ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Some lessons for pension reform from OECD experience

Green Paper on Pensions:
Learning from International Experience

Dublin, 29 May 2008

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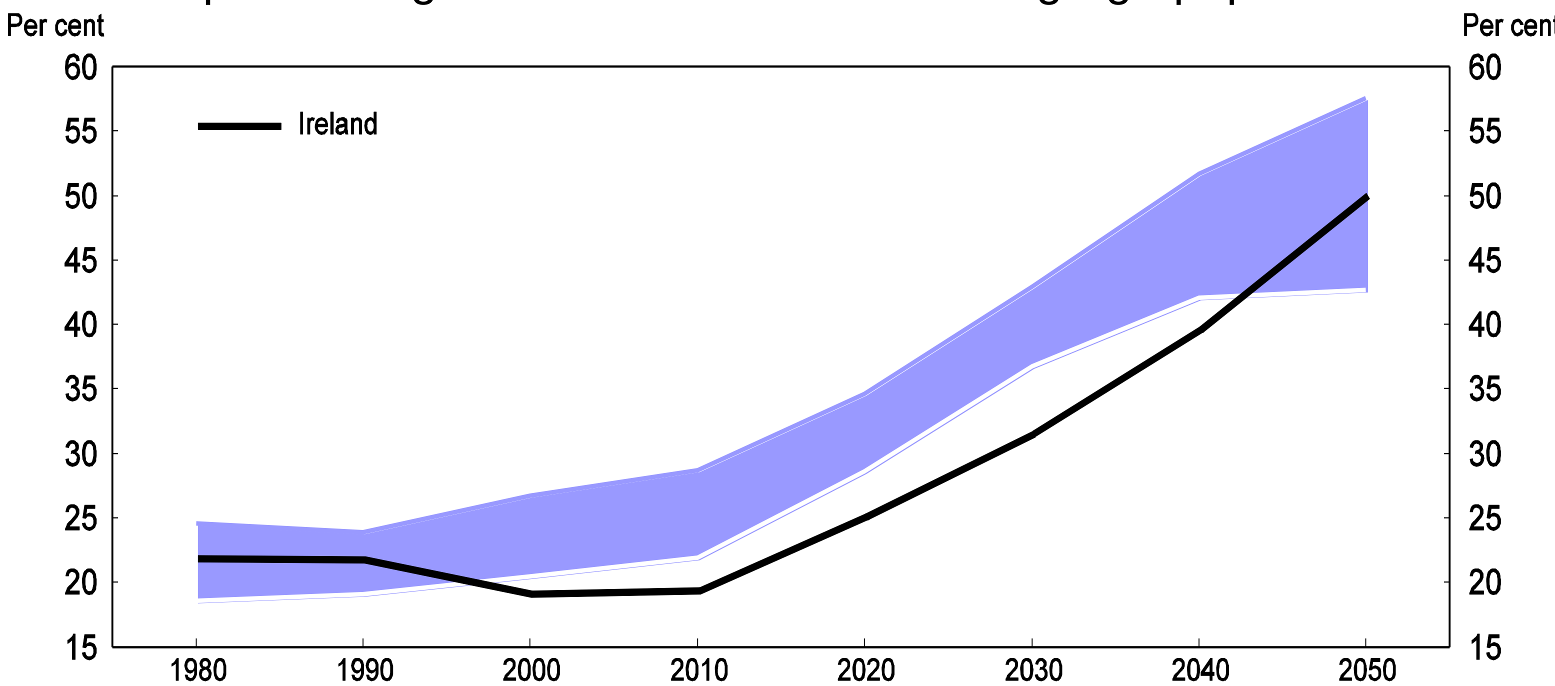
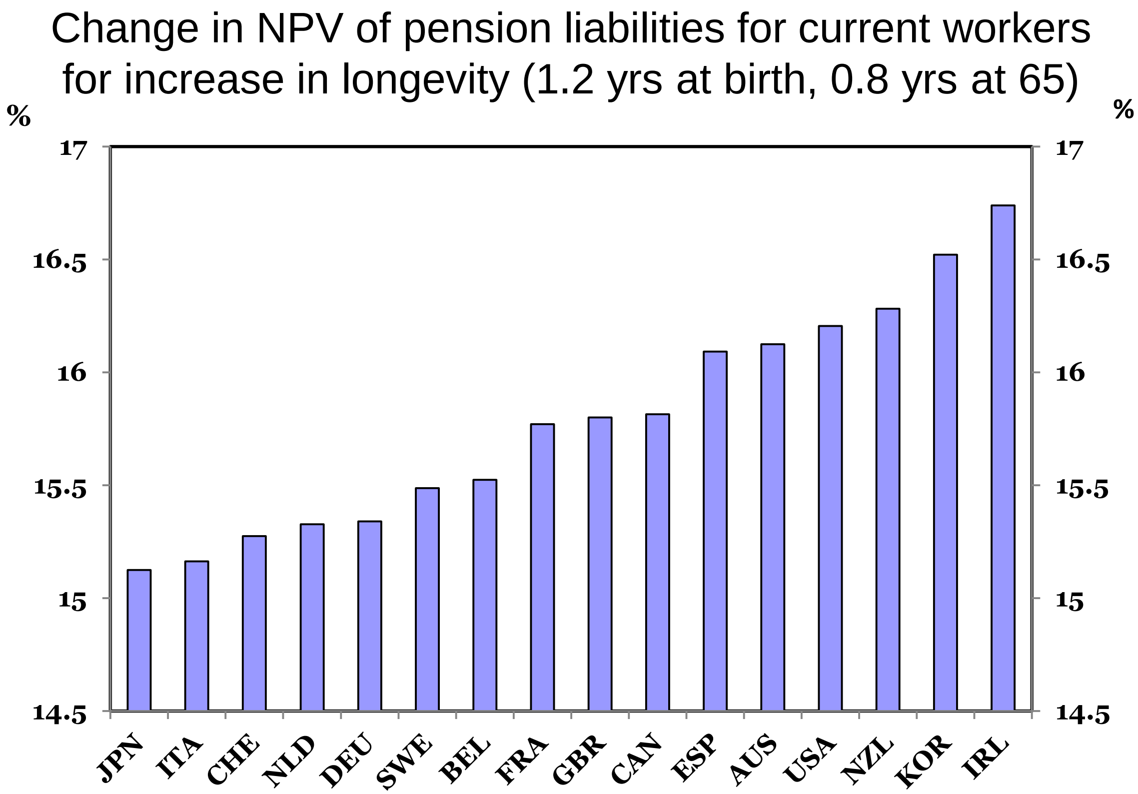
Ireland's position is unusual

