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How to balance adequacy of coverage with financial sustainability?

Preliminary draft

Abstract

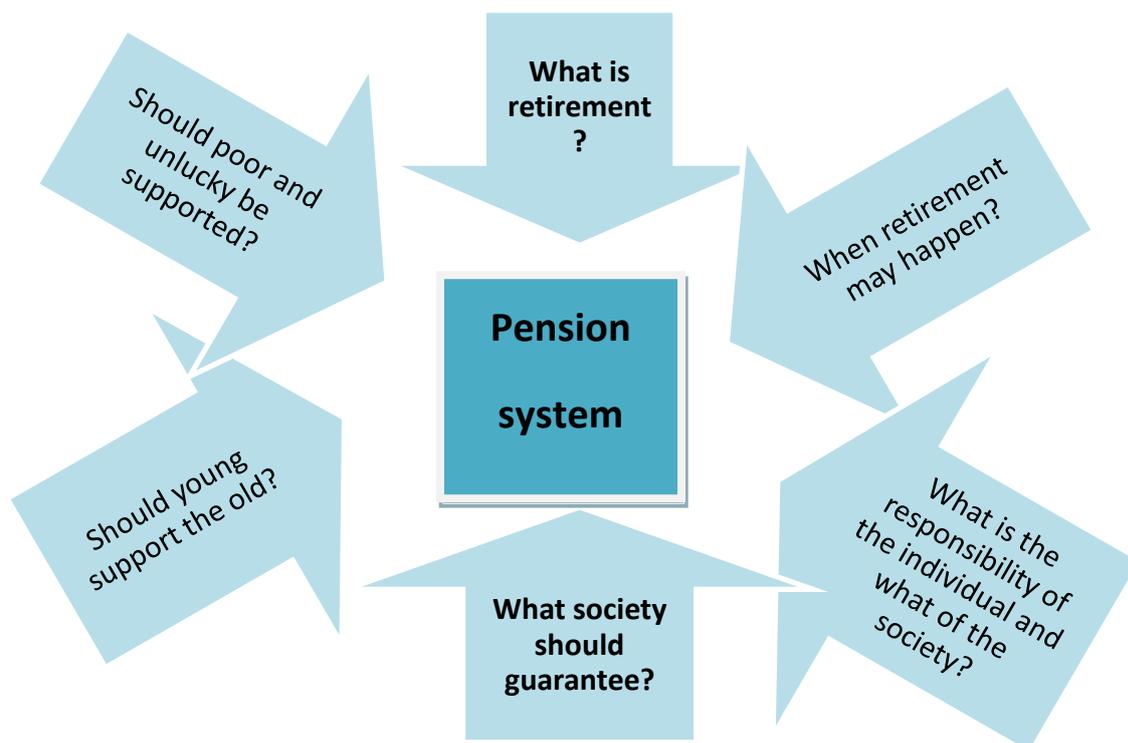
Many reforms of contributory pension schemes implemented over recent decades strengthen – through various mechanisms - the links between benefit entitlements and contribution paid over whole careers. Many of these reforms introduce more or less automatic mechanisms to balance pension schemes financially – mostly through lowering benefit entitlement – in unfavourable labour market or demographic conditions. As a result however, adequacy of coverage – both in terms of number of people contributing long enough to be entitled to full pension and in terms of future benefit levels – decreases. In particular, the protection levels of those with shorter, broken careers (due for example to longer spells of unemployment, precarious employment, child care etc.) and low lifetime earnings decreased. Also, there are no systemic balancing mechanisms in place to prevent benefit level to fall below levels which do not prevent anymore poverty in the old-age. The question to be discussed is what mechanisms should be put in place to secure adequacy of coverage and benefit levels: to what extent current reforms of contributory schemes should be revisited, how non-contributory elements of the pension systems should be strengthened, and how much room is left to policy discretion when automatic balancing results in socially undesired outcomes.

