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Comment on the European Commission's "Green Paper towards adequate, sustainable and safe European pension systems"

Abstract

The Green Paper aims at launching a European debate about some of the key challenges that are facing European pension systems. This is a great initiative and this author agree with most of the suggestions, but also thinks that even more drastic policies may be required. For instance, to ensure sustainability (which is the purpose of pension systems and a necessary requirement for adequacy), the social security systems should be redesigned so that the allocation of aggregate risk between the taxpayers and the retirees is explicitly defined. In this way, people would know what risk they are facing and they would know how specific shocks affect benefits and taxes. This indexation should be performed so that the systems are sustainable to any shock. An important partial goal for achieving sustainability is (according to the Green Paper) to achieve a sustainable balance between time spent in work and time spent in retirement. This goal is likely to require (major) labour-market policies on *both* the demand and the supply sides. Examples here include eliminating the existing subsidized pathways to early retirement, lower replacement rates, prohibiting of age discrimination and possibilities to improve the employability of older workers. It is also important to reduce the distortions in the labour market to increase participation for the younger groups and to improve the EU statistics on pensions, since much more research related to social security is needed.

1 Introduction

The Green Paper aims at launching a European debate about some of the key challenges that are facing pension systems. The background is that the goal of providing adequate and sustainable retirement income for EU citizens will already be associated with several major challenges in the near future. The large cohort of baby boomers is approaching retirement, and at the same time, Europe's working-age population is relatively small and shrinking. These effects are amplified by the facts that Europeans are living longer than ever before and that the retirement age has been falling (by a lot) since the introduction of the pension systems. In addition, people are staying longer in education and thus starting work later and later in their lives. The fact that people are living longer is of course a good thing, but with the current design of the welfare systems, these trends constitute severe challenges for the European economies.

The financial crisis has also severely aggravated the underlying challenge from demographic ageing. The scale of fiscal deterioration is argued to be equivalent to offsetting 20 years of fiscal consolidation. According to the Green Paper, the overarching objective is to ensure that the social security system can deliver sustainable and adequate pensions. The suggested means to reach this goal in the face of the adverse trends described

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above include making sure that the time spent in retirement does not continue to increase (relative to the time spent working), and that the obstacles to the mobility of production factors within and between member states are removed. In addition, it is desirable to revise solvency rules and to make legal protection rules for pension funds coherent within the EU.

Below, some (but not all) of the questions addressed in the Green Paper are discussed. One recommendation in this comment for ensuring adequacy and sustainability is that the social security systems are redesigned so that the way in which aggregate risk – such as demographic or financial shocks – affects benefits and taxes is explicitly defined. In this way people can be aware of the risk they are facing. This indexation should be carried out so that the systems are sustainable basically to any shock. Such indexation schemes are, however, far from the European social security systems today, and to the best of the author´s knowledge, no one has even made suggestions in this direction.

The goal of achieving a sustainable balance between time spent in work and time spent in retirement will likely require (major) labour-market policies on *both* the demand and the supply sides. Examples here include eliminating the existing subsidized pathways to early retirement, lower replacement rates, prohibiting of age discrimination and possibilities to improve the employability of older workers. However, this author does no believe in common EU principles for pensions. In particular, the large differences between the countries are likely to require different policies for different countries. Finally, it is also important to reduce distortions in the labour market to increase participation for the younger groups and to improve the EU statistics on pensions, since much more research related to social security is needed.

