Network for Studies on Pensions, Aging and Retirement

The self-employment pension puzzle

Self-employed people fail to fulfil their pension ambitions

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How do self-employed people in the Netherlands prepare for retirement? They generally cannot count on benefits from a compulsory company pension plan, or their entitlement is relatively small. The key question therefore is: do self-employed people set money aside voluntarily, and will their savings be sufficient to meet their expectations when it comes time to retire?

This Netspar Brief compares various data sources to help solve the self-employment pension puzzle. When all the pieces are put together, it becomes apparent that self-employed people's future pension capital most likely does not correspond to their current expectations regarding their retirement benefits as they enter their golden years.
Self-employed people and those in traditional employment tend to have similar expectations regarding their retirement age and replacement rate (the ratio between the amount of their pension benefit and their final salary). Retirees who have been employed throughout their career will likely find that their expectations will be met when they start drawing their pensions, but many self-employed people could very well be in for a bitter disappointment. Both groups are very motivated to save for retirement, self-employed people even more so than their peers in regular employment. However, self-employed individuals tend not to have accrued much capital in a company pension plan, so they must save far more in a private capacity if they are to attain a similar pension entitlement.

Self-employed people know how important it is to save for retirement, yet they often have a difficult time meeting their goals, in spite of the best intentions. Many people in traditional employment face the same difficulties, but self-employed individuals often find themselves in particularly dire straits. Their entitlements in the second and third pension pillars are often too low. They may also face higher mortgage costs after retirement due to a higher residual debt and the loss of the mortgage interest deduction. Moreover, in many cases self-employed people do not have more private savings than their peers in traditional employment with comparable incomes. A study of their more unconventional means of saving for retirement does not suggest that self-employed people prepare for retirement in any meaningful way.

A market failure may be to blame for the fact that self-employed people do not have a clear understanding of the financial impact of retirement, nor that they will unlikely be able to meet their retirement savings goals due to simple procrastination and impractical short-

sightedness. In any event, situations should be avoided in which people are suddenly confronted with an unexpectedly low pension entitlement upon retirement. Policymakers may wish to intervene and correct this market failure by developing an appropriate architecture to help people make sound choices. One option is to reconsider the ‘opt-in’ structure of current pension plans for self-employed people. A viable alternative may be an ‘opt-out’ structure in which self-employed people are automatically included in a pension plan unless they actively revoke their participation. Such an opt-out arrangement would be a milder alternative to compulsory savings, because people would be presented with a standard and the option not to participate.