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Joint Report on Pensions

Progress and key challenges in the delivery of
adequate and sustainable pensions in Europe

Country profiles

Table of Contents

- Country profile: Belgium 3
- Country profile: Bulgaria 9
- Country profile: Czech Republic..... 16
- Country profile: Denmark 21
- Country profile: Germany 27
- Country profile: Estonia 34
- Country profile: Greece..... 41
- Country profile: Spain 47
- Country profile: France 54
- Country profile: Ireland..... 61
- Country profile: Italy..... 67
- Country profile: Cyprus 73
- Country profile: Latvia..... 79
- Country profile: Lithuania..... 85
- Country profile: Luxembourg 91
- Country profile: Hungary 96
- Country profile: Malta..... 101
- Country profile: Netherlands..... 106
- Country profile: Austria 112
- Country profile: Poland 117
- Country profile: Portugal 123
- Country profile: Romania..... 130
- Country profile: Slovenia 135
- Country profile: Slovakia 141
- Country profile: Finland..... 147
- Country profile: Sweden 153
- Country profile: United Kingdom..... 159

Country profile: Belgium

Description

The Belgian statutory pension system (pay-as-you-go) covers old-age and survivors risks. It comprises three schemes: a scheme for salaried workers in the private sector, a scheme for the self-employed and a scheme for civil servants. Pensioners who have paid contributions to more than one of these three schemes receive a "mixed-career" pension. The retirement pension is determined on the basis of three elements: career, wages and family situation.¹ For both self-employed and private schemes, every worked year counts for 1/45th in the calculation of the pension. The pensions can be combined with other revenues from professional activities (within a certain limit, however). The risk of invalidity is covered by a specific scheme and at the statutory retirement age (65) people transit from the invalidity to the old age pension scheme.

The pensionable age is established at 65 years for both men and women (under all three schemes). Until June 1997, the legal retirement age for women was 60, and for men 65. Women needed 40 years of salaried service for a full pension, men 45 years. To solve the problem of unequal treatment of men and women, a gradual equalisation of the pensionable age at 65 years and of the required career length was introduced. As of 1 January 2009 the legal retirement age for both men and women is 65, and for both the career length is 45 years to be entitled to a full pension. Early pension take up remains possible without penalisation for salaried workers of the private sector from age 60 but only on the condition of a 35-year career. Until 1991 pensions were reduced by 5% for each year below the pensionable age. Some kind of penalisation is still applicable for the pensions of the self employed. Except for civil servants, the legal retirement age is not compulsory. Pension is taken up on request of the retiree and can be taken up later.

Pensions for workers and self-employed are calculated on the basis of the full contributory career and provide 60 % (for a single person) or 75 % (for a head of family) of the mean revenues earned throughout the entire contributory career up to a certain wage ceiling. For this reason, no formal maximum pension is defined in the legislation: the pension will in practice be limited due to the application of the wage/income ceiling taken into account for the pension calculation. For civil servants however, pension rights are calculated on the basis of the income of the last five years before retirement (multiplied by the number of worked years and divided by 60), while the family situation has no influence on the pension amount. For civil servants however, a maximum pension is applicable.

A new scheme of "sectoral pensions" was introduced in 2003 (Law on the complementary pensions), in order to extend the second pillar of occupational pensions. Membership is mandatory at sector level, depending on collective agreements, but in those sectors where no collective agreement is concluded, enterprises can voluntarily install a second pillar pension plan. Wherever such pension plans exist in execution of the Law of 2003, adherence is compulsory for the entire workforce (of the firm or submitted to the sectoral collective agreement) and guaranteed by the employer. Complementary pensions are also accessible for

¹ Pensioners (except civil servants) receive a supplementary family amount if they have to support a partner with no (or very low) pension entitlement. In the future this pension will be more and more frequently replaced by two pensions for single people because of higher participation of women in the labour market.

the self employed. Further, voluntary individual pension schemes are promoted with tax deductions for contributions up to a maximum ceiling (of 870 EUR per year for the income year 2009).

In 2008 contributions to autonomous pension funds and group life insurance schemes represented 1.7% of GDP while 56.5% of active population was covered.² 20% of the current pensioners are covered by occupational pensions and it can be observed that in 4/5 of the cases, occupational pensions are paid out as lump-sum payments and not in annuities. Participation is higher among new retirees and raising to over 1/3 of the retiring workforce.

A person who has worked full-time during at least 30 years of employment (i.e. 2/3 of a full career) can benefit from a guaranteed income in the pension schemes for salaried workers and self-employed people, in proportion to the career length. For people with a mixed career, a new scheme for minimum pensions has also been introduced. A guaranteed minimum pension is provided for civil servants with at least 20 years of service.

Individuals with insufficient income who are 65 or older are protected by a means-tested social assistance scheme, GRAPA³ (*Garantie de Ressources aux Personnes Agées* — guaranteed income for the elderly).

Depending on their income, pensioners can benefit from preferential co-payment rates for health care services. The *maximum à facturer* in health care insurance is also applicable to pensioners (absolute limitation of co-payments of patients, depending on income level)

In March 2010, the Belgian Federal Minister of Pensions published a Green Paper on pensions, which sets state of pension affairs in Belgium, and which should lead to a White Paper expressing proposals of further reforms. The main orientation issuing from the Green paper seems to lead into a reflection on raising the employment rates, primarily acting up increasing the effective retirement age rather than on the pensionable age.

Current performance

A certain number of initiatives has been taken in recent years to increase the employment rate among older workers. However, they have resulted in a limited progress. Only 30.4% men and 19.7% women at the age of 60 stayed at work in 2009, which are respectively the fourth and the seventh worst results in the EU-27, which is far away from the 50% target of the year 2000. The overall employment rate (15-64) of 61.6% in 2009 is also lower than in the EU-27 and than in all the neighbouring countries.

The effective average age of exit from the labour market (59 years in 2009) is below the legal early retirement age (60 years), which is among other reasons, due to the existence of specific schemes embedded in the unemployment insurance.

Despite the fact that people leave the labour market early, pension expenditure has been slightly below the EU-27 average at 10.7% of GDP in 2007 (EU-27: 11.8%). The at-risk-of-poverty rate among people aged 65 and more was two percentage points (pp) higher than in the EU-27 on average (21% vs. 19%) and 8 pp higher than for the population under the age of 65 (21% vs. 13%). However, home ownership is high among retirees in Belgium compared to

² OECD GPS database.

³ IGO: Inkomensgarantie voor Ouderen.

other Member States, which also influences overall poverty.⁴ For 2008, the net and gross replacement rates for a theoretical worker retiring at 65 after a 40 years contribution career came to 70.85% and 46.01%, respectively.

Impact of the crisis

The financial crisis had a direct effect on pensions via a fall in assets values in the funded part of the pension scheme. The economic crisis led to a decrease in employment rate. Still the employment situation in Belgium has held up relatively well compared with the EU. In 2009, the employment rate of people aged 15-64 reached 61.6%, down by 0.8 pp. compared to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 1.4 pp. to 67.2%, a considerably stronger decline than the 0.2 pp. decline to 56% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of the elderly part of the male workforce remained nearly unchanged, up by 0.1 pp. to 42.9% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of the elderly part of the female workforce managed to grow more by 1.4 pp. to 27.7y% (EU: up by 1 pp to 37.8%), even during the crisis.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 1.2 p.p of GDP in the 'lost decade' scenario⁵) also in the long-term unless corrective action is taken.

Outlook

Developments in the old-age dependency ratio (population 65+ to population 15-64) over the next 50 years will be somewhat below the EU average (BE: 26% in 2007, 46% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to expand by 2% between 2007 and 2060, compared to a drop of 15% for the EU27 as a whole by 2060.

Labour market participation rates are projected to increase in Belgium over the long-term, especially for women and older workers, but less than in the EU-27. The participation rate was below the EU average in 2007 (BE: 67.3, EU: 70.6%), and is projected to remain lower also in 2060 (BE: 69.7%, EU: 74.1%).

Belgium belongs to the group of Member States where the increase in gross public pension expenditure is projected to be significant. The level of expenditure in 2007, at 10% of GDP, is close to the EU average (10.2%), but the projected increase is larger in Belgium, with 4.8 percentage points of GDP for the period 2007-2060 (EU: +2.4 p.p.). At the end of the projection period (2060) the expenditure to GDP is expected to reach 14.7% of GDP, or 2.1 percentage points above the EU average.

The demographic transition to an older population, combined with the societal change from one-earner families to two-earner families (and issuing pension rights) is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure in Belgium by 7 ½ percentage points of GDP (compared to 8.7 pp. for the EU as a whole).

⁴ See also ISG report on poverty.

⁵ See Table 76 in the 2009 Ageing Report p. 239.

The impact of demographic factors on expenditure will only be partially counterbalanced by restricted pension eligibility (contributing to a reduction in the expenditure by -0.9 pp of GDP) and a drop in the relative level of public pension benefits (by -1 pp). The benefit ratio, which compares the average public pension benefit to an average wage, is projected to decline slightly from 44.8% in 2007 to 43.2% in 2060.

The gross and net theoretical replacement rates for an average-wage worker with a 40-year career are projected to increase by around 3.5 percentage points between 2008 and 2048, due to the maturing of the 2nd pillar pensions. In 2048 the absolute values will amount to 74.4% and 49.97% respectively. The negative effect of 3 years of unemployment which came to 1.49% of the NRR in 2008 will be almost doubled by 2048 (2.47%), mostly due to lower entitlements from the 2nd pillar of those with unemployment career breaks. In the same period the negative effect of a 3 year childcare break would be increased from 0.35% to 1.19% compared to situation of a female worker with full career (greater gap is also explained by lower entitlements out of 2nd pillar).

The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 is symmetrical now (around 1% loss/gain in case of early/late retirement). In the future working longer should be more stimulated (with a 6.12% gain in NRR when retiring at 67 instead of 65 and 3.46% loss in NRR when retiring at 63 instead of 65). This reflects the fact that the case-types are not responding to the 'full pension' condition for Belgian pensions (the 45 years) and that in fact the pension is calculated on the entire wage career of the beneficiary. The NRR for low earners would improve from 105% now to almost 109% compared to the situation of the average earner NRR in 2048, (predominantly 2nd pillar pension effect) while the NRR for high earners would drop from 70% to 65% compared to the average earner (wage ceiling effect). The effect of a 10 year career break on the NRR would increase from a loss of about 10% now to a loss of 15% in the future (predominantly 2nd pillar pension effect), both with respect to a full career. The decrease in the NRR 10 years after retirement which in 2018 for workers retired in 2008 amounts to 9% would be more serious in 2058 at 12.8% (predominantly 2nd pillar pension effect).

Challenges

The Belgian pension system has not seen big changes since the substantial reforms in the 90's and the introduction of the Law on complementary pensions in 2003. Small changes have been made, but they relied mainly on initiatives set in motion through earlier measures. In the absence of major reforms, Belgium has concentrated on reducing its level of public debt in its efforts to prepare for ageing induced increases in public expenditure. However, a profound reflection on pension reforms has been carried out. It has led to the publication of the Green Paper (see above), which should be followed by a White Paper formulating proposals and suggestions for further reforms.

The challenge Belgium faces with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed as at 'medium' risk by the Commission/Council.⁶ The projected increase in pension expenditure over the long-term at 4.8% of GDP is significantly higher than the EU average. Implementing further reforms to the pension system that contain the high projected increase in pension spending would be necessary to put it on a more sustainable path.

⁶ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Belgium should tackle the problem of relatively high poverty among pensioners (especially compared to younger population), without reducing incentives to stay active on the labour market longer.

Taking measures that increase participation and employment rates for all of working age, which are currently below the EU average, notably for older workers, would crucially improve Belgium's ability to continue to provide pensions that are both adequate and sustainable. Since the average effective retirement age is relatively low (59 years) compared to the legal retirement age (65 years), which is also reflected in the low employment rates of older workers, it is particularly important to implement measures that increase the effective retirement age. Achieving a more appropriate balance between working years and years spent in retirement and maintaining it for the future by adjusting entitlements (i.e. pensionable ages and/or benefit levels) in line with increases in life expectancy would be important for Belgium when seeking to enhance the stability of the pension system.

The Green Paper on pensions offered a good opportunity to address the issues that Belgium will face with regard to the sustainability and adequacy of pensions at the back of its ageing population and the current situation caused by the crisis. The political situation has caused a stand-still in pension policy. The new government could use the analytical part of the Green Book to form an ambitious policy package on pensions.

The main consequences of the crisis on the Belgian pension system concern the weakening of public finances. The current level of gross debt is above the Treaty reference value and the budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Ensuring primary surpluses over the medium term and undertaking reforms of the labour market and the social security system, in particular a further pension reform aimed at curbing the projected substantial increase in pension expenditure, would contribute to reducing the risks to the sustainability of public finances.

Background statistics

	Belgium			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	13	12	14	16	16	17
At-risk-of-poverty rate 65+	21	20	22	19	16	22
At-risk-of-poverty rate 75+	24	22	25	22	18	24
Income inequality 0-64	4.2			5.1		
Income inequality 65+	3.1			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.74	0.75	0.74	0.85	0.88	0.83

Adequacy projections: BE	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	70.85	74.4	3.5	46.01	49.97	4.0
TRR 3 years unemployment	69.79	72.56	2.8	43.33	46.68	3.4
TRR 3 years childcare break	70.6	73.51	2.9	45.85	49.09	3.2
TRR 10 years career break	63.79	62.53	-1.3	38.41	36.85	-1.6
TRR shorter working (retirement at 63)	70.15	71.82	1.7	44.07	45.59	1.5
TRR longer working (retirement at 67)	71.58	78.96	7.4	47.73	53.82	6.1
TRR 10 years after retirement	64.55	56.09	-8.5	40.11	36.06	-4.1
TRR low earner (66% average)	74.66	80.95	6.3	50.32	55.65	5.3
TRR high earner (100-200% rising profile)	50.1	48.45	-1.7	30.7	29.35	-1.4
Benefit ratios: social security pensions 2007/2060				44.8*	43.2	

	Belgium			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	10.9	11.0**	10.7*		12.0**	11.8*
Employment rate 15-64	60.9	62.4	61.6	62.2	65.9	64.6
Employment rate 55-64	25.0	34.5	35.3	36.9	45.6	46.0
Employment rate 55-64 women	15.4	26.3	27.7	27.4	36.8	37.8
Employment rate 55-64 men	35.1	42.8	42.9	47.1	55.0	54.8
Effective labour market exit age***	56.8	61.6	:	59.9	61.2	61.4
Public debt	107.9	89.8	96.7	61.9	61.6	73.6
Budget balance	0.0	-1.2	-6.0	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	26	38	46	25	38	53
Public pension expenditure, % of GDP	10.0	13.9	14.7	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	7.4	8.7
Employment	-0.5	-0.7
Eligibility	-0.9	-2.6
Level of benefits	-1.0	-2.5
Total (including residual)	4.7	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Bulgaria

Description

Bulgaria has a three-pillar pension system. The first pillar is a mandatory public PAYG scheme. The second pillar includes the mandatory insurance in the universal and professional pension funds. The third pillar includes the voluntary pension funds and the voluntary pension funds with occupational schemes. The second- and third-pillar pension funds are managed by private pension insurance companies and the social insurance in them is carried out on a fully-funded principle on the basis of defined contributions. In 2009 some 2.83 million people (37.3% of the total population) came under the public pension scheme, 2.89 million people (38.1% of the total population) were insured in the universal pension funds and 224 873 persons (2.97% of the total population) in the professional pension funds. In addition, 600 465 persons (7.92% of the total population) were insured in voluntary pension funds and only 4 641 persons were insured in the occupational pension funds.

In the **public system of compulsory pension insurance of PAYG type**, pension contributions are calculated on the basis of "insurable income" (income which lies between a determined minimum and maximum levels), which is determined by major occupation groups and the main economic activities carried out.

As from 1st January 2010 the social insurance contributions for the "Pension Fund" of the public pension system have been reduced from 18% to 16%. The employer pays 8.9% and the remaining 7.1% is paid by the employee. Correspondingly, the state shall transfer additional 12% of the insurable incomes of all insured persons into this fund's budget. The pension contribution for the self-employed is 16⁷%. Currently there are ongoing discussions on future first pillar system changes that would imply raising the contribution rate and the required periods of pension insurance.

A right to pension for length of insurance and old age under the first pillar (i.e. the State public insurance) is acknowledged in case persons meet two conditions at a time: they should have completed certain age and the sum of their age and the length of their insurance should be either equal or exceed a certain defined sum of points. The sum of age and years of contribution has to equal 100 points for men and 94 points for women. The current retirement age is 63 years for men and 60 for women.

In general, early retirement in Bulgaria is not a general option. It is possible only for persons working under hazardous and very unhealthy working conditions. Early retirement opportunities among civil servants and in some public sector structures have recently been the subject of review due to some perverse effects. The pension legislation was amended in the last years to introduce incentives for deferring the withdrawal from the labour market. Persons who reached the pensionable age and who are still working can rely on a bonus (3% for each year of deferment).

The main public pension is called "insurance and old-age pension". In 2009, the average monthly amount was BGN 263.47 (€134) and the minimum amount (as of 31.12.2009) was BGN 136.08 (€69.5). Approximately 21.4% of retirees receive pensions (personal and

⁷ 2010 contribution rate for those born before 1960.

survivor) below BGN 160 while 26.7% receive more than BGN 300, thus indicating significant differences within the public pension scheme, attributable to differences between the lengths of periods of affiliation and past insurable income basis for paying contributions. Minimum income support for older people exists in the form of the 'social pension for old age'. While the minimum amount of 'individual insurance and old-age pension' is set each year under the law governing the public social security budget, the amount of the 'social pension for old age' is determined by the Council of Ministers.

A law establishing a demographic reserve fund was adopted in 2008. It will accumulate reserves over at least ten years from 90% of all privatisation revenue, 25% of any budgetary surplus, as well as other revenue sources. The fund can only be used to keep the public pension scheme in balance, and its future investment policy needs to be carefully chosen in view of the current financial crisis.

Currently the government is discussing a new draft law (expected to be tabled in the autumn 2010) aiming to guarantee the long-term financial stability of the Bulgarian pension system and to improve the adequacy of pensions. Within the context of ageing and expected higher longevity it contains stricter criteria for access to pension thus trying to limit expenditures and ensure more revenues also through active ageing. It also aims to gradually increase the required length of insurance (not the pensionable age) by 3 years to 40 years for men and 37 years for women in 2013. Public pensions are not foreseen to increase in 2011.

The supplementary pension insurance includes the second (mandatory) and the third (voluntary) pillars of the Bulgarian pension system. Unlike the State public insurance, the contributions are accumulated and capitalised in individual accounts. The supplementary pension funds are managed by private pension insurance companies licensed and supervised by the Financial Supervision Commission.

The mandatory second pillar comprises two types of pension funds: universal and professional. The universal pension funds cover all persons, insured in the State Social Insurance, born after 31.12.1959, and provide life-time old-age pensions, as well as payments in case of disability and death. In the professional pension funds participate all persons, working under 1st and 2nd labour categories (heavy or hazardous working conditions), irrespective of their age. These funds provide fixed-period pensions for early retirement, as well as payments in case of disability and death. The universal pension funds will start paying out pensions in 2015 and the professional pension funds in 2013. In 2007, the contribution rate for the universal funded scheme was raised to 5%. The contribution is shared between the employer and the employee. Self-employed persons pay the whole amount of the contribution. For the professional fund the contribution rate amounts to either 12% or 7% (depending on the labour category) and is entirely at the employer's expense. Each person may participate only in one universal and only in one professional pension fund.

The third pillar consists of the voluntary pension funds and the voluntary pension funds with occupational schemes. The voluntary pension funds provide life-time and fixed-period old-age pensions, disability pensions and survivors' pensions. The voluntary pension funds with occupational schemes offer fixed-period old-age pensions and survivors' benefits. In both funds one-off payments and programmed withdrawals are also offered. The voluntary pension funds' members are entitled to an old-age pension when reaching the statutory retirement age or up to 5 years earlier. The insured persons in the voluntary pension funds with occupational schemes acquire the right to an old-age pension at the age of 60. It may also be paid out up to

5 years earlier, in accordance with the collective agreement establishing the occupational scheme. The contribution rates are determined in individual social insurance contracts or in the contract of the employer (undertaking sponsoring) with the pension insurance company.

The supplementary pension insurance does not replace, but supplements the State pension insurance by giving opportunities to insured persons to receive alongside with the state pension one or more pensions if certain conditions stipulated by law are met. Currently there are ongoing discussions opened by the Financial Supervision Commission on strengthening the second and third pillar. This would imply a major legal revision, leading to risk-based supervision; strengthening funds risk assessment, management and reporting and stricter supervisory requirements to funds.

Current performance

The relative median income of people aged above 65 in relation to the age group 0-64 amounted to 66% in 2008, falling sharply compared to 2006 (79%) and still even lower than the EU27 (84%). The risk of poverty rate of those aged 65+ (33.8%) is considerably higher than in 2007 (23.9%) and than the EU-27 average in 2008 (18.9%). For 2008, the net replacement rate was 58.8% (the third lowest in the EU-27) and the gross replacement rate 47.3% for a theoretical worker retiring at 65 after 40 years career.

Bulgaria spent about 7.3% of its GDP on pensions in 2009 (ESSPROS data)⁸, an amount slightly lower than in former years and significantly lower than the EU-27 average (11.8%).

Employment rates for older workers (55-64) stood at 46.1% in 2009, in line with the EU-average and marking a sharp increase over the past several years. The average exit age from the labour force in 2009 was 60.8 years.⁹

Recent public statements by the National Social Security Institute refer to a continuing decrease in social contributions collection (despite some measures put in place to encourage declaring income and paying health and pensions contributions). According to the National Statistical Institute, 28% of all employed persons in the private sector only pay contributions on the minimum wage. Contribution evasion is one of key obstacles to the financial balance of public schemes. In efforts to expand the number of contributors Bulgaria has reduced contribution levels in recent years.

Impact of the crisis

The financial crisis decreased the value of the assets of the public buffer fund and the supplementary pension funds and highlighted their sensitivity to market volatilities. According to the Financial Supervision Commission the accumulated net assets in the system of the supplementary pension insurance by the end of 2008 were BGN 2,299 billion and had decreased by 0.83% compared to the net assets in 2007. The decrease of the total net assets of the pension funds reflects the effect of the global financial crisis on the development of the private pension insurance sector in Bulgaria. In 2009 the trend of growth of the net assets of the pension funds was restored. The total net assets of the pension funds grew by 37.27 % compared to 2008 and reached 3.156 billion at the end of 2009. This increase shows that the sector has succeeded to recover from the effects of the global financial crisis.

⁸ According to NSSI data Bulgaria spent about 9.8% of its GDP on pensions in 2009 .

⁹ According to NSSI data.

In 2008 the average rate of return compared to the net assets (not modified) of the universal pension funds was -20.15%, of the professional -23.13%, and of the voluntary -24.71%. The negative rate of return of the pension funds for 2008 was substantially influenced by the downward price trend of the financial instruments at the Bulgarian and foreign capital markets. In 2009, the situation improved and the average rate of return compared to the net assets of all types of pension funds was positive: 7.91 % of the universal pension funds; 7.85% of the professional; 7.60%, of the voluntary and 6.03 % of the voluntary pension funds with occupational schemes. Despite the drop in 2008, the average rate of return for the 2005-2009 period was still positive, exceeding 3%.

However, as a result of the crisis, public confidence and interest in funded schemes decreased. Consequently, in 2009 the number of persons having an account in a voluntary fund decreased by 1% as compared to 2008 according to the Financial Supervision Commission.

The subsequent economic crisis caused a dramatic decline in GDP trends, moving from high growth in 2008 (6%) to deep recession in 2009 (-5%). The European Commission's 2010 spring forecast expect no change to GDP in 2010 (0% growth). The crisis also worsened the employment situation in Bulgaria and unemployment is expected to reach almost 8% in 2010, while it was at 5.6% in 2008.

In 2009, the employment rate of people aged 15-64 declined by 1.4 percentage points (p.p.) to 62.6%, compared to 2008 (EU: down by 1.3 percentage points to 64.6%). The male employment rate fell by 1.6 p.p. to 66.9%, a similar fall to the 1.2 p.p. decline to 58.3% recorded for women. The employment rate of old men (55 to 64 years) fell by 1.7 p. p. to 54,1% (EU: down by 0.2 p.p. to 54.8%), whereas the employment rate of old women still managed to grow by 1.5 p.p. to 39.2% (despite of severity of the economic crisis in Bulgaria this growth was slightly above the EU average of 1 p.p. to 37.8%).

Further to the financial and economic crisis, the situation of public finances worsened in Bulgaria as a result of the crisis, though government debt has remained relatively low.

Outlook

For the base case (male worker retiring at 65 after 40 years long career) both the net (NRR) and gross theoretical replacement rates (GRR) are expected to increase around 16 p.p. between 2008 and 2048 (among the two highest increases in the EU-27), though starting from rather low levels. NRR is set to increase from 58.8% in 2008 to 75% in 2048 and GRR is to increase from 47.3% in 2008 to 63.6% in 2048. The projected share of the GRR for the PAYG scheme will decline significantly to reflect the transfer of part of the public pension contribution to the funded schemes (second pillar), which will cover around 20% of the gross replacement rate in 2048 (i.e. 12.4 percentage points).

Apart from the hypothetical male worker retiring at 65 after a full career, most of the workers represented by the "variant cases" also improve their replacement rates in the future compared to the present situation. However, not all of them gain to the same extent. This identifies that although the trend of replacement rates is in general growing for all types of career profiles, some are relatively more protected than others by the Bulgarian pension system.

