Defusing the Pension Time Bomb
Increasing Employment Rates – A Key Policy Measure for Maintaining Sustainable Pensions in Europe

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Abstract

Demographic changes and pressure on public finances are the main driving forces for reforms of welfare and pension systems in Europe. There are high-pitched calls – particularly from countries such as Austria, Italy, France, Germany and the United Kingdom – for attention to be re-focused on basic facts, arguments and interests. Reforming pension systems is one of the priorities of the current Italian Presidency. This article seeks to provide an introduction to the debate currently taking place in numerous current and future EU Member States. After a description of the main financing methods of pension systems, the role of the EU institutions in the pension reform process will be analysed. Further on, some light will be thrown on the need to reconsider the financial, social and employment implications of pension systems in Europe. Particular attention is given to the work-retirement process, i.e. the initiative to boost employment rates in order to increase contributions to social protection systems and to reduce public expenditure.

I. Introduction

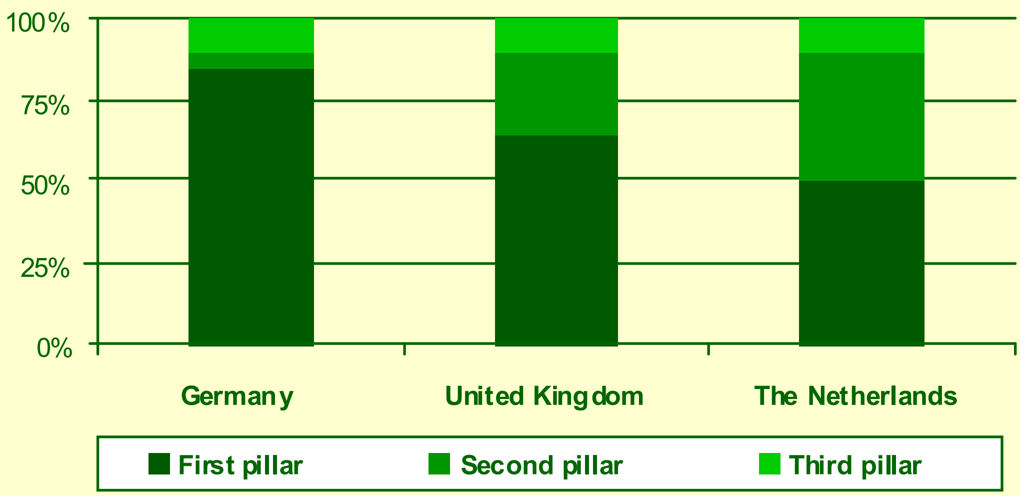
It is common knowledge that it is not biology, but culture that defines when people retire. When the German Chancellor Bismarck introduced a retirement age of 70 in 1889, it was both cultural and social factors which shaped his political decision.[1] At that time, average life expectancy was less than 45 years.[2] The large majority of people died before they reached retirement age. But times have changed. Today's generation is the most prosperous and healthiest ever, with a much higher life and health expectancy. European citizens enjoy retirement almost as a "second life" which can go on for 20 to 30 years. The Welfare State, however, seems to be overburdened. The large increases in expenditure on public pensions projected for most European countries constitute a "time bomb" situation. Acquired rights are called into question because it is simply not clear whether social security systems can afford to fulfil pension claims. Within the EU, the number of contributors per pensioner within the statutory pension system is diminishing. Faced with low birth rates, the EU will move from having four to only two persons of working age for every retired person.[3] The Central and Eastern European countries are not being spared this demographic shift towards ageing. Although populations in Eastern Europe are still younger on average than in the EU, they are ageing even more rapidly, because of their – in some cases – extremely low birth rates.[4] In response to increasing pressures on public finances, Member States have undertaken several reforms aimed at ensuring adequate incomes for older people and combating poverty after retirement. The time for substantial reforms is "ticking away"; if reforms are not undertaken, the situation will call for large increases in taxation and/or large cuts in public services, either of which would be quite unpopular in European countries.

