Pension Coverage Lessons for the United States from Other Countries

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EXECUTIVE SUMMARY

Introduction
While the United States has instituted numerous pension policy innovations over the past twenty years, including notably 401(k) plans, pension coverage has remained stagnant at roughly 50 percent of workers. Frustration over the failure of pension policy to increase coverage has raised the issue of what can we learn from other countries, some of which have considerably higher pension coverage rates than the United States. To address this question, we survey countries with pension systems similar to that in the United States. We examine both the major approaches chosen and particular policy innovations.

Purpose
Few countries with well-developed pension systems use exclusively the U.S. approach to encourage pension coverage, which is voluntary with tax incentives. Among countries that use that approach, it is rare for coverage to exceed 50 percent of the private sector workforce. Higher coverage rates are achieved by systems that provide contracting out, systems that are based on widespread coverage of the workforce by labor unions, and mandatory systems. The use of widespread labor contracting is not possible in the United States because of the low percentage of jobs covered by collective bargaining.

Methodology
In this report, we examine pension policies that countries have developed to increase coverage in occupational pensions and individual accounts. We argue that the wide variety of policies can be grouped into four pathways. Those pathways are voluntary with tax incentives, contracted out, widespread labor contracts and mandatory. These pathways can be characterized as ranging from unrestrained choice, to a choice between two alternatives—a government provided pension versus a private sector provided one, to a mandatory arrangement determined by collective bargaining between employers and trade unions, to a government imposed mandate.

The pathways approach focuses on the incentives or degree of compulsion provided for extending pension coverage. While some countries provide no incentives for pension participation, this discussion focuses on policies that countries have enacted to encourage pension coverage. Within that frame of reference, degrees of compulsion vary from countries that provide tax incentives but no compulsion on employees, to countries that provide further incentives through contracting out from Social Security, to countries that mandate coverage, either as a legal mandate or through compulsory labor-management agreements. Within these degrees of compulsion, the report also considers the disincentives that may be aspects of government policies. In examining the degree of incentives or compulsion, we consider both the percentage of workers affected (the extensive margin) and the degree to which they are affected (the intensive margin). Degrees of compulsion can be thought of loosely as the cost of not participating in a pension, ranging on a scale from zero, where no incentives or disincentives are provided to any worker or employer for providing coverage, to 100, where coverage is effectively mandated for every worker. This formulation ignores negative values, where there are disincentives but no incentives.
Main Findings
The pathways approach to extending coverage focuses on increasing incentives or compulsion for workers to participate. It appears that that approach is unlikely to lead to important increases in coverage. An alternative approach to extending coverage focuses on expanding the groups to which policies apply. The three groups considered in this report are job changers, part-time workers, and non-workers.

Conclusions
Few countries with well-developed pension systems use exclusively the U.S. approach to encourage pension coverage, which is voluntary with tax incentives. Among countries that use that approach, it is rare for coverage to exceed 50 percent of the private sector workforce. Higher coverage rates are achieved by systems that provide contracting out, systems that are based on widespread coverage of the workforce by labor unions, and mandatory systems. The use of widespread labor contracting is not possible in the United States because of the low percentage of jobs covered by collective bargaining.

Both contracting out and mandating are technically possible approaches to extending private sector pension coverage, and both are being considered in the context of Social Security reform. Within a voluntary approach, however, the experience of other countries suggests that there are further policies that could be considered, including extending coverage to part-time workers and non-workers.
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INTRODUCTION
While the United States has instituted numerous pension policy innovations over the past twenty years, including notably 401(k) plans, pension coverage has remained stagnant at roughly 50 percent of workers (US BLS 2003). Frustration over the failure of pension policy to increase coverage has raised the issue of what can we learn from other countries, some of which have considerably higher pension coverage rates than the United States (Table 1). To address this question, we survey countries with pension systems similar to that in the United States. We examine both the major approaches chosen and particular policy innovations.

