The Relationships Between Public and Private Pension Schemes: An Introductory Overview

by Max Horlick*

Only recently have social insurance and private pensions, collectively, come to be thought of in terms of a total social security benefit package. The economic problems brought on by the 1974 oil crisis initially triggered consideration of a common, integrated role for the two systems. The second oil crisis reinforced the relative expansion in private pension programs, as a supplement to social security. Before these events, private and public pension programs interacted in only a limited number of ways, confined to relatively few countries. These interactions were largely confined to collective bargaining, whereby private pensions were gradually extended to nearly all employees in France and Sweden; mandating, or legally requiring private supplementation of social security, debated in several countries in the early 1970's, but postponed by the 1974 oil crisis; and contracting out, or covering a part of the social security benefit under a private plan, as in the United Kingdom. Overall, the tradition of private pensions was not very strong or broad-based. The current debate centers on which public/private pension mix is desirable from the point of view of an old-age income-maintenance program. A new element is the rising support for a "third pillar"—individual tax-encouraged savings—not only as a supplement, but as an alternative to social insurance.

Introduction

The integration of public (social security) and private benefit systems (occupational schemes) was once an issue that was primarily of academic interest. No longer is that the case. The relative roles of the two systems and the relationship between them are the subject of current policy debates, particularly in the industrialized countries.

These countries are now faced with seemingly opposing needs in this regard. On the one hand, the world recession and accompanying high unemployment have led to large budget deficits. The deficits, in turn, dictate a need for higher taxes, increased government revenues in general, and perhaps the necessity to reduce government subsidies to social and other programs. On the other hand, a rising level of expectation with regard to the earnings replacement rate has built up over the years in the various countries. Consequently, an increasing social security gap may have to be made up from other sources. While pensions are being reduced, pressure is building for new and expanded programs in other areas of social security. These include workers' compensation, sickness and accident coverage, occupational health and safety, severance pay, leave of absence for family reasons, and so forth.

Governments are examining the total impact of such initiatives so that the changes can be introduced on a rational and phased basis. Austerity programs

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have led to a shrinking of social security benefits and at least to the suggestion of a reduction of tax incentives for private benefits. However, to reduce the tax incentives for the private benefits is to make them shrink, just at a time when they may be most needed.

Shifting more of the burden to the private sector has its problems. Pensions are just one element of the compensation package and must be balanced by the companies against the constant demands by employees for improvements in wages and salaries, benefits, and working conditions.

Most observers agree that the best solution and guarantee for a healthy retirement income system is a strong economy. As one Minister of Finance phrased it, "pension reform must fit in with the social, economic, and fiscal objectives of the government and must avoid major disruption to the economy. Indeed, it must strengthen the economy and we must regard any change in the pension system as a positive contribution for the well-being of [the people] and the well-being and the strength of our overall society." This same point applies to all of the countries where changes are being discussed or contemplated.

The current policy debates in various countries have reopened questions about the respective roles of social security and of the occupational schemes—particularly of the use of regulation and taxation to influence action in the private sector. For example, public pensions are generally universal in the industrialized countries, but should private coverage also be extended to all and, if so, by what means? Should benefits be integrated? Should private plans be required to make up for reductions in social security benefits? What will be the financial impact on companies of requiring them to follow social security retirement age practices? Can increased government control of private funding methods and vesting and portability lead to a decline of private provision? Is the use of public tax policy to encourage private savings going to be a threat to private pension plans?

Historical Perspective

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. Before that time, employers had helped employees with large families. Later, employers provided a pension for disabled workers. Other types of voluntary benefits were aimed at discharging a moral obligation to retiring workers with long service and providing an incentive for good and young employees to continue to work for a particular employer. The spread of collective bargaining led to an expansion of private pensions in the 20th century.

