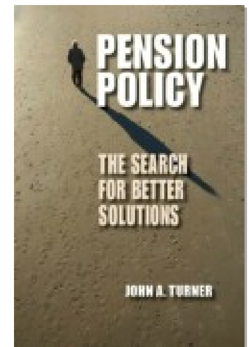
Pension Policy

Turner, John A.



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Mandates

Pathways to Expanding Private Sector Provision

How can pension coverage be expanded? How can retirement benefits and retirement savings be increased? How can the range of individual choice with respect to retirement income be enlarged? Roughly half of U.S. workers are covered by a pension, with older workers and higher income workers being more likely to be covered than their counterparts (Purcell 2006). Workers in small firms are much less likely to be covered than workers in large firms.[1]

Mandating private pensions (Ghilarducci 2008) or individual accounts as part of Social Security (President's Commission to Strengthen Social Security 2001) has been proposed as the answer to those questions. While the debate is heated at times, and apparently dormant at others, it is a continuing area of disagreement among pension experts. Mandating appeals to some people on both economic and ideological grounds. On economic grounds, they argue that mandatory individual accounts would increase savings. Some liberals favor mandating private pensions as the only way to extend pension coverage to most of the workforce. Some conservatives argue that mandatory individual accounts as a partial replacement for Social Security would enhance individual freedom, private property ownership, and personal responsibility while reducing the government's role in the economy (ibid.).

At the heart of the debate is whether mandates should supplement Social Security or partially replace it. Some people oppose mandates that replace Social Security, arguing that individual accounts may entail too much financial market risk, especially for financially vulnerable retirees (Gillion et al. 2000). Individual accounts that partially replace Social Security are also accompanied by high transition costs to pay the benefits already promised under the old Social Security system.

Individual accounts that are add-ons to Social Security, however, may be viewed differently because they retain Social Security as the traditional base of retirement income. They also do not require transition

costs because they do not reduce the funds allocated to pay for Social Security benefits already promised. They result in higher contributions being paid by workers and employers to the retirement income system, but in some cases that may be desirable when inadequate resources are being set aside for future retirements.

FOUR PATHWAYS TO PENSION COVERAGE—DEGREES OF COMPULSION

Countries have developed a variety of policies to encourage the development of pension plans. These policies, however, can be grouped into four pathways to pension coverage that are differentiated by the degree of incentive or compulsion provided to workers to participate in the plan (Rein and Turner 2001). These pathways vary from 1) unrestrained choice for the worker (including whether to participate in a pension plan), to 2) a choice between two alternatives—participating in a government-provided pension versus a private-sector-provided one—to 3) a mandatory arrangement determined by collective bargaining between employers and trade unions, to 4) a government-imposed mandate. The focus of this chapter is on mandating, but by way of introduction all four approaches are compared.

Voluntary participation, with tax incentives. The pathway the United States uses to encourage employers to provide pension coverage is voluntary with tax incentives. Pension law does not require employers to provide pensions, and employees are not required to be covered. Regulations require an employer who offers a plan to cover a minimum percentage of full-time workers.

A weakness of this approach is that, practically without exception, countries that have used this approach have not raised pension coverage above 50 percent for private sector workers. With this approach, coverage rates tend to be relatively low among low-wage workers (Hinz and Turner 1998).

Labor contracting. A second pathway with an element of mandating is widespread labor contracting. In some countries where all or most

of the labor force is covered by a collective bargaining agreement, a high percentage of the labor force has pension coverage through pension plans resulting from collective bargaining. Countries using this approach include France, the Netherlands, Denmark, Norway, and Sweden. This approach can only be used in countries where a high percentage of the labor force is covered by a union or where, as in the Netherlands, under labor law a collective bargaining agreement can be mandatorily extended to other firms in the same industry.

Contracting out. Contracting out involves requiring participation in a retirement income plan but permitting a choice between participating in social security or in an alternative private plan. With contracting out, the employer and workers reduce their contribution to social security if they participate in a private sector plan that provides benefits meeting at least minimum requirements. For those workers choosing to contract out, the reduced contribution to social security reduces the benefit the worker ultimately receives from social security, but the worker receives an added benefit through the individual account. Contracting out maintains free choice, and it may encourage private sector employers to provide pension plans.

This approach is called "a voluntary carve-out" in the United States. In Japan, contracting out has been provided on a fairly neutral basis with respect to incentive for participation, with the government neither subsidizing nor disfavoring it. The United Kingdom, by contrast, encourages contracting out by subsidizing it. This approach was proposed for the United States by President Bush in 2005 in his second inaugural address and subsequent State of the Union message.

