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# Pillar Interaction and System Robustness

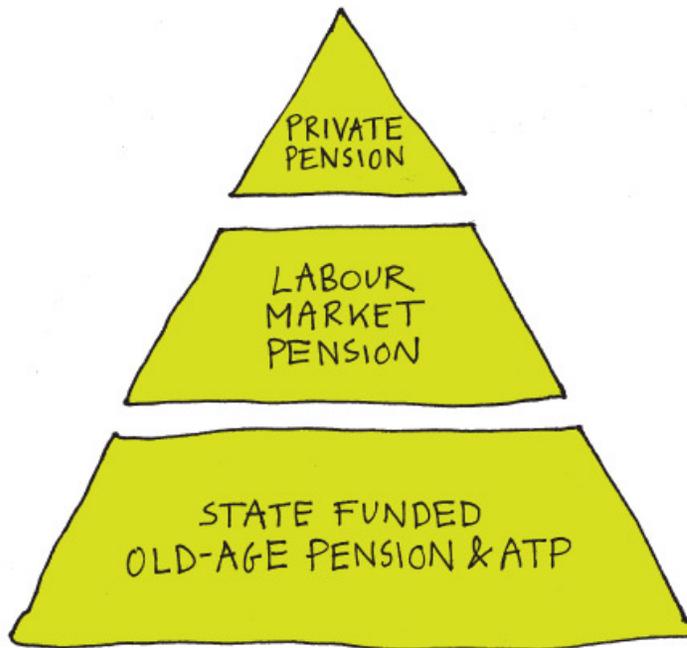
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## - experiences from Denmark

24 June 2015. Ole Beier Sørensen, Chief Pension Researcher, ATP.



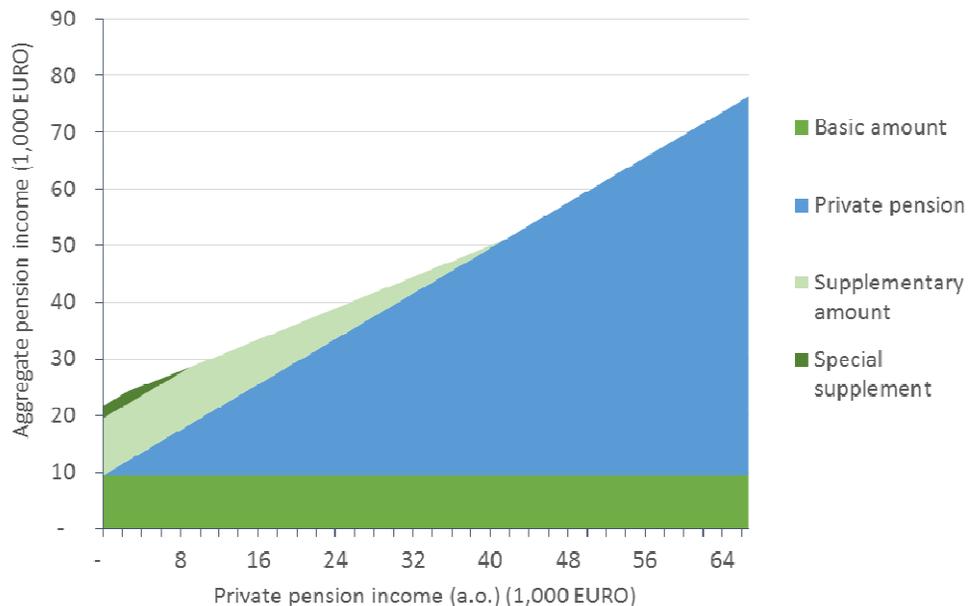
## The Danish pension system.....