Retirement income policy can be broken into component parts in different ways. This report presents two approaches; the pathways approach focuses on the incentives or degree of compulsion provided for extending pension coverage. While some countries provide no incentives for pension participation, this discussion focuses on policies that countries have enacted to encourage pension coverage. Within that frame of reference, degrees of compulsion vary from countries that provide tax incentives but no compulsion on employees, to countries that provide further incentives through contracting out from Social Security, to countries that mandate coverage, either as a legal mandate or through compulsory labor-management agreements. Within these degrees of compulsion, the report also considers the disincentives that may be aspects of government policies. In examining the degree of incentives or compulsion, we consider both the percentage of workers affected (the extensive margin) and the degree to which they are affected (the intensive margin). Degrees of compulsion can be thought of loosely as the cost of not participating in a pension, ranging on a scale from zero, where no incentives or disincentives are provided to any worker or employer for providing coverage, to 100, where coverage is effectively mandated for every worker. This formulation ignores negative values, where there are disincentives but no incentives.

The relationship approach views the institutional arrangements from a different perspective, focusing on the relationship between Social Security and private pensions.

FOUR PATHWAYS TO PENSION COVERAGE
Four pathways have been used to encourage pension coverage in member countries of the Organization for Economic Cooperation and Development (OECD) (Rein and Turner 2001). They are voluntary with tax incentives, contracting out of Social Security, labor contracting through collective bargaining, and mandatory. Within each pathway further distinctions can be drawn as to degrees of compulsion. This report discusses the four pathways countries have used to extend pension coverage and compares that to the relationship approach. Countries can be categorized as having chosen a dominant pathway, but often more than one pathway is used by a country to extend pension coverage. The report examines the applicability of other countries’ approaches to extending U.S. coverage. The report concludes by considering specific policies to expand pension coverage in the United States based on policies in other countries.

The wide diversity of policies to extend pension coverage can be classified into four pathways. Any of the four pathways can be used with either individual accounts or defined benefit pensions.
Voluntary with Tax Incentives.

The pathway the United States uses to encourage pension coverage can be characterized as voluntary with tax incentives. Employers are not required to provide pensions, and employees are not required to be covered. If an employer chooses to provide pension coverage, regulations may require that the employer offer coverage to most or all workers. Often, part-time workers are excluded from the requirement.

This approach differs considerably between defined benefit and defined contribution pensions. With a defined benefit pension, if the employer provides a pension to a worker, the worker’s participation is automatic. If an employer offers a defined contribution pension, participation by workers may be automatic or it may depend on the worker choosing to contribute.

With this approach, pension coverage is encouraged through favorable tax treatment of employee pensions. The extent of the incentive is higher the higher are marginal tax rates, and also depends on the degree to which pensions are tax exempt.

Three fundamental principles apply to the taxation of most pensions in the United States and most other countries taking this approach:

1. Contributions are tax exempt (excluded from income) or tax deductible (E, signifying exempt),
2. Pension investment earnings are tax exempt (E), and
3. Pension benefits are taxable (T, signifying taxable).

This general approach of taxation of pensions is sometimes called the EET model. In the United States, for most types of pension plans, employee contributions are not tax deductible, the 401(k) plan being an exception. In the United Kingdom, workers can receive lump sum benefits tax free, which provides an extra tax incentive. With this model, which analyzes the tax treatment of pensions in three separate periods, in effect tax payments are deferred until benefits are received in retirement.

This approach results in lost tax revenue to the national government. It can be an inefficient use of revenue because it induces higher-income workers simply to shift their other savings to tax-favored accounts. With a progressive tax system, under which lower-income workers have lower marginal tax rates, there may be little incentive for low-income workers to participate. A criticism of this approach is that it targets incentives to higher-income workers because they have higher marginal tax rates. There is a trade-off between the cost to the government from the tax incentives offered and the amount by which pension participation is increased. Also, there may be a trade-off between encouraging low-income workers to participate and providing too much in incentives to higher-wage workers, who are more likely to participate in any case.

