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The Green Paper on Pensions: A critical review

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Abstract

In July the European Commission launched a consultation on pension policy through the Green Paper 'Towards adequate, sustainable and safe European pension systems' (European Commission, 2010). The Green Paper represents a summary of challenges and solutions to pension policy. Here we briefly set out a critical understanding of the paper. We look at two key dimensions the paper has focused on: present and future challenges; possible solutions to the most evident tensions. We also add what seems to us the most evident missing point: the impact of two decades of reforms across Europe.

Pension policy will continue to be at the core of the political agenda for years. It is important to learn from past reforms, and to abandon ideological positions, while trying to act to make retirement programmes work in protecting against major social risks. Eventually, the present paper advances some proposals for a more balanced debate on pension policy.

Keywords: Green Paper; pension reforms; ageing; financial crisis.

1. INTRODUCTION

In July the European Commission launched a consultation on pension policy through the Green Paper 'Towards adequate, sustainable and safe European pension systems'. The Green Paper represents the first step in the broad reflection EU institutions and many stakeholders have been involved in. It is a summary of challenges and solutions to pension policy. This note is divided in three parts. The following section looks at the present and future challenges to pensions in Europe. The Green Paper has focused on population ageing being the most dramatic risk for the long-term sustainability of pension schemes (especially those of the first pillar). Economic and financial crisis has represented the most recent challenge to both public and private pensions. The Green Paper shows no pension programmes are safe from the effects of the crisis while private pensions (and those based on funding) are the most affected. And recent reforms are going to produce huge effects on both financial sustainability and benefit adequacy. Section three summarises the solutions proposed by the Green Paper: to increase retirement age and employment rates, while reforming the regulation of financial markets and pension funds, and revising the pension promise (i.e. further reducing public pensions). Section four sheds light on the most evident missing point in the analysis proposed by the GP: the assessment of two decades of pension reforms and the growing pension gap. Section five concludes.

2. PRESENT AND FUTURE CHALLENGES

The Green Paper shows in the last three decades pension policy has been under siege in many respects: policymakers and analysts have focused on the main short-, mid- and long-term challenges to the sustainability of retirement programmes. The pension 'time bomb' has been assumed to explode due to population ageing, slow economic growth, unemployment, wage stagnation and other factors.

a) Reform outcomes: the first contradiction in the Green Paper

The assessment of the last wave of reforms across the EU reveals the first contradiction in the Green Paper: while reforms are assumed to have led to the progressive individualisation of old age risks (with negative effects on the capacity of individuals to deal with poverty and income losses in their old age), the need to further recalibrate pension policy (and put public spending under further control) is referred to. On the one hand, recent reforms are assumed to have contributed to lessening strains on the long-term sustainability of public retirement schemes. On the other, the same reforms have contributed to increasing adequacy gaps. A few examples of the need to rethink the broad logic of pension policy innovation are proposed: this is the case of the privatisation of

pensions, the development of supplementary pension funds and the subsequent costs and risks individuals must deal with (see Section 3 for a more in-depth critical assessment of reform outcomes).

b) Ageing: what is the real magnitude?

The Green Paper mainly focuses on population ageing, showing demographic trends have and will have a huge impact on pension spending. While there is a general consensus about the worrying future scenario for the EU countries, understanding of the magnitude of these critical trends varies in many respects. One issue is related to misuse of the old-age dependency ratio to express the demographic threat to socio-economic institutions. As shown by Natali (2008), ageing (in relation to the baby-boom generation) is a transition more than a long-standing shock. Once the wave of “baby-boomers” going into retirement ends, our population will be more balanced. What is more, the old-age dependency ratio, which is a simple measure of ageing, does not take into account the proportion of the population that is actually productive. It ignores the number of people of working age who do not work. Taking account of the population actually in work can provide a more useful indicator that reflects more fully the productivity capacity of a given population. This is the economic dependency ratio: the number of those who are out of work to those who are in work (regardless of age). According to recent calculations from the DG for Economic and Financial Affairs (Ecfina), the old-age dependency ratio is expected to worsen in the period 2003-2025 and 2025-2050. Yet the economic dependency ratio will improve between 2003-2025 and will then (rapidly) decrease in the following decades. The two projections are thus not consistent with each other, the first one related to the old-age ratio being much more alarming.

c) Financial and economic crisis: what impact on pensions?

