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Mandatory Employer Pensions in Ireland, Germany, and the United Kingdom

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EXECUTIVE SUMMARY

Introduction

U.S. policymakers have long been concerned about low and stagnant rates of private pension coverage. Retirees who depend fully on Social Security benefits are generally poorer than those who also have other retirement benefits. The fact that a substantial proportion of workers do not have employer-based pensions also tends to inhibit debates over long-term Social Security policy. Without employer pensions, some retirees could face substantial hardship if, for example, the early or normal retirement ages for receiving retirement benefits were raised beyond the age when they were able or willing to work.

The United States is currently debating whether pension coverage gaps should be filled by making 401(k) plans mandatory. Germany, Ireland, and the United Kingdom have voluntary employer pension systems, but each country has also enacted a 401(k)-type pension that is mandatory on employers.

These plans may offer lessons for the United States as it attempts to increase retirement income coverage. This paper describes their key features with an eye to how the plans operate and how their operational features compare with those of 401(k) plans. The programs are explicitly designed to fill gaps in employer-provided retirement plans, though each also has a component similar to U.S. individual retirement accounts (IRAs).

Purpose of the Report

The report has four major purposes:

1. To describe laws in Ireland, Germany, and the United Kingdom that require employers to offer, or designate, a pension plan that employees can use for tax-advantaged retirement savings

2. To present and assess early data on the operation and results of these plans

3. To place each plan in the social, political, and economic context of each country, pointing out similarities and differences between the three countries studied as well as between these countries and the United States

4. To draw policy lessons that the United States may be able to apply in ongoing pension policy debates and outline needs for future research

Methodology

The report relies on primary and secondary sources of information. Government documents serve as primary sources, describing the plans and providing operating data. Secondary sources include analyses and perspectives published by nongovernmental organizations and for-profit entities such as insurance companies. Secondary sources also

include academic research on the development of these plans, their operation, and their effects on retirement saving.

Empirical Findings

Ireland. Personal Retirement Savings Accounts (PRSAs) were enacted in 2002 to fill gaps in the system of employer-provided pensions, as well as to provide a retirement savings opportunity for those outside the workforce. Employers are required to offer a PRSA if they do not offer another pension plan. However, even if they do offer another pension plan, they must still offer a PRSA if they have employees who are not eligible to participate in the other plan or, if eligible, are not permitted under the terms of that plan to make additional voluntary contributions. Those who are not working may establish a PRSA and contribute on their own. Contributions are tax deferred when made, and benefits are taxable on receipt at retirement or disability.

PRSA participation and contributions have been low among both employees and those who are not working. Most employer plans are "empty shells," with no participants or contributions, and not all targeted employers have established plans. Lack of take-up could mean that a population-wide retirement and savings plan might take time to catch on. The Irish government has also committed itself to aggressive monitoring of employers' compliance with the mandate.

Germany. Riester pensions were enacted in 2002. They are named after the labor minister at the time. They offer both tax incentives and direct subsidies to employees and other individuals. Riester pensions provide employees the opportunity to convert up to 4 percent of salary into pension plan contributions. In 2004, nearly half of the workforce was covered by collective bargaining agreements providing for salary-conversion plans. Lower-income households are eligible for a generous subsidy.

While union contracts have driven participation, an estimated half of contributions represent transfers from savings vehicles that do not benefit from tax preferences. A complex law with frequent changes, lengthy transition periods, exemptions, and special regulation is believed to have increased popular uncertainty. The tax-deductible contribution ceiling for Riester pensions is low and is being phased in through 2008. As a result, many potential participants may feel they can postpone a decision without serious financial disadvantage, so coverage may grow further as the regulatory environment stabilizes.

United Kingdom. Stakeholder pensions were enacted in 2001. Like PRSAs and Riester pensions, stakeholder pensions are intended to fill gaps in the voluntary employer-sponsored pension system and to supplement retirement savings for some employees who already participate in employer pensions. They are also intended to generate new retirement savings opportunities for certain caregivers and disabled persons.

The combination of an employer mandate with voluntary employee participation has not yet fulfilled expectations. As in Ireland, not all targeted employers are complying with

the legal requirement to designate plans. Many designated plans are empty shells, with few or no participants or contributions, though participation jumps markedly if the employer contributes to the plan. Many employees who do participate make small contributions or transfer balances from other plans.

Conclusions

Since 2001, three countries with similar pension systems have adopted mandatory 401(k)-type pension plans. Several lessons can be drawn from the experience with these programs.

Employer contributions. Perhaps the single most important conclusion from this review is that employer contributions drive employee participation. In the United Kingdom, eligible employees whose employer contributes to the plan are more than five times as likely to contribute themselves as those whose employer does not contribute. As in 401(k) plans, employers may contribute, but are not required to do so.

Even when employees do contribute, however, their contributions may not all result in new saving. In both Germany and the United Kingdom, a substantial share of plan contributions has come from other pension plans or savings vehicles.

Participation. A program's impact on coverage depends critically on its goals. Eligibility for the Irish and UK employer-based programs is drawn fairly narrowly, encompassing primarily those workers with no private pension coverage or coverage that is deemed by government standards to be inadequate. These criteria tend to target lower-wage, intermittent, or highly mobile workers, and those in smaller firms. Both countries have found that workers' take-up rates have thus far been disappointing.

