Pension Policy in EU25 and its Possible Impact on Elderly Poverty

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(Independent research, and not the views of the European Commission)
Overview of our research
(a study financed by the European Commission during early 2006)

Part I: An account of income-based poverty amongst the current populations of older people

Part II: A review of recent reforms in pension policy in EU25, and a review of expected impact on retirement incomes and poverty risks among future populations of older people
Work we did in Part I.....

I. Review of Concepts and Measurement Methods used in accounting poverty risk amongst older people;

II. Results: A statistical portrait of risk of poverty amongst older people in EU25;

III. ‘Who are the good pupils in the classroom’: Identifying good practices by linking poverty among the current pensioners to the pension policy.
Methods used in measuring elderly poverty risk

- Limited to ‘monetary’ aspects of personal well-being
- Choice of poverty line as 60% of national median income (.. certain degree of arbitrariness!)
- Critically, no account of housing resources and financial wealth was possible (.. relative economic status of older people underestimated)

Our paradigm has been that policy purposes are best served if a harmonised method is adopted in such EU-wide studies; methods which have attained some degree of consensus....! Thus, the Laeken Indicators methods had been adopted, as per ISG recommendation
CEECs in NMS10 are largely countries with the lowest risk of poverty for older people.

With the exception of Cyprus, all other Member States with high poverty risk belong to EU15: Ireland (40%), Spain (30%), Portugal (29%), Greece (28%), and UK (24%).

EU15 (19%) vs NMS10 (9%).
Poverty risks across groups

- In the majority of countries, the poverty risk is clearly higher for female elderly; more so in EU15 (21%) than in NMS10 (10%).

- Further analysis shows that females aged 75+ have the highest poverty risk.

- Breakdown across household type shows that in many countries single elderly persons have the highest risk of poverty across all household types (single parents, the other subgroup)
What link with pension policy?

• **Netherlands**: the country with the lowest poverty risk:
  – universal residence-based basic pensions; indexing in line with wages
  – mandatory occupational pensions;
  – generous survivors‘ benefits in occupational pensions

• **Sweden, Austria and Germany**: relatively generous pension crediting for absences from labour market; yet much higher poverty risk for women?

• **CEECs**: have had a generous defined-benefit public pension schemes; less often early retirement; and good redistribution possible (e.g. Poland).
Work we did in Part II.....

I. Detailed and systematic review of pension reforms implemented in EU25 over the last 10 years;

II. Analyse possible impacts of pension reforms on retirement incomes and poverty risk of the elderly populations;

III. Quantitative Projections of poverty risk amongst the future generations of elderly populations (not to be discussed in this presentation, see our 2nd Report!).
Pension reforms in EU countries

For convenience of analysis, the reforms that have taken place can be classified into two broad sets:

– **Parametric reforms** (i.e. maintaining the *PAYG* nature of the existing system, but making substantial changes in pension rules -- in retirement age, accrual rates, contributions, indexation, etc.)

– **Systematic reforms** (i.e. moving away from the *PAYG DB-type* public pension system and adopting *DC-type* personalised accounts system -- thus, linking pension receipts more strictly to pension contributions and to investment decisions and performance)

Hybrid reforms (Germany, France and Austria)
So..., what is the difference?

- Parametric reforms appear to be less drastic, yet they also faced considerable political opposition;
- Their impact on financial sustainability and pensioner incomes could be equally impressive, or more (France 21%, and Sweden 20%, decline in RR);
- Main difference lies in the sharing of longevity risks
  - Sticking to DB system implies that the longevity risk is still borne by the pension provider;
  - shift to DC structure in systematic reforms implies greater risks borne by individuals (though with a greater intergenerational fairness; and better fiscal sustainability).
1. Parametric Reforms: what changes?

**Typical contribution side changes**

- The most frequent reform involved changing the state pension age (a reform that is more justifiable in view of rising longevity);
- Many countries also changed contribution rates;
- Contribution requirements were also toughened, by rolling back early retirement opportunities and increasing years of contributions required for a full pension (*Austria, Germany*).
1. Parametric Reforms: what changes?