Population aged over 65 relative to working-age population



- Relatively small share of population over 65
- Eventually, similar pressures

Huge uncertainty

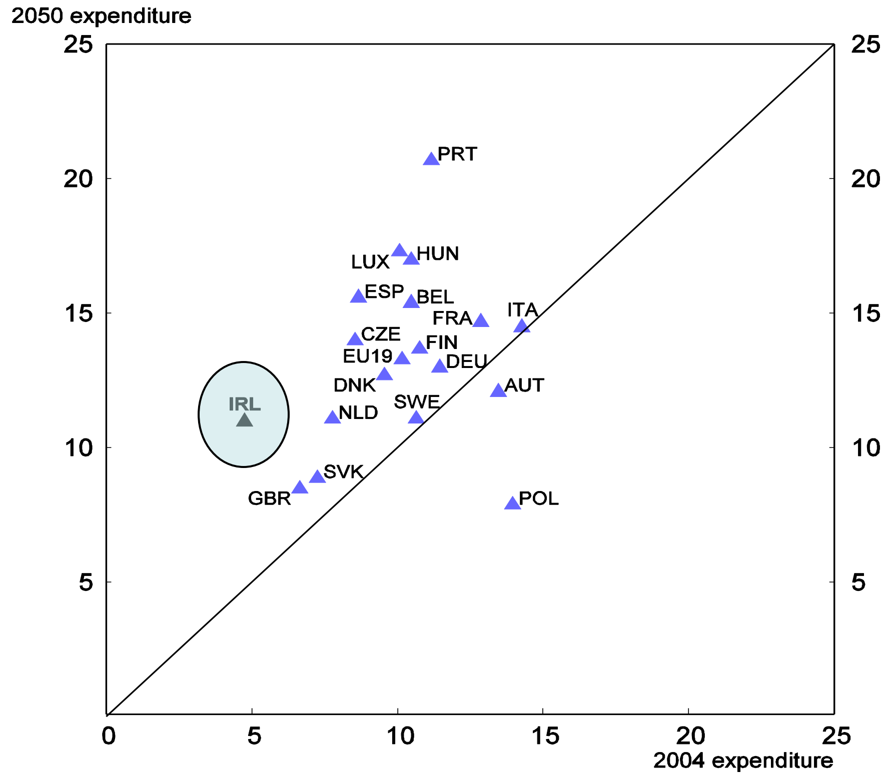


- Relatively young population

=> greater risk from changes in longevity

Substantial adjustment needed

Public expenditure on pensions in 2004 and 2050 (%GDP)



