role of social pensions.

At the left-hand side of the Table are six changes that will strengthen social pensions. In France, Korea, Mexico and Sweden, new social-pension programmes were introduced, either in addition to or as a substitute for existing provision.

TABLE 3 HERE

At the right-hand side, four countries are shown that abolished their minimum pensions as part of reforms to link pensions more closely to earnings when working. Finland, by shifting from basic to minimum pension, will also see a smaller role for social pensions in future.

Down the middle of Table 3 are changes that do not directly affect social pensions. This is because they are focused on cuts in second-tier, earnings-related schemes or increases in pension eligibility age. However, these reforms will have an indirect effect on social pensions in some cases. The lower level of second-tier benefits will mean more workers with relatively low earnings will in future be eligible for social pensions during retirement.

Figure 3 explores the impact of pension reforms on the future value of pension entitlements for workers entering the labour market in 2004. It compares the situation for a person who spent a full career under the reformed pension system with the benefits that would have been received had the system not been changed. The results shown are net replacement rates: that is, the value of the pension in retirement, after taxes, compared with the level of earnings when working, after taxes and contributions. In each case, the left-hand chart shows the position of low earners: people earning 50% of the economy-wide average each year of their working life. At the right-hand side are the net replacement rates for average earners.

The countries are divided into three groups depending on the effect of their reforms on the retirement income of workers at different earnings levels. In the top panel (Figure 3a) are countries that protected low earners from the impact of the reforms. In France and Sweden, for example, the benefits for average earners will be about 20% lower as a result of the reforms while those of low earners are scarcely changed. In Mexico and Portugal, the reduction in benefits for average earners are around 50 and 40% respectively. The reduction for low earners is only around half this level in both cases. In the United Kingdom, recent reforms left the pensions of average earners unchanged, but they increased the benefits for low earners by nearly 25%. All of these reforms, therefore, increased the targeting of the pension system on people who had low incomes when working.

FIGURE 3 HERE

The bottom panel shows countries with reforms that worked in the opposite way. In Poland, for example, benefits for average earners will scarcely change as a result of the reform while for low earners they will fall by over 20%. Similarly, average earners are expected to lose around 5% of benefits in the Slovak Republic, compared with 13% for low earners. These countries explicitly wanted to strengthen the link between pensions in retirement and earnings when working in the belief that this was fairer than a redistributive system and that it would reduce distortions in the labour market.

Social pensions in the retirement-income package

The taxonomy illustrated in Figure 1 divides retirement-income provision into tiers. The most relevant division is the one between first-tier schemes, which we call social pensions for short, and second-tier schemes, where retirement incomes depend on earnings when working. Figure 4 shows how retirement-income packages (from mandatory schemes) derive from these different programmes. The calculations include individuals across the earnings range: from 30 to 300% of average (mean) earnings in each country. Data on the distribution of earnings are then used to weight the calculated pension entitlements for workers on different earnings levels. The results are only for full-career workers: we do not know the exact career path of workers at different earnings levels. They therefore understate the role of first-tier schemes, which, of course, are most important for people with less-than-full careers.

Nonetheless, the chart is a useful description of different countries' retirement-income systems. Ireland and New Zealand have basic schemes alone. In the United Kingdom, there is a public earnings-related scheme, but its role is limited. Indeed, the recent reform will move to a pure flat-rate scheme. In Korea, the value of the pension is based half on individual earnings and half on average earnings. First-tier schemes are also important in Australia, Canada, Denmark, Japan, the Netherlands and Norway. At the other end of the scale are countries where social pensions play an insignificant role in providing old-age incomes for full-career workers. Nevertheless, as the next section of the paper shows, social pensions are significant because of their role in covering workers with less-than-full careers.

