An Introduction to the Danish Pension System

Senior Economist Jens-Christian Stougaard (jcs@lo.dk)
The Danish Confederation of Trade Unions (LO-Denmark)

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1. Introduction

The Danish pension system has gone through a reform-process for the better part of the last decade. The main changes have been the introduction of labour market pension schemes for privately employed blue- and white-collar workers, which were established in 1989-1993 plus revisions of the three tax financed retirement schemes. In total the movement towards more weight on a funded system with less weight on 'pay-as-you-go' financing of future pensions has continued.

The three tax-financed retirement-benefits can be summarized as:

- State retirement pension at the age of 65.
- Early retirement benefit from the age of 60 (only available to persons who have contributed to unemployment insurance for at least 25 out of the last 30 years before early retirement).
- Early retirement pension (can be given to a person – regardless of age (18-64 years) – who have lost at least 50 per cent of their working capability).

The first and last are purely tax-financed on a 'pay-as-you-go' basis whereas the middle is partly (1/4) financed by the insured. Focus of this paper will be on the state retirement pension and the labour market pensions plus the possibilities of supplementary payments in all of the above schemes.

The Danish pension system has two main unique features, which the presentation below will focus on. First of all Denmark has – in line with Sweden – an element of individual savings in the state retirement / statutory schemes. Secondly, our Labour Market Pension Schemes, which are based primarily on collective agreements, only exist in two other countries – the Netherlands and Iceland.

In the next section highlight will be put on these special features as the three pillars of the Danish pension system are described. In section 3 the total pension savings are discussed along with taxation.

2. The Three Pillars of the Danish Pension System

The Danish pension system comprises three parts, which together make up the total pension system, *cf. table 1*.

Table 1. The Three Pillars of the Danish Pension System

State Retirement & Statutory Schemes	Labour Market Pension	Individual Schemes
State retirement pension Statutory Schemes - ATP - SP	Agreement based Firm based Public sector employees	

The three pillars are described in detail in the following sub-paragraphs.

2.1 First Pillar: State Retirement Pension and Statutory Schemes

The first part is the public-financed State Pension. The State Pension ensures a basic standard of living for old age. The State Pension is based on an equal amount for all, but it is reduced to a certain extent according to the size of any additional income.

The State Pension is divided into a basic amount, adjusted for any additional earnings, and a pension supplement, which is adjusted for any additional income in general. For a single pensioner the maximum basic amount was DKK 49.560 per year in 2000. The full pension supplement is approximately the same amount. The highest State Pension for a single pensioner corresponds to approximately 45 per cent of the salary of an average production worker.

The cost of the State Pension is financed through tax income on a ‘pay-as-you-go’ basis.

The statutory schemes, basically comprises two different pensions – the Supplementary Earnings-Related Scheme (ATP) and the Special Pension (SP). They are both contribution-defined pension schemes, which are fully funded. The schemes are independent legal units, but there is a common administration for both schemes comprising the social partners.

There are some differences between the contributions to the two schemes.

ATP was established by law in 1963. The scheme is therefore relatively old. Contributions to ATP comprise a fixed sum, which is related to the extent of work (number of working hours). The contribution corresponds to about 1 per cent of salary for the average member of LO. Employers pay 2/3 and the employee pays the remaining 1/3.

Up to the beginning of the ‘1990s contributions to ATP were only for those in employment. However, during the ‘1990s, those receiving unemployment benefits, and a number of other groups on transfer incomes, have become included of the scheme. People receiving daily benefits pay a double contribution in order to compensate for loss of agreement-based labour market pensions during unemployment (see below).

However, there is a significant difference between the sizes of the pension, depending on how much the pensioner has worked previously.

The SP scheme commenced in 1999 and is therefore still in it's initial stages. It is also a defined contribution scheme, with contributions at 1 per cent of gross salary for all. Individuals pay the entire contribution themselves. Before the contribution is added to the individual's account, it is converted in relation to the scope of employment so that everyone with the same number of hours earns the same pension rights.

The characteristics of the three elements in the first pillar are shown in *table 2*.

Table 2. State retirement pension and statutory schemes

	SRP	**ATP**	**SP**
Financing	Taxes / PAYG	Contributions from employer (2/3) and employee (1/3)	Contributions from employee
Contributions	Taxes / PAYG	Fixed amount	1 per cent of income
Members	People born in Denmark or residents for more than 10 years between the age of 15 and 65 years	Wage earners: >16 years and >9 hours/week plus unemployed and persons on maternity leave	Wage earners and self-employed
Benefits	Equal for all and independent of former income, but a part is means tested	Life long age pension from age 65	Pension paid in instalments (10 years from age 65)
Coverage	99 per cent	98 per cent	98 per cent

2.2 Second Pillar: Labour Market Pensions

In addition to statutory labour market pensions there are agreement-based schemes. These are also typically contribution-defined, fully funded schemes.

A large number of groups in the labour market have had labour-market pensions for a significant number of years. Schemes for academics were established in the 1950's and 1960's while some groups within the public sector got theirs in the 1960's and 1970's. Up to the end of the 1980s, about 1/3 of all employees had a labour-market pension. This group primarily comprised higher-paid executives and academics, as well as a large proportion of those employed in the public sector. The remaining 2/3 without agreement-based labour-market pensions were typically blue- and white-collar workers within the private sector.

As part of collective bargaining at the end of the 1980s and beginning of the 1990s, labour-market pension schemes were established for those groups. The schemes follow the collective-agreement structure and are typically sector-specific.

Contributions from public-sector employees have reached the original goal of 12 per cent (16 per cent for certain groups of academics), while contributions from private-sector groups vary from agreement to agreement. Typical contributions in the private sector for academics and higher paid white-collar workers are currently at about 15 per cent of wages and salary, which compares with the preliminary goal of 9 per cent of wages and salaries which will be reached in 2003 for the rest of the employees in the private sector.

