Mandating Private Pensions: Experience in Four European Countries

by Max Horlick*

This study examines the experience of four countries—the Netherlands, Sweden, Switzerland, and the United Kingdom—in which the mandating of private pensions exists or has been considered. Proposals to mandate private pensions in the United States have been introduced in Congress several times. The analysis of foreign thinking presented here provides a background on the reasoning behind such a policy and on the integration of private and public systems and the problems involved. A prime reason for mandating private pensions—instead of seeking higher social security benefits or additional social security layers—has been the pressure to avoid higher payroll taxes. Some countries already had such high contribution rates that they sought other means to improve benefits. Adding a layer of private pensions, it was thought, does not involve Government mechanisms and keeps the money in the private sector. Yet mandating by law creates many problems, and no country has fully implemented such legislation.

The Employee Retirement Income Security Act (ERISA) in 1974 was the first major Government effort to supervise the benefits of private pension plans in the United States. The 1974 law has many provisions dealing with employee benefit-plans in general but concentrates on establishing minimum Federal standards for participation in and the vesting and funding of private pension plans.

A nonprofit Federal Pension Benefit Guaranty Corporation was set up under that law to guarantee the pension obligations of a plan that terminates without adequate assets on hand. Employers with defined benefit plans must pay premiums to an insurance fund operated by this corporation to insure the accrued vested retirement benefits of participants if a plan fails.

ERISA does not mandate private pension plans but does require an employer who has or will establish a pension plan for his employees to meet conditions specified in the law to qualify for favorable tax treatment. Provisions of the tax code limit benefits by specifying how the private pension can be integrated with social security benefits and holding down the size of death and other ancillary benefits. The law has no provisions for portability—the transfer of accumulated pension credits from one job to another to provide a basis for receiving full pensions—except to a limited extent on a voluntary basis.

In enacting ERISA, Congress moved cautiously and in a piecemeal fashion in order not to affect adversely the development of private pensions. Provisions were therefore included to encourage the establishment of private pension plans by individuals not participating in a private or government pension plan other than the basic social security program—old-age, survivors, disability, and health insurance (OASDHI).

Congress was aware that such plans depend on the voluntary efforts of individuals and that a large proportion of the more than 30 million wage and salary workers not covered by private pension plans may not be affected by their development. How and whether private pension plans can be made available to a larger segment of the population is thus a matter of increasing interest.

One suggestion is to make private pension coverage mandatory for all those covered by OASDHI. The

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question of assuring a second layer of protection for those covered is intertwined with the history and nature of OASDHI. That program, since its inception in 1935, has been a wage-related social insurance program financed through equal contributions from employers and employees (and contributions from the self-employed).

Benefit levels under OASDHI have been frequently liberalized, but opinions on the correct level differ. The program has often been characterized as providing a floor of protection, with private savings and pension plans acting as supplements to bring this floor up to adequacy. Studies have shown, however, that private pension coverage in the United States has generally been confined to the larger and wealthier firms who pay the highest wages and to unionized industries. For those in the lower earnings strata—blacks, women, workers in small and nonunion firms—the major if not the sole source of retirement income is OASDHI.

Some hold that the present provisions of the social security and private pension systems have thus produced a dichotomous form of protection with (1) "first-class" citizens protected under both and (2) "second-class" citizens protected only under the social security program. To eliminate this cleavage, the alternatives often suggested are further liberalization of the benefit structure under social security or extension of the private pension system.

Expanding the social security system has many attractive features. First, the universal coverage of OASDHI assures workers that their protection will follow them when they change jobs. In addition, OASDHI has many socially oriented elements that private plans have difficulty matching. It provides a broad array of benefits besides retirement benefits. The benefit formula is weighted in favor of the lower-paid and shorter-term workers, thus making possible a meaningful level of benefits for retirees or the disabled who have few years in covered employment. In contrast, private pension plans tend to emphasize more nearly adequate retirement income for the regularly employed, above-average earner and long-term employee rather than for the individual with only a short-term attachment to a particular employer.

The disadvantages of expanding the social security system have also been catalogued. The cost of expansion would be reflected immediately in the tax rates, since OASDHI is essentially a pay-as-you-go system. At times, benefit outlays have exceeded contributions, and such deficits would be further compounded if benefits were liberalized. Opinions differ on how current deficits should be met: through increases in the tax rates or through a contribution from general revenues. These methods, however, would affect the Federal budget, and much pressure has developed against increasing Federal spending on income-maintenance programs.

The fear has been expressed that expanding the social security system might stunt the growth of private pensions. Employers who must pay a larger OASDHI payroll tax might be unable to afford increases in pension benefits or might not feel obligated to provide the pensions if their workers were protected by an adequate social security floor. Workers who see their social security payroll deductions increasing might press for cash compensation from their employers now rather than waiting to receive it later through pension or profit-sharing plans.

Private retirement plans are seen as having several advantages over a public system. Moreover, they provide needed funds for capital development and investment, and the social security system does not. They also permit private employers (and unions) a degree of flexibility in tailoring or adapting their plans and financing to meet special circumstances—demands for early retirement provisions, for example, which can rarely be met by a homogeneous public system.

As often happens in the social insurance field, many of the emerging problems are common to more than one country. In Western Europe, several countries have grappled with the problems of keeping social security in line with the public's view of what constitutes an adequate benefit level and with the changes produced by an inflationary economy.

The four countries dealt with here were chosen partly because of their differing stages of development in this area. In the Netherlands and in Switzerland, the concept of a mandatory, occupational, private pension system has been accepted, but the details have yet to be worked out. In Britain, the law establishing the quasi-mandatory system, which was not effective until April 1978, calls for a different approach in that employers can either come under the second layer through a Government-operated system or through "contracting out." In Sweden, the private pension layer is already operative but is not fully mandatory; nevertheless, all employers belonging to nationwide federations must establish such plans.