The negative effect of 3 years of unemployment which came to 5.88% of the NRR in 2008 will be less than halved by 2048 (3.74%). In the same period the negative effect of a 3 year childcare break would be substantially increased from no difference with a female worker with no children today to 8% lower NRR in 2048. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, which is symmetrical, would be largely maintained over the period (around 14% higher/lower NRR than retirement at 65). The NRR for low earners would be improved from 95% to 101% of the NRR of the average earner, while the NRR for high earners would drop from 99% to as little as 76% of the average earner. The effect of a 10 year career break on the NRR would reduce from a loss of about 32% in 2008 to a loss of 21% in 2048. The decrease in the NRR 10 years after retirement compared to the year of retirement, which in 2008 amounts to 32%, would be less serious in 2048 at 14.2%.

Long-term financial sustainability is a key challenge, as the public pension system is projected to be in deficit for the next 42 years. According to the budgetary projections made by the AWG in 2009, public expenditure on social security pensions will increase up to 11.3% in 2060 (initial level of this simulations is 8.3% in 2007).

This results from the strong demographic challenge faced in Bulgaria. The fertility rate (1.38) is quite low and life expectancy is set to increase from 69.7 years for men and 76.7 years for women in 2008 to 81.6 years for men and 86.5 years for women in 2060. Based on these trends, the old-age dependency ratio will go from 25% in 2008 to 64% in 2060, much higher than the EU-27 average (53% in 2060).

Challenges

The pension reforms in Bulgaria started in early 2000's setting up a three-pillar system composed of a PAYG scheme and the new privately managed mandatory and voluntary funded schemes, aiming to pursue the principle "security through diversity". The combination of these components is to improve over time the currently lower-than-average adequacy of pensions and to find a right balance with sustainability concerns. The crisis highlighted the need for mitigating risks of the different components of the pension system under changing economic circumstances.

The projected increase in pension expenditure over the long-term at 3% is somewhat higher in Bulgaria compared with the EU average, though starting from a relatively low level. Thus Bulgaria faces a certain challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and was assessed to be at 'low' risk in this regard by the Commission/Council.¹⁰ Implementing further reforms to the pension system by containing the high projected increase in pension spending or adjusting its financing would contribute to put it on a more sustainable path.

Total replacement rates, currently being among the lowest in the EU, are projected to rise significantly over the long-term towards the EU average, and this is so for most career profiles, though the gains show varying degrees among them. In particular, female workers with breaks for childcare and high earners are the less favoured by income-smoothing gains over time. Currently many pensioners are exposed to poverty, especially elderly women. There is also a visible gender gap in terms of employment rates. Ensuring decent living conditions for older people, whose share in the total population is growing, is therefore part of

¹⁰ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

the ongoing challenge. Despite pension increases, the public continues to perceive pensions to be low, especially in their role of income smoothing. Public confidence in the pension system could be strengthened if pension adequacy is improved, which in turn will encourage people to refrain from grey non-contributory economic activities and to enrol in voluntary pension funds.

An important contribution to sustainability and to adequacy could be made by increasing participation rates and encouraging people to work longer. Increases and gender equalisation of the pensionable age should be introduced before population ageing becomes most visible.

The regulation of the pay-out phase in the private pension funds still needs to be detailed. Annuities are the best option from the point of view of protection against poverty in the old-age. In designing details of the pay-out phase, the authorities should take into account gender preoccupations (e.g. unisex mortality tables). A review of special pension regimes is also needed so that privileges become transparent, benefits calculated over life-time earnings and the effective retirement age is increased.

Improving adequacy and financial sustainability also calls for more social security revenues. Eliminating the maximum ceiling on insurable income could bring in resources from the higher income deciles. Limiting the abuse of paying contributions on the minimum wage level in the private sector could also improve social security revenues. The policy of reducing social contribution rates needs to be reassessed against the artificially low levels of minimum insurable income on which rates are based. Another key challenge is the inclusion within the social security scheme of some 350,000 persons not paying social security contributions. Bulgaria's further attention is needed to improve law enforcement and promote joint activities between tax and labour inspectorates as part of the overall effort against undeclared work and income.

Beyond asset reductions in the funded schemes in 2008 the main crisis impact on the Bulgarian pension system concerns the weakening of public finances. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

	Bulgaria			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	19	19	19	16	16	17
At-risk-of-poverty rate 65+	34	27	39	19	16	22
At-risk-of-poverty rate 75+	40	30	47	22	18	24
Income inequality 0-64	6,8			5,1		
Income inequality 65+	4			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0,66	0,69	0,64	0,85	0,88	0,83

Adequacy projections: BG	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	58,8	75,0	16,2	47,3	63,6	16,3
TRR 3 years unemployment	48	61,7	13,7	39	50,9	11,9
TRR 3 years childcare break	46	54,1	8,1	37	43,7	6,7
TRR 10 years career break	40	59,2	19,2	32	48,5	16,5
TRR shorter working (retirement at 63)	51	64,1	13,1	41	53,2	12,2
TRR longer working (retirement at 67)	67	86	19	54	74,2	20,2
TRR 10 years after retirement	40	64,3	24,3	32	53,4	21,4
TRR low earner (66% average)	56	75,8	19,8	47	63,6	16,6
TRR high earner (100-200% rising profile)	59	57	-2	43	47,8	4,8
Benefit ratios: social security pensions 2007/2060				44,4*	35,6	

	Bulgaria			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure		7,6**	7,3*		12,0**	11,8*
Employment rate 15-64	50,4	64,0	62,6	62,2	65,9	64,6
Employment rate 55-64	20,8	46,0	46,1	36,9	45,6	46,0
Employment rate 55-64 women	10,3	37,7	39,2	27,4	36,8	37,8
Employment rate 55-64 men	33,2	55,8	54,1	47,1	55,0	54,8
Effective labour market exit age***				59,9	61,2	61,4
Public debt	74,3	14,1	14,8	61,9	61,6	73,6
Budget balance	-0,3	1,8	-3,9	0,6	-2,3	-6,8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	25	36	64	25	38	53
Public pension expenditure, % of GDP	8,3	8,6	11,3	10,1	11,4	12,5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	9,1	8,7
Employment	-0,5	-0,7
Eligibility	-3	-2,6
Level of benefits	-1,8	-2,5
Total (including residual)	3	2,4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Czech Republic

Description

The Czech pension system consists of a public scheme supplemented by voluntary personal pension saving schemes. The universal public pension scheme is based on PAYG and defined benefit. The whole population is covered by the pension benefit and pension rights are also credited during temporary absences from the labour market (e.g. unemployment, childcare). The pension contribution rate is 28% of gross income with employees paying 6.5 p.p. and employers 21.5 p.p.

The mandatory public pension system covers three main benefits: old age, disability and survivor's pension. One is eligible for pension benefits if one is insured for at least 25 years and has reached the pensionable age. This criterion will rise gradually to 35 years of insurance in 2019. Another criterion is if one has reached an age 5 years higher than the statutory retirement age for men of the same years of birth and has an insurance period of at least 15 years (will gradually rise to 20 years in 2014). There are three degrees of disability benefits, depending on the severity of the disablement. Disability pensions are paid until the beneficiary reaches the age of 65, after which they are transformed into old-age pensions. Survivor's pensions are paid out to a widow(er) or an orphan (dependent child).

Pensions consist of a basic amount and a percentage amount based on the insurance period and gross earnings. The basic amount is the same for all pensioners and independent from the insurance period and earnings. The earnings related component is derived from the person's historical incomes. Currently all incomes since 1986 are assessed and after reaching the final state 30 years before retirement will be taken into account. The pensions are regularly indexed in January by at least 100 % of price inflation and at least of 1/3 of real wage growth.

Public pension provision is complemented by a private system of voluntary, fully funded, defined contribution, personal pension savings schemes ("the third pillar") with direct state support. To promote this type of insurance, the Government provides a subsidy and tax incentives were introduced in 2000. In 2008 there were 10 pension funds active on the market. The number of participants has been steadily growing up to over 4 million individuals and the system has amassed assets equal to 6% GDP. Despite the high coverage, low contribution rate and the fact that since its creation it has been used mostly as a savings mechanism, with 71% of payments taking the form of a lump sum, has yet prohibited the system from becoming a significant source of adequate old age incomes.

Since the beginning of the transition in 1990, there have been a number of steps taken towards improving the long-term sustainability of the pension system focussed on parametric changes to the mandatory first pillar as well as the introduction of the voluntary fully-funded third pillar. The most recent parametric changes adopted from January 2010 include several important measures. Firstly study periods will no longer count as non-contributory qualifying periods. Secondly, it has been agreed that the retirement age will continue to be gradually increased by 2 months per year up to the age of 65 for men. For women it will grow at a higher pace, by 4 months per year until it reaches the retirement age for men or the final state, which is dependant on the number of children raised (from 65 for women one or none child to

62 for women with five or more children)¹¹. Thirdly, the required insurance period will be gradually prolonged from 25 years now to 35 years in 2019. Fourthly, to support longer working lives, benefits are being reduced at increased rate for early retirement occurring more than 720 days before reaching the statutory retirement age, while unlimited concurrence of pension and gainful activity has been allowed, with the exception of an early retirement.

The contribution/benefit formula results in considerable redistribution from high to low earners. Thus annual capping of social security contributions is set at a very high level and benefits for high-wage earners are not proportional to the amount they contribute to the system. But on April 16, 2010 the Czech Constitutional Court declared the pension system unconstitutional, as it failed to provide reasonable replacement rate for high-wage earners. To allow the Czech authorities time to prepare necessary modifications the Court postponed the effects of the decision until 30th of September 2011.

Further reforms are under discussion and the Expert Advisory Group of the Ministry of Finance and the Ministry of Labour and Social Affairs presented several reform measures in June 2010, including series of parametrical changes, aimed at securing a long-term sustainability of the public PAYG pension pillar, both on the income and expenditure sides of the pension system and strengthening the role of the fully funded savings pillar(s). The Czech government acknowledged the results presented by the Expert Advisory Group and expressed will to prepare the pension reform in accordance with these results, but the final form of the reform may differ from the presented alternatives.

Current performance

The relative median income of people aged 65+ in relation to the age group 0-64 dropped by 4 p.p. from 2005 (83%) to 2008 (79%) and thus fell below the EU27 average (84%). The risk-of-poverty-rate for the population 65+ (7%) is among the lowest in the EU but has increased from 5% in 2005. There is a significant gender difference (men 3%, women 10%). The reason for lower female pensions is lower income during working life. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career came to 58.5%. At 77,6 % the net rate is close to the EU average

The calculations of the theoretical replacement rates reflect elements of income redistribution within the system, as the low income worker (2/3 of the average earning) has a replacement rate greater than 72%, while for the average wage earner it is 58% and 36% for higher income groups, represented by rising earnings profiles (from 100 to 200 % of average income).

The employment rate of older workers at 46.8% in 2009 has been increasing in the last 10 years as a combined result of economic growth, the increase in the retirement age and financial incentives to continue working. While the employment rate of older men (59.6% in 2009) is above EU average the employment rates of older women are low (35.0% in 2009). Only 21.8% of women are still in employment at age 60.

In 2008 the average exit from the labour market at 60.6 years was 1.5 years below the pensionable age for men. Pension expenditure at 8.2% of GDP in 2007 was relatively low (EU-27: 11.8%).

¹¹ The retirement ages applicable for year 2010 are 61 years and 10 months for men and between 60 years and 4 months to 56 years and 4 months for women.

Impact of the crisis

While the financial crisis decimated the value of assets on the financial markets and highlighted their sensitivity to market volatilities, the combination of conservative investment strategy and strict state regulation left the Czech pension funds virtually unharmed. Along with the fact that savings are moderate, schemes immature and DC, benefits primarily taken as lump sums the impact on present and future pensions was small – apart from the impact that may follow from diminished public confidence in funded schemes. The economic crisis caused a decline in GDP growth and employment rates fell from 66.6% in 2008 to 65.4% in 2009. The inflation rate was high in 2008 (6.3 %) in particular because of some one-off measures like increase in indirect taxation, and rising housing and energy prices. As a consequence of the negative growth and the rate fell to 0.6% in 2009.

Due to the way the Czech pension system is financed (PAYG) and designed (e.g. unemployed earn pension entitlements) the direct effect of the economic crisis on current and future pensioners has so far been limited. Still indirect effects following from the deterioration of the budget position may turn out to be serious.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.2 p.p of GDP in the 'lost decade' scenario¹²) also in the long-term unless corrective action is taken.

Outlook

The Czech Republic will be one of the fastest ageing countries in the EU. The old-age dependency ratio is projected to rise from 21% to 61% between 2008 and 2060 (EU27: from 25% to 53%).

Population ageing is the main cause of the pressure on the sustainability of Czech pensions. In an unreformed public pension system the ageing effect would result in an expenditure increase of 9.5 percentage points (pp) of GDP between 2007 and 2060, as calculated in the Ageing Report 2009. Nevertheless, tougher pension eligibility rules, including an increased pensionable age, should reduce the expenditure by 3.5 pp of GDP over the same period. The benefit ratio is projected to drop from 45.2% in 2007 to 37.6% in 2060. As a consequence, lower benefits will contribute to a reduction in public pension expenditure equal to 1.2 pp of GDP. Due to the combined effects of population ageing, restricted pension eligibility, relatively lower benefits, and higher employment rates, public pension expenditure is projected to rise from 7.8% of GDP in 2007 and 7.1% in 2030 to 11.0% of GDP in 2060.

From 2008 to 2048 the total net replacement rate is projected to drop from 77.6% to 59.6% while the gross rate will reduce from 58.5% to 46.1%. These sharp declines in replacement rates are mainly caused by the increase in the official retirement age which leads to shortening of the period of deferred retirement, which is 4 times more credited for the pension entitlement. 3 years of unemployment only affect TRR's in a minimal way in 2008 and protection will be equally good in 2048. In the same period the negative effect of a 3 year childcare break would be substantially reduced from 5.32% to just 1.24%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, where the malus of

¹² See Table 76 in the 2009 Ageing Report p. 239.

early retirement is less than the bonus of staying on, would be weakened over the period. The NRR for low earners would be reduced from 90.1% to 74.1% while the NRR for high earners would drop from 47.7% to as little as 35.2% (thus illustrating some of the background to the court ruling). The effect of a 10 year career break on the NRR would reduce from a loss of about 43% to a loss of 36%. The decrease in the NRR 10 years after retirement which in 2008 amounts to 18.5% would be less serious in 2048 at 14.4%.

Challenges

Following the ongoing reforms which raise pensionable ages, improve flexibility in retirement, extend contribution period requirements and lower benefits levels the Czech Republic has put it self on track towards achieving a better balance between adequacy and sustainability concerns in pension provision. The Czech system currently performs very well on adequacy indicators while generating relative low expenditures. In the longer term it is less impressive. Still, while absorbing one of the strongest ageing trends in the EU it manages to constrain overall pension expenditure in 2060 to a level below the EU average while maintaining an NRR at 58%.

The challenge the Czech Republic faces with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed to be at 'high' risk by the Commission/Council.¹³ The projected increase in pension expenditure over the long-term at 3.3% is more than 30% higher than the average for EU-27. Further reforms of the pension system that contain the high projected increase in pension spending or adjust its financing are indispensable in order to put it on a sustainable path.

Low employment rates and exit ages for older workers and women in particular weaken the foundation for easing the transition from large to small cohorts in the labour market as the population ages. Achieving and maintaining an appropriate balance between years in work and years spent in retirement is a key challenge. Recent reforms increase the pensionable age, but the introduction is phased in over a long period. Bringing changes forward and making the parameters of pension entitlements adaptable to future increases in life expectancy would enhance the financial stability of the pension system. All along it would be important to underpin changes to the pension system with labour market measures that enable and encourage people to work longer.

Given longer-term reductions in public pension benefit levels the Czech Republic may also need to consider how it could improve opportunities for people to compensate for this by building supplementary entitlements in occupational or personal schemes.

The main crisis impacts on the Czech pension system concern the weakening of public finances as an effect of the economic recession. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. The budgetary position in 2009 compounds the budgetary impact of population ageing. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

¹³ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

	Czech Republic			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	9	9	10	16	16	17
At-risk-of-poverty rate 65+	7	3	10	19	16	22
At-risk-of-poverty rate 75+	8	3	11	22	18	24
Income inequality 0-64	3.6			5.1		
Income inequality 65+	2.3			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.79	0.8	0.78	0.85	0.88	0.83
Adequacy projections: CZ	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	77.6	59.7	-18.0	58.5	46.1	-12.3
TRR 3 years unemployment	59.1	59	-0.1	44.5	45.6	1.1
TRR 3 years childcare break	54.6	58.9	4.3	41.1	45.8	4.7
TRR 10 years career break	56.2	41.8	-14.4	42.3	32.3	-10.0
TRR shorter working (retirement at 63)	66.1	51.6	-14.5	49.8	39.9	-9.9
TRR longer working (retirement at 67)	90.1	69.2	-20.9	67.9	53.5	-14.4
TRR 10 years after retirement	66.8	51.3	-15.5	50.3	39.7	-10.6
TRR low earner (66% average)	97.9	74.1	-23.8	76.3	60.5	-15.8
TRR high earner (100-200% rising profile)	47.7	35.2	-12.5	33.5	25.8	-7.7
Benefit ratios: social security pensions 2007/2060				45.2*	37.60	
	Czech Republic			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	8.5	8.3**	8.2*		12.0**	11.8*
Employment rate 15-64	64.9	66.6	65.4	62.2	65.9	64.6
Employment rate 55-64	36.1	47.6	46.8	36.9	45.6	46.0
Employment rate 55-64 women	22.1	34.4	35.0	27.4	36.8	37.8
Employment rate 55-64 men	51.6	61.9	59.6	47.1	55.0	54.8
Effective labour market exit age***	58.9	60.7	60.6	59.9	61.2	61.4
Public debt	18.5	30.0	35.4	61.9	61.6	73.6
Budget balance	-3.7	-2.7	-5.9	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	20	36	61	25	38	53
Public pension expenditure, % of GDP	7.8	7.1	11	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	9.5			8.7		
Employment	-0.5			-0.7		
Eligibility	-3.5			-2.6		
Level of benefits	-1.2			-2.5		
Total (including residual)	3.2			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Denmark

Description

Denmark has a multi-pillar pension system. The statutory public old-age pension provision which in the 1990's was adapted to fit the superstructure of occupational and voluntary, personal schemes has two elements. The first is a universal, non-contributory, residence-based scheme (People's Pension) financed from general taxation on a pay-as-you-go basis. Benefits are taxable and consist of a flat-rate part and an income-tested part. The second is a funded defined-contribution scheme (ATP) financed from mandatory contributions from all employed persons and recipients of temporary transfer income (unemployment benefits etc.) organised in a separate fund under tri-partite management.

This base of statutory pensions is supplemented by occupational pension schemes based on collective agreements and by voluntary individual pension savings plans. Occupational pension schemes expanded substantially in coverage and contribution rates in the last 2 decades and today cover almost 90% of wage-earners, who typically pay contributions between 12% and 17% of their gross wages. Most are fully funded defined-contribution schemes with obligatory annuitisation. Voluntary, individual pension savings plans are widespread but of rather uneven coverage. The majority result in lump sum benefits. Contributions for funded schemes are tax-exempt (within limits), while investment returns and benefits are taxed.

The pensionable age in statutory and occupational schemes is 65 years for both men and women. Early exit from age 60 is possible for contributors to the voluntary early retirement pension linked to the unemployment insurance scheme. With the 2006 reform it was decided that the early retirement age in this scheme will be increased from 60 to 62 between 2019 and 2022, and the pensionable age in People's Pension and ATP raised from 65 to 67 between 2024 and 2027. As of 2025 (voluntary early retirement pension) and 2030 (Public old-age pension) the retirement age respectively the pensionable age will be indexed to life expectancy.

The flat-rate part of the public old-age pension is tested against work income above a significant level. The income-related part is tested against certain types of earned, capital and pension income. A supplementary benefit is paid to those who have no other income than the full old-age pension. A personal allowance may be granted to old-age pensioners to cover reasonable necessary expenses following a specific assessment of their needs. Pension income is underpinned by a range of needs- and income-tested benefits targeting pensioners (e.g. housing and heating benefits, health allowances). The effective purchasing power of pensioners is also raised by age-related tax rebates (e.g. on owner-occupied housing) and discounts on drugs, transport, admissions and radio/TV.

Current performance

The average income of people aged 65+ relative to the 0-64 age group stands at 70% (2007), which is lower than in most other Member States, while the risk of poverty for the elderly population at 18% is lower than the EU average (19%), but higher than for the total

population (12%). Under a broader definition of income, including imputed rent, the risk of poverty in Denmark for elderly people is almost the same as for the rest of the population.¹⁴

The non-contributory, residence-based old-age pension ensures a minimum level of income provision for older people in Denmark. This pension keeps the risk of poverty for older people at a moderate level, but current theoretical replacement rates are low compared to almost all other Member States. The aggregate replacement rate of 39% (2007)¹⁵ should be seen in relation to the supplementary benefits (housing benefits, heating benefits, health allowances, reduced tax on owner-occupied housing) and free services targeting pensioners (health and long-term care, including free home help). Moreover, as occupational and voluntary pension schemes mature replacement rates are expected to increase substantially.

For 2008, the total net and gross replacement rates (including statutory and occupational schemes) for a theoretical worker retiring at 65 after a 40 years contribution career came to 73.7% (including a means-tested housing allowance) and 52.5%, respectively.

The employment rate of older workers (55-64) at 57.5% in 2009, while among the highest in the EU, drops markedly for the 60-64 age group reflecting the impact of the voluntary early retirement benefit option. The average exit age (61.3 in 2008) from the labour market increased slightly since 2007 and remains close to the EU average but Denmark is one of the few Member State rates where the rate is lower than it was in 2000. In Denmark public pension expenditures constitutes about 9.1% of GDP, which is lower than the 2007 EU-27 average of 10.1%.

The calculation of both public and occupational pensions is based on gender-neutral principles. Women have a high employment rate (73.1% vs. EU27: 58.6% in 2009) and occupational pension coverage is as high for women as for men. However, women work part-time more often than men and the gender pay gap (17%) resulting from this and other factors in Denmark will be reflected in lower average benefits for female pensioners.

Impact of the crisis

The marked drop in the value of fund assets at the height of the financial market crisis in 2008 had a limited effect on current pensioners as most occupational schemes are still rather immature. It was also very important that regulators eased solvency rules to avoid that funds were forced to lock in their losses and would have to offload their housing bond portfolios, which subsequently could have had a rather negative impact on the mortgage market. Yet pensions in payment from personal schemes were affected and high premiums on transfer out of schemes were erected. Meanwhile, returns in 2009 were so good that losses from 2008 have been fully recouped.

Compared to 2008 (78.1%) the employment rate of the population aged 15-64 has dropped somewhat in 2009 (75.7%). The employment rate for older workers has so far held up despite the crisis. Yet, if unemployment becomes entrenched it could increase the proportion of older workers using the early retirement option. The increase in unemployment from 3.3% in 2008 to a forecasted 6.9% in 2010 has been less pronounced than in many other EU Member States, and while it has hit young people in particular, the level of youth unemployment in Denmark

¹⁴ Eurostat database.

¹⁵ For further information on the aggregate replacement rate and other pension indicators, please refer to: http://epp.eurostat.ec.europa.eu/portal/page/portal/employment_and_social_policy_indicators/omc_social_inclusion_and_social_protection/pension_strand

is still comparatively low. But unemployment is still rising and an increasing part threatening to become long-term. The risk that the adequacy of the supplementary DC pensions could be reduced to a noteworthy degree for the affected is therefore increasing..

As a result of long-standing commitments to debt reduction general government gross public debt had been reduced to 27% of GDP in 2007. Yet, gross debt developments have been strongly affected by stimulus responses to the financial and economic crisis and contracting tax revenues, thus increasing the gross debt ratio to a forecasted 49.5% in 2011. The government budget surplus (4.8% of GDP in 2007), which still exceeded 3% of GDP in 2008, has turned negative in 2009 and it is forecasted that the deficit will increase further to 5.5% of GDP in 2010. As a result Denmark received its first ever excessive deficit report in May 2010. In a quick response the government adopted *The Fiscal Consolidation Package* before the summer recess which is intended to strengthen the structural balance by 1.5% of GDP and reduce the annual deficit to less than 3% by 2013 without affecting pensions.

Estimates in the 2009 Ageing Report suggest that the crisis could increase pension expenditure relative to GDP (by an additional 0.2 p.p of GDP in the 'lost decade' scenario¹⁶) also in the long-term, unless corrective action is taken.

Outlook

The adverse demographic trend which Denmark is expected to face in the coming decades is less than the EU average. Between 2008 and 2060 the demographic old-age dependency ratio (population older than 65 to population aged 15-64) is expected to increase from 24% (EU27 average: 25%) to 43% (EU27 average: 53%).

According to the 2009 Ageing Report, public expenditure on pensions will increase from 9.1% of GDP in 2007 to 10.6% in 2030, and fall back again to 9.2% in 2060. This projected growth is below EU-27 average, as the impact of demographic transition on pension expenditure (projected to add an expenditure equal to 6.5 percentage points of GDP between 2007 and 2060) in large part will be counterbalanced by tougher eligibility rules for pensions (projected to reduce the expenditure by 4.9 pp, mainly due to higher retirement age),. Relatively stable public pension expenditure will be accompanied by increasing importance of occupational pensions (gross occupational pension expenditure will rise from 5.6% of GDP in 2007 to 8.9% in 2060).

Between 2007 and 2060 the public pension benefit ratio, which compares average public pension benefit to the average wage, is projected to drop slightly from 39.4% to 37.8%. If occupational pensions are included in calculations, the total benefit ratio increases from 64% to 75%.