A major distinction between social security and employer-provided benefits was the voluntary nature of the private pension and the compulsory nature of the public pension. Another major distinction was the aim of social security to provide a retired worker with a floor of protection while the aim of company plans was to reward work with the company, based on length of service and the amount of pay. The private plans were part of the employer-employee relations program, first based on the employer's interest in maintaining an efficient workforce and later related to an effective working relationship with organized labor.

Basically, what brought the separate evolutionary patterns together was the pressure for higher benefits. By the time the 1974 oil crisis arrived, the European systems of social security (which date back to the early days of the century) still did not have what society considered an adequate old-age benefit. Interest had already turned, therefore, to the role of the private sector as a means of supplementation.

In the 1940's, national debates focused on the respective roles of the public and private programs and how they should be integrated. Debates of the 1880's on adequacy and equity were revived. A flat-rate benefit for which virtually all workers or all residents would be eligible was adopted by some countries, including the United Kingdom, Sweden, and Canada. The intent was to provide some form of bare subsistence-level benefit.

By the late 1950's, the flat-rate universal benefit was judged insufficient by some countries, which added an earnings-related second layer. Canada, Denmark, Finland, Norway, and Sweden adopted this additional benefit. Typically, it was financed by worker and employer contributions with, in some cases, a general revenue supplement to make up any deficit.

The flat-rate layer was aimed at providing a basic minimum for the very low earner. Above that level, the social security benefit was to make up the largest component of the old-age package. Moreover, in some countries, a private pension was counted on to bring the level up to a specified higher amount. For those with earnings levels far above the average—managers and executives, for example—the private pension was to become the major component. Here the objective of the flat-rate benefit was to give the lower earner a higher proportion—which could in theory exceed 100 percent of previous earnings—through the public social security programs.

Not all countries followed this two-tier route, however. From the start, countries such as Austria, France, the Federal Republic of Germany, and Italy had one-layer, contributory earnings-related systems.

Goals

What were these countries trying to achieve in terms of income maintenance? Some of the countries wanted pensioners to maintain their previous level of living through an "adequate" benefit adjusted to price changes. Others aimed at permitting pensioners to enjoy general productivity improvements, through benefits adjusted in line with earnings. Their target was for the old-age security programs (public and private) to replace 40-50 percent of earnings. Over the years, however, these expectations increased, and a replacement range of 60-70 percent of earnings came to be considered necessary, with about 20 percent from private pensions. Until 1974, these were the goals, and the countries were progressing toward them. There were some minority voices that warned of the high cost and the impact on productivity. Others did not really think that the goals would actually be achieved.

National Income Maintenance Systems, Public and Private

To understand, on an internationally comparable basis, what issues and problems are involved in the interrelationship of public and private benefits, it is necessary to review programs and, more especially, to define terminology. A useful expression in the private sector, which brings all of the benefits together, is the "total benefit package." It may include some or all of the following elements: social security old-age pension, private pension, severance pay (which, in some countries, is a substantial amount granted upon separation from the firm or upon retirement), a life insurance annuity, a health plan, a savings plan, and profit sharing.

Some consider that the monthly retirement benefit from social security itself contains several parts payable monthly for life: (1) a cash annuity and (2) an in-kind "medical care annuity" in the form of medical-care insurance protection—the value of which increases implicitly as the cost of medical care rises. Health insurance is a very important part of retirement benefits. A reduction in health insurance benefits may be even more burdensome to the beneficiary than a reduction in cash benefits because it may be more difficult to replace benefits lost as a result of health care cuts than it is to replace cash benefits.

Total Benefit Package

The total benefit package, from the public administration point of view, is the national income maintenance program. The four main types of national income maintenance programs are:

- A relatively high flat-rate benefit system with an old and extensive private pension network (exemplified by the Netherlands);
- An earnings-related system with a limited private pension network (exemplified by the Federal Republic of Germany);
- An earnings-related social security system with an almost universal private pension system (exemplified by France); and
- A multi-tier system with a universal layer, an earnings-related second layer, and private pensions for all organized workers (exemplified by Sweden).