Within the basic framework of tax preferences for pensions, other policies can be enacted to provide further encouragement for participation. In the United States, eligible moderate- and lower-income employees may be able to claim a tax credit for half of their pension contributions up to a maximum credit of $1,000 for, called the “savers credit,” for contributions to a retirement plan starting in 2002. Tax credits, however, are valueless to workers who do not pay taxes, so to
provide an incentive to low-income workers with no income tax liability, the tax credit would need to be refundable. In addition, employers can take a tax deduction for contributions to a tax-qualified retirement plan. Finally, small businesses can claim a tax credit for certain costs of starting a new plan for their employees.

As well as providing incentives for pension coverage, government policy also provides disincentives through regulatory burdens. The disincentives to employers providing plans can be minimized by reducing the cost of pension regulations. While providing a pension is a voluntary choice for U.S. employers, those that do so are required to cover a minimum percentage of their full-time workers.

From an employee’s perspective, lack of adequate regulation can be a disincentive for employee participation because employees do not feel that their interests are adequately protected, which causes their pension benefit claims to be risky.

In addition to the tax incentive, there are at least three other ways within the voluntary framework to encourage workers to participate in a defined contribution pension plan. First, workers can be encouraged to participate in contributory pension plans by the employer offering a match for employee contributions. For example, the match could be dollar-for-dollar up to a certain level of employee contributions, with a lower match rate, or no match, beyond that. An employer match increases employee participation, but the marginal effect of moving to a higher match rate is generally small (Papke 1995). Second, employers also can encourage workers to participate by providing them financial education as to the need for adequate retirement savings.

Third, with negative election employees are automatically enrolled in employer-provided pension plans, that being the default option; however, employees may choose to not participate. Closely related to negative election is the option of requiring that workers make a choice, rather than allowing opting out to be a default of no choice. Evidence from studies in the United States suggests that negative election is a more successful way to increase pension coverage than employer matching contributions (Madrian and Shea 2001). A variant on this approach is that employees are required to make an active choice, rather than allowing them a default resulting from inaction.

The voluntary approach is also used exclusively by Canada and Ireland, but few other countries rely exclusively on it. Most countries with well-developed pension systems began with this approach and maintain it as part of their pension policy, but have moved beyond it to further encourage private sector provision of pensions.

A strength of this approach is that it maintains freedom of choice for individuals and employers. A weakness is that, practically without exception, countries that have used this approach have not raised pension coverage above 50 percent for private sector workers (Dailey and Turner 1992). With this approach, coverage rates tend to be relatively low among low-wage workers (Hinz and Turner 1998). Because tax incentives are provided by exempting contributions and investment earnings from income taxation, this approach offers greater incentives to higher-income workers than lower-income workers in a progressive income tax.
system because higher-income workers have higher marginal tax rates (Reagan and Turner 2000).

In sum, within the voluntary with tax incentives approach a relatively high degree of compulsion (incentive) would be achieved if employers offering a pension were required to cover all workers, if benefits were locked in until retirement, and if tax credits were offered. A relatively low degree of compulsion (incentive) would be achieved, if the marginal tax rates workers faced were low, if the amounts that could be contributed were low, and if the tax treatment were relatively unfavorable, for example, with employee contributions not being tax exempt.

Contracting Out. A second pathway to encouraging pension coverage, which is designed to go beyond the approach of voluntary with incentives, is contracting out. This approach involves a choice between participating in Social Security or in an alternative system. With contracting out, the employer and the worker may reduce their contribution to Social Security if the worker participates in a private sector plan that provides benefits meeting at least minimum requirements. For those workers choosing to contract out, the reduced contribution to Social Security reduces the benefit they ultimately receive from Social Security. This approach, called “a voluntary carve out” in the United States, is used by Japan and the United Kingdom.

