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from:	The Social Protection Committee
to:	Permanent Representatives Committee (Part I) / Council (EPSCO)
Subject:	Interim EPC / SPC joint Report on Pensions - Executive summary

Delegations will find attached the executive summary of the interim EPC - SPC joint Report on Pensions, as finalised by the Social Protection and Economic Policy Committees and presented with a view to the session of the Council (EPSCO) on 7-8 June 2010.

The text of the full report is to be found in Addendum 1 to this document.

EUROPEAN COMMISSION

EPC Secretariat
SPC Secretariat

Interim EPC-SPC Joint Report on Pensions

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Executive Summary

Ensuring that public policies cater for sustainable, accessible and adequate retirement incomes now and in the future remains a priority for the EU. While Member States share similar fundamental challenges there are considerable differences in the timing of demographic ageing, the design of pension arrangements, the growth potential and in constraints on account of the fiscal situation and external competitiveness. The projected increase in public spending due to population ageing poses an important challenge to EU Member States. Policy action to improve the long term sustainability of public finances while ensuring adequacy of pensions is crucial.

A - CHALLENGES AND ACHIEVEMENTS

(1) People today are healthier and live longer than ever in history. At the same time they have fewer children than they used to.

Over the last decades, life expectancy has steadily been rising, with an increase of up to two and a half years per decade. If reduction of mortality continues at this pace, most people in the EU will live very long lives. This would mean life expectancy at birth for men would increase by 8.5 years and by 6.9 years for women over the next fifty years. Fertility rates have decreased in almost all Member States and in some they have remained very low. The combination of rising longevity and lower fertility will lead to a steep aggravation of the old age dependency ratio. The size of the working-age population is projected to shrink and this will reduce potential labour supply and economic growth. This will have far-reaching consequences for economic, budgetary and social developments.

(2) Faced by a strong increase in the old age dependency ratio, most Member States have over the last decade reformed their pension systems to retain sustainability as well as adequacy and to ensure fairness between and within generations and between men and women. Reforms have brought important progress, notably in sustainability for public pension schemes, and to varying degrees also in some aspects of adequacy and minimum income provisions for older people in particular.

The adopted reforms considerably limit the growth in projected public pension expenditure over the long-term, as appears from the 2009 Ageing Report. Thereby reforms may greatly improve the ability of public schemes to continue to provide adequate pension benefits in a sustainable manner. Nonetheless, public pension expenditure in the EU as a whole is projected to rise by 2 ½ p.p. of GDP by 2060, which equals an increase of 23% on average of public pension expenditure, and in some Member States substantially more.

Improvements in sustainability largely result from closer links between contributions and benefit accruals, actuarial adjustment mechanisms and changes to valorisation and indexation rules, which as shown by the December 2009 ISG-SPC report[1] tend to reduce the earnings-related replacement rates for people retiring at the same age as today.

With many reforms the challenge in public pension delivery increasingly turns to achieving adequate replacement levels while ensuring sustainability. Reforms of public schemes usually contain measures to raise replacement rates through extension of working life and in several Member States new or expanded supplementary pension schemes have opened additional possibilities for many people to compensate for limitations in public provision through greater savings and the build-up of additional entitlements.

Many reforms have resulted in wider coverage (e.g. inclusion of farmers, self employed, women with low entitlements etc.) and better fit with gender roles (e.g. crediting of caring years) and changing labour markets, though some problems still needs to be addressed (e.g. atypical careers and short term contracts). The shift from best years towards career average as calculation base for earnings-related pension schemes in many Member States has enhanced their intra-generational fairness and sustainability.

Changes adopted have also pertained to pensions currently in payment. Several reforms have led to increases in minimum pensions and supplementary allowances.

1 For more detailed information see the report "Updates of current and prospective theoretical pension replacement rates 2006-2046", http://ec.europa.eu/social/main.jsp?langId=en&catId=752&newsId=551&furtherNews=yes

Underpinned by restrictions on early retirement and stronger work incentives, periods of high labour demand and changes in the characteristics of the 55-59 year olds have resulted in higher employment rates of older workers thus reversing long standing trends towards earlier retirement.

(3) Recognizing the progress, the challenge of adapting the pension systems in some of the EU Member States to expected demographic changes is still very real. Additional reforms of pension policy will be needed in several countries. Furthermore, there are signs that ongoing reforms might bear considerable risks in terms of both adequacy and sustainability. As changes in pension systems will tend to make benefits more contingent on developments in labour and financial markets, important risks relate to employment rates not increasing enough or capital markets not delivering as expected. Budgetary consolidation, which is more urgent after the economic crisis, is essential in order to reduce public debt and to contribute to financing the future increase in public pension expenditure.

In many Member States reforms are changing pension systems from largely single tier to truly multi-tier systems. In most Member States, the bulk of pension income will continue to be provided by public pay-as-you-go schemes. As the role of funded and defined-contribution pensions grows and public pensions increasingly become based on life-time earnings-related contributions, future pension adequacy will increasingly rest on good economic performance, the ability of labour markets to provide opportunities for longer and less interrupted contributory careers, a strengthened relationship between contributions and benefits in pension systems, and a combination of safe and appropriate returns from financial markets.

Moreover, there are considerable risks remaining. In some Member States additional reforms of pension policy will be needed in view of the scale of demographic changes ahead. For several countries where the pension reform process has not been set sufficiently in motion, there is an urgent need to review the 'pension promise' in view of what the rest of the economy can be expected to support. For some other countries, additional measures might be needed to ensure the lasting success of reforms already implemented.