From 2008 to 2048 the total net replacement rate (including statutory and occupational schemes) is projected to reduce from 73.7% (including a means-tested housing allowance) to 69.5% while the gross rate will improve from 52.5% to 58.0%. While at present the largest contribution to retirement income comes from the first pillar schemes (around 85% of the gross replacement rates), occupational pensions will be a more important source of income in 40 years time for wage earners with medium to high income (when it will represent around 50% of the gross replacement rates). The negative effect of 3 years of unemployment will be

¹⁶ See Table 76 in the 2009 Ageing Report.

around 1.7% of the NRR in 2048 (while it was 0% in 2008). In the same period the negative effect of a 3 year childcare break would increase from 0% to just 1.3% of the NRR of a female without children. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, which in 2008 is 3.9% higher / 1.2% lower than the NRR when retiring at 65 will change over the period: 5,8% higher NRR when retiring at 67 and 0,4% also higher¹⁷ NRR when retiring at 63. The NRR for low earners would fall over time to around 95% of the NRR of the average earner, while the NRR for high earners would fall to around 43% of the average earner NRR. A 10 year career break has no effect on the NRR in 2008, but it would entail a loss of 8.1% of the NRR in 2048. The increase in the NRR 10 years after retirement which in 2018 amounts to 7.4% of the NRR of the year of retirement (2008) would in 2058 be 2.7% higher than at the year of retirement 2048.

Despite the present rise in unemployment, increasing labour supply continues to be among the key challenges and priorities of the Danish government, as it is considered essential to secure the financing of the welfare society over the longer term. The macro-fiscal framework, the 'Denmark 2015 plan', relies on counteracting the negative demographic impact and raising structural employment by 20 000 by 2015. Measures have addressed retirement age thresholds and activation and work incentives for older workers and people with a foreign background. The indexation of the pensionable age will countervail the long term impact of rising longevity, but the timing of the reform (beginning 2019) will mean that the most of the large age cohorts (baby-boomers) will have retired before it takes effect. Thus, the rising age thresholds in the pension system will not contribute to the labour supply over the short to medium term. *The Fiscal Consolidation Package* from May 2010 raises labour supply through reforms of the unemployment benefit system and further initiatives have been announced for the autumn to reform disability pensions and study grants with the focus on increasing labour supply at entry as well as exit points.

In response to the rapidly rising complexity of the future pension package pension institutions have established a web-based portal that allows people to view their combined income from the various elements in the pension system.

Challenges

The present Danish pension system has emerged from two decades of structural reforms which as they strengthen incentives to work longer, neutralise the impact of future longevity growth and stabilise public pension expenditure while raising overall replacement rates from below to above the EU average have put the country well on the road to achieving a good balance between sustainability and adequacy concerns in its pension provision.

The projected increase in pension expenditure over the long-term at 0.1% of GDP - despite projected improvements in overall replacement rates due to increased occupational pension - is substantially lower than the EU average. The challenge Denmark faces with regard to

¹⁷ The variant case involving working till 63 years of age is different from the other cases in that the new source of income at 63 is not a pension but a subsidised (DC) pre-retirement scheme (efterløn). The pre-retirement scheme (efterløn) is maximum 182.780 kr. in 2008 whereas pension for the 65 year old (folkepension) is maximum 122.712 kr. in 2008.

ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed to be at 'low' risk by the Commission/Council.¹⁸

Funded schemes quickly recovered from the effects of the 2008 financial market tumble but the effects of the economic crisis in terms of fewer and lower contributions and lower returns on active investments will affect their future contribution to adequacy.

The maturation of occupational pensions should raise the future adequacy of pensions. It will also contribute to a better balance between public expenditure to tax exemption of contributions and revenue from taxes on benefits in payment. But the growing importance of fully funded, defined contribution pension schemes will also raise the risk of accruing insufficient pension savings and of large income inequalities among pensioners. Temporary absence from the labour market (due to e.g. illness, unemployment, maternity, child-caring etc.) will not be mitigated by crediting in occupational or personal schemes, but lead to reduced pension savings and thus to a smaller supplementary pension. Differences in income and labour market performance related to gender, education and chance will be closely mirrored in future supplementary pension incomes. Periodic reviews of the contribution of private pensions to the balance of adequacy and sustainability concerns in the pension system may therefore be called for.

The long-term success of the Danish pension system in both sustainability and adequacy terms will depend on further progress in efforts aimed at increasing participation and employment rates of older workers and of 1st and 2nd generation immigrants. The country is still a distance from achieving an appropriate balance between working years and years in retirement. Thus it is a concern that the upward adjustments of the early and normal pensionable ages only begin to take effect 10 to 15 years from now, when large parts of the baby-boomers have retired. The question for the short to medium term remains whether these reforms should not be moved forward to mitigate the shrinking of the working age population, increase revenue and limit the medium term rise in public spending on pensions. Given Denmark's need to boost its labour force, the lack of progress in lifting the average exit age and its intention to raise the pensionable age it is questionable if it can continue the popular, but long contested early retirement option. In collaboration with the social partners Denmark would also very much need to underpin changes in pensionable ages with stronger labour market and work place measures to enable and encourage people to work longer.

A budget policy leading to quick debt reduction has been sustained throughout the growth years. Following the onset of the crisis the government responded with several stimulus packages which in combination with the contraction of tax-revenues caused a sudden shift in the budget position from surplus to consecutive years with a considerable deficit. While the relative modest levels of debt can be substantially reduced through the newly adopted convergence programme without having to affect pensions, budget consolidating efforts could be strengthened if the planned rise in early exit and pensionable ages were moved forward.

¹⁸ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

	Denmark			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	11	11	11	16	16	17
At-risk-of-poverty rate 65+	18	17	19	19	16	22
At-risk-of-poverty rate 75+	23	26	21	22	18	24
Income inequality 0-64	3.6			5.1		
Income inequality 65+	2.9			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.7	0.72	0.7	0.85	0.88	0.83
Adequacy projections: DK	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	73.7	69.5	-4.2	52.5	58.0	5.5
TRR 3 years unemployment	73.7	68.3	-5.4	52.5	56.8	4.3
TRR 3 years childcare break	73.7	68.6	-5.1	52.5	57	4.5
TRR 10 years career break	73.7	65.6	-8.1	52.5	54.4	1.9
TRR shorter working (retirement at 63)	72.5	69.9	-2.6	57.3	58.4	1.1
TRR longer working (retirement at 67)	77.6	75.3	-2.3	57	63.4	6.4
TRR 10 years after retirement	81.1	72.2	-8.9	57.6	59.7	2.1
TRR low earner (66% average)	102	94.6	-7.4	76.8	79.7	2.9
TRR high earner (100-200% rising profile)	46.2	43.1	-3.1	28.0	32.5	4.5
Benefit ratios: social security pensions 2007/2060				39.4*	37.80	
	Denmark			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	10.5	10.7**	10.8*		12.0**	11.8*
Employment rate 15-64	76.3	78.1	75.7	62.2	65.9	64.6
Employment rate 55-64	55.7	57.0	57.5	36.9	45.6	46.0
Employment rate 55-64 women	46.6	49.8	50.9	27.4	36.8	37.8
Employment rate 55-64 men	64.1	64.3	64.1	47.1	55.0	54.8
Effective labour market exit age***	61.6	60.6	61.3	59.9	61.2	61.4
Public debt	52.4	34.2	41.6	61.9	61.6	73.6
Budget balance	2.3	3.4	-2.7	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	23	38	43	25	38	53
Public pension expenditure, % of GDP	9.1	10.6	9.2	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	6.5			8.7		
Employment	-0.1			-0.7		
Eligibility	-4.9			-2.6		
Level of benefits	-0.5			-2.5		
Total (including residual)	0.1			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Germany

Description

The general pay-as-you-go, earnings-related first pillar statutory pension scheme covers around 80% (35 million actively insured persons) of the employed population in Germany.¹⁹ Civil servants' and the majority of the self-employed are not insured in the statutory public pension scheme. Pensions for retired civil servants are paid directly from public budgets. Further more, special schemes exist notably for farmers and the liberal professions (e.g. for doctors, lawyers, architects).

For each year of contributions, an insured person in the statutory pension scheme receives "earnings points" depending on the individual income position in relation to the average earned income. When retiring, the cumulated pension points are multiplied with the pension type factor (which is one for old age pensions) and with the pension point value. The pension point value is adjusted annually by an index which is based on gross earnings development but curbed by the sustainability factor and the increase in the pension contribution rate. Even if there is no minimum pension guarantee, there is a universal basic income scheme for needy elderly and people who can not work due to health reasons, which was newly established in 2003. In 2009 this scheme covered about 800.000 people

Major reforms have been implemented since 1992. These have (1) increased the statutory pensionable age to 65, with actuarial reductions in the case of pensioning before that age and (2) given incentives to strengthen the second (occupational) and third (private) pillar, (3) revised the pension adjustment formula (in particular via the 'sustainability factor', which is geared to changes in the ratio between contribution payers and pension recipients), and (4) introduced mechanisms to take into account time committed to child care. Some of these reforms, in particular the modification of the pension formula, could lead to lower pension levels in the first pillar statutory pension scheme: a stepwise reduction of the net pension level until 2030 by about 20%.

To offset this reduction, reforms have promoted the development of supplementary pension schemes. Legislation provides for five options for occupational provision: *Direktzusage* (book reserves), *Unterstützungskasse* (support fund), *Direktversicherung* (direct insurance), *Pensionskasse*, and *Pensionsfonds* (pension fund). Moreover, a new voluntary by state-subsidised, fully funded, direct-contribution scheme (*Riester-Rente*) was set up in 2002. This is a privately managed funded scheme. The contributions are strongly state-supported. The scheme is supported by the tax deductibility of contributions and by bonuses (independent of wages), inter alia aimed at low-income groups.

At the end of 2007 64% of the employees subject to social insurance contributions (excluding civil servants) were covered by an occupational pension scheme and at the end of 2009 13.3 million people were contributing to the voluntary pension scheme (*Riester Rente*).²⁰

¹⁹ Joint Report on Social Protection and Social Inclusion 2009, Country Profiles, SEC(2009)255, European Communities 2009.

²⁰ Updates of current and prospective theoretical pension replacement rates 2006-2046. Annex – country fiches, December 2009, Indicator Sub-Group of the Social Protection Committee.

In 2007 it was legislated to increase the pensionable age from the current 65 to 67 in 2029. The increase will be phased in gradually, starting in 2012, the first generation to be affected being those born in 1947. With at least 35 years of insurance records it is possible to retire at the age of 63 but with a malus of 3,6 % per year of early retirement.

Current performance

The income position of older people in Germany is good. The relative median income of people aged above 65 in relation to the age group 0 – 64 amounted to 87% in 2008 – less than in 2005 (93%), but more than in the EU-27 (84%). It is also reflected in the figure for the poverty risk of population 65+ (15%) which is three percentage points higher than it was in 2005 but still one percentage point below the EU-27 average. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (41.4%). The net rate amounts to 64.1%.

At present, the level of pension expenditure is comparable high but has recently been decreasing: according to ESSPROS data, pension expenditure was 13.4% of GDP in 2004 and 12.4% in 2007 (EU-27 average: 11.8%). The reason is that pension reforms, especially the reduction of early retirement and the lowering of the pension adjustments, show positive effects.

In 2009 Germany had the fifth highest employment rate of older workers in the EU at 56.2%, compared to only 37.4% in 2000. This is an impressive increase, even if it is partly a result of a cohort effect, as large cohorts now enter the older worker category (55-64). It should be noted that there still is a considerable proportion of people who retire at age 60. While 61.9% of men and 42.7% of women aged 60 is still in employment (49.1% and 31.6% in EU-27), the figure for the 59 years olds is almost 10 and 12 percentage points (pp) higher. The effective retirement age of old age pension has increased from 62.2 years in 2000 to 63.5 years in 2009. The labour market exit age has increased from 60.6 years in 2001 to 61.7 years in 2008. It is still a bit higher than in the EU-27 on average.

Impact of the crisis

The financial crisis was followed by an economic recession, which hit the country in the second half of 2008. Notwithstanding this adverse economic framework conditions, Germany has managed to continue raising the employment rate of population aged 15-64 in 2009 thanks to improvement in employment of women (+0.8 pp) and older workers (+2.4 pp). Employment rates of men decreased slightly by 0.3 pp. Due inter alia to state subsidised short time work schemes – and increased working time flexibility at company level, unemployment remained almost constant despite considerable drop in the GDP during the crisis. Moreover, the extended regime of short work allowances not only helped to stabilize the German labour market, but especially minimized the risk of future pension reduction by bridging working career breaks and thus possible pension gaps, which otherwise could have occurred.

To assure further adequacy, in 2008 and 2009 pension benefits have been temporarily increased beyond what would have been originally foreseen by the automatic adjustment mechanisms. The impact of the *Riester Faktor* on indexation was deferred so that pensioners could benefit from wage increases in 2007 and 2008. Due to this legislation, pension indexation was 0.65 % higher in 2008 and 2009. Moreover, in 2009 pension legislation was amended, a pension guarantee was adopted which prevents nominal pension cuts as of 2010.

The amendment makes pensioners relatively better off in a time of nominal wage decline, which occurred in 2009 the first time since World War II. In return, it is legislated to fully compensate the suspension of the *Riester* factor and the omitted pension cuts by reducing the indexation of pensions as of 2011.

Second and third pillars have proved their resistance in times of the financial and economic crisis, as the majority of occupational provision is of DB nature or, in some cases, DC with minimum revenue requirement. Due to obligatory participation to the German Pension Security Association, pension provision organised directly by employer is to a large degree safeguarded. Occupational pension provision organised via external suppliers is subject to supervision concerning capital requirements. Members of *Riester* plans are protected from loss of invested capital through the obligatory nominal value maintenance guarantees.

Outlook

German population is slightly older than in the EU on average. The old-age dependency ratio comparing the number of those aged 65 and more to the working age population aged 15-64 was equal to 31% in Germany in 2007 (26% in the EU-27) and is projected to climb to 59% in 2060 (53% in the EU-27).

Public expenditure on social security pensions is projected to go up from 10.4% of GDP in 2007 to 12.8% in 2060. The projected increase is slightly lower than the EU average, as the demographic pressure on pension expenditure should be counterbalanced by legislated increase in the retirement age, closing down of early retirement paths, expected further rise in employment rate in general and of older workers in particular, and lower pension benefits in the public scheme relative to wages. As a result, the increase of public pension expenditure is comparable low compared with the approximately doubling of the old age dependency ratio in Germany.

Given the growing importance of occupational and voluntary (*Riester*) individual pensions, total national pension expenditure in 2060 will be substantially higher than 12.8% of GDP without leading to additional risks for public finance. The increase of expenditures of funded pension schemes is important to warrant adequate income of the elderly.

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is projected to decline slightly from 64% in 2008 to 61.5% in 2048. Though, taking into account the already legislated increase of the statutory retirement age to 67, the NRR will increase until 2048 to 67.2%. A closer look at the replacement rates reveals that RR of the pay-as-you-go pillar is decreasing due to the demographic factor in the pension adjustment formula, which takes into account the changes in the relation of pensioners to employees. The decline of the replacement rate of the pay-as-you-go pillar will be compensated by the increase of the occupational and voluntary pensions. This reflects the constant increase of the coverage of occupational pension scheme and success of the *Riester Rente*.

A 3 years unemployment break of an average earner reduced the NRR by 3.3% in 2008 and should reduce by 3.2% in 2048. As care breaks are credited, in 2008 the NRR of a female worker with a 3 year childcare break was higher by 1.9% than the NRR of a worker without children and without break, and in 2048 should be lower by 0.6% only. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 sets a high incentive on

prolonging working lives. While the malus is 3.6% per year of early retirement, the bonus is 6% per year of deferred retirement. The NRR of people retiring at 67 in 2008 were 16.1% higher than for those retiring at 65, but the bonus will drop to 9.3% in 2048. This is due to increase of the statutory retirement age to 67, which leads to a switch from bonus (+6%) to malus (-3.6%). The NRR for people retiring at the age of 63 is 11.7% lower in 2008 compared to a retirement at 65. In 2048 this difference will decrease to 10%. The NRR for low earners should increase slightly from 58.2% in 2008 to 60.3% in 2048 while the NRR for high earners would drop from 46.2% to 42.6%. The effect of a 10 year career break on the NRR would be reduced from a loss of about 25% to a loss of 21.3%. If the NRR 10 years after retirement for a worker retired in 2008 should be maintained (0% reduction due to wage indexation), the NRR should be lower by 3.1% in 2058 for those retired in 2048.

Despite a positive general outlook, the future situation of some groups needs closer monitoring, especially those with longer career breaks due to unemployment and groups not covered by compulsory insurance.

Germany is among countries where the net replacement rates for low-wage earners is and will be relatively low compared to other European countries. Nevertheless, poverty is low. In Eastern Germany, due to *unemployment rates and low wages*, the replacement rates for post-1960 birth cohorts however might fall. In West Germany, people with low education levels could be at risk of old-age-poverty, since they have been far more affected by long-term unemployment and low paid employment than earlier post-war adult generations. This is due to the fact that working careers and contributory records are closely reflected in the calculation of pension benefits.

The average pension of women is much lower than the pension of men (about half in West Germany and 2/3 in East Germany), mainly due to a lower number of working years, more years spent working part-time, a lower income and a low appreciation of child raising and care-work.²¹ Though, it is expected that this difference will decrease due to the increase of female employment rates and due to the fact, that bonuses for child raising have been increased significantly since 1992 which will lead to higher entitlements of future female pensioners. For married women (men) insurance pensions are often replenished by the income of their husband (wife) or survivor's pension.

In Germany, pensions in payment are in principle indexed on wages, but three automatic adjustment mechanisms are applied to indexation. First, as the pension system aims to balance contributions and federal subsidies against pension expenditure during the year, there might be an automatic increase in the contribution rate,²² which is balanced by a decrease in pension indexation. Second, a so-called *RiesterFaktor* takes into account the increase in total contributions outside the statutory system. Annual indexation is slowed down as the state-subsidized amount rise that people can save for their old-age provision. Third, a "sustainability factor" takes into account the demographic imbalances between the working population and the retired. Positive change in the relation between the working population and the retired triggers an increase in pension benefits and vice versa.

Indexation is thus variable and depends on the economic and demographic developments. In the long run it will be lower than wage indexation, as the public pensions benefit ratio reveals.

²¹ In Germany, the gender pay gap is at 23% (EU-27: 18 %) and 45.4 % of women work part time (EU-27: 31.1%) compared to 9.4% of men (EU-27: 7.9%).

²² Contribution rate is, however, limited to 20% before 2020.

The indicator compares the value of the average benefit of public pension as a share of the economy-wide average wage, so reflects the average situation of population of pensioners and not only those who have just retired. It is projected to fall from 51% in 2007 to 42% in 2060.

Altogether, the indexation scheme shows the commitment of the German Government, to balance adequacy and sustainability concerns in the pension system.

Challenges

The 2007 reform concluded a long series of reforms of the German pension system which as they strengthen incentives to work longer, installs an automatic mechanism for balancing revenues and expenditure, expands occupational and voluntary individual provision to supplement the public scheme, neutralises largely the impact of future longevity growth and stabilises overall replacement rates while reducing public pension expenditure have put the country well on the road to achieving a good balance between sustainability and adequacy concerns in its pension provision.

These reforms demonstrate Germany's determination to deal with the demographically driven challenge, as all reforms have been modelled with a view to ensure long-term adequacy and sustainability of the pension systems.

However, Germany faces a challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population and the country was assessed to be at 'medium' risk by the Commission/Council.²³ The projected increase in pension expenditure over the long-term at 2.3% of GDP is somewhat lower than the EU average. As occupational schemes and the *Riester-pension* largely are projected to offset for those covered the decreasing replacement levels in the first pillar overall replacement rates are projected to remain largely constant over the long-term.

Future national challenges could be summarised as follows: Firstly, the achievements of the past pension reforms should be safeguarded in the long run. In particular, recent modifications of the pension adjustment formula should be corrected in later years by reversing – as legislated – the deviation from the pension adjustment formula. Secondly, success in both sustainability and adequacy terms will depend on continuing the achieved progress in increasing participation and employment rates of women and older workers and combating regionally concentrated, long-term unemployment. Future challenges can therefore be seen less in pension policy but more in enhancing labour market participation especially in higher age-groups. It is important that the positive development regarding the employment rate of older workers continues especially against the background of the employment challenge implied by the increase of the pensionable age to 67. In this context it is reassuring that Germany implements necessary upward adjustments to the pensionable age swiftly without long run-in periods.

There is a need to push forward the change of views of employers and employees on prolonging working lives. Furthermore there is a need to monitor future pension adequacy for certain specific groups like employees with longer career breaks and/or low income in the earnings-related public scheme, certain groups of self-employed (without a compulsory insurance) or those who have not built sufficient entitlements in the *Riester* scheme or

²³ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

occupational schemes. According to calculations, replacement rates for low wage earners will remain low by European standards. Nevertheless poverty rate of elderly people in Germany is below EU-average. However, the German Government has just established a commission to deal with poverty issues relating to pensioners.

The increasing complexity of the pension system generates a need for greater transparency regarding total pension income from different pension schemes (public, occupational, private). If future pensioners are to plan and respond to incentives in the pension system access to information about already accumulated and simulated future pension entitlements would be called for. Germany has already taken measures to assure well informed population firstly by providing annual pension information sheets on the accrued entitlements for every insured person in the public pension scheme. Secondly, the initiative *Altersvorsorge macht Schule* (Old-age provision is coming to schools) has to be especially mentioned in this context. In cooperation with various important stakeholders in the respective fields, the Federal Government has launched this so-far unique educational approach: independent pension insurance advisers providing information in adult education centres throughout Germany on all matters concerning financial provision for old age. The participants in the initiative were given an enhanced basic ability to estimate their old-age provision needs and assess the options for their old-age provision. This initiative has proven a very successful and helpful support to people when informing about and planning personal old-age provision.

While in Germany the lasting impact on funded schemes would seem to be very limited, the economic crisis in its weakening of public finances could leave a longer lasting mark on the basis for public provision. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the risks to the sustainability of public finances.

Background statistics

Current adequacy (2008)	Germany			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	15	15	16	16	16	17
At-risk-of-poverty rate 65+	15	12	18	19	16	22
At-risk-of-poverty rate 75+	14	10	18	22	18	24
Income inequality 0-64	4.9			5.1		
Income inequality 65+	4			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.87	0.88	0.86	0.85	0.88	0.83

Adequacy projections: DE	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	64.1	61.5	-2.6	41.4	43.4	2.0
TRR 3 years unemployment	62	65	3.0	40	47.2	7.2
TRR 3 years childcare break	65.3	66.8	1.5	42.3	48.9	6.6
TRR 10 years career break	48.1	48.4	0.3	31.1	32.2	1.1
TRR shorter working (retirement at 63)	56.6	55.4	-1.2	36.5	38.1	1.6
TRR longer working (retirement at 67)	74.4	67.2	-7.2	48.7	49.1	0.4
TRR 10 years after retirement	64.1	59.6	-4.5	41.4	41.8	0.4
TRR low earner (66% average)	58.2	60.3	2.1	41.4	43.4	2.0
TRR high earner (100-200% rising profile)	46.2	42.6	-3.6	28.8	30.9	2.1
Benefit ratios: social security pensions 2007/2060				51.4*	42.50	

Current sustainability	Germany			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	13	12.9**	12.4*		12.0**	11.8*
Employment rate 15-64	65.3	70.7	70.9	62.2	65.9	64.6
Employment rate 55-64	37.4	53.8	56.2	36.9	45.6	46.0
Employment rate 55-64 women	28.7	46.1	48.7	27.4	36.8	37.8
Employment rate 55-64 men	46.2	61.8	63.9	47.1	55.0	54.8
Effective labour market exit age***	60.6	62.0	61.7	59.9	61.2	61.4
Public debt	59.7	66.0	73.2	61.9	61.6	73.6
Budget balance	1.3	0.0	-3.3	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	30	46	59	25	38	53
Public pension expenditure, % of GDP	10.4	11.5	12.8	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	7.9	8.7
Employment	-0.8	-0.7
Eligibility	-1.9	-2.6
Level of benefits	-2.2	-2.5
Total (including residual)	2.4	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Estonia

Description

The Estonian pension system is composed of statutory and supplementary pension schemes. There are two kinds of **statutory schemes**: the State PAYG DB pensions and mandatory funded DC pensions. Pension benefits of PAYG scheme can be divided into two groups: employment-related and national pensions. The employment-related benefits are the old-age pension, the pension for incapacity for work and survivors' pensions. They are financed by 20 percentage points (or 16 in the case of members of the mandatory funded pillar) of the 33% social tax, paid by employers. The purpose of the national pension is to guarantee a minimum income for those who are not entitled to an employment-related benefit. They are financed from the general State budget. The coverage of the PAYG system is practically universal.

In 2010, the statutory retirement age was set at 63 years for men and 61 years for women. It will be equalised at 63 by 2016, and as from 2017 it will gradually increase to 65 by 2026. There is a possibility for early retirement 3 years prior to the normal retirement age if the person has a work record of at least 15 years (qualification period for receiving the old age pension). For every month of early pension the pension entitlement is reduced by 0.4%. Where the pension is deferred the entitlement is increased by 0.9% for every month after the normal retirement age. In April 2010 Parliament adopted amendments to the State Pension Insurance Act, according to which the retirement age will rise for both men and women by 3 months a year as of 2017, reaching the age of 65 years by 2026.