The countries studied encounter or have encountered similar problems in implementing their mandatory private pension system. The problems may take different forms or are intensified as the result of local conditions, but their general shape remains the same for the most part. These countries provide an excellent demonstration of the complex and interrelated nature of the mechanism for developing an integrated income-maintenance system. The historic development of the social security programs, the socioeconomic conditions, the social priorities, and the needs may differ from one country to another, but the problems wrestled with in

coordinating the public and private schemes are similar. Yet these countries have chosen different approaches in achieving the goal of using the private pension system to provide a second layer of social security protection.

In the Netherlands and in Switzerland, the approach takes the form of making private pensions mandatory: In the Netherlands, on top of a flat-rate benefit system; in Switzerland, on top of an earnings-related national social security system. In Sweden, the social security system consists of both an earnings-related component and a flat-rate component, with private pensions contributing a third part of an integrated system. Private pensions are not mandatory, however. The Swedish law provides that collectively bargained pension agreements between national employer and union organizations will be extended to other employers who are affiliated with employer organizations. In the United Kingdom, a mandatory earnings-related system is added to a flat-rate system, and employers are given the option of contracting out the earnings-related part through occupational pension schemes that provide benefits equal to those under the flat-rate component.

The question not yet addressed is whether the goal of making the private pension movement an integral part of the national system is desirable. Some countries have favored the alternative route of expanding the basic social security system to provide an adequate retirement program. It is generally recognized, however, that a broadly based social security system cannot readily meet special needs or the needs of higher-income workers. Thus, the development of private pensions in these countries has been encouraged through favorable tax treatment. The growth of private pensions remains essentially determined by the natural forces of the economy, competition, collective bargaining, and the internal needs of a firm, rather than by government edict.

As noted, the United States departed from this pattern with its adoption of pension reform legislation in 1974. The emphasis is still on voluntarism, however, since no employer must establish a pension plan.

Some proposals have been made in the United States to make the private pension system a more active force in assuring an adequate level of retirement income for all wage earners. These proposals range from requiring all employers to establish pension plans to giving employers the option of contracting out or of providing penalties in the form of additional payroll taxes for companies that do not establish plans.

The European experience is helpful in evaluating these proposals. The application of such experience to the United States, however, depends not so much on technical aspects as on the nature of our social policy and traditions.

The experience of these countries shows in practice what is already theoretically obvious—that mandatory programs are expensive in terms of additional payroll cost. The decision would have to be made whether such a program is affordable as an alternative to expanding social security. The U.S. tradition of social policy has been in the latter direction thus far.

If the example of some of the European systems is followed, the low earners, the self-employed, casual workers, women with partial careers or divorced late in life, and certain others would be excluded. The act of exclusion emphasizes the division between those who will benefit, and they are already the better-off, and those who will not. Traditionally, public rather than private programs have applied to the latter group. The European experience suggests that the less well-off be taken care of through a social security universal benefit or through extensive means-tested programs to supplement social security benefits or both.

Implications and Problems

The topic of mandatory private pensions is not new. Mandated pensions have been implemented in some European countries; they have come up in congressional hearings in the United States several years in a row. The mandating of these pensions raises many problems and issues, as the previous discussion have shown. The forces and the background that brought this practice into being in Europe do not exist in the United States in the same way. Although economic needs are similar, the social forces are not.

Private pensions are more prevalent in European countries for a variety of reasons, including longer tradition. Moreover, private pensions became a topic of countrywide, labor-management negotiations at an earlier stage. Abroad, the fringe benefits tended historically to make up a greater proportion of the total pay package than they did in the United States. That is, in Europe, the take-home pay made up a smaller part of total compensation, and such fringe benefits as paid vacations, private pensions, sick pay, and training made up a greater proportion. National or industry-wide labor-management negotiations have devoted more attention to these supplements in the Netherlands and in Sweden.

These often annual negotiations were, in turn, instrumental in broadening coverage under company and industry benefit plans. Eventually, the plans covered almost all wage and salary workers, or at least all organized workers. Thus, mandating of private pensions represented a rather short additional step. This is more or less the pattern that has emerged in the Netherlands under its proposed plan and in Sweden and elsewhere (Finland and France, for example). In countries—like

Switzerland and the United States to a certain extent—without this type of labor-management pattern, mandating is not an evolutionary or voluntary process but must be done by law.

In the countries studied, the introduction or proposed introduction of mandating came about in several different ways. In France, the Netherlands, and Sweden, the spread was through national labor-management agreements. Particularly because of close cooperation developed during World War II, unions and employer organizations work together in a way that has not evolved in the United Kingdom and the United States. They participate in the actual operation of the economy, with representation on national planning bodies and in the setting of wage increases and the making of social security policy. In the United Kingdom, the mandating of pensions is not the path currently chosen, but the process of contracting out social security has been a contributory factor in the development and spread of private pension plans. The national differences are reflected in the differing ways of handling such things as integration with social security, indexing, and portability.

Because of the different evolution of industrial relations in the United States, no such degree of collaboration has occurred. Consequently, the step-by-step broadening of private plans experienced abroad would be difficult to bring about by fiat here. The experience in Switzerland is most applicable, because there, too, the economy has been to a greater degree influenced by market forces.

Some very basic considerations are to be taken into account in considering the mandating of private pensions. Would it be acceptable at all? Who is to administer a system of mandated plans? In France and in Sweden, labor-market forces do that, but these forces do not operate in the same way in the United States. Alternatively, would an expanding, centralized administration be acceptable?

