

# **Pension Reform, its Broad Context and Perspective**

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## **Abstract**

This paper discusses the issue of pension reform in the context of its consistency with broad intergenerational arrangements and general conditions which influence the speed of change and degree of success. The role of the State in underpinning the overall change is also discussed. The paper highlights the need for consistency between pension reform and other reforms and underlying social arrangements. Similarly, it stresses the importance of efficient and effective use of public resources in the light of the formidable challenge posed by population ageing and the need to respond with a consistent strategy in key policy areas.

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<sup>1</sup> The views expressed are those of the author and do not necessarily represent those of the Ministry of Finance

## **1. Introduction**

Given the dimension of the challenge of population ageing and its macroeconomic impact it would be difficult to point out any single country which has not already changed or modified its pension system. However, in many cases already reformed pension systems still fail to meet the objectives of ensuring long-term financial sustainability and adequacy of pensions (EC 2006). This means that in many countries reformed systems still fail to eliminate the contingent liabilities for governments (e.g. Augusztinovics 2007). What is also important to observe is that countries in South East Europe with equally newly reformed pension systems might also face similar challenges in the future: ensuring adequacy and sustainability of pension systems. Thus, the overall countries' experience with pension system reform suggests that pension reform is an ongoing endeavour and its success depends not only upon its design but also on its consistence with other important arrangements and institutions underpinning the way the societies function.

This paper aims at addressing broad issues that should be taken into account when reforming pension system and when reforming reformed pension systems.

## **2. Ensuring consistency between pension reform, social model and economic and demographic characteristics**

An important dimension to consider when facing pension reforms is that they are not made in a vacuum of social contracts but on the background of a complex set of existing intergenerational and intragenerational social, labor and financial contracts. Moreover, changes in pension systems are made against different ageing structure profiles, stages of economic and financial development and labor market structures and performance. These characteristics to a large extent limit the possibilities for alternative design of pension arrangements and affect their relative success if are not properly taken into account.

When addressing pension system reform it is important to clarify that what is at stake is the reform of collective insurance system whose aim is not the distribution of income among individuals. Rather, it is the provision of income irrespective of income position of the individual based on own contributions. Pension insurance and its benefits (income transfers upon retirement) are usually based on an individual's historical earning records. From this perspective a system facilitates individual's own income replacement at the time of retirement. There are, however, systems that grant a basic provision irrespective to income from earnings (e.g. Denmark, Netherlands and to some extent UK) which are usually topped up by mandatory occupational pensions. Even in these cases it can be argued that the primary role of the public pension systems is still insurance against the contingency of insufficient savings and not distribution. Nevertheless, there are also systems that include certain distributive features, such as a limit to maximum pensions or access to minimum pension when income contribution did not reach a given level.

The primary function of a pension system is to insure income upon retirement. Pension systems are only part of the complex set of arrangements ensuring that income is smoothed out throughout the life of individuals. With the evolution of societies, the insurance against lack of income for survival in old age has been formalized in contracts with different degrees of risk sharing with different pooling sizes. In many European societies (inspired by Bismarck) the shift

has come from an informal risk sharing arrangement where at least three generations lived together, ensuring income smoothing out through life, into one in which the arrangement became formal and mediated by the State in the form of pay-as-you-go pension system. Such system diversified dependence on family risk to a broader risk sharing arrangement with universal pooling within a country. Now the movement seems to be towards government sponsored arrangements where individuals rely only on their own individual insurance and assume their own risk alone.

The change in pension system insurance has been facilitated by the State and its power to compel risk sharing and by the development of financial markets. The degree of unbundling of risk pooling or resistance to it in systemic pension changes seems to be rooted in idiosyncratic factors, attitude toward risk and degree of social cohesion. The attitude towards risk unbundling might be also motivated by wrong perceptions as to income redistributive possibilities of pay-as-you-go pension systems and non-transparency of its financial possibilities given worsening of demographic profiles.