In Germany, in contrast, salary-conversion plans were made mandatory on all employers, regardless of their other pension offerings, because the program's goal was to introduce defined contribution plans and ease the transition to lower Social Security replacement rates, rather than to target workers with no pension coverage. Unions also actively pursued salary-conversion plans in negotiating collective bargaining agreements. As a result, more than half the workforce was covered by a Riester pension by 2004.

Enforcement and education. Both Ireland and the United Kingdom have found that not all targeted employers comply with the designation requirement. As targeted firms tend to be small enterprises, both enforcing pension requirements and educating potential participants about retirement savings may pose challenges.

Plan fees. Both PRSAs and stakeholder pensions are permitted to charge fees that are high by U.S. standards. Mandatory plans should be held to a high standard regarding transparency of charges and fees in the investment options they offer. Fees should also be affordable for participants.

Future Research

As their populations age, many developed countries will look for policy options to increase the share of retirement income delivered through private pensions, and employer mandates will probably be considered. Accordingly, it is likely that these programs will continue to be studied for their effectiveness and efficiency.

Future research should include collecting detailed data on coverage and participation in these plans. Efforts should focus especially on workers such as part-time and contingent workers, whose pension coverage has historically been limited. Research on coverage should also include an effort to understand which, if any, firms are noncompliant with the mandate and why. Such research should be separate from enforcement efforts aimed at punishing noncompliance.

Finally, both researchers and policymakers need to know whether mandatory private pensions can improve policy debates over troubled Social Security programs. If making 401(k) plans mandatory expands private pension coverage, Social Security debates may be able to consider a broader range of policy options.

Lessons for the United States

Participation in pension plans sponsored by private-sector employers in the United States has been stagnant for a long time. Put simply, not much—even the popular and flexible 401(k) plan—has worked.

Three countries have adopted a new retirement policy model—a defined contribution plan propelled by an employer mandate. In Ireland and the United Kingdom, these plans are directed at employees and employers who have proven hard to reach with other pension interventions.

The experiences of these three countries suggest that employer pension mandates may not expand private pension coverage or generate new savings in the near term. But the United States may have advantages over these countries in making such plans work. PRSAs, salary-conversion plans, and stakeholder pensions are new ideas that have yet to gain a foothold in the popular imagination. In contrast, the 401(k) plan is part of the popular vernacular. Many employees who are currently without coverage may have participated in a 401(k) plan in a prior job or have a spouse, other family member, or friend who has done so. Employees covered by a mandate are thus likely to be familiar with the basic concept.

Another circumstance favoring the United States is that employers that already sponsor 401(k) plans have had substantial success in attracting employee participation through automatic enrollment. Under this approach, employees are automatically enrolled in a plan at a small threshold contribution rate. They must make an affirmative decision to opt out of contributing to the plan—and most do not. Automatic enrollment combined with

an employer mandate could be the “magic bullet” that would spur private pension growth.

Although the 401(k) plan has been very popular, it has not delivered universal private pension coverage. It may be time to ask whether making it mandatory can close the deal.

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INTRODUCTION

U.S. policymakers have long been concerned about low and stagnant rates of private pension coverage. Retirees who depend fully on Social Security benefits are generally poorer than those who have other retirement benefits as well. The fact that a substantial proportion of workers do not have employer-based pensions also tends to inhibit forward-looking debates over long-term Social Security policy. Without private pensions, some retirees could face substantial hardship if, for example, the early or normal retirement ages for receiving Social Security retirement benefits were raised beyond the age when they are able or willing to work.

The United States.is currently debating whether 401(k) plans should be made mandatory on employers. Germany, Ireland, and the United Kingdom have voluntary employer pension systems much like the U.S. system, but each country has also recently enacted a 401(k)-type pension that is mandatory on employers. Benefits earned under these plans are in addition to Social Security[1] benefits, plan features may be negotiated between employers and employees, and the plans create private pension rights. Each plan also has a corresponding individual version that resembles individual retirement accounts (IRAs).

This paper describes key features of the mandatory employer-based plans in Ireland, Germany, and the United Kingdom, focusing on how the plans operate and how their features compare with the much older 401(k) plans.[2] A comprehensive review of the research and policy literature on the three European plans is outside the scope of this paper, but data on plan performance are presented as available. After describing each country's plan, the paper summarizes their common features and draws possible lessons for U.S. pension policy.

IRELAND

Introduction

Ireland is one of the younger industrialized countries in demographic terms. Only 11.1 percent of the population was age 65 or older in 2004, compared with 19.5 percent in Japan, 19.3 percent in Germany, and 19.0 percent in Italy, which are among the oldest developed countries (Organisation for Economic Cooperation and Development [OECD] 2005b).

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[1] European sources typically refer to government-provided retirement benefits as "public pensions" (see, for example, OECD [2005a]). In the United States, however, this term refers to retirement benefits provided to federal, state, and local civil service employees. A similar terminology problem arises with what are called employer-provided defined benefit plans in the United States; these plans are typically called occupational pensions in the countries covered in this report. This report refers to public pensions as Social Security and uses the terms "occupational pensions" and "employer-provided pensions" interchangeably. Private pensions are those sponsored by private-sector employers.

[2] The Revenue Act of 1978 added section 401(k) to the Internal Revenue Code. In 1981, the Internal Revenue Service issued regulations that clarified the tax treatment of employee contributions to these plans, thereby paving the way for their rapid growth.