II. Distribution versus Funding

There are two principal financing methods for pensions: distribution and funding. Financing pensions by *distribution* means that state-based public pensions ("first pillar pensions") are based on the principle of solidarity between generations. Within these "pay-as-you-go" systems, current contributions are paying current pensions. Countries like "Bismarckland" Germany, France, Greece, Italy and Spain mainly have first pillar pension systems. Financing pensions by *funding*, however, means that, instead of instant distribution to the benefit of the retiree, private actors provide contributions for later retirement benefits. People save while working to accumulate a fund that will buy them an annuity at retirement. Occupational pension schemes, to which the employee and eventually also the employer contribute, are financed by funding. They constitute the "second pillar" of the pension system. Pension schemes funded by the individual, for instance by a life insurance or a private investment fund, constitute "third pillar" pensions. Within the EU Member States, there are great differences in how these pensions schemes are composed to build an aggregated retirement income (see graph 1 comparing three Member States).

In the majority of Member States, public pensions are the main source of income for older people and this is likely to remain the case, even though occupational and private pension provisions are expected to become more important. However, one of the main reform trends underway is promoting more financially-sustainable pension systems by increasing space for contributions

Graph 1: Importance of the 3 Pension Pillars for the Retirement Income



to occupational and private pension arrangements. In particular, countries with a Bismarckian philosophy are trying to convert their monolithic public insurance systems into multi-pillar systems with stronger occupational and private pension schemes. Coverage of occupational pension schemes is, however, satisfactory only in The Netherlands and Sweden, where ca. 90% of the workforce have occupational pension schemes. In Italy, for example, only 5% of the workforce have occupational pension plans. The overall trend is evident: the downsizing of statutory social security pensions will further increase the role of employer-sponsored pension plans. In the long run, some responsibility must be transferred from the State to the individual. In summary, experts agree that distribution and funding schemes are complementary.[5] Public pensions should not be replaced, but supplemented by occupational and private pension schemes.

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III. The EU Pensions Process

According to the principle of subsidiarity, the primary responsibility for political decisions on reforming pension systems lies with the Member States. The European institutions have, however, an increasing role to play. Article 2 of the EC Treaty states that the Community's core tasks are to promote a "high level of social protection" and "social cohesion".[6] Maintaining a high level of social security will remain an important objective, since forthcoming reforms of pension systems might trigger the risk that some parts of the population (such as women with interrupted careers due to child care) will have less retirement income than they would have if they retired today.[7] At the Lisbon summit in March 2000, the European Council mandated the Member States to analyse the long-term future of their social protection systems. The European integration process will thus compel European countries to reform their welfare systems. The growth and stability pact imposes on governments drastic limits on inflation and public budget deficits. Ministers of Finance can no longer manipulate exchange rates; consequently, the room for manoeuvre to stimulate the economy for the sake of necessary reforms is substantially curtailed. Moreover, the rapid integration of the world economy accelerates competition between national economies. The threat of the exodus of local industry further reduces the possibility of governments' raising tax in order to ensure sustainable social expenditure.

A "Maastricht for Pensions"?

The Italian Presidency of the Council of the European Union has identified the reform of social security systems as one of its priorities during its tenure – from July to December 2003.[8] The Roman government's idea is to synchronise social policies with economic and employment policies. It has launched a plan for a new "Maastricht for welfare" referring to the EC Treaty limiting public deficits to three percent of gross domestic product. Prime Minister Silvio Berlusconi dared to speak even of a "Maastricht for pensions". According to the principle of subsidiarity, however, the EU has no competence to define common standards for pension systems in EU Member States. The route to achieving sustainability of pension schemes will vary from Member State to Member

State. Thus, the "Maastricht for pensions" initiative is really a means of launching a homogeneous classification system for accounting for social costs at EU level by the end of 2005.[9]