What is to happen to existing plans? If contracting out were to become a feature, how could it be made attractive for a firm to continue its own plan (tax angles)? In a competitive economy, and without the tradition of cooperation mentioned earlier, would companies be willing to help each other?

In addition to traditions and attitudes, there are technical concerns: (1) Integration of public and private systems, (2) coverage, (3) inflation, (4) indexing of wage credits, (5) vesting, (6) financing, (7) adequacy, and (8) the entry generation.

Integration

The subject of whether and how social security and private pensions should be integrated bears on the arguments—in the United States as well as abroad—between those who favor a considerable improvement or expansion in social security (raising the replacement rate) and those who believe it is better to supplement the floor of protection through the private sector. Underlying the two positions are differing assumptions about future demographic and financial trends. Discussions of the relative roles of social security and private plans tend to focus on anticipation of higher and higher costs for social security because of anticipated, unfavorable, contributor-to-beneficiary ratios and financial deficits. It has been pointed out, however, that private, pay-as-you-go pensions would also suffer and, therefore, do not provide a solution.

The practice of multitier systems or "layering" spread after World War II. During the war, a report published in the United Kingdom by Lord Beveridge proposed a contributory social security system consisting of a flat rate for all adults, fixed at a subsistence level, with supplements for children. A national assistance program would provide for those who could not participate in the contributory system. This concept was influential, and the flat rate was adopted in a number of countries. By the late 1950's, however, some countries (including Canada, Denmark, Finland, Norway, and Sweden) saw that the flat-rate, universal benefit was insufficient. Their solution was to add an earnings-related, second layer.

A universal benefit is paid to all citizens or permanent residents. It is financed entirely by general revenue in Canada and Denmark. In Sweden, the Government pays about 55 percent and employers and the self-employed pay the rest. In Finland, workers and employers pay for the universal, old-age benefit and general revenue pays for survivor benefits. In Norway, the Government, workers, and employers all pay according to a complicated formula.

The earnings-related, second layers were set up in the early 1960's. Usually, 20–40 years are needed before the full benefit is paid. The eventual goal is for the two layers to produce a benefit that is about 60–65 percent of final pay. Contributions are usually paid by both the worker and employer, and general revenue may make up the deficit. In several countries, there is no Government contribution.

Even in countries with both layers—and some of them have the highest replacement rates in the world—debates continue for still higher benefits. Labor groups have generally pressed for higher social security benefits. Employer groups have tended to favor the strengthened social security and mandated or proposed mandating private pensions.

A discussion of the history of the programs should include an examination of what their respective roles were originally intended to be. For private pensions in

some of the countries, the employer originally helped employees with large families, beginning early in the 19th century when industrialization was expanding. Later, the employer came to pay a pension to workers who had been disabled. There followed other types of voluntary benefits aimed at discharging what was regarded as a moral obligation to retiring workers with long service in the firm. Employers also faced this problem of how to dismiss old employees no longer able to work efficiently. A further reason was the retention of good and young employees in their service. The spread of collective bargaining led to an expansion of private pensions in the 20th century.

The earliest social security systems were usually noncontributory and intended to provide a subsistence to pensioners who were not well off, but they specifically excluded those who had been on relief. The obligation of the State was specifically recognized in Germany. In the late 19th century, parliaments came to realize that on a national scale some minimum amount of protection against dependency in old age could be brought about only by legislation. The trend toward compulsory social insurance with separate systems for white- and blue-collar workers came later.

A main distinction was the voluntary nature of the one and the compulsory nature of the other. Another distinction came to be the aim of social security to provide a retired worker with the financial ability to maintain his previous standard of living. At that time, the aim of company plans was to reward work with the company by providing pensions based on length of service and on the amount of pay.

Basically, what brought the separate evolutionary patterns together was the pressure for higher and higher benefits. The European systems of social security, in most of the industrial countries, have a far longer history than does that of the United States. Because of the extended period of development, it could be expected that they had reached some state of equilibrium and important changes or innovations would no longer be needed. This kind of situation has, however, not come about either in the short run or in the long run, in large part because of inflation and higher expectations.

Social pressures for higher benefits have continued in all countries. The present range of social security benefits has been paid for by employer/employee contribution rates that go as high as 50 percent of payroll for the whole welfare package, and as high as 20 percent for old-age survivors, and invalidity insurance. In addition, there may be a general revenue supplement. It was believed that the payroll tax was already as high as it could go. Opposition arose to increasing the contribution from general revenue.

The alternative of raising the ceiling, which has existed in the United States, was not available in most European countries. The ceiling already was high enough to include the total earnings of virtually all workers. In addition, in some countries the main source of income of the private pensions was often the amount above the social security ceiling. Further raising the ceiling meant cutting off private pensions.

Another obstacle in some countries was the complaint of employers that their "social costs" (fringe benefits) were as high as 40 percent of payroll. These fringe benefits included contributions to social security, to private pensions, and required vacation pay.

The need for requiring private supplementation on top of the one or two layers of social security was decided upon as the answer in a number of countries. It was expected that a combined benefit would thus be produced that would be high enough to attain the long promised objective of enabling retired workers to maintain the level of living they had when active.

Another element of integration, in addition to the formula, is the common use of wage figures by both systems. In the Netherlands, both the public and the private pensions would have a common floor and a common ceiling, with movements of the ceiling used for indexing. In Sweden, the public and private systems have in common a national base amount. The amount of covered earnings, the level of the ceiling, and the degree of indexing of both the public and the private systems are calibrated to movements in the national base amount. Another type of coordination is represented by the requirement under contracting out in the United Kingdom that the private pension guarantee at least the amount that would have been paid by social security.