Keywords: social security, pensions, poverty, demographic ageing

The design and shapes of pension systems are usually result of less or more explicit social contracts. Societies define (see Figure 1)

- What retirement is: does it happen only when person is not able to work anymore or it is rather a well deserved period of rest after working life?
- At what age or after how many years of working career it should happen?
- What society as a whole sees as adequate guarantee to its elderly (only alleviation of poverty for those unable to support themselves, or a minimum income at old-age or guaranteed replacement rates – as proportion of pre-retirement income for all residents)?
- What is the desired degree of solidarity in financing incomes of retired persons (people should save for themselves; or younger generation should support the elderly as a principle; or at least those unable to save enough should be supported).

Figure 1: How social contract on pension is shaped?



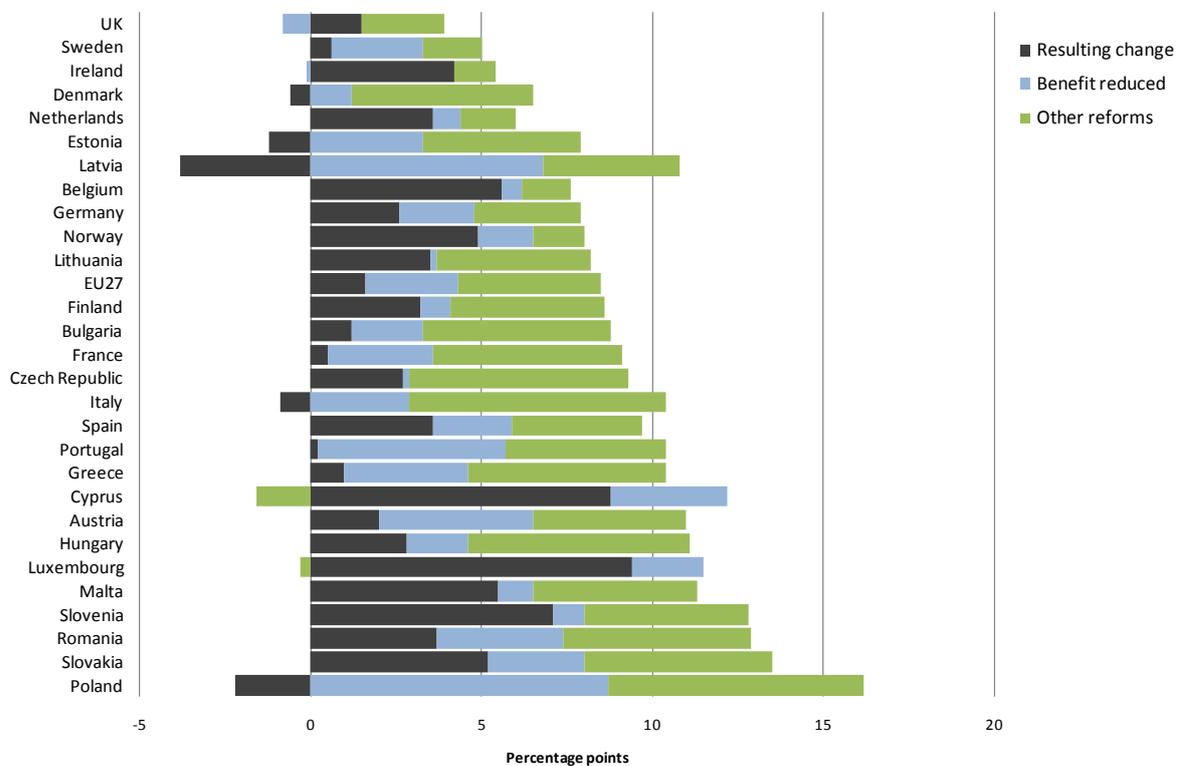
Different answers to these questions generate different institutional and financing solutions; different pension systems in different countries with different shares of mandatory and voluntary provisions; different defined benefit and defined contribution systems and different degrees of prefunding as well as different roles the public and private sectors.