FIGURE 4 HERE

Coverage of social pensions

The diversity of retirement-income programmes with 'social-pension' characteristics in OECD countries and the multiplicity of such programmes within countries hinders the presentation of data on coverage of social pensions. The very diverse paths that OECD countries have followed to guarantee some level of income adequacy in old age also reflects very divergent public policy decisions about whether it is more effective to rely on resource testing or to provide minimum benefits as an entitlement. The debate as to what approach is the most cost effective will doubtlessly continue in the future as OECD countries continue to reform and readjust their pension programs. For example, a lively discussion is currently underway in the United States about reintroducing a minimum pension benefit as a way of helping low-income women and minorities in retirement.

Figure 5 provides data for 23 countries, giving the percentage of people of pension age who are in receipt of social pension benefits. The chart does not include recipients of basic pensions on the grounds that these are, by design, always near-universal. In the Netherlands and New Zealand, which are not shown in the chart, basic pensions are based on adult residency in the country, and so virtually 100% of older people receive a benefit. (We will return to the issue of basic pensions below.)

Where appropriate, the coverage data are divided between different programmes. In Portugal, for example, almost 60% of pensioners are on the minimum contributory pension, with an additional 17% covered by the non-contributory social pension or the solidarity benefit. Coverage of both minimum contributory benefits and safety-net benefits are similarly high in Greece.

In Finland and Sweden more than half of older people are also in receipt of minimum pensions. However, the coverage of the safety-net benefit (provided by social assistance) is very narrow in both countries compared with Greece and Portugal. This probably reflects the history of a large informal sector in the southern European countries that must rely on last-resort safety-net benefits. The Scandinavian countries have a tiny informal sector and comprehensive protection, through pension credits, for people out of paid work.

In most countries, however, the data in Figure 5 relate to a single retirement-income programme. The range of coverage of these programmes is huge. In Australia, for example, the public pension is resource-tested. However, more than 75% of older people are eligible for the benefit. Compare this with Germany, where just 2% of older people receive social assistance. While both are resource-tested schemes, the way they work in practice is fundamentally different. A programme such as Australia's has been described as 'affluence-tested' because the benefit is paid to most older people and denied only to the richest pensioners (Piggott and Whitehouse, 2001). In contrast, the German programme is best characterised as 'poverty-tested', because benefits under the social-assistance programme are paid only to the very poorest older people.

Some of the countries shown also have basic pensions. In the United Kingdom, for example, while just under 25% of older people are in receipt of the resource-tested programmes – pension credit and savings credit – some 98% receive at least some payment from the basic pension. The situation is similar in Canada, the Czech Republic, Denmark, Ireland and Japan, where basic pensions have near-universal coverage. These schemes are not covered in Figure 5.

Allowing for the role of basic pensions, the chart shows a huge difference in coverage of social pensions. Fewer than 5% of older people receive social pensions in Germany, the Slovak Republic and the United States. In the three Scandinavian countries shown, in contrast, more than half of older people get a social pension. In France, Italy and Spain, coverage of social pensions is 35-40%.

FIGURE 5 HERE

Conclusions

High-income countries have adopted many different means of achieving the goal of keeping retirement incomes above a minimum level. It is important, therefore, to avoid restricting the analysis of social pensions to 'last-resort' programmes. This paper has therefore taken a broad definition of 'social pensions', including any programme that provides retirement income that is unrelated to individual contributions or earnings in that category.

Social pensions are the dominant part of many high-income countries' retirement-income systems. These include Australia, Canada, the Czech Republic, Denmark, and the United Kingdom. In addition, Ireland and New Zealand do not have mandatory earnings-related pension provision, and so basic or resource-tested pensions are all that is mandated. In some other OECD countries, coverage of social pensions among older people is very broad. This group comprises Finland, France, Greece, Italy, Portugal, Spain, and Sweden. Together, these countries make up one half of the 30 that are members of the OECD.

The retirement-income floor in half of OECD countries is set at 25-35% of average earnings.

In recent reforms, a third of countries have strengthened role of social pensions. But, equally, a third of countries have weakened role of social pensions. In the other third of countries that have reformed their pension systems, social pensions were not directly changed. However, cuts in earnings-related benefits imply a greater role for social pensions in the future.