At the same time, however, employer-sponsored pensions cover only 50 percent of the workforce (OECD 2005b). Policymakers were concerned that limited pension coverage provided less retirement income than most workers would need. This concern led to the enactment of Personal Retirement Savings Accounts (PRSAs) under the Pensions (Amendment) Act of 2002 (Pensions Board 2003a). The PRSA was particularly intended for women, part-time workers, contract workers, and those in seasonal employment (Mensah, Schneider, and Aboulfadl 2004).

Coverage and Participation

Mandatory PRSA access for certain employees. Employers that do not offer a pension plan are required to offer PRSAs. In addition, employers that do offer a pension are required to offer a PRSA if they have any "excluded employees." Excluded employees fall into one of the following categories:

- They are included in the pension plan but are eligible only for death benefits.
- They are ineligible to participate in the pension plan and will not, under the plan rules, become eligible to participate for pension benefits within six months from the date they commenced employment.
- They are included in a pension plan, but the plan sponsor has decided not to permit employees to make additional voluntary contributions (AVCs). AVCs are voluntary pension contributions made by a plan participant that exceed the amount (if any) required under the plan's provisions. Pension plan participants whose plan permits AVCs may not make contributions to a PSRA while covered by the pension plan.

The requirement to designate a PRSA provider applies to all employers, regardless of number of employees, so long as they have even one excluded employee. Part-time, contract, and seasonal employees must be offered a PRSA if they are excluded employees. Employers may contribute to a PRSA but are not required to do so.

Voluntary coverage. In addition to wage-and-salary employees meeting certain criteria, almost every adult under age 75 may also open a PRSA, including employees, the self-employed, the unemployed, homemakers, and those caring for a child or other dependent person. The PRSA law does not provide for a minimum eligibility age, so students are also eligible.[3]

Institutional Arrangements

PRSAs are defined contribution plans that are structured as contracts between the participant and a PRSA provider. They are intended to be low-cost, flexible investment

[3] Other laws may limit the types of contracts into which minors may enter, however.

accounts. PRSAs are owned by the participant, and are thus fully portable, both among employers (if applicable) and among PRSA providers.

Two types of PRSAs are available. They differ in the investment fees and investments permitted.

Standard PRSA. Employers that do not offer a pension plan are required to designate at least one Standard PRSA product to which their employees may contribute. This account may charge fees up to a limit of 5 percent of contributions and 1 percent of assets per year. In the United States, fees charged to pension participants vary from 0.07 percent of assets for an S&P 500 stock index fund available to 401(k) participants, up to more than 3.0 percent for an actively managed international stock fund (Turner and Korczyk 2004). The PRSA plan fee limits would thus be at the higher end of what U.S. pension plan participants could expect to pay.

Other than temporary holdings of cash, Standard PRSAs may invest only in pooled funds (investment entities that are similar to mutual funds). Most PRSA contracts in force to date are Standard PRSAs. (See further discussion in "Participation and Contributions," below.)

Nonstandard PRSA. This account is a contract that does not limit plan fees and/or allows investment in assets other than pooled funds.

Neither the Standard nor the Nonstandard PRSA may charge the participant for transferring the value of the account to another provider or to an employer-sponsored plan. An employee can also transfer balances from an employer-provided pension plan to a PRSA if the employee has 15 or fewer years of covered service, and the plan is being terminated *or* the employee is changing jobs.

PRSA providers may impose minimum limits on contributions and account transfers. The provider may terminate a small account that has been inactive for two or more years and return the account balance to the account owner.

As of 2003, 52 PRSA products offered by 10 providers had been approved. Approved providers included eight insurance companies, one investment company, and one building society (bank). Agents may sell PRSAs on behalf of approved providers.

Employers are required to designate a PRSA provider for eligible employees, but eligible employees need not contribute to that PRSA or, indeed, to any PRSA at all. An eligible employee may open a PRSA with any authorized provider. An employee who chooses to use a provider other than the one designated by the employer must make contributions directly to that provider, however, while those using the employer's designated provider may contribute through payroll deduction.

Participation and Contributions

While PRSA eligibility is broad, participation, as measured by enrollment and contributions, has been more limited. As of the end of September 2005, 59,251 PRSAs had been opened. Of this total, 46,359 were Standard PRSAs and 12,892 were Nonstandard PRSAs. Assets held in PRSAs totaled €329 million.[4]

At the end of September 2005, 74,284 employers had signed up with a PRSA provider under the employer mandatory access requirements (table 1). As of that date, 25,555 employees had taken out PRSAs through their employers. This total is equivalent to more than 1 percent of the economically active population.[5] Of the 74,284 providers designated by employers, only 8,193, or 11 percent, reported contributions. Many plans are thus "empty shells." The Irish government has committed itself to aggressive monitoring of employer compliance with the mandate (Parliament of Ireland 2003).

Regulation

Several regulatory entities are responsible for approving and monitoring PRSA providers and resolving disputes concerning the operation of these plans.[6]

The Pensions Board. The Pensions Board and the Revenue Commissioners, the Irish tax and customs authority, share the responsibility for approving PRSA products. The Pensions Board regulates both employer-provided pension schemes and PRSAs. The board is charged with promoting the security and protection of plan participants and improving pension structures and retirement income adequacy (Pensions Board 2005b).

The board can also investigate, prosecute, and bring court action in cases where pension laws have been violated (Pensions Board (2003b). The board includes government representatives as well as representatives of trade unions, employers, pension plan trustees, the pension industry, consumer interests, pensioners, and various professional groups involved with employer-provided pension plans and PRSAs, such as actuaries and accountants.