2 Comments: Adequate and sustainable pensions

According to the Green Paper, the purpose of pension systems is to ensure adequate retirement income. Unfortunately, the concept of adequacy is a little vague as it does not have an exact definition. One definition that has been used is that adequacy implies:

"securely financed, adequate income that does not destabilise public finances or impose an excessive burden on future generations, while maintaining fairness and solidarity, and responding to the changing needs of individuals and society".[1]

Note that this definition stresses the importance of stable public finances. In fact, sustainability is a necessary condition for adequacy. For this reason, the focus has in most countries up till now mainly been on securing sustainability. The Sustainability Report (Economic Policy Committee (2009)) computes indicators of sustainability and figure 1 shows the S2 indicator, which approximates the gap (as a percentage of GDP) that must be closed off permanently in order to ensure that the government will be able to finance all future public budget obligations. The indicator consists of two components. First, there is a gap stemming from the initial budgetary position (IBP). Second, there are costs related to ageing and additional required expenditures, which are referred to as long-term changes (LTC). The indicator thus provides a compact measure of the long-term risk.

The value of the S2 indicator shows a value of 6.5 per cent of GDP for the EU countries as a whole. The decomposition shows that for this group, the IBP is responsible for 3.3 percentage points of the S2 gap. This means that even without taking the cost of ageing into account, the European countries should tighten their fiscal stance by an average of 3.3 per cent of GDP. The LTC then contributes roughly the same amount. There are, however, large variations in terms of both the absolute values of the indicator and the sources of risk, i.e. the contribution of the IBP and the LTC components. Clearly, additional reforms are needed for the majority of the countries to put them on a more sustainable path, and in some cases, major reforms are needed. As mentioned by the Green Paper, several countries have already started implementing reforms in response to the sustainability challenges. However, much more remains to be done.

1 Draxler and Mortensen (2009).

SUSTAINABILITY GAP (S2 INDICATOR) ACROSS EU COUNTRIES

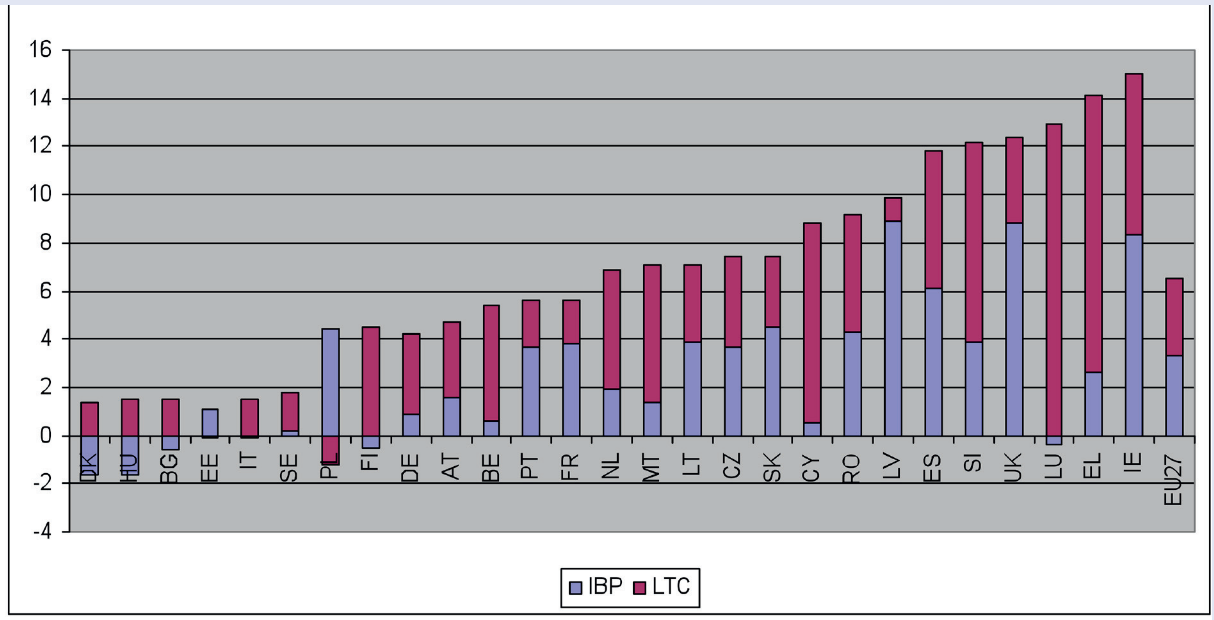

FIGURE 1:
S2 indicator. IBP – initial budgetary position; LTC – long-term change in expenditure. Source: Sustainability Report 2009, p. 35. The S2 indicator is the sum of the red (LTC) and the blue (IBP) bars, hence it is slightly negative for Denmark and Hungary. The country abbreviations are defined at the end of this paper.

