

## Sustainable and Adequate Pensions: How far have we come?

Juraj Draxler

Europeans worry about their pensions. They also resist reforms. The technically easiest solution – to raise the retirement age – tends to run up against universal opposition. It is advisable to provide a wide reform package, offering trade-offs to various stakeholders. But finding the right balance is not easy.

It is not surprising, then, that the European Union is now a diverse patchwork of reform attempts.

### Who is reforming and how?

The Scandinavians, with their consensual approach to politics, have been at the forefront of reforms in the EU-15 area. In 1998, Sweden completely overhauled its pension system. The previous defined-benefit scheme is gradually being replaced by a notional defined contribution (NDC) system.<sup>1</sup>

In 2005, Finland also overhauled its system, with a range of parametric adjustments that significantly improved the long-term sustainability of publicly mandated pensions.

Then there is the biggest reform group, the post-communist new member states. All of them, except the two richest, Slovenia and the Czech Republic, took the World Bank's advice and implemented 'multi-pillar reforms'. Each<sup>2</sup> split its public pension

<sup>1</sup> In an NDC system, people have individual accounts credited with their contributions. The account assets are only notional, financed on a pay-as-you-go basis. However, they are indexed to overall economic performance and demographic developments, so the system is actuarially fair.

<sup>2</sup> Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia.

system into two pillars. The first remains a publicly administered, pay-as-you-go scheme. The second consists of privately managed accounts with assets invested in the financial market.

These are, then, the far-reaching reforms that have been passed with relative ease. Elsewhere, measures have been far more cautious.

Austria introduced (after strong trade union protests) a reform in 2003 which has helped to improve the sustainability of its pension system. Two years earlier, in 2001, Germany's reform measures created a framework for a tier of funded accounts. The reform also cut down on some spending. However, the overall sustainability improvement is modest. Italy is trying to phase in an NDC pillar similar to Sweden's, but the transition period spans decades, and this ongoing reform is complicated by continuing protests from the public.

Most of Europe relies on piecemeal adjustments: tightening eligibility rules, closing off access to early pensions and providing financial disincentives (deductions from statutory pensions) to retiring early – as well as, conversely, premiums for retiring later than the statutory age.

In the process, governments also do raise the retirement age. But, as said, this is a singularly unpopular measure and increments tend to be modest.

This policy brief highlights the main findings of the project on Adequacy and Sustainability of Old-Age Income in the EU (AIM). Financed by the EU's 6<sup>th</sup> Framework Programme, AIM brought together 13 institutes from across the EU, led by CEPS, in three and a half years of collaborative efforts to come up with up-to-date statistics and projections concerning old-age income in the EU. The author, Juraj Draxler, is Associate Research Fellow at CEPS. He can be reached at [juraj.draxler@ext.ceps.eu](mailto:juraj.draxler@ext.ceps.eu).

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## Myths and real options

In the future, it will be necessary for people to work longer. Since World War II, longevity tended to advance much faster than adjustments to the statutory pension age. Every successive generation could look forward to a longer retirement period than the previous one. This could not go on, even if we forget about other complicating factors, such as falling birth-rates or a slowdown in productivity growth.

It is not difficult to envisage a reform that spreads the ‘cost’ of change evenly over working life cohorts, so that one generation does not have to be more dramatically affected than others.<sup>3</sup> After the reform is fully phased in, the new system should continuously ensure that people do not take out more in pensions than they paid in.

How to achieve such a self-sustaining system? There is a range of choices that should lead to a better balance between what people pay in and what they take out.

The pension formula could directly reflect this concern, that is, it could be as *actuarially fair* as possible. In fact, one of the most discernible trends in Europe today is to get rid of those pension formulas where a pension is calculated in relation to the wage in final years. Most people earn more at the end of their careers, and this can create overgenerous pensions as well as favour those with steeper earning profiles.

So, pension systems are gradually more and more adjusted to take into account all contributions paid by the worker, not just the contributions in the final working years. This is now also technically easy, as governments today are capable of keeping contribution records over the entire career and thus provide the worker with a defined-contribution pension.

Defined-contribution pensions can be achieved by directly changing the formula in the public pension system. This is what the Swedes have done.

The alternative option is to convert the public pension system into a funded one, in which contributions are used to buy assets in the financial market.<sup>4</sup>

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<sup>3</sup> See J. Myles (2002), “A new social contract for the elderly?”, in G. Esping-Andersen, D. Gallie, A. Hemerijck and J. Myles, *Why We Need a New Welfare State*, Oxford: Oxford University Press.

