

**Assessing the adequacy and
sustainability of
pensions on the basis of
indicators of the Open Method of
Coordination**

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Introduction

This paper explains how the Indicators Sub-group of the Social Policy Committee has developed indicators that complement the Ageing Working Group's work on pension sustainability. I set out what these indicators in the context of the Open Method of Co-ordination [OMC] can achieve in terms of monitoring and evaluating adequacy of pensions along side the monitoring of the financial sustainability of publicly funded pension systems.

Background

It is well known that the prospect of an ageing population in all EU Member States led to concerns about the impact of generous earnings related publicly financed pensions on future sustainability and the stability of fiscal policies. The scrutiny of the problem in the context of peer reviews among Member States had an important role to play in the reform of the most generous pension systems. Just as the process produced reforms, people started to raise raised concerns as to the adequacy of the resulting less generous pensions. The ISG was given the remit of recommending a set of indicators to monitor the adequacy of pensions.

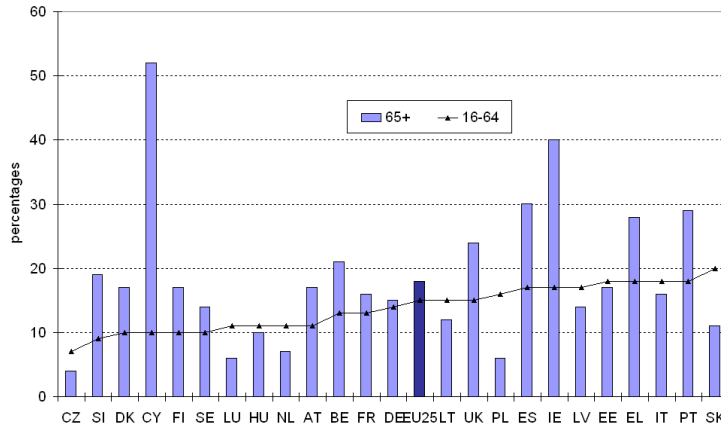
Measuring Adequacy

We started from the indicators that were already in use to measure poverty and social exclusion across all households. The key indicators are:

- **Poverty risk of 65+ (EU – SILC)**
- **Relative median income of 65+ (EU – SILC)**
- **Aggregate replacement rate (EU – SILC)**
- **Theoretical replacement rate (ISG - OECD)**

The first indicator, the at risk of poverty for the 65+ measures the percentage of people 65+ living in households with an income below 60% of the median household income. Figure 1 shows the most recent data and compares the at risk rate for 65+ with the rest of the population of working age:

Poverty risk among elderly



Source Eurostat, income data



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Figure 1 Poverty Risk among the Elderly

This indicator needs to be assessed in conjunction with information about the level of median household income as well as other poverty thresholds especially 50% of median income.

The second key indicator is a measure of the average incomes of the elderly compared with the rest of the population. The latest data is shown in figure 2 together with an indicator that expresses average pensions received by a younger retired population relative to average earnings of people below aged 50 – 59.

These indicators of course only tell us about the relative adequacy of the incomes of elderly people today. They do not tell us about the distributional impact of pension reforms on the elderly in the future. Dynamic micro simulation models would, in theory, answer many of the questions about future adequacy. But a few years ago when we were developing these indicators of pension adequacy there were few if any reliable functioning models of this kind. We therefore adopted an indicator that defined a replacement rate – pensions relative to earnings – for a set of very simplified stylised assumptions. These are the theoretical replacement rates. The assumptions are deliberately simple and designed to reveal how each country's pension system delivers pensions in the future. The fixed assumptions allow the different results to be a reflection of differences in pension systems. The reality will be a reflection of the different economic circumstances and the different employment and pension entitlement records of different countries. These replacement rate indicators must be

evaluated together with information about how representative the assumptions are.