The Revenue Commissioners. Ireland's tax and customs authority is in charge of administering the tax provisions governing contributions to and benefits paid from retirement plans, including PRSAs.

The Pensions Ombudsman. The Pensions Ombudsman is an independent entity authorized under law to investigate and resolve disputes concerning pension plans, including PRSAs. The Ombudsman also investigates disputes of facts or law concerning pensions.

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[4] As of January 23, 2006, US$1.00 was equal to €0.81. US$1.00 was equal to £0.56.
[5] Author's calculation based on the Pensions Board (2005a) and on the International Labour Organisation (200**5).**
[6] As of this writing, information on the incidence of PRSA regulatory violations and their prosecution by responsible authorities was not available.

The Insurance Ombudsman. Some PRSAs are structured as insurance policies. The Insurance Ombudsman can investigate and resolve complaints regarding such accounts.

The Irish Financial Services Regulatory Authority (IFSRA). IFSRA regulates all aspects of financial services and can resolve disputes concerning the selling or mis-selling of PRSAs.

Tax Treatment and Deduction Limits

PRSA contributions are exempt from income taxes as well as Social Security and health system taxes (Health Levy) up to the tax deductibility limits. These limits range from 15 percent to 30 percent of earnings and increase with the employee's age (table 2). Employee contributions to all types of retirement savings plans, including employer-provided pensions, are aggregated for the purposes of these limits. PRSAs thus act to fill in gaps in the availability and quality of employer-provided pension coverage and are not intended to duplicate or overlap with other tax-deferred savings vehicles. Nondeductible contributions are permitted. Investment returns are tax deferred during the funding period. Annual earnings are capped at €254,000 for PRSA purposes.

Benefits are fully taxed. Upon taking benefits, account owners must annuitize at least part of their account balances unless they have a pension or life annuity that meets a minimum standard.

Relationship to Other Retirement Income

The basic Social Security pension is a flat benefit payable to those who meet the contribution conditions under one of nine separate sets of rules.[7] Therefore, even though PRSA contributions benefit from tax relief, the exclusion of these contributions from the Social Security tax base does not affect the PRSA participant's Social Security benefits. Consequently, benefits from PRSAs are additive to Social Security benefits.

Summary

PRSAs are intended to fill in gaps in the system of employer-provided pensions. They also provide a retirement savings opportunity for those outside the workforce. Employers are required to offer a plan if they have even one eligible employee.

PRSAs have had a slow start; both employer compliance and employee participation and contributions have been low. This could be attributed to a number of causes. One possibility is that a population-wide savings plan may take time to catch on, especially if it is aimed at workers with no pension experience. The Irish government has also committed itself to aggressive monitoring of employers' compliance with the mandate.

[7] These rules vary by age and contribution history (Government of Ireland 2006).

GERMANY

Introduction

Germany is one of the oldest industrialized nations in demographic terms, with 19.3 percent of the population aged 65 or older in 2004 (OECD 2005b). Germany is also facing profound demographic stresses, with a rapidly aging population and low fertility. Over the next 30 years, Germany's overall population is projected to decline by 5 percent, and the working-age population is projected to decline by more than 10 percent (Watson Wyatt Worldwide 2005).

Given these problems, German policymakers determined that the retirement income system needed reform to remain financially sustainable over the long term. A complex reform was enacted in 2001 and went into effect on January 1, 2002. The reform is called the "Riester reform" after Walter Riester, the labor minister at the time the reform was enacted. A subsequent pension reform that simplified several aspects of the Riester reform was enacted in 2004 and went into effect on January 1, 2005.

The German pension system had been under constant financial pressure since the unification of the two German states in 1990 (Bonin 2002). The Riester reform was designed to alleviate these pressures by reducing the share of retirement income provided through Social Security and increasing the share provided through private, funded pensions. The Riester reform had several major goals:

- Stabilizing contribution rates and reducing replacement rates in the Social Security retirement system

- Promoting both individual and occupational, or employer-sponsored, funded private pensions as a way to offset the planned decline in Social Security benefits

- Creating a true multipillar retirement system, as opposed to the prior public sector–based system

In particular, the Riester reform introduced pension funds based on the defined contribution principle for the first time. Although this type of plan had long been available in other countries, it had not been available in Germany prior to the Riester reform (Boersch-Supan 2005). The Riester pensions thus represented a major effort by policymakers to change the structure of the pension system.

The reform introduced defined contribution plans based on the salary- conversion concept. This feature is analogous to salary-reduction plans in the United States. Under a salary-conversion plan, an employee may request that up to 4 percent of the salary subject to Social Security contributions be contributed to a company pension. Riester pensions include both individual and occupational pensions.

Coverage and Participation

Coverage. While Irish employers must offer PRSAs and UK employers must offer stakeholder pensions if they and/or their employees meet certain criteria, German employers must offer salary-conversion plans only on "request" by their employees. Such requests may include provisions in negotiated collective bargaining agreements.

Participation. Riester pensions have grown substantially from a slow start. The take-up rate grew from 9 percent of eligible workers in 2002 to 35 percent in 2003 (Boersch-Supan and Wilke 2003). By 2004, 20 million workers, or nearly half the workforce, were covered by collective bargaining agreements providing for salary conversion (Federal Republic of Germany 2005).