All the above social contracts are from time to time subject to revisions as demographic, economic and social circumstances and peoples' perceptions and attitudes change. During their

more than hundred years long history, social security pensions systems have evolved with changing circumstance and attitudes. One can also see that successful reforms of pension systems involve widely accepted revisions of the prevailing – explicit or implicit - societal agreements. Reforms which go against prevailing perceptions of what is fair and adequate usually fail.

From time to time such social contracts cross borders and result in international social agreements which may take shape of international standards like ILO Conventions and Recommendations (including, with respect to pensions in particular Convention no 102 (International Labour Organization 1952) concerning minimum standards in social security and Convention no 128 (International Labour Organization 1967) concerning invalidity, survivors' and disability benefits), European Code of Social Security (Council of Europe 1964)) or other international agreements – like ones developed within the European Union.

Figure 2: Projected changes in pension expenditure 2010-2060 (change in percent of GDP)



Source: EU Ageing report 2012

Demographic developments have of course significant impact on social security systems in general and pension systems in particular. Figure 2 presents results of the projections of pension expenditure until 2060 for all EU member countries. Projected changes in expenditure (measured as percentage of GDP) between 2010 and 2060 were decomposed into different factors driving the level of pension expenditure – either pushing them up (like increase in demographic dependency) or pulling them down (like reductions in benefit levels or increase in actual retirement ages. The overall

size of bars for each country shows what would be the increase in pension expenditure (in GDP percentage points) if there will be no reforms or other policy changes. It shows thus the potential – and quite dramatic - impact of the demographic change. Blue parts of these bars show how this large potential increase is being reduced by reductions in benefit generosity (causing benefit amounts to increase over the projection period at lower rates than increases in of productivity).

The green parts of these bars show the reduction of potential increase caused by other changes in the pension system design (like increases in retirement ages) and expected changes at the labour market (mainly increased labour force participation at all ages). The balance of these factors driving future pension expenditure is shown by the size of black parts of bars at Figure 2, representing the actual projected increase in pension expenditure. These increases, thanks to the reforms undertaken, are much smaller in most of the countries than the ones which would result from demographic changes not counterbalanced by various policy responses.

Analyzing recent results of projections of future trends in pension expenditure in all European Union member countries , one can see that there is no unavoidable “pension crisis” as a result of ageing populations. On the contrary: most of the countries adopted reforms which fully, or at least to a large extent, counterbalance cost effects of expected demographic change. Some countries seem to be more successful than others; in some other countries there are obviously still things to be done and further reforms pending. On the other hand, in some other countries one can even see that the expected ratios of pension expenditure to GDP are expected to go down and thus reforms undertaken may be overshoot.

The question is, whether these projections will actually materialize? Some of the projected results are highly sensitive to assumptions of increased labour force participation and later retirement. These may not fully materialize if labour market and other conditions do not change as expected. In case of reforms which impact mostly on reduced future benefit levels, there may be future political obstacles: when people realise that the pension systems are not delivering levels of protection perceived by them as adequate and fair, some of the reforms may be reversed.