The compulsory funded defined-contribution (DC) scheme was introduced in 2002 by diverting a portion of contributions from the statutory PAYG scheme into private funds. Participation is mandatory for persons born in 1983 or later. In essence, it is an individual savings scheme, where the amount of pension benefits depends on total contributions over the working career and yields of pension funds. It covers the risk of old age and not invalidity. Funded pensions are inheritable. The contribution rate is 6% of wages – the employee pays 2% from the gross wage (withheld by the employer) and the employer another 4% (as part of the 20% pension contribution). The first benefits were paid out in 2009.

The Estonian pension social protection system in general includes minimum income guarantees (national pension that serves as a minimum pension guarantee, a guarantee that old-age pension will not be lower than national pension and subsistence benefit). As at January 1, 2010 about 1.5% of all pension recipients were paid a national pension and about 2.6% received subsistence benefit in addition to their pension (mainly to compensate for heating costs during the winter months).

In 1998, supplementary **voluntary private pension schemes** were introduced, participation in which can take a form of pension insurance policies offered by licensed private insurance companies or units of pension funds managed by private asset managers. Tax incentives have been introduced to encourage participation in the voluntary private pension schemes, but it is still limited to around 14% of labour force (with about 53 thousand contributors and about 71 thousand contracts in the form of life insurances in 2009). To enhance the occupational pension provision, a proposal to reduce tax on employer's contributions was sent to inter-ministerial consultation in July 2010.

Current performance

Pension expenditure in Estonia has stayed around 6.0% of GDP for almost the whole last decade (EU27 in 2007: 11.8% - ESSPROS data). Adequacy of pensions is an issue in Estonia as the relative standard of living for older people and replacement rates are rather low. The median income of people aged 65+ to income of people aged 0-64 decreased from 73% in 2005 to 62% in 2008, the lowest in the EU (EU-27 average was 84% in 2008). The poverty rate among the elderly stood at 39% in 2008, which is one of the highest results in the EU-27 (18.7%). The national pension of 128 € in 2009 that serves as a minimum pension guarantee (which is slightly below the absolute poverty threshold of 150€ per month) covers the minimum food basket, but has persistently been below the national minimum cost of living as well as the relative poverty line.

According to ISG calculations the net theoretical replacement rate for a worker with 40 years career retiring at 65 in 2008 was at 39.5%. The average gross old-age pension in 2009 (after indexation in April) was 278€ (38% of the average gross wage). As the average wage level is predicted to decline in 2010 and 2011, so the net replacement rate could reach 50% in the coming years. The pension formula favours low-wage recipients, who receive relatively higher replacement rates.

Generally, the financial incentives for working after retirement age are good in Estonia, as pension can be drawn in combination with salary. As a result, Estonia's indicators for the employment of older people are higher than the EU average. In 2009 the employment rate was 60.4% for 55–64 year-olds (well ahead the EU-27 average: 46%). The employment rate of women of that age group is especially high – 61.2% against 37.8% in EU-27 and is expected to remain high due to the increased retirement age in the future. Old-age pensioners show an increasing tendency to remain on the labour market after reaching retirement-age, thereby continuing to increase the actual labour-force withdrawal age: in Q1 2009 25% of 65-66 year olds (and 17% of 69-70 year olds) were working.

The average exit age from the labour force was 62.1 years in 2008 (EU: 61.4). It has increased slightly since 2001 (61.1 years), reflecting the increase in the retirement age (an ongoing process until 2027), the reduction of pension rights in cases of early retirement and incentives for deferred retirement. At the same time, about half of pensioners retire before statutory retirement age by taking up early retirement pension, special pensions and pensions under favourable conditions, which points to a need to look further at early exit pathways for older workers.

Part-time work has traditionally been low in Estonia: it was in 2009 13.8% for women and 7% for men against 31.5% for women and 8.3% for men in the EU-27. As people close to retirement or after retirement have a limited choice either to work full-time or to exit the labour market, increased possibilities for them to work part-time would further increase the number of employed elderly.²⁴

Unemployment of 55-64 olds increased from 4.1% in 2008 to 9.4% in 2009 (against EU-27 average 5.1% to 6.3%) due to the crisis. But the activity rate remained high even at the time of crisis – 66.7% against EU-27 of 49.1% in 2009.

²⁴ Explanatory Note to the Amendment Proposal of the Pension Insurance Law, 2010.

Estonia's gender pay gap of 30.9% in 2007 was almost twice the EU average of 17.6% but the gender differences as regards average pensions for men and women are today below 5%. Unless the wage gap decreases, gender differences in pensions are expected to increase when the pension of a woman with a full employment history reaches only 86% of the pension of a man with a full employment history. This is mainly caused by the strengthened income-relation of the pension scheme.²⁵

Impact of the crisis

Following a period of moderate economic decline in the first three quarters of 2008, the financial crisis was followed by a severe economic recession, which hit the country as from the last quarter of 2008. Decline in the economic output was coupled with declining employment and increasing unemployment. In 2009, the employment rate fell to 63.5% (15-64 years), while it had reached 69.8% in 2008. The employment rate of older people also decreased to 60.4% in 2009 (2 pp lower than in 2008).

Responding to the rapidly declining tax revenues, the Parliament adopted in February 2009 a negative additional state budget, cutting public expenditures in total by about 8% compared to the earlier adopted budget for 2009. As a part of the package of constraining public expenditures, an modification of pension indexation rules was adopted in February 2009. According to the former rules (which were just adopted in 2008), the pension index depended on increase of social tax revenues and increase of the consumer price index with relative shares respectively 80% and 20%. The amendment allows the Government to adopt an index which is smaller than that calculated according to the above mentioned formula in cases when the expected GDP real growth for the same year is negative or when the deficit of the state pension insurance budget (the difference between expenditures on state pensions and revenues from social tax) for the given year is expected to exceed 1% of GDP. Application of this index increased state pensions from 1 April 2009 by only 5%, instead of 13.8% foreseen by the previous index (against the relatively high increase of wages and prices in 2008). Nonetheless, as pension expenditures increase in a situation of declining GDP, the share of pension expenditures in GDP rose to 9% in 2009, which is the highest expenditure level from the time of regaining independence.

The financial crisis has also had a severe impact on the value of pension assets in the mandatory funded pension scheme. In 2008, the weighed average rate of return of the mandatory funded pension scheme was minus 24%, which was partly compensated by an increase by 14.8% in 2009. For pension funds investing in equities, the decline in the value of pension fund assets was particularly severe in October 2008. In response, the fund managers re-shifted assets in fund portfolios from equities more towards deposits and government bonds. At the same time, the impact of the financial crisis on conservative pension funds investing only in fixed-interest instruments (no equity exposure) has been rather minor, the net asset value declining by 2.4% over 2008 and increased by 9.0% over 2009, whereas the index for the most aggressive funds increased by 17.1% in 2009.

From 1 January 2009, withdrawal of mandatory funded pensions is available for persons who joined the scheme in 2002 and have meanwhile reached the pension age. However, retirees who had invested in higher-risk pension funds would face a significant loss as compared to the value of contributions paid into the funds, if they decide to withdraw a pension in the

²⁵ The Socio-Economic Impact of Pension Systems on Women, February 2009:
<http://ec.europa.eu/social/BlobServlet?docId=5001&langId=en>

current situation. While most of the fund managers and custodian banks had recommended lower-risk pension funds for older persons, this is not a legal requirement and the investment risk of pension funds is entirely on fund participants.

To secure continuous payment of state pensions, the Government decided to temporarily suspend contributions to the mandatory funded scheme (both the individual contribution of 2% and the 4% share transferred from social tax) from 1 June 2009 until 31 December 2010. However, persons with ten years or less before statutory retirement (born 1954 or later) had the possibility of resuming individual contributions from 1 January 2010, in which case also state contributions on account of social tax were likewise resumed. Other age groups could continue to pay individual contributions from 1 January 2010, but no contributions from social tax were transferred. About 37% of people covered by the scheme continued to make their payments. For other participants of the funded scheme (i.e. persons not opting for voluntary continuation of individual contributions), contributions to the funded scheme will partly resume from 2011, when a 1+2% scheme is applied, and return from 2012 to full amount of 2+4%. Moreover, in order to keep the cost of special pension schemes (0.1% of GDP in 2009) under control, changes to the legislation are being discussed that would prevent new entrants from acceding to the scheme whilst increasing the retirement age for these groups of employees.

Despite the crisis these short-run measures increased the old-age pensions, disability pensions, and survivor's pensions both in nominal and real terms. Compared to other socio-economic groups current pensioners are relatively well protected. The economic crisis and drop in social tax revenues has clearly acted as a catalyst for some long-term reforms that influence the pension system. In addition to the pension age increase that was approved in April 2010, also discussions on a flexible retirement age, abolishment of special pension rights, and introduction of occupational pensions are being held.

Outlook

Demographic trends suggest future pressure on public finances. Despite the projected rise in birth rates (from 1.65 in 2008 to 1.66 in 2060), Estonia has one of the fastest declining populations in Europe. In 2008, life expectancy at birth was 68.7 years for men and 79.5 for women and is projected to be 80.8 and 87.5 years respectively in 2060. The old-age dependency ratio (population 65+ as % of population 15-64) is projected to increase from 25% in 2007 to 56% in 2060.

Nevertheless, according to national calculations, the increase of the retirement age to 65 years would lower the annual deficit of the state pension scheme by about 0.6% of GDP in 2026 (or by about 5%-10% of pension expenditure) and keep additional 15 - 20 thousand people on the labour market. According to the Ageing Report 2009, public pension expenditure is projected to decrease from 5.6% of GDP in 2007 to 4.9% in 2060, as a result of the diversion of part of public pension contributions into privately funded schemes.

The projections of the net theoretical replacement rates indicate that first pension as compared to the last wage is projected to increase from 39.5% in 2008 to 47.9% in 2048 for a worker with a 40 year career retiring at age 65. The increase of retirement age to 65 is estimated to push the average net replacement rate up by 2-2.5 percentage points in the long-run. Despite the growth, the replacement rate projected for 2048 is the lowest in the whole EU-27. The negative effect of 3 years of unemployment or childcare on the NRR would increase from

3.8% in 2008 to 4.8% 2048. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 (+24.6% bonus and -11.9% malus in 2008), would be somehow reduced in 2048 to +16.5% and -9.8%. The NRR for low earners would increase from 34.8% in 2008 to 43.2% in 2048 while the NRR for high earners from 49.2% to 55.8%. The negative effect of a 10 year career break on the NRR would increase from a 13.9% reduction in 2008 and 17.3% in 2048. The decrease in the NRR 10 years after retirement which in 2018 for workers retired in 2008 amounts to 3.3% would be at 3.5% in 2058 for those retired in 2048.

Workers with career breaks due to childcare or unemployment are also expected to receive low replacement rates in the future, thus being exposed to poverty. The negative effect of 3 years of unemployment which came to 3.8% of the NRR in 2008 will be more pronounced by 2048 (a 4.8% reduction). In the same period the negative effect of a 3 year childcare break would be also increasing from 3.8% to 4.8%.

The benefit ratio (an average pension benefit from public and mandatory funded scheme compared to an average wage) in Estonia in 2060 at 22% is projected to be the lowest in the EU-27. The prospective replacement rates reflect relatively higher initial pension benefits for workers with full careers in the future. The prospective benefit ratios show possible decline in relative living standards for an average pensioner.

Projections of replacement rates also reflect an increasing role of the defined-contribution mandatory funded pillar. By 2048 the contribution of the funded tier is projected to reach 44% of the gross replacement rate of a worker retiring at 65 after 40 years at the average wage (the share was 0% in 2008 as the system is still in the accumulation phase).

Challenges

The pension reform in Estonia, started in 1998, modified the pay-as-you-go scheme and introduced new mandatory and voluntary funded components. The reformed system helps to limit public pension expenditure in the future, but it poses a risk that people with short professional careers may not have sufficient resources to ensure a decent subsistence at pensionable age. Transparency of the system is outstanding, especially due to high level of internet usage of the public and availability of most information and transactions via electronic channels.

Estonia was assessed to be at 'low' risk with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population.²⁶ The projected decrease in pension expenditure over the long-term at 0.7% of GDP is below than the projected increase in the EU on average. Total replacement rates are projected to increase from a relative low level over the long-term, but they will be the lowest in the EU, implying that the existing system may become subject to socio-political pressure. The statutory funded scheme is projected to offset the fall in the replacement ratio in the public scheme to a certain extent.

Despite comprehensive pension reforms introduced in the last fifteen years, implementing further measures would contribute to put it on a more sound footing, particularly if they address adequacy concerns. In the wake of the crisis the government has already taken a number of measures in the right direction, e.g. increasing the pensionable age. Taking other measures that increase participation rates, which are already above the EU average, would

²⁶ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

provide an important further contribution to sustainability and adequacy of public pensions. In particular, an appropriate balance between working life and life in retirement needs to be found and making the retirement age automatically adaptable to future increases in life expectancy would enhance the stability of pension provisions. The authorities could also revise a number of special pension schemes, where the pensionable age remains considerably lower than in the public scheme, while they offer higher pensions.

Given the very low projected replacement rate, ensuring adequate pensions in the future will be a major challenge, in particular for people with short professional careers. The future adequacy of pensions in their income smoothing function is also at risk, as current and future replacement rates and relative living standards of older people compared to working population are rather low. This points out to a need of appropriate indexation rules, carefully balanced between adequate provision and sustainability of the system. Reasonable default options in the funded scheme that protect workers nearing retirement against volatility in the financial market also should be envisaged.

Avoiding major political pressures for better pensions will not be possible unless Estonia takes steps to address adequacy concerns in public pensions and greatly improve opportunities for people to compensate low mandatory pensions by building complementary pension entitlements in occupational and personal schemes.

The current level of gross debt is very low in Estonia and maintaining sound government finances, in line with the current budgetary plans, would contribute to limiting the already low risks to the long-term sustainability of public finances and will keep Estonia well-prepared to meet the demographic challenge.

Background statistics

	Estonia			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	15	15	16	16	16	17
At-risk-of-poverty rate 65+	39	25	46	19	16	22
At-risk-of-poverty rate 75+	48	29	55	22	18	24
Income inequality 0-64	5			5.1		
Income inequality 65+	3.3			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.62	0.66	0.59	0.85	0.88	0.83
Adequacy projections: EE	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	39.5	47.9	8.4	31.5	38.3	6.8
TRR 3 years unemployment	38	45.6	7.6	30.3	36.5	6.2
TRR 3 years childcare break	38	45.6	7.6	30.3	36.5	6.2
TRR 10 years career break	34	39.6	5.6	27	31.7	4.7
TRR shorter working (retirement at 63)	34.8	43.2	8.4	27.8	34.6	6.8
TRR longer working (retirement at 67)	49.2	55.8	6.6	39.3	44.7	5.4
TRR 10 years after retirement	38.2	37.6	-0.6	30.4	29.6	-0.8
TRR low earner (66% average)	34.8	43.2	8.4	27.8	34.6	6.8
TRR high earner (100-200% rising profile)	49.2	55.8	6.6	39.3	44.7	5.4
Benefit ratios: social security pensions 2007/2060				26.5*	15.8	
	Estonia			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	6.6	6.0**	5.9*		12.0**	11.8*
Employment rate 15-64	60.3	69.8	63.5	62.2	65.9	64.6
Employment rate 55-64	43.3	62.4	60.4	36.9	45.6	46.0
Employment rate 55-64 women	37.9	60.3	61.2	27.4	36.8	37.8
Employment rate 55-64 men	50.4	65.2	59.4	47.1	55.0	54.8
Effective labour market exit age***	61.1	62.5	62.1	59.9	61.2	61.4
Public debt	5.1	4.6	7.2	61.9	61.6	73.6
Budget balance	-0.2	-2.7	-1.7	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	25	34	56	25	38	53
Public pension expenditure, % of GDP	5.6	5.6	4.9	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	4.6			8.7		
Employment	-0.2			-0.7		
Eligibility	-1.6			-2.6		
Level of benefits	-3.1			-2.5		
Total (including residual)	-0.7			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Greece

Description

The first pillar pension system includes primary and auxiliary pensions. Primary pensions consist of pay-as-you-go financed schemes, which are dispersed across industrial sectors and provide varying levels of pension. The largest funds are IKA (for wage earners) and OGA (for farmers) while a separate scheme (OAEE) also covers the self-employed. Employees' and self-employed pensions are defined-benefit. The equal retirement age for men and women was stipulated for those persons who entered the pension system from 1993, the current legal retirement age for men is 65 for both men and women. A second tier of the first pillar consists of occupation-based auxiliary funds which provide supplementary pensions. They cover all employees and a small percentage of the self-employed and typically offer additional replacement rates around 20%. This auxiliary pension replacement rate had been set to be up to 20% from 2013 by Law 3655/2008 and has been reset by Law 3863/2010 to be of any amount according to what annual actuarial valuations suggest.

The statutory retirement age is 65, but some funds are still in the process of adjusting upwards to this standard, in line with the 2008 reform, which has also merged the existing 133 main and auxiliary pension funds to just 13. The newly adopted law on the 15 July 2010 for Social security and labour relations introduces a further merging of the existing pension funds to essentially three. The IKA –ETAM fund includes not only the employees of private sector but also as from 1.1.2011 the new entrants of civil service and from 1.1.2013 the statutory pension of the maritime sector (NAT).

Second-pillar occupational pensions are not widespread. Third pillar life insurance benefits, not as popular as in several other Member States, typically come in the form of a lump-sum and only rarely as an annuity.

Means-tested benefits are provided to those 65 and over without a sufficient insurance record, whilst a large number of pensioners receive contributory pensions at a guaranteed minimum level. A means tested pension supplement (known as EKAS, to which OGA pensioners are not eligible) is provided to pensioners whose total income (from any source, including pensions) fulfils certain criteria.

On 15 July 2010 the Greek Parliament adopted the Law 3863 which on top of the measures prescribed by the Economic Adjustment Program (reduction of the highest pensions, abolition of Easter, summer and Christmas bonuses, freeze in indexation) introduces drastic medium-term savings in pension expenditure in 2010-2013 as well as a comprehensive pension reform, with a view to ensuring its medium and long term sustainability. The reform brings in:

- a unified statutory retirement age of 65 years (including for women as from 1.1.2013), a minimum retirement age of 60 years (including for workers in heavy and arduous professions and those with 40 years of contributions), and creation of an automatic adjustment mechanism linking the retirement age with the increase in life expectancy (from 1.1.2021),
- a gradual increase in the minimum contributory period for retirement on a full benefit from 37 to 40 years,

- the introduction of stricter conditions and regular re-examination of eligibility for disability pensions, a substantial narrowing of the list of heavy and arduous professions,
- a merger of the existing pension funds and a unified new pension system for all current and future employees, an abolition of the special rules for the persons insured before 1993 (while retaining acquired rights),
- an amendment of the pension award formula in the contributory based scheme to strengthen the link between contributions paid and benefits received (with accrual rate limited to an average annual rate of 1.2%) and an extension of the calculation of the pensionable earnings to the entire lifetime earnings (while retaining acquired rights),
- a reduction of the pension benefits (by 6% per year) for people entering retirement between the ages of 60 and 65 with a contributory period of less than 40 years,
- the creation of a means-tested minimum guaranteed income for pensioners (i.e. for those with no less than 15 years of insurance) and for elderly people above the statutory retirement age who fulfil certain criteria regarding their income and their residency in the country,
- the development of control systems combating social insurance contribution evasion, the implementation of a single control system of pension payment and the implementation of a monitoring system for forced collection of social contributions,
- a Solidarity Contribution for Pensioners concerning relatively high pension incomes (above 1400 €) which is kept in a separate account in order to cover deficits of different sections of the basic pension system.

The government must, also, soon face the issue of the equalisation of retirement age between men and women in the public sector in response to the respective ruling by the European Court of Justice.

Current performance

Pension expenditure in Greece has been recently slightly higher than in the EU on average (2007: 12.1% of GDP vs. 11.8% in the EU-27)²⁷. At 42.2% in 2009, employment rate of older workers (55-64) has not progressed much since the beginning of the decade. Between 2002 and 2008 the country has not seen any progress in terms of increasing the effective retirement age, which has stayed at the level of 61.3-61.4 years.

The Greek pension system has been highly complex and segmented for many years. This fragmentation of the system contributed to high inequalities in terms of benefits received by pensioners. High pension expenditure is reflected in high average replacement rates for workers with full careers. Despite high replacement rates people aged 65 and more are exposed to higher at-risk-of-poverty rates (22%) than in the EU on average (19%). This is due to the fact that the average insurance period is 25 years (21 years for women), far below 35 required for full pension. Moreover, discretionary indexation of pensions might leave living standards of older pensioners further behind working age population. Finally, the situation might be diverse for workers covered by other schemes than IKA-ETAM and these who were covered by a number of schemes during their working life.

The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (109%) is high compared to the EU average.. These replacement rates are estimated to fall drastically as a result of the 2010 reform.

²⁷ ESSPROS.

Impact of the crisis

The financial crisis was followed by an economic recession, which hit the country in 2009. Compared with the EU, the employment situation in Greece for this year, has held up relatively well in spite of the crisis. In 2009, the employment rate of persons aged 15-64 reached 61.2%, down by 0.7 percentage point (pp) compared to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 1.5 pp to 73.5%, in contrast to an increase of 0.2 pp to 48.9% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) fell by 1.4 pp to 57.7% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of older women still managed to grow by 0.2 pp to 27.7% (EU: up by 1 pp to 37.8%), even during the crisis.

The crisis unveiled a very difficult state of Greek public finances. The government deficit and debt has increased strongly, which made it very difficult and expensive for the Greek state to refinance debt coming up for renewal in money markets. The pension and labour reforms are part of an adjustment programme the government has adopted as part of a package agreed with the European Union, the European Central Bank and the International Monetary Fund.

Outlook

Developments in the old-age dependency ratio (population 65+ as % of population 15-64) will be more pronounced in Greece relative to the EU on average (EL: 28% in 2007, 57% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to drop by 18%, compared with 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in Greece over the long-term, especially for women and older workers, but less than in the EU-27. The participation rate was below the EU average in 2007 (67.1%, EU: 70.6%), and is projected to remain in that position also in 2060 (EL: 68.8%, EU: 74.1%).

Greece is in the group of Member States where the increase in public pension expenditure had been projected to be very significant. The level of the expenditure, as calculated in the 2009 Ageing Report, had been projected to increase from 11.7% of GDP in 2007 (the EU-27 average: 10.1%), to reach 24.1% in 2060 (EU-27: 12.5%). This would have been the second largest increase in the EU-27. Several factors lie behind the projected increase in public pension expenditure.

The demographic transition to an older population is the main driver. This effect alone would push up expenditure significantly in Greece, by 12.7 percentage points of GDP (compared to 8.6 for the EU-27 as a whole). Before the 2010 reform, the demographic transition would not be counterbalanced by restricted pension eligibility (e.g. higher retirement age, abolition of some early exit paths from the labour market) to the same extent as in the EU-27 on average. In consequence, the coverage ratio, which is the ratio of the number of pensioners under the public scheme (all ages) divided by the number of people aged 65 years and above had been projected to fall less in Greece than in the EU as a whole, resulting in expenditure savings of only 0.4 pp of GDP between 2007 and 2060 (savings of 2.6 pp are projected for the EU-27 as a whole).

In the IKA-ETAM scheme covering private sector employees (around 53% of the workforce) the net theoretical replacement rate of a standard worker with average earnings and retiring at 65 after 40-years long career is projected to decrease from 120% in 2008 to 110% in 2048 (the highest projected result in the EU). However, in reality, even before the reform, replacement rates were lower, around 65%, due to short careers of around 25 years

Greece has recently adopted a new law (15 July 2010) for pension reform addressed to ensure the sustainability of the pension system. As a result, projected increase in expenditure and projected adequacy of pension benefits would be different from the results from the 2009 scenarios summarised above.

Alignment of statutory retirement ages between women and men and restricting access to early retirement could improve both adequacy and sustainability of the system. The newly adopted law provides an amendment for equalization of retirement age for women in the public sector as of 1.1.2013 at the age of 65 years. Simplification and defragmentation of the system introduced also by the new law could further enhance adequacy and reduce inequality. The reform would bring means-tested minimum guarantee income and would also strengthen the link between contributions and benefits (creating incentives to contribute to the system and generating risk of higher inequalities). It seems that replacement rates of average-wage earners are set to decline drastically. It is too early to assess how the minimum guarantee income will protect replacement rates of low-wage earners. However, with expenditure growth under control the system would be considerably more sustainable and future pension promises more reliable, which would also benefit adequacy.

Challenges

The economic crisis has revealed that generous pension promises for the Greek working population have not been sustainable. The new law adopted in July 2010 intends to put the pension system on a sustainable path through major changes to its design. The impact of the pension reform on the adequacy of pensions (both in terms of poverty avoidance and maintenance of income after retirement) needs to be closely monitored.

Greece faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and had been assessed to be at 'high' risk in this regard by the Commission/Council.²⁸ The projected increase in pension expenditure over the long-term [at 12.4%] was dramatically higher in Greece than the EU average (2.4%). Though total theoretical replacement rates in the pre-reform system had been projected to fall slightly over the long-term in Greece they would have remained the highest in the EU.

The success of the comprehensive pension reform adopted by the Parliament in summer 2010 depends crucially on longer working lives and an increase in the participation rate, which is below the EU average notably for older workers. Securing an appropriate balance between working years and years spent in retirement and maintaining it for the future by adjusting pensionable ages in line with increases in life expectancy as the new legal framework provides for, would be important for Greece when seeking to enhance the future stability of adequate and sustainable pension provision. Underpinning pension reforms with strong labour market and work places measures to enable and encourage people to work longer would also be necessary.