In the literature on pension policy, there is a large consensus on the fact that pension programmes (be they public or private) are not immune from the consequences of economic recession and financial crisis (European Commission, 2010). Yet the impact differs a lot if we consider first, second and third pillar schemes.

For the first time, the EU discourse on pension funds is nuanced: pension funds have been heavily hit by the crisis and this has shown their potential weakness. The first reason for weakness is related to the falls in interest rates and asset values: private pension funds lost over 20% of their value in 2008 and despite the recovery of 2009 many are still far off the required solvency levels. The Green Paper’s assessment is even more critical of the effects of tax incentives many EU member states introduced to favour the development of supplementary pension funds. Here, the key question is regressive redistribution and the impact on public budget stability (Natali, 2010).

For public pensions, the main problem is related to the deterioration of public budgets and the further deterioration to be expected as a consequence of high unemployment and slow recovery.

d) What about the interplay between retirement schemes and labour market changes?

What is missing in the analysis proposed by the Green Paper is the complex interplay between pension and employment policy. In many EU countries pension reforms have consisted in the reduction of public pension benefits, while labour markets have seen important changes towards more flexibility, lower employment protection, and activation. In some cases the combination of these two processes leads to increased risks of pension gaps, especially for some social groups (atypical workers, women, migrants, etc.). Many analysts have talked of new cleavages between insiders and outsiders, the latter being at risk of income losses in their old age (Jessoula, 2010). This is particularly the case of pension systems based on contributions: not only supplementary funded schemes (those based on a defined-contribution logic), but public pensions financed through contributions

(e.g. notional defined contribution systems, as in Sweden, Poland and Italy). Periods of inactivity, low contributions (due for example to low wages), and limited or incomplete coverage of supplementary schemes may be the source of this gap.

3. WHAT ABOUT TWO DECADES OF REFORMS?

While the Green Paper starts its overview of pension policy with a summary of the last wave of reforms, this summary is largely incomplete. Firstly, the Green Paper does not refer to the implicit evidence of twenty years of innovation: the latter has proved pension reforms are a very complex political process but they do happen. From an institutional point of view, pensions inherited from the past largely shape the room to manoeuvre policymakers have. Yet they do not represent a veto on reforms. A vast literature has thus proved social policy reforms are an example of progressive (or path-departure) innovation (Table 1 summarises key measures in some EU countries).

Table 1. Main Reforms in some EU countries, 1990-2010

	Main reforms
France	Pension Reform 1993 Pension Reform 1995 Pension Reform 1997 Pension Reform 2001 Pension Reform 2003 Pension Reform (public sector) 2008 Pension Reform 2010
Italy	Pension Reform 1992 Pension Reform 1993 (supplementary pensions) Pension Reform 1995 Pension Reform 1997 Pension Reform 2004 Welfare Protocol 2007 Pension Reform (public sector) 2009
Poland	Pension Reform 1991 Pension Reform 1997 Pension Reform 1998 Pension Reform 2002 Pension Reform 2004 Pension Reform 2008
UK	Pensions Act 1995 Welfare Reform and Pensions Act 1999 Child Support, Pensions and Social Security Act 2000 State Pension Credit Act 2002 Pensions Act 2004 Pensions Act 2007 Pensions Act 2008

Progressive change happens when institutions are partially renewed in line with partial redirection of core principles. While change is progressive and at first glance marginal and incremental, at the end of the transformation process the result is in-depth renewal of past institutions. This means much of the alarm on the ‘immovable’ institutional landscape and the increased reluctance of Europeans to accept the revision of past pension entitlements was largely exaggerated.

Secondly, the lack of a more in-depth assessment of the outcomes of pension reforms risks limiting the analysis of solutions to future challenges. The first and most evident effect of reforms is the containment of public spending and the future reduction of pension entitlements. The generosity of the public pillar is decreasing as a consequence of recent reforms and of new features of the socio-economic context (e.g. new social risks; more flexible labour markets, etc.). EU projections show the expected future decline of gross

and net replacement rates (from public schemes) in all countries. Table 2 below shows the magnitude of cutbacks: in some countries (Estonia, Sweden, Latvia, Italy, etc.) public pensions will fall in future decades with a consequent increase of adequacy gaps.