Unions have been an important factor propelling the growth of Riester pensions for both members and nonmembers. Collective bargaining agreements formally bind only the parties to the agreements, but employers typically apply the terms of the agreements to all employees, whether or not they are union members, and the government can declare certain contracts binding on all the employees in a given region and industry (European Industrial Relations Observatory On-Line 1999).

But coverage does not necessarily lead to new retirement savings. By one estimate, as many as half of the participants in Riester pensions transferred funds from unsubsidized retirement savings vehicles (Boersch-Supan 2005).[8] Yet even in the presence of substitution, the growth of Riester pensions may advance the overall goals of the reform. Because benefits from Riester pensions are available only in annuity form, even transferring existing savings into Riester pensions can help to fill the retirement income gap resulting from planned reductions in Social Security benefits.

Institutional Arrangements[9]

The Riester reform encompasses issues ranging from tax and pension policy to pension-related family benefits. The present discussion focuses on the salary-conversion plans and does not consider the changes to the Social Security system.

While the design of Irish PRSAs and UK stakeholder pensions emphasizes flexibility and ease of use, the design of German salary-conversion plans emphasizes adherence to standards. Key standards include annuitization, the minimum benefit guarantee, and charges and contribution rules.

Annuitization. For a pension to qualify for the Riester tax incentives (See further discussion in "Tax Incentives and Deduction Limits", below), either most of the accumulated capital must be annuitized, or the plan must offer at least a fixed yearly payment if annuitization is deferred to age 85. While some supplementary survivor's

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[8] Stakeholder pensions in the United Kingdom have also tended to receive transfers from other savings, primarily other pension schemes (see "United Kingdom," below).
[9] This discussion relies on Bonin (2002), Boersch-Supan and Wilke (2003), and Boersch-Supan (2005).

coverage is permitted, the annuitization requirement effectively means that pension benefits cannot be bequeathed, assigned, or pledged as collateral. This requirement is not popular, because many Germans prefer to be able to use their account balances as loan collateral or bequeath them to survivors (Boersch-Supan 2005).

Minimum benefit guarantee. At the participant's retirement, the nominal value of the fund—including any subsidies paid into the fund—must be at least equal to the value of accumulated contributions, and lifelong benefits must at least maintain their nominal value over the participant's lifetime. This guarantee differentiates the salary-conversion plans from PRSAs, stakeholder pensions, IRAs, and section 401(k) plans, where the participant bears the full risk of market value fluctuations.

But the employer's guarantee is limited. The nominal value guarantee protects the employee only against a loss of invested and contributed capital. Over time, with inflation, the real value of the pension account will decline even if the guarantee is invoked. The employee thus bears the plan's investment risk, with the employer's guarantee acting to protect the employee against catastrophic losses.

Even though the guarantee might have little long-term value to the participant, however, the employer would likely protect itself against the risk that it would be invoked. Accordingly, the guarantee is likely to reduce plan returns, as cautious investment managers will invest in fixed-income instruments over equities (Bonin 2002).

Charges and contribution rules. Initial commissions and administrative charges must be spread equally over at least 10 years. Other than this requirement, investment fees and other plan costs are not regulated, although costs must be disclosed when a plan is initiated as well as yearly thereafter. A participant must be allowed to suspend or discontinue contributions, as well as terminate the policy, with three months' notice.

The numerous requirements imposed on Riester pensions have led some observers to conclude that these pensions are overregulated (Bonin 2002). Although strong regulation may enhance consumer protection, it may provide a formal product standard rather than the transparency consumers need to make informed (Boersch-Supan and Wilke 2003). Stringent regulation also increases the cost of pensions (Boersch-Supan and Wilke 2003). But others suggest that as financial service providers compete for Riester pension contributions, the transparency of products, expenses, and investment returns can increase (Schwind and Klein 2002).

Regulation

Regulatory duties for Riester pensions are shared by several governmental agencies, depending on the funding instrument used.

The Federal Financial Markets Authority. This entity is charged with certifying Riester pension plans. Certification is based on compliance with regulatory requirements (see "Institutional Arrangements," above).

The Federal Insurance Authority. Investment vehicles permitted for funded pensions are also subject to the jurisdiction of the Federal Insurance Authority. The Insurance Supervisory Act regulates investments in insurance plans.

The Government Pension Insurance Fund. This fund insures pension funds against insolvency. No investment limitations apply to pension funds.

Tax Treatment and Deduction Limits

The Riester pensions—both individual and occupational—carry a direct subsidy for lower-income households. The Riester reform took into consideration that many lower-income households would not benefit from tax deferral because they did not pay income taxes. These households may thus have no incentive to accumulate retirement income. To ensure that everyone has incentives to save for retirement, the reform includes a direct savings allowance for households based on income. For the lowest-income households, the subsidy is almost as large as the contribution itself (Boersch-Supan 2005).

Tax incentives for saving are conveyed as a rebate, or return, of taxes the participant paid on the pension contribution, rather than, as in the United States, exclusion of the contribution from income subject to tax. Households receive the greater of the tax rebate or the direct savings allowance, paid directly into the pension account. A nonworking spouse is eligible for the allowance as long as pension contributions are made on that spouse's behalf. An extra allowance is also available for each child; children are seen as future contributors to the pay-as-you-go public pension plan and therefore worthy of support (Bonin 2002).

Only participants in funded pension plans are eligible for the Riester incentives. Book-reserved plans, where pension accruals are carried on the employer's books as a liability, may not be restructured to take advantage of these incentives.