²⁸ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Despite high replacement rates for workers with full careers in the pre-reformed system, fragmentation contributes to high inequalities in terms of benefits received by pensioners and relatively high at-risk-of-poverty rate. It remains to be seen how the reformed system will protect workers with broken careers and low-wage earners from poverty and what replacement rates it will offer for average-wage earners.

The economic crisis brought the long standing perilous state of public finances into the open and further aggravated the public budget position of Greece. Budgetary consolidation is absolutely essential to avoid a public debt crisis. The current level of gross debt is well above the Treaty reference value and the budgetary position compounds the long-term budgetary impact of an ageing population. Reducing public debt, which will require achieving high primary surpluses for a very long period of time, would be crucial to secure financing for future increases in public pension expenditure.

Background statistics

	Greece			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	20	19	20	16	16	17
At-risk-of-poverty rate 65+	22	21	24	19	16	22
At-risk-of-poverty rate 75+	28	27	29	22	18	24
Income inequality 0-64	6.2			5.1		
Income inequality 65+	4.5			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.86	0.89	0.84	0.85	0.88	0.83
Adequacy projections: EL	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	120	110		109	100	
TRR 3 years unemployment						
TRR 3 years childcare break						
TRR 10 years career break						
TRR shorter working (retirement at 63)						
TRR longer working (retirement at 67)						
TRR 10 years after retirement						
TRR low earner (66% average)						
TRR high earner (100-200% rising profile)						
Benefit ratios: social security pensions 2007/2060				73.1*	80.50	
	Greece			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	11.1	12.0**	12.1*		12.0**	11.8*
Employment rate 15-64	56.6	61.9	61.2	62.2	65.9	64.6
Employment rate 55-64	39.4	42.8	42.2	36.9	45.6	46.0
Employment rate 55-64 women	24.8	27.5	27.7	27.4	36.8	37.8
Employment rate 55-64 men	55.7	59.1	57.7	47.1	55.0	54.8
Effective labour market exit age***	:	61.0	61.4	59.9	61.2	61.4
Public debt	103.4	99.2	115.1	61.9	61.6	73.6
Budget balance	-3.7	-7.7	-13.6	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	28	38	57	25	38	53
Public pension expenditure, % of GDP	11.7	17.1	24.1	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	12.7			8.7		
Employment	-0.6			-0.7		
Eligibility	-0.4			-2.6		
Level of benefits	0.8			-2.5		
Total (including residual)	12.4			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Spain

Description

The Spanish public pension system consists of an earnings-related scheme financed through contributions on a PAYG-basis. Special schemes exist for civil servants working for the central government, the justice system or for people working for the armed forces. The general scheme is mandatory for all employees and self-employed and provides pension entitlements after a minimum contribution period of 15 years (of which at least 2 years must have occurred in the last 15 years before retirement). The contribution rate is 28.3% of gross earnings (4.7 percentage points paid by the employee and 23.6 by the employer). It covers, in addition to old-age, disability, maternity and survivors risks and temporary incapacity.

Benefits are calculated as a percentage of a so-called 'base pension'. The base pension is an average of the contributions paid during the 15 years before retirement (up to an annual ceiling of € 38.376 corresponding to about 190% of the average wage). A full pension of 100% of the 'base pension' is reached after 35 contribution years and at retirement at the standard age of 65. The percentage of the base pension that is paid decreases if the person has contributed less than 35 years to the system. Employees can extend their working career above the 65 years limit and receive incentives to do so. Early-retirement is possible since 61 (under certain conditions and with reductions in the benefits).

The general scheme provides a guaranteed minimum contributory pension and a non-contributory pension. Contributory pensions are the sole responsibility of the central state, while non-contributory pensions are managed by the autonomous regions. In 2010²⁹, the total number of the Social Security contributory pensions is 8.7 million, of which 48.7% are paid to men and 51.3% to women. The majority of beneficiaries receive old-age pensions (59.3%) and survivor pensions (26.4%), while the remaining recipients are the permanently disabled (10.8%), orphans (3.1%) and other family members (0.4%). The earnings related pensions are topped up to the minimum levels for pensions. The share of pensioners receiving top-ups was 27.5% in 2009³⁰; it has been in decline as a result of the higher pension entitlements of new retirees and despite increases in minimum pension levels. It is worth to note that the proportion of women receiving minimum pensions is much higher than the proportion of men.

Introduced in 1990, non-contributory pensions cover 5% of pensioners, and provide a means-tested guaranteed minimum income for those without earnings related pension benefits (e.g. because of insufficient contribution periods or a lack of contributions). Women are the main beneficiary of the non-contributory pensions due to the high number who in the past could not enter the labour market. In addition, pensioners benefit from additional services: right to healthcare and social services..

Average annual pension payment amounts to € 10.923 in 2010. Minimum contributory pensions (between € 7.805 and € 10.152 for retirees over 65) and non contributory pensions (€ 4.755,80 in 2010) are lower. Pensions are adjusted annually in line with the consumer price index, although minimum pensions have increased in real terms in recent years.

²⁹ Source : www.seg-social.es -> Estadísticas. Data for July 1st 2010.

³⁰ Informe Económico Financiero del Presupuesto de la Seguridad Social.

A reserve fund for social security surpluses to deal with future projected financial strains was established in 1997. The fund has benefited from a surplus in the accounts of the social security system since 2002 (a trend that continues in 2010) and it has accumulated € 60 bn at the end of 2009 (5.7% of GDP).

The Spanish pension system is prominently public and the weight of private provision is limited. According to the OECD, Spanish private pension system has accumulated assets that represent around 8% of GNP (and an additional 3% coming from the externalisation of occupational pensions), which is below the OECD average of 60%. The number of supplementary occupational and voluntary individual pension plans was estimated at 10.6 million in 2009, 81 % of which belong to the modality of individual plans. Records are made by plans, but the number of persons covered is lower than the number of plans (rough estimates showing 8 million people). Along with this, Autonomous Communities are promoting parallel schemes, which could increase the total number of members by approximately 1 million. Individual insurance contracts enjoy the same fiscal treatment as pension plans. The benefits can be drawn in the form of regular payments or lump-sum payments. The Government has modified fiscal conditions in order to make monthly payments more attractive than lump sums. In 2009, about 44% of beneficiaries chose to take lump sum payments (corresponding to around 66% of benefits).

At the end of January 2010 the Spanish government presented a reference document for an important pension reform. The reform was justified by the magnitude of the ageing challenge, that, although it is meant to start later than in other EU countries, it will be rather sharp (second highest life expectancy in the world, number of pensioners to double between 2010 and 2040, etc) making therefore necessary to guarantee the sustainability of the social security system beyond 2030. The initial proposal included: prolonging working lives and increasing effective retirement age, by discouraging early retirement and increasing the statutory retirement age, that would gradually move from 65 to 67; strengthening links between contributions and benefits, e.g. by increasing the number of years used as the earnings base, in order not to penalise those losing employment at the end of their working life and to avoid fiscal planning; favouring greater flexibility in personal decisions regarding retirement, including through the development of supplementary pensions. Other alternatives are being discussed in order to achieve similar savings to those initially planned in the Government's proposal.

In the forefront of public debate, the document is currently discussed in the framework of the Toledo Pact cross-party Parliamentary Commission in charge of pension issues. The Government expects to reach an agreement before the end of 2010.

Current performance

The current relative median income level of people aged 65+ is relatively low compared to the general population (78% relative median income ratio and aggregate replacement ratio of 48%, both below the EU27 average). The rate of poverty risk of population 65+ at 27.4% in 2008 was 8.5 percentage points higher than the EU average. However it has been reduced over the last years (it had reached 30.7% in 2006). Furthermore, according to national data³¹,

³¹ National Statistic Institute, *Living Conditions Survey*, data available since 2007. At risk of poverty rate for the elderly in 2008: 14.1% (provisional data for 2009: 13.7%); At risk of poverty rate for the total population in 2008: 15.5%; (provisional data for 2009: 15.5%). See references also to this in the country fiche for Spain of the 2010 Joint Report on Social Protection and Social Inclusion).

that computes the ownership of the first residence, the risk of poverty rate for the elderly, at 14.1%, is below the rate for the general population since 2008 (in Spain 87.5% of people 65+ own their houses). Poverty rates among the elderly increase with age and also by gender (elderly women having a higher poverty rate than men). The proportion of women depending on minimum pensions is much higher than that of men. Due to that, attention has been given to improve conditions for widowhood pensioners.

The current net theoretical replacement rate (for a worker retiring at 65 after 40 years of contributions with average earnings) was 95.3% in 2008 and the gross replacement rate 88.3%, both of them well above the EU (unweighted) average. In terms of adequacy, the statutory pension scheme therefore provides relatively high income replacement for the type of theoretical worker used in the calculations of TRR, but less so on average, as shown by the aggregate replacement ratio.

In 2007 Spain spent about 9% of its GDP on pensions (ESPROSS data), the lowest share in the last decade and below the EU-27 average.

The employment rate of older workers (55-64) has risen from 36.8% in 2000 to 44.1% in 2009, but is still below the EU average of 46%. At 32.2% employment rates for older women are almost 20 percentage points below that of men at 56.7%. While 62.3% of men and 35.6% of women aged 59 stay at work, the indicator is only 53.8% and 28.1% for those aged 60. The average exit age from the labour market was in 2008 (62.6) almost 2.5 years lower than the statutory retirement age, but above the EU average and with a faster improvement between 2001 and 2008. Effective average retirement age in 2009 was 63.7.

Impact of the crisis

Because the Spanish pension system is prominently a public PAYG system and the weight of the private provision is very limited, the financial crisis had no direct effect on present or future pensioners. The value of assets in voluntary pension saving schemes was affected by the drop in asset values and partly recouped during 2009/2010.

The subsequent economic crisis, however, has left deeper issues for the Spanish pension system through lower growth and higher unemployment and the resultant decline in contribution and tax revenues. The crisis caused a decline in GDP growth from 0.9% in 2008 to -3.7% in 2009. The employment situation in Spain has been greatly affected by the crisis with unemployment rates still rising, up to 20.1 in the Q2-2010 and youth unemployment up to more than 40%. In 2009, the employment rate of people aged 15-64 declined by 4.5 percentage points compared to 2008 to 59.8% (EU: down by 1.3 percentage points to 64.6%). The male employment rate fell by 6.9 percentage points to 66.6%, a considerably stronger fall than the 2.1 percentage points decline to 52.8% recorded for women. The employment rate of old men fell significantly too by 4.2 percentage points to 56.7% (EU: down by 0.2 percentage points to 54.8%), whereas the employment rate of old women still managed to grow by 1.2 percentage points to 32.3% (despite of severity of the crisis in Spain this growth was slightly above the EU average of 1 percentage point to 37.8%). Until end of 2009, early retirement (112,427 new early retirees in total) does not seem to have increased as a consequence of the crisis.

Spells of long term unemployment cause a lower and slower build up of pension rights and can therefore cause an impact on the adequacy of pension entitlements. The impact of the

crisis on unemployment has also meant a reduction of the number of contributors to social security (1.5 million employed contributors less than in 2007, although most of those continue to contribute as unemployed). The surplus in the Social Security budget continues in 2010.

The situation of public finances worsened very considerably in Spain as a result of the crisis. In view of the important increase of the country's debt and deficit, the government announced on 12 May 2010 a package of measures involving €15bn of budget cuts through a 5% cut in public sector pay, a freeze on cost of life adjustments for pensions in 2011 and reduced public investment. The freeze in pensions has the aim of saving € 1500 millions per year (pensions are the biggest item of the national Social Security budget). The freeze will not apply to the beneficiaries of minimum pensions (28% of the total) nor to the beneficiaries of non-contributory pensions (around half million people).

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 1.4 percentage points of GDP in the "lost decade" scenario³²) in the long-term up to 2060. This scenario does not update population projections, thus the increase in expenditure could be partly offset by a reduction in immigration (as compared to the baseline scenario) due to the crisis, meaning a lower number of new pensions in the future.

Outlook

According to Eurostat 2008 projections, Spain is among the half of EU Member States that will see an increase in population. The gain in population projected between 2008 and 2060, mainly due to immigration, exceeds 7 million people, the third largest increase in absolute terms after the UK and France. Developments in the old-age dependency ratio over the next 50 years will happen later, mainly around 2030, although more quickly in Spain than the EU average. Despite the inflow of immigrants the working-age population is projected to drop by 9%, compared to the 15% for the EU as a whole.

The projections show that, although current participation rates are below the EU 27 average, they will exceed the EU27 average in 2060, especially due to increases for women and older workers. Confirming the rapid and intensive aging of the Spanish population, the group of people aged over 64 will increase over the next decade by 1.29 million. If in 2009 they accounted for 16.8% of the total population, they would be 18.9% in 2019 and continue to increase its weight in the total population to reach 31.9% in 2049.

Spain is in the group of Member States where the increase in public pension expenditure is projected to be very significant. The level of expenditure in 2007 (8.4% GDP) was below the EU27 average (10.1% GDP), but the projected increase is much larger in Spain, with 6 ¾ percentage points of GDP for the period 2007-2060, most of the increase taking place from 2030 onwards. At the end of the projection period (2060) the expenditure to GDP is expected to be 15.1, or 2 ½ percentage points above the EU-27 average.

The demographic transition to an older population is the main driver behind this projected increase in public pension expenditure. This effect by itself would push up expenditure very significantly in Spain. Estimates of this effect show increases of 3.5 percentage points by 2030 (less than the 4.5 points for the EU), but 10 percentage points of GDP by 2060 (compared to 8.7 percentage points for the EU as a whole). With current legislation, the

³² See Table 76 in the 2009 Ageing Report.

demographic transition will be not counterbalanced by restricted pension eligibility (the so-called coverage effect, e.g. higher retirement age, abolition of some early exit paths from the labour market) to the same extent as in the EU-27 on average. Reduced pension coverage will save only 0.9 pp in Spain between 2007 and 2060, compared to 2.6 pp in the EU-27.

The benefit ratio is projected to decline from 57.8% in 2007 to 52.2% in 2060. This is the result of indexation rules and the increase in longevity.

On the contrary, the net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is not projected to change much, going from 95.3% in 2008 to 96.6% in 2048 while the gross replacement rate (GRR) is projected to increase from 88.3% to 89.6% over the 40 years time span³³.

The negative effect of 3 years of unemployment which came to -2.8% of the NRR in 2008 would be similar by 2048. 3 years break for childcare does not affect NRR and protection for these workers will be equally good in 2048. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 would still be asymmetric in 2048 (as it is now): a worker that retires 2 years earlier will get 11.5% lower NRR while the worker that stays on for 2 more years will gain only 4.7% higher NRR, both compared to a 40 contributory years career. The NRR for low earners would remain around 100% of the average earner NRR while the NRR for high earners would stay around 85% of the average earner NRR. The effect of a 10 year career break on the NRR would remain representing a loss of about 8.5% compared to a full 40 years career. The decrease in the NRR 10 years after retirement is around 6.5% (compared to the NRR at the year of retirement), both currently and as projected for 2048.

Challenges

While up to now the Spanish pension system has performed well on adequacy indicators and has not been problematic on sustainability measurements, this position will on present trends be challenged over the next 50 years, due to the strong demographic ageing and added pressures from the crisis. Additional reforms that can secure long term financial sustainability and adequacy are needed. Renewed efforts have to be made to better meet adequacy and sustainability concerns in the future, within the framework of the consensual mechanisms for handling a reform of the pension system, which has emerged as one of the key assets established in earlier reforms.

Spain faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.³⁴ The projected increase in pension expenditure over the long-term at 6.7% is significantly higher in Spain than the EU average. The starting point is however lower than the EU average and the increase will be sharper only after 2030. Implementing further reforms to the pension system that contain the high projected increase in pension spending would be necessary to put it on a more sustainable path.

³³ The simulations for current and future TRR are both done on the basis of the pension legislation in force in 2008, since there are no changes approved as yet. Therefore the differences between current and future TRRs result only from the different profiles of wages' growth at the two points in time 2008 and 2048. For further information please see annex 5.

³⁴ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Providing adequate pensions becomes also a challenge to be addressed. Key policies on increasing minimum pensions have had an important effect on dealing with current basic adequacy, although the at-risk-of-poverty of the elderly population, if house ownership is not considered (see footnote 3), is still higher than the EU average. Under current legislation, theoretical replacement rates are projected to remain high and above the EU average.

The crisis has added some urgency for looking carefully at pension sustainability and adequacy in Spain. Although the system has performed well during the crisis, the decrease in the number of employed contributors to social security owing to the high unemployment rates is a matter for concern.

In a contributory earnings-related system moving towards a closer relationship between contributions and benefits (as announced in the objectives of the pension reform) tackling unemployment and precarious jobs will be a precondition for longer contributory careers and therefore, for the success of pension provision, both in adequacy and sustainability terms. Taking measures that increase participation and employment rates for all working age, notably for young (where unemployment is radically centred), women and older workers, would crucially improve Spain's ability to continue to provide pensions that are both adequate and sustainable. It is also important to close the gender gap in employment rates and to increase participation of women in the labour market.

The public deficit situation makes it necessary to embark on reforms of the pension system to secure financial sustainability of public finances. Doing this would seem to commit Spain first of all to achieve a more appropriate balance between working years and years spent in retirement, in particular in view of the very high remaining life expectancy at pensionable age. Furthermore, not just raising the exit and the pensionable age would seem important. Underpinning pension reforms with labour market and work places measures to enable and encourage people to work longer would also be necessary. Spain would also have to review how it could stimulate occupational and personal schemes that would allow people to compensate for the possible reduction of benefit levels in the public scheme.

Moreover, given the significance of the impact of the crisis on the public finances' position, budgetary consolidation will be essential in order to reduce public debt and raise Spain's capacity to finance future increase in public social expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

	Spain			EU-27		
	Total	Men	Women	Total	Men	Women
Current adequacy (2008)						
At-risk-of-poverty rate 0-64	18.1	17	19	16	16	17
At-risk-of-poverty rate 65+	27.4	25	30	19	16	22
At-risk-of-poverty rate 75+	33	30	34	22	18	24
Income inequality 0-64	5,6			5,1		
Income inequality 65+	4,2			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0,78	0,78	0,78	0,85	0,88	0,83

Adequacy projections: ES	2008 net	2048 net	difference	2008	2048	difference
				gross	gross	
Theoretical replacement rates (TRR) base case	95,3	96,6	1,3	88,3	89,6	1,3
TRR 3 years unemployment	92,6	94,1	1,5	85,4	86,9	1,5
TRR 3 years childcare break	95,3	96,6	1,3	88,3	89,6	1,3
TRR 10 years career break	87,1	88,3	1,2	79,5	80,6	1,1
TRR shorter working (retirement at 63)	84,4	85,6	1,2	76,9	77,9	1,0
TRR longer working (retirement at 67)	99,9	101,4	1,5	93,6	94,9	1,3
TRR 10 years after retirement	89,0	90,3	1,3	82,5	83,7	1,2
TRR low earner (66% average)	95,3	96,7	1,4	88,3	89,6	1,3
TRR high earner (100-200% rising profile)	81,2	81,4	0,2	73,5	72,4	-1,1
Benefit ratios: social security pensions 2007/2060				57,8*	52,20	

	Spain			EU-27		
	2000	2008	2009	2000	2008	2009
Current sustainability						
Esspros pension expenditure	9,6	9,0**	9,0*		12,0**	11,8*
Employment rate 15-64	56,1	64,3	59,8	62,2	65,9	64,6
Employment rate 55-64	36,8	45,6	44,1	36,9	45,6	46,0
Employment rate 55-64 women	20,0	31,1	32,3	27,4	36,8	37,8
Employment rate 55-64 men	54,7	60,9	56,7	47,1	55,0	54,8
Effective labour market exit age***	60,3	62,1	62,6	59,9	61,2	61,4
Public debt	59,3	39,7	53,2	61,9	61,6	73,6
Budget balance	-1,0	-4,1	-11,2	0,6	-2,3	-6,8

	Spain			EU-27		
	2007	2030	2060	2007	2030	2060
Sustainability: projections						
Old-age dependency ratio	24	34	59	25	38	53
Public pension expenditure, % of GDP	8,4	10,8	15,1	10,1	11,4	12,5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	10,7	8,7
Employment	-0,9	-0,7
Eligibility	-0,9	-2,6
Level of benefits	-1,7	-2,5
Total (including residual)	6,7	2,4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

(1) People 65+ at-risk-of-poverty with house ownership considered have the following rates: 14.1 (T), 15.0 (M) 13.5 (F). For less than 65, the same rates are: 15.8 (T), 15.2 (M) and 16.3 (F).

Country profile: France

Description

The French pension system is largely statutory in nature: the system comprises different pay-as-you-go schemes, depending on the sector of activity, which are financed by social security contributions and taxes.

The *régime général* covers employees of the private sector (around 60% of the workforce) and provides basic defined-benefit pension. It cohabits with statutory supplementary pay as you go schemes (*régimes complémentaires obligatoires*) established by collective agreements and with a close link between benefits and contributions. Civil servants and employees of public-sector companies are covered by special schemes. The differences between the *régime général* and the public sector scheme have become less stressed in the past few years due to successive pension reforms

Pension benefits are opened at a minimum pensionable age. Except for some special schemes, the minimum pensionable age was set at 60 (until the 2010 reform). From this age on, people can retire and will receive a pension benefit which depends on the length of their contribution record and their past wages (an average of the 25 best years in the *régime général*). In order to get a full pension benefit, one needs to meet the condition on the contribution length or to retire at 65 (until the 2010 reform), the age that insures people to leave with a full pension benefit whatever their contribution length. The contribution length is reviewed to increase automatically in order to keep constant the ratio between contribution length and remaining life expectancy. Therefore, the contribution period will increase up to 41 years for the 1952 generation and 41.5 thereafter. When none of these conditions is met, pension rate is lowered proportionally to the number of missing quarters (*décote*). Symmetrically, when people have contributed more than required, they get a higher pension (*surcote*). Since the 2003 reform, workers who started to work young (before age 16 or 17) and who have a long contribution record (at least the minimum seniority condition) can retire between age 56 and 59 and draw a full pension from the *régime général* (and aligned ones).

As these rules apply to the private sector, numerous other schemes apply to civil servants or specific private sector job sectors. The last reforms aimed at bringing together these different rules: in 2003, pension ages and contribution periods were aligned between public and private sector.

Among other non-contributory benefits and coverage (*pension de réversion*, family advantages, unemployment periods contributions), a universal means-tested minimum pension exists (*minimum vieillesse*), which is getting currently revalorised (of 25% over 5 years by 2012).

The extensive role of statutory schemes in France leaves little room for the development of voluntary, individual or sectoral schemes, which benefit from tax incentives. However, reforms in 2003 encouraged the development of both occupational and individual pension provision.

Given its impact on the financing of the pension system, increasing labour market participation of older workers has become a Government priority since 2006, and many legal schemes have been created since:

- The “Delalande” contribution, tax applied on any company firing a worker aged 50 or more which created disincentives for employers to hire older workers, has been removed;
- Job seeking exemptions for old unemployed people are to end in 2012;
- Firms were to take by the end of 2009 some steps to promote old workers labour force participation, chosen among a given list; companies which failed to take these steps were to support financial penalties.

The Government issued proposals for a pension reform in 2010. A draft law has been endorsed by the Parliament in October and was to be promulgated in November (at the time this report was being prepared). The key objective of this reform is to make the pension system financially balanced by 2020, while ensuring adequacy.

Pensionable ages would be increased by 2 years at a rate of 4 months a year, starting with the 1951 generation. The minimum pensionable age would be 62 for people born in 1956 (age reached in 2018) and the age that qualifies for a full pension benefit (whatever the contribution length) would be 67 for people born in 1956 (who would reach this age in 2023). The contributory period would be increased to 41.5 years by 2020 and is to continue to rise thereafter according to life expectancy. Some workers with long careers (under specific conditions) will still be able to retire before the minimum pensionable age, between 58 and 61. This opportunity will be extended to people who started to work before age 18. People who are disabled (under specific conditions) will be able to retire before the minimum pensionable age, at 60.

Adequacy would be strengthened by increasing the compensation period (for the number of contributory years) for youth unemployment periods from 1 to 1.5 year. Women's pensions will be slightly improved by including maternity leave benefits in the reference wage for the pension calculation.

The convergence between the public sector pension scheme and the *régime général* will be enhanced. The 2010 reform plans an alignment on contribution levels over the next 10 years (currently 7.85% for public sector and 10.55% for private sector).

Still, this country fiche does not reflect the potential impact of this pension reform. In particular, all the prospective indicators presented do not reflect the potential impact of this reform on financial sustainability and adequacy of pensions, since they reflect the legislation that was standing before the 2010 reform.

Current performance

The French pension system is currently successful in ensuring that retirees maintain their living standards after retirement. The at-risk-of-poverty rate for people aged 65 and more has declined since 2005 and in 2008 was markedly lower than the EU average (11% vs. 19%) and somewhat lower than for French population 0-64 (14%). The equivalised disposable income of the older population relative to that of the population aged 0-64 reached 96% in 2008, 12 percentage points more than the average for the EU-27. For 2008, the net and gross replacement rates for a theoretical worker retiring at 65 after a 40 years contribution career at the average wage came to 77.9% and 64.3%, respectively.

Although the employment rate of workers aged 55-64 has progressed in the last decade and reached 38.9% in 2009, it is still lower than the EU-27 average of 46%. The employment rate is particularly low after age 60. In 2009, while the employment rate of workers aged 55-59 is close to the European average, the one of workers aged 60-64 is only 17% compared to 30.4% in the EU-27. The average exit age from the labour force at 59.3 in 2008 is one of the lowest in the EU. Given the fact that France has the highest remaining life expectancy at 65 in the EU (unweighted average for both genders), people spend a relatively longer time in retirement than the European average.