A problem that may arise with contracting out, because of its voluntary nature, and a reason why full mandating is sometimes viewed as preferable, is adverse selection. With adverse selection, the workers who most benefit from contracting out leave the social security system, eroding its financial base. For example, in the United States, depending on the way the contracting out would be structured, and to the extent that the social security system redistributes income from upper-income to lower-income workers, upper-income workers may be more likely to contract out of the system than lower-income workers.

U.S. Social Security has a progressive benefit formula, providing a higher replacement rate for lower-income workers than for higher-

income workers. This aspect of progressivity is offset by the higher mortality rates of low-income workers than high-income workers at older ages, which means that high-income workers receive their benefits for more years, on average.

Mandating. Increasing retirement income by mandating private pensions is an alternative to making Social Security more generous. While Social Security provides a uniform structure of benefits and contributions across the workforce, mandatory private pensions generally allow greater flexibility and diversity in the types of arrangements, including differences in early retirement age. The mandatory pension approach can either require employers to provide a pension plan for their workers or require workers to have an individual account plan with a third-party provider.

Australia and Switzerland mandate that employers provide pensions. Sweden mandates individual accounts managed by a government agency. The government collects the pension contributions and distributes them to the mutual funds chosen by workers, with the employer's only role being to transmit the workers' contributions to the government.

Mandatory pension systems that supplement a traditional social security system often do not cover all workers. They often exclude low-wage, part-time workers and short-tenure workers. Even with these exclusions, mandatory pension systems tend to have high coverage rates.

Relationship to Social Security

An alternative approach to the pathways approach to understanding the types of pension arrangements is to categorize pensions according to their relationship to social security. Pensions can either be add-ons to or carve-outs from social security. An add-on is a pension plan that supplements the social security benefit. The add-on does not affect social security benefit levels. A carve-out, by comparison, replaces part or all of the social security benefit. Though in reforms that completely replace an old system with a new one (such as in Sweden) this distinction can get blurred, in reforms such as the type being considered in the United States this is a major distinction.

Add-ons and carve-outs can be either voluntary or mandatory. This taxonomy results in four categories of pension plans: voluntary add-ons, mandatory add-ons, voluntary carve-outs, and mandatory carve-outs.

VOLUNTARY CARVE-OUT ACCOUNTS

With a voluntary carve-out, for example as proposed by President Bush, workers have a choice. They can remain in the Social Security system or withdraw from it, either partially or fully, depending on the structure of the voluntary carve-out. In exchange for a reduction in both current taxes and future social security benefits, the worker is obliged to contribute to an individual account. The employer's contributions to social security also may be transferred to the individual account.

The United Kingdom has such a system of "contracting out" of social security, known as the State Second Pension (S2P) Scheme (Blake 1995).[2] Rebates of social security contributions are paid into the individual accounts of people who give up their right to receive the State Second Pension or its forerunner, the State Earnings-Related Pension. Workers can invest these rebates in contracted-out company or personal pensions.

The United Kingdom was late in establishing an earnings-related social security program, which it did not do until the 1970s. At that time, a well-established private pension system was already in place. Voluntary carve-outs were permitted in the United Kingdom not to reduce a preexisting social security program but to protect a preexisting defined benefit private pension system. Later, for ideological reasons, workers were allowed to establish private accounts to reduce their participation in social security.

Generosity of the Trade-Off

The trade-off between contributions to an individual account and reductions in future social security benefits is the most important aspect of the structure of voluntary carve-outs, but it is difficult to calibrate the generosity of the trade-off. The smaller the reduction in the worker's future social security benefits that accompanies the reduction in

the worker's social security payroll taxes, the more favorable to the worker is the voluntary carve-out—consequently, the more likely it is that the worker will choose it. However, another directly related trade-off exists: the more favorable the voluntary carve-out is to the worker, the more costly it is to the government. A generous voluntary carve-out may result in a substantial subsidy of individual accounts by the traditional social security system or by government general revenue.

The trade-off, or benefit offset, determines the voluntary carve-out's effect on social security's long-run solvency. If the worker is required to forgo a part of benefits actuarially equivalent to the benefits that would have been paid for by the reduction in his social security payroll taxes, social security's finances will not be affected over the long run. A transition effect occurs, however, as social security contributions are reduced years before the outflows are reduced. If the benefit offset deviates from actuarial equivalence, it will affect the desirability to workers of taking the carve-out, and will have a long-term effect on social security finances that could be either positive or negative.