The wrong perception of a predominant income redistributive function of a pay-as-you-go system might be due to the fact that usually a pay-as-you-go pension system is part of a universal social system in which inter-individual transfers of insurance nature over the lifecycle constitute the bulk of transfers and backbone of the system. This system contrasts with welfare systems with strong targeting element where the emphasis is on inter-personal transfer. Furthermore, countries with large intra-individual redistribution over each individual's lifecycle are usually associated with high aggregate social spending. In such countries, relatively low public social spending of intra-individual redistributive nature is sufficient to generate considerable inter-individual redistribution of yearly income (Stahlberg 2007).

Bringing transparency as to the possibilities of pension system benefits facilitates risk shifting. The key issue is that it can be established only if it is accompanied by reform measures for which a broad consensus is needed. To achieve this, it is important to clarify which elements of pensions systems are of social insurance nature and which of them correspond to welfare system. Getting consensus over reform also depends on the credibility of the system as measured by relative contributions to it. In countries where systems still enjoy credibility, the possibilities for risk unbundling seem to be restrained compared for example with those countries in where systems practically collapsed and where a pension reform was perceived as part of broader transition reform agenda. In credible systems, payroll taxes (i.e. pension contributions) are not perceived largely as taxes and thus have limited distortionary effects on incentives.

Progress in reforming a pension system, in determining the degree of pension risk unbundling, involves making the risks the pension system covers explicit and addressing them appropriately. As a reform of pension system is part of a complex set of universal system of inter-individual transfers and legal arrangements supporting them, it is equally important to assess their interaction and ensure an overall consistency.

Pay-as-you-go systems still deliver pensions but the adverse demographic effects captured by the extension of life expectancy and decline of fertility rates will lead to unsustainability starting at the end of next decade. The adverse changes in demographic variables require an appropriate policy response now to ensure adequate level of future pensions. Prolonging working life can

deal to a great extent with the increase in longevity while diversifying the sources of retirement income can help to offset the drop in fertility rates. Concrete policy responses include prolonging retirement age including streamlining incentives for retirement and creating room for partially funded pensions within existing levels of pension contributions. In countries relying more on funded pension schemes already the issue is to ensure coverage and soundness of the system.

Dealing with incentives for retirement may seem straightforward, but a careful assessment should be given as to where the incentive should be placed: on the final pension or on wages. This is particularly relevant in light of the type of predominant labor market contract in an economy (e.g. seniority system, permanent contracts) and in light of fiscal implications.

Countries in Europe have different degrees of development of financial system and face different challenges in the labor market. With transition costs determined by demographic profiles, these are the two key issues to address when transferring risk to individuals and determining the ambition of reforms. In particular, the institutional setting should allow managers of private pensions to deliver a return higher than wage growth. Similarly, coverage should be universal which can be facilitated by appropriate financial return on pensions and particularly by encouraging labor market participation and reduction of informal economy, thus addressing labor market conditions. For those countries belonging to the EU, the integration of national financial markets and improving the functioning of local markets can facilitate achieving average pension returns at the level of EU market. To some extent such policy might be relatively straightforward to implement and deliver. However, in the case of labor market reform implementing policies are very demanding.

Countries have embraced different approaches to market labor reform. Different approaches and their implementation also took place under different circumstances (e.g. post crisis in Denmark, UK). Labor market reform seems also to exhibit a consistency with the degree of pension risk already transferred to individuals and with financial possibilities that this process provides to the State to underpin a given labor policy. Table 1 shows government expenditure on labor market policies and relative labor market performance indicators. Expenditure in labor market policy is broadly consistent with the degree of pension risk transfer and of course with social model and specific labor market problems. When pursuing labor market reform, it is also important to ensure consistency between the possibilities of pension risk transfer and the constraints this imposes on the overall fiscal expenditure necessary to underpin different reforms.

