Public-Private Pension Mix in Selected Countries and Its Implications

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Introduction

As population aging since the late-20th century has emerged as the most significant factor threatening the financial sustainability of public pensions, governments around the world have taken a wide range of reform measures, including changes in benefit formula and benefit indexation, new link between benefit levels and life expectancy, incentives for late retirement, etc. It is against such a backdrop of shrinking role of public pension that private pension has grown in popularity in the realm of old-age income security. Often, private pension is expressly considered part of the reform package, an option to help offset shortfalls stemming from reduced public pension benefits, but there are other times when it gets strengthened without policy intervention.

The National Pension's adequacy as an old-age income protection system has been put to question ever since its benefit levels were reduced following the two rounds of reform—one in 1998 and the other in 2007. The 2007 reform of the National Pension was accompanied by the establishment of Basic Old-Age Pension, which later in 2014 was transitioned into Basic Pension. Earlier in 2005, the government had implemented the Employee Retirement Benefit Security Act. Also, the Korean government announced the cross-ministerial Private Pension Promotion Plan in 2014 in order to help buffer the impact of public pension retrenchment.

Private pension is regarded as a promising way to reduce the burden of public pension funding while still meeting an appropriate level of old-age income protection. However, some point out that strengthening private pension will not only not help ensure an appropriate level of old-age income protection, but also aggravate old-age income inequality. This study is aimed at examining public-private pension mix in selected countries and drawing implications for Korea.

Public-private pension mix in Denmark, Germany, the United Kingdom, and Italy

Of the countries examined in this study, Denmark and the UK have in place Beveridgean (flat-rate) basic state pension, while Germany and Italy have been running Bismarckian (earnings-related) schemes. The two different types of public pension have led to starkly disparate paths of development in private pension. In a Bismarckian system, which primarily seeks to ensure that people in old age maintain a standard of living comparable to their pre-retirement living standards, the role of private pension is likely to be kept to a minimum. In a Beveridgean system, where the focus of public pension is on meeting basic needs and preventing poverty, there is a higher public expectation for private pension, especially among middle and high income groups. For reasons that will become clear below, each of these two systems has variations of its own, depending on the politico-social background out of which it has grown over the years.

Denmark since early on had a public pension system consisting of a basic pension and the ATP scheme, a fully funded supplementary labor market pension with a minor role in old-age

income security, leaving ample potential for private pension. However, it was not until the early 1990s when, with a tripartite agreement, the labor market pension as a share of overall pension income was substantially expanded.

As for Germany, even with its long history of having both public pension and voluntary retirement pension (not least for large firms), the country's public component had been so dominant in old-age income security that the role of private pension had for long been insignificant. A fundamental change came in the early 2000s when a set of reforms brought significant cuts to public pension while introducing state-subsidized private pension programs. The reform taken place in 2001, in particular, has further attempted to strengthen private pension by granting people a legal right to convert part of their earnings into pension contributions.

In the United Kingdom, where a multi-pillar income protection system had been in place for long periods, reforms have significantly expanded private pension by allowing individuals to contract out of the public second tier—the State Earnings Related Pension Scheme (SERPS) and the State Second Pension (S2P)—to employer-provided occupational pensions in 1978 and to personal retirement savings accounts in 1986.

In the case of Italy, despite the hike in the public pension contribution rate from 26 percent in 1992 to 33 percent in 1995, the outlook for its funding remained worrying. The 1995 pension reform in Italy introduced a notional defined contribution (NDC) scheme with a greater emphasis on private pension provisions, allowing individuals to divert *Trattamento di Fine Rapporto* (TFR)—a severance pay scheme applied to all private sector employees since 1982—to private supplementary pensions.

As illustrated in <Table 1>, in both Denmark and the United Kingdom, private pension account for a considerable share of overall old-age pension expenditure. In the Bismarckian systems of Germany and Italy, private pension spending is minuscule next to public pension spending.