The Joint Pensions Report

The EU institutions have undertaken several measures with regard to pension systems. One important measure at the EU level is the "Joint Report by the Commission and the Council on adequate and sustainable pensions" adopted by the European Council on 3 March 2003.[10] For the first time, the EU institutions have analysed national pension systems and their ability to face the challenge resulting from demographic and financial pressures. Earlier in 2002, the Member States provided National Strategy Reports on their pension reforms to the institutions in Brussels. Member States will have to ensure that their pension systems respond to changing societal needs, such as increasing the labour market participation of women and the growing share of part-time, self-employed and temporary workers. The Joint Pensions Report and cooperation between the Member States is based on the open method of coordination.[11] At the Laeken summit in December 2001, Member States agreed on 11 common objectives designed to secure the future of their pension systems. Two of these objectives, raising employment levels and extending working lives, are examined in more detail below.

The Single Market for pension provisions has not yet been achieved.

The Pension Funds Directive

Another important measure concerns the Single Market for the provision of pensions. The EU ensures the smooth functioning of the Single Market. The free movement of workers, capital and the freedom to provide services[12] are, however, not fully achieved yet with regard to pension provisions. This is in particular the case for work-related pension schemes. The communication from the Commission "Implementing the framework for financial markets: action plan" identified a series of actions that are needed in order to complete the Internal Market for financial services. At the Lisbon summit in March 2000 it was decided that a framework Directive should pave the way for enhanced cross-border provision of pension services. On 13 May 2003, the Directive concerning the promotion of occupational retirement provisions was adopted.[13] The Directive applies to second pillar pension schemes and provides a legal framework for institutions that intend to offer pension funds across borders. Once the EU framework is transposed, a pension fund provider will be allowed to distribute his fund services in other Member States after approval by his home country. After 13 years of negotiations, the Directive is a compromise between security and flexibility concerning how pension funds are allowed to invest contributors' money. The clock is now ticking for the countries to implement the Directive within two years; only then will pan-European pension funds be able to make full use of the Single Market. A common framework for occupational pension services would have clear cost benefits: the oil company BP, for instance, estimates the yearly costs for managing pension funds for its employees all over Europe at 40 million Euros.[14]

Initiatives in Favour of the Integration of Pension Markets

Taxation issues are, however, excluded from the scope of the Pension Funds Directive. To legislate an EU-level compromise is not conceivable at this stage, as the tax systems are too different. The functioning of tax regimes frequently results, however, in discrimination between residents and non-residents or between domestic and foreign pension providers. These conflicts may create obstacles to cross-border movements within the Single Market and, consequently, might become a matter for the European Court of Justice (ECJ).[15] The recent judgement in the "Danner Case", for instance, represents an important step paving the way towards the setting up of a more efficient system of co-ordination between tax authorities in the different Member States.[16] The ECJ ruling helped to remove one important obstacle to the free provision of pension services within the Single Market. In 2003, the European Commission initiated infringement procedures against Belgium, Denmark, France, Italy, Portugal and Spain with regard to eliminating tax obstacles to the cross-border provision of occupational pension schemes that are contrary to European Community law.

IV. How to Boost Employment Rates

Pension systems in most European countries must be adapted to longer lives and better health of the workforce. Does it make sense for individuals to retire five to 10 years earlier than their parents did, when they are in far better health and are likely to live six to nine years longer? Policy makers can long debate the design of pension schemes or social equity and distribution. It would be useless, however, if there are not enough people to pay into the system. Thus, one of the main conclusions of the Joint Pensions Report is the need to raise employment. The more people are in employment, the more people contribute to the financing of pensioners' income. Increasing employment rates is the key strategy for maintaining sustainable pensions. The rationale for this measure is its mitigating effect on developments in the relation between contributors and beneficiaries. Drastic cuts in future pension levels can be averted by raising the retirement age, in particular of workers older than 55 years. Thus, there is room for improvement since the EU has low employment rates compared, for instance, to the U.S. and Japan.