The extent to which this approach provides an incentive for private provision of pensions depends on the terms of the voluntary carve out. In Japan, contracting out has been provided on a fairly neutral basis, with the government neither subsidizing nor disfavoring it. The United Kingdom, by contrast, encourages contracting out by providing it on a favorable basis. It does so by providing a rebate that is larger than the actuarial equivalent of the Social Security benefits foregone when a worker contracts out of Social Security. The United Kingdom provides contracting out both through defined benefit and defined contribution plans, while in Japan it is permitted only through defined benefit plans.

One problem that may arise with contracting out, due to its voluntary nature, and a reason why mandating is sometimes viewed as preferable, is adverse selection. With adverse selection, the workers who most benefit from contracting out leave the Social Security system, eroding its financial base. An advantage of contracting out is that it maintains freedom of choice, and it may encourage private sector provision of pension plans.

Within this approach, a relatively high degree of compulsion (incentive) would be achieved if all workers were eligible for contracting out, and if the reduction if social security benefits with contracting out were relatively small. A relatively low degree of compulsion (incentive) would be achieved if the contracting out were offered on an actuarially neutral basis.

Labor Contracting. A third pathway is widespread labor contracting. In some countries where all or most of the labor force is covered by a collective bargaining agreement, a high percentage of the labor force is covered through pension plans resulting from collective bargaining. The ability to use this approach also depends on the effective legal backing provided for collective bargaining. Both defined benefit and defined contribution plans are used in this approach. Countries using this approach include France, the Netherlands, Denmark, Norway,
and Sweden. In Sweden, traditionally these plans have been defined benefit, but since a major Social Security reform in 2000, most have converted to defined contribution plans. This approach can only be used in countries where a high percentage of the labor force is covered by a union or where, as in the Netherlands, a collective bargaining agreement can be mandatorily extended to other firms in the same line of business. Thus, this approach cannot be used in the United States.

With this approach, a relatively high degree of compulsion would be achieved if all employees were in jobs covered by mandatory collectively bargained pension plans. A relatively low degree of compulsion would be achieved if the union coverage of the workforce were relatively low and the legal support for extending the results of collective bargaining were weak.

Mandating. A fourth pathway is mandating. Mandating private pensions is an alternative to raising the Social Security payroll tax and benefit level. Social Security pensions are mandatory because it is generally felt that many people will not save adequately for retirement on their own or with the incentives provided for a voluntary system. Thus, it is felt that some degree of compulsion is needed in the retirement income system.

An issue in mandating is whether that should take the form of expanded provision through Social Security or through a private-sector provided benefit. Mandating private provision is thus related to the issues of privatizing Social Security. While Social Security provides uniformity, mandatory private pensions generally allow greater flexibility and diversity in the types of arrangements.

A mandate can be placed on the employer or the employee. A mandate that all employers provide a pension is equivalent in compulsion on workers to a mandate that all workers be covered by a pension.

This approach can either require employers to provide a pension plan for their workers or require workers to have an individual account plan with a third-party provider. Switzerland mandates employer provision (Gillion, Turner, Bailey and Latulippe 2000). In Australia, there is a de facto mandate in that employers who do not establish pension plans are required to pay a tax that is more costly than the required pension contributions. In Australia, these plans can be defined benefit, but predominantly are defined contribution. In Switzerland, they are a hybrid plan similar to cash balance plans. Sweden imposes the requirement on workers.

An approach to mandating that involves a considerably lesser degree of compulsion is to require that the employer offer a pension but not require that employees participate in one. The United Kingdom with its stakeholder pensions, as well as Ireland and Germany, mandate that employers who do not otherwise offer a pension offer defined contribution pensions if the employee chooses to contribute to one. Employers are not required to contribute to these pensions. An approach that has not been taken could be to combine an employer mandate with negative election, as discussed in the section on voluntary with incentives.

The degree of compulsion associated with a mandate is tied to the enforcement of the mandate. In many countries, there is wide spread contribution evasion in mandated Social Security.
Security programs, arising in part because of ineffective enforcement (Bailey and Turner 2001). Thus, in some countries a mandate is associated with a low degree of compulsion because the mandate is not effective.