The tax-deductible contribution rate for both individual and salary-conversion Riester pensions rises in increments from 1 percent of earnings in the introductory year (2002) to a fully phased-in value of 4 percent in 2008. This percentage is calculated in relation to the share of earnings subject to taxation on behalf of the public pension system. Both employer and employee contributions are permitted. Employee contributions to a salary-conversion plan vest immediately. Employer contributions vest after five years as long as the employee is at least 30 years old.

The 2004 reform extended the general principle of tax-free contributions and taxable benefits to all types of pension plans. Employer and employee pension contributions will gradually become tax free up to a ceiling, while most pension benefits will become fully taxable (Hewitt Associates 2004). This treatment follows a European Commission initiative encouraging uniform pension taxation principles across the European Union.

Relationship to Other Retirement Income

One author believes that Germans have an “emotional attachment…to the pay-as-you-go principle” for funding retirement income (Bonin 2002). This attachment is based on the belief that funded private pension funds weaken the intergenerational solidarity considered characteristic of the Bismarckian social insurance model. Supporters of funded pensions, in turn, argue that such pensions are essential to avoid unmanageable stress on the Social Security system.

Riester pensions, including salary-conversion pensions, are thus seen as a true innovation in retirement income policy. They represent an attempt by policymakers to break with a long history.

Summary

Riester pensions offer both tax incentives and direct subsidies to employees as well as individuals. Riester pensions are not yet universal, despite the generous subsidy offered to lower-income households.

However, frequent changes in pension law, along with lengthy transition periods, exemptions, and special regulation, are believed to encourage those eligible to defer participation (Cheuvreux-Germany 2004). Moreover, since the tax-deductible contribution ceiling for Riester pensions is not only modest but also not yet fully effective, many potential participants may feel they can postpone a decision without serious financial disadvantage (Becker and Deutsch 2003).

UNITED KINGDOM

Introduction

The United Kingdom is one of the older industrialized countries in demographic terms. While persons aged 65 or older constitute 12.4 percent of the U.S. population and 11.1 percent of the Irish population, 15.6 percent of Britons are 65 or older (OECD 2005b). Retirement income issues are important public policy questions in the United Kingdom.

In the United Kingdom, retirement income is provided through a complex system comprising several components:

- The basic state pension, a flat amount that depends only on the years of contributions credited
- The state second pension (S2P)[10], an earnings-based addition to the basic pension that is not available to the self-employed

[10] The S2P replaced the State Earnings-Related Pension (SERPS) in 2002.

- Occupational pensions offered by employers, also not available to the self-employed

- Personal pensions that are available to both wage and salary workers and the self-employed

- Stakeholder pensions, which, like personal pensions, can be initiated individually or through an employer

Despite the apparent breadth of options, less than half of the working-age population—38 percent of women and 46 percent of men—was accruing rights under a private pension in 2003–2004 (Pensions Policy Institute [PPI] 2005). Most employees without pensions work in smaller firms. In 2003, 85 percent of employers with 1,000 or more employees provided an occupational plan, compared with fewer than 15 percent of employers with fewer than 20 employees (National Statistics Online 2005).

Stakeholder pensions were inaugurated in October 2001. They were intended primarily for the 4 to 5 million workers with earnings between 50 percent and 100 percent of the national median and no private pension.

Coverage and Participation

Some employees must be allowed access to a stakeholder pension, while others may be excluded even if the employer is required to offer a plan. Some groups may also purchase stakeholder pensions directly.

Mandatory stakeholder pension access for certain employees. Employers without occupational pensions are required to offer designated stakeholder pensions unless

- they have fewer than five employees;

- they offer an occupational pension plan that all employees are eligible to join after one year of employment; or

- they contribute at least 3 percent of the employee's earnings into another form of personal pension, so long as that pension has no penalties for employees who leave the plan and meets certain other conditions.

Employees who may be excluded. Although an employer may be required to designate a stakeholder pension, the employer may exclude certain employees from the plan. Employees may be excluded if they

- have been employed by the sponsoring employer for fewer than three consecutive months;

- are already enrolled in the employer's occupational pension plan or declined enrollment when it was offered;
- are excluded from the occupational pension plan based on its age rules (if the plan provides that workers under age 18 or within five years of the plan's normal retirement age may be excluded); or
- earned less than the lower earnings limit subject to Social Security contributions[11] for one or more weeks during the previous three months.

Lower earners, frequent job changers, and certain younger and older workers may thus still find it difficult to earn substantial pension credits.

Voluntary coverage. Other groups may purchase stakeholder pensions directly, on a voluntary basis. These persons include the following:

- Participants in occupational pensions whose contributions to their occupational plan are below Inland Revenue (tax authority) limits
- Self-employed and unemployed persons
- Those not working because they are caring for a child under age six or for a disabled person and are eligible for certain state benefits for that reason, or who have a long-term disability themselves

All stakeholder pensions must be contracted out of the S2P; that is, they must guarantee to pay a pension at least as good as that available under the S2P.

Participation and contributions. In 2003, 52 percent of employers provided their employees with some type of pension or access to pensions, compared with 29 percent in 2000. UK authorities believe that this expansion was partly driven by the introduction of stakeholder pensions (National Statistics Online 2005).

Nevertheless, some 70,000 employers may not be in compliance with the requirement to designate a stakeholder pension plan (United Kingdom House of Commons 2004). In addition, as of 2003, 82 percent of designated stakeholder plans were "empty shells" with no members (Association of British Insurers [ABI] 2003).