Table 2. Effects of reforms on pension benefits (Gross average replacement rates)

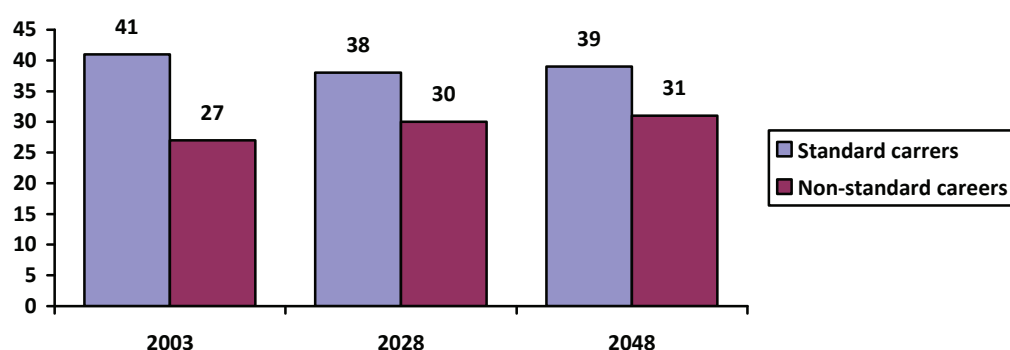
	Public pensions only			Public + Private pensions		
	2007	2060	% change	2007	2060	% change
Belgium	45	42	-7%			
Czech Republic	33	27	-18%	33	27	-18%
Denmark	33	33	0%	71	84	18%
Estonia	28	16	-43%	28	31	11%
Greece	61	67	10%			
Italy	67	49	-27%			
Latvia	33	22	-33%	33	33	0%
Lithuania	32	29	-9%	32	37	16%
Luxembourg	53	62	17%			
Hungary	49	38	-22%	49	43	-12%
Austria	49	38	-22%			
Portugal	58	56	-3%			
Romania	36	44	22%	36	49	36%
Sweden	49	31	-37%			

Source: Zaidi (2010)

What is more, the effects of cutbacks is not equally distributed across different socio-economic groups. This is a major issue the Green Paper does not address. Here we propose two lines of reflection: one related to the potential/effective cleavage between insiders and outsiders (the latter being, for example, non-standard employment relations); the second dimension is consistent with the income level of citizens and workers (low versus high earners).

Figure 1 refers to the case of the UK: in 2003, specific socio-economic categories were most at risk of inadequate protection against old-age risks. This was (and is) the case of women and of non-standard employment relations (part-time, temporary contracts, interrupted careers, etc.). In many EU countries, reforms have increased the individualisation of risks in line with the actuarial logic of both public and private schemes (Bridgen and Mayer, 2007).

Figure 1. Pension income/average earnings for typical/atypical workers and women, UK (2003)



Standard career, individual starts working at 21, for 44 years with full-time, median earnings, makes private pension contribution of 8% per year, retirement at 65

Non Standard career, individual starts working at 25, spells of part-time work and self-employments, higher earnings, lower contributions to private pensions, retirement at 67

Source, Steventon and Sanchez (2008)