Mandatory pension systems typically do not cover all workers, often excluding low-wage workers, part-time workers, and workers with short tenure. Even with these exclusions, mandatory pension systems tend to have high coverage rates.

With mandating, the extent of the administrative burden placed on employers varies considerably, based on the structure of the mandate. Mandating through employer-provision of defined benefit plans places a far greater burden on employers than does mandating individual accounts. In mandating individual accounts, the system in Chile places a greater burden on employers than does the system in Sweden. The system in Chile requires each employer to serve as a clearinghouse, sending the employee’s contribution to the appropriate pension provider. The system in Sweden reduces the burden on employees by having them send all employee contributions to the government, with the government taking on the clearinghouse function.

Within this approach, a relatively high degree of compulsion would be achieved if all workers were required to participate in a pension plan, all employers were required to provide one, and these requirements were effectively enforced. A relatively weak degree of compulsion would be achieved if employers were mandated to offer a pension plan, but workers were not required to participate.

**RELATIONSHIPS APPROACH**

An alternative approach for categorizing the universe of retirement income policies is to classify them by the relationship between pensions and Social Security. Pensions can either be add-ons to or carve-outs from Social Security. An add-on is a pension plan that supplements the Social Security benefit, while a carve-out is a pension plan that replaces part or all of the Social Security benefit. Add-ons and carve-outs can either be voluntary or mandatory, resulting in four categories of pension plans under this approach—mandatory add-ons, voluntary add-ons, mandatory carve-outs, and voluntary carve-outs.

While the pathways approach to deconstructing retirement income policy focuses on the incentive for pension coverage, the relationship approach focuses on the relationship between Social Security and private pensions. Table 2 indicates the connection between the two approaches. The pathway of voluntary with tax incentives is a voluntary add-on approach. The pathway of contracting out is a voluntary carve-out approach. Depending on the interpretation of what constitutes a mandate, labor contracting can be considered a mandatory add-on. The mandate is the result of labor market negotiations between unions and employers rather than a governmentally imposed requirement. A governmentally-imposed mandate can take the form of either an add-on or a carve-out.

**IMPLICATIONS FOR THE UNITED STATES**

A number of countries have moved beyond the approach of voluntary with tax incentives to provide further incentives for pension coverage, and have succeeded in raising coverage. The contracting-out approach was proposed for the United States in 1935 through the Clark
Amendment to the original Social Security Act. Because of lack of support for the amendment in the House of Representatives, it was not included in the final version of the Act (Dewitt 2000). The approach has not received serious consideration since then. A voluntary carve-out from Social Security, however, as contained in the recommendations of the President’s Commission to Strengthen Social Security (2001)--the commission appointed by President George W. Bush--would be a contracting-out approach.

The pathway of widespread labor contracting can only be used in countries where most of the labor force works in jobs covered by collective bargaining. Because that is not the case in the United States, such a pathway cannot be used.

Mandating was proposed in the United States by a commission created during the Carter administration. The proposal of the Carter Commission in 1981 for a Minimum Universal Pension System (MUPS) was rejected by the Reagan administration. While individual retirement accounts (IRAs) are available to all workers in the United States, mandatory individual accounts are currently being considered in the form of an add-on or carve-out from Social Security.

LESSONS WITHIN A VOLUNTARY FRAMEWORK

This section discusses lessons from other countries that would apply within the scope of the present voluntary U.S. system. While the pathways approaches to extending coverage focus on the intensive margin, increasing incentives or compulsion for workers to participate, the three approaches to extending pension coverage discussed in this section focus on the extensive margin by expanding the groups to which policies apply. The three groups considered are job changers, part-time workers, and non-workers.