In many countries, it was the custom for the employer to "promise" employees that, upon retirement, they would receive a specified amount or percentage of pay as a pension. This amount, provided partially from social security and partially from a private plan and treated as one pension amount, is often called a benefit under an "integrated formula."

Private Pension Types

The term "private pensions" is probably understood differently in each country because the structure of their programs may differ. The diversity of terminology used—occupational fund, complementary pension, parastate benefit, company old-age provision, for example—illustrates this point. In practice, regardless of country, the term "private pensions" lumps together a wide variety of mechanisms, and more than one can exist in an individual country. The principal mechanisms are:

- A national pay-as-you-go network, which looks like social security but is operated by private or semipublic agencies, as in France. Although these provisions were made mandatory by degree, government regulation is relatively slight and primarily done through the tax law.
- Insured plans, which are pension programs operated by life insurance companies as group life insurance. These exist in many countries, notably in the Federal Republic of Germany and the Netherlands, where they fall under insurance law. Variations are found in Finland, where special pension insurance companies operate mandatory plans, and in Sweden, where several special agencies insure the funds of the blue-collar and the white-collar workers.
- An insurance-type company set up by the employers, specifically to run their plans, as in the Federal Republic of Germany. These, too, fall under insurance law.

- A legally separate pension fund or foundation, as in the Federal Republic of Germany or in Finland.
- A nonprofit mutual association, as in Belgium.
- A company savings plan, as in the smaller companies in Switzerland. (A variation of this technique is proposed in the United Kingdom.)
- A book reserve plan, which does not have an actual pension fund but in which the company records obligations to future pensioners and pays pensions out of current financial operations. This plan, or a variation of it, is found in Finland and the Federal Republic of Germany.

Each of the mechanisms may be overseen by different government agencies or, except for tax purposes, possibly by none at all. The employee may contribute and, thereby, have an absolute right to at least his or her contributions with interest. The coverage may be voluntary or compulsory. The accrued entitlements may be guaranteed by a semipublic agency, most often with the employer paying for the guarantee.

Common Features

Coverage under private programs may be more limited than under public programs as, for example, in disability and survivors' pensions. Often the social security ceiling plays a key role in regard to private pensions. Contributions and benefits for private pension purposes may apply to that portion of earnings above the social security ceiling. In such a case, movements in the social security ceiling directly affect the income of the private pension schemes, as in France.

Retirement age is another important issue in the interrelationship of private and public pensions. The lowering of the retirement age has not been accomplished without problems. Typically, private schemes conform with the retirement age fixed under social security, and, when the social security retirement age has been lowered or made flexible, private schemes have had to adapt. The private insured or funded plans use actuarial assumptions about future contribution needs and investment return. When the retirement age is lowered, as in the public systems, benefits will have to be paid for a longer period. With increased longevity, a legislated requirement for some form of indexing, and a growing population of elderly, future obligations for both public and private systems are expected to increase greatly.

Public Policy Alternatives

In the past, discussion of the public-private interrelationship on a comparative basis has been almost entirely limited to the integrated benefit formula and to a description of each of the systems. There are perhaps four main ways that the private pension programs have interacted or failed to interact with public policy: Collective bargaining, mandating, contracting out, and other.

Collective bargaining. In several European countries, national representatives of management and labor meet periodically to develop national agreements on wages and fringe benefits and to contribute toward the formulation of the country's labor and economic policies. Some countries have permanent national commissions that directly participate in economic policy, including such aspects as the impact of social security changes on the financial pattern. Private pensions and particularly national policies toward them also form a major part of their policy thinking. Collective agreements have gradually extended private pensions until they have come to cover just about all employees, as is the case in France and Sweden. In these countries, the government has played, at most, a minor role in this evolution. The result is, in effect, a national private pension layer that is supplementary to social security, but technically unrelated to it.