<sup>4</sup> Two countries in the EU rely on a significant tier of funded, occupational pensions (beside the flat-rate public pension): the UK and the Netherlands. The Dutch system is more consolidated and dominated by large sectoral

Such a conversion is complicated in countries with mature public schemes: it creates transitional deficits once contributions are diverted to the funded system. In its 1994 report *Averting the Old-Age Crisis*, the World Bank recommended that at least the countries that could bridge this financing gap by using proceeds from mass privatisation should split the public system into two ‘pillars’, the new one being funded with assets managed by private pension funds.

The report helped decisively to draw the attention of the policy sphere in the new member states and beyond to the impending problems of financing pension payouts.

However, there has also been a backlash among some leading academics against selling funded systems as a miracle cure for the problems connected with ageing.<sup>5</sup>

It still remains to be seen how the post-communist second-pillars will fare. The reforms were accompanied by glitzy advertising of the pension funds. They were sold on the argument that since pay-as-you-go systems are going to be affected by demographic developments, the problem needs to be solved by having a funded system. However, funded schemes do not operate outside the real economy; they, too are influenced by demographic and productivity effects. The argument is therefore misleading, but rhetorically effective.

It remains to be seen whether these schemes deliver in terms of providing for more effective asset allocation in domestic economies or other touted benefits. They might. But caution is in order. Pay-as-you-go schemes became so popular in the post-war period partly due to the fact that they are, to some extent, fraud-proof. They only redistribute contributions and do not accumulate lifetime savings of individuals.

The post-communist schemes also remain fairly skeletal. In most cases, for example, detailed legislation still needs to be put in place to guide the annuitisation of assets. They also do not include any

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pension funds. The Nordic states also have a relatively strong presence of mandatory or quasi-mandatory occupational funded pensions.

<sup>5</sup> See P. Diamond (1998), *The Economics of Social Security Reform*, NBER Working Paper 6719, National Bureau of Economic Research, Cambridge, MA. See also P.R. Orszag and J.E. Stiglitz (1999), “Rethinking Pension Reform: Ten Myths About Social Security Systems”, paper presented at the conference on New Ideas About Old Age Security, World Bank, Washington, D.C. And N. Barr (2001), *Reforming Pensions: Myths, Truths and Policy Choices*, IMF Working Paper 139, International Monetary Fund, Washington D.C.

effective smoothing mechanisms to mitigate exposure of savers to financial market turbulences.

## Creating incentives

Raising the statutory retirement age is one way of getting more people to work and continue supporting pension payouts rather than put claims on the system.

Another way is to provide people with incentives to work longer voluntarily. Financial incentives work. Empirical research shows, however, that reforms have to implement higher premia for working longer than those provided by the reforms introduced since 2000 to date. One AIM study<sup>6</sup> demonstrates that actuarial reduction of statutory pensions by 5 % points for each year of early retirement and even higher accruals for postponed retirement would increase retirement age by around 4.4 years on average. Improving well-being at work or improving health, on the other hand, would have minor effects.

Other reports do, however, stress that a complex intervention in the labour market is needed to complement changes to pension formulas. For example, the UK Pensions Commission proposed in its 2006 final report a series of measures to help achieve a higher employment rate of old-age workers:

- Implementing and enforcing anti-age discrimination legislation. The legislation that came into force in the UK in 2006 following a European Commission directive makes age discrimination punishable if affecting workers before the statutory retirement age. However, beyond this mark it is possible to fire employees on the grounds of age.
- Ensuring good incentives for older workers to remain in the workforce. At present, UK retirees do not have the option of drawing on a part-time public pension while continuing working.
- Ensuring good financial incentives for employers to employ older workers. The Commission proposed to consider reducing employers' national insurance contributions for old-age workers.
- Putting more emphasis on occupational health.
- Putting more emphasis on the education and re-training of older workers.

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<sup>6</sup> H. Piekkola (2008), *Flexible Pension Systems – Postponed Retirement and Distributional Fairness*, ENEPRI Research Report, Centre for European Policy Studies, Brussels (available at [http://shop.ceps.eu/BookDetail.php?item\\_id=1742](http://shop.ceps.eu/BookDetail.php?item_id=1742)).

