APPENDIX X

Pensions Reform in Selected EU Member States

The World Bank and the European Union respectively are at the forefront to introduce pension institutional frameworks that will seek to ensure that the pensions nations will provide in the future will continue to ensure that old age is not and does not become synonymous with poverty.

The Stockholm European Council in March 2001 laid the groundwork for an open method of coordination on pensions - with the process finally launched by the Laeken European Council in December 2001 on the basis of a set number of common objectives under three headings referred to in the previous section. National strategy reports on pensions were submitted by member states to the Commission in September 2002, which were subsequently analysed by the Commission.

The report titled 'Joint Report by the Commission and the Council on Adequate and Sustainable Pensions' issued on 10th March 2003 states that the first comprehensive assessment of national pensions systems and policies at the EU levels shows that:

> *"... Member States are committed to ensuring the adequacy of their pension systems. At the same time, many Member States face very high expenditure increases in their pension systems under current policies and have yet to take measures ... These expenditure increases could seriously undermine the sustainability of public finances in the long term. However, ensuring long term financial sustainability is not only important in its own right but is also a necessary precondition for an adequate provision of pensions in the future.*
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> *Member states are fully aware of the interdependence between financial sustainability and adequacy in the context of an aging society: the financial sustainability of pensions systems is a necessary precondition for an adequate provision of pensions in the future, while ensuring adequacy is a precondition for obtaining political reform for the necessary reforms of the pension systems".*[14]

It is not the intention of this Discussion Paper to delve extensively into a detailed analysis of pension reforms overseas. Nevertheless, a short synopsis of work underway in a select number of Member States of the European Union is important as it presents in a clinical manner the span of policy options available and the measures adopted by other nations. This provides a yardstick against which the recommendations for a new national Pensions institutional framework can be measured.

01. Germany[15]

The general PAYG earnings related pension scheme covers around 82% of the employed population in Germany (33 million). The contribution rate stands at 19.5% paid equally by employers and employees. The contribution pays 63% of the expenditure on the pensions scheme with the remaining paid out of the federal public budget. First pillar schemes account for 78% of all incomes of people aged over 65. Second pillar provisions tend to be organised at company level in the private sector. Different financing models are possible, ranging from books reserves (internal funding guaranteed by compulsory insolvency insurance) to external funds and group insurances. Individual third pillar provision accounts for around 10% of total income in old age. Older people without sufficient incomes are entitled to means tested benefits.

The main challenge in Germany is seen to be maintaining financial sustainability in the face of an expected doubling of the old age dependency ratio over the coming decades.

In the new formula, increases in the contributions to old-age pension insurance and in the contributions to the voluntary private-funded pension schemes are deducted from the gross wage which constitutes the pensionable wage and the basis for the calculation of the adjustment index. Financial sustainability will also be strengthened by the fact that calculations of pensions and their annual adjustment are modified in such a way that the rise in total expenditure will be slowed.

The Government's strategy to cope with the financial challenge relies on increasing employment and productivity, in other words, strengthening the contribution base. There is scope for lowering the unemployment rate and raising labour market participation, in particular of women and older workers. The introduction of actuarial reductions for early pensions is likely to produce results in the coming years.

As private pension provision develops, it becomes increasingly important to ensure that individuals have sufficient information to be able to make the right choices, that occupational pensions provision is made widely accessible (notably through collective agreements) and that it does not exclude certain groups of workers (notably part-time and temporary workers) and discourage labour mobility.

The German pension system has been gradually adapted since the 1990s to the challenges of demographic aging. A major focus of the measures of 1992, 1997 and 2000 was to reduce the need for future increases in contribution rates, notably by raising the labour-force participation rate of older workers and hence the effective retirement age. The statutory retirement age is currently being raised to 65 years for all types of pensions except invalidity pensions. Early retirement is only possible at reduced pension levels. Thus, conditions for early retirement were tightened and financial incentives for working longer were introduced.

The latest reform also improved the protection of older people against the risk of poverty. Although there is no guaranteed minimum pension, the granting of social assistance to older people is no longer subject to a means-test against their children's income (even if they were to have sufficient resources to support their parents), nor is the income of household members other than the partner taken into account. In order to compensate for the planned reduction in replacement levels under the statutory scheme, massive support for the development of private pension provision has been made available not only in the form of tax deductibility, but also through direct grants for people on lower incomes and families with children who could not take advantage of the tax deductions.