- Long term financial sustainability
- Adequacy
- Intergenerational equity
- High scores on three key objectives:
  - Poverty alleviation
  - Income replacement
  - Risk sharing
- No labour market distortions
- Clear incentives for deferred retirement

## ....targets public benefit by way of income testing...

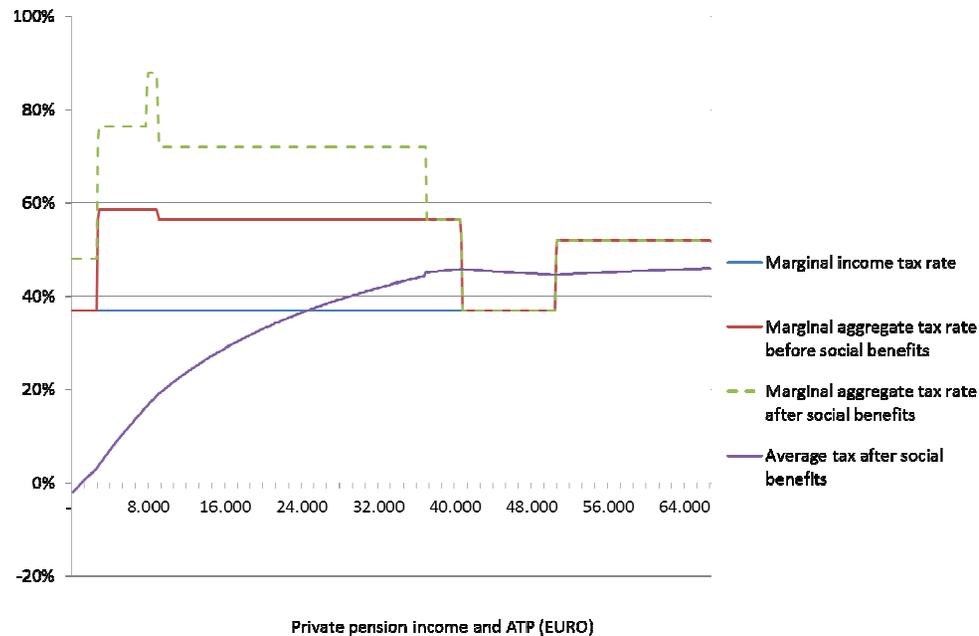
Income testing the basic pension (singles 2015)



- The full basic pension is higher for singles than for spouses/co-habitants
- The basic pension is income tested
- A higher private pension will mean a somewhat lower public pension
- Taper rates above a certain private income threshold:
  - 30.9 pct. for singles
  - 15 pct. for couples at household level
- **A particular Danish point:**
  - Policy driven solidarities rely entirely on the public pension and on pillar interaction

## ...thereby creating high implicit marginal tax rates...

Explicit and implicit tax rates – single retirees

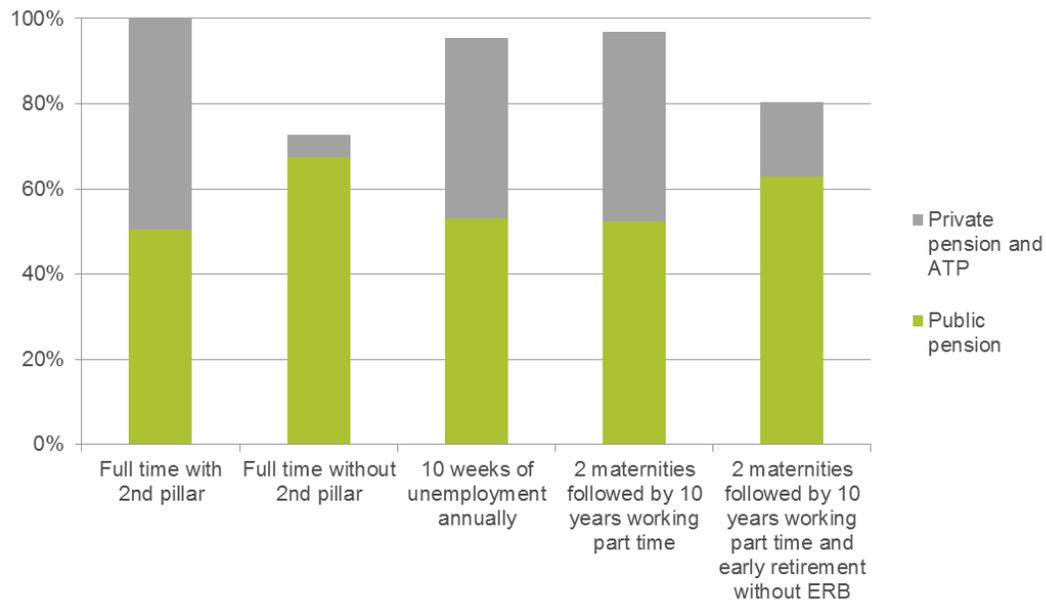


- Public benefits are targeted by way of income testing (cf. above)...
- ...leading to high implicit tax rates
- A matter of quite some dispute...
- ....as work and savings incentives are affected

Source: ATP 2014.