B - REMAINING RISKS AGGRAVATED BY THE ECONOMIC CRISIS

(4) Sustainability and adequacy concerns for all types of pension schemes have been aggravated by the crisis. Lower growth prospects and increasing deficit and debt affect sustainability. Regarding adequacy, today's pensioners have generally been well-protected against the crisis, but pensions may be affected by unemployment periods and lower contributions and poorer returns in financial markets. The crisis has an impact on the currently active population, and thus on the accumulation of pension rights, notably for younger generations.

With secure incomes from public pensions, which have been allowed to perform their role as automatic stabilisers, current pensioners have so far been among the population groups least affected by the crisis. Exceptions apart, benefits from funded schemes still play only a marginal role in the pensions of retired Europeans and just a few Member States with very acute public budget problems have had to adjust public pensions in payment. In several Member States, funded schemes will be much more important for benefit delivery in the future.

The crisis has strongly reduced the market value of pension fund assets and it has led to a sharp deterioration in public finances, which to varying degrees is putting stress on public spending for pension provision. After the steep tumble in financial markets prices in 2008, many pension funds have been able to recoup some of their losses in 2009[2] and early 2010. This should be seen against the background of the scale of fiscal deterioration as a result of the crisis which, expressed in terms of debt, represents nearly 20% of GDP, which will severely constrain public pension provision. This, in combination with pre-existing weaknesses and imbalances implies that there will be an unprecedented need for coordinated fiscal consolidation.

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[2] See OECD "Pension Markets in Focus". October 2009, Issue 6.

(5) The crisis has highlighted the need to review the degree of financial market exposure and the design of risk sharing in funded pensions.

The trend observed in some Member States towards more private sector funded pension provision can help reduce explicit public finance liabilities, but it also creates new challenges and forms of risks. Variations in the ability of funded schemes to weather the present crisis show that differences in design, regulation and investment strategy matter. Achieving a better balance for pension savers and pension providers between risks, security and returns will be key to enhance public confidence in funded pensions and ensure their contribution to adequacy of retirement incomes.

C - AGGRAVATED CHALLENGES AND PROSPECTS

(6) Adequacy and sustainability are two faces of the same coin. In general, people need to work more and longer to ensure both.[3] There is no one-size-fits-all solution to pension delivery: all systems have pros and cons and all need to adapt to long-term demographic and economic trends. The challenge for policy makers is to aim for a good balance between sustainability and adequacy. The crisis and possible lower economic growth will make this harder and more urgent. It is therefore vital to strengthen awareness of available routes to adequate income in retirement. Transparency and information are essential to gain public trust and guide behaviour. To fully ascertain the balance between adequacy and sustainability in pension systems, better coordinated work at EU level on measurements and data will be needed.

The overall framework agreed by the Stockholm European Council – the tree-pronged strategy of:

(i) reducing debt at a fast pace; (ii) raising employment rates and productivity; and, (iii) reforming pension, health care and long-term care systems – for coping with the challenge posed by ageing populations remains valid and progress on each of the three pillars will be indispensible.

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3 People in bad health may require special consideration.

Nevertheless, in some countries the crisis has increased the urgency to modernise pension policies using a holistic approach. Budgetary consolidation and attaining the medium-term budgetary objectives is essential in order to reduce public debt and to contribute to financing the future increase in public pension expenditure.

The crisis will affect all pension designs. It has revealed some weaknesses in certain aspects of reformed systems that will need to be addressed, in particular, the role of funded schemes and the interaction between public and private pillars.

The crisis has also highlighted that economic growth, employment, good regulation of financial markets solidarity and fairness between and within generations are interlinked key components of pension policy. Macroeconomic stability and well-functioning labour and financial markets are needed for pension systems to work well. Reducing structural unemployment would bring major benefits.

Without working longer, the adequacy-sustainability balance will be difficult to reach. Many pension reforms on their own would reduce annual replacement rates unless people work more and longer. People need to be made aware of possibilities for raising their level of retirement income through the build up of supplementary pensions and extra entitlements, while having access to appropriate information on the various related risks. The crisis adds to the need for policy-makers to provide stability by being transparent on pension policy, on the routes that are and will be available to retirement incomes in the future and to provide guidance, so as to enable people to change their behaviour.

(7) Employment rate improvements over the last decade may come under threat and there is still considerable need for progress. Growth prospects, appropriate work incentives, open labour markets and increasing effective retirement ages are needed to enable more people working more and longer.

Only around 40% of people are still in employment at the age of 60 and female employment rates are still substantially below those of men. This represents a huge untapped potential and raising the overall employment rates for all, in particular of older workers and women, and thereby increasing effective retirement ages will be a key policy objective for EU Member States. The positive aspects of migration should be fully exploited.

Achieving the necessary extension in working lives in view of continuous gains in life expectancy will prove challenging as adjustments will also be needed in age management in work places and labour markets and in the expectations and behaviour of workers.

Tax/benefit and wage systems could provide financial incentives for people to remain economically active and building their own human capital. Policies to tackle age-discrimination and to promote life-long learning, flexible retirement pathways and healthy job opportunities for older workers would also be needed.

Besides measures concerning the pension systems, governments need to promote opportunities for people to work more and longer and for further developing additional sources of income. Having access to pension schemes which are simple to understand, of low cost and suited to the modern workplace is essential to address the ageing transition. Involving all stakeholders (e.g. the social partners) to achieve this will be important.