The development of occupational pensions, which were traditionally voluntary benefits provided by the employer, will be boosted by the granting of the right to employees to demand that part of their earnings be converted into pension contributions. Such contributions are generally not subject to income tax nor, for a limited period, to social insurance contributions. Pension rights based on such employee contributions are vested immediately. This will be beneficial for people who interrupt their careers or change jobs and should improve occupational pension benefits for women. The 2001 pension reform also sought to further improve pension rights for women. In view of the fact that bringing up children often leads to reduced earnings (e.g. through part-time working or career breaks), pension entitlements are awarded by assuming average earnings during the first three years after the birth of a child. After that and up to the 10th year, low pension entitlements due to part-time working can be topped up.

02. France[16]

The French pension system is based on compulsory PAYG schemes, which cover 98% of total pension expenditure and are financed by social security contributions and taxes. The architecture of the schemes varies according to the sector of activity. Pension schemes for private sector employees cover 63% of total pension expenditure. Alongside a basic, general scheme with strong solidarity elements, mandatory supplementary pension schemes are established by collective agreements and financed on a PAYG basis. The benefit formula of these supplementary schemes is based on a point system and ensures a close link between contributions and benefits paid. Financial equalisation mechanisms exist between these different schemes.

A guarantee of a minimum level of resources for old people and the households to which they belong is provided through a means-tested complement to pensions received from other schemes. The extensive role of compulsory PAYG schemes in the French pension system leave little room for the development of other voluntary occupational or individual plans which nevertheless benefit from fiscal incentives.

In France, because of the early onset and the magnitude of the baby-boom, the number of new retirees will increase sooner and more significantly than in other Member States. Maintaining financial sustainability in the face of an expected rise of the old-age dependency ratio over the coming decades is seen as the main challenge.

Raising the effective age of withdrawal from the labour market (without increasing pension rights) is estimated to have a relatively large impact. Currently, the employment rate of older workers is still very low and the estimated labour-market exit age is, at 58.1 years, one of the lowest among EU countries. There is, therefore, large scope for increasing the labour supply of older people. The Government does not intend to raise the minimum legal age of retirement, which is now at 60, but rather aims to introduce incentives to postpone the effective withdrawal from the labour market.

The Government's strategy to cope with the financial challenge also relies on increasing employment among other groups, so as to strengthen the contribution base. There is scope for lowering unemployment and raising the employment rates of young people and women. A driving principle of the forthcoming reform is the safeguard of the compulsory schemes financed on a PAYG basis, which are regarded as an essential condition for inter-and intra-generational solidarity.

The pension adjustment is related to prices instead of wages, although leaving scope for some additional adjustments in the base of favourable economic performance. In order to reinforce the insurance character of the system, a 'solidarity fund' financed out of taxes was created with the purpose of funding certain solidarity elements (minimum old-age allowance, benefits awarded on the basis of the number of children, periods of national service, old-age contributions for the unemployed).

A pension reserve fund was created in 1999 with a view to smoothing contribution rates during the retirement of the baby-boom cohorts. However, assets of the reserve fund currently amount to less than 1% of GDP and will be difficult to boost, as aging will begin already from 2007 onwards.

03. Ireland[17]

The first pillar provides for flat rate payments and is financed through pay-related contributions from employers, employees and the self-employed. Supplements are payable for dependents, for those living alone and to pensioners over 80. Similarly, structured social assistance pensions are payable on a means-tested basis to those without a sufficient social insurance record.

The old-age (insurance-based) pension currently pays an amount equivalent to approximately 31% of gross average industrial earnings; the mean-tested pension pays slightly less. Rates of payment have increased significantly in recent years and the government has committed itself to a policy of ongoing real increases to the basic pension rates until 2007.

The second pillar consists of voluntary occupational pensions usually provided by individual employers. The third pillar is made up of individual pensions. The State facilitates and encourages second- and third-pillar pensions through favourable tax treatment of contributions and investment returns and by regulatory systems designed to safeguard pension entitlements.

Approximately 68% of members of occupational pension schemes are of the defined-benefit type with the remainder being defined-contribution schemes. The membership of second- and third-pillar schemes has been increasing by an average of 5% in each of the last five years as the workforce expanded rapidly. Currently, just over 50% of workers have supplementary pension coverage.

Aging presents challenges for Ireland of at least the same magnitude as for other Member States; the only difference is that this challenge, reinforced by increased longevity, will appear later.

The relative income situation of older people reflects notably the fact that Ireland is currently the only Member State without some form of compulsory income-related pension provision for a majority of workers. Moreover, the expansion of occupational pensions coverage - and employment in sectors that are well covered -

will take some time before producing its full impact on pensioner incomes.

As a means both to allow people to maintain an appropriate living standard in retirement and to contribute to spreading the future financial burden, raising the coverage of supplementary pensions is seen as crucial. Currently, occupational and private pension plans cover about 50% of employees and there are particularly low rates of coverage in certain sectors (eg 'hotels and restaurants' and 'wholesale and retail trades'). The government is seeking an increase in coverage to 70% of employees.