2050: more than 10%

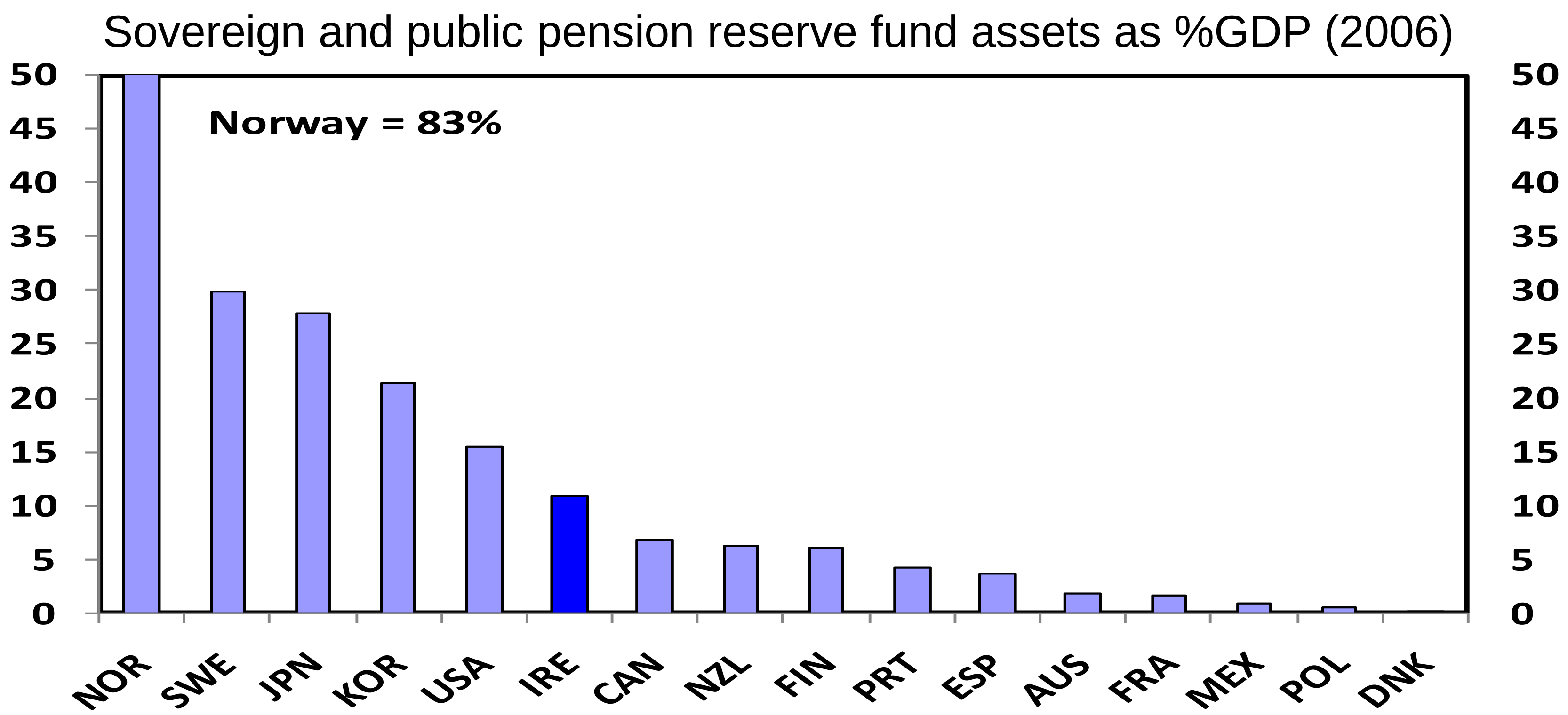
2004: less than 5%

- Public spending on pensions is at a low level
- Without reform, it will rise sharply

Margins for manoeuvre

- Ireland has a number of margins:
  - taxes are low relative to the OECD average
  - net government debt is close to zero
  - 1% of GNI is saved each year in the NPRF
- But, substantial changes will be needed
  - pensions reform must be part of this

Building pension reserves

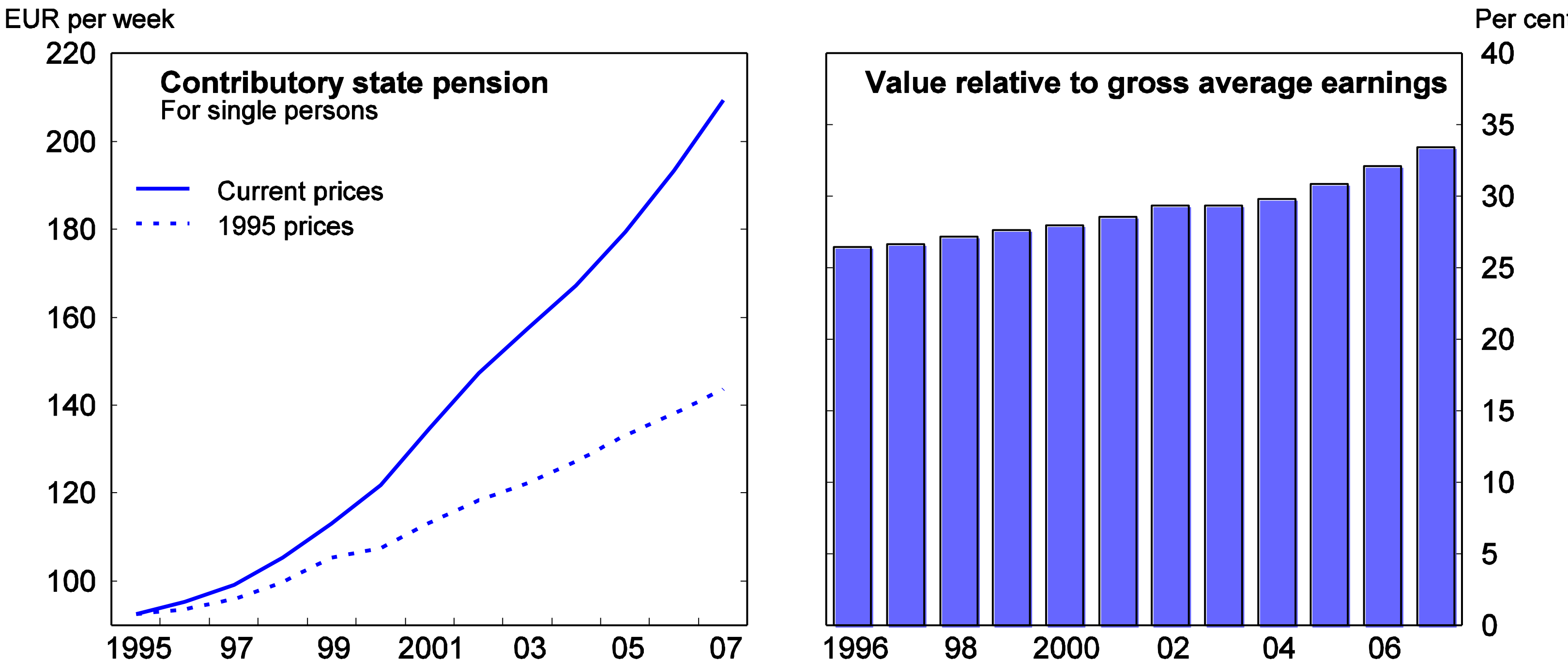


- NPRF is substantial
  - – invested in relatively high-return assets
  - => should meet around 1/3 of the increase

