THE DECLINE OF THE TRADITIONAL PENSION

The traditional (final- or average-salary) pension that employers have provided their employees has suffered a huge decline in labor force coverage in the United Kingdom and the United States, and less severe declines in Canada and elsewhere. The traditional pension provides a precious measure of retirement security by paying retirees an annuity for life. This study compares developments in the countries just named and in Australia, Denmark, Germany, Japan, the Netherlands, Sweden, and Switzerland to explain the forces behind the decline of the traditional pension and to contrast the experience of public-sector employer-provided plans, where it remains dominant. Given the great value of the longevity insurance that the traditional plan provides, and the risks its diminished coverage entails, the book proposes a set of measures that either stem the decline or endow defined-contribution pensions with some of the attributes of the traditional plan.

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The Decline of the Traditional Pension

A Comparative Study of Threats to Retirement Security

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For Carolyn and Marjorie

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I hope that *The Decline of the Traditional Pension* will contribute to the enhancing of retirement security in the countries it surveys, and perhaps in other countries as well. Despite all the help I have received, I assume full responsibility for any errors that remain in it.

Introduction

Traditional Pensions in Trouble

The defined-benefit plan has been the preeminent pension form for over a century. Virtually all of the national pensions of industrial countries are defined-benefit plans, as are many of the national pensions in developing and emerging-market countries.[1] It remains the dominant second-tier plan for public-sector employees (i.e., civil servants, teachers, and other occupations working for governments at any level, and employees of public-sector enterprises and decentralized public agencies). Similarly, until recently it has been the dominant form in the private sector of those countries where the second tier covers a significant share of the workforce. Employer-provided defined-benefit plans are invariably average- or final-salary plans.

The labor force coverage of employer-provided plans varies greatly from one country to another, mainly because of variations in the coverage of private-sector employees. In some advanced economies, and notably in France and Italy, coverage is low.[2] However, in a group of ten advanced countries that includes five G-7 members (the United States,

[1] The book uses *national pension* to refer to the first tier of a country's pension system – the mandatory government-financed system that covers all or virtually all of a country's residents. It may be flat-rated, earnings-related, or a combination of both. The American equivalent is Social Security; the Canadian equivalent is the Canada/Quebec Pension Plan; and the Japanese equivalent is the National Pension (a flat rate scheme), plus the Employees' Pension Insurance (EPI) for private sector employees and Mutual Aid Associations (MAA) for public-sector employees. The EPI and MAA are earnings-related. The plans that governments and other public-sector employers provide their employees are referred to as *public-sector employer-provided plans*. They are part of the second tier.

[2] France has two economy-wide plans run by the private sector, one for blue-collar workers, and the other for white-collar workers and managers. However, these plans are PAYG, and in many respects they function more like a public than a private plan.

Table I.1. *Quantitative structural features of defined-benefit and defined-contribution pension plans in ten countries (in percent except for column 5, which is expressed in percentage points)*

	All employer plans		Role of defined-benefit plans			
	Assets in relation to GDP	Labor force coverage	Share of defined benefit in total as of date shown		Change in defined benefit share since date shown	
Australia	105.4	90.1	3.0	FY2007	…	…
Canada	55.3	34.2	79.6	2007	9	1995
Denmark	32.4	90.5	2.0	2005	…	…
Germany	4.1	59.0	100.0	2006	…	…
Japan	20.0	62.0	93.0	2008	–7	2001
Netherlands	132.2	100.0	97.0	2005	–3	1998
Sweden	8.7	90.0	14.0	2006	–30	2003
Switzerland	119.4	86.0	26.0	2005	–14	1990
United Kingdom	86.1	29.6	89.8	2007	2	2004
Open DB schemes only	…	…	36.0	2007	–36	2000
United States	74.3	50.0	17.0	2007	–16	1989

Sources: Column 1: OECD: Private Pension Outlook (2008b)

Column 2: National authorities and author's estimates; for Denmark, denominator is full-time employees; includes both public- and private-sector employees.

Columns 3 & 4: National authorities, country studies, and author's estimates.

Columns 5 & 6: National authorities, country studies and author's estimates.

Canada, Germany, the United Kingdom, and Japan), as well as Australia, the Netherlands, Denmark, Sweden, and Switzerland, employer-provided pensions cover a significant share of the labor force. The absolute number of employees covered by public- and private-sector plans in these countries is large, and private-sector plan assets amount to about 70 percent of the group's GDP (Table I.1).[3] The book's analysis of developments in employer-provided pensions concentrates on these ten countries.[4]

3 The combined GDP of these ten countries amounts to 70 percent of the combined GDP of OECD members and over half of global GDP. Their combined labor force exceeds 340 million.