2.1 Ensuring sustainability

What really should be undertaken is to formalize explicitly the way that aggregate risk enters into the social security system. This would have the absolute advantage that people then would know how their income would be affected by, for instance, a shock to the financial system. In addition, the allocation of risk should be consistent with sustainability so that the systems are stable basically to *any* aggregate shock. This requires an exact definition of how benefits and contributions will respond to an aggregate shock, so that when a shock hits the economy, they respond in a sustainable way. In particular, this is important for large shocks. The Green Paper suggests that the retirement age is adjusted upwards with increasing life expectancy (p. 9). This is a good example of an explicit formalization for shocks to life expectancy.

The risk is, of course, already present under the current systems, but how contributions and benefits will respond to large aggregate shocks is not *explicitly* defined. Instead, people face political risk, i.e., the probability that taxes and benefits will change within the political process in response to shocks. The demographic shock of the baby boomers has, for instance, been "realized" for a long time, but the way in which taxes and benefits will respond is still unclear in most countries. In addition, the recent "financial shock" is likely to cause *ad hoc* responses. This political risk is much less predictable and hence potentially much more costly for people.

One (small) step in this direction is the transition towards defined-contribution schemes. This is something that many countries have already implemented and today around 60 million Europeans are enrolled in DC schemes. A defined-benefit plan (DB) guarantees a certain payout at retirement, according to a fixed formula that usually depends on an agent's previous income and the number of years within the plan. In a defined-contribution (DC) plan, instead, the employer's annual contribution is specified. Hence, the systems have different risk-sharing characteristics. Under the DB system, pensions are formally relatively safe whereas taxes have to vary.[2] Hence, such a scheme has low formal risk for the retirees and higher formal risk for the workers. A DC system acts in the opposite way.[3]

In addition to the formal risk, there is, however, political risk.[4] As stated above, political risk implies that benefits are reduced in an *ad hoc* manner in response to aggregate shocks. It is hard to judge which of the two systems is more risky for retirees when political risk is also considered.

The trend towards more DC-based systems is most likely a good thing. In fact, Bohn (2009) shows that a *laissez-faire* economy places too much risk on young individuals and too little risk on the old. This tends to be grossly inefficient and people could then be better off if this inefficiency is corrected. This inefficiency is then amplified in a system with defined benefits, whereas a DC system reduces the inefficiency. Olovsson (2010) finds similar results. He also shows that there are positive effects on aggregate savings when moving to a system with more stable contributions (and variable benefits). This is desirable since social security systems tend to crowd out savings. A DC system thus encourages savings and stabilizes tax rates and public finances.

The process of formalizing the way in which taxes and benefits respond to aggregate shocks should, however, be taken further. In particular, the formalization should include large shocks, which are the ones that really pose a threat to sustainability. This will imply a higher *formal* risk for the retirees, since it requires lower benefits in bad times and higher benefits in good times.[5] However, the actual risk (i.e., including political risk) will not be higher. It is much better for people to know what kind of risk they are facing so that they can save optimally. As long as the risk is predictable and well understood, people can complement their retirement benefits with private pensions (or, alternatively, this is achieved in a multi-pillar system with a funded component). Such indexation schemes are, however, far from the European social security systems today, and as far as I know, no one has even made suggestions in this direction.

Nevertheless, it is absolutely crucial that the risk is well understood. This is also pointed out in the Green Paper, for instance where it states that these regimes require that people understand the information at their disposal in order to make informed and qualified choices. This is extremely important. Otherwise, people are going to save too little, which will increase the political pressure for social security reform.