Overview

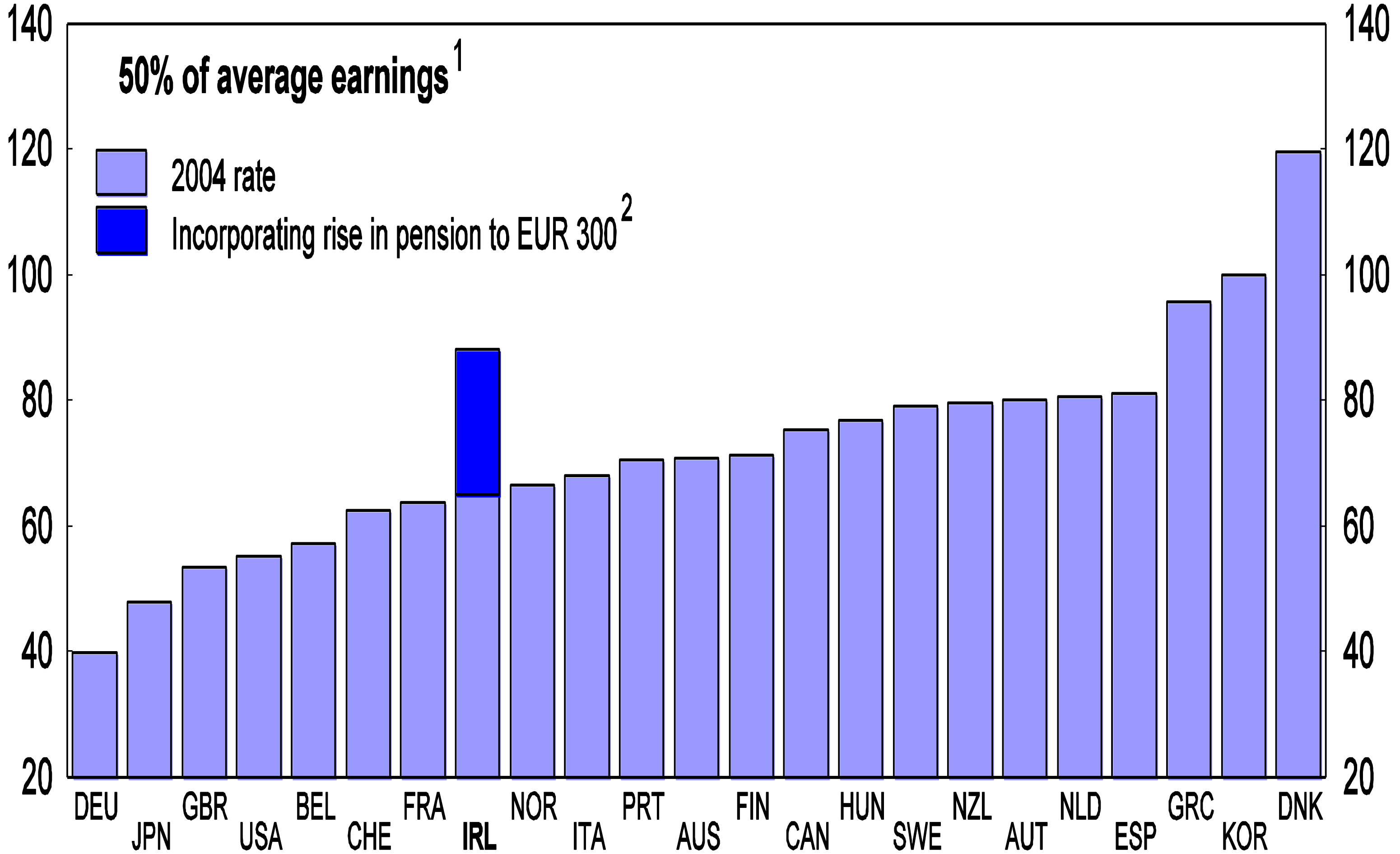
- The state pension
- The ‘pensions gap’
  - raising coverage
  - good quality employer schemes
  - encouraging saving

Raising the state pension

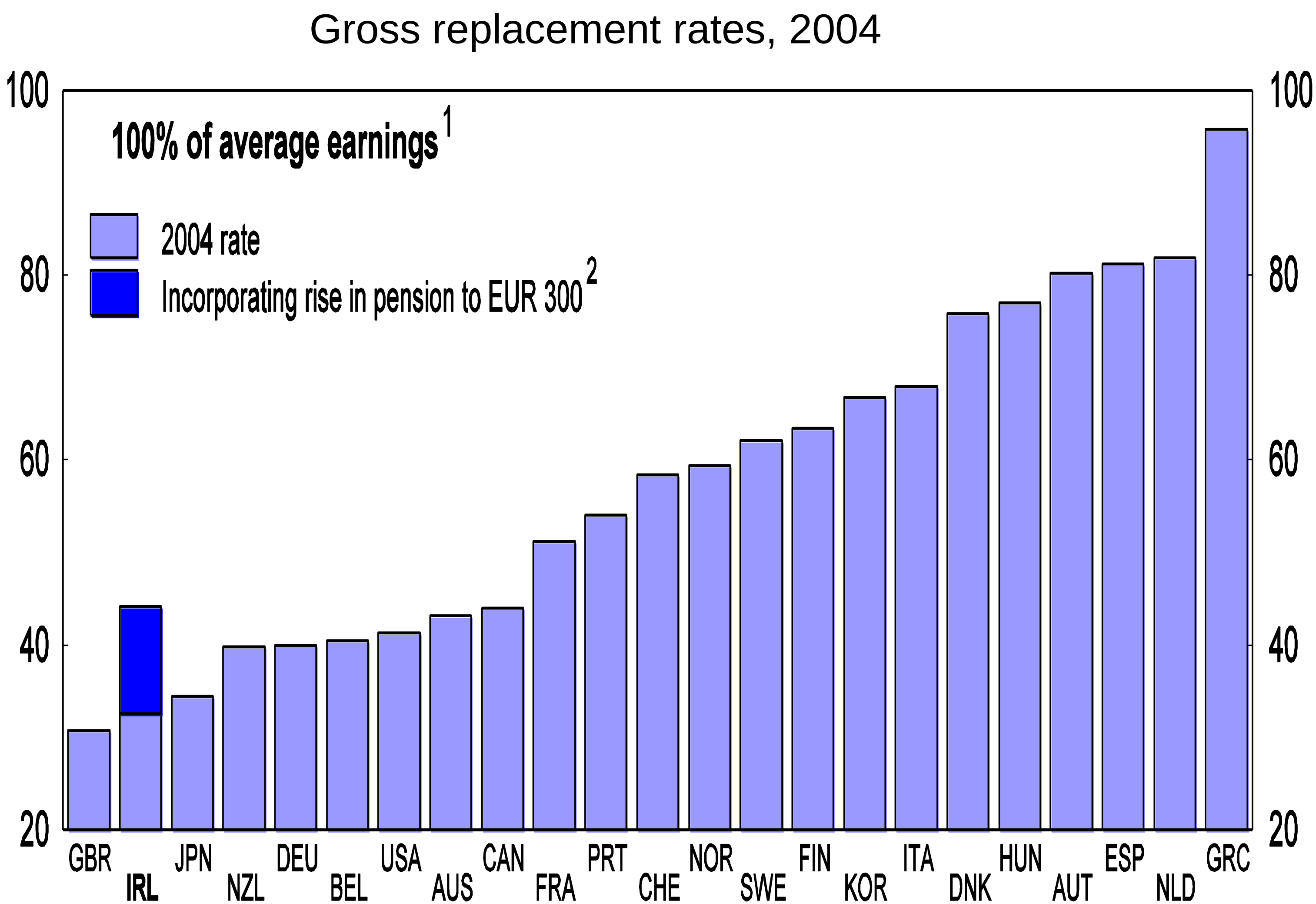


- The value of the state pension has increased
  - facilitated by strong economic performance
  - NPPI 34% GAIE target achieved