As a result of the progressive extension of compulsory insurance between the mid-1970s and the mid-1990s, 86% of pensions will be social-insurance-based by 2016. The absence of a means test and the fact that these contributory pensions are paid at a higher rate than social assistance pensions should reduce the number of pensioners on very low incomes. The Government has also set a target for supplementary pension coverage which should reach 70% of the workforce. To this end, the government will introduce personal retirement savings accounts (PRSA) from 2003 onwards as the main vehicle for increasing coverage. PSRAs will be subject to statutory limits on administrative charges, and pension entitlements can be maintained without penalty when an account holder changes or ceases employment. However, participation in a PRSA will be voluntary for an individual, but employers will be obliged to facilitate this unless they already operate an occupational pension schemes.

A key element of the Irish strategy is to build up a reserve fund to partially pre-finance public pensions to be paid out after 2025. The assets of the Reserve Fund will be drawn down by future Ministers for Finance commencing in 2025 until at least 2055.

04. United Kingdom[18]

The first pillar of the UK pension system consists of a flat-rate basic pension and an earnings-related additional pension, the State second pension that replaces the previous State earnings-related pension scheme (SERPS, introduced in 1978). These two tiers of the first pillar are financed through earnings related National Insurance contributions. The pensionable age is 65 for men and 60 for women. Legislation is in place to equalise State pension age at 65 by 2020. A full flat-rate pension requires 44 years of national insurance contributions for men and 39 for women. Pensions cannot be taken up before these ages, but may be deferred in return for higher benefits later (7.5% per year of deferral).

A unique feature of the UK pension system is the possibility to contract out of the earnings related tier of the PAYG financed first pillar. This requires coverage by an occupational or personal pension scheme providing equivalent or better benefits than the earnings related component of the statutory scheme. About 60% of the employed are in such contracted-out schemes and are entitled to a national insurance contribution rebate.

Occupational pension schemes tend to be established by a single employer and are generally of the defined-benefit type, providing pensions based on years of service and final pay. However, there is a trend towards defined-contribution schemes. Around 44% of the working population were contributing to an occupational or personal pension scheme in 2000/01 and 60% of pensioner households had income from an occupational pension scheme and 71% had investment income (including personal pensions).

Personal pensions were introduced in 1988 to offer a private second pension to people without access to an occupational scheme or who change jobs frequently. 12% of employees and 44% of the self-employed are building up personal pensions. To make private second pensions more attractive, stakeholder pensions were introduced in April 2001. The non-contributory minimum income guarantee provides means-tested support to people over 60, depending on their income and capital. Between 1979 and 1996, average net income of pensioner households rose by 64% while average earnings grew by 36%; however, the income of the poorest fifty of pensioners grew only by 30%.

Whereas adequacy had developed into a major challenge over the 1980s and 1990s, financial sustainability appears to be secured well into the future. Public pension expenditure was 5.5% of GDP in 2000 and was projected

by the Economic Policy Committee to fall to 4.4% by 2050, reflecting a smaller increase in old-age dependency ratios than in the rest of the EU and, most of all, indexation of basic pensions to prices so that their value in relation to earnings will decline.

In view of the importance of private provision, the current diversity and complexity of private pension schemes pose particular challenges. Individuals are faced with a range of choices when they start or change employment. The large number of schemes raises issues of the feasibility of close supervision. Many pension schemes have significant holdings of equities which have produced high returns historically but do introduce an element of volatility. Many pension schemes and life insurers appear to have suffered badly from the recent downturn on world stock markets.

The introduction of the State second pension in April 2002 will enable people on lower earnings to build up more pension entitlements. In addition, individuals will be credited second pension rights for periods when they cannot work due to caring responsibilities or disability. From 2002, low and moderate earners who contract out in favour of an occupational scheme will receive a top-up to ensure that they will also benefit from the improvements resulting from the State second pension.

With regards to the employment of older workers, there is a policy of encouraging people to work beyond the pensionable age. People may delay claiming their pension or even 'de-retire' when they have claimed, and earn increments.

05. Sweden[19]

The new first-pillar scheme introduced in 1999 consists of an earnings-related (contributory) scheme and an old-age guarantee pension scheme (non-contributory). The income-related scheme is contribution-defined and financed from a contribution rate 18.5% pensionable earning during the entire career. Sixteen percentage points of the contribution are used for PAYG financing and are accumulated at a given interest rate as a notional pension capital (which accumulates roughly in line with earnings); 2.5 percentage points are invested in one or several funds chosen by the scheme member (the so-called premium pension scheme). The earnings-related pension system is separate from the government budget and financed only by contributions which are to be held constant at 18.5%. The notional PAYG capital and the capital accumulated under the premium pension scheme are converted at the time of retirement into a pension the amount of which depends on the average life expectancy at the age of retirement.