Reforming the pension systems is, in any case, going to constitute major challenges, since several of the required policies are going to be unpopular among middle-aged and older people and these groups are generally politically very strong (this is probably one of the reasons why this policy has not been suggested yet).

3 Achieving a sustainable balance between time spent in work and time spent in retirement

3.1 Time spent in retirement

The retirement age declined by a great deal during the twentieth century. This decline occurred simultaneously with the increase in life expectancy, which has resulted in a substantial increase in the expected duration of the retirement period. In 1900 in the U.S., a 65-year-old male could expect to live another 11 years, compared with 12 years in 1940 and 15 years in 1990.[6] Hence, whereas a 20-year-old male could expect to live 6 per cent of his life in retirement, a 20-year-old in 1990 can expect nearly 30 per cent. These trends are similar for Europe (even though there is a large variation in the actual retirement ages in different European countries).[7]

It is thus important to make sure that the time spent in retirement does not continue to increase relative to the time spent working. However, this is not going to be easy and in fact, it is probably not going to happen

2 The formal risk does not include political risk.

3 So when the Green Paper says on page 4 that "while citizens now have more choice, they are also exposed to more risk", this is not entirely correct, since the risk has been there all the time.

4 See McHale (1999).

5 Sweden has actually taken a step in this direction, and benefits are reduced in bad times and increased in good times in a way that is meant to be sustainable.

6 See Eisensee (2006). For women the increase has been even more pronounced – the corresponding numbers are 12, 13 and 19, respectively.

7 Again, there are (very) large individual differences between countries. For instance, the actual retirement age is 59–60 in France compared with 63–65.5 in Sweden. See Statistics Sweden at http://www.scb.se/statistik/_publikationer/LE0001_2009K03_TI_14_A05TI0903.pdf.

at all unless the required policies are implemented to change these trends. To make it possible to break the negative trends it is then first crucial to gain a good understanding of the driving forces behind them.

One possible factor contributing to the lower retirement age could simply be that leisure is a “normal good”, implying that people want to “consume” more of it as they become richer. Another factor may come from economic incentives, for example, within the social security system. There is evidence suggesting that the retirement age depends on the social security system and that it varies negatively with the replacement rate.[8] There also seem to be strong peer effects in the retirement decision, so that the probability of a person retiring increases when his/her peers retire.[9] All three of these factors are likely to be important for the observed decline in the retirement age, and each of them requires its own specific policies. The last factor, for instance, suggests that there are externalities in the retirement decision.

The suggestions in the Green Paper for how to reach the goal of a higher retirement rate are somewhat vague. Increasing the eligibility age is mentioned as one possibly important signal. This is probably correct. On the other hand, the effective retirement age has been well below the eligibility age for a long time and it is the effective retirement age that needs to be increased – but that is not necessarily affected by changes in the eligibility age. To increase the actual retirement age it is instead probably much more important to eliminate the existing subsidized pathways to early retirement. This, in combination with lower replacement rates, is more likely to be a successful policy for increasing the retirement age.

Another suggestion in the Green Paper is to enable access to training and adjustments for all workers. This is a very good suggestion in order to make it possible for people to stay longer in the workforce. It is necessary, but on its own this policy is likely to be weak.

To increase the retirement age significantly, a policy must be chosen in such a way that economic incentives on several fronts encourage people to stay longer in the workforce. In fact, action is needed on *both* the demand and the supply side. First, there must be strong economic incentives to carry on working. As argued above, these can come from eliminating the existing subsidized pathways to early retirement and lower replacement ratios, among other things. Second, incentives for employers to hire and retain older workers must be provided and strengthened. A number of policies are possible, such as prohibiting age discrimination and abolishing mandatory retirement. Third, older workers must have possibilities to improve their employability. These three factors are probably all needed at the same time and if one of them is neglected, the goal of adequate and sustainable pensions is unlikely to be reached.