Reforming a pension system in countries that rely on pay-as-you-go systems by transferring risk to individuals touches upon the intergenerational agreement or the “hand-shake” across generations as well as upon the underlying supporting contracts. Social systems that rely on intergenerational income transfers as means of smoothing out income through life cycle, including pension and education expenditure, are underpinned by supportive labor contracts, earning profiles and can be argued even by the degree of progresivity of personal tax systems. In these countries the slope of earning profiles across different age groups tends to be relatively steep and exhibits high degree of age-related earnings progression as evidenced in France, Italy, Luxembourg and Germany (Figure 1). In France and Italy, earnings appear to peak just before retirement (age-group 55-59) Nevertheless, in most countries, earnings tend to peak at ages 50-54. Underlying labor contracts are usually characterized by rewarding seniority, predominance of fixed-term contracts and stronger employment protection legislation (Figure 2). Progressive

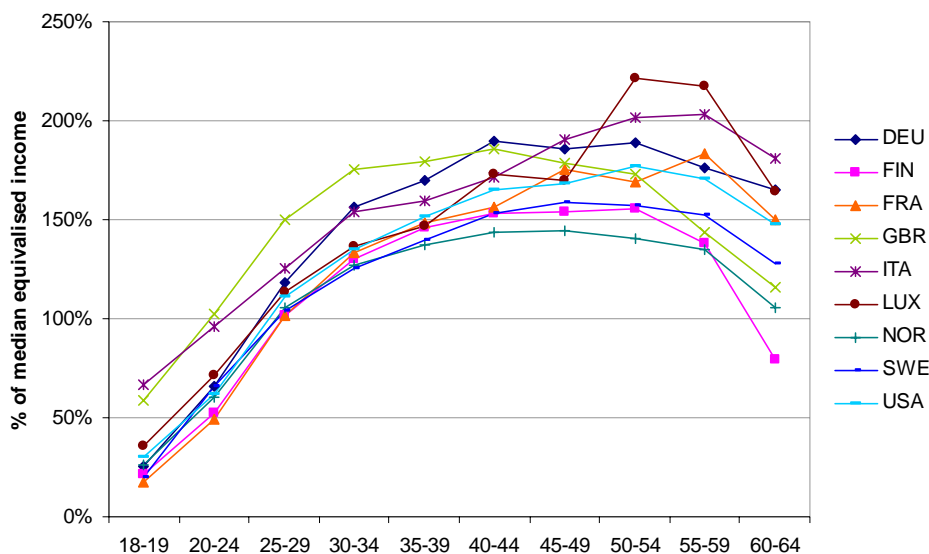
personal income tax systems also contribute to smooth out the income through the lifetime cycle. Before joining the labor market, individuals receive transfers, then after joining it they usually have lower salaries and pay low taxes. As they age, their labor income increases as well as the tax paid thus underpinning the intergenerational system of social transfers.

**Table 1. Labor market indicators**

	Expenditure in labor market policy as % of GDP 2005	Employment rate 2006	Unemployment rate 2006
Denmark	4.0	77.4	3.9
Germany	3.0	67.2	8.4
Netherlands	2.9	74.3	3.9
Finland	2.6	69.3	7.7
Sweden	2.3	73.1	7.0
France	2.3	63.0	9.4
Spain	2.0	64.8	8.5
EU (15 countries)	2.0	66.0	7.4
Ireland	1.3	68.6	4.4
Italy	1.3	58.4	6.8
Poland	1.2	54.5	13.8
Slovenia	0.7	66.6	6.0
Hungary	0.6	57.3	7.5
Greece	0.5	61.0	8.9
Latvia	0.5	66.3	6.8
United Kingdom	0.3	71.5	5.3

Source: Eurostat and Slovenia MF

**Figure 1. Average amount earned by those with positive earnings in each age group**



Notes: Earnings include employment and self-employment incomes. They are measured at the individual level and expressed as a percentage of median equivalised household income (see notes to Table 3). See text for further details.