According to Eurostat³⁵ France had the third highest current pension expenditure in the EU-27 in 2006 (with 13.2% of GDP) and 2007 (13.3%), while projected trends are significantly lower than in the EU-27.

Impact of the crisis

The crisis had several effects on the French pension system. Firstly, the crisis, through lower growth and higher unemployment, affected the receipts of the French pension system made up with contributions based on wages. Secondly, the assets of the reserve funds were affected by the drop in asset values (and partly recouped during 2009/10). However, as the French pension system is based to a very large extent on the PAYG mode of financing, pensions were largely spared by the financial crisis and could act as an automatic stabilizer. All in all, the economic crisis has left deeper financial issues for the French pension system. The last COR (*Conseil d'Orientation des Retraites*) report, published in April 2010, projects a 30 billion € deficit in 2010, growing to 70 billion € in 2030 and a 100 billion € in 2050. The borrowing needs for the pension system would reach between 1.7% and 2.1% of GDP in 2020 and 2.7-3% in 2050.

Because of the crisis, the level of deficits formerly projected for 2040 in the 2007 COR report is now supposed to be reached in 2025 in volumes or 2015 in percentage of GDP. This is consistent with estimates from the 2009 Ageing Report which indicates that the crisis would increase pension expenditure by an additional 1.2 p.p of GDP in the 'lost decade' scenario³⁶ also in the long-term unless corrective action is taken.

Outlook³⁷

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is projected to decrease in France from 77.9% in 2008 to 61.0% in 2048. This decrease in NRR can be partly explained by the fact that, while the current situation of adequacy is relatively favourable:

- in the basic pension scheme (CNAV) the past wages are valorised like the price index and the insurance period required to receive a full benefit will gradually increase;
- in the supplementary scheme (ARRCO/AGIRC) the acquisition cost of a pension point is projected to increase with wages, while the take up points would be increasing with prices.

³⁵ ESPROSS

³⁶ See Table 76 in the 2009 Ageing Report p. 239.

³⁷ This section does not reflect the potential impact of the pension reform that was being debated in France at the time this report was prepared. In particular, all the prospective indicators presented do not reflect the potential impact of this reform on financial sustainability and adequacy of pensions, since they reflect the legislation that was standing before the 2010 reform.

The negative effect of 3 years of unemployment which came to 6.1% of the NRR in 2008 would have increased by 2048 (9.4 %). In the same period the negative effect of a 3 years childcare break would be reduced from 3.5% to 2.7%. The effect of a 10 years career break on the NRR would be maintained. The relative bonus/malus effect of retiring 2 years after or before age 65, which is currently skewed towards a stronger malus would become symmetrical. The NRR for low earners would be reduced from 78% to 61% while the NRR for high earners would drop from 55% to 37%. The decrease in the NRR 10 years after retirement, which in 2008 amounts to 16.8%, would be maintained.

The benefit ratio, which is the ratio between the average benefit of public pension and the economy-wide average wage, is also projected to drop from 63% in 2007 to 48% in 2060.

National data confirm a drop in the future adequacy of pensions. Since 2000, reports of COR have fed public debate and have paved the way for the recent reforms. According to the COR latest report, if one chooses the year 2008 as a reference point (base 100), the ratio between the average net pension and the average net wage will decline by 3-6% by 2020 (under a no policy change scenario) . By 2050, the purchasing power of pensions relative to wages might have declined by 15-23%, assuming that the supplementary pension take up point values remain indexed on wages, while acquisition values would be indexed on wages. If this rate-of-return diminishes (take-up point values indexed on prices), the ratio might even decline by 20-29%.

Challenges³⁸

With the 2003 reform, France has made significant progress in its efforts to improve and maintain the equilibrium of pension provisions. While currently the French pension system performs relatively well on adequacy indicators and is only moderately problematic on sustainability measurements, this position will on present trends be markedly eroded over the next 50 years.

The challenge France faces with regard to ensuring the long-term sustainability of public finances at the back of its ageing population was assessed to be at '*medium*' risk by the Commission/Council³⁹. The projected increase in pension expenditure over the long-term at 1% of GDP is significantly lower than the EU average, but the level in 2009 is already relatively high. And it is notably achieved through a significant decline of the benefit ratio over the long-term.

The sustainability of the French pension system is sensitive to the economic dependency ratio. The main reason for the declining dependency ratio is the combination of relatively low exit ages and relatively high remaining life expectancy at pensionable age. Achieving and maintaining a far better balance between years in work and years in retirement as planned in the 2010 reform would be key in ensuring both sustainability and adequacy.

The efforts made in collaboration with the social partners to raise employment rates and exit ages of older workers should therefore be closely monitored in the next years. As many steps

³⁸ This section does not reflect the potential impact of the pension reform that was being debated at the time this report was prepared.

³⁹ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

have been taken since the 2006 “*Plan national d’action concerté pour l’emploi des seniors*”, a regular and demanding follow-up of these reforms has to be organised in order to further improve older workers labour market participation. Finally, with the hardening of pension eligibility rules, a rise in the number of retirements for health reasons may occur, as experienced in other countries. These figures should be monitored so as to better understand old workers motivations and needs in the years to come.

Attention should also be drawn at the fulfilment of the contribution period requirement, as younger cohorts may have difficulties to reach full contributory records. The pension system still needs to adapt to the structural increase in the age of exit from the education system and the concentration of long-term unemployment on this group.

General reliance on PAYG financing insulated French pensions from the immediate impact of the financial crisis. Yet, with decreasing replacement rates in public provision and strained public finances, France puts the emphasis on a rise in exit ages and of the employment of older workers, in order to ensure sustainability and adequacy, which will strongly rely on the efficiency of measures taken to expand opportunities for workers to expend their working lives.

With crisis-inflicted weakening of public finances, budgetary consolidation would contribute to the reduction of public debt and can contribute to financing the future increase in public pension expenditure. The budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability of public finances. Ensuring primary surpluses over the medium term would contribute to reducing the risks to the sustainability of public finances.

Background statistics

	France			EU-27		
Current adequacy (2008)⁴⁰	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	14	13	14	16	16	17
At-risk-of-poverty rate 65+	11	10	12	19	16	22
At-risk-of-poverty rate 75+	12	10	13	22	18	24
Income inequality 0-64	4.3			5.1		
Income inequality 65+	3.8			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.96	1.02	0.92	0.85	0.88	0.83
Adequacy projections: FR	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	77.9	61.0	-16.9	64.3	49.3	-15.0
TRR 3 years unemployment	73.2	55.3	-17.9	60.4	43.8	-16.6
TRR 3 years childcare break	75.2	60.5	-14.7	61.8	48.8	-13.0
TRR 10 years career break	57.7	44.7	-13.0	45.8	35.2	-10.6
TRR shorter working (retirement at 63)	61.5	54.3	-7.2	50.7	43	-7.7
TRR longer working (retirement at 67)	89.3	66.8	-22.5	74.4	54.4	-20.0
TRR 10 years after retirement	64.8	50.7	-14.1	53.5	41	-12.5
TRR low earner (66% average)	78.4	61	-17.4	66.6	49.3	-17.3
TRR high earner (100-200% rising profile)	55.4	37.1	-18.3	42.0	27.4	-14.6
Benefit ratios: social security pensions 2007/2060				63.3*	47.50	
	France			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	12.9	13.2**	13.3*		12.0**	11.8*
Employment rate 15-64	61.7	64.9	64.2	62.2	65.9	64.6
Employment rate 55-64	29.4	38.2	38.9	36.9	45.6	46.0
Employment rate 55-64 women	26.1	36.0	36.6	27.4	36.8	37.8
Employment rate 55-64 men	32.9	40.5	41.4	47.1	55.0	54.8
Effective labour market exit age***	58.1	59.4	59.3	59.9	61.2	61.4
Public debt	57.3	67.5	77.6	61.9	61.6	73.6
Budget balance	-1.5	-3.3	-7.5	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	25	39	45	25	38	53
Public pension expenditure, % of GDP ⁴¹	13	14.2	14	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	8.4			8.7		
Employment	-0.5			-0.7		
Eligibility	-2.2			-2.6		

⁴⁰ For a complete set of pension indicators, please refer to:

http://epp.eurostat.ec.europa.eu/portal/page/portal/employment_and_social_policy_indicators/omc_social_inclusion_and_social_protection/pension_strand

⁴¹ See Table 76 in the 2009 Ageing report for estimates of public pension expenditure over the long-term incorporating the impact of the crisis.

Level of benefits	-4	-2,5
Total (including residual)	1	2,4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Ireland

Description

The pension system in Ireland comprises two main elements. The first is the state-run social welfare system and the second comprises voluntary supplementary pensions provided through a variety of arrangements and regulated by the state.

The state-run system provides pension payment on a contributory or on a means tested basis. The contributory scheme is based on contributions made by individuals/employers to the social insurance fund. A person's entitlement under this scheme is based on a certain level of social insurance contributions made over a person's working life. The means based element is based on an assessment of a person's means and is financed through taxation.

Those who are unable to contribute because of unemployment or illness are, subject to conditions, credited with contributions, while arrangements are also in place to protect the pension entitlements of those who spend time out of the workforce on caring duties.

Supplements are payable for dependants, for those living alone and to pensioners over 80. The state pension is intended to provide an adequate basic standard of living only. The pension payments are not indexed according to an established rule but are adjusted each year in line with targets set by the government and take account of budgetary considerations.

The contributory pension currently pays an amount equivalent to approximately 32% of gross average earnings. The means-tested pension pays slightly less. Payments have increased significantly in recent years. At the same time, the share of those claiming means-tested pension payments has fallen from 45% to 30% in the period 1994 to 2004 and is projected to fall to 14% in 2017. The overall target is an income in retirement of 50% of gross pre-retirement income, including income from other sources (first pillar pension, income from a supplementary pension, investments and other income).

The second element takes the form of supplementary pensions sponsored by the employer or personal pensions such as retirement annuity contracts (RACs) or Personal Retirement Savings Accounts (PRSAs)⁴². The State facilitates and encourages second and third-pillar pensions through measures such as favourable tax treatment of contributions. At the beginning of the decade 33% of pensioners had an occupational or personal pension which contributed to about 25% of post retirement income. Numbers are likely to grow in the years ahead due to the higher proportion of people in work participating in pension schemes. Overall supplementary pension coverage in 2008 was at 54% of the workforce.

The third element is public service pension schemes. They cover up to 300,000 staff and about 90,000 pensioners. They are mainly statutory schemes. The vast majority of public service schemes are financed on a Pay As You Go (PAYG) basis.

Approximately 69% of members of occupational pension schemes are in defined-benefit (DB) type with the remainder in defined-contribution schemes. Ireland has not seen the same level of shift from defined-benefit to defined-contribution pension provision as has been seen

⁴² Personal pensions are not income related but depend on contributions and fund performance.

elsewhere, though the trend is still very apparent in the Irish system with most new schemes operating on a defined-contribution basis.

In March 2010 the Irish government published the National Pensions Framework which sets out the Government's intentions for reform of the pension system in Ireland. The framework is based around many of the issues raised in the 2007 Green Paper on Pensions. The main provisions are:

- mandatory social welfare pension provision will continue and the government will seek to maintain the level of the state pension at 35% of average weekly earnings, to increase the age when the state pension can be received to 66 in 2014, 67 in 2021, and 68 in 2028, and to allow for the postponement of the receipt of the state pension beyond these years,
- to adopt a more progressive pension tax relief of 33% with lower earners receiving more tax credits than they have to date with higher earners receiving less, although many will have more choice in how they draw down their pension,
- to introduce mandatory pension provision for employees (auto-enrolment with a possibility to opt-out) not already in an occupational pension together with mandatory employer contributions from those employers not already providing an employee pension scheme. a new single public service pension scheme will be introduced for new entrants into public service in 2010. The main provisions of this scheme will include a new minimum retirement age of 66 years which will be linked henceforth to the State pension age, a maximum retirement age of 70 and a pension based on career average' earnings.
- to strengthen the regulatory regime for DB schemes. These measures will include consideration of providing the pensions regulator with further statutory authority in relation to the investment approach adopted by the trustees of pension schemes.

Current performance

The level of expenditure on pensions in 2007, at 5.2% of GDP, is below the EU average 11.8%⁴³. The at-risk-of-poverty rate of people aged 65 in 2008 is slightly higher than the EU average (21% vs. 19%) but declined considerably between 2007 and 2008. The relative median income of people above 65 years has also improved dramatically since 2005.

By 2008, the occupational and private pension coverage was at 61% of those in employment, up just two percentage points since 2002. Men have higher coverage than women, though the gap has closed in recent years, and employees have higher coverage than the self-employed. A relevant share of pensioners will, therefore, continue to rely mainly on the statutory state pension. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (76%) is relatively high compared to the EU average. The net rate amounts to 84%.

The employment rate of people between 55 and 64 years old had been increasing prior to the crisis and while dropping to 51% in 2009 was still above the EU-27 average of 46%. The employment rate of men has declined significantly since 2006, while the employment rate of women showed a positive trend until 2007 and has subsequently declined too. The average exit age from the labour market was at 64.1 in 2006, higher than the EU-27 average.

⁴³

ESSPROS.

Impact of the crisis

The first effect the financial crisis caused was the shock to stock markets. Pension funds lost on average 35%. Among those who have been exposed most are pensioners and those coming up to retirement, who are or will be dependent on private pensions and had little protection against a sudden decline in stock prices. Among those most affected are people in defined contribution plans.

Ireland was very seriously affected by the financial and subsequent economic crisis with two consecutive years of negative growth in 2008-09 resulting in a cumulative decline in real GDP of close to 10% and only emerged from recession in Q1 2010. The budget deterioration in Ireland has been especially large.

The labour market was also hit hard. In 2009, the employment rate of people aged 15-64 reached 61.8%, down by 5.8 pp. compared to 2008 (EU: down by 1.3 pp to 64.1%). The male employment rate fell by 8.6 pps. to 66.3%, a considerably stronger decline than the 2.8 pp. decline to 57.4% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of males aged 55-64 fell strongly too by 5.2 pp. to 60.9% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of women in the same age group remained almost unchanged, down by 0.1 pp. to 41% (EU: up by 1 pp to 37.8%). Part-time employment has increased recently (from 18% in 2007 to 21.2% in 2009) and the rate was above the EU average for men and women at 10.5% and 33.8% respectively in 2009. The unemployment rate more than doubled between 2008 and 2010 to 13.8% and is expected only to decline slightly in 2011. The government budget registered a deficit of 7.3% of GDP in 2008 and rose to 14.3% in 2009.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.9 p.p of GDP in the 'lost decade' scenario⁴⁴) also in the long-term unless corrective action is taken.

Outlook⁴⁵

Developments in the old-age dependency ratio (population aged 65 and more to population 15-64) in Ireland will be similar to the EU average (IE: 16% in 2007, 44% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to rise by 32%, compared with a drop of 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in Ireland over the long-term, especially for women and older workers, and more than in the EU27. The participation rate was above the EU average in 2007 (72.5% in 2007, EU: 70.6%), and is projected to remain so also in 2060 (IE: 76.3%, EU: 74.1%).

Ireland is expected to experience a significant increase in public pension expenditure in the coming years, with expenditure as a percentage of GDP forecast to rise by 4.6 percentage points over the period 2007-2060 (EU: +2.4 pp). Expenditure is expected to rise to 8.6% of GDP by 2060; almost 4 percentage points below the EU average.

⁴⁴ See Table 76 in the 2009 Ageing Report p. 239.

⁴⁵ All calculations presented in the fiche are based on the pension framework as of 2008 (provisions of the Green Paper on pensions have not yet been taken into account).

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure significantly in Ireland, by 5.9 percentage points of GDP (compared to 8.7 for the EU as a whole). The coverage ratio is projected to fall less in Ireland than in the EU as a whole (by 40 percent, compared with 30 for the EU). Hence the coverage effect has a relatively smaller effect in moderating expenditure in Ireland relative to the EU27 average. Unlike in the majority of Member States, the benefit ratio, which compares the value of an average public pension benefit to an average wage, is projected to increase from 27.3% (public pensions) in 2007 to 53%(public and private pensions) in 2060. As a consequence of the increasing relative level of public pension benefits, expenditure will increase by 0.7 pp of GDP between 2007 and 2060.

The Indicator Sub-Group of the SPC has calculated theoretical replacement rates for a worker in the private sector retiring at 65 with 40 years service and 40 years service in a DC occupational scheme with a 10 per cent contribution rate (5% employee/5% employer). Both net and gross theoretical replacement rates are expected to fall substantially between the base year 2008 and 2048 by approximately 20 percentage points. The main driver behind this decline is improved life expectancy that feeds into higher annuity costs in the occupational pension component over time. This implies that on average pensioners will experience a relative deterioration in living standards vis-à-vis workers in the future unless they prolong their working lives. The negative effect of 3 years of unemployment which came to 7.14% of the NRR in 2008 will have declined substantially by 2048 (2.50%). In the same period the negative effect of a 3 year childcare break would be reduced from 3.75% to 2.5%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, would be largely maintained over the period for the bonus. However, the malus will become significantly smaller. The NRR for low earners would be reduced from 99% to 83.7% while the NRR for high earners would drop from 62% to 47.9%. The effect of a 10 year career break on the NRR would increase from a loss of about 5.95% to a loss of 7.89%.

Challenges

Occupational pension schemes in Ireland are underpinned by the State pension scheme. While from the point of view of beneficiaries the State element of pension provision was not impacted by the crisis, the supplementary element experienced significant funding losses. In response to these losses, the requirement by members of DC pension schemes to buy an annuity on retirement was temporarily lifted thereby allowing a person to determine the most appropriate time to purchase an annuity. In relation to DB pension schemes, a range of administrative measures were introduced to ease the funding pressures on schemes. In addition legislation was introduced to facilitate a broader review of the ‘pension promise’ to ensure that a scheme was structured in a manner which would allow the scheme to deliver on a revised ‘pension promise’. Despite these measures and while many trustees/employers are currently reviewing the structure of their scheme, the funding of DB schemes remains a serious concern. The measures outlined in the national pensions framework to keep the funding standard under review, to strengthen the role of the pensions regulator and the suggested model for the structure of a DB scheme are welcome initiatives. However, the task of bringing pensions back to a healthy state after crisis setbacks presents Ireland with a sizable challenge.

Ireland faces a significant challenge in ensuring the long-term sustainability of the public finances in light of its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.⁴⁶ The projected increase in pension expenditure over the long-term is significantly higher in Ireland compared with the EU average, even if it starts to rise from a relatively low level. Implementing further reforms to the pension system by containing the high projected increase in pension spending or adjusting its financing would contribute to put it on a more sustainable path.

Taking measures to increase participation rates further, even if already above the EU average for older workers, would provide an important contribution to both sustainability and the adequacy of provisions. An appropriate balance between working years and years in retirement needs to be found and maintained. Linking changes in the parameters of pension to future increases in life expectancy would contribute to this. The recent decision by the Irish government to increase the State pension age is a step in this direction, as is the proposal to allow people to defer their pension past pensionable age and to make up contribution shortfalls. Underpinning pension reforms with labour market and work places measures to enable and encourage people to work longer would also be necessary.

Ensuring higher enrolment in occupational and private pensions is one of the crucial challenges for the Irish pension system as rates have risen only slightly in recent years and are still some way from the overall target of 70% coverage. While some progress was made in increasing coverage for women, younger people and those employed in certain sectors remain a key challenge. The auto-enrolment system for employees who do not already have access to an occupational scheme which the Government plans to introduce in 2014 is expected to achieve the overall pension coverage targets

An important issue is to ensure quality of protection of pension entitlements in the case of insolvency of sponsoring employer. Though poverty problems for pensioners have been reduced challenges in this area to be addressed remain. Moreover, the future adequacy of pensions for low-wage earners and people with broken careers needs to be closely monitored.

In addition to the impact on funded schemes the crisis also affected the foundation for public pensions through its impact on public finances. Gross debt, which soared during the crisis from a previously low level, is now already above the Treaty reference value and the budget position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the risks to the sustainability of public finances.

⁴⁶ See the assessments of the latest 2009/10 round of stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

	Ireland			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	15	14	15	16	16	17
At-risk-of-poverty rate 65+	21	19	23	19	16	22
At-risk-of-poverty rate 75+	24	17	28	22	18	24
Income inequality 0-64	4.5			5.1		
Income inequality 65+	3.8			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.73	0.74	0.72	0.85	0.88	0.83
Adequacy projections: IE	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	84	69.3	-14.7	76	60.6	-15.4
TRR 3 years unemployment	78	69.3	-8.7	70	60.6	-9.4
TRR 3 years childcare break	81	67.6	-13.4	73	58.2	-14.8
TRR 10 years career break	74	62.9	-11.1	66	52.7	-13.3
TRR shorter working (retirement at 63)	81	68.1	-12.9	74	59	-15.0
TRR longer working (retirement at 67)	86	71.2	-14.8	79	63.4	-15.6
TRR 10 years after retirement	79	66.4	-12.6	70	56.5	-13.5
TRR low earner (66% average)	99	83.7	-15.3	94	77.2	-16.8
TRR high earner (100-200% rising profile)	62	47.9	-14.1	48.0	37.5	-10.5
Benefit ratios: social security pensions 2007/2060				27.3*	31.60	
	Ireland			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	3.6	5.0**	5.2*		12.0**	11.8*
Employment rate 15-64	64.5	67.6	61.8	62.2	65.9	64.6
Employment rate 55-64	45.1	53.7	51.0	36.9	45.6	46.0
Employment rate 55-64 women	27.1	41.1	41.0	27.4	36.8	37.8
Employment rate 55-64 men	62.9	66.1	60.9	47.1	55.0	54.8
Effective labour market exit age***	63.2	:	:	59.9	61.2	61.4
Public debt	37.8	43.9	64.0	61.9	61.6	73.6
Budget balance	4.8	-7.3	-14.3	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	16	25	44	25	38	53
Public pension expenditure, % of GDP	4	5.4	8.6	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	5.9			8.7		
Employment	-0.2			-0.7		
Eligibility	-1.5			-2.6		
Level of benefits	0.7			-2.5		
Total (including residual)	4.6			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Italy

Description

The statutory pension schemes, including old age, invalidity and survivors' pensions cover 100% of the registered employed population in Italy. The pension contributions amount to 33% of employees' gross remuneration (9.2% paid by the employee and 23.8% paid by the employer). The self-employed and workers with atypical contracts (*parasubordinati*) pay, respectively, 20% and 26%.

Pension reforms started in the 90s to progressively unify basic rules of a previously fragmented statutory pension system. The 1995 reform introduced a Notional Defined Contribution (NDC) system. This will fully apply to individuals entering the labour market from 1996 onwards, while people with at least 18 years of contributions in 1995 will continue to be subject to the previous (earnings related) system and people in between will see their pension calculated by a mix of the old and the new formula. As a result, people are currently retiring under the mixed regime. Only workers with long contribution records (at least 35 years) will maintain the more generous earnings-related regime until 2013- 2015. As from that date, the NDC method will have a large and increasing weight to determine the amount of benefits and will be fully phased in from 2033-35 onwards⁴⁷.

Under the NDC system benefits are calculated on the basis of the amount of contributions paid throughout the entire career, capitalised at the average growth rate of GDP over the previous five years. Such notional capital is multiplied by age-of-retirement-specific transformation coefficients (similar to the annuity rates in private schemes) to obtain the final pension settlement. In order to keep the pension system actuarially fair, transformation coefficients are subject to a three-year update, according to changes in life expectancy at the age of retirement (Laws no. 335/95 and no. 127/2007).

Along with changes in the calculation rules, several other reforms have been adopted over the last years to increase the eligibility requirements (age and contributions) to be entitled to old age pensions (Laws no. 503/92 and no. 102/2009) and early pensions (Laws no. 335/95, no. 449/97 and no. 243/2004 as modified by Law no. 247/2007). The latest reform, enacted in July 2010 (Law 122/2010), has strengthened the “exit window” mechanism⁴⁸, equalized the statutory retirement age of women and men in the public sector and introduced an automatic mechanism for adjusting the minimum age requirements to changes in life expectancy.

As a result of the reforming process, the statutory retirement age is 65 for men and women in the public sector, and 60 for women in the private sector. Early retirement is allowed on the basis of either 40 years of contributions, regardless of age, or 35 years of contributions together with an age requirement gradually increasing through time from 60 (61 for the self-employed) in 2010 to 62 (63 for the self-employed) in 2013⁴⁹. The age requirements are actually higher by 1 year (1 year and half for the self-employed) because of the further

⁴⁷ At the beginning of this period, more than half of the pension benefits will already be calculated with the NDC method.

⁴⁸ Such a mechanism postpones access to pension entitlements as it delays the actual payment of pension benefits once minimum age and/or contribution requirements are met.

⁴⁹ Workers are allowed to access early retirement one year earlier, provided that they record at least 36 years of contributions.

postponement envisaged by the “exit window” mechanism⁵⁰. Starting from 2015, the adjustment of the pensionable age requirements to changes in life expectancy, which applies to early/old age pensions and old age allowances (*assegno sociale*), will produce further increases in the retirement age of about 4 months every three years. Over the period up to 2050, the cumulative increase will account for about 3.5 years.

Pension reforms have also improved the minimum income guaranteed to elderly people (safety net) providing social assistance lump sums in addition to the old age allowance and the minimum contributory pension⁵¹ (Laws no. 448/2001 and no. 127/2007). In 2010 social assistance is such that it guarantees to people aged 70 and over an annual income of at least €7,760 for a single person and €13,120 for couples (including the spouse's income). These grants are slightly reduced for people in the age bracket 65-69.