All schemes divide the financing of contributions at 2/3 from employers and 1/3 from employees.

Apart from providing supplementary income to persons over the age of 65 most schemes also offer a supplement to persons receiving early retirement pensions. One additional feature to this is that the economic risks of becoming disabled are shared between the persons within the individual schemes (see below). This is of course in sharp contrast to the individual schemes. Finally it is also possible to take out a lower pension at the age of 60 as a supplement to early retirement benefit.

Most of the new pension-schemes are constructed as non-profit life insurance companies that are owned by both the employer organisations and the unions. This means that in reality every decision including decisions on investment is the result of a collaborative process.

The fundamental rules for life insurance companies and pensions funds were established by the EU directive on life insurance, which was first implemented in Danish legislation in 1994 and later revised according to the 3. Life Insurance Directive. The Danish pension model implies that contributors are guaranteed a minimum pension when retired and that assets should always cover liabilities. Therefore legislation to reduce potential risk among other things incorporates a ceiling on equities in the portfolio. From 2000 this ceiling has been 70 per cent of total assets but most of the newer pension schemes currently run a lower but rising rate (about 50 per cent) in order to meet legal requirements.

A smaller part of labour-market pensions are enterprise-based schemes covering individual enterprises. With the introduction of collective agreements at the end of the 1980s and beginning of the 1990s, existing company schemes were, to a large extent, replaced by collective-agreement schemes.

The agreement-based schemes cover those who receive a salary from an employer. Pension contributions are not made for people receiving unemployment benefits, sickness benefits, etc. In the long term 85-90 per cent of future pensioners are expected to receive a labour-market pension.

Labour-market pensions for certain groups of public servants are also based on legislation. They cover about 130.000 public servants presently employed within the central administration and local authorities. In contrast to other schemes, these public-servant pensions are defined benefit systems financed through taxes on a 'pay-as-you-go' basis.

The characteristics of the three elements in the second pillar are shown in *table 3*.

Table 3. Labour market pensions

	Agreement based	**Enterprise based**	**Public servants**
Financing	Contributions (1/3 employee and 2/3 employer)	Contributions (Typically 1/3 employee and 2/3 employer)	Taxes / PAYG
Contributions	Public sector: 12 per cent (16 per cent for certain groups of academics), Private sector: High-wage white-collar workers: 15 per cent. Blue- and white-collar workers: 9 per cent (as of 2003)	Various (9-15 per cent)	15 per cent of wages or defined benefit
Members	Typically everybody above 21 years with 9 months tenure	Various	Certain groups of public sector employees
Benefits	General: Solidarity principles (basic benefits). Life long retirement pension from 65 years of age, early retirement pension, benefits to widows and children. Collective sharing of investment risks	Various	Life long retirement pension from 65 years of age, early retirement pension, benefits to widows and children.
Coverage	85-90 per cent of wage earners	< 5 per cent	< 4 per cent (being phased out)

2.3 Third Pillar: Individual Schemes

The third part of the pension system is made up of schemes taken out by individuals themselves, either directly with a pension company, or indirectly through an employer to a pension company. Individual pension savings have increased considerably over the past 10-15 years.

This development has been strongly influenced by particularly favourable tax rules. Schemes are typically taken out with a bank, or life-insurance company, and are usually pure savings products.

These types of account give more flexibility in deciding what to invest in. However it is important to notice that the costs of having an individual savings/investment account is considerably higher than the cost associated with the savings in the labour market pension schemes or ATP/SP, since there are huge economies of scale at work. As a rule of thumb it is fair to say that the annual administrative costs of an account in a labour market pension scheme is about 10 times higher than an account in ATP/SP. On the other hand the costs of an individual savings/investment account is up to 100 times higher than an account in ATP/SP.

3. Total savings and taxation

In 1999, total pensions savings in Denmark amounted to DKKbn 1.260, corresponding to about the same figure as GDP, *cf. table 4*. As labour-market pensions are still being built up, the value of pensions savings will grow significantly in future decades. Years back it was the view that if the new labour market pension schemes stopped at a contribution of 9 per cent of the wages the total assets in private and public pension funds would reach 150 per cent of GDP in 2030. Since the contributions looks like they are going to rice to 12 per cent this of course will lead to a larger pension build-up.

Table 4. Assets in private and public pension funds

	1990	1995	1999	1990	1995	1999
	---- DKKbn ----			---- Per cent of GDP ----		
Life insurance companies[1)]	201.1	314.9	527.1	24.4	31.2	42.9
Labour market pension funds[2)]	110.1	162.6	225.1	13.3	16.1	18.3
Banks	95.4	143.3	211.9	11.6	14.2	17.2
Total private pension assets	406.6	620.8	964.1	49.3	61.5	78.4
ATP and SP[3)]	109.0	162.8	295.8	13.2	16.1	24.1
Total	**515.6**	**783.6**	**1,259.9**	**62.5**	**77.6**	**102.5**

1) The new agreement-based labour-market pensions are typically placed with life-insurance companies, while older agreement based schemes often are lodged with general pension funds.

2) Including company pension funds, which in 1999 amounted to approximately DKKbn 31.

3) Includes assets in LD and DMP.

Source: Ministry of Finance.

Pension savings are in principle taxed by the ETT-principle:

- **E**xemption from contribution
- **T**axation of returns
- **T**axation of benefits

However, contributions are taxed by an 8 per cent labour market contribution like normal wage income. The returns are then taxed by 15 per cent within the scheme while the benefits are taxed by normal income tax with the exemption from the 8 per cent labour market contribution.