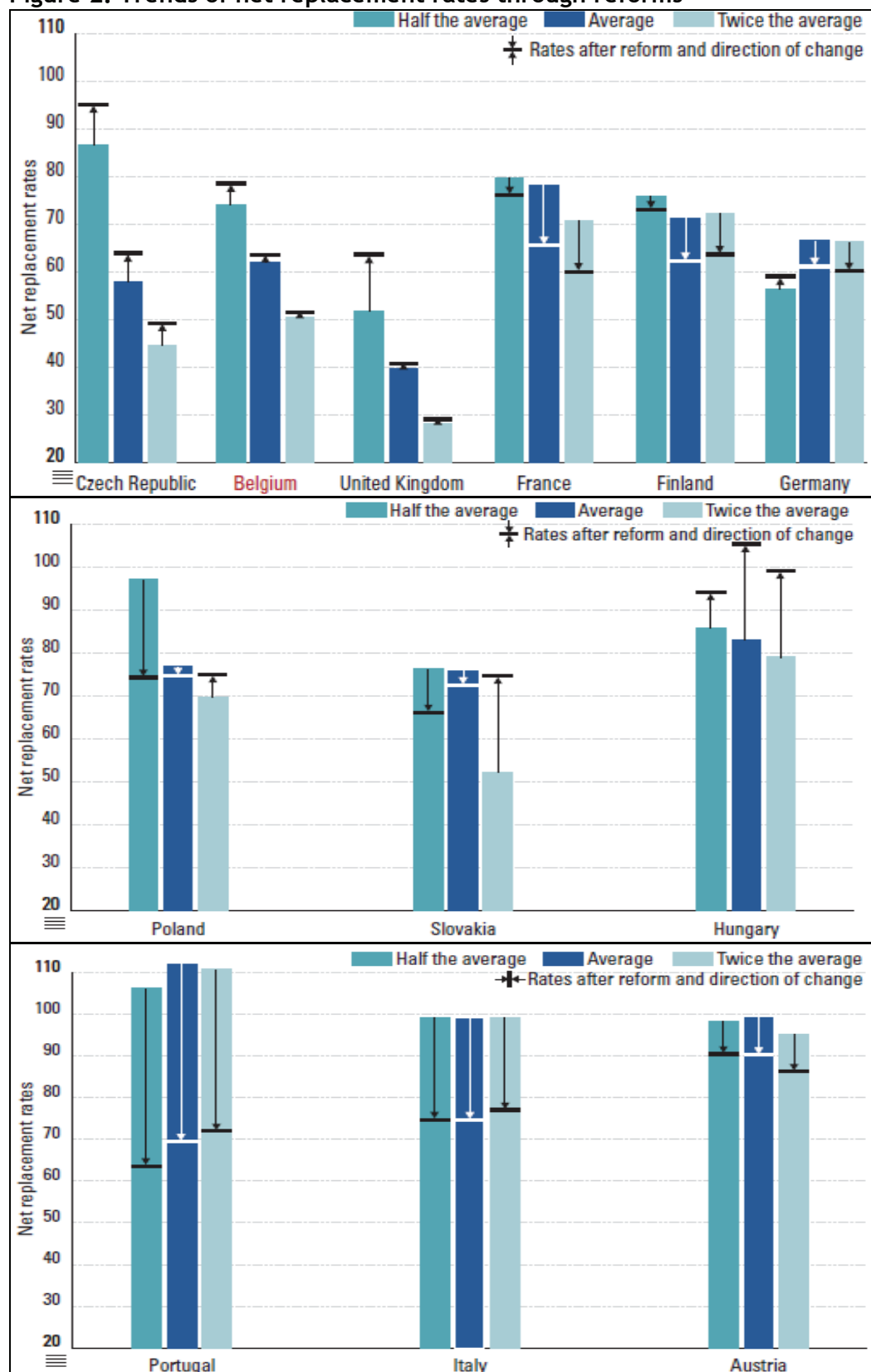
Another dimension of the distributive outcomes of pension reforms is related to the impact of cutbacks on different earnings-level groups. Recent OECD data show the kind of distributional strategies policymakers have implemented in different countries. Here we refer to the work of Zaidi (2010).

Figure 2 simulates the impact of reforms for those workers who entered the labour market in 2006, by comparing the situation for a person who spent a full career under the reformed pension system with the benefits that would have been received had the system not been changed. The results shown are reported in terms of net replacement rates: that is, the value of the pension in retirement, after taxes, compared with the level of earnings when working, after taxes and contributions. For each country, the first row shows the position of low earners: workers earning 50% of the economy-wide average each year of their entire working life. The second row shows the net replacement rates for average earners and the third row for above-average earners (workers earning 150% of the average). EU countries have followed three different strategies to introduce cutbacks.

The first strategy is the most redistributive: countries like the UK, Germany and France have protected low-earners from benefit reduction, while average and above-average earners suffer some cutback. The second strategy is much less redistributive: it consists of higher cutbacks for low-earners while increasing benefits for average and high earners. The reform strategy here is consistent with the introduction of incentives to work more and to contribute more.