4 There are not many countries in which employer-provided pensions cover a significant share of the labor force with assets that are large in relation to GDP. The ten countries that are the object of this study include all the industrial countries whose employer-provided pension plans have assets equivalent to at least 15 percent of GDP, apart from Finland, Iceland, and Ireland, which were excluded because of the small size of their economies

Until recently, defined-benefit plans held most of the assets of private-sector employer-provided plans in the ten countries, and the number of defined-benefit plan participants was much greater than the number of defined-contribution plan participants. These plans usually took the form of career-average or final-salary plans, and these are the *traditional* plans to which the book's title refers. However, the traditional pension's coverage of private-sector workers is falling, and in some countries, its future looks bleak.

In the United States and the United Kingdom, the decline in labor force coverage of plans that are still open has been precipitous, so much so that many observers believe that the defined-benefit plan cannot survive as an institution in the private sector. In 1989, defined-benefit plans in the United States covered 32 percent of the work force against 28 percent covered by defined-contribution plans. By 2007, coverage of defined-benefit plans had declined to 17 percent, and coverage of defined-contribution plans had increased to 41 percent.[5] In the United Kingdom, membership in open private-sector defined-benefit plans dropped from about 4 million in 2000 to 1.3 million (about 4 percent of the labor force) in 2007. In Australia, the demise of the defined-benefit plan is virtually complete, hastened by the pension reform of 1992, which introduced the Superannuation Guarantee, a compulsory employer-administered plan. Small- and medium-sized enterprises that had previously offered no pension plan to their workers now chose to offer defined-contribution plans, probably because they were cheaper to administer and less risky. They proved to be popular.

Defined-benefit plans may not have suffered so dramatic an erosion of membership in the other countries, but some declining trend is evident. In Canada in 1995, 87 percent of the members of private-sector employer-provided plans were covered by defined-benefit plans. By 2007, the share of defined-benefit membership in the private sector had fallen to less than 75 percent (Statistics Canada 2009). In Germany and Japan, a reform permitting defined-contribution or hybrid pensions was passed only eight years ago. Defined-benefit pensions remain preeminent, but defined-contribution plans have begun to spread.[6]

(OECD 2006). Germany, with externally invested assets of less than 15 percent of GDP, is also included because of its size and because it is an interesting case in light of its recent introduction of hybrid plans.

5 These figures include participants covered by both types of plans, so there is some double counting.

6 In Germany, the new plans have a guarantee on contributions and are classified legally as defined-benefit plans.

In the Netherlands, defined-contribution plans remain rare, but traditional pension plans now include a mechanism that changes the way risk is shared among the sponsor, workers, and pensioners to forestall the emergence of financial imbalances. In Sweden, the full implementation of a notional defined-contribution national pension system (NDC system) in 1999 prompted a wholesale move away from defined-benefit plans in the private sector. In Denmark and Switzerland, defined-contribution pensions, albeit with features that make them resemble defined-benefit plans, have been dominant for two decades.

In the realm of national pensions, the financial strains caused by increasing longevity have threatened to dislodge the defined-benefit plan from its prominent position. In countries like France and Germany, the effect of aging has been reinforced by the impact of declining labor force utilization on collections of the payroll taxes that finance the national pension plan. Aging has also affected the finances of the defined-benefit plans provided by public-sector employers.

Despite the financial pressures to which national pension plans have been subject, most countries have maintained the basic, typically earnings-related form of the plan, although some of them have enacted reforms that have raised average retirement ages and reduced accrual rates. Others have added an adjustment mechanism to offset the financial impact of aging. For example, Germany has added a "sustainability factor" to the adjustment formula for pensions that reduces pensions when the increase in the old-age dependency ratio increases (International Monetary Fund 2004a).

Sweden's reform of its first tier is more fundamental than Germany's. Sweden's NDC system was complemented by an individual account system. Of a total contribution rate of 18.5 percent, 16.0 percentage points finances the NDC system, leaving 2.5 percentage points for the individual account scheme, known as the premium pension. The premium pension may be invested in one or more of as many as 700 investment funds. In addition, the reform made the pension that members of a particular age cohort receive a function not only of members' earnings history, but also of the cohort's life expectancy, and incorporated an automatic balancing mechanism that suspends the indexation of pensions to restore balance (Könberg, Palmer, and Sundén 2006, 455–7; Turner 2009).