Coverage

In the United States, a great number of workers are not covered by private pension plans. They are generally in the less well-organized industries, small establishments, or agriculture or are the self-employed. Abroad, private pensions have also not normally covered the entire labor force, primarily because of historical development. As here, the larger establishments or groups of companies could afford to create and maintain private pension plans. The small family businesses—so common to Europe—the self-employed, the marginal firms, and declining industries could not.

There, as here, public social security funds have been created with the specific intent of covering the entire working population. One of the aims of mandating has been to rectify the existing imbalance and to provide public and private plans for all workers. This intention suggests two ranges of questions: First, how do the countries intend to cover additional groups

and exactly who are they? How would their thinking apply in the United States? Second, should all of the economically active be covered by private pensions? Is the inclusion of marginal groups a realistic function of a privately financed plan?

In the countries that favor mandating, the decision was to include everyone possible. The rationale was that only in this way could plans be made both widespread and uniform. It should be pointed out that none of the countries visited now have 100-percent coverage under private plans. The highest level has been reached by Sweden, where 90 percent of the blue- and white-collar workers in the private sector are included. The Netherlands has 80 percent, Switzerland about 66 percent, and the United Kingdom and the United States about 50 percent. The proposed Netherlands plan would incorporate all private-sector wage and salary workers under age 65. Sweden considers that its private coverage is tantamount to complete. The national negotiations over private plans cover organized workers. It considers that the others are in very small establishments that may not be organized and are therefore outside the scope of the agreements. The Swiss plan would require that all workers aged 25 and over who earn more than a basic amount be covered. The British approach is to provide all wage and salary workers with earnings above a basic level—a second, earnings-related layer. This layer can be provided either through social security or through contracting out. Following this legislation, some 10 million employees are expected to be contracted out.

Exactly who is left out varies somewhat from country to country. In general, the unionized workers and higher-paid employees in bigger companies are most likely to be included and the low-paid workers in small nonunion establishments are least likely to be included. Inclusion of the self-employed in some sort of general system has been difficult. Of course, private arrangements for the better-off self-employed exist in these countries, and it is primarily the small businessman, tradesman, or artisan who would not benefit.

Usually provision is made for cutting off marginal or beginning workers, even when plans are mandated. That is, the age when benefit accrual begins is specified, as well as the maximum age beyond which accrual stops. Provision is also made to assure that the person is really in the regular labor force and not a seasonal or part-time worker—hence the requirement that a stipulated number of hours be worked. An earnings floor is also specified. The cut-off mechanism may be through requirement of a certain number of hours per week of work (such as 16 hours in Sweden). Another device is to have a minimum wage floor (as in Switzerland and the United Kingdom). The expectation in such a case is that the marginal workers will qualify for a minimum or perhaps means-tested social security benefit.

It is evident that in reality it is not practical to expect 100-percent inclusion of all workers under regular company benefit or group plans. The United Kingdom in 1973 considered a unique approach that would have brought protection for marginal groups. The plan, called the reserve pension scheme, would have required all the employed over age 21 to participate—unless they were members of a regular private plan. Financing was to have come from employer and employee contributions. This plan was intended to catch people who could not be covered by regular plans—workers with high mobility, those earning a low income in irregular employment, or those working for very small firms who could not afford a regular plan.

Problems anticipated included, for example, the accumulation of large sums of money that would be subject to political pressure. In addition, some concern about possible abuses was expressed. An estimated one-third of the workers—primarily casual and part-time workers, workers in smaller companies, and the self-employed—would have come under the reserve scheme.

Inflation

Perhaps the basic problem in promoting the generalization of private pensions is the unequal way of dealing with inflation. Social security benefits are indexed, while private pensions for the most part are not. The private plan, by tradition, has depended on the economic standing of the firm—the parent firm must be solvent so that payroll contributions and the return on fund investments increase more rapidly than do pensions. The question arises then on the fixing of financial responsibility for postretirement pension increases in a coordinated public/private system, when private pension schemes have not provided such increases except on an *ad hoc* basis when financing permits?

The adjustment technique is all important from the point of view of private pensions. Adjustment must be decided either by a predetermined, automatic formula or by management decision. In the latter case, management retains flexibility on the frequency and the cost of adjustments. The other side of the coin is that workers have no guarantee that adjustments will keep up with the cost of living, and no funding is provided for indefinite future changes. In an automatic system, management gives up flexibility, but the worker is assured that indexing will occur.

The question of inflation is regarded as extremely important in the United States. The public sector leads the way in indexing, and the private sector has followed to a limited degree. The tendency is to rely mostly on

social security for revaluation, except in a profitable year. Relatively few firms want an indexing commitment, and few have formal indexing provisions. At an indexing rate of 5–6 percent a year, the benefit would double after 15 years, and survivor benefits must be paid. This kind of pattern has deterred the spread of indexing.

Before the mandating of private pensions can be even considered here, solutions must be found for small firms and declining industries. Some way of curbing the effect of inflation in the long run must be found to limit open-ended obligations. Decisions must also be made on whether to use price or wage indexes and to what extent.

In the Netherlands, the proposed new system would keep pensions up in value at least in terms of the cost-of-living index, through special financing arrangements. The thinking calls for a Government or industrywide equalization fund that would be financed through pay-as-you-go contributions. To permit adjustment in line with prices, the financing is to be based on funding but with pay-as-you-go aspects with respect to current pension levels.

In the past, the amount of inflation proofing has varied from plan to plan, with about one-third based on career earnings, rather than final pay, but usually with frequent adjustments. In the question of whether to use pay-as-you-go funding, the latter won out. The pay-as-you-go approach, however, would have created the possibility of automatically keeping income and outlays in line. Under a proposed compromise, each employer would pay 70 percent on any increases in earnings for the period in which the worker is in his firm. This portion, when combined with the paid-up segments earned from other employers, would combine to approach a full pension—regardless of mobility. The cost of back service on any increase in pay would be spread out over the years from entry into the system to age 65.