Occupational schemes are represented by supplementary, voluntary funded pensions. The reformed system (created in 1993) is based on three options: closed (negotiated) funds regulated by collective agreements; open funds managed by financial intermediaries that can be joined by workers individually or in groups; and pension insurance policies. Despite legislative intervention, the number of workers enrolled in private pension funds remained low. For this reason, the 2004 pension reform and Law No 296/2006 introduced further measures to boost the second pillar in two ways, by providing higher fiscal incentives and by automatically transferring the TFR (*Trattamento di Fine Rapporto*) ‘end-of-service allowance’ (a portion of the worker’s pay set aside by the employer and then paid as a lump sum at the end of employment) to occupational pension schemes (except in the case the employee refuses it, according to the so called ‘silent-assent’ mechanism). The new rules were phased in 2007; as a result, during that year the total membership of private pension funds increased by about 1.5 million workers, thereby reaching a total of 4,56 million members. The increase was below expectations and subsequent developments in the two-year period 2008-2009 (another half a million increase) show that the Italian context is still not so favourable to the development of second pillar pensions. Anyway, in 2009, the participation rate in supplementary schemes (both open and closed) was around 22% of the employed population, with a growth of 4.7% in comparison of 2008. Such a trend keeps going, notwithstanding the persistent effects of the crisis on the labour market: thus, over the first six months of 2010, the number of workers enrolled in private pensions funds increased further by 120 thousand, reaching the overall amount of 5,2 million.

Current performance

The relative median income of people aged above 65 in relation to the age group 0-64 amounted to 88% in 2008, higher than in 2005 (85%) and than in the EU27 (84%). The rate of poverty risk of population 65+ (18%) has remained stable since 2005, but it is still 2 percentage points higher than the EU average. The gross theoretical replacement rate in 2008 (79.6%) is high, and the net rate is even higher (88.3%).

⁵⁰ This actually means that the minimum retirement age to be entitled to an old age pension is 66 for male employees and female workers in the public sector, 61 for female employees in the private sector, 61.5 for female self-employed workers and 66.5 for male self-employed workers. In the case of early pensions with 35 years of contributions, the minimum requirement age is 63 for employees and 64.5 for the self-employed.

⁵¹ The latter is available only under the earnings-related and mixed regimes and is subject to the fulfilment of the age and contribution requirements to be entitled to a pension.

Italy spent about 14% of its GDP on pensions, an amount that was stabilised over the period 2003-2007, before the economic crisis in 2008-2009, when GDP fell sharply, causing an increase in the pension expenditure to GDP ratio.

The employment rate of older workers (55-64) remains low (35.7% in 2009, compared to the EU average of 46%). Furthermore, the employment rates for older women, at 25.4%, are among the lowest in the EU. The effective retirement age in Italy, 60.8 years, remains below the EU average (61.4). As long as the old rules apply, disincentives to continue to work are fairly strong. The gradual increase of minimum eligibility requirements for public pensions coupled with new incentive mechanisms (introduced in 2004) are a concerted attempt to encourage work for this particular cohort.

The large numbers of undeclared jobs — many of them held by pensioners — remain an issue. To tackle this, the possibility of cumulating work and pension income without any reduction in the amount of pension benefit was extended since first January 2009 (law 133/2008) for all contributory pensions.

Impact of the crisis

Because it is currently based to a very large extent on the PAYG mode of financing, the Italian pension system had been relatively spared by the financial crisis. The crisis may have, however, diminished the public confidence in private funded schemes, undermining the government's efforts to boost second pillar pensions.

The subsequent economic crisis caused a decline- in GDP of 1.3% in 2008 and 5% in 2009. Unemployment rates raised from 6.7% in 2008 to 7.8% in 2009 and 8,5% in 2010 (European Commission spring forecast). Compared to 2007 the employment rate of population aged 15-64 remained at 58.7% in 2008 and declined to 57.5% in 2009 (the decline was 0.8 p.p. for women and 1.6 p.p. for men). On the contrary the employment rate of older workers (55-64) continued an increasing trend: 33.8% in 2007, 34.4% in 2008 and 35.7% 2009 (increasing trend both for women and men).

Estimates in the 2009 Ageing Report reveal that the crisis would increase public pension expenditure to GDP ratio further (by an additional 0.3 p.p in the 'lost decade'⁵²) in the long-term until 2060. This increase is lower than the EU average.

Among the measures recently adopted by the Italian government to reduce the public deficit (Decree law no. 78/2010, converted with amendments by law no. 122/2010), the pensionable age has been permanently increased both for the old-age and early retirement schemes. Starting from 2011, once pension requirements are met, the actual payment of pension benefits is deferred by 12 months for employees and 18 months for the self-employed. Furthermore, the statutory retirement age of women in the public sector has been equalized to that of men already in 2012.

Outlook

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is projected to grow slightly from 88.3% in 2008 to 89.80% in 2048. NRR are

⁵² See Table 76 in the 2009 Ageing Report p. 239.

significantly higher than total gross replacement rates (GRR), which are set to decline from 79.6% in 2008 to 74.9% in 2048 (66 percentage points coming from the statutory pensions and the rest from occupational schemes). This is due to considerable ageing of the population and the drop of the public pension replacement rates, following the gradual application of the new NDC public pension scheme and the actuarial correction of the pension system parameters prescribed every three years by the pension law. As a result of this decline in replacement rates in the statutory scheme, future adequacy of pensions will depend, in addition to longer working lives, on the development of the supplementary social security entitlements. The diversion of the TFR towards private pension funds is expected to complement public pension gross replacement rates by 9 p.p. by 2048.

The negative effect of 3 years of unemployment which came to 4.5% of the NRR in 2008 will remain the same in 2048. In the same period the negative effect of a 3 year childcare break would also remain stable around 2.6% lower NRR than a female without children. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, which is symmetrical in 2008 (around 4.5% higher/lower NRR than retiring at 65), would not be maintained over the period, as early retirement in 2048 would be penalised with 8.7% lower NRR and late retirement rewarded with 5% higher NRR. The NRR for low earners would be slightly reduced from 99% of the average earner NRR today to 96,5% in the future, while the NRR for high earners would drop slightly from 82% to 79% of the NRR of the average earner. The effect of a 10 year career break on the NRR would remain over time at a 23% loss with respect to a full career. The decrease in the NRR 10 years after retirement with respect to the year of retirement, which in Italy amounts to 13.5%, would also remain stable over time. This identifies that the different "variant cases" have similar developments over time and the Italian pension system preserves evenly their relative positions.

Italy is expected to face strong adverse demographic trends in coming decades, due in particular to one of the lowest fertility rates in EU and very high life expectancy (84.3 years for men and 89 years for women by 2050). The demographic changes will lead to a sharp rise in the old-age dependency ratio (population aged 65 and over as a percentage of the population aged 15-64), which is already now the highest in the EU. Between 2008 and 2060 it is expected to increase from 30% (EU27 average: 25%) to 59% (EU27 average: 53%).

Despite the particularly strong pressure of the ageing population, Italy will experience a trend of considerably slower pension expenditure growth than that of the EU average. According to the budgetary projections made by the AWG in 2009, public expenditure on social security pensions will increase slightly from 14.0% in 2007 to up to 15.6% in 2040, falling back to 13.6% in 2060. This result stems from the pension reforms undertaken between 1992 and 2008, embodied in the 2009-AWG projections. The latest pension reform (Law no. 122/2010), foreseeing increases in the retirement age, aims at achieving further improvements of both financial sustainability and adequacy in the mid-long term.

Challenges

Pension reforms over the last decades in Italy have managed to stabilise pension expenditure and this is projected to be so over the mid and long-term, despite the demographic pressures, and in particular owing to the gradual maturation of the NDC pension scheme introduced in 1995. The 1995-reform created strong links between contributions and benefits, thus providing important incentives to work longer, both for new entrants to the labour market and for those who still have the right to retire early under the old rules. But pension reforms have

not been sufficiently underpinned by labour market and work places measures to enable and encourage people to enter the labour market early and work longer.

The projected decrease in pension expenditure over the long-term at 0.4% of GDP contrasts with the average projected increase in the EU, though starting from the highest level of pension expenditure in the EU (around 14% of GDP compared to 10% of GDP for the EU27 average). Thus, the challenge Italy faces with regard to ensuring the long-term sustainability of the public finances because of its ageing population, its current general government deficit and its very high debt, was assessed as of '*medium*' risk by the Commission/Council⁵³.

Total NRRs, currently relatively high compared with the EU average, are projected to remain broadly constant over the long-term and this is also the case for most "variant cases". However, recent reforms are projected to result in a decline of gross replacement rates already for a 40-year career. Given that in the past years most careers in Italy have been substantially shorter, ensuring adequate pensions for future pensioners still represents a challenge, in particular given the late entry in the labour market by the young workers, the rise in atypical work and the limited take up of private schemes. The issue of pension rights for workers with atypical contracts would have to be addressed in measures to secure the continued adequacy of the NDC scheme.

The significant decline in public pension replacement rates is due to the gradual shift from the previous earnings-related method to the actuarially fairer NDC one. However, the projected decline in replacement rates will be contained by the future increases in retirement age, linked to life expectancy changes. Notwithstanding, a significant contribution to the future adequacy of pensions will also come from the development of the supplementary social security entitlements, e.g. through the mechanism of automatic transfer of the TFR to occupational pension-schemes.

Taking measures to increase participation and employment rates, notably for young people, women and older workers, and to extend working life at both ends, remains crucial for meeting future sustainability and adequacy challenges. As from 2015, the automatic adjustment mechanism of the retirement age to changes in life expectancy will enhance the stability of the pension system. But it will also be useful to underpin such mechanisms with further labour market policies and work place initiatives that effectively allow and inspire older workers remain longer in employment. Furthermore, in compliance with a European Court of Justice ruling, Italy increased the pensionable age of public sector female workers from 60 to 65, equalising it to that of male workers as from 1 January 2012. Along this line, a measure sometimes suggested would be the extension of this to the private sector, which would also help to increase employment rates of women.

The main crisis impact on the Italian pension system concerns the weakening of public finances mainly as an effect of the economic recession, provided that, in structural terms, the public budget deficit has only increased slightly. The current level of gross debt is well above the Treaty reference value and the 2009 budgetary position compounds the long-term budgetary impact of an ageing population. Budgetary consolidation that reduces public debt is therefore essential to secure a better basis for financing future public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the medium risks to the sustainability of public finances.

⁵³ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

	Italy			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	18	17	19	16	16	17
At-risk-of-poverty rate 65+	21	17	24	19	16	22
At-risk-of-poverty rate 75+	22	17	25	22	18	24
Income inequality 0-64	5,3			5,1		
Income inequality 65+	4,4			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0,88	0,91	0,85	0,85	0,88	0,83
Adequacy projections: IT	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	88,3	89,8	1,5	79,6	74,9	-4,7
TRR 3 years unemployment	84,3	86	1,7	75,7	71,1	-4,6
TRR 3 years childcare break	76,1	68	-8,1	67,8	55,3	-12,5
TRR 10 years career break	67,9	69,1	1,2	60	56,2	-3,8
TRR shorter working (retirement at 63)	84,3	82	-2,3	75,7	67,2	-8,5
TRR longer working (retirement at 67)	92,5	94,2	1,7	83,6	79	-4,6
TRR 10 years after retirement	76,4	77,6	1,2	68,1	63,2	-4,9
TRR low earner (66% average)	88	86,7	-1,3	79,6	74,9	-4,7
TRR high earner (100-200% rising profile)	71,8	71,4	-0,4	61,4	56,7	-4,7
Benefit ratios: social security pensions 2007/2060				68,5*	47,30	
	Italy			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure					12,0**	11,8*
Employment rate 15-64	53,4	58,7	57,5	62,2	65,9	64,6
Employment rate 55-64	27,3	34,4	35,7	36,9	45,6	46,0
Employment rate 55-64 women	15,2	24,0	25,4	27,4	36,8	37,8
Employment rate 55-64 men	40,3	45,5	46,7	47,1	55,0	54,8
Effective labour market exit age***	59,8	60,4	60,8	59,9	61,2	61,4
Public debt	109,2	106,1	115,8	61,9	61,6	73,6
Budget balance	-0,8	-2,7	-5,3	0,6	-2,3	-6,8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	30	42	59	25	38	53
Public pension expenditure, % of GDP	14	14,8	13,6	10,1	11,4	12,5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	10,4			8,7		
Employment	-1,1			-0,7		
Eligibility	-3,2			-2,6		
Level of benefits	-5,5			-2,5		
Total (including residual)	-0,4			2,4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Cyprus

Description

The pension system in Cyprus relies significantly on public provision, with private provision playing a less significant role. The statutory *General Social Insurance Scheme (SIS)*, compulsory for every person employed or self-employed, consists of two parts: a basic part replacing 60% of the lower part of earnings and a supplementary part replacing earnings in excess of this limit at an accrual rate of 1.5%. The basic part is based on insured earnings before and after the 1980 reform whereas the supplementary part is based on earnings since October 1980. The weekly basic pension is equal to 60% of the average weekly insurable earnings (up to a certain ceiling). The supplementary pension is earnings-related. The financing of the basic part is on a pay-as-you-go basis. The financing of the supplementary part is on a partially funded basis, since currently the annual income from contributions is higher than the benefits expenditure.

The pension system has traditionally been financed by tripartite contributions. Following the pension reform in effect as of April 2009, the rate of contribution for the employed persons is 17.9%, where the employer pays 6.8%, the employee 6.8% and the State 4.3% of earnings up to a ceiling, which for 2009 was of €4004 per month. The contribution rate for the self-employed is 16.9% of which 4.3 percentage points are paid by the State. The SIS covers in addition to old age, invalidity pensions, widow's pensions, orphan's pensions and disability pensions as well as short term benefits (sickness, unemployment, maternity and work injuries). Basic pensions are indexed in line with earnings, whereas supplementary pensions are linked to the price index. People with insufficient insurance records under the SIS are entitled to a minimum pension. In this regard, there is a significant gender gap, as it is mostly women who receive the minimum pension.

The Social Pension Scheme, that is also part of the statutory pillar, guarantees an old-age pension to everyone over the age of 65 who is not entitled to a pension from the General Social Insurance Scheme or from any other source and fulfils residence eligibility conditions. The overwhelming majority of social pension beneficiaries are women, especially those with low participation rates in the labour market and non-remunerated family work in agriculture.

Under the General Social Insurance Scheme the pensionable age is 65. However, old-age pension can be paid at the age of 63, under specific contribution conditions. Incentives for postponing retirement translate into an increase in pension benefits (in particular, increase by 0.5 % for every postponed month from the date the beneficiary is entitled to a pension, up to a maximum at age 68).

Employees in the public sector enjoy supplementary mandatory pension schemes (that of the Government Employees Pension Scheme or the Semi-Government Employees Pension Schemes). The statutory retirement age is 63, but early retirement is allowed from the age of 55 (58 for government employees who joined the employer on or after 1 July, 2005) without any actuarial reduction of benefits. In practice, almost all government employees remain in active employment until the statutory retirement age. Participation of the employees in the financing of Government schemes is limited to a share in the cost of survivors' pensions, which is 11.2% of the total of all pensions.

A major proportion of the private sector's employees have supplementary coverage in the form of lump-sum payments under non-statutory provident funds established by collective agreements.

With the basic aim of restoring the long-term sustainability of the SIS, and consequently of the public finances, a pension reform of social security was introduced in March 2009. The reform focused mainly on the revenue side introducing gradual increases of contributions.

On the revenue side the reform includes gradual increases in contribution rates – seven increases by 1.3 percentage points every five years – first increase in April 2009 and last increase in January 2039.

On the expenditure side the reform primarily consisted of:

- ✓ Stricter eligibility conditions to old-age pension introduced gradually over the period until January 2012 - increase of the minimum contribution requirement to 10 years of paid contributions (pre-reform - the minimum requirement was 3 years); and
- ✓ Maximum limit of 6 years on credits granted to an insured person in the lower band for any period of full time education or approved training after the age of 16 (pre-reform - there was no maximum limit imposed), introduced as of January, 2010.

With the basic aim of tackling the poverty of old-age pensioners, in December 2009 the Scheme “Grants to pensioners’ households with low income” was introduced. That Scheme is a means-tested cash benefit scheme addressed to pensioners’ households whose total annual income is below the poverty threshold.

Current performance

The relative median income of people aged above 65 in relation to the age group 0-64 amounted to 59% in 2008, far lower than in the EU27 (84%). The rate of poverty risk of population 65+ (48.3%) has remained stable since 2005, and is far higher than the EU average. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (47%) is low compared to the EU average. The net rate amounts to 53%.

Pension expenditure in Cyprus is below the EU-27 average (CY: 6.8% of GDP vs. EU: 11.8% in 2007). The employment rate of older workers (55-64) remains relatively high (56% in 2009, compared to 46% EU average). The employment rate for older women (40.8%) is 30 percentage points lower than that of men (71.7%). The average exit age from the labour market in Cyprus at 63.5 years in 2008 was above the EU average (61.4).

Impact of the crisis

The overwhelming PAYG character of pension provisions meant that the financial crisis had a rather limited direct impact on provisions.

The Cypriot economy contracted by 1.7% in 2009 and the contraction still continues in 2010 (-0.4% in the first 6 months). Labour market was affected with unemployment increasing from 3.6% in 2008 to a forecasted 6.7% in 2010. Higher unemployment creates a risk of

reduced or interrupted pension accruals for the unemployed. Over 2009 the economic crisis began to erode the public budget position.

Nevertheless, the employment situation in Cyprus has held up better compared with the EU in spite of the crisis. In 2009, the employment rate of people aged 15-64 reached 69.9%, down by 1 percentage point (pp) compared to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 1.6 pp to 77.6%, a stronger decline than the 0.4 pp decline to 62.5% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) rose by 0.8 pp to 71.7% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of older women managed to grow by 1.4 pp to 40.8% (EU: up by 1 pp to 37.8%), even during the crisis. Unemployment is expected to reach about 7% in 2011.

In December 2009, as mentioned above, the Scheme “Grants to pensioners’ households with low income” was implemented, as a means of addressing the steadily high poverty rates among elderly people.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 1.7 p.p of GDP in the 'lost decade' scenario⁵⁴) also in the long-term unless corrective action is taken.

Outlook

Developments in the old-age dependency ratio (comparing the number of people aged 65 and more to the number of people 15-64) over the next 50 years will be markedly below the EU average (CY: 18% in 2007, 44% in 2060, EU: 25% in 2007, 53% in 2060). Cyprus would benefit significantly from migration inflows and growth in the working-age population (15-64) which is projected to rise by 43%, compared with a drop of 15% for the EU as a whole by 2060.⁵⁵

Labour market participation rates are projected to increase in Cyprus over the long-term, especially for women and older workers, but less than in the EU-27. The participation rate was well above the EU average in 2007 (13th highest at 73.9%, EU: 70.5%), and is projected to remain in that position also in 2060 (CY: 78.0%, EU: 74.1%).

Cyprus is in the group of Member States where the increase in public pension expenditure is projected to be significant. The level of expenditure in 2007, at 6.3% of GDP,⁵⁶ is below the EU average of 10.2%, but the projected increase is larger in Cyprus, with 11.4 percentage points of GDP for the period 2007-2060 (EU: +2.4 pp). At the end of the projection period (2060) the expenditure to GDP is expected to be at 17.7%, or 5 percentage points above the EU average⁵⁷.

⁵⁴ See Table 76 in the 2009 Ageing Report p. 239.

⁵⁵ Eurostat 2008 population projections.

⁵⁶ Definition of expenditure as in the Ageing Report 2009.

⁵⁷ This assessment of the long-term sustainability of the public pension provision in Cyprus does not include the impact of the recent pension reform. In particular, based on national estimates, the pension reform would improve the public finances by increased revenue (through future increases in contributions) and reduced social insurance pension expenditure.

Several factors stand behind the change in public pension expenditure. The demographic transition to an older population is the main driver. This effect alone would push up expenditure in Cyprus, by 10.8 percentage points of GDP (compared to 8.7 for the EU as a whole). Change in pension eligibility is the second factor. As the relative number of pensioners to population aged 65 and more is projected to increase (unlike in the majority of Member States), it will add another 1.6 pp of GDP to expenditure.

As mentioned, current theoretical replacement rates, calculated for a hypothetical average wage male worker with a 40 year long career retiring at 65, are low. Following the maturity of the supplementary part of pensions that was introduced in 1980, replacement rates will gradually increase until around 2025. The year of maturity of the Scheme is 2020, when the gross replacement rates stabilize. The net replacement rates continue to increase after that year under the assumption that the basic part of pension will continue to be indexed to earnings. This increase is the consequence of the impact of increases in social insurance contributions biting into the gross wage and reducing the net wage. Total net replacement rate is projected to increase from 53% in 2008 to 70% in 2048.

The negative effect of 3 years of unemployment, which reduces the NRR by 7.6% in 2008, will be less pronounced by 2048 (with a 5.7% reduction). In the same period the negative effect of a 3 year childcare break would be reduced from 5.8% to 4.6% (compared to a female without children). The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, which is currently non-existent, would amount to a malus of 4.3% and a bonus of 2.9% in 2048. The NRR for low earners should increase from 58% to 68% while the NRR for high earners would rise from 45% to 55%. The effect of a 10 year career break on the NRR would be almost constant over the time, with a reduction of 22.6% in 2008 and 21.4% in 2048. The decrease in the NRR 10 years after retirement which for pensioners retiring in 2008 amounts to 9.5% would be similar for those retired in 2048 at 10%.

Challenges

Pension expenditure in Cyprus is now relatively low, but many pensioners are exposed to the risk of poverty. However, with the second part of the compulsory pension introduced only in 1980, the Cypriot pension system is still in the maturation phase. It is expected that in the long-term question of pension sustainability will replace the issue of adequacy as the main concern. In recent years, the authorities tried to find a better balance between providing adequate and sustainable pensions and a number of useful measures have been adopted.

Cyprus faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.⁵⁸ The projected increase in pension expenditure over the long-term at 11.4% is significantly higher in Cyprus than the EU average, though starting, from a relatively low level. Total replacement rates are projected to increase over the long-term and to get close to the EU average.

While reform measures have been taken recently, implementing further reforms to the pension system that address the high projected increase in pension spending might be necessary in the medium to longer-term to put it on a more sustainable path. For this purpose, according to a recent amendment to the social insurance legislation, every three years an actuarial valuation

⁵⁸ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

exercise takes place primarily to assess the financial position of the SIS in the long-term, and the Minister of Labour and Social Insurance, if needed, must submit a set of proposed reform measures to secure the long-term viability of the SIS.

In the short and medium-term Cyprus will need to take major steps to lower the excessively high at-risk-of-poverty for people 65+ /pensioners – which at 48.3% in 2008 was the second highest in the Union after Latvia, taking into account the constraints of public finances.

The main crisis impact on Cyprus' pension system concerns the weakening of public finances. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation, in line with the Council recommendations (Art. 126.7), reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Improving the primary balance over the medium term and implementing further measures aimed at curbing the substantial increase in age-related expenditure would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

Current adequacy (2008)	Cyprus			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	11,7	10,4	13	16	16	17
At-risk-of-poverty rate 65+	48,3	42,5	53,3	19	16	22
At-risk-of-poverty rate 75+	65	62,6	66,8	22	18	24
Income inequality 0-64	3,8			5,1		
Income inequality 65+	4,5			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0,59	0,64	0,56	0,85	0,88	0,83

Adequacy projections: CY	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	53	70	17	47	61	14
TRR 3 years unemployment	49	66	17	44	57	13
TRR 3 years childcare break	49	62	13	46	56	10
TRR 10 years career break	41	55	14	37	47	10
TRR shorter working (retirement at 63)	53	67	14	47	58	11
TRR longer working (retirement at 67)	53	72	19	47	62	15
TRR 10 years after retirement	48	63	15	44	56	12
TRR low earner (66% average)	58	68	10	55	61	6
TRR high earner (100-200% rising profile)	45	55	10	36,0	44	8
Benefit ratios: social security pensions 2007/2060				53,7*	56,50	

Current sustainability	Cyprus			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	5,8	6,8**	6,7*		12,0**	11,8*
Employment rate 15-64	65,7	70,9	69,9	62,2	65,9	64,6
Employment rate 55-64	49,4	54,8	56,0	36,9	45,6	46,0
Employment rate 55-64 women	32,1	39,4	40,8	27,4	36,8	37,8
Employment rate 55-64 men	67,3	70,9	71,7	47,1	55,0	54,8
Effective labour market exit age***	62,3	63,5	:	59,9	61,2	61,4
Public debt	58,8	48,4	56,2	61,9	61,6	73,6
Budget balance	-2,3	0,9	-6,1	0,6	-2,3	-6,8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	18	27	44	25	38	53
Public pension expenditure, % of GDP	6,3	10,8	17,7	10,1	11,4	12,5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	10,8	8,7
Employment	-0,5	-0,7
Eligibility	1,6	-2,6
Level of benefits	-0,3	-2,5
Total (including residual)	11,4	2,4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Latvia

Description

A notional defined-contribution (NDC) pay-as-you-go pension scheme was introduced in Latvia in January 1996, replacing a defined-benefit pay-as-you-go pension scheme.⁵⁹ At the introduction of the scheme, workers were credited with initial, notional capital to compensate them for their years of work prior to the reform.⁶⁰

A share of total social insurance contributions for pensions (currently 18 p.p. of a total of 20% of gross wage) are recorded in notional individual accounts, and are accumulated at a given rate of return (indexed with increase in average social insurance contributions' wage sum) until retirement. Pensions are calculated by dividing the amount accumulated in the notional account by projected cohort unisex life expectancy at retirement. The statutory minimum retirement age has been gradually increased until it reached 62 for both men (in 2003) and women (in 2008).