Mandating. The great improvements in social security programs in the 1950's and 1960's had brought not only added features and benefits, but also added costs. On the one hand, the public programs had not reached their objectives in terms of income replacement, despite the high level of expenditures; on the other hand, public pressures for further increases in benefits continued to mount. Several countries moved to legally require—or mandate—private supplementation on top of social security as the answer. The expectation from this type of arrangement was that the two programs would produce a combined benefit high enough to attain the long promised objective of enabling retired workers to maintain their level of preretirement living. Requiring employers to provide the added pension would avoid increases in public expenditures on income maintenance programs. Just as the countries were debating seriously on how to implement such programs, the 1974 oil recession forced postponement. For example, in Switzerland, the 1972 constitutional amendment that provided for mandatory private pensions was not implemented until 1974.

Contracting out. The United Kingdom has long provided for "contracting out"—a part of the benefit can be taken out of social security and covered by a private plan instead, provided the private benefit is at least as good. Contracting out is seen as reducing public expenditures, keeping more money in the private sector for investment, encouraging private plans, and giving employers more flexibility in the benefit package. About half of the country's workers are in contracted-out plans. Under the coordinated public-private scheme that went into effect in April 1978, all employed persons received a basic flat-rate social security benefit and also participated either in an approved private plan or the government-operated earnings-related scheme. That is, the base amount is paid by social security and a supplementary amount is provided by either social security or the employer's plan. Currently, debates on the private-public mix have been reopened.

Other. The three alternatives above imply the existence of a coordinated policy, either public, private, or both, at the national level. In other countries, the role of the private pension has not been as clearly defined. This means that there may be little government regulation beyond some tax advantages, or that government regulation is relatively recent, as in the Federal Republic of Germany and the United States. In countries such as Italy and Spain, the replacement rate of social security is so high that there has been little incentive until recently to spread private plans to the regular labor force.

In yet other countries, there was little tradition of private pensions. The social security replacement rate for the average worker was regarded as adequate, and the tax regulatory laws discouraged the creation of employer-based benefits. However, several of these countries, such as Portugal and Spain, have recently begun to pave the way for the expansion of private pensions through new organic legislation aimed in that direction. In Belgium, a new law has been passed that is intended to clarify and strengthen the position of private pensions.

Public or Private Alternatives

Following the 1974 recession, continued economic problems coupled with current and projected unfavorable demographic patterns led in approximately 20 countries to a review of the prospects for social security and the role of private pensions. Before the recession, some countries had favored the alternative route of expanding the social security system to provide an adequate retirement program. However, even in times of prosperity, it has been generally recognized that a broadly based social security system cannot really meet special needs, particularly those of more highly paid employees. Hence, the development of private pensions in some countries has been looked upon with favor and even encouraged through favorable tax treatment. But the growth of private pensions remains essentially determined by such factors as the natural forces of the economy, competition, collective bargaining, and the internal needs of the firm.

In other countries, the emphasis is still on voluntarism: No employer is required to establish a pension plan, though tax-incentive encouragement is given to those employees not covered by a staff retirement plan to establish their own employee retirement program on an individual basis.

Public Role

An expansion of the social security system has many attractive features. First, the universal coverage offered by public programs assures workers that their protection will follow them when they change jobs. A second advantage is the vesting and complete portability of credits provided. Individual workers have their earnings automatically combined from all places of employment, and full credit is given toward the computation of their retirement benefits. A third advantage of the public system is that its ability to finance benefits rests on the entire economy rather than on a single firm or industry, thus giving social security a financial security not easily matched by private plans. Fourth, benefits adjust readily to changing price and wage conditions through automatic benefit increases tied to rises in the cost of living and through ceiling and formula increases tied to the rising incomes of the population. Finally, the public program has many socially oriented elements not found in private plans. It provides a broad array of nonretirement benefits not always found in private plans: Survivors' protection for widows, disability protection before retirement for workers and their families, and health insurance benefits for the aged and the disabled. The pension formula may weight the benefits in favor of the lower-paid retirees or the disabled who have few years in covered employment. This contrasts with private pension plans, which tend to emphasize more adequate retirement income for the regularly employed, above-average earner and the 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 cited. The cost of expanding the system would be reflected immediately in higher contribution rates. In recent years, outlays in a number of countries have exceeded contributions, and such deficits would become greater were benefits further liberalized. The means by which current deficits are being met—through an increase in the contribution rates, a rise in the ceiling, or contributions from general revenues—affect the national budget, and much pressure has developed against increased spending on income maintenance programs.