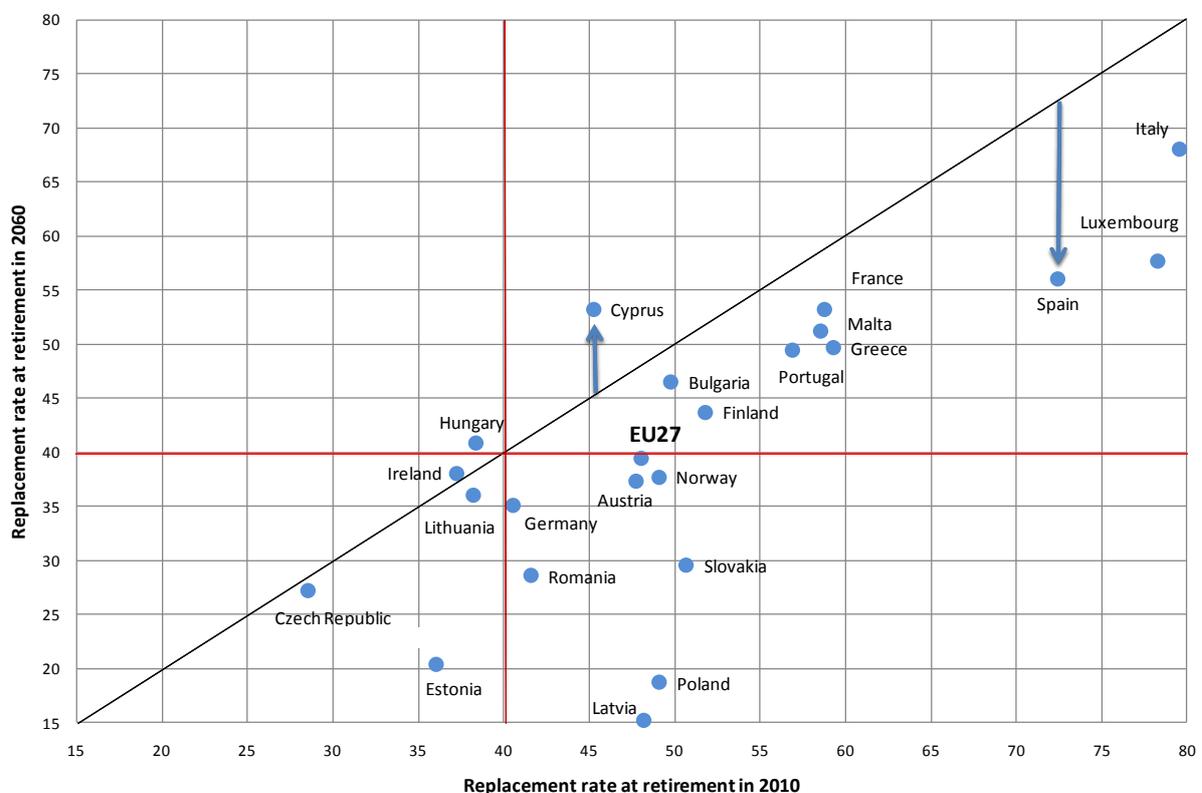
On the one hand one can see that many reforms can actually achieve sustainability preventing undesired increase of expenditure on pension, despite demographic changes. On the other hand one can see that some of these reforms are putting quite a high downward pressure on future benefit levels and the question arises to what extent these benefit levels, much lower than today, will be accepted as adequate in the future.

Figure 3 presents changes in future replacement rates of the public pension schemes in the European Union. The countries which are located on the graph below the 45 degrees line are those where the expected replacement rates are going down, and the distance between the 45 degrees

line and the points representing the countries shows how much these replacement rates are being reduced by the reforms. In some countries the expected decrease in replacement rates seems quite significant.

ILO social security conventions and the European Code of Social Security require pension systems in ratifying countries to deliver replacement rates of 40% or 45% already after 30 years of contributions for all those with earnings lower than the prevailing average. From Figure 3 we can see that public pension systems in many countries will not provide such replacement rates even to those contributing for longer than 30 years. Also, 40% threshold for those with lowest earnings (close to minimum wage) will place the beneficiaries below poverty thresholds (see Figure 4).