Employment of old-age workers is one of the major social policy challenges facing Europe today. The Lisbon agenda included the target employment rate of 50% of older workers (55-64). We know now that this target is unlikely to be reached for the EU as a whole in 2010. But the employment rate of older workers *has* actually been rising. In quite a few member states it even already exceeds the target. The EU Commissioner for Social Affairs Vladimir Spidla has recently sounded an upbeat note on the trend, noting that most countries will have achieved the rate with only a slight delay after the reference year of 2010. He also called for vigorous efforts to implement a comprehensive active ageing strategy in the EU.<sup>7</sup>

## Sustainability versus adequacy

Many economics tools have been developed in the past two decades to help deal with the issues related to ageing and old-age income. Generational accounting came in 1980s. In the 1990s, earlier theoretical work was given full empirical implementation in dynamic programming rule and option value models.

Increasingly complex models allow us to simulate the effects of pension reforms on aggregate pension expenditure and on the incomes of various population subgroups.

At the same time, datasets have improved. Comprehensive replacement rates now take into account several sources of old-age income. This allows us to much better estimate old-age security than by looking at the simple ratio of wages and pensions.

Accounting for changes in socio-economic conditions spanning little more than a few years is beyond the power of any economic model. However, projections give us important insights into how pension systems work and interact with the labour market. They allow us to see what the future would be like if certain conditions in the present would not change.

And what we know is that the present rate of consumption of old-age people in some European countries is, under current economic conditions, not going to be possible for today's younger generations. A paper produced as part of the AIM project clearly illustrates, using the example of selected EU

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<sup>7</sup> V. Spidla (2008), "Active ageing and the European Employment Strategy", *The Journal*, AARP International (available at [http://www.aarpinternational.org/journal\\_sub/journal\\_sub\\_show.htm?doc\\_id=641352](http://www.aarpinternational.org/journal_sub/journal_sub_show.htm?doc_id=641352)).

countries, that young people will not be able to attain the rate of consumption of today's pensioners.<sup>8</sup>

This poses two challenges. The first is the dilemma, discussed in the previous section, of reducing aggregate pension spending. The average pension will still probably remain fairly generous, given that EU economies will continue to be among the richest in the world. But the second challenge, from a social policy point of view, is to make sure that the change in pension rules does not have a dramatic impact on certain population groups.

What are the groups that can be affected? The general trend in Europe is to phase out defined-benefit pensions and implement formulas that are more defined-contribution. This will affect those with interrupted careers. For instance, women – as they have child-bearing and caring responsibilities. Research shows that applying unisex mortality tables is a much more effective way of compensating women than giving them pension credits for the periods when they are out of employment.<sup>9</sup>

Another particular concern, also expressed in AIM research, is that the new defined-contribution schemes in the post-communist member states will pose adequacy problems for future pensioners. With persistently high unemployment levels in the region and precarious jobs, many people are at risk of not saving enough.

## Conclusion – Is the future gloomy?

As some member states have shown, very radical pension reforms are possible – if they are well-planned and delivered after careful consultations. This is most notably the example of Sweden.

Also, the 'multi-pillar reforms' in the new member states might deliver a good balance of sustainability and adequacy. However, in these and other cases, governments need to ensure that the system will not only provide sustainable average pensions, but also provide adequate cover to all. Governments will need to carefully monitor the developments and study projections of old-age income of various population groups.

In addition, in the case of funded schemes, these should be properly regulated. Governance risks do not go away just because these schemes are relatively new and so far scandal-free.

No. The future is not gloomy. Europeans do not have to face a pension crisis. All that is needed is that economists keep doggedly pointing out the risks of non-reforms and present policy-makers with clear, non-dogmatic options. Reforms are certainly possible and the range of reform paths diverse enough to give political leaders room for manoeuvre as they strive to achieve an optimal constellation of stakeholder interests.

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<sup>8</sup> M. Weale and E. Khoman (2008), *Are we living beyond our means? A comparison of France, Italy, Spain and the United Kingdom*, NIESR Discussion Paper No. 311, National Institute of Economic and Social Research, London (available at [http://www.niesr.ac.uk/pdf/100408\\_94720.pdf](http://www.niesr.ac.uk/pdf/100408_94720.pdf)).

<sup>9</sup> See the following AIM report: M. Belloni and E. Fornero (2008), *Gender Difference in Retirement Income and Pension Policy – Simulating the Effects of Various DB and DC Schemes*, ENEPRI Research Report, Centre for European Policy Studies, Brussels (available at [http://shop.ceps.eu/BookDetail.php?item\\_id=1695](http://shop.ceps.eu/BookDetail.php?item_id=1695)).