Typical benefit side changes

• More countries moved away from uprating of pensions in line with earnings to a less generous uprating (e.g. in line with prices)

• Changes in pension formula leading to a reduced generosity of public pensions
  – Accrual rates fallen in many instances; this tends to a lowering of the income to be replaced.
  – Pensionable salary to be less often the final salary and more often a representative salary during lifetime (Austria: 15 best to 45 years).
1. Parametric Reforms: possible impact

Why such reforms in the first place?
• Reforms driven mainly by fiscal sustainability and intergenerational fairness concerns.

What impact for the future elderly populations?
• Pensions set to replace less of pre-retirement annual income (unless people are able to extend their working careers);
• Pension incomes will lose their value relative to earnings during retirement;
• Automatic stabilisation may create confusion over what pension entitlements are accrued;
• Those with lower lifetime employment and earnings will be affected most (in particular women with caring duties).
2. Systematic reforms

1. World-Bank multi-pillar model
   – Poland, Estonia, Latvia, the Slovak Republic, Lithuania and Hungary all implemented multi-pillar reforms before they joined the EU (and also in Romania and Bulgaria).

2. NDC schemes (as in Sweden)
   – Reforms in some other European countries influenced by the NDC reforms of Sweden and Italy and in some cases, namely Poland and Latvia, the first pillar was converted from PAYG to NDC.
2.1 Multi-pillar type reforms

Why such reforms in the first place?

• Move towards a funded system; more individual responsibility, and better incentives for savings for retirement (laudable objectives in their own right…)

• Increased share of private funded pensions;

• Fully funded system is viewed more risky and costly and such a drastic move less politically defensible.

• (partly) (for the NMS only), a strong desire to join the EU, a transition towards the market economy;
2.1 Multi-pillar type reforms

What impact for the future elderly populations?
They are too new to assess their long-term impacts, but

- Individuals have opted to shift to personal accounts without having recourse to enough information (e.g. Hungary);
- Early problems with administration of personal accounts:
  - Decentralised system, with higher administrative costs (more burdensome to lower-income persons);
  - Risks of mis-selling (e.g. in Hungary)
  - Inactive accounts or contributions not enough (may not be a problem in Poland);
  - Returns recorded so far fall short of expectations (Hungary).
- Shifting of risks to individuals (more intergenerational fairness, but the transition at the expense of greater risks for social sustainability)
- Less redistribution possible (negative impact for women and other vulnerable groups with low lifetime employment)
2.2 NDC type reforms: what impact?

- NDC systems tend to be less risky:
  - notional accounts, so no investment risk
  - Centralised administration, so less costly
  - Securitisation of pension entitlements
- Yet, greater income risks compared to the pre-reformed public DB-type system;
- Lower pension incomes and greater poverty risk, for both men and women, as the longevity risk passed onto contributors of the same generation;
- Automatic balancing mechanism lacks clarity of their impact on pension income entitlements
- Pension crediting for labour market absences are very crucial (and they are different across NDC systems; – Hungary, Poland and Sweden).
Conclusions: Impact of pension reforms

• Reduction in the redistributive element that were previously present in public DB pension schemes;

• If gender differentials in employment and earnings continue, it will lead to a greater gender inequality;

• Pensioner positions will depend on how well they will be able to extend their working lives while facing a prospect of reduced benefits;

• Generosity of benefits may be on the decline, although the pension coverage is on the rise;

• Social sustainability risks (…although economic sustainability of these pension systems have improved!.... Policy reversals in the UK!)
What next?

• European policymakers are to be made aware of these findings, with options for further reforms so as to continue to meet the social objective of pension systems:
  – The Finnish EU Presidency conference in Helsinki, 4-5 December 2006)

• European Pension Policy Observatory for a continuous monitoring of changes in pension systems and their impact on the risk of pensioner poverty (Spanish Government initiative, tbc)