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[Add in SOCX expenditure number. Change GDP per capita to USD]

Table 1. **Key indicators: OECD countries**

Country	*Population (m)*	*Proportion of the population aged over 65*	*Life expectancy male birth*	*Life expectancy female birth*	*GDP/capita (local currency)*	*Coverage of mandatory pension system – % of population aged 15-64*	*Coverage of mandatory pension system - % of labour force*
Australia	20.6	12.7	77	83	50,407	69.6	92.6
Austria	8.3	16.7	76	82	31,139	68.7	96.4
Belgium	10.5	17.6	76	82	30,017	61.6	94.2
Canada	32.6	13.1	77	83	44,333	71.4	90.5
Czech Republic	10.2	14.2	73	79	315,244	61.5	86.3
Denmark	5.4	15	75	80	302,179	75.0	94.6
Finland	5.3	15.9	75	82	31,718	67.2	88.7
France	61.4	16.6	77	84	29,207	61.4	89.9
Germany	82.4	18.8	76	81	28,192.	65.5	88.2
Greece	11.1	18.2	77	81	19,193	58.5	85.3
Hungary	10.1	15.2	69	77	2,358,974	52.0	86.0
Iceland	0.3	11.8	78	82	3,751,624	79.8	88.7
Ireland	4.2	10.9	76	81	41,253	64.0	88.1
Italy	58.4	20	77	83	25,248	58.4	92.4
Japan	127.8	19.7	78	85	3,983,134	75.0	95.3
Korea	48.3	9.4			17,555,401	54.7	78.0
Luxembourg	0.5	13.8	75	81	73,672	95.5	100.0
Mexico	104.9	5.3	73	78	87,246	22.7	34.5
Netherlands	16.3	14.1	76	81	32,688	70.4	90.3
New Zealand	4.1	12.3	77	81	39,472		
Norway	4.7	15	78	82	461,623	75.8	90.8
Poland	38.1	12.9	70	79	27,741	54.5	84.9
Portugal	10.6	17.1	74	81	14,657	71.9	91.4
Slovak Republic	5.4	11.8	70	78	303,507	55.3	78.5
Spain	44.1	16.5	77	84	22,260	63.2	91.0
Sweden	9.1	17.2	78	83	319,309	72.4	91.0
Switzerland	7.5	16	79	84	64,962	79.1	100.0
Turkey	73.0	5.4	69	71	7,897	24.3	45.0
United Kingdom	60.6	16	76	81	21,488	71.4	92.7
United States	299.4	12.3	75	80	43,864	72.5	92.5