Another cited disadvantage of an expanded social security system is the fear that it might thwart the growth of private pensions. Employers who have to pay a larger contribution may be unable to afford increased private pension benefits, and they may not feel obligated to provide these because their workers are protected by a more adequate social security floor. Workers who see their social security payroll deductions increasing may press for cash compensation rather than greater deferrals of income into pension or profit-sharing plans.

Private Role

Private retirement plans are also seen as having several advantages over a public system. For one, they provide needed funds for capital development and investment. They also permit employers (and unions) a degree of flexibility in tailoring or adapting their plans and financing to meet special circumstances in a company, industry, or geographic area.

Social pressures for maintaining or even improving social security benefits have continued in all countries. However, social security benefits have been paid for by employer-employee contribution rates that have gone as high as 50 percent of payroll for a social security package (that includes old-age, survivors', and disability benefits, health insurance, work injury protection, unemployment insurance, and family allowances), and as high as 20 percent for old-age, survivors', and disability insurance alone.

However, these pressures have largely been unrelieved, for a number of reasons. It is generally felt that the contribution rate, especially for companies, is as high as it can go. In most countries, increasing the contribution from general revenue has been opposed. Raising the contribution ceiling to increase social security receipts—an alternative that exists in the United States—is not an available option in most European countries. In some countries, the ceiling is already so high as to include the total earnings of virtually all workers. In other countries, the private pension contribution may be assessed on earnings above the social security ceiling. Therefore, raising the ceiling still further means cutting off the source of financing for private pensions.

Issues in Private Pension Expansion

In those countries that have been debating the role of private pensions or have recently passed legislation to encourage their spread, a number of problem areas have emerged. These problems fall into several broad categories: coverage, vesting and portability, financing, treatment of older workers, guaranteeing pension rights, integration, and inflation.

Coverage

Public plans in the industrialized countries cover almost the entire population. The flat-rate benefits under the universal layer are payable to all residents who become disabled or who retire. The earnings-related plans now cover all the economically active and their dependents.

Private pensions, on the other hand, have not normally covered the entire labor force, primarily because of their historical development. For the most part, only large establishments or groups of companies could afford to create and maintain private pension plans. The small family businesses so common in Europe—the self-employed, marginal firms, and declining industries—could not.

The percentage of employees covered by private pensions varies widely, from around half in countries such as the United Kingdom and the United States to almost complete coverage in others, such as France and Sweden.

Questions have been raised concerning the role of public policy in this matter. Should the government have a role? Does the gap between that part of the labor force covered under social security and private pensions and that covered under social security alone represent a failure in public policy?

One rationale cited in national debates for requiring private pensions is the need to rectify the coverage imbalance, thus providing private plans for all workers. This intention suggests a number of questions. First, should all of the economically active be covered by private pensions? How do the countries intend to cover what additional groups? Is the inclusion of marginal groups a realistic function of a privately financed plan? Should they be covered rather by a means-tested allowance if they do not qualify for some basic minimum? Should not social security be considered as sufficient to provide them with an adequate replacement rate?

In the countries that favor mandating of private pensions, the decision was to include everyone possible. The rationale was that only in this way could plans be made both widespread and uniform. However, in studying the experience of these countries, it should be pointed out that none have as yet achieved 100 percent coverage under private plans. The highest level has been reached by Sweden, where 90 percent of the manual and nonmanual workers in the private sector are included. Sweden considers that its private coverage is tantamount to complete. The national negotiations over private plans cover organized workers. The negotiator considers that the others are in very small establishments that may not be organized and are, therefore, outside the scope of the agreements.