According to a projection undertaken by the

European Commission, a one-year increase in the effective retirement age would absorb about 20% to 30% of the average expected increase in pension expenditures in 2050. In view of the target set at the Barcelona European Council in March 2002, namely to raise the average age of withdrawal from the labour market by five years by the year 2010, it might be sufficient if most people stay in the labour market until the statutory retirement age, which in most countries is 65. While raising the retirement age seems attractive from an economic point of view, it faces big problems in public opinion which, in turn, will make reform campaigns difficult for politicians. According to a Eurostat survey (Eurobarometer October 2001), only 23% of European citizens are in favour of this strategy, while 40% express strong and 29% slight disagreement.

Early retirement is the "original sin" in a lot of European countries.

Early Retirement and Gradual Retirement

Retirement behaviour of people is often problematic. Early retirement seems to be the "original sin" in a lot of European countries. Policies allowing employees an early exit from work have been used to create jobs, in particular for the younger generation, but this strategy has usually failed. Most jobs done by elderly employees are not interchangeable with jobs for the younger. It is not simply a matter of the younger filling the shoes of the older staff member. Instead, the overall volume of work has to be increased. Early retirement policies with their enormous costly effects made it too easy for employers, unions and workers to shift labour market problems onto pension schemes. Instead of adjusting unemployment statistics in the short term, it seems better to address the causes of the problem in the long term. However, "success stories" of countries such as The Netherlands, Denmark and Sweden show that this trend can be reversed.[17] To conclude, there will continue to be a need for social protection schemes which allow people to retire early under certain circumstances, for instance in the event of long-term illness. But early retirement must be an exception to the rule.

The need to combat early retirement policies is complementary to the need for gradual progressive retirement, e.g. to combine a partial pension with part-time work according to one's own preferences and physical abilities. Retirement is normally an abrupt process, whereas gerontologists have long praised the concept of gradual retirement as helping workers to avoid the "pensions shock". Research has shown that "cliff-edge" retirement, i.e. going from full-time to zero work, can be problematic for both employees and employers. There is much advocacy by the academic world for the merits of a gradual withdrawal from working life both for employees and for employers. There is evidence that employees perform with higher job satisfaction, whereas employers benefit from a higher retention of the workforce and of the skills of experienced workers. However, when it comes to new forms of retirement, attitudes matter. Altering the expectations of older workers will require that they be offered better opportunities to stay in working life. Gradual retirement is still a limited phenomenon in practice.[18] Many companies are reluctant to let their employees retire gradually. Part-time work is still "ghettoised": it is largely perceived as a special form of employment which employers do not wish to accommodate. Government policies promoting more gradual retirement have largely failed, because the schemes have been overcomplicated or because they have been swamped by programmes that offer full early retirement.

With regard to retirement patterns, little change has been observed. Positive incentives for older workers to remain in employment might not be large enough to induce them to leave the labour market later. The incentives originating from the tax or social security systems need to be substantial in order to have an impact on the worker's decision to retire or to combine work and pension.[19] As a comparison,[20] if a worker has the choice between working 35 hours a week and 40 hours a week with an unchanged weekly wage, it is evident that he will opt for the 35 hour week. In contrast, offered a choice between a 35 hour week and a 40 hour week with five hours more wages paid in the latter case, it would not be surprising if the majority chose the 40 hour week. As a result, reforms extending working lives would obtain support if there were clearly communicated and substantial incentives for employees to work longer.

Social Dialogue and a New Culture of Ageing

Social dialogue aimed at seeking full participation of the social partners is of the utmost importance. Changing employer and union practices in transition from work to retirement will require a major effort in close co-operation between social partners, as shown by "best practices" in countries such as Sweden and The Netherlands. The broad acceptance of a reform is a precondition for its long-term sustainability. The burden imposed by the demographic changes must, therefore, be distributed equally among generations. Reform measures should be implemented gradually; there will be no "big bang" reforms. The measures must be announced well in advance and need a strategy which reaches beyond the next election. The precondition for this is a broad consensus.