Source: OECD; World Bank pensions database

Figure 1. **Taxonomy of pension systems**

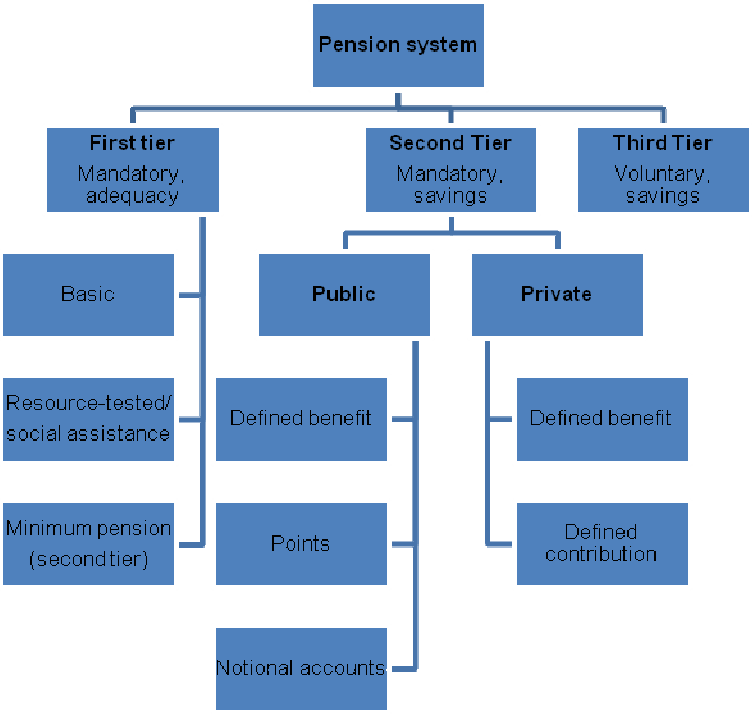
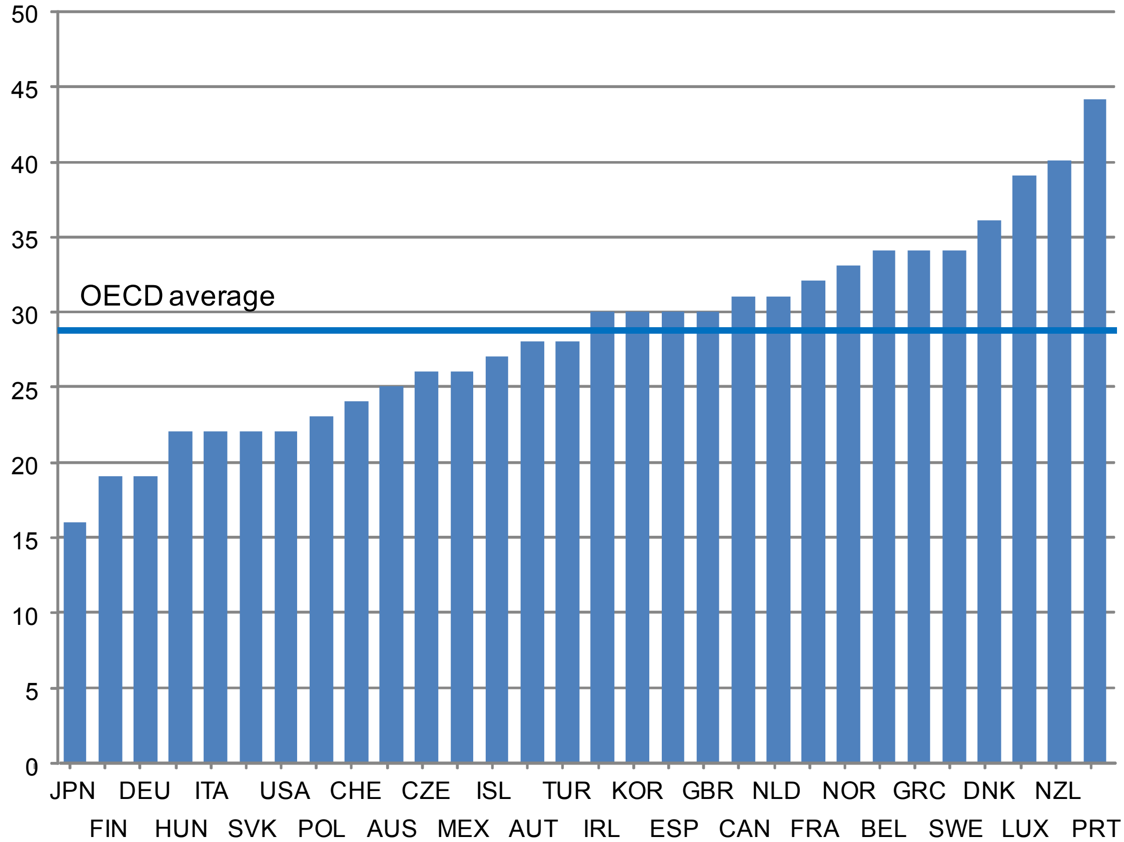


Table 2. **Social pensions in OECD countries**

	Resource tested	*Basic*	*Minimum*		*Resource tested*	*Basic*	*Minimum*
Australia	X			Korea		X	
Austria	X			Luxembourg		X	X
Belgium	X		X	Mexico		X	X
Canada	X	X		Netherlands		X	
Czech Republic		X	X	New Zealand		X	
Denmark	X	X		Norway		X	X
Finland			X	Poland			X
France	X		X	Portugal	X		X
Germany	X			Slovak Republic			X
Greece	X		X	Spain	X		X
Hungary			X	Sweden			X
Iceland	X	X		Switzerland	X		X
Ireland	X	X		Turkey	X		X
Italy	X			United Kingdom	X	X	X
Japan		X		United States	X		

Source: OECD (2007).