**Locking-in Benefits.** In Canada and most other countries with well-developed private pension systems, once a benefit has become statutorily vested (meaning that it is vested under the statutory vesting rules), it is locked-in until retirement. Job changers are unable to cash out their pension benefits. In a defined contribution plan, the real value of the benefits are unaffected for job changers because the plan assets continue to be invested. In a defined benefit plan, the nominal value of the benefit is maintained but the real value is eroded by inflation because benefits are based on the worker’s nominal earnings at the time of job change.

By contrast, in the United States, workers changing jobs can and frequently do cash out their accumulated pension benefits, thus eventually reaching retirement without pension coverage. Locking-in benefits, however, may cause some workers to not participate in a pension plan due to the loss of liquidity of their funds.

**Extending Coverage to Part-time Workers.** Most countries with private pension systems cover a larger fraction of part-time workers than the United States. In Australia, the requirement for coverage is based on earnings rather than hours, but effectively those working 500 hours a year must be covered. In the European Union, if a firm’s practice of not covering part-time workers causes discrimination against women because they are disproportionately part-time workers, part-time workers must be covered. In the United States, companies with pension plans need not cover employees working fewer than 1,000 hours a year.
Lowering the 1,000-hour rule would not benefit part-time workers who do not work a sufficient number of years to be vested. For workers who vest but change jobs shortly thereafter, benefits from defined benefit plans would be small, but in defined contribution plans for young workers, the account balance could grow to be a substantial amount at retirement. Covering workers with small benefits would increase employer costs. The added costs might induce some employers to stop providing a plan. Lowering the 1,000-hour rule would be most beneficial to long-term part-time workers and those short-term part-time workers who were covered by defined contribution plans.

**Extending Coverage to Non-workers.** In the United States, the opportunity for pension coverage is linked to the worker’s employment. The only exception for those out of the labor force is that a non-working spouse can be covered under the Individual Retirement Account (IRA) of a working spouse. The Danish ATP (Labor Market Supplementary Scheme) is a mandatory plan. While it was initially restricted to workers, persons temporarily or permanently out of the workforce can now contribute to it. For unemployed participants, the state pays between half and two-thirds of the contribution. Almost all persons are now covered by the ATP. The Swedish Premium Pension (mandatory individual accounts) allows one spouse to transfer his or her pension contributions for a year to the other spouse, who may or may not be working (Turner 2003).

A recent change in pension law in the United Kingdom allows pension coverage for any person, with no minimum age limit. Because high-income parents may have offspring who become low-income adults, the approach used in the United Kingdom would extend coverage to more low-income workers in the future, who would have coverage based on a pension their parents had established for them as children. It would also allow parents to establish a pension for a child who would be unable to work because of a disability.

**CONCLUSIONS**

Few countries with well-developed pension systems use exclusively the U.S. approach to encourage pension coverage, which is voluntary with tax incentives. Among countries that use that approach, it is rare for coverage to exceed 50 percent of the private sector workforce. Higher coverage rates are achieved by systems that provide contracting out, systems that are based on widespread coverage of the workforce by labor unions, and mandatory systems. The use of widespread labor contracting is not possible in the United States because of the low percentage of jobs covered by collective bargaining.

Both contracting out and mandating are technically possible approaches to extending private sector pension coverage, and both are being considered in the context of Social Security reform. Within a voluntary approach, however, the experience of other countries suggests that there are further policies that could be considered, including extending coverage to part-time workers and non-workers.
REFERENCES


Table 1. The Approach Used by Different OECD Countries for Expanding Pension Coverage

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<th>Country</th>
<th>Type of System</th>
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<td>Australia</td>
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<tr>
<td>Canada</td>
<td>Voluntary with incentives</td>
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<tr>
<td>Japan</td>
<td>Contracting out</td>
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</tr>
<tr>
<td>Netherlands</td>
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<td>Switzerland</td>
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<td>Contracting out</td>
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Table 2. Relationship between the two systems for deconstructing retirement income policy

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<td>Contracting out</td>
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<tr>
<td>Mandatory</td>
<td>Labor contracting; Mandatory</td>
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Source: the authors.