The third strategy is more linear: benefit reduction is expected for all three groups (low, average and above-average earners). Pension policy reproduces labour market inequalities with no major redistributive effects.

Figure 2. Trends of net replacement rates through reforms



Source, Zaidi (2010).

The analysis of reform outcomes is important to assess the future adequacy gaps for the different parts of the population. The third aspect of a broad assessment of pension reforms is related to the apparent individualisation of old-age risks. All EU countries have seen the transfer of economic and demographic risks to the individual. Beyond any normative issue of redistribution, this individualisation could improve uncertainty and economic costs for the insured individual and for society as a whole (Barr and Diamond, 2010). The recent financial crisis has proved the market may be largely inefficient in the allocation of risks (Natali, 2010). This is particularly true for the case of old-age: pension market failures are related to mis-selling and mismanagement of private products; the lack of complete information for workers, high administrative costs, etc. A vast literature has clearly advanced a more critical understanding of the progressive individualisation of risks along these lines (Barr and Diamond, 2010; De Deken, 2007; Leisering, 2003).

4. PROPOSED SOLUTIONS

The Green Paper puts forward some proposals for facing long- and short-term challenges to old-age protection in Europe. Firstly, the Commission stresses the persistent validity of the strategy advanced by the Stockholm European Council of 2001: reducing debt; raising employment rates and productivity, and reforming social protection schemes (pensions and health-care). Secondly, and for pensions in particular, the emphasis is put on:

- Addressing the adequacy gap (through activation measures to reduce the risk of unemployment, and the improvement of basic safety schemes);
- Increasing the retirement age. This measure is advocated for two reasons: for the positive effects on pension spending, and for the parallel improvement of average benefits.
- The revision of the regulation of both financial markets and funded pension schemes: these are two key aspects the financial and economic crisis have highlighted.
- The further solution advanced by the Green Paper is 'to review the pension promise in view of what the rest of the economy - and public budgets - can be expected to provide'.

a) *A more nuanced approach: more flexibility and more focus on distributional effects*

Here we propose a more nuanced approach to present and future challenges on pension policy. Some of the solutions we advocate are consistent with the Commission's reading, others are alternatives:

- The need to focus on adequacy gaps, especially for those social groups most at risk is largely shared in the recent scientific literature. This is particularly the case of non-standard employment relations affecting women, young workers, and migrants. These groups need more protection through the complex interaction of pension and employment policies;
- While increasing the retirement age could be a 'win-win' solution to safeguard financial sustainability of pension programmes while increasing benefits, this strategy should be more flexible, for instance with the definition of a specific statutory and effective retirement age for different occupational groups with different life expectancy. Another option is to introduce a flexible retirement age (following the Swedish example) and the possibility of combining part-time work with a pension benefit.
- The need to balance the economic dependency ratio thus depends on the ability to reduce the number of unemployed of working age: this is a major challenge for the European economies in the coming years.
- While the need to improve regulation of financial and pension markets is largely shared, there are some more structural problems and sources of inefficiency that regulation

may have problems to face and reduce.¹ Typical inefficiencies of pension markets in the allocation of risks should increase policymakers' awareness of the persistent need of the state and public authorities to provide protection for the whole population. Privatisation should not be pursued at all costs. Some open questions remain about the role supplementary funded schemes should play in the different countries: what proportion of pension income should be paid by private/funded schemes?

5. SOME CONCLUDING REMARKS

Long-term challenges and the recent economic and financial crisis have both stressed the persistent need for adequate protection against old-age risks. Public pensions have proved to be decisive in providing protection for the elderly, while the fall of asset values has put pension funds under strain. This should trigger a much more intense debate on the right balance of public and private, paygo and funded schemes in the future.

The Green Paper has started such a debate but more emphasis should be put on specific issues: the need for more a flexible approach to retirement age; the need for more effective regulation of both financial and pension markets, and the improvement of pension benefits for specific social groups and occupational categories (e.g. women, non-standard employment relations, etc.).

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¹ See Stewart and Yermo (2008), and Nugée and Persaud, (2006).