The public benefits and private pensions in Sweden indirectly take into account changes in the consumer price index. Movements in the national base amount directly bring about the revaluation of benefits and pensions. The public benefits are linked to the movements in the base. Social security can have a number of adjustments each year—that is, a 3-percent rise sustained for several months triggers an adjustment.

In Switzerland, social security benefits must be reviewed every 3 years or sooner when the price index increases 8 points. In practice, however, annual adjustments have been made in recent years. Under the proposed mandatory private network, current pensions will be revalued by the cost-of-living index—presumably once a year through what is basically a pay-as-you-go method.

In the United Kingdom, the occupational fund is to be responsible for revaluing the rights of early leavers in regard to the guaranteed minimum pension under contracted-out schemes. Another responsibility relates to revaluing current pensions. Particularly interesting is the method used to deal with "open endedness"—that is, limiting the future cost to the private funds and to the employer. For the first time, the employer has a legally binding earnings-revaluation obligation. In the past, any "topping off" of a pension fund by the employer was at his own discretion when profits permitted. A concern with mandatory revaluation was that firms already in a financially weak position could be forced either to give up their private pension plans or to enter bankruptcy.

In the debate stages of the law, it was believed that an open-ended requirement would lead to a sizable shift to social security, away from private pensions. It was also felt that this shift might lead to a loss of public confidence in private pensions through the concern that, since they depend on funding, they could not earn at a greater rate than inflation. The social security system, however, relies on "pay as you go." The solution to limit the responsibility of occupational funds for indexing until after the worker retires is also new. In the case of workers contracted out, social security will cover revaluations in the second layer, and the first layer will be taken over entirely by social security.

Indexing

Benefits under private plans must accrue for a long period of time—most often from 20 to 40 years. During so long a time, the rise in the cost of living (and wages) may have been so great that the earnings record, the amount accrued, and the pension calculated on this record can lose a significant amount of purchasing power by the time the pension is paid out. Most serious in a period of sharp or extended inflation are the pensions calculated on career earnings, which gradually erode and need periodic updating, and those involving flat amounts, which are raised from time to time through negotiation. Least affected is the final-pay formula, which is in effect self-adjusting. The factor that limits the ability of the private benefit plan to revaluate past wages is, of course, the long-range cost.

Another complication is the long-held belief that there should be a specific or fixed relationship between the worker's earnings and his eventual pension. In view of the long-range increases in both prices and wages this relationship is no longer practical, however, and, at least in theory, the goal often may become not a specific target amount but some workable minimum-to-maximum range.

Indexing was a more serious problem in the past in

the United States. Most plans have turned to the use of final pay, and, for a career employee, the updating of the earnings record is thus not so serious a problem. For plans with a defined contribution formula, however, the problem of adjustment continues to exist. The method of adjustment determines how often the updating occurs and is a key in the cost. Generally, automatic adjustments are made, based on a specified percentage of escalation of a price or wage index or *ad hoc* adjustments. The automatic adjustments are more capable of keeping up the value of earnings in all the formula types, but they are the most expensive.

Ad hoc adjustments of the wage base or of flat-benefit accruals give more flexibility to the employer and permit him to take into greater account the financial picture in his company. On the other hand, in long periods of inflation, they can result in a lower pension and penalize long service. The same forces have applied not only in the United States but in the study countries as well.

Wages and the cost of living have risen so sharply in recent years that a formula based on any spread of years will yield an extremely low pension unless adjusted. In several of the study countries, for example, wages more than tripled in the period 1960–74, and prices more than doubled.

To cope with this situation, the study countries turned in both existing and proposed plans to the final-pay idea as the solution. Two countries take final pay to mean the last 3 or the last 5 years. Sweden offers a less final set of years—the period 7–10 years before retirement age. The options for the United Kingdom may be the last or best 1–5 years under private pensions or, as in that country's social security system, 20 years revalued.

A foreign system that offers a different kind of solution is the French private pension custom of *répartition*—a kind of pay-as-you-go system that redistributes the contributions of employers and current workers to pensioners. No accumulation of reserves is provided for. This system was developed in answer to severe, post-World War II inflation. *Répartition*, like the practice in the Scandinavian countries, is based on pension points.[1] As long as inflation is moderate and the economy is going well, *répartition* should work well in a country that requires pensions. The operators of this system have, however, foreseen problems. The rising proportion of beneficiaries and the declining proportion of contributors, for example, could mean eventually that the prorated share of receipts could become so small as to be insignificant.

Vesting

Mandating means vesting, and all four of the existing or proposed systems under study will be characterized by vesting. Without a vesting provision, many workers run the risk of leaving before working long enough to qualify for a pension. It has generally been accepted as a necessary feature of a good plan.

Recent labor-market developments have emphasized the need for this guarantee. One element that has led to strong support for vesting is the increase in labor mobility. An original intent of the employer in having a benefit plan was to try to retain workers and minimize turnover. With automation, mechanization, increased productivity, and the decline of old industries and the rise of new, mobility has become a necessity. In fact, one of the reasons behind the movement toward mandating was the desire for universal vesting and portability to facilitate and even encourage mobility, and this argument was used in several countries. More recently, the increase in unemployment in countries that had very little in the past also emphasized the need for vesting, when discontinuity because of unemployment became frequent.