Employee contribution patterns have been disappointing; designated plans are not necessarily generating substantial new savings. Many payments into stakeholder pensions are transfers from other pensions and thus do not represent new saving. New contributions, in turn, tend to be small, averaging £117 monthly overall, £90 for employer-sponsored plans, and £155 for individual plans. Contributions among targeted workers—those earning between £10,000 and £19,999 annually—are even lower; these

[11] Social Security contributions are not levied on earnings below a minimum level.

participants contribute an average of only £46 to £67 monthly (author's calculation based on ABI [2003]). At these contribution rates, stakeholder pensions in their current form may not generate substantial retirement income.

Employers are not required to contribute to designated plans, but employer contributions are critical to employee participation. Among plans with members, 90 percent receive employer contributions. Among eligible employees, 13 percent participate if the employer does not contribute, but 70 percent participate if the employer does contribute.

Institutional Arrangements

Like PRSAs, stakeholder pensions are designed to be flexible and easily transferred among pension providers. Employees whose employer designates a stakeholder plan need not use that provider, but if they choose another provider, they must make contributions directly rather than through payroll deduction.

Stakeholder pensions were developed in part due to the very large administrative costs that have been associated with personal pensions.[12] For persons joining a stakeholder pension plan on or after April 6, 2005, administrative fees are limited to 1.5 percent of assets, falling to1 percent after 10 years of participation. As in the case of Ireland's PRSAs, however, these charges are high by American standards. Pension funds may pass on to participants certain other fees as specified by law and may also impose other charges if they are contractually agreed and disclosed. Some charges are prohibited, however; participants may not be charged for stopping or restarting contributions or transferring to another plan.

Managers or trustees of stakeholder accounts are not restricted in their investment of plan assets. Participants may make their own investment choices. However, if those nearing retirement do not choose otherwise, their balances will be "lifestyled," or invested in steadily less risky investments as they age.

Regulation

As in Germany and Ireland, several regulatory and "watchdog" bodies are responsible for approving and regulating stakeholder pension plans.

The Occupational Pensions Regulatory Authority (OPRA) and Inland Revenue. OPRA and Inland Revenue share responsibility for ensuring that stakeholder pensions meet the statutory and tax conditions. OPRA maintains a roster of registered (approved) stakeholder pension plans.

The Pensions Ombudsman. The Pensions Ombudsman is an independent agency, constituted by Parliament, whose head is appointed by the secretary of state for work and

[12] During the 1990s, many occupational pension participants were pressured and misinformed into abandoning generous occupational pensions in favor of high-cost personal pensions. For an explanation of the scandal and its consequences, see Gillion et al. (2000).

pensions. The Ombudsman deals with complaints concerning the management of occupational, personal, and stakeholder pensions.

The Financial Services Authority (FSA). The FSA is an independent government "watchdog" responsible for regulating financial services and protecting consumer rights. The FSA regulates commercial financial services providers that offer stakeholder pensions.

The Financial Ombudsman. The Financial Ombudsman Service is an independent agency that resolves disputes between consumers and financial firms concerning the selling or marketing of personal and stakeholder pensions.

Tax Treatment and Deduction Limits

As in Ireland and Germany, the stakeholder pension plan contribution is made from after-tax earnings. The tax authority then makes tax relief payments on behalf of eligible contributions directly into the pension account.

Two kinds of tax relief, or rebates, are available, both based on the participant's age and earnings: income tax rebates and rebates of the National Insurance Contributions paid on the stakeholder pension contribution. Participants may generally contribute up to £3,600 annually to their stakeholder pension. This total includes employee/participant contributions; employer contributions, if any; and income tax relief paid by the tax authority into the plan. The limit does not include the National Insurance Contributions rebate paid on behalf of participants who have contracted out of the S2P.

Relationship to Other Retirement Income

The relationship between stakeholder pension plans and other retirement income options is complex. Workers, as well as certain people outside the workforce, may rely entirely on government plans for their retirement savings, or may hold a mixed portfolio of public and private plans. Those who are offered private plans, or who choose a personal or stakeholder pension, also have a range of choices. Workers may opt out—contract out—of the S2P to enroll in a qualified private pension plan—and then reverse their decision if their circumstances change. Joining an employer's pension plan is not mandatory; workers may opt out of an employer plan in favor of a personal or stakeholder pension. Further complicating the relationship between various sources of retirement income, the UK retirement income system has changed frequently over the last two decades, often before the prior set of changes had fully phased in or been comprehensively evaluated.

Summary

Like the Irish PRSAs, stakeholder pensions are intended to fill gaps in the voluntary employer-sponsored pension system as well as to generate new retirement savings opportunities for those who, for one reason or another, are not accruing benefits under the employer-based system.

Also like PRSAs, however, the combination of an employer mandate with voluntary employee participation has not yet fulfilled expectations. Not all targeted employers are complying with the legal requirement to designate plans. Even if the employer does designate a plan, the plan may, by law, exclude certain employees. Many designated plans have no participants. Many employees who do participate make small contributions or transfers from other plans rather than contribute new savings.

CONCLUSIONS

Since 2001, three countries with similar pension systems have adopted mandatory 401(k)-type pension plans. Germany and the United Kingdom are already aging and are trying to mitigate the long-term fiscal impact of demographic changes on their Social Security programs. Ireland, while a demographically young country, is trying to avert future fiscal problems. Particularly in the United Kingdom, coverage gaps had proven resilient to other policy initiatives. Furthermore, in no country were coverage gaps or benefit shortfalls likely to be filled through expansion of Social Security programs.