Gross replacement rates, 2004



- Projected increases imply a relatively high pension for low earners



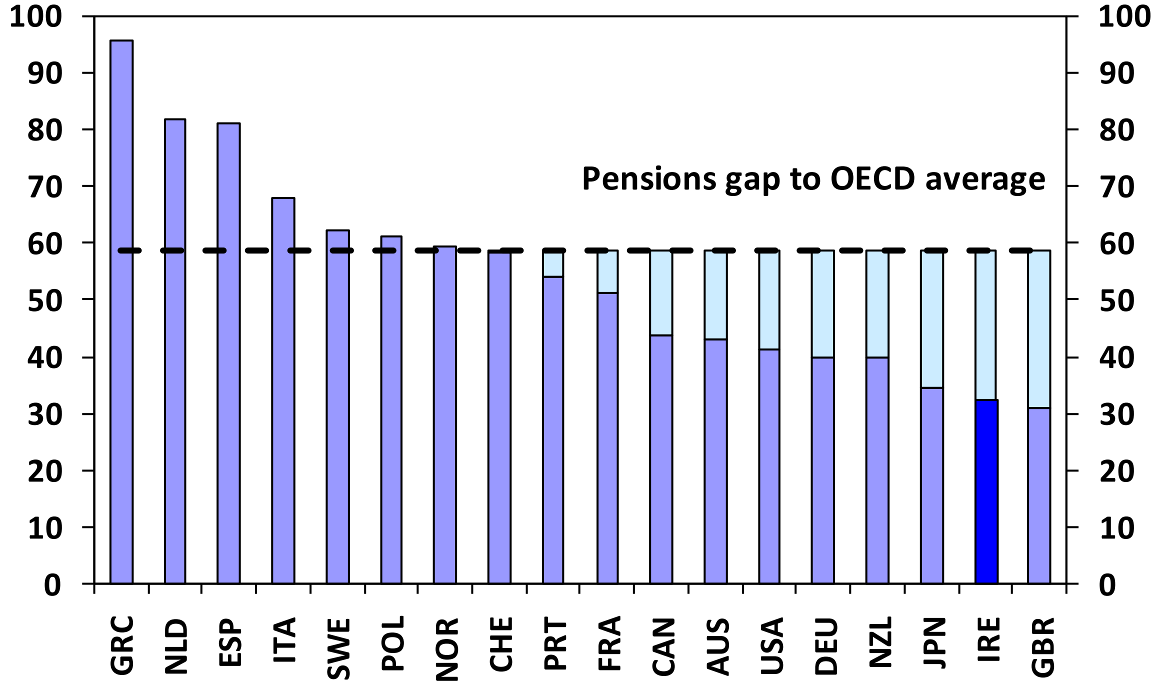
- But, the quasi-universal state pension cannot be the only instrument

Survey recommendations

- Set long-term objectives:
  - target pension value relative to earnings
  - index retirement age to longevity
- Modernisation
  - actuarial-equivalent if defer retirement
  - consider further limiting means testing under the non-contributory pension
  - replace in-kind allowances with cash

The pensions gap

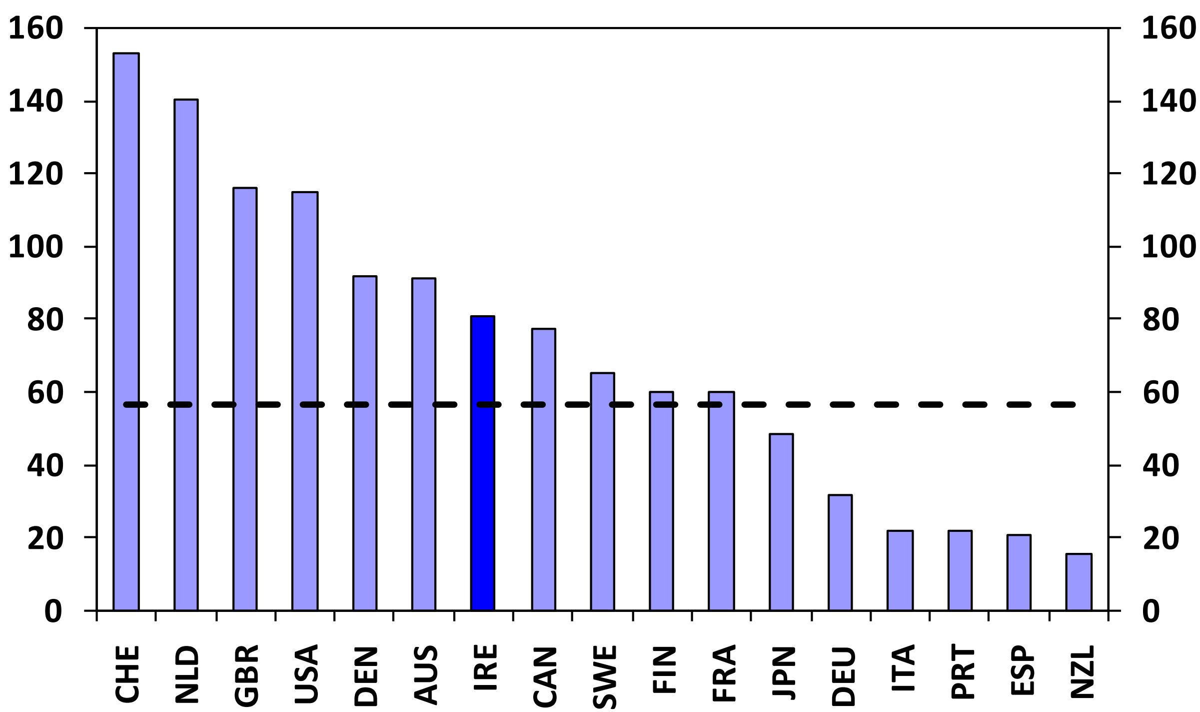
Gross Replacement Rates for Average Worker