The carve-out functions like a long-term loan to the worker from the social security system. The worker borrows from his future social security benefits, with the loan principal being the reduction in the worker's social security contributions. The worker receives the rate of return earned on his investment of his individual account, which would be an expected 3 percent real (but with interest rate risk) if he or she were to invest in U.S. Treasury bonds. The worker repays the loan through reduced receipt of social security benefits at the rate specified by the carve-out. If that rate were 2 percent real, workers would receive a government subsidy of 1 percent per year on the account balances in their individual accounts because they would be effectively borrowing from the government at 2 percent and receiving a rate of return on the investment of the loan at 3 percent.

The interest rate credited to workers' hypothetical accounts for determining the benefit offset is a risk-free interest rate since it is applied to the account with certainty. In contrast, the investment earnings rate workers receive on their accounts is a risky rate. Whether workers would take the voluntary carve-out would depend on three factors: 1) how risk-averse they are, 2) what other investments they have, and 3) what special tax incentives, if any, the government provides.

The Structure of the Trade-Off between Reduced Contributions and Reduced Benefits

For a voluntary carve-out account, the trade-off between reduced contributions to social security and reduced benefits from it can be structured other ways. For example, the reduction in social security benefits can be the same percentage as the reduction in the worker's social security contributions. The reduction in social security benefits with a carve-out can be set as an equal percentage reduction in social security benefits for all workers choosing to take the carve-out. For instance, if social security contributions by the worker are reduced by x percent, the future benefits accrued during that period are also reduced by x percent. This way is arguably the simplest administratively.

Age neutrality. An additional complexity in designing carve-outs is to make the reduction in social security benefits age neutral. With age neutrality, if a worker finds it optimal to take the voluntary carve-out at one age, the worker will find it optimal to continue opting out at older ages. This desirable, conceptually simple feature is difficult to achieve because of the difference in accrual patterns between traditional defined benefit social security plans and individual accounts.

For defined benefit plans and individual accounts with equal benefits at retirement, generally the individual account accrues benefits more rapidly for workers at young ages. In contrast, the defined benefit plan accrues benefits more rapidly for workers at older ages, because defined benefit plans tend to be backloaded in their benefit accruals. These different patterns of accrual create an incentive for workers to take the voluntary carve-out when young but not when older. The problem of the switching incentives this causes can be addressed by requiring that once a worker has chosen a carve-out, the decision is irrevocable. Such an arrangement raises issues of equity, however, if the terms of the trade-off are subsequently amended, which they almost certainly would be.

The United Kingdom's system demonstrates why these terms would likely be amended over time. Rather than having a single rebate rate for all workers, the United Kingdom has an array of rebate rates, depending on the worker's age. Younger workers receive lower rebates on their payroll taxes (known as National Insurance contributions) than older workers since individual accounts of equal lifetime generosity are more

favorable than defined benefit plans for younger workers. In 2001–2002, a 20-year-old received a 4 percent rebate, while a 50-year-old received the maximum rebate of 9 percent. Age-related rebates designed to keep the contracting-out arrangements age neutral are complex, expensive to administer, and probably poorly understood by workers.

The rebate's size is not fixed for all time in a voluntary carve-out system, but can be expected to change over time. The UK rebate structure is reevaluated by the Government Actuary every five years to incorporate changes in life expectancy and interest rates. The rebates have been calculated based on the expense in the private sector of providing a replacement benefit, with an additional amount added to the rebate as an incentive to take it.

Gender neutrality. A further problem in designing voluntary carve-out individual accounts is to structure the trade-off so that it is gender neutral. Because women have a longer life expectancy than men, a gender-blind trade-off will not be gender neutral in effect. The trade-off in the United Kingdom is not gender neutral. Instead, it encourages men and women to take the voluntary carve-out at different ages. For example, in the late 1990s, 93 percent of eligible men in Britain aged 45–54 chose the individual account, compared to only 32 percent of eligible women in that age group (Whitehouse 1998).

For many years, Japan structured its voluntary carve-out with different rebates for men and women. With changed views of gender equity, that is no longer the case (Turner and Watanabe 1995). An additional issue relates to how changes in life expectancy affect benefits in a voluntary carve-out account and in social security.

In sum, the experience in the United Kingdom demonstrates that voluntary carve-out accounts are complex to structure and operate. It is difficult to set the relationship between the amount going into the carve-out account and the corresponding reduction in the worker's social security benefits.

PENSION PRIVATIZATION IN OECD COUNTRIES

While mandatory employer-provided pensions have long been favored by some people, they have not been at the top of the U.S. agenda for possible implementation for several decades. However, a number of countries have adopted them as they have sought to expand coverage from the lower coverage rates provided by a voluntary system.

Australia

Unlike in other countries in the Organisation for Economic Co-operation and Development (OECD), the basic social security benefit in Australia is an income-tested and asset-tested benefit, which about 70 percent of retirees receive. To qualify for this benefit, workers must prove that their income and assets fall below a set level. Australia is unique among developed countries in that it has never had an earnings-related social security program.