Figure 3: Average replacement rates at retirement in public pension schemes in 2010 and projected for 2060 (selected European countries)

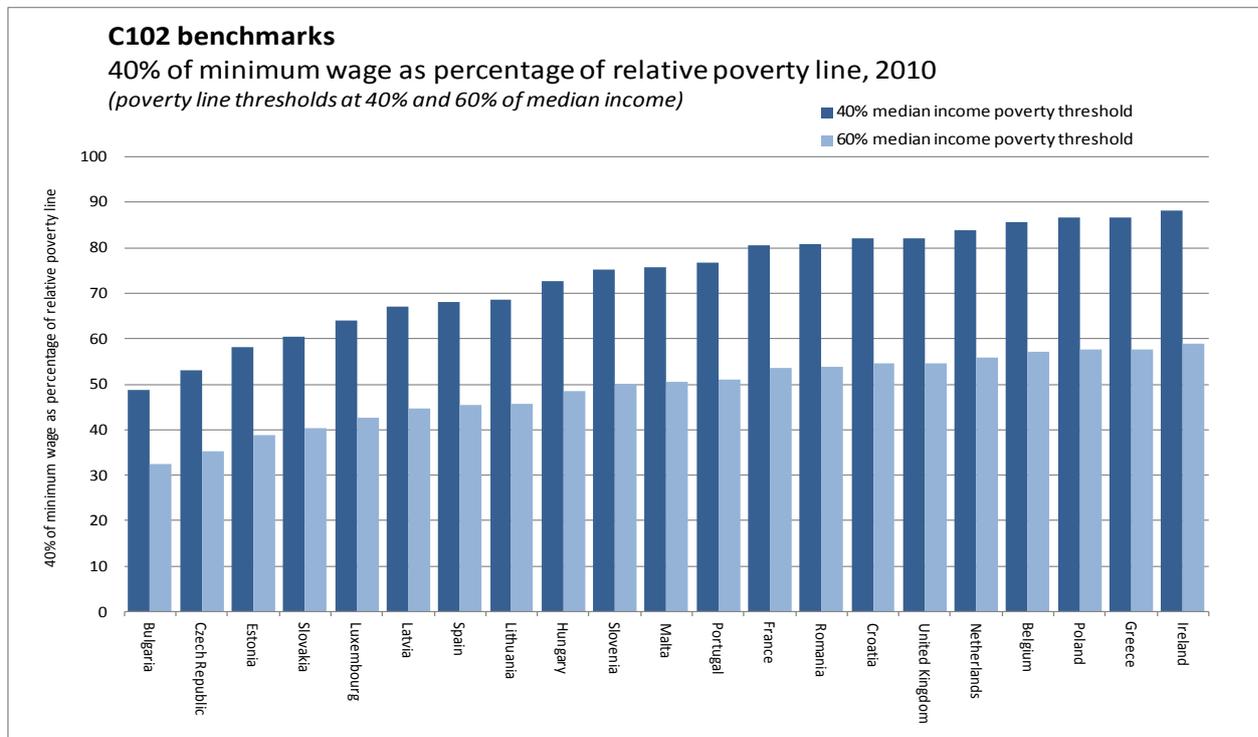


Source: EU Ageing Report 2012

While existing agreed international standards in social security (both ILO Conventions and European Code or Social Security) focus on protection of those with lower earnings and shorter careers (Hagemejer 2009), most of the recent reforms of the contributory pension schemes are in the first place reducing replacement rates of those with lower earnings and with shorter, broken careers. This group of people (mainly women) may not get that protection widely recognized as adequate from the contributory parts of pension system. While reforms have almost eliminated

redistribution from many contributory pension schemes, this has not been sufficiently compensated by strengthening non-contributory provisions like basic income or minimum pension guarantees, and other similar mechanisms (Hagemeyer 2012).

Figure 4: 40% of minimum wage as percentage of relative poverty lines



Source: EUROSTAT data, own calculations

A number of countries' pension reforms have been aimed at introducing various automatic or semi-automatic mechanisms which would react to changing demographics, economic and labour market conditions, and modify the scheme's parameters (in particular those deciding about pension entitlements) to bring expenditure to closer balance with revenue. Analysis shows this is true of the reforms introducing Notional Defined Contribution schemes (Latvia, Italy, Sweden, and Poland) as well as some other reforms implemented in many OECD countries (see Holzmann, Palmer, Robalino 2012) These reforms aim at establishing, at the core of the public tiers of the pension systems, schemes which are still PAYG financed, but purely earnings related, calculating pension amounts on the basis of adjusted earnings from the whole contribution career.