The United Kingdom is undertaking a major reform of its pension system. The current form of the first tier will be retained but made more generous, although starting pensions will be reduced over time to compensate for the fiscal impact of aging. The employer-provided system will be substantially changed by requiring employers to offer a pension to their employees. Employees not wishing to be covered will need to opt out (Department of Work and Pensions 2006a).

The Decline of the Traditional Pension is motivated by concerns over the consequences of the diminished standing of traditional pension plans. Despite certain shortcomings, these plans have served as a strong second pillar in pension systems that cover a large number of workers in some of the world's largest economies. Their diminished role may jeopardize retirement security for millions of workers around the world.

Working people who plan for a secure income in retirement confront three risks, apart from the risk that saving rates will fall when spells of unemployment, illness, or disability reduce earned income. First, they may save too little, either because of miscalculation or a failure or inability to stick to a saving plan. Second, even if they save enough, either underperforming financial markets or their own ill-considered investment decisions may prevent them from accumulating sufficient savings by the time they retire. Finally, even if workers skirt these perils and retire with an adequate nest egg, they may still suffer a needless diminishment of their welfare if they either neglect or are unable to purchase a life annuity, or some other form of longevity insurance.

Maintaining a traditional defined-benefit plan is not the only possible policy that employers can adopt to enhance the retirement security of their employees. However, it does provide protection against these three specific risks to a secure retirement. The capacity of other pension plans to do likewise is untested, and whether the arrangements that replace traditional defined-benefit pensions will be adequate in this respect is far from certain. A defined-contribution plan, if the contribution rate is high enough and if participation in the plan is a condition of employment, undoubtedly does achieve one important goal of a program of retirement income security: By forcing the participant to save, it mitigates the first risk.

Unfortunately, defined-contribution plans do not necessarily address the second and third risks. They may not even mitigate the first risk, that of inadequate saving, effectively. With 401(k) plans in the United States – now the dominant pension form in that country – the employee is free to decide whether or not to participate and what his or her contribution rate (up to a limit that the plan specifies) should be. These plans are also vulnerable to the second risk, because the investment decision is typically left to plan participants. The collapse of global equity markets in the fall of 2008 has brought home this risk as nothing else could to members of defined-contribution plans everywhere. Moreover, distributions from 401(k) plans are usually not annuitized, which increases the risk that the participant may outlive his or her resources in retirement. The failure of these and other alternatives to a defined-benefit plan to deal with all of the risks confronting retired people can, in principle, be addressed or at least mitigated. That they can does not mean they will, however.

Participation in a defined-benefits plan does entail risks of its own, notably the risk that the plan sponsor may not be able to honor its commitments to plan participants, and the risk that plan participants may need to relinquish their employment before they have become fully vested. However, a well-designed defined-benefit plan should substantially reduce the risks faced by plan members in saving for retirement and managing their finances once they have retired. As this book will explain, the pension plans that will replace them may not be capable of replicating the features that allow them to reduce effectively the risks to a secure income in retirement.

In light of these concerns, *The Decline of the Traditional Pension* has three main aims. The first is to explain as fully as possible the forces behind the decline in the traditional pension and account for the staying power of traditional pensions in the public sector, as well as assessing whether they can retain their dominant position given the pressures they are under. The second aim is to propose reforms that would reduce the risks to the retirement of private-sector workers and possibly public-sector workers that the erosion of the traditional pension's position has created. The private-sector reforms would aim to revive the traditional pension if possible, encourage variants of it that would provide a substantially similar degree of protection, or develop alternative forms that preserve its most valuable features should revival not be in the cards. The public-sector reforms would consider ways in which public-sector pensions might be put on a more sound financial footing. The third aim is to review some recent innovations in first-tier plans, notably the Swedish reform mentioned above.

The forces behind the decline of the traditional plan. Pension experts have identified many different causes of the decline of traditional plans, especially the decline of the traditional plan in the United States. Even before the collapse of global equity markets in the fall of 2008, some observers had fingered financial market volatility, and in particular the decline in long-term interest rates that has taken place in global markets since the late 1990s, coupled with the collapse of the high-tech stock market boom (the dot.com boom) in the early 2000s. Other experts have fingered complex and changeable regulatory frameworks, which have caused excessive