To supplement the income-tested benefit, Australia has introduced a privatized retirement income system, called the Superannuation Guarantee, less formally known as Super. That system involves requiring private sector employers to provide pensions that are primarily individual accounts. The contribution rate is 9 percent of salary. Since the government pension is unfunded, the change represents a move from an unfunded toward a funded system.

Because contributions are mandated by legislation and paid into funds administered and invested by the private sector, the government has introduced extensive safeguards to ensure that employees' pension entitlements are secure. This regulation has resulted in increased complexity and added costs. The safeguards place a heavy burden on trustee boards responsible for overseeing the funds' management.

Sweden

Sweden has instituted a mandatory individual account system that incorporates lessons learned from the experiences of Chile and other countries, particularly in ways to reduce administrative costs. This individual account system reflects a desire to increase the amount of

prefunding in the Swedish retirement income system, and to move to a system with greater emphasis on the role of the capital market and individualism (Harrysson and O'Brien 2003).

Through measures that took effect in 1999 and 2000, Sweden replaced its traditional defined benefit social security program with a notional account plan supplemented by a mandatory, funded individual account. A notional account system is one where each worker has an account that is credited with contributions and interest earnings. However, the system is financed on a pay-as-you-go basis, so the individual accounts are not funded, and the account balances are bookkeeping entries. Out of a total contribution rate of 18.5 percent of earned income, 16.0 percent is for the notional account system and 2.5 percent is for individual accounts, called the Premium Pension. Starting in 2000, Swedish workers were allowed to choose from 460 pension funds to manage their pension investments, with the default fund being a government-run fund. By 2005, the number of funds had grown to more than 600.

The Premium Pension system is administered by a new government agency, the Premium Pension Authority (PPM, or Premipensionsmyndigheten in Swedish). The PPM acts as a clearinghouse and record keeper for the funded individual account system. This new agency was needed because the individual account system includes a broad range of new activities that would have been difficult to undertake within the traditional functions of the National Insurance Board. In addition, a central agency is expected to help keep administrative costs low because of scale economies in administration (Palmer 2001).

United Kingdom

The United Kingdom has encouraged contracting out to individual account plans, but it is continuing to make changes in its retirement income system (Blake and Turner 2002). While every developed country has a social security system, the United Kingdom is unusual in giving every employer and every employee the option of contracting out part of social security. By comparison, contracting out in Japan is available only through employer-provided defined benefit plans.

Contracting out in the United Kingdom has developed into a highly complex system. In 1986, the United Kingdom passed an act designed

to encourage contracting out from the State Earnings-Related Pension Scheme (SERPS), a defined benefit plan, using individual accounts. Previously, contracting out had only been possible with employer-provided defined benefit plans. That act enabled occupational plans to contract out by providing an individual account. It also enabled individuals to contract out of SERPS or out of their employer-provided contracted-out defined benefit plan using a personal pension called an Approved Personal Pension. Workers with personal pensions are permitted to recontract into social security if that later appears to be favorable, and many do so.

The United Kingdom replaced SERPS with a new pension program called the State Second Pension (S2P), which took effect in April 2002. Workers and employers are permitted to contract out of the State Second Pension. The S2P was initially earnings-related, but in April 2007 it became a flat rate benefit, even though contributions are earnings-related. While the State Second Pension is a flat rate pension, the rebates paid to workers opting out remain related to earnings. This arrangement provides greater incentive for lower-income earners to stay in the plan and for middle- and higher-income earners to opt out.

Employees who contract out of S2P receive a rebate on their social security contributions. The rebate is intended to reflect the savings to the government from not having to pay the pension to that participant. The rebate is paid directly into the employee's contracted-out pension fund.

CONCLUSION

This chapter presents an overview of mandating pension provision around the world. It discusses both contracting out and pension mandating, and it also discusses issues relating to mandatory individual accounts. The chapter describes the main features of mandated and privatized systems in several countries. Mandating has been far more common an approach than voluntary carve-outs.

While voluntary carve-outs may appeal because they expand the range of choice, the feasibility of managing such a system hinges in part on the complexities of structuring the rebate for the voluntary carve-

out. The idea of offering the choice to participate in a funded individual account pension rather than in the social security program is appealing on ideological grounds to some people. However, it is difficult to structure voluntary carve-outs so that they are age and gender neutral and so that they are neutral in their effect on the financing of the social security program. These difficulties are among the reasons few countries have adopted voluntary carve-outs.

Notes

1. This chapter draws heavily from Turner (2006).
2. Prior to April 2002, it was called the State Earnings-Related Pension Scheme (SERPS).