Several lessons can be drawn from the experience with these programs.

Employer Contributions

Perhaps the single most important conclusion from this review is that employer contributions drive participation. In the United Kingdom, eligible employees whose employers contribute to the plan are more than five times as likely to contribute themselves as those whose employers do not contribute. As in 401(k) plans, employers may contribute but are not required to do so.

Even when employees do contribute, however, their contributions may not all result in new savings. In both Germany and the United Kingdom, a substantial share of plan contributions has come from other pension plans or savings vehicles.

Participation

A program's impact on coverage depends critically on its goals. Eligibility for the Irish and UK employer-based programs is drawn fairly narrowly, encompassing primarily those workers with no private pension coverage or coverage that is deemed by government standards to be inadequate. These criteria tend to target lower-wage, intermittent, or highly mobile workers, and those in smaller firms. Both countries have found that workers' take-up rates have thus far been disappointing.

In Germany, in contrast, salary-conversion plans were made mandatory on all employers, as long as employees requested that a plan be offered. The mandate applied regardless of employer size or prior pension offerings, because the program's goal was to ease the transition to lower Social Security replacement rates rather than to target workers with no

pension coverage. Unions also actively pursued salary-conversion plans as a desirable element of collective bargaining agreements. As a result, more than half the workforce was covered by a Riester pension by 2004.

Enforcement and Education

Both Ireland and the United Kingdom have found that not all targeted employers comply with the designation requirement. Because targeted firms tend to be small enterprises, both enforcing pension requirements and educating potential participants about retirement savings may pose challenges.

Fees and Participant Education

Mandatory plans should be held to a high standard regarding transparency of charges and fees in the investment options they offer. Participants should understand what it costs to save for retirement; which transactions cost them money; and what happens to small, inactive, or lost accounts. Participants should be offered investment options with moderate fees, but ones that can still generate an adequate retirement income or an adequate retirement income supplement.

Future Research

As their populations age, many developed countries will look for policy options to increase the share of retirement income delivered through private pensions, and employer mandates will probably be considered. Accordingly, it is likely that these programs will continue to be studied for their effectiveness and efficiency.

Future research should include collecting detailed data on coverage and participation in these plans. Such efforts should focus especially on part-time and contingent workers, whose pension coverage historically has been limited. Research on coverage should also include an effort to understand which, if any, firms are noncompliant with the mandate, and why. Such efforts should be separate from enforcement efforts aimed at punishing noncompliance. Understanding which firms opt out of the mandate could help in the design or redesign of more effective policy interventions.

Finally, both researchers and policymakers need to know whether mandatory private pensions can help stabilize troubled Social Security programs. Social Security changes are typically implemented with a long lead time, so it will be some time before it is possible to determine whether improved private pension coverage can reduce fiscal pressures on Social Security programs. However, if making 401(k)-type plans mandatory expands private pension coverage, policymakers might be able to consider a wider range of Social Security policy options.

Lessons for the United States

Participation in pension plans sponsored by private-sector employers in the United States has been stagnant for a long time. Put simply, not much—even the popular and flexible 401(k) plan—has worked.

Three countries have adopted a new retirement policy model—a defined contribution plan propelled by an employer mandate. In Ireland and the United Kingdom, these plans are directed at employees and employers who have proven hard to reach with other pension interventions.

The experiences of these three countries suggest that employer pension mandates may not expand private pension coverage substantially in the near term. But the United States may have advantages over these countries in making such plans work. PRSAs, salary-conversion plans, and stakeholder pensions are relatively new ideas that have yet to gain a foothold in the popular imagination. In contrast, the 401(k) plan is part of the popular vernacular. Many employees who are currently without coverage may have participated in a 401(k) plan in a prior job or have a spouse, other family member, or friend who has done so. Employees covered by a mandate are thus likely to be familiar with at least the basic concept.

Another circumstance favoring the United States is that employers that already sponsor 401(k) plans have had substantial success in attracting employee participation through automatic enrollment. Under this approach, employees are automatically enrolled in a plan at a small threshold contribution rate. They must make an affirmative decision to opt out of contributing to the plan—and most do not. Automatic enrollment combined with an employer mandate could be the “magic bullet” that would spur private pension growth.

While the 401(k) plan has been very popular, it has not delivered universal private pension coverage. It may be time to ask whether making it mandatory can close the deal.

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TABLES

Table 1. Personal Retirement Savings Accounts as of September 30, 2005, in Euros and Numbers of Plans and Participants

FEATURE	VALUE
Total assets	€329 million
Average asset value per contract	€5,551[a]
Number of PRSA Contracts	
By type	
Standard	46,359
Nonstandard	12,892
Total	59,251
By sponsorship	
Employer-based	25,555
Individual	33,696
Total	59,251
Employer-Designated PRSAs	
Employers designating a provider	74,284
Number of contracts under employer designations	25,555
Number of designations with contributions	8,193

Source: Author's calculations based on Pensions Board (2005a).

[a] Total assets divided by number of contracts.

Table 2. Annual Limits on the Tax Deductibility of PRSA Contributions

AGE	PERCENT OF NET RELEVANT EARNINGS[a]
Younger than 30	15
30–39	20
40–49	25
50 and older	30

Source: Pensions Board (2003a)[a]

[a] See text for definition.