<Table 1> Pension systems in selected countries: structure and expenditure

Country	Public-private mix					Public and private pension expenditure (as % of GDP, 2012)		
	Public		Private					
	State (1st pillar)		Employer (2nd pillar)		Individual (3rd pillar)	Total (A)	Private pension (B)	(B/A x 100)
	1st tier (Basic needs)	2nd tier (Earnings-related)	2nd tier (Collective agreement)	2nd tier (Employment contract)	3rd tier (Individual decision)			
Denmark	BP +ATP		DC (quasi-mandatory)	-	-	11.2	5.1	(45.4)
Germany	SA	Point	DB/DC (Voluntary)	DB/DC (Voluntary; large firms)	DC (Voluntary/ Riester)	11.4	0.2	(1.8)
UK	BP + SA	DB (Contracting-out)	-	DB/DC	DC	9.4	3.2	(34.2)
Italy	SA	NDC	DB/DC (Voluntary)	TFR	-	15.8	0.3	(1.8)

Note: BP=basic pension; SA=means-tested social assistance; 'pillar' indicates the sector in which the pension plan is located; 'tier' is about the function of a pension benefit.

The governance of private pension

Unlike in the case of public pension, there is more to private pension governance than the state. The governance of private pension involves, beside the state, a variety of other responsible actors and their interactions. Following the typology of Ebbinghaus & Wiβ (*The Varieties of Pension Governance: Pension Privatization in Europe*, Oxford University Press, pp.351-383, 2011), this study distinguishes three modes of governance: (1) pension commitment based on collective agreement by social partners such as employer and unions; (2) employer-sponsored pension; (3) the individual retirement saving decisions.

The collectively negotiated scheme is marked by such advantages as broad coverage, effective risk pooling, high portability and lower administrative costs. A case in point is Denmark's. Also, in the Bismarckian-type welfare states of Germany and Italy, pension schemes administered by social partners, limited though their roles still remain, have been gaining in importance ever since the 1990s.

An employer-provided occupational pension plan can be used as an effective tool when it comes to employee retention. However, as most of its control is in the hands of the employer, the employees have only a limited say in how it is managed. The occupational pension plans in the United Kingdom, mostly linked as they are to an employment relationship between the sponsor and the participant while involving only a limited degree of state intervention, remain company-specific rather than universal or sector-wide.

In the case of individual retirement saving decisions, although the state acts as provider of a legal framework, it is the individual who has to solely bear the investment risk. In the United Kingdom, employees can opt out of the mandatory State Second Pension (S2P) and instead establish personal pension arrangements. In contrast, Germany's Riester schemes exemplify well-structured state interventions.

Coverage and contribution rates

In recent years, with the increasing cutback of public pension benefits, the need has emerged for private pension plans with coverage comparable to that of public schemes. Private pension schemes that are based on collective agreements, such as Denmark's, usually have coverage comparable to that provided by mandatory private pensions, such as one in Switzerland. Private pension coverage in Denmark is either mandatory or quasi-mandatory, with clauses on occupational pension being included in 80 percent of all private-sector collective agreements reached after 1991. Contribution rates for occupational pension plans in Demark are determined by collective agreements, mostly in the range of 12~18 percent. Two-thirds of contributions to Denmark's private pension are paid by the employer and one-third by the employee.

Private pension coverage in the United Kingdom has expanded to a great extent ever since private-sector workers were allowed the option to contract out of public pension (SERPS/S2P). An important difference between the two countries, however, is that in one, private pension coverage is guaranteed via public pension, and in the other, private pension is guaranteed on its own, independent of public pension. In the United Kingdom, contribution rates for private-sector occupational pension plans vary widely depending on income levels, averaging between 20~21 percent for DB plans and around 9 percent for DC plans. While contribution rates for DC plans are determined at the time of their design, contribution rates in DB plans are

determined yearly, depending on the liabilities the fund carries. As DB-type occupational pension plans saw their unfunded liabilities grow since the beginning of the 2000s, many employers, coming up against the need to increase their contribution rates, moved from DB to DC plans. In the process, as DC plans often accompany reduced benefit levels and a shift of financial market risks to individuals, concerns have been raised about whether current contributions rates are high enough to yield an adequate old-age supplement.