With respect to what is called "outcomes" of the pension schemes, that is benefit amounts and the degree to which income from work before retirement is replaced by a pension at retirement (replacement rate), different reform approaches are equivalent, These include purely earnings related benefit formula calculating the pension as a multiple of accrual rates, number of years of

contributions and average of adjusted earnings from the whole contribution career, those based on a point system and notional or nonfinancial defined contribution schemes (NDC) -.

Using adjusted life-time earnings or contributions as a basis to calculate pensions reduces resulting pension levels and replacement rates – in comparison to those defined benefit schemes which excluded, from calculation, earnings from early stages of work careers which are usually much lower, or earnings from other periods in individual careers where earnings were low.

Such reduction of pensions is not uniform and has redistributive effects. Losers are of course all those who, in particular at early stages of their careers, have low earnings and haphazard earnings patterns. It is easy to show that pension “outcomes” depend not only on the total amount of earnings, and thus contributions paid during the whole work career, but also on when over the career those earnings and contributions were received and paid. A person who had a constant stream of earnings over the whole career will have higher pension and higher replacement rate than another person who had the same (unadjusted) sum of life-time earnings and paid overall the same amount of contributions into the scheme but started earning (more than the first person) and paying contributions after a delay of several years.

Those who delays the start of work and their contribution career in order to achieve higher education levels may have the resulting loss in future pension compensated by higher earnings at a later stage of their careers, but only if the returns from this investment in human capital are high enough. On the other hand, there are usually small chances for such a compensation from higher earnings at later stages of their careers for those who at young ages are struggling to get formal employment and - if have employment at all - it is usually of a precarious character. Similarly such a compensation in form of higher future earnings is not usually rewarded to those (mostly women) who, having to care for children, are for some time out of work, work part-time or on parental leave.

To compensate for the above losses in all these schemes, including NDC, there exist different forms of honouring certain non-contributory periods. In the four NDC schemes presented above, compensated is only a very small part of the loss in future pension entitlements – with the exception of Sweden where the proportion of loss compensated is higher than elsewhere.

NDC pension schemes, similarly to funded DC but also to any DB earnings-related scheme where pension calculation is based on adjusted whole career earnings, are not just translating differences of earnings in the labour market into differences of pensions: these differences are actually amplified and pension levels may be more differentiated than are levels of earnings.

There is a need to investigate the redistribution features of these allegedly “actuarially fair” schemes more closely (whatever the notion of “actuarial fairness” may actually mean). Returns on individual contributions paid over the contributing career differ depending on the time distribution

of the amounts paid in. At the same time, - as these schemes are PAYG - actual contributions are paid to a “common pot” and thus it may happen that at the end people with relatively low earnings are actually partially supporting pension benefits of those with higher earnings. Much more research is needed into how different distributions of earnings over the working careers relate to final pension amounts before one can claim horizontal equity, fairness and transparency in redistribution through NDC and similar PAYG schemes.

One of the ways to secure financial sustainability of the reformed schemes was to build, into the design of these schemes, strong economic incentives to contribute more for longer and to delay retirement. Incentives are seen as strong if there is a positive link between the duration and amounts of contributions and the age of retirement and the resulting pension levels.