Encouraging people to work longer in their lives is a top priority, since this yields three positive gains: first, it boosts labour force growth and reduces the negative impact of population ageing on growth; second, it improves public finances by reducing expenses and increasing tax revenues; and finally, it helps employers by smoothing the pace at which they have to replace the older workers. However, since some of the necessary policies are not going to be popular, there is a potential role for the EU in providing information about the necessity of these reforms.

3.2 Time spent working

Another way to reach the Green Paper´s goal of increasing the time spent in work relative to the time spent in retirement is to increase the employment rate and hours worked per person. In fact, the labour supply can be more fully mobilized, this will reduce the dependency ratios, improve the public finances and increase potential growth. This is mainly achieved by reducing distortions in the labour market. The argument of removing obstacles to move within the EU applies here. There is also an ongoing academic debate about how distortionary taxes actually are. A large and growing literature argues that taxes on labour and consumption have a large (negative) impact on the amount of work hours per person per year (examples include Davis and Henrekson, 2002, Ragan 2005, Prescott, 2004, Rogerson 2007, Olovsson, 2009).

8 See for example Eisensee (2006) and Palme and Svensson (2004).
9 Brown and Laschever (2009).

There are again, however, large differences between the countries and it is not necessarily the case that the countries with the highest tax rates (i.e., the Nordic countries) have the lowest level of work hours per person. It seems, however, that the combined amount of distortions is an important determinant of the hours worked. For instance, the Nordic countries heavily subsidize child care, which partly counteracts part of the high labour taxes.[10]

For women at least, there is also a positive correlation between participating at a young age and participating at a high age.[11] This suggests that lower participation rates for older women in one country than in another also reflect lower participation rates for women more generally. Hence, it is important to reduce labour market distortions for the younger workers and to increase their participation rates.

This is an important factor, since the ratio of the "inactive" population is projected to increase. The potential impact particularly on the public finances is thus very large.

4 Mobility to move within the EU

The Green Paper also stresses the importance of free movement of production factors, in particular labour and capital, so that resources can be used in the most efficient way. Workers must thus be able to move freely within the EU without losing work-related pensions. In addition, it is desirable that supplementary pension rights are not lost when people move jobs within or between countries. These are sound ambitions and they are important goals for the long run. However, how important these restrictions are in the short (and even the medium) run is an open question. People do not move much between – or even within – countries in Europe compared with, for instance, the U.S. It is doubtful that people will start moving if these constraints are removed. For the short (and medium) run, it is much more important to reform the pension systems so that they become sustainable and to provide economic incentives that encourage people to work at older ages.

5 Improving EU statistics on pensions

Another suggestion in the Green Paper is that the EU statistics on pensions are improved. This is a very good idea. More research on social security is needed. In fact, most research on social security is based on just one country. Cross-country studies are very uncommon, but in fact a great deal of important knowledge and insights could probably be gained from comparing different systems. It is thus valuable to have access to comparable data. It is highly important that the data generated then also become available to researchers (such as the OECD data). Much research about social security and savings in general is needed and this research is crucial when designing policy and evaluating different welfare systems and making predictions. This is thus also a highly important step towards making it possible for people to make informed decisions.

10 See Ragan (2005), Olovsson (2009) and Rogerson (2007).
11 OECD (2006), pp. 29–31.

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Country abbreviations

BE Belgium
BG Bulgaria
CZ Czech Republic
DK Denmark
DE Germany
IE Ireland
EE Estonia
EL Greece
ES Spain
FR France
IT Italy
CY Cyprus
LV Latvia
LT Lithuania
LU Luxembourg
HU Hungary
MT Malta
NL the Netherlands
AT Austria
PL Poland
PT Portugal
RO Romania
SI Slovenia
SK Slovak Republic
FI Finland
SE Sweden
UK United Kingdom

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