## ...while facilitating extensive risk sharing

Net pension result and work life course (single APW)

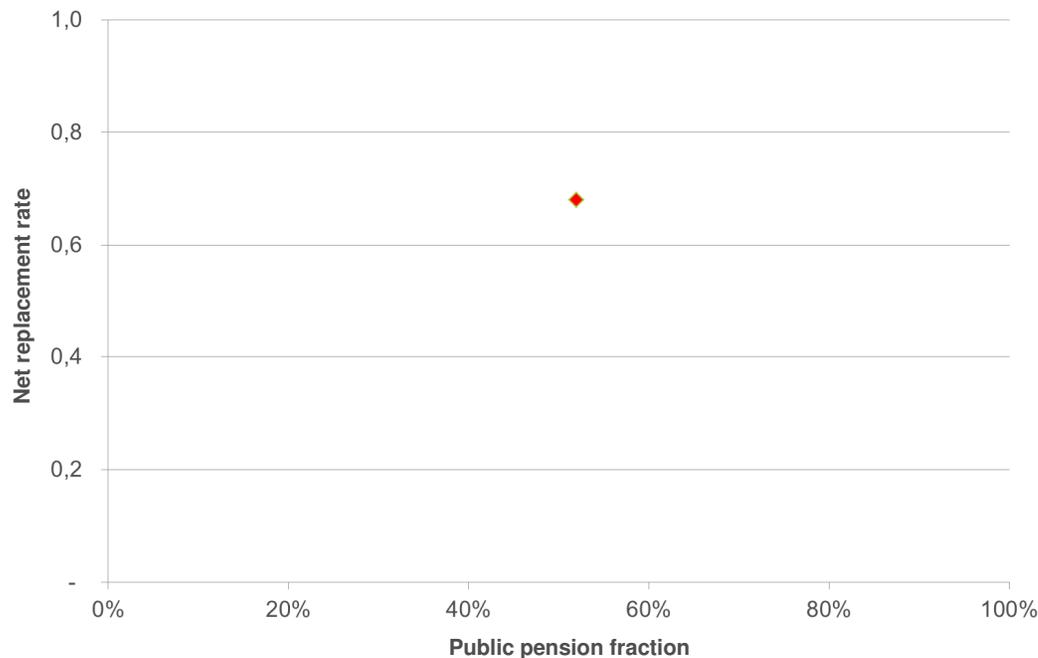


- 2nd pillar coverage is generally important,...
- ...and spells of unemployment or other adversities have net-pension effects
- However, the consequences of standard life choices and life events are reduced...
- ...as the interaction of pillars picks up some of this income risk...
- ...and shifts it from the individual onto society

Note: Modelled 25 year old APW entering the labor market in 2014. Source: ATP 2014.

# Financial development and pensions are linked...

Net-replacement rate and public pension fraction (single APW)