The problem is that potentially strong incentives to work longer may not work in reality as there are other factors determining if and how long people can stay in employment. These other factors include – among others – overall labour market demand and prevailing unemployment rates, the state of health of older workers (determined to a large extent by working conditions during their work careers), their family situations (like the need to care for sick family members), their productivity (depending too what extent they had a chance to be included in life-long learning to keep up with changing technologies) and attitudes and choices of employers (see ILO 2013). Despite intentionally strong incentives, older workers may be in fact forced out of the labour market and left in poverty with insufficient pensions. It is also becoming more and more obvious that even in a NDC scheme there is a need to adjust the minimum legal retirement age upwards as employers may not keep (nor invest in their training) older workers knowing that any moment they can take decision to retire.

Some argue that the adequacy of benefit levels should be determined by individual choice of the age of retirement beyond a publicly fixed minimum age, or even that people should be allowed to retire when they individually decide that their pension balances are adequate. In the framework of PAYG financed schemes, this may lead to negative selection resulting in the situation when only rich have the chance to retire while those poorer work until they die.

Reforms removed from benefit formulas the redistributive components aimed to protect against poverty those with lower earnings and shorter careers. It is obvious that within any defined contribution (or similar) pension scheme there is no built-in guarantees that the benefits will reach adequacy policy targets. On the contrary, for a given contribution rate and given rate of return, unless scheme members work long enough to match increasing life expectancy, replacement rates will be falling. While those downward automatic adjustments in benefits can work as automatic financial stabilizers, this may be a sustainability trap in the longer term: when promised benefits

start to be seen as inadequate, the willingness of members of the schemes to contribute may reduce.

Existing mechanisms guaranteeing income security in old-age in the countries which embarked on NDC or similar reforms do not seem to be adequate and there is a risk of a resurgence of old-age poverty.

NDC and similar schemes are seen as an automatic (while not very transparent) way to reduce pensions and encourage people to retire later. They were expected to reduce the need for policy intervention and social dialogue involved in the process (as a factor slowing the necessary decisions it down). The recent financial and economic crisis showed very clearly that one cannot rely on such automatic adjustment mechanisms. There is and there always will be a conflict between long-term concerns and shorter-term needs and there has to be a compromise between the two. The same however applies to long-term concerns about benefit adequacy – unless we are able to build mechanisms into the system securing not only financial stability but also benefit adequacy, there will permanently be a need for discretionary interventions into the system.

What we need is not to keep politicians away from pensions (that's not only unrealistic also undesirable: pension policy is part of the overall social policy). We need to make sure that decisions taken by politicians are the right ones, balancing shorter and longer term needs as well as balancing benefit adequacy with financial sustainability. A key prerequisite must be to ensure through democratic mechanism the full participation of each group of stakeholders – workers, employers and governments – in establishing the relevant standards and in creating and maintaining the permanent structures through which pension systems may be monitored, verified and adjusted in a responsible way (see Woodall and Hagemeyer, 2009).

Some of these reforms should thus be revisited to see to what extent they went too far, completely removing the redistributive element and thus protection of weaker members of these schemes from the contributory parts of public pension systems. One has also to see how to strengthen the non-contributory guarantees in different forms like basic state pension which may be universal or means-tested, and different kinds of subsidies to contributions compensating at least partially for careers which are shorter and broken due to extend periods of child care, care provided to sick or old members of the family or due to the extended unemployment spells. Such reviews should be undertaken as a follow-up to the new international labour standard in social security, ILO Recommendation no 202 concerning national floors of social protection adopted in 2012, which complements Convention 102. By adopting this Recommendation all countries committed themselves to guarantee, to all older persons in their countries, basic income security at a level allowing life with dignity.

The focus of the discussion here has been problems of European and other developed countries. One should however end with a reminder that the global majority of the elderly live outside Europe in developing countries, and globally the major challenge is that the majority of the population has no coverage. There is only a relatively small percentage of people contributing to any pension scheme around the world and, among those who are already elderly, only a small minority receives any type of pension (see ILO 2010 and ILO 2013). There is thus majority of the world whose main worries are different: how to develop pension systems which will be both sustainable on the long run - because they will be also affected by the demographic aging - and provide coverage for the now uncovered majority.

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