With regard to general attitudes and expectations of every citizen, a "new culture of ageing" seems to be needed. The capacities of older people represent a great reservoir of resources, which has been insufficiently recognised and mobilised. There is a potential to facilitate greater contributions from people in the second half of their lives. The definitions for "retirement" and the question "who is old?" should be reconsidered. In France, for example, 88% of staff aged 65 consider themselves "not old" in the sense of not suffering from

Graph 2: Reform Measures

Focus on Employment Policy
- Increasing employment rates
- Raise effective retirement age
- Combat youth unemployment
- Enhance female employment rate
- Boost gradual retirement options
- Combat early retirement
- Establish age-neutral pay systems
- Promote age diversity within working staff

Focus on Social Policy
- Social dialogue: consensus betw. social partners
- Develop a new culture of ageing
- Intergenerational fairness:
- Separate age and non-age related benefits
- Provide lifelong training for older workers
- Combat social exclusion of vulnerable groups: women, long-term unemployed, etc.
- Improving child care facilities to increase female participation on the labour market

Main measures and aspects aiming at reforming pension systems in Europe

Focus on Economic Policy
- Increase coverage by occupational and private pensions: 2nd and 3rd pillar pensions
- Closer link between benefits and contributions (actuarial fairness)
- Calculate pensions on basis of contributions during working life
- Create jobs by lowering non-wage labour costs and payroll tax
- Boost a Single Market for pan-European pension funds
- Approximate Member States' tax systems

any physical incapacities. In their mid sixties, people are generally healthy. That people live longer in good health implies that the potential for extending working life has grown markedly. It is, however, crucial to reduce working time at the end of the career. In summary, living longer means that people's second stage of life, i.e. their potential working life, has become longer. Raising the effective retirement age is therefore in line with increased life and health expectancy.

When discussing the financial architecture of the pension pillars, decision makers should focus more on changing labour market conditions.

V. Conclusions

The main conclusions for maintaining adequate pensions sustainable are the following:

- Responsibility for pensions is continuously and irreversibly shifting away from governments towards individuals and private corporations.
- When discussing a reconstruction of the 'three pillar pension system', policy makers should focus more on changing labour market conditions.
- Increasing the employment rate is the logical answer to demographic ageing and budget deficits.
- Delaying retirement has almost become the holy grail of numerous social security reform proposals, since this would ease the burden on public finances substantially.
- Priority must be given to reversing the paradox of early retirement combined with increasing life expectancy.
- Retiring more gradually is the right way to secure the maximum degree of self-determination and self-responsibility for employees.
- The incentives to work longer must be both clearly communicated and substantial, if employment rates are to be increased substantially.
- In most countries, successful reforms have only been achieved by extensive social dialogue.

Room for manoeuvre between benefit levels and contribution rates may become slimmer with every month by which necessary reforms are delayed. There is, however, nothing inevitable about the ticking "pensions time bomb". Policy processes can determine to a large extent whether or not societies can maintain sustainable pensions, if they achieve a balance between the European social model and a competitive economy. Real reforms depend on economic growth and on social consensus. However reluctant people are to see the retirement schemes change, change is a must in most European pension systems.

NOTES

[1] Germany was the first country in the world to introduce the disability pension – and later the old age pension – for people aged 70. It was in 1913, when the old age pension was contributed to all employees aged 65.

[2] Taking infant mortality into account, in 1881-1890 life expectancy was even lower: for men it was 37 and for women 40 years. Axel H. Börsch-Supan, Christina B. Wilke, The German Public Pension System: How it Was and Will Be, Mannheim Research Institute for the Economics of Ageing, Discussion paper no. 34-03, at www.mea.uni-mannheim.de.