The question arises as to whom vesting should cover. In a general mandatory system, the answer would have to be "everybody." Usually a minimum age standard is specified, however, since younger workers may be in training or apprenticeship and they move around before settling on a permanent job. The same considerations must be taken into account for vesting as for coverage. Will people still "fall through the cracks" in the vesting process? Many job changes by a young worker after reaching the vesting age could defer vesting for him to such an extent that his eventual pension could be greatly reduced. Another problem is women's entering and leaving the labor force during their child-raising years.

In addition to considering who would be vested, the question arises as to what would be vested. Is it to be the old-age, or survivor, or disability pensions? Are the provisions to be the same for all three? Three of the study countries would begin vesting in the late twenties (Switzerland at age 25, the United Kingdom at 26, and Sweden at 28). For disability pensions, however, the minimum age is 18 in two countries.

Financing

How do you assure that adequate funds will be accumulated or available for future pension obligations when the basis for fiscal solvency will vary widely from one private pension to another, depending on such factors as industry variance, labor-force makeup, and economic competition? The foreign experiences shed light on how these matters have already been thought

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[1] See Max Horlick and Alfred Skolnik, **Private Pension Plans in West Germany and France** (Research Report No. 36), Social Security Administration, Office of Research and Statistics, 1971, pages 71-73.

through. In any consideration of mandating, financing immediately becomes one of the key issues.

From an overall point of view, there are basically four alternatives. One is pay as you go (with an equalization fund to pool part of the costs), the French variant of *répartition*, some kind of funding, and contracting out. It must also be considered that three periods of time are involved: The point at which a new system starts, the period of buildup to full benefits, and the period of indexing benefits.

In the pay-as-you-go arrangement, the system is self-regulating in terms of future increases in benefits and indexing. The pool arrangement may be used to cover indexing by sharing part of the costs. The burden of indexing may be shifted to social security, as in the United Kingdom.

Small companies face a serious problem. The existing good funds have no special problem with regard to funding in meeting whatever standards may have been set in the past. The spread of benefits to all kinds and sizes of establishments and industries, however, means that ability to fund adequately will vary. Greater need exists for group planning, multiemployer arrangements, or a general pooling. Without mandating or fiscal encouragement, small employers may not feel that they can afford to participate because of the hardship of funding requirements.

Mandating means that a vehicle must be found for small plans, covering even two or three employees. As experience in the United States has shown, the establishment or improvement of pensions can be too costly a process for the employer with a small business and relatively few employees. Many were forced to discontinue pension plans in recent years because of financing problems as well as the amount of paperwork necessary to maintain required-reporting records and forms. The thinking in the United States has been that if pensions are to be under national standards, there must be a facility to make coverage available at a reasonable price—that is, an administrative device to handle multicompany situations to spread the risk. Alternatively, some kind of State pool involving group insurance may be used. A main problem in this country is that any kind of national system would have to satisfy differing State laws. Even if these problems are surmounted, the fact is that a small company is not likely to have had a pension plan in the past. Would it then have to pay for past service in order to produce a decent retirement level?

The study countries offer two ways of facing these issues—pooling and contracting out. The pool, or equalization fund, is a specific feature of the Dutch and Swiss approaches. The equalization fund represents a device specifically intended to protect small employers. By pooling a certain portion of the contributions, the cost is spread out over many risks. This type of arrangement helps not only the small employer, but other areas in a weak financial position—industries with an older labor force or in decline.

The Dutch plan would set up a national norm. Those above this norm would, through the pool arrangement, pay more than the other members, and these extra amounts would be distributed to help those who fall below the norm and who would be required to pay in less. More specifically, the Netherlands would establish a central leveling office, whose main purpose would be to figure out the cost of a mandated system for the country as a whole. Each firm would have its costs determined on the basis of the sum of the pensionable salaries as related to the age of its workers. Those funds receiving less in contributions or whose costs are excessive would be paid through that office. Those who are above the country average in terms of receipts would pay in.

The Swiss equalization fund has three main functions: To pay for cost-of-living adjustments in the future, help pay for the pensions of the entry generation, and cover individual funds that go bankrupt. Funds that have the most problems, such as older-than-average work forces or the highest proportion of beneficiaries, will receive more than they pay in. In other words, as in any of the equalization arrangements, the better-off funds will be subsidizing the poorer funds. In the Swiss case, however, this "solidarity" is expected to end after the problem of the entry generation has been solved—nominally after 40 years. It is not expected that the financing of pensions that may still be inadequate at that time will continue through this type of pool.

The Swedish blue-collar fund also operates on a cooperative basis to the extent that the value of pensions is calculated for the entire blue-collar sector and then the cost is levied on all employers and at the same rate. The contracting-out approach is, of course, represented by the United Kingdom.

The foreign experience has shown that each method has its own weaknesses and problems. First, how would a pool arrangement be phased in? If workers are newly brought under private plans through the pool, the country is really creating an inverse social security system. Such a situation was found acceptable in Switzerland but not in the Netherlands, where new entrants are not going to receive the same level of pensions as long-time members.

What to do with the pool money has also been debated. The answer in several countries is not to have a buildup at all, but rather to pay as you go. Fund building in Europe proved to be disastrous in the past because of periods of extreme inflation. Arguments also arose that the buildup of so large a fund could heavily

influence the national capital investment market. Opponents of this particular argument held that the money would still be under private-sector control and be available for needed private investment.

Another serious problem for the United States is the question of what mandating does for companies who already have good plans and meet or exceed minimum standards. In a sense, by contributing to a pool, they are penalized in favor of those who have not had a plan before. It would be difficult to see large corporations being happy at the idea of supporting the pensioners of other companies that had not chosen to have a plan. Particularly, it would be complicated for companies with stock or capital-accumulation plans instead of pension plans to convert.