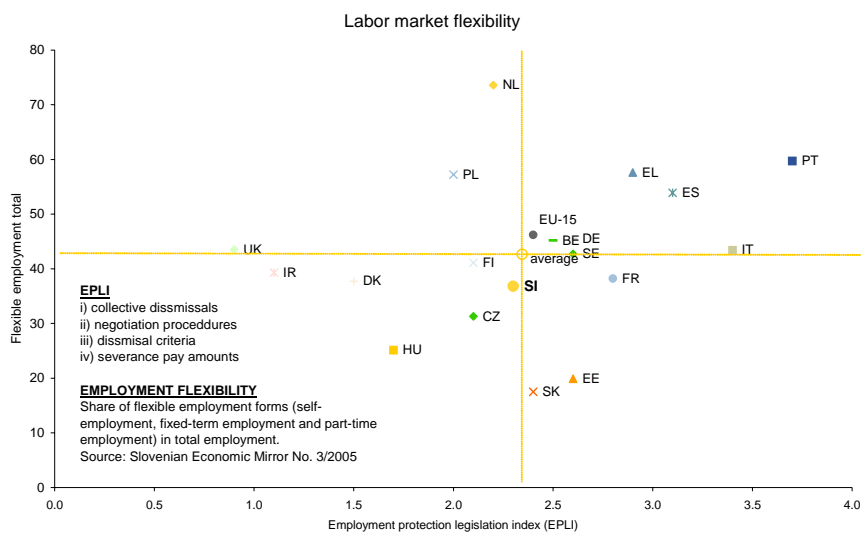
Source: Dang, T T, H Immervoll, D Mantovani, K Orsini and H Sutherland, 2006,

Countries with relatively advanced degree of pension risk transfer to individuals (i.e. individuals relying on pension savings (Table 2) tend to have less stringent employment protection legislation and thus flatter earnings structures across age groups (Figure 2). In these countries that

have reduced or eliminated intergenerational transfers associated to pension income, the key issue is ensuring coverage of the system, particularly in mandatory programs (Table 2).

Irrespective of the systems fostering participation in labor market is critical. In countries relying on the intergenerational “hand-shake” this is pursued by the universal intra-generational transfers system which also results in low poverty incidence. In other systems, this is pursued by alignment of tax and benefit systems and targeted mean tested benefits. Thus the experience of countries that chose systems with high degree of risk unbundling, low or inexistent transfer of pension income for retirement indicates that other contractual and institutional arrangements also have to be aligned to ensure consistency. Furthermore, it implies that reforms in areas other than pensions alone have to be implemented. Therefore, one of the key issues when reforming pensions is to look for consistency in the policy setting, sequencing of reforms and their appropriate pace.

**Figure 2.**



Source: Eurostat and Umar

Besides consistency with the overall policy setting, another issue to observe is the constraint that the demographic profile and the time of its worsening imposes to the scope for reform itself. Countries that have earlier diversified income sources for retirement have a relative advantage in this regard. In these cases the challenge is different and concerns: charges, discontinuity in contributions, investment strategies, investment performance, fund annuitisation, provider incentives and regulation (Blake 2007). The scope for reform in countries that rely primarily on pay-as-you-go systems is heavily constrained by the demographic profiles. Progress towards diversification to income sources by, for example, fostering transition to compulsory savings in defined contribution schemes within the existing level of pension contributions, is constrained by the size of associated transitional deficits. Combination of policy measures, including: prolonging retirement age, incentives for delaying the retirement and reforms that create some room for private savings seems the way forward (e.g. Sweden and German pension reforms). In proceeding in that direction, careful attention should be placed to address appropriately the social insurance and welfare assistance dimensions.

**Table 2.** Type of system and coverage rate 1/

	Coverage rate (%)			
	Statutory pensions	Type of statutory scheme (DB, NDC or DC)	Occupational and voluntary pensions	Type of supplementary scheme (DB or DC)
NL	100	DB	91	DB
SE	100	NDC and DC	90	DB
DK	100	DB	78	DC
DE	Nd	DB	70	DC
UK	100	DB	56	DB
IE	100	DB	52	DB
BE	68	DB	40-45	DC
IT	100	DB and DC	11.4	DC
LV	100	NDC and DC	/	/
PL	77	NDC and DC	/	/
EE	100	DB and DC	/	/
LT	83	DB and DC	/	/
HU	100	DB and DC	/	/
SK	Nd	DB and DC	/	/
CZ	100	DB	/	/
AT	100	DB	/	/
SI	100	DB	/	/
FI	100	DB	/	/
LU	92	DB	/	/
ES	89	DB	/	/
CY	86	DB	/	/
PT	82	DB	/	/
EL	Nd	DB	/	/
FR	Nd	DB	/	/
MT	Nd	DB	/	/

1/ Coverage rates refer to the coverage of the labour force; in some cases (notably for occupational and voluntary pensions), this can refer to the coverage of the employees in the private sector. They also provide information on the type of scheme taken into account (DB, defined benefit, DC, defined contribution, NDC Notional defined contribution).