[3] Economic Policy Committee report Budgetary challenges posed by ageing populations from 24 October 2001, pp. 12-18 (EPC/ECFIN/630-EN). It is noticeable that the "old-age dependency ratio" indicates that the ratio of people over 65 to people of working age will double between now and the year 2050. This ratio does not show the balance between economically active and inactive persons.

[4] Deutsche Bank Research, EU Enlargement Monitor, No. 9, 15 October 2002.

[5] Giovanni Tamburi, The future of pensions and retirement (2002), pp.14ff, The Geneva Association, an international association for the study of insurance economics, Geneva (CH).

[6] The EC Treaty also foresees, in Article 3 (1 k), Community activities seeking to strengthen social cohesion. Further social policy provisions are laid down in Articles 136ff.

[7] According to an OECD report, pension reforms might entail the risk of inadequate income for some vulnerable groups. In the future, the "social time bomb" may tick for groups such as the long-term unemployed, employees moving cross-border within the EU, employees moving in and out of self-employment, single older women with a weak labour-market attachment, or widows benefiting from low survivors' pensions; Organisation for Economic Co-operation and Development (OECD), Ageing and Income – Financial Resources and Retirement in 9 OECD Countries, 2001, p.14-15.

[8] The programme of the Italian Presidency is published at http://www.ueitalia2003.it/EN/LaPresidenzaInforma/Programma/

[9] Ettore Greco, Vice-Director of the Roman Istituto Affairi Internazionali, Prioritäten der italienischen EU-Präsidentschaft, Integration, Zeitschrift des Instituts für Europäische Politik in Zusammenarbeit mit dem Arbeitskreis Europäische Integration, p.195.

[10] See at http://www.europa.eu.int/comm/employment_social/soc-prot/pensions/2003jpr_en.pdf.

[11] The Lisbon Council proposed that work on social protection should be facilitated by applying "a new open method of coordination". This was introduced "as a means of spreading best practice and achieving greater convergence towards the main EU goals" in areas where Community powers are limited. See also: Philippe Pochet, Social Benchmarking, Policy Making and New Governance in the EU, Journal of European Social Policy 2001: 291-307.

[12] Article 39, 56 and 49 EC Treaty.

[13] Directive of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (2003/41/EC), Official Journal L 235, 23/09/2003 p.10-21.

[14] Also the European Commission has quoted this figure several times recently.

[15] The Communication from the Commission and the Council, the European Parliament and the Economic and Social Committee, The Elimination of Tax Obstacles to the Cross-border Provisions of Occupational Pensions, COM(2001) 214, enhanced the scope to eliminate taxation-induced obstacles to cross-frontier portability of pensions. See also: Report No. 45 from the Centre for European Policy Studies (CEPS) Task Force on Cross-Border Portability of Pension Rights, Cross-Border Portability of Pension Rights: An Important Condition for an Integrated Market for Pension Provision, April 2003: 12-19.

[16] Case C-136/00, Rolf Dieter Danner v Finish Government (judgment of 3 October 2002).

[17] Per K. Madsen: 243-266, Frans Pennings: 285-311, ed. Hedva Sarfati & Giuliano Bonoli, Labour Market and Social Protection Reforms in International Perspective: Parallel or converging tracks? Abingdon, (Ashgate 2002).

[18] In the late 90s, the share of an age cohort that changes from full-time to part-time working was only around 3% in most industrial countries, according to Eurostat and national labour force surveys. See also: Organisation for Economic Co-operation and Development (OECD), Reforms for an Ageing Society, 2000, p.91-92.

[19] Delsen, L. (2003), Tax and social protection systems incentives and disincentives to be active in the labour market, ed. M. Jepsen, D. Foden and M. Hutsebaut, Active Ageing: what strategies to develop?, Brussels: European Trade Union Institute.

[20] Pierre Pestieau, Raising the Age of Retirement to Censure a Better Retirement, 2003, at http://www.issa.int/engl/reunion/2003/anvers/2anvers.htm and http://www.issa.int/engl/homef.htm. ❑