A further aspect of financing is the question of how to handle different patterns. How do you handle age and sex differences? It is difficult enough to attempt to provide a defined contribution in the case for men. For women workers, the cost of annuities may be higher and the turnover rate is usually greater. The Swiss proposal takes care of this situation for the lengthy period of transition by providing for differing contribution rates by years of coverage, age, and sex. That is, men aged 25–29 and women aged 25–26 would contribute at an 8-percent rate. At the other end of the age scale, men over age 50 and women over age 47 would pay 19 percent at the start of the system. A specific replacement rate (60 percent) was decided on. What contributions were needed from the various groups to attain this goal then had to be figured out.

If vesting, portability, and coverage become mandatory in a period of high mobility and high inflation, how to limit employer liability becomes an important issue in the long term. When workers leave the plan or firm long before retirement, bearing the cost of indexing becomes the main problem. Continuing to index the pension to a meaningful degree long after retirement is also a problem.

The limitation of liability in the Netherlands is so spelled out that the employer is responsible for 70 percent of wage increases for the period a worker was in his employ. The Swedish blue-collar fund limits increases to 4 percent. In a sense, Sweden also provides another limit—the employer pays only from surpluses. In the United Kingdom, responsibility for revaluation reverts to social security. The point system under the French private pension funds provides still another way.

Adequacy

How do you assure that all lower-income, short-term wage earners will not be discriminated against in a coordinated system where private pensions have traditionally been geared to meet the needs of upper income, long-term career employees? In dealing with this subject, the issue has generally been reduced to two primary points—what should the replacement rate be in general and for low earners in particular, and should low earners necessarily receive anything at all from private pensions.

As seen in the previous discussion, under an integrated public/private system, the amounts received are negatively related. Low-income earners receive a comparatively high replacement rate from the social security benefit and relatively less than private plans. High-income earners receive relatively less from social security because of the ceiling and relatively more from private plans, which take into account earnings above the ceiling. Put another way, private pension plans have tended to place greater stress on adequacy for the average or above-average earner and for the worker with long attachment to a plan, rather than for workers with short service or low earnings. Many feel that the replacement rate should be higher for low-paid employees and lower for highly paid employees.

This point raises the question of what the ideal replacement rate should be. The belief is that it cannot and should not be 100 percent for everyone and that there must be some limit. The benefit manager in the individual firm or plan may establish an objective—to replace a certain portion. Then comes the decision as to how much at various wage and salary levels should come from social security and how much from the private plan. In one U.S. industry fund, for example, the objective is two-thirds up to a maximum. The mix has to be determined.

Generally, the ideal replacement rate provides an income sufficient to maintain the retired worker (and his dependents) on a level of living reasonably consistent with what he had before retirement. Generally, it is also considered that social security should provide the basic amount or a floor of protection. Under a mandatory system, in order to assure adequate amounts, the private pension would have to provide determinable pensions at some set level for all. Yet, as seen previously, it may not be possible to include all. Particularly, the question arises whether very low-income workers and part-timers should not be excluded altogether from private pensions and left under social security or means-tested protection.

In general, the range of 60–75 percent has been discussed as an ideal in the United States. Theoretically, a regional variation is called for because of differing State and local taxes. The 60 percent would be for high incomes and 75 percent for low incomes after long service. In the United States, the weighted benefit formula is already slanted in favor of lower-income workers. A weighted formula is rare abroad.

The Netherlands set the flat-rate social security bene-

fit at a level regarded as sufficient, along with the national health coverage and other provisions for the aged. Under mandated private pensions, the private-pension calculation would deduct for the portion of the wage considered to be covered adequately by social security.

In Sweden, the universal benefit was originally expected to provide a subsistence amount but did not. The answer was to install the second, earnings-related social security layer. The two together actually make up a type of weighting, tilted in favor of the low earner.

Switzerland has two means-tested programs for those ineligible for social security. For the eligible, a minimum benefit is specified. The original intent was that the retiree depends also on savings and a private pension (three pillars). The proposed mandated private pension system is aimed at achieving a pension that, when added to social security, will eventually equal 60 percent of the final, 3-year average. Thus, for persons earning at the minimum level (12,000 francs a year), the entire benefit would come from social security. The proposed plan would cover only earnings above that amount.

In the United Kingdom, the flat-rate benefit makes up a high replacement for very low earners. They would, additionally, be eligible for a wide range of means-tested benefits. The replacement of earnings at the basic component level is 100 percent. Between that level and the scheme's upper level of about seven times the basic component, the replacement provided is 25 percent. That country has a formal guaranteed-minimum pension. The contracted-out or occupation scheme must provide an earnings-related pension on earnings between the basic level and the ceiling, which is at least as good as the public benefit, although most plans would provide substantially more.

The other countries also have a guaranteed minimum—that is, they pay either a universal amount or have a minimum benefit. In practice, the amount of the private pension for the lowest earner is small and the bulk of the retirement income is from social security benefits and assistance.

Entry Generation

How do you handle the problem of initating a new coordinated system and providing immediate protection to workers not now covered by a private pension, especially older workers, who will not have time to build up pension credits over a long period of time?

The study countries have or propose a long period of buildup until maturity—20 years in the United Kingdom, 20–30 years in Sweden, and 40 years in the Netherlands and Switzerland. Such a long period, needed to build up financing for accrual of full pensions, affects three groups of workers: Those close to retirement when the system is inaugurated, those with a medium buildup possible (perhaps 10-20 years), and younger workers. The existence of three groups implies that three kinds of provisions are necessary. From a strictly financial point of view, the first group would receive nothing, the second group would receive a partial pension, and only the third group could build up to a full amount.