- Relatively large ‘pensions gap’
  - – need private saving
  - – important to get private pensions right

Private pensions well-developed

Pension funds and life assurance assets as % of GDP, 2004



- Ireland does well, on average
  - substantial pension fund assets
  - 62% coverage of 30-65 year olds

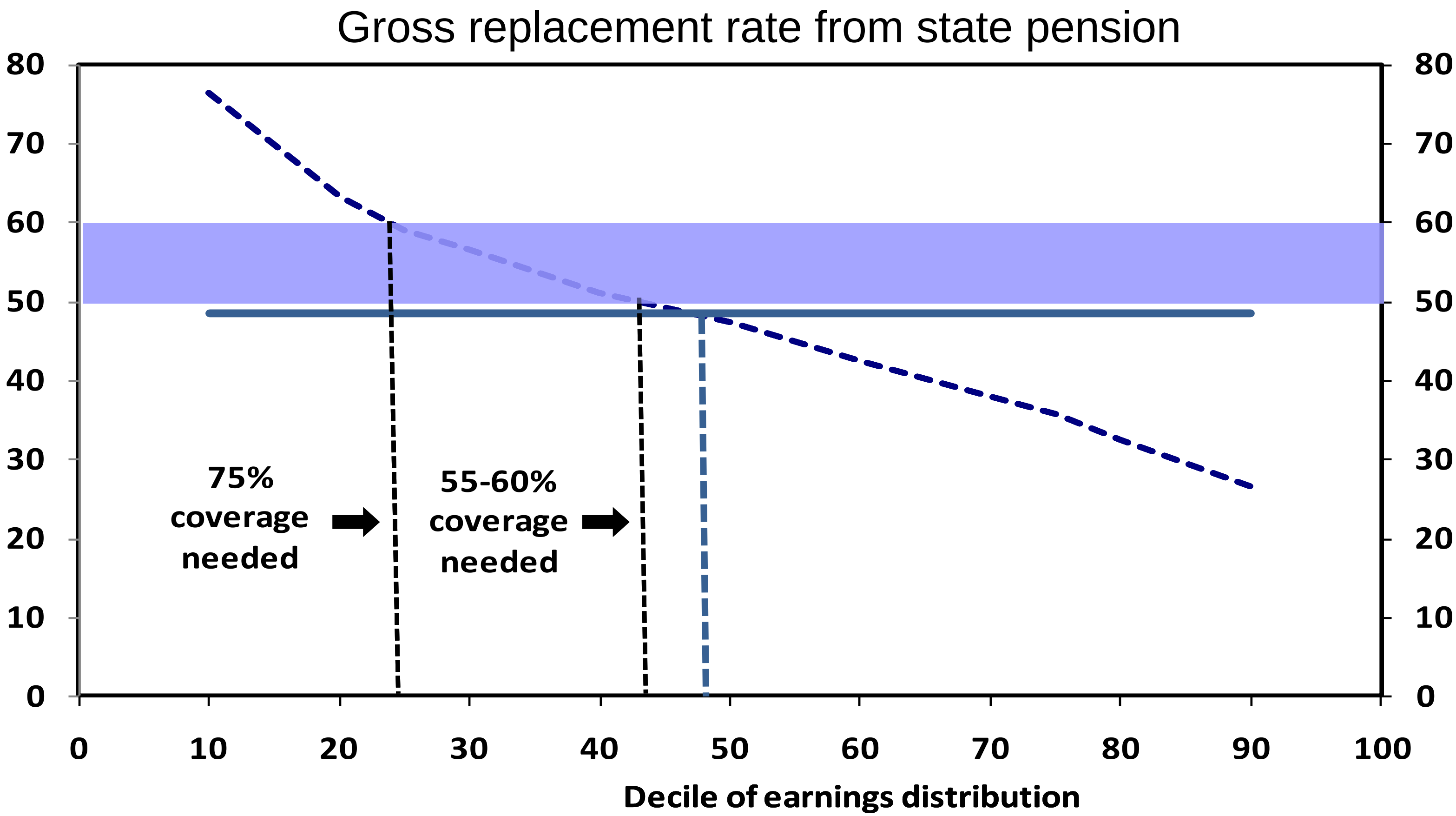
Two challenges

- Good performance is *necessary* given the relatively large pensions gap
- Two main challenges:
  - Are enough people saving ? (coverage)
  - Are people saving enough ? (adequacy)

Are enough people saving?