Figure 2. **Value of social pensions, per cent of average earnings**



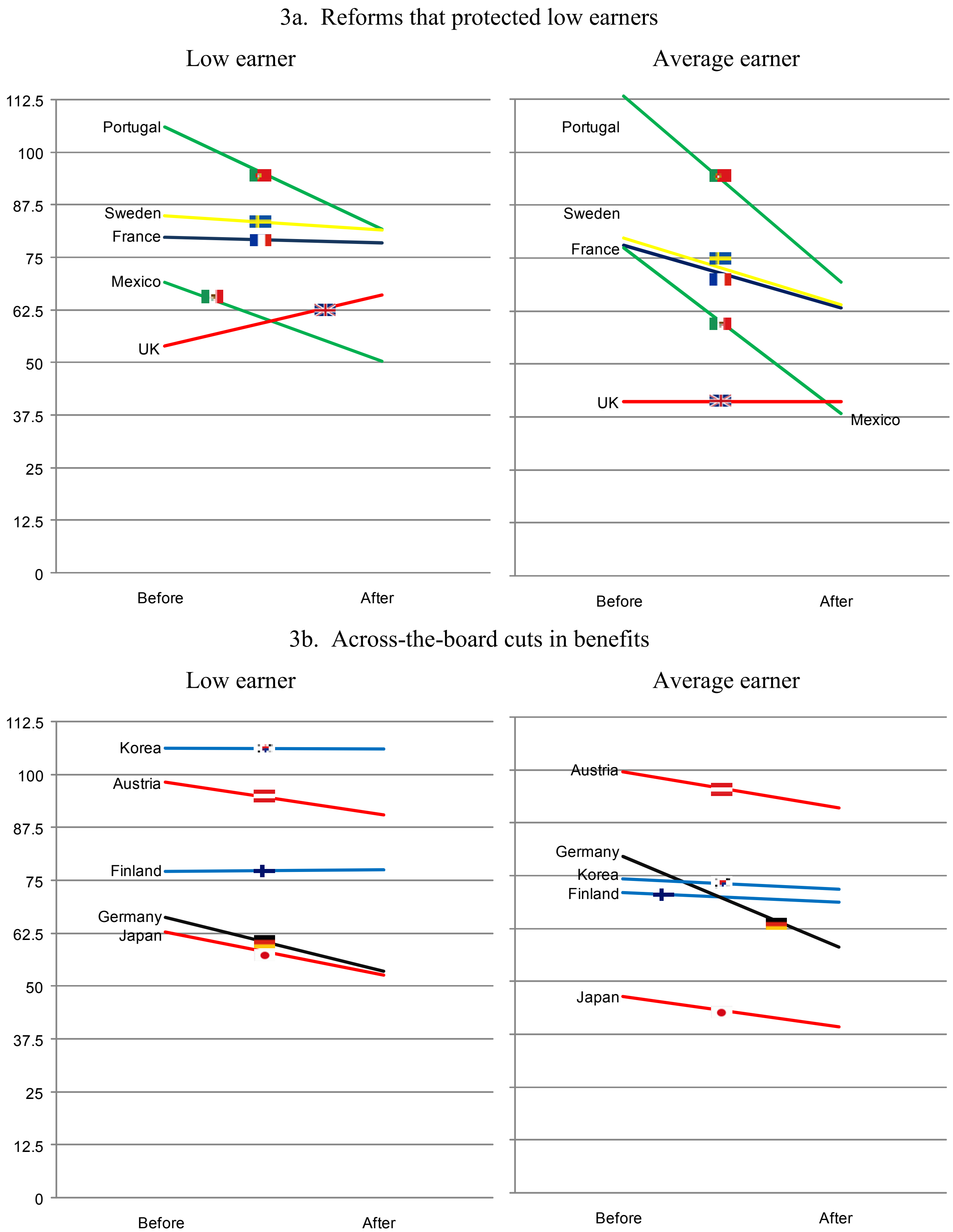
Source: OECD (2007).