Who is left out varies somewhat from country to country. In general, it is the unionized workers and higher-paid employees in large companies who are most likely to be included; the lower-paid workers in small nonunion establishments are the least likely. Inclusion of the self-employed in some sort of general system has been found to be technically difficult. There are, of course, private arrangements for the better-off self-employed in these countries, and it is primarily the small businessman, tradesman, or artisan who would not benefit. The proposed mandatory system in the Netherlands, for example, would not cover the self-employed on the assumption that they (1) have income from business activity, (2) can sell their businesses upon retirement, or (3) have personal savings.

Part-time, low-income, and seasonal or occasional workers may also be omitted, even when plans are mandated. Usually a provision exists for not covering marginal or beginning workers through a minimum-age stipulation, a length-of-service requirement, or through a requirement of a certain minimum number of hours per week of work (such as 16 hours in Sweden) or a minimum amount earned.

Vesting and Portability

All of the mandated systems have vesting and portability. However, some vehicle had to be found for small plans. The French took care of this through a national private pay-as-you-go network. The national union of pension funds coordinates the records of all regular wage-and-salary workers so that transfers from one employer to another or from one industry to another are treated in much the same way as under social security. In Sweden, manual and nonmanual workers each fall under a different national private fund.

Financing

In any consideration of mandating, financing immediately becomes a key issue. Small companies face a serious problem. Existing private plans of large companies or of strong industries face no special problem with regard to meeting any financial standard set. However, the spread of benefits to all kinds and sizes of establishments and industries means that there will be varying abilities to adequately finance the private program. A vehicle must therefore be found for funding small plans, covering as few as two or three employees. There is, thus, a greater need for group planning, multiemployer arrangements, or general pooling.

From an overall point of view, three basic financing alternatives appear in the European systems: (1) a pay-as-you-go system, (2) an equalization fund to pool part of the costs, and (3) other types of funding arrangements. In the pay-as-you-go arrangement, the system is self-regulating in terms of future increases in benefits and indexing. 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 also other firms or industries in a weakened financial position, such as those with an older labor force or in decline. The burden of indexing may be shifted to social security, as in the case of the United Kingdom. The funding arrangement may be in the form of a reserve administered by an insurance company or other agency segregated from the sponsoring company.

Older Workers

Initiating a new coordinated system and providing immediate protection to workers who are not currently covered by a private pension and who will not have time to build pension credits over a long period of time is not without its problems. 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. The range of possibilities depends on the number of workers already covered, the age of the funds themselves, general economic conditions, and pressures of universality. One way to keep costs down is to give no back credit, as in the proposed Dutch system. For example, a worker aged 55 when the Dutch system starts would be credited for just 10 years upon retirement at age 65. This is acceptable, in part, because basic coverage is already provided under the flat-rate social security benefit.

Another way to keep costs down is to find some means to shorten the qualifying period for older workers so that they obtain some benefit from the new system. The Swiss, whose program normally requires 40 years of contributions, have succeeded in doing this through special transitional measures. The 40-year contribution requirement is reduced to 20 years for persons aged 25 to 45 when the system begins. For those aged 46 to 55, the number of years required for a full benefit depends on the size of earnings, with the formula weighted in favor of the low earner.

Guarantees

Another area of common public and private interest is that of guaranteeing the financial security of vested benefits. When the government begins to play some regulatory role, or when pensions are required through collective bargaining or law, there is at least a tacit need for some form of protection guarantee in the event of the bankruptcy of the company sponsoring the private pension. It is interesting that two countries—the Federal Republic of Germany and the United States—created agencies for that purpose on the eve of the 1974 world recession, which was to lead to the failure of so many companies with pension plans.

The guarantee is normally provided by a special agency set up under law. For each country, the provision of an insolvency guarantee poses the need to make decisions on questions such as the method of financing, the level of benefits to be guaranteed, and the indexing of guaranteed benefits.