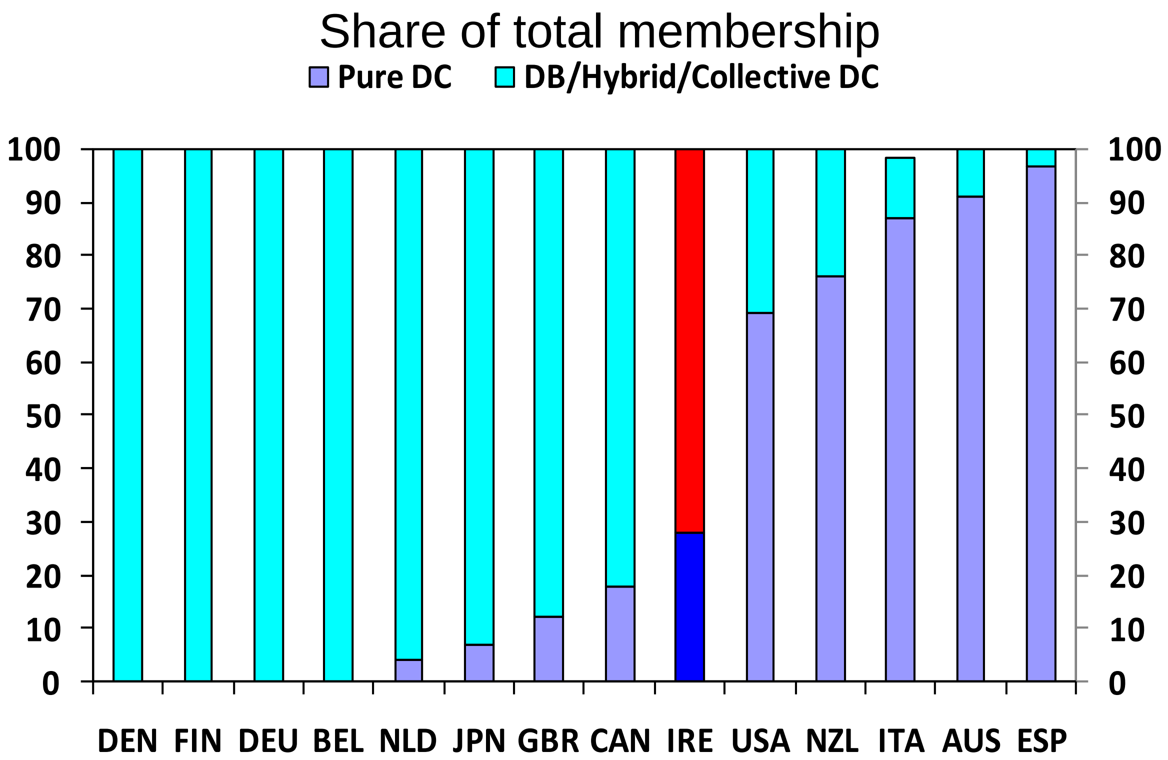
- Some gaps in coverage
  - mostly where employers do not provide scheme
- As in other countries, difficult groups:
  - women, low-paid workers, some industries
  - income-profile is particularly steep in Ireland
- This is <u>not</u> just because workers are young

How many people should save?



- This requires a fine judgement
  - – many workers at around the 50% level

Are people saving enough?



- Employer schemes key to private pensions
  - Defined Benefit (DB) schemes widespread
  - should provide good pensions for many

Pension schemes (1)

- Rising share of Defined Contribution (DC)
  - shift risk completely to employees
  - contribution rates appear relatively high

- Policy should encourage employers to provide good schemes
  - funding regulations should promote high levels of benefit security at a reasonable cost

  => trade-off between security and cost

Pension schemes (2)

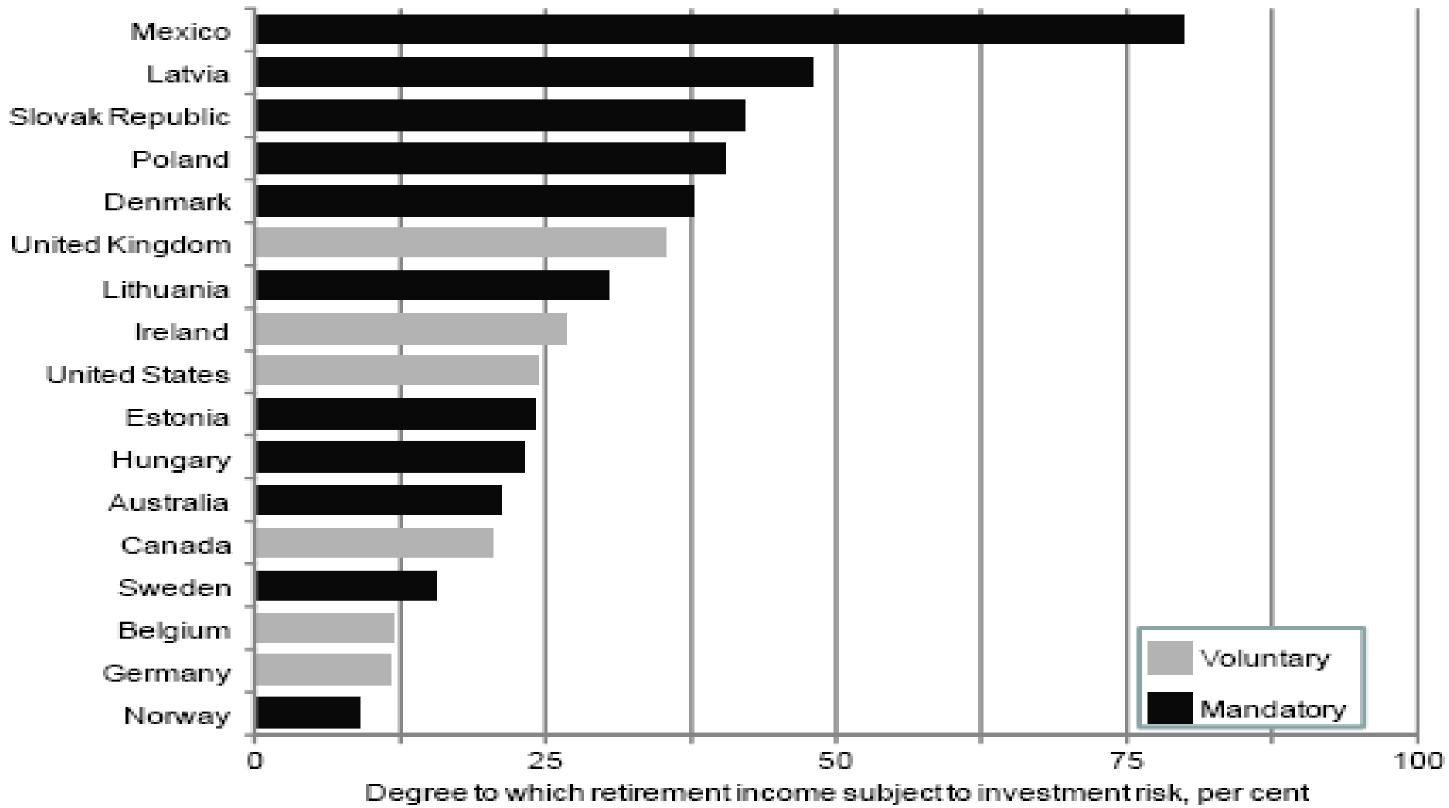
- DB/hybrid schemes attractive
  - share risk, reduce cost of providing
  - developing in Ireland
- 'Termination/Wind Up' Funding standard may be restrictive
  - less restrictive in other countries
    - although relatively long time to correct underfunding
  - OECD Guidelines on Funding and Benefit Security in Occupational Pension Plans