Table 3. **The effect of recent pension reforms on social pensions**

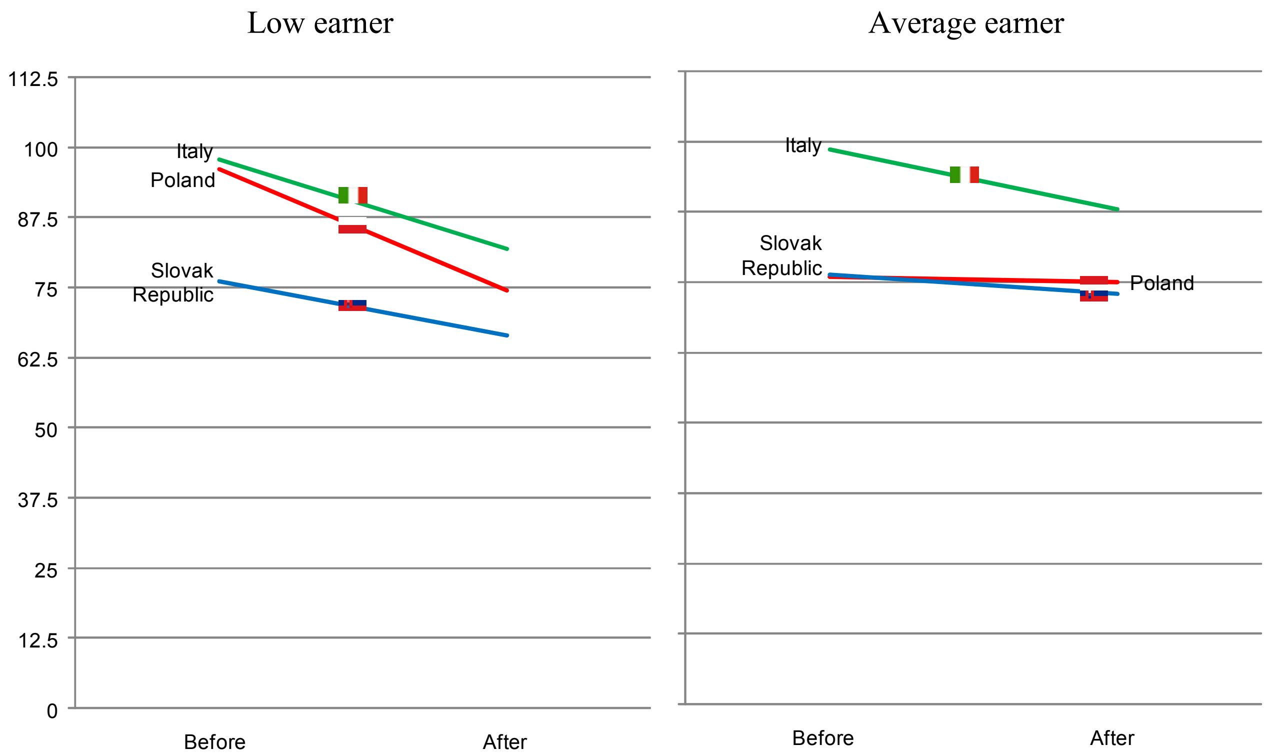
Stronger social pensions	*No direct effect*	*Weaker social pensions*
France New, higher, minimum income	**Austria** Cuts in earnings-related pension	**Finland** Move from mixed basic/pension-tested benefit to pure pension-tested benefit
Ireland Increase basic pension relative to earnings	**Germany** Cuts in earnings-related pension	**Hungary** Abolish minimum pension
Korea New universal basic pension	**Japan** Cuts in basic and earnings-related pension	**Italy** Abolish minimum pension
Mexico New minimum pension	**New Zealand** Increase in pension age	**Poland** Abolish minimum pension
Sweden Replace basic pension with pension-tested benefit at much higher level	**Portugal** Cuts in earnings-related pension	**Slovak Republic** Abolish minimum pension
United Kingdom Higher minimum income; new minimum credit in earnings-related scheme		