<Table 2> Coverage rates and contribution rates for private pension plans in selected countries

Country	Coverage rate (private sector employees)		Contribution rate	
	Occupational plan	Personal plan	Occupational plan	Personal plan
Denmark	95%		12~18%	
Germany	50%	44%	4% of pre-tax earnings	4% (for maximum state subsidies
UK	52.3%	19%	DB (20.5%): employer 15.6% + employee 4.9%	
			DC (9.1%): employer 6.5% + employee 2.7%	
Italy	25% (32%)		5~10%	

Note: Numbers are based on the most recent data available since 2000; the figures for Italy in bracket include the pre-reform PEF

In Germany, reforms in 2001 introduced a legal right that entitled private-sector employees from 2002 on to convert part of their earnings (4 percent) into an occupational pension plan. In the case of the Riester scheme, the contribution rate that entitles participants full state subsidies stays at 4 percent since 2008, after having been increased from 1 percent in 2002. The contribution rates for the German private pension plans—occupational pension plans (based on earnings conversion) and the state-subsidized Riester scheme—are substantially lower than those for comparable plans in Denmark and the UK. Whereas it is the employer's responsibility to finance occupational pensions (*Direktzusage* and *Unterstützungskasse*) that have traditionally functioned as a tool for long-term employee retention, the retirement plans which have grown popular since the early 2000's (*Direktversicherung*, *Pensionskasse* and *Pensionsfonds*) are financed in principle by employees' voluntary contributions. Also, like the case has been in the United Kingdom, German employers have increasingly shifted from DB to DC schemes. To be sure, Germany achieved a significant expansion of private pension coverage, but, again as is the case in the United Kingdom, there is a need for further consideration of how to make private pension into an adequate old-age security supplement.

In Italy, although a recently implemented law has provided employees to turn their TRF plans into either occupational or personal pension plans, private pension coverage as a whole remains limited. Furthermore, the rate of participation in private pension is widely uneven across different demographic groups and among people of different employment statuses. Closed Pension Funds (CPF), Italy's key occupational pensions, require of employees a contribution of 9.29 percent of salary, of which three-quarters (6.91 percentage points) comes from the TFR. Although older workers are still paying relatively little into their occupational pension plans, employees who entered the labor market after 1993, with their higher contribution rates, may expect a considerably higher level of occupational pension benefits. Still, however, with the public pension converted into an NDC scheme and the large private pension coverage gaps, the future of Italy's multi-pillar income security remains highly uncertain.

Conclusion

With the declining role of public pension, private pension has attracted increasing attention. However, how much has been achieved in terms of strengthening private pension varies considerably across countries. In Germany and Italy, for example, where Bismarckian earnings-related schemes had been kept as the most important source of old-age income security, private pension schemes have not yet been developed to such an extent as to compensate for the decline in recent years of public pension schemes. In the United Kingdom, the first pillar (universal public pension), even with the Beveridgean basic pension as its first tier, fall short as a poverty prevention system.

The increasing trends in recent years toward DC schemes have brought to the fore the question of how risk should be distributed in the dimension of private pension system. In these circumstances where the various designs of DC plans suggest different degrees of risks for different individuals and the problem of information asymmetry between the principal (the enrollee) and the agent (the pension fund management agency), the role of the state in private pension governance gains added importance.

Against a background where the income replacement rate of the National Pension has been cut back in recent years, increasing private pension coverage should be a top priority goal. In August 2014, the Korean government announced a plan to strengthen private pension. Its key component is the principle that mandates that from 2022, every employer, irrespective of the number of employees, must furnish a retirement pension plan, even for non-regular workers who meet certain employment period requirements. However, given that the Durunuri Social Insurance Subsidy Program as it stands remains less than effective in bringing those outside the National Pension into it, it remains to be seen if the government's plan will succeed in filling the large gaps in private-sector occupational pension coverage.

Strengthening multi-pillar old-age security requires more than just increasing private pension coverage, and more so in a country like Korea where there is a sizable population of atypical workers and self-employed individuals of whom many remain excluded from the National Pension, let alone from occupational pension plans.

The government's 2014 plan includes strategies for enhancing the rationality and resilience of asset management, protecting retirement pension rights, and establishing infrastructures for promoting private pension programs. Compared to cases in other countries, however, developments in private pension (occupational pension) in Korea have been heavily government-driven. As can be seen in the case of the National Pension after more than a quarter-century since its inception, for a pension scheme to function properly, it is essential that it gain public trust. Further thoughts should be devoted to how best to encourage private pension participants to actively take part in the management of the fund to which they are contributing and, therefore, entitled.