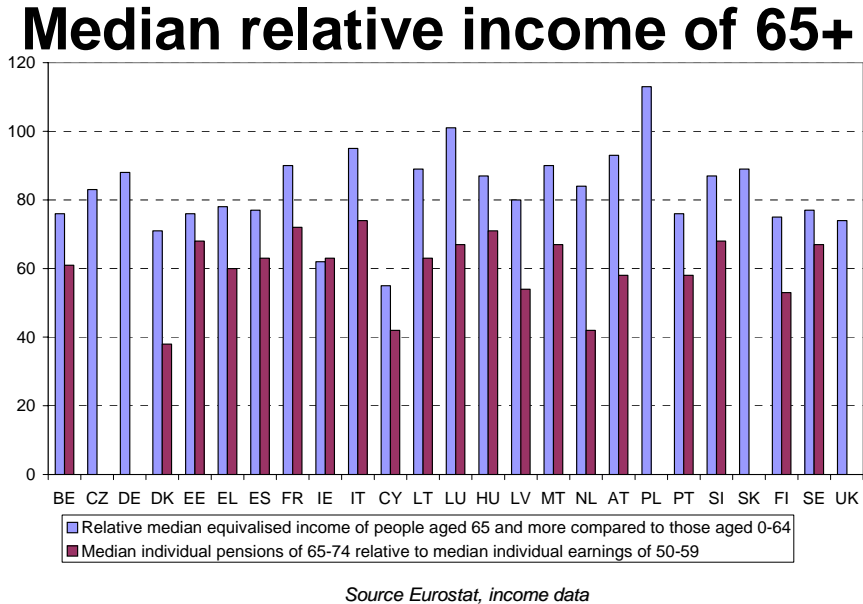


Figure 2 Median Relative Income for 65+

Some Questions for Discussion

At this point I want to pause and pose some questions about the twin arms of the OMC in pensions.

- Total Population v the Elderly** The OMC concerned with poverty and social exclusion is about the risk of poverty of all households with special focus on some key groups such as children and the elderly. The OMC that considers sustainability is about the fiscal sustainability of transfers to the elderly given the prospect of rising numbers of elderly people. It may be more appropriate to consider fiscal sustainability of all income transfers to all sectors of the population made through the public sector. If the number of elderly is set to grow and the number of working age to fall the overall impact of public income transfers needs to be considered not just the impact of ageing on public expenditure.
- Public v Private** Most of the analysis of the future of pensions concentrates on public provision of pensions. This is understandable because in many Member States the bulk of pension provision is through the public finances. But adequacy is about the total household income

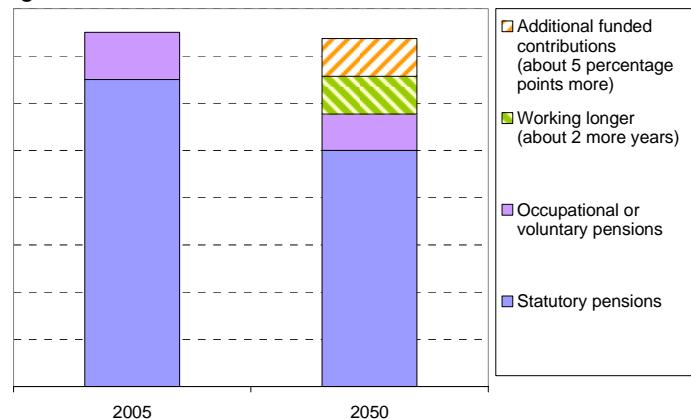
and therefore the ISG's proper concern should be about the total income transfers to retired households, public and private regardless of the mechanism of the transfer. It also applies to the question of sustainability. If doubling the retired population means today's earning related pensions are not affordable in terms of public provision, they will not be sustainable just by switching the transfer to private pension suppliers.

Theoretical Replacement Rates

These are very stylised calculations using common assumptions to illustrate how pension reforms have reduced the generosity of pensions in the future. Figure 3 is an illustrative demonstration of how reductions in pension reforms reduce the replacement rate for a hypothetical worker who has worked for 40 years on average earnings. It also shows how the reduction in replacement rate can be offset by working longer or by increasing pension contribution rates. The latter of course would raise questions of sustainability. Two years longer working life is not enough to offset the reduction in pension generosity. Although this varies across Member States and across different pension regimes, 5 years extra employment is needed to offset the impact of ageing: "there is no pension problem to which the answer is not 70"