It is the older group that presents the main problem, and the solution depends partly on financial considerations and partly on the outlook of the society. One way is to give no back credit, as in the proposed Netherlands system, to keep down costs. The mandatory system would not retroactively give pension credits. A worker aged 55 when the system starts, for example, would be credited for just 10 years upon retirement at age 65. This approach is acceptable in part because basic coverage for the flat-rate benefit already exists.

Another way is to find some means to shorten the qualifying period for older workers so that they obtain some mileage from the new system. The Swiss have succeeded in doing this through special transitional measures where normally 40 years of contribution will be required. The 40-year contribution requirement is reduced to 20 years for persons aged 25–45 when the system begins. For those aged 46–55, the number of years required to be entitled to the full amount depends on the size of earnings, with the formula weighted in favor of the low earner. A minimum of 10 years is needed to receive a reduced benefit. Workers over age 55 would be able to receive only reduced benefits. The Swedish blue-collar fund also requires fewer years of contribution during a transitional phase. Eventually, 30 years of service will earn a full amount. Twenty years are required up to 1981, however, with a 5-percent reduction for each missing year. In addition, from 1981 to 1990 (when the plan will first cover a period of 30 years) fewer contributions will be required. In the British case, the earnings-related layer will be reduced if a worker reaches retirement age with less than 20 years of contributions.

Also influencing the long-range pattern of financing for all the countries are two trends involving the age picture. First, social security systems have tended in general to provide for earlier and earlier retirement or for flexible retirement. Such action, of course, affects the private pensions that have coordinated benefits or have to make adjustments such as occurred in Sweden when the retirement age was lowered from 67 to 65. Earlier retirement means a shorter period of contributions and a longer period in beneficiary status. The other factor, which has caused concern in Europe for many years, is the aging of the population. A demographic trend toward more and more retirees and pro-

portionately fewer and fewer active workers is apparent. This imbalance has been caused by a sequence of unusually small generations through wartime losses and low birth rates during the depression of the 1930's—plus several "baby booms" that will result in relatively large generations. In addition, longevity has been extended and labor-force participation rates of workers over age 60 have been dropping.

Notes and Brief Reports

OASDHI-Covered Earnings of Indochina Refugees, 1976*

In 1976 (the first year in which most of the refugees from Vietnam, Cambodia, and Laos had an opportunity to complete a full year of employment) about 56,500 individuals were reported with earnings covered under the old-age, survivors, disability, and health insurance (OASDHI) program.[1] This group represented about 42 percent of the 134,000 Indochina refugees who had had a social security number issued to and processed for them through the end of 1976. (About 144,350 refugees were settled in the United States in this period.) For those aged 20–59—in what are generally considered the most productive years—about 73 percent had covered earnings: 87 percent of the men and 54 percent of the women.

Covered Earnings of Workers

The median amount of earnings for all Indochina refugees was $3,646, compared with $4,429 for the men and $2,383 for the women (table 1). Nineteen percent of the total group earned less than $1,000, and 4 percent received $10,000 or more. For the men, 14 percent had earnings of less than $1,000 and 5 percent earned $10,000 or more. Among the women, 28 percent earned less than $1,000 and 1 percent earned $10,000 or more.

Age and Sex of Workers

Men were approximately twice as numerous as women, but their percentage distributions by age were similar. As in 1975, the great majority of these workers

* Prepared by Harold A. Grossman, Division of OASDI Statistics, Office of Research and Statistics, Social Security Administration.

[1] See Harold A. Grossman, "OASDHI-Covered Earnings of Indochina Refugees, 1975," **Social Security Bulletin,** June 1978.

Table 1.—Number and percentage distribution of Indochina refugees with OASDHI-covered earnings, by amount and sex, 1976

Earnings	Workers: Total [1]		Male		Female	
	Number	Percent	Number	Percent	Number	Percent
Total	56,540	100.0	37,291	100.0	19,028	100.0
Less than $50	671	1.2	278	.7	392	2.1
50–99	670	1.2	305	.8	363	1.9
100–499	4,395	7.8	2,078	5.6	2,301	12.1
500–999	4,803	8.5	2,583	6.9	2,193	11.5
1,000–1,999	7,432	13.1	4,154	11.1	3,251	17.1
2,000–3,999	12,447	22.0	7,508	20.1	4,884	25.7
4,000–5,999	12,640	22.4	8,779	23.5	3,809	20.0
6,000–7,999	7,962	14.1	6,583	17.7	1,350	7.1
8,000–9,999	3,426	6.1	3,080	8.3	339	1.8
10,000–15,299	1,870	3.3	1,740	4.7	125	.7
15,300 or more	224	.4	203	.5	21	.1
Median earnings [2]	$3,646		$4,429		$2,383	

[1] Includes 221 persons with sex unrecorded.
[2] Computed from distribution with $500 intervals.

Table 2.—Number and percentage distribution of Indochina refugees with OASDHI-covered earnings, by age and sex, 1976

Age [1]	Workers: Total [2]		Male		Female	
	Number	Percent	Number	Percent	Number	Percent
Total	56,540	100.0	37,291	100.0	19,028	100.0
Under 15	688	1.2	417	1.1	267	1.4
15–19	8,315	14.7	5,112	13.7	3,167	16.6
20–29	25,723	45.5	17,103	45.9	8,524	44.8
30–39	12,147	21.5	7,891	21.2	4,207	22.1
40–49	6,882	12.2	4,703	12.6	2,156	11.3
50–59	2,367	4.2	1,740	4.7	616	3.2
60–69	385	.7	302	.8	83	.4
60–64	295	.5	230	.6	65	.3
65–69	90	.2	72	.2	18	.1
70 and over	33	.1	23	.1	8	(3)

[1] Age on birthday in 1976.
[2] Includes 221 persons with sex unrecorded.
[3] Less than 0.05 percent.