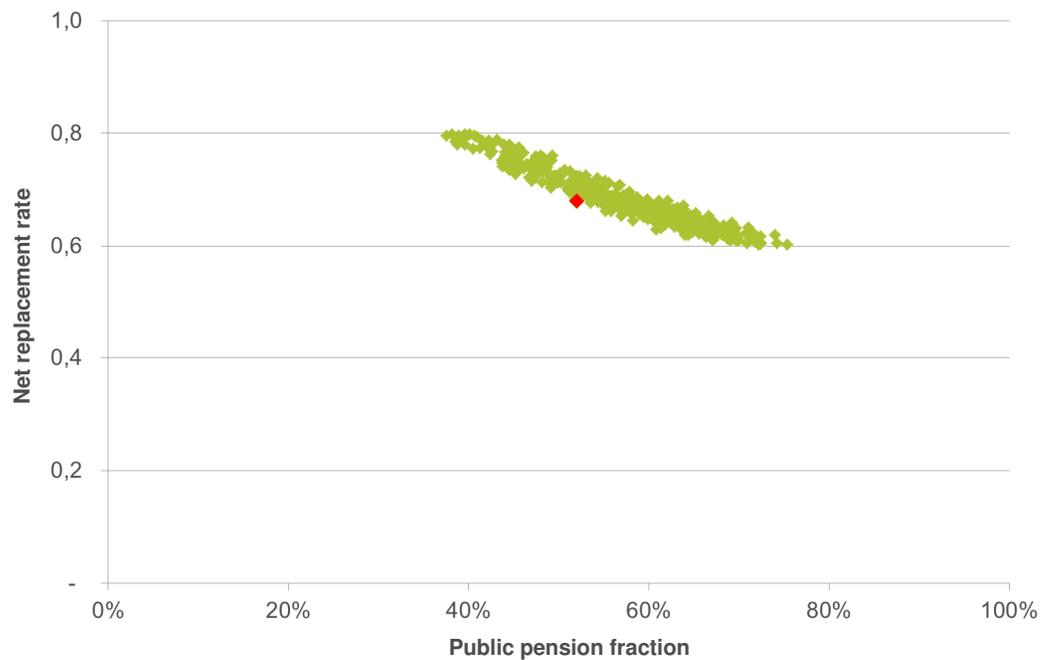
- **Consider the nurse, Anna:**
  - A standard scenario provides a net replacement rate of 70...
  - ...and a public pension fraction of around 50
- **But the standard scenario is deceiving....**
- **...inflation, wage growth and investment returns are not stable over time**



Source: ATP 2015.

# Financial development and pensions are linked...

Net-replacement rate and public pension fraction (single APW)

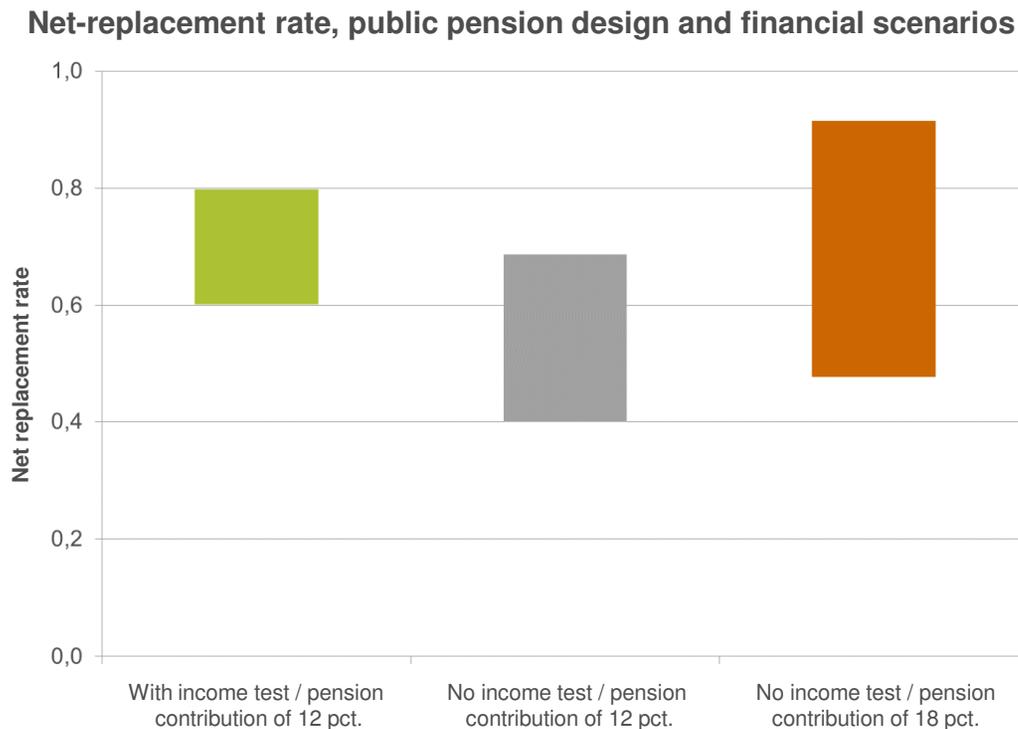


- Exposed to 500 variable scenarios...
- ...Annas' pension outlook looks less certain:
  - The net-replacement rate ranges between 60 and 80...
  - ...while the public pension fraction ranges from 35 to 75

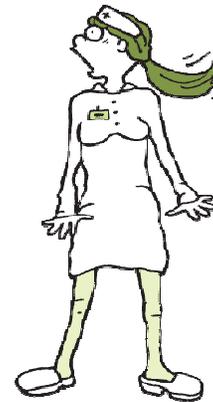


Source: ATP 2015.