Source: Current and Prospective Theoretical Pension Replacement Rates. Report of the Indicators Sub-Group (ISG) of the Social Protection Committee. May 2006

It has been claimed that reform is an ongoing task. However, delaying it has costs in terms of room creation for savings and their foregone stream of financial returns needed to offset the decline in replacement rates or to reduce the sole emphasis of prolonging the retirement age. Addressing these costs by means of diversifying pension income requires a fair burden sharing among currently coexisting generations. It touches not only the level of current unsustainable pension benefits but also future lower benefits. Creating room for savings within existing level of pension contributions requires a view on the sustainable systems' overall replacement rate. This touches upon benefits of current pensioners and longer working lives for exiting and future generations.

### 3. Delimiting the role of the State: Using resources effectively and efficiently

Another important element in a pension reform is defining the role of the State and its obligations. As the issue involves reform of State-sponsored pension insurance, system reforms have to ensure both adequacy of pensions and sustainability. Many pension systems or reformed systems in EU countries still fail to meet one or both criteria (European Commission 2006). The breaching of the criterion of financial sustainability is very obvious as estimated in the evolution of future expenditure associated to pensions and other age related expenditures (Table 3). What is

less obvious is the hidden financial effect on sustainability of pension systems associated with lack of adequacy of pensions and of insufficient coverage. In these cases, the contingent liability status for the State arising from low pension benefits or low system coverage does not disappear. Thus pension reforms have to meet the two mentioned criteria. Similarly, comprehensive and fair assessment of the financial sustainability of a State sponsored pension system has to include the impact of inadequate pension benefits.

**Table 3. Indicators of sustainability and adequacy of pensions**

	Evolution of statutory pensions expenditures between 2004 and 2050	Gross replacement rate all pensions		Change	Contribution rate used
		2005	2050		
BE	5,1	43	47	4	50,5
CZ	5,6	61	53	-8	28,0
DK	3,3	49	64	15	13,6
DE	1,7	43	48	5	23,5
EE	-0,1	33	36	3	22,0
EL	-	105	94	-11	20,0
ES	7,1	91	85	-6	28,3
FR	2	66	49	-17	20,0
IE	6,4	67	67	0	30,0
IT	0,4	79	80	1	39,6
CY	12,9	46	57	11	16,6
LV	1,5	61	55	-6	20,0
LT	3,7	31	42	11	26,0
LU	7,4	91	91	0	24,0
HU	9,9	66	77	11	26,5
MT	-0,4	72	53	-19	30,0
NL	3,5	71	69	-2	21-22
AT	-1,2	64	69	5	22,8
PL	-4,6	63	36	-27	36,9
PT	9,7	75	70	-5	34,8
SI	8,3	68,6*	53	-15,6	24,3
SK	4,1	49	50	1	
FI	3,1	57	52	-5	21,6
SE	0,6	68	56	-12	30,9
UK	2	66	69	3	34,6 - 38,4

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Source: European Commission 2006. Synthesis Report on adequate and sustainable pensions 2006 and Ministry of Finance of Slovenia

In determining the role of the State in a pension reform it is important to define and disentangle the elements of social insurance from those of welfare assistance. This in turn can streamline labor incentives and improve contribution coverage. Blurring the link between contributions and benefits in the pay-as-you-go systems as part of reform efforts can only hinder the outcome of reforms. This, for example, is the underlying philosophy of notional defined contribution systems in which individual accounts are credited with notional interest.

The main characteristic of social insurance programs is that they are mandatory or induced by fiscal subsidies (Feldstein 2005). This implies that government involvement takes different forms: underwrite potential contingent liabilities of the system by compelling participation,

supplement resources to individual contributions or favor certain groups of individuals. As mentioned above, one of the main aims of reforming a pension system is to bring transparency with respect to the insurance and welfare elements. In order to ensure overall integrity and consistency of the system, the State financial backing should also correspond to these two elements. Transparency in turn contributes to ensure that intertemporal constrained resources are used efficiently and effectively within and across generations of taxpayers. This is particularly relevant with regard to the use of fiscal incentives for motivating voluntary savings outside of what is strictly the universal insurance system. The issues at stake are: i) the relatively poor effectiveness in encouraging voluntary savings for low- and middle-income individuals and the opportunity cost associated with not using these resources to support the sustainability of mandatory system or to reduce public debt and; ii) the lack of power to increase overall savings rather than simply influence the composition of savings, for which there is ample agreement.