Source: OECD (2007)

Figure 3. **Impact of pension reforms on net replacement rates by earnings level**



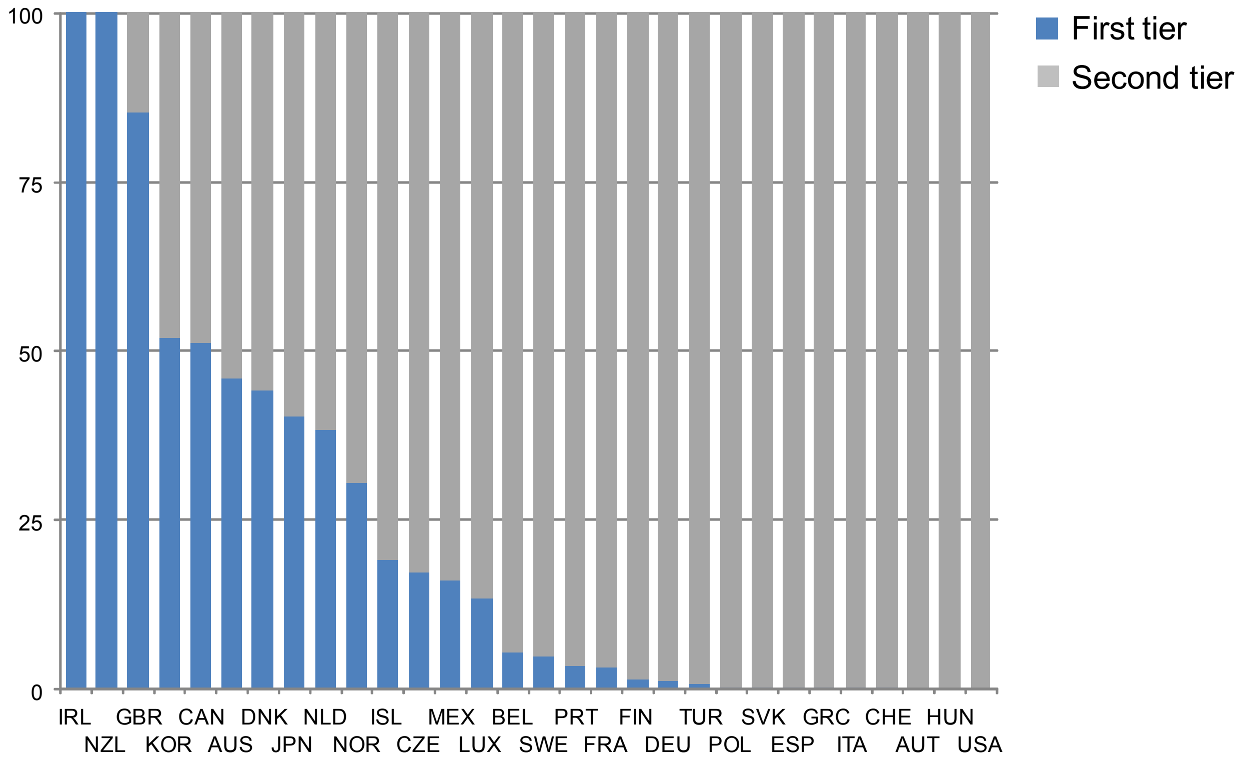
3c. Reforms that strengthened the link between contributions and earnings



Source: OECD (2007)