The old-age guarantee pension provides a minimum pension for people over 65 years after 40 years of residence in Sweden. It tops up the pension entitlements from the statutory earnings-related pension scheme to be guaranteed amount and is financed by taxes. A new form of means-tested support for elderly people not entitled to the guarantee pension (mainly immigrants) will be introduced in 2003. In addition, means-tested housing allowances contribute significantly to many pensioners' incomes.

The second pillar consists of large occupational pension schemes based on collective agreements and covering around 90% of employees. The contributions are typically between 2 and 5% of wages. Traditionally, these pensions were defined benefit, but are becoming increasingly defined-contribution schemes. In 2000, pensions paid out of these schemes accounted for 17% of total pension disbursements.

Third-pillar schemes contributed around 4% to total pension disbursements in 2000. Such voluntary individual pension insurance is tax deductible.

The projected increase in the old-age dependency ratio is much smaller in the case of Sweden than for the EU as a whole. Moreover, the design of the new pension system will limit the future growth of pensions expenditure. Spending on old-age pensions under the public scheme is expected to increase from 9% to GDP in 2000 to 11.4% in 2040, decreasing thereafter. This rise is comparatively small and is not expected to represent a major financial challenge.

The employment rate of older workers is the highest in the EU. Early retirement is not a major problem. However, the number of older workers on sick leave has been rapidly increasing during recent years, thus raising issues regarding the working environment of older workers.

As the guarantee pension is linked only to the price index, real income growth will lead to a rising income gap between wage earners and pensioners with earnings-related pensions above the guarantee level, on the one hand, and pensioners who are only entitled to the guarantee position on the other hand. In the long run, this could lead to increased relative poverty risks, unless dependence on the guarantee pension can be reduced by rising entitlements to earnings-related pensions. Women might be particularly affected by such an evolution as their earnings generally tend to remain lower than those of men. As survivors' benefits are being reduced, persons with low individual pension incomes will be particularly exposed to a sharp fall in their living standards upon the loss of their partner. However, at present older women are still entitled to widow's pensions under transitional rules.

The response to the challenge of ageing and certain inequitable aspects of the previous defined-benefit scheme (higher pensions for people with irregular earnings profiles, but the same contribution effort) was a comprehensive redesign of the pension system in 1999 which fully come into effect in 2003. The earnings-related scheme aims for actuarial neutrality. Redistributive elements include: pension credits for the unemployed or for parents during the first four years of their child; and the guarantee pension. Those mechanisms are financed out of the general budget.

The challenge of financial sustainability is addressed through an automatic balancing mechanism built into the earnings-related pension scheme. It is designed to maintain the contribution rate constant at 18.5% of earnings and operates through an adjustment of the index applied to the notional pension capital of the PAYG part. If the contribution base of the system deteriorates due an economic slowdown or unfavourable demographic developments, then the index is revised downwards. Moreover, the conversion of the notional pensions capital takes account of life expectancy at the age of retirement and, thus, neutralises a major cause of rising pensions expenditure.

Meeting the financial sustainability challenge will also be made easier thanks to the large buffer fund which was established as early as 1960 to smooth out fluctuations in the flow of pension contributions and disbursements. This buffer fund is expected to contribute to the long-term financing of the pension system. Its assets amounted to 26% of GDP in 2001.

All financial risks under the new earnings-related pension scheme (longevity, falling contribution base) are borne by beneficiaries. However, the systems provides for a high degree of flexibility, both in terms of the choice of retirement age and in terms of the possibility of combining income from work with a full or partial pension. Actuarial neutrality will allow individuals to play their working life in such a way as to obtain an adequate pension and, thus, offers strong incentives for increased labour-market participation of older workers (already the highest in the EU). This requires, however, that employability and the ability to work are maintained. Currently, the government tries to address the problem of a rise in sick leave through a comprehensive programme aimed at promoting better health in working life. If a large number of people are unable to earn adequate pension entitlements, financial risks are shifted to the general budget (through the guarantee pension).

[14] Pg 8, Joint Report by the Commission and the Council on adequate and sustainable pensions, ECOFIN 76, SOC 115, 7165/03, 10th March 2003, Brussels

[15] Pgs 120 – 124, ibid

[16] Pgs 134 – 138, ibid

[17] Pgs 139 – 142, ibid

[18] Pgs 178 – 182, ibid

[19] Pgs 174 – 176, ibid