Integration

When a country requires both social security and private pensions—whether through industrial negotiations or law—it must figure out how the two fit together and what each component ought to contribute. This is "integration" per se and, in the past, has been almost the sole subject of international comparative work. The objective is to structure the private plans so as to "integrate" them with the social security benefits to produce the intended amounts. As indicated earlier, one approach is to have social security provide a basic minimum for the very low earner. Above that level, the social security benefit would make up the largest component of the old-age package, with the private pension bringing it up to a specified higher amount. At earnings levels far above the average, as in the case of managers and executives, it was foreseen that the private pension would become the major component in the package. More technically, there are several ways that have usually been used to integrate the social security benefit with the private pension. In one form, a defined amount of compensation is replaced, part by social security and part by private pension. The social security payment is deducted from the total amount. As the indexed social security component grows, the private one is progressively reduced. This technique has become less frequent here and abroad, as a result of union pressure. Another element of integration, in addition to the benefit formula, is the common use of wage figures by both systems. In the Netherlands, for example, both the public and the private pension have a common contribution floor and ceiling, with movements in the ceiling used for benefit indexing. In Sweden, the public and private systems have a common national "base amount." The amount of covered earnings, the level of the ceiling, and the degree of indexing of both the public and private systems are calibrated to movements in the national base amount.

Adequacy

Generally, the ideal replacement rate provides an income sufficient to maintain the retired worker (and dependents) at a level of living reasonably consistent with preretirement earnings. Generally, it is also considered that social security should provide the basic amount or a floor of protection for all.

Initially, the target in a number of countries was to replace about 40 percent to 50 percent of earnings with social security benefits for the average worker. Over the years, national discussions have indicated increased expectations of a combined public-private replacement rate ranging from 60 percent to 70 percent of earnings.

Table 1 shows combined replacement rate goals for average workers in selected countries.

Table 1.—Target combined replacement rates for average workers

[In percents]

Country	Goal	Public	Private
France	70	50	20
Federal Republic of Germany	75	50	25
Netherlands	70	40	30
Sweden	65-70	55-60	10
Switzerland	60	40	20
United Kingdom	60	40	20

Inflation

Perhaps the basic problem in promoting the generalization of private pensions is the difficulty of dealing with inflation. Social security benefits are usually indexed, while private pensions may often not be. The question arises then as to how to determine financial responsibility for postretirement pension increases in a coordinated public-private system, when private pension schemes have not been equally geared to providing such increases.

Benefits under private plans have to 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 of wages tends to be so great that the earnings record, the amount accrued, and the pension calculated on this record may lose a significant amount of purchasing power by the time the pension is paid. Besides maintaining purchasing power, there may be an intention to compensate for increases in productivity. However, the factor that limits the ability of the private benefit plan to revalue past wages is, of course, the long-range cost. Currently, pressures to revalue pensions have led many companies to limit or drop private pension programs where possible.

One foreign system that offers an alternative solution is the French private pension system, which incorporates the custom of **répartition**, where there is little accumulation of reserves. The French system redistributes the contributions of employers and current workers to pension recipients. In a period of high inflation and economic adversity, the system has worked well. However, the administrators of this system have foreseen problems, particularly those related to the increasing proportion of beneficiaries and the decreasing proportion of contributors brought about by an aging population and long-term unemployment, which could mean that the prorated share of receipts could eventually become small.

Savings: The Third Pillar

The role of the third pillar—private savings—is not a clear one. Many countries hold the view that savings are significant as a feature of old-age protection. However, it may well be that, in actuality, the third pillar is just a theory. It is not clear that government policy in many countries is really directed toward support for this pillar as a source of income for old age, although this is a live issue in Canada, France, Switzerland, the United Kingdom, and the United States. One researcher concluded that "there is little evidence that policymakers have attempted to translate asset promotion, workers' thrift, and so on into a theory of self-help that could be used to justify reduced financing commitments to other social programs." However, he concludes that it would be a mistake to overlook the fact that savings programs are directly related to social security, understood in the broader sense—a concern for securing the life chances of individuals and families.