## ...and without pillar interaction uncertainty increases



- Without income tested benefit elements private pensions will be more important...
- ...and so will risks related to private pensions
- Anna would be facing much greater uncertainty as regards old age income



- Anna would need to cope...
- ...but how?

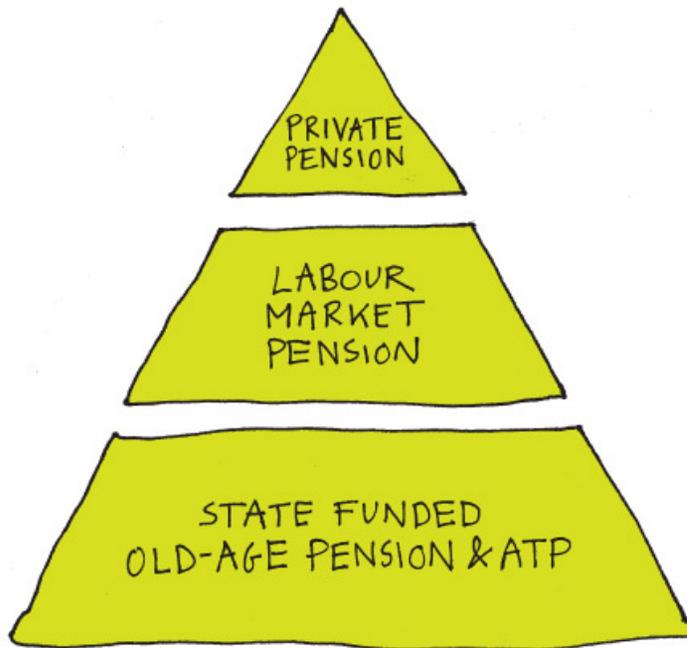
Source: ATP 2015.

## Pillar interaction provides robustness....



- Life is uncertain
- Pillar interaction reduces risks
  - Small private pension
  - Adverse labour careers
  - Unfavourable investment results
  - Post-retirement private income loss
  - Business cycles....
- Pillar interaction helps handle general uncertainties of life

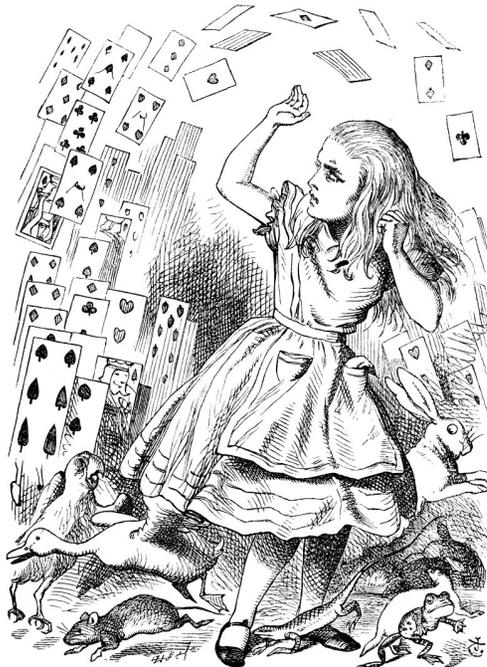
## Possible take home lessons...



- Apply a multi-pillar approach in order to meet diverse objectives
- Be clear about the public/private division of responsibilities...
- ...and do not confuse risk sharing and politically driven redistribution
- Legitimacy and transparency go together...
- ...and probably individual property rights is a prerequisite
- But still: Collectivity pays!...
- ...and the base line is the same:

**You cannot escape the balancing act:  
Incentives versus social concerns**

## ...Denmark is doing good - but challenges remain



*” ...it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that”*

- Adequate, sustainable and equitable
- Danish style pillar interaction leads to high implicit tax rates...
- ...especially for low and mid-income groups
- ...while being crucial to risk sharing, solidarity and system robustness
- There are no easy fixes available in the balancing act