Theoretical replacement rates

Declines can be compensated by longer working lives and additional savings

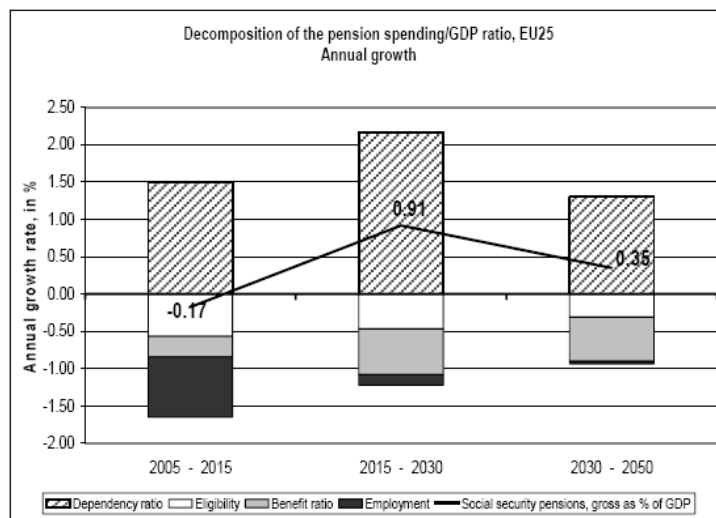


Source : Stylised illustration from ISG results on gross replacement rates for a worker retiring at 65 after 40 years of contributions at the average wage

Figure 3 Theoretical Replacement Rates

It has also been possible to use the theoretical replacement rates to contribute to understanding the forces driving the future growth in pension expenditure. Figure 4 below shows how different factors will drive the growth in pension expenditure.

Expenditures trends



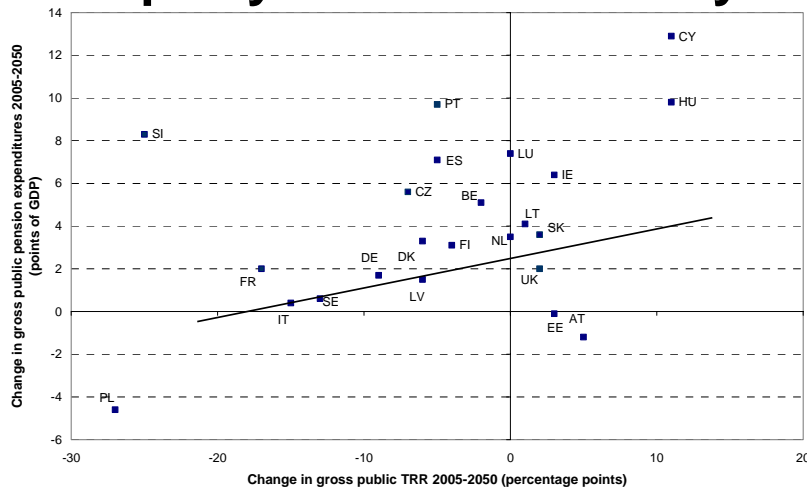
Source : AWG projections

Figure 4 Expenditure Trends

In the first decade the effects of increases in the dependency ratio are off set partly by the growth in employment that has been happening especially among older workers. The fifteen years 2015 to 2030 will be when the increases in dependency rates dominate and produce annual growth rates in pension spending/GDP ratios. The average growth rate of just under 1% would be half of a percentage point higher if it were not for the reductions in pension generosity. In the 20 years after 2030 reductions in generosity also contribute to dampening the effect of rising dependency rates.

Not all countries have reformed pensions to reduce generosity. Figure 5 below shows the spread in reductions in replacement rates. There is a weak relationship between reductions in replacement rates and growth in public pension expenditure.

Adequacy and sustainability



Source: ISG and AWG projections (public pension schemes include the funded tier of statutory schemes).

Figure 5 Adequacy and sustainability

The methodology developed to calculate theoretical replacement rates is also relevant to assessing the incentive effects that different pension systems provide for longer working or early retirement. The ISG has not concluded its work in this area but some things are clear. The age group for whom incentives to work longer/retire earlier is the age group 60 to 65. In general replacement rates are higher the higher the age of retirement. In some Member States, increases in replacement rates appear low for delaying retirement age in statutory pensions.

Incentives to work longer can be lower for those on lower wages - Incentives can be significantly different for different earnings levels and the situation for average wage earners does not fully reflect a country's incentive structures for working longer. In particular, for lower wage earners, incentives have to be coherent with the interaction between minimum incomes for pensioners and standard earnings related schemes.