Benefits for retirees

- Need to ensure adequate benefits
- Fragmented contributions histories
  - reduce value of expected benefits
  - need to save from early age to avoid high contribution rates
- Requirement to purchase annuities
  - only applies in some schemes
  - depends on efficiency of annuities market

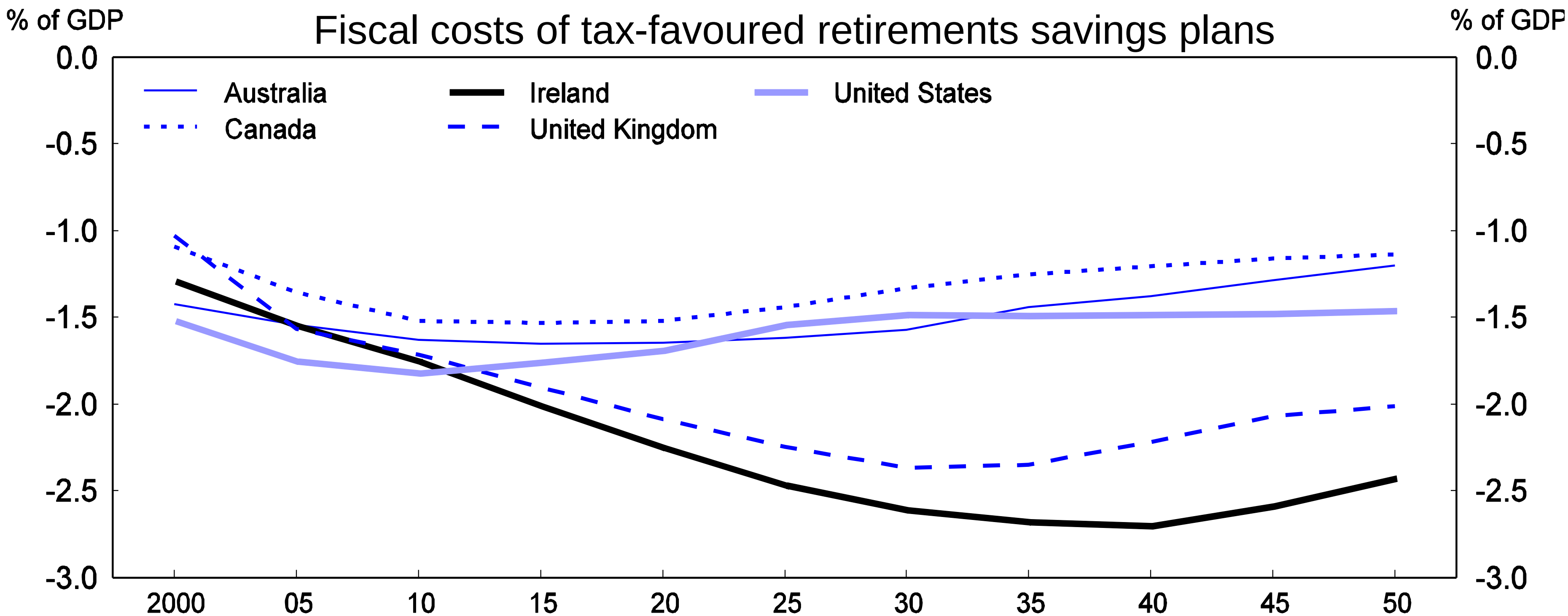
Investment risk

Figure 1. Investment risks faced by average earners



- The state pension already gives protection
  – reasonable for individuals to face some risk

Encouraging private saving (1)



- The current system of tax incentives is expensive and poorly targeted

Encouraging private saving (2)

- Other ways of encouraging saving:
  - Matching contributions
  - ‘Soft’ compulsion – ‘opt out’ schemes
    - limited experience but gaining popularity

- ‘Hard’ compulsion may be necessary

- Financial education is important
  - understanding risks

Survey recommendations

- Replace tax breaks with capped matching contributions
  - lower the level of support, target it better
- Facilitate private pensions:
  - reconsider funding standard
  - reconsider requirements to purchase annuities
  - increase flexibility to work beyond 65
- 'Soft' compulsion
  - PRSA opt out if other provision inadequate

Conclusion

- Prepare state pension for long-term
  - longevity indexation, clear targets
  - modernise some details
- Reform incentives
  - replace tax breaks with matching contributions
  - ‘soft’ compulsion
- Improve private pensions for workers & firms
  - reconsider funding standard
  - reconsider requirements to purchase annuities

Further information

- *Economic Surveys*: Ireland (OECD, 2008)
  www.oecd.org/ireland
- *Pensions at a Glance* (OECD, 2008)
  www.oecd.org/els/social/ageing/PAG
- *Pension Markets in Focus* (OECD, 2007)
  www.oecd.org/daf/pensions/pensionmarkets

- OECD Working Party on Private Pensions

  www.oecd.org/department/0,3355,en_2649_34853_1_1_1_1_1,00

- *OECD Guidelines on Funding and Benefit Security in Occupational Pension Plans* (OECD, 2007)

  www.oecd.org/dataoecd/3/22/38547978.pdf

- *Antolin, P.* et al, *"Long-term Budget Implications of Tax-Favoured Retirement Plans"* (OECD, 2004)

  www.sourceoecd.org/10.1787/138080145732