Tax incentives for voluntary savings include: i) tax deduction for contributions; ii) the deferral of taxes on account earnings; iii) government matching of contributions. Evidence from the United States indicates that the first two approaches have not enticed low- and middle-income families to contribute much to such accounts (Dulfo et al 2005). With regard to the effect of matching contributions in encouraging the savings, the literature is not conclusive. It points out that savings tend to match the amount provided by the State which again leads to the issue of the opportunity cost of these resources vis-à-vis sustainability of mandatory pension insurance. However, in the case of low- and middle-income families, data from the US shows also that the incentive is not too strong. Thus, the evidence suggests that primary beneficiaries of tax incentives are high income earners and that tax incentives have strong distributional effects. Therefore, to ensure that scarce public resources are used effectively and efficiently the use of tax incentives should be limited to the compulsory social insurance only.

The importance of the use of scarce resources effectively as part of a broad strategy dealing with the demographic challenge of ageing of population is even more evident taking into account that the State has to preserve human capital and foster labor market participation. Key task in this regard is to encourage life-long learning to deal with increased longevity. It is equally important to increase the education level and skills of labor force and of new generations which should enhance employability and own responsibility and will contribute to an uninterrupted participation in pension schemes.

A key element in a strategy of effective unbundling of pension risk pooling is fostering financial literacy. This requires transparent (i.e. return, risk and cost) and well-functioning pension markets including provision of well designed universal products. A well-functioning pension product market constitutes the best incentive for individuals to save.

#### **4. Conclusions**

Pension reforms have to maintain consistency with the stage and changes in the complex texture of intergenerational transfers and contracts characterizing all social systems. Such systems are built on preferences, values and risk attitudes of their population. The pace of reforms and their success are heavily influenced by them. Similarly important in setting the scope of unbundling pension risk sharing and the success of reform are the demographic structures themselves, the stage of development and functioning of the labor and financial markets.

For countries relying on pay-as-you-go systems, pension reform might imply a partial or total dismantling of one of the key insurance mechanisms underpinning the social model based on intergenerational income transfer. For these countries the issue is whether to maintain the degree of broad social risk pooling underpinned by the set of intergenerational insurance transfers through alternative policy instruments or simply to change to a model in which welfare assistance is the dominant feature. Not conceptualizing these changes in a comprehensive manner and pursuing unarticulated piecemeal reforms in various areas could result in worse outcomes.

Nevertheless, the issue is far more complicated than the rational conscious choice between policies and of pursuing consensus upon it. This is because the demographic effects of ageing of population are fast approaching (2020). For many countries this implies that a total risk unbundling from the pool of population towards individuals is financially unfeasible. For these countries, the option seems to be ensuring consistency between the degree of pension risk unbundling, reforms in other key areas and their financing. In these cases, pursuing labor market reforms similar to those of countries whose pension systems already rely on private savings and labor market participation is underpinned by large social transfers could lead to inconsistency and add to already unsustainable long-term fiscal pressures.

The aim of pension reform is to insure adequate income upon retirement while at the same time ensuring long-term financial sustainability. The role of the State is fundamental in handling the demographic challenge. Its success depends upon introducing transparency upon financial possibilities of the pay-as-you go systems, delimiting its insurance function from welfare assistance and defining the role of the State with regard to these functions.

The State has a key role in facilitating policies to deal with the challenge of ageing of population which place an extra premium on already scarce public resources. This is why the State should foster consistent reforms that correspond particularly to the degree and possibilities of unbundling pension risk to individuals. Similarly, in light of important financial requirements associated with preserving and improving human capital to cope with the challenge of ageing and provision of pensions, scarce financial resources underpinning pension entitlements at best should be restricted to the compulsory system.

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