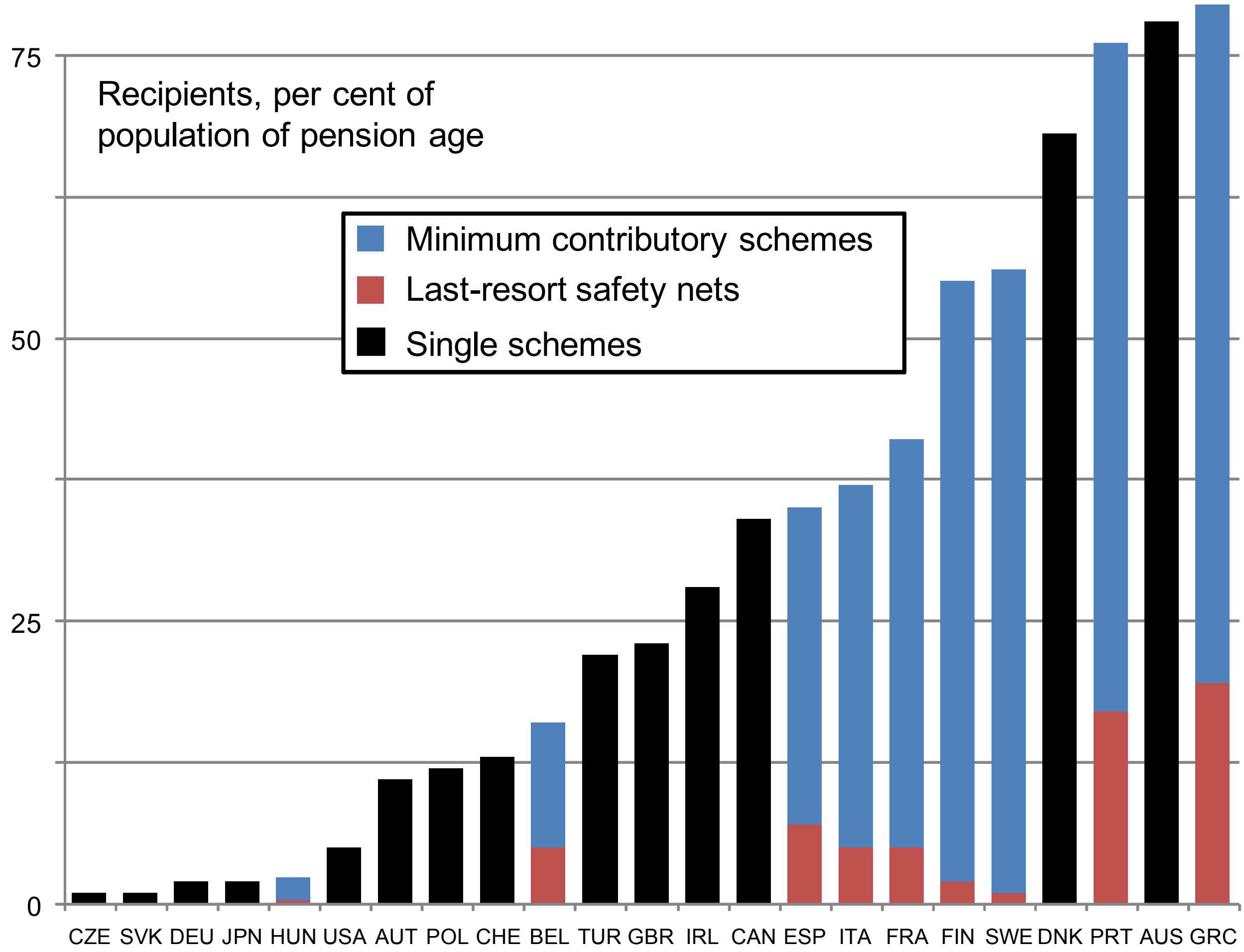
Figure 4. **Pension wealth from first- and second-tier retirement-income programmes**

per cent of total



Source: OECD (2007).

Figure 5. **Coverage of social pensions**



Source: OECD, European Union, Social Policy Committee (2006), national officials.

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