Certain existing programs reflect the third pillar concept. One of the most recent indications of increasing government efforts to encourage individual savings for retirement is the creation of Individual Retirement Accounts, or IRA's, in the United States. In the Netherlands, companies for many years have paid some form of increment to encourage a variety of workers' savings plans, although these are not specifically aimed at retirement. The basic idea in the Netherlands is to encourage firms to supplement workers' savings by offering special exemptions from taxes and social charges on the employers' contributions. In some countries, the government may add a supplementary bonus to the account in addition to the interest accrued if the account is frozen, or blocked, for a specified number of years. The number of employees involved in such plans may be quite large on a countrywide basis.

Tax Policy

The tax treatment of public and private employee benefits has recently been the subject of debates in a number of countries. On the one hand, there has been publicity concerning the loss of revenue due to favorable tax treatment of certain contributions and benefits and, on the other, a need is apparent to grant additional incentives to encourage the expansion of private benefits. The tax provisions were seldom questioned in the past, since saving for retire- ment has generally been considered worthy of support. A related concern has been that the tax incentives, while lessening the general revenue receipts from the whole population, tend to favor only a part of the labor force, namely the better-paid employees in larger companies and members of the stronger unions. A third issue that has arisen in some countries is the differing tax treatment of various kinds of benefits. Notably, lump-sum benefits are usually not taxable, while annuities from life insurance are taxable. Critics say that this seems to encourage employees to accept a lump sum and this is, in some cases, inadequate for retirement. A fourth issue on which there is no universal agreement is whether a pension—private or public—is a continuation of wages, a replacement for wages, or something else, such as a subsistence-level benefit, a guaranteed old-age income, or a return on the investment of labor. The national attitude toward this question influences tax policy on old-age benefits.

In addition to encouraging the growth of pension and savings plans, tax laws have influenced their structure. For instance, to qualify for favorable tax treatment, private pension plans must satisfy certain requirements for coverage, vesting, funding, and so forth. Moreover, the provisions have influenced the financing mechanism by (1) encouraging the establishment of particular forms of pensions, (2) favoring entirely employer-financed plans, or (3) making plans contributory.

Compensation in the form of employer contributions is deductible by the employer when contributions are made and not taxable to the employee until benefits are payable. This mechanism accomplishes the following:

- It allows the employer to put aside money in advance of future benefit payments and to take advantage of the tax-exempt status of investment income.
- It makes the contribution available for investment during the employee's working years.
- It means that benefits at time of distribution are likely to be taxed at a lower marginal rate than if they had been taxed as they accrued to the employee, since the employee's income is usually lower after retirement.

In economic terms, the situation has been characterized as follows: Fringe benefits have tended to be either taxed at a far lower rate than current wage and salary payments or not taxed at all. This public policy, in effect, has lowered the price of fringe benefits. The deductibility of employer contributions as a business expense, combined with corporate tax rates, lowers the cost to the employer.

Directly taxing a fringe benefit raises its relative price. Recent econometric studies indicate that, as the price of a fringe benefit is raised, the quantity of fringe benefits demanded by employees is lowered. Thus, the relative growth of fringe benefits could be seriously limited or even reversed by the lowering of general tax rates and the taxing of specified fringe benefits. However, benefit advocates caution that, if private sector efforts are not encouraged, pressures may build up to increase public programs in these areas. Proposed cutbacks to get more taxable revenues effectively mean that employees will receive less and that more of this income will become taxable. Since social security is being indexed, what will fill the gap?

Conclusion

A decision regarding the existing and possible interrelationships involved in the various programs for old-age income maintenance has to be reached not only by a researcher, but by the national parliaments. What to do and what mix to adopt is precisely what is being debated at this very moment in many countries. What is perhaps new and different is rising support for the third pillar—individual tax-encouraged savings—not only as a supplement, but even as an alternative, to group solidarity through social insurance.