The funded defined-contribution pension scheme started operation in July 2001. It is a fully funded statutory pension scheme, where a part of the social insurance contributions (currently 2p.p. of the total of 20%) have been diverted from the NDC scheme and are invested in privately managed pension funds. Membership in the funded pillar was mandatory for those who were born after 1st July 1971 and voluntary for those who are born after 1st July 1951 and before 1st July 1971.

The voluntary private pension pillar (started operation in July 1998) is incentivised by some income tax exemptions. This type of pension provision covered around 16.3% of the economically active population at the end of 2009.

Current performance

As regards the adequacy and sustainability of pensions, **at-risk-of-poverty rates** of people aged 65 and more were on the increase in LV in the pre-crisis period between 2005 and 2007, and in 2008 (data published in 2009) reached much higher levels than the average in the EU (47,5% in LV vs 19% in the EU-27). A significant gender gap in this respect was also observed with 51% of women and 41% of men aged 65 and more in at-risk-of-poverty. People aged 75 and more are exposed at even higher risk of poverty (56% of women and 50% of men). This is also due to the fact that those recently retired receive considerably higher benefits than retirees from previous years: in years 2004 through 2009 rates of return credited were particularly high, so those working during those years saw a very high real rate of growth of their NDCs. In addition, in 2008 lower pensions (below 213.43 EUR per month) were indexed by around 30%, but pensions of a value between 213.43 and 320.15 EUR⁶¹ – by around 16% (inflation rate in 2008 – 15,4%), so the relative income position of pensioners

⁵⁹ Pensions awarded before 1996 were not affected by the introduction of the new scheme.

⁶⁰ In order to simplify implementation, the initial capital was based on the number of prior years of work and their wages in the years immediately following the reform. In other words, the initial capital implicitly assumed that wages in all prior years were at their level immediately after the reform. Given that wages typically increase with age and experience, this could be viewed as an overestimate of what would have been in their accounts if they had been contributing to NDCs for their entire working life.

⁶¹ 10th September 2010: 1 LVL = 0,702804 EUR

was improved and it should be reflected in 2009 and 2010 at-risk-of-poverty rates, as no significant reform has been adopted yet in that field (taking into account the consequences of the 21 December 2009 Constitutional Court ruling mentioned below⁶²). The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (47.5%) is low compared to the EU average. The net rate amounts to 63.8%.

Before the crisis relative **pension expenditure** was on decline in Latvia and it dropped from 9.5% of GDP in 2000 to 5.3% in 2007,⁶³ which can be partly explained by very high growth of GDP, especially in the last years before 2008. However, the supplemental payment implemented in 2006 for those with low old age pensions (to address the perceived inequity in the system) was extended to all old age and disability pensioners in 2009, strongly increasing pension expenditure. Latvia maintains high employment rate of people at the age of 60, especially women (51.3% in 2009, the fourth position in the EU), less so men (51.4%, the sixteenth position). High poverty rate among pensioners is probably one of incentives for older workers to stay in the labour market.

Impact of the crisis

With GDP drops of 4.6% in 2008, 18% in 2009, and a projected of 3.5% for 2010, Latvia is the worst hit country in the EU-27. The crisis has swept away all the improvement in the employment rate registered in the last decade. The employment rate of population aged 15-64 reached a peak in 2008 (68.6%) and dropped to 60.9% in 2009, not much higher level than in 2000 (57.4%). The real return on contributions to the mandatory funded pension scheme invested in the first year of its operation was negative at the end of 2008.⁶⁴

Facing the crisis, the Government proposed and the Parliament adopted some austerity measures. First, provisions for pension indexation in 2009 and 2010 were abolished. However, this can still mean an increase in real terms thanks to deflation. Starting from 2011 price indexation instead of indexation on wages and prices will be re-introduced (the original indexation was based on prices, but Latvia moved to the so-called "Swiss formula", based on prices and wage sum, during the boom).

Second, a part of contribution to the funded defined-contribution (DC) scheme was diverted to feed pay-as-you-go notional defined-contribution (NDC) scheme. In 2008 out of 20% pension contribution 8 pp fed into funded DC scheme, and 12 pp into pay-as-you-go NDC, and the government intended to increase the share allocated to funded scheme to reach the proportion of 9-11 pp in 2010 and 10-10 pp in 2011. Nevertheless, to address the cash deficit in the social insurance budget and to keep the long term financial stability of the social insurance system the government decided to decrease the cost of prefunding of ageing expenditure, and in 2009 out of 20% pension contribution only 2 p.p. feed into funded DC scheme and 18 p.p. into pay-as-you-go NDC. In 2011 the proportion is currently planned to be 4-16 p.p., and from 2012 onwards 6-14 p.p.

Third, in the amendments to the 2009 budget (2nd half of the year) it was decided that old-age pensions would be reduced by 10%. Pension benefits for working pensioners were reduced by 70%, and early retirement pensions from 80% to 50% of the value of old-age pension. All cuts were made across the board. In December 2009 the Constitutional Court acknowledged

⁶² See third sub-paragraph within the paragraph "impact of the crisis"

⁶³ ESSPROS database.

⁶⁴ ASISP reporting.

that the 10% cuts for old-age pensioners and 70% cuts for working pensioners, given the way the legislation was adopted, breached the principle of legitimate expectations and decided that reduction in the level of benefits should be reversed. Following the judgment of the Constitutional Court, pensions' deductions were cancelled from 1st February 2010 and deductions for time period since 1 July 2009 to 1 February 2010 were reimbursed in April 2010. The Court nevertheless recognised the general possibility for the government to change pension outlays during an economic crisis, by following an appropriate procedure involving extensive consultation.

It should be noted that the treatment of pensions remains overall favourable in terms of burden-sharing of the fiscal austerity measures, when comparing with the active population, given the drop of wages in Latvia, as well as the massive increase of unemployment.

Despite the reduction in the contribution rate to the mandatory funded pension scheme, State Social Insurance budget recorded a deficit in 2009 (-213 million LVL) and 2010 (-264 million LVL on 8 months, nevertheless mostly due to exceptional pension repayments following the Constitutional Court ruling which took place in April 2010). Current expenditure has partially relied on the accumulated surplus from previous years.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.9 p.p of GDP in the 'lost decade' scenario⁶⁵) also in the long-term unless corrective action is taken.

Outlook

Latvian population is currently slightly younger than the EU average. The old-age dependency ratio comparing the number of those aged 60 and more to the working age population aged 20-59 will be more favourable in Latvia than in the EU-27 until beginning of 2040's, but then ageing in Latvia will accelerate and in 2060 there will be 90 people aged 60 or more for every 100 people aged 20-59 (79 in the EU-27).⁶⁶

Despite accelerated population ageing the projections of the Ageing Report 2009 show a moderate drop in gross public social security pension expenditure from 5.4% of GDP in 2007 to 5.1% in 2060. The expenditure would reach 10% of GDP when the mandatory funded tier is taken into account. However, recent reforms introduced in the wake of the crisis might change the proportional importance of mandatory pay-as-you-go and funded pillars.

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after a 40-years career is projected to decrease from 63.8% in 2008 to 57.4% in 2048. The decrease is due to the fact that the new system combines NDC and DC components with the in-built automatic adjustment mechanisms. For instance, the value of pension benefit takes into account a life expectancy adjustment factor putting the longevity risk fully onto the individual. Meanwhile, the remaining life expectancy at 65 in Latvia is projected to increase by 7.5 years for males and 6.6 years for females between 2008 and 2060. Individual decisions to work longer could help preserve the level of the NRR in the future. According to calculations the NRR is projected to reach 63% for those who intend to retire in 2048 at the age of 67 with 42 year contributory period. This is because the relative bonus/malus effect of

⁶⁵ See Table 76 in the 2009 Ageing Report p. 239.

⁶⁶ Europop 2008 projections.

retiring 2 years after and 2 years before age 65 (+14% bonus and -12.1% malus in 2008), would be largely maintained over the period (+10.1% bonus and -11.4% malus in 2048).

In the mixed NDC-DC system the link between contributions and benefits is considerably strengthened, so that people with short working lives risk to receive inadequate income in the old age. The negative effect of 3 years of unemployment, which reduced the NRR by 2.1% for those retiring in 2008, will increase by more than a factor of three to reach 7.4% in 2048. In the same period the negative effect of a 3 year childcare break on the NRR would increase from 0% in 2008 to 7.9% in 2048.⁶⁷ Replacement rates of people with incomplete careers are projected to be very low, at 43.5% in 2048 for a person with a 10 years career break. This is because the effect of a 10 year career break on the NRR would be only slightly reduced from a loss of about 25% in 2008 to a loss of 24% in 2048.

The NRR for low earners would be reduced from 63.8% in 2008 to 55.6% in 2048 (one of the lowest results in the EU-27) while the NRR for high earners would drop from 57.1% to as little as 40.9%. The NRR 10 years after retirement is projected to drop by 28.2% in 2018 for those retired in 2008. The drop would be less pronounced at 17.2% in 2058 for those retired in 2048. Nevertheless, the net replacement rates in 2058 calculated for those who retired in 2048 decrease to 47.5% (value for 2058 compared to the NRR for base case retiree in 2048 at 57.4%), as a consequence of both the indexation of pensions to prices only and the less-than-full indexation to prices for pensions above a certain threshold.

The benefit ratio, which is the average benefit of mandatory public and private pension as a share of the economy-wide average wage is projected to stay at a much lower level than the NRR, reaching 25% in 2060 (as compared to 24% in 2007, the lowest level in the EU-27).⁶⁸ The value of the benefit ratio will remain low in the future, as only a part of retired population will have retired after 40-years career as assumed in the NRR calculations, and price indexation might erode the value of benefits for older pensioners as compared to real wages.

Challenges

The fundamental pension reforms of 1996 and 2001 in Latvia established strong contributory principles and working incentives by introducing a NDC supplemented by a mandatory, fully funded scheme. Thus Latvia took crucial steps towards achieving a better balance between sustainability and adequacy concerns in its pension provision. However, the financial and economic crises produced major contractions of the economy with subsequent consequences for public finances. As employment rates dropped, the problem of contribution evasion aggravated and general revenue streams collapsed the country was forced to adopt ad hoc measures and prepare further reforms.

Latvia faces a challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population. The country was assessed to be at 'high' risk in this regard by the Commission/Council,⁶⁹ even if the projected decrease in pension expenditure over the long-term at 0.4% of GDP is below than the projected increase in the EU

⁶⁷ Impact of childcare and unemployment breaks on the value of TRR is calculated with reference to country-specific legislated retirement age (62 in Latvia) and not 65 as in the bas-case scenario.

⁶⁸ 2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060), European Economy 2/2009, p.97.

⁶⁹ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

on average. Total replacement rates, currently close to the EU average, are projected to fall significantly over the long-term to become one of the lowest in the EU. Relatively high reliance of pensioners' income on funded defined-contribution pensions (in combination with pay-as-you-go notional defined-contribution scheme) might bear risks for future adequacy of pensions, especially for workers with broken careers and low-wage earners.

Despite reforms introduced in the last fifteen years, implementing further reforms to the pension system would contribute to put it on a more sustainable path. Taking measures that increase participation rates, though being before the crisis above the EU average, would provide an important contribution to sustainability and to adequacy. In particular, an appropriate balance between working life and life in retirement need to be found and making the retirement age automatically adaptable to future increases in life expectancy would enhance its stability. Special pension regimes and retirement ages should be made transparent and reviewed. Early retirement provisions should also be revised to increase the effective retirement age and to improve future sustainability and adequacy of the system.

It is possible that as a consequence of the crisis the relative poverty rates among pensioners will temporarily decrease. In the light of the ruling of the Constitutional Court the absolute level of pension benefits has been preserved, while the country currently experiences deflation and considerable reduction in wages. However, in the medium term, price indexation coupled with renewed growth in wages can lead again to higher at-risk-of-poverty, especially among older pensioners. The government should take into account lessons from the current crisis and pre-crisis situation when new retirees received considerably higher pensions than older retirees and at-risk-of-poverty of older people increased dramatically.

The financial and economic crisis produced a highly serious deterioration of the public budget position affecting the basis for pensions in payment. The budgetary position in 2009 has deteriorated considerably and compounds the budgetary impact of population ageing. To secure the foundation for financing present and future public pension expenditure further budgetary consolidation will be essential. Reducing the primary deficit over the medium term would contribute to reducing the high risks to the sustainability of public finances. In this context the Latvian government should also carefully assess the balance between the amount of prefunding they can afford and the additional long-term costs they will face if they reduce prefunding

Background statistics

	Latvia			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	21	20	21	16	16	17
At-risk-of-poverty rate 65+	51	45	54	19	16	22
At-risk-of-poverty rate 75+	58	57	58	22	18	24
Income inequality 0-64	7.2			5.1		
Income inequality 65+	5.6			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.54	0.6	0.53	0.85	0.88	0.83
Adequacy projections: LV	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	63.8	57.4	-6.4	47.5	42.8	-4.7
TRR 3 years unemployment	51.5	44.3	-7.2	38.3	32.9	-5.4
TRR 3 years childcare break	52.6	44	-8.6	39.1	32.7	-6.4
TRR 10 years career break	47.9	43.5	-4.4	35.7	32.3	-3.4
TRR shorter working (retirement at 63)	56.1	50.9	-5.2	41.7	37.8	-3.9
TRR longer working (retirement at 67)	72.8	63.2	-9.6	54.2	48.6	-5.6
TRR 10 years after retirement	45.8	47.5	1.7	34.1	35.3	1.2
TRR low earner (66% average)	63.8	55.6	-8.2	47.5	42.8	-4.7
TRR high earner (100-200% rising profile)	57.1	40.9	-16.2	42.5	32.2	-10.3
Benefit ratios: social security pensions 2007/2060				24.0*	12.60	
	Latvia			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	9.5	6.1**	5.3*		12.0**	11.8*
Employment rate 15-64	57.4	68.6	60.9	62.2	65.9	64.6
Employment rate 55-64	35.4	59.4	53.2	36.9	45.6	46.0
Employment rate 55-64 women	25.8	56.7	53.3	27.4	36.8	37.8
Employment rate 55-64 men	48.2	63.1	53.1	47.1	55.0	54.8
Effective labour market exit age***	62.4	63.3	62.7	59.9	61.2	61.4
Public debt	12.3	19.5	36.1	61.9	61.6	73.6
Budget balance	-2.8	-4.1	-9.0	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	25	35	64	25	38	53
Public pension expenditure, % of GDP	5.4	5.9	5.1	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	5.7			8.7		
Employment	-0.2			-0.7		
Eligibility	-1.6			-2.6		
Level of benefits	-3.9			-2.5		
Total (including residual)	-0.3			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Lithuania

Description

Lithuania's statutory social insurance pension system consists of two tiers: the State pay-as-you-go defined-benefit pensions and a mandatory funded defined-contributions scheme.

The State social insurance pension system was reformed in 1995 with introduction of a flat-rate basic pension and a supplementary part depending on years of service, individual wage and average insurable income in the country. The system is contributory, 23.3% of gross wage paid by the employer and 3% by the employee (data as of 2010).

The mandatory funded pension scheme was introduced in 2004. The scheme is actually voluntary though opting out after joining is not permitted. It is based on defined-contribution principle and financed by a fraction of the social insurance contribution (5.5% of gross wage by 2007, reduced to 2% as of 2009 and this reduction in July 2010 was prolonged. The decision to restore the contribution rate will be enacted when extraordinary financial and economical situation in the country will come to an end. At retirement, the participant has to purchase a pension annuity from an insurance company.

Supplementary voluntary pension provision also exists but its take-up remains marginal at 0.1% of the labour force (2008). The number of participants has further decreased by 1.4 % in 2009. It is possible to establish **occupational pension schemes** though as yet none have been created despite the fact that a special “Law on Funded Occupational Pensions” was adopted in 2006.

Those not having the minimum qualifying period for entitlement to social insurance pensions may receive a social **assistance pension** when they reach old age. In 2006 its coverage was extended to all elderly and disabled without entitlements in the social insurance system.

The regular legal retirement age is 62.5 years for men and 60 for women. The qualifying period to receive full pension is 30 full years (a minimum qualifying period being 15 years), with a full year consisting of at least 12 minimum monthly salaries. An early retirement pension scheme was introduced for the long-term unemployed in 2004. Under that scheme pensions are reduced by 0.4% for every full month remaining until the retirement age and the reduced pension is fixed at this level. Staying longer in the labour force (and not claiming pension benefits) is rewarded by pension benefit increased of 8% per annum.

Current performance

Pension expenditure in Lithuania in 2007 was lower than in the EU-27 on average (6.6% of GDP vs. 11.8%).⁷⁰ This is due to a more favourable population structure and to the fact that in the pre-crisis rapid economic growth period pensions have increased at a lower pace than the GDP. In the beginning of the decade the share of pension expenditure in GDP was 7.8%. Recently, in the period of economic crisis, it increased, due to the contraction of the economy

⁷⁰ ESSPROS database.

(7.2 % in 2008 and 8.95 % in 2009).⁷¹ In general, there is no automatic indexation mechanism for pensions and these are increased or decreased on *ad-hoc* basis.

As a consequence of less than complete coverage with full pensions and their relatively low levels at-risk-of-poverty rate of people older than 65 was at 29% in 2008, more than the EU average (19%) and the rate for the population 0-64 (18%). Poverty of older people was on increase between 2005 and 2007, and there is a considerable gender gap, with women exposed to a higher risk (36% in 2008). The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (49%) is low compared to the EU average. The net rate amounts to 66%.

The employment rate of older workers (55-64) was higher than the EU-27 average in 2009 (51.6% vs. 46%), which in a big part is a result of the structure of the 55-64 age group in Lithuania, where younger cohorts have a relatively high share (the cohort effect).

Impact of the crisis

Funded schemes suffered negative returns as an effect of the financial crisis but as funds are still rather immature the main setback to Lithuanian pensions came as the economic crisis reduced revenues and raised expenditure and thus weakened public finances.

Lithuania is one of the Member States the most adversely affected by the crisis. GDP declined by 15% in 2009, and economic growth will probably return only in 2011. Economic decline was reflected in the labour market. Unemployment soared from 5.8% in 2008 to a (18.1% in Q1-2010. In 2009 the employment rate (15-64) declined by 4.2 percentage points to 60.1%, the level registered in the beginning of the decade. Employment rates of female and older workers (55-64) resisted better the overall decline, and the employment rate of older women even increased by 0.5 pp. to 48.3% (EU: up by 1 pp to 37.8%). Higher unemployment creates a risk of reduced or interrupted pension accruals for the unemployed. The government finances have deteriorated strongly despite several substantial consolidation rounds including cuts in expenditure and revenue increases.

According to the ISG calculations, a three year career break due to unemployment before the retirement could result in a net replacement rate lower by 4.9 percentage points (pp) of the last wage for a person retiring in 2008 and 3.7 pp in 2048.

Pensions and other social benefits have been temporarily cut in 2010-11 (on average by 4.5 % from January 2010) to reduce the deficit of the State social security fund. Progressive character of cuts aimed at protection of the most vulnerable recipients of smaller benefits. Due to the decline of the average wage in 2009, the average old-pension relation to the net average wage (macro replacement rate) increased considerably (from 46.5% in 2008 to 50.7% in 2009).

In the wake of the crisis Lithuania has also reduced contribution rates to the funded pillar from 5.5% to 2% of gross wage and the difference has been reverted to feed the social insurance scheme and to reduce the social security fund deficit.

⁷¹ Annual National Report 2010, Pensions, Health and Long- Term Care (Lithuania), May 2010 (T. Medaiskis, D. Jankauskienė)

A new pension reform is now in preparation in Lithuania. The government adopted a reform concept in June 2010; the reform is to take place in two stages. The reform aims at an increase in retirement age to 65 for women and men by 2026, a stronger contribution-benefit link (through either NDC or a point system), a reduction in privileged pensions and at a certain autonomy of social security from the state budget through building of reserves and through the state budget taking over the costs of non-contributory provisions. On 15 July the government adopted a law which increases the pensionable age as of 2012 by annually adding 4 months for women and 2 months for men until 2026. For the present the Parliament -has postponed the vote on this measure.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.3 p.p of GDP in the 'lost decade' scenario⁷²) also in the long-term unless corrective action is taken.

Outlook⁷³

Developments in the old-age dependency ratio (people aged 65 and more to people aged 15-64) will be much more pronounced in Lithuania relative to the EU average (LT: 23% in 2007, 66% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to drop by 42%, compared with 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase only slightly in Lithuania over the long-term, especially for women and older workers, but less than in EU-27. The participation rate was below the EU average in 2007 (at 68.1% in 2007, EU-27: 70.6%), and is projected to remain in that position also in 2060 (LT: 68.2%, EU-27: 74.1%).

Emigration could significantly undermine the employment rate in Lithuania in a long term. Lithuania has one of the highest negative rates of crude migration (net) in the EU (-4.6% against 1.9%⁷⁴ in the EU-27). The majority of emigrants are from the age group 20-34. Continuation of this trend in a long run could severely worsen the ratio of contributors and beneficiaries.

Lithuania is in the group of Member States where the increase in public pension expenditure is projected to be significant. The level of expenditure in 2007, at 6 ¾% of GDP, is below the EU average (10.2%), but the projected increase is larger in Lithuania, with 4.6 p. p. of GDP for the period 2007-2060 (EU: +2.4 pp). The level of public pension expenditure increased to 8.95 % of GDP in 2009⁷⁵ mainly due to the shrunk economy. At the end of the projection period (2060) the expenditure to GDP is expected to be 11.4, or 1 ¼ percentage points below the EU average.

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure significantly in Lithuania, by 9 ½ percentage points of GDP until 2060 (compared to 8.7 for the EU as a whole). Costs of ageing for pension expenditure will be partially counterbalanced

⁷² See Table 76 in the 2009 Ageing Report p. 239.

⁷³ All calculations presented in this part do not take into account the fact of reduction in the contribution rate to the funded pension scheme and recently discussed pension reform.

⁷⁴ Provision value.

⁷⁵ National data.

by more restrictive rules on pension eligibility, which will help to save 2.4 pp of pension expenditure between 2007 and 2060, and also lower public pension benefits relative to wages.

Lithuania is also relying on private pension provision in the future (private mandatory pensions). While being negligible currently, they are projected to amount to 2% of GDP by 2060. This provides an important contribution to adequate pensions. The benefit ratio, which compares an average pension benefit to an average wage, is projected to decrease from 33% in 2007 to 28% in 2060 when only social insurance pensions are taken into account and to 32% in 2060, if mandatory funded scheme is also included.

Projections of replacement rates, which compare first pension to the last wage of a male worker retiring at 65 after 40 years career, also reflect growing importance of funded scheme. Between 2008 and 2048 the gross replacement rate in the state social insurance tier will decline from 48% in 2008 to 35% in 2048. The development of the funded tier is expected to increase its contribution to the gross replacement rate from 1 pp in 2008 to 13 pp in 2048, as workers gradually acquire seniority in membership in funded scheme. Thus, the total gross replacement rate for the average wage earner is projected to decrease by 1 percentage point to 48%. The decrease of net replacement rate by 4 percentage points to 62% is mainly due to the income tax reform.

The current Lithuanian pension system is also projected to provide in the future low replacement rates for workers with career breaks due to childcare, unemployment or longer withdrawal from the labour market. The negative effect of 3 years of unemployment, which reduced the NRR by 7.1% for those retiring in 2008, will be slightly more pronounced in 2048 with a reduction of 7.4%. In the same period the negative effect of a 3 year childcare break would increase from 0% to 2.1%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 (+19.1% bonus and -17.8% malus in 2008), would be largely maintained over the period (+17% bonus and -15.7% malus in 2048). The NRR for low earners would be reduced from 82% in 2008 to 76.7% in 2048 while the NRR for high earners would drop from 45% to as little as 38.9%. The negative effect of a 10 year career break on the NRR would continue with a 23.6% reduction in 2008 and 22.8% in 2048. The decrease in the NRR 10 years after retirement which in 2018 for workers retired in 2008 amounts to 7.1% would be slightly less serious at 6.6% (value for the NRR in 2058).

Challenges

Lithuania has reformed the pension system in the last 15 years, by introducing a flat-rate and earnings-related components in the main social insurance scheme, as well as a quasi-mandatory funded defined-contribution scheme. The reforms established a good basis for achieving a better balance between sustainability and adequacy concerns in pension provision.

Despite these efforts, Lithuania faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.⁷⁶ The projected increase in pension expenditure over the long-term at 4.6% is significantly higher in Lithuania than the EU average. Total replacement rates, being relatively low currently, are projected fall slightly over the long-term and become among the lowest in the EU for workers with career breaks.

⁷⁶ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

The Lithuanian government intends to further reform the pension system. The key long-term reform issue is the rapidly emerging demographic pressure that conflicts with retirement ages of 62.5 for men and 60 for women. Implementing further reforms to the pension system by containing the high projected increase in pension expenditure or adjusting its financing would contribute to put it on a more sustainable path. Taking measures that increase participation rates, which is below the EU average, would provide an important contribution to both sustainability and adequacy. In particular, an appropriate balance between working years and years spend in retirement need to be found. Linking the pensionable age and/or adjusting benefit levels in line with future increases in life expectancy could make a major contribution. But in order to succeed it would also be important to underpin pension reforms with labour market and work places measures that enable and encourage people to work longer.

It is possible that as a consequence of the crisis the relative poverty rates among pensioners will temporarily decrease. However, pension increases during the pre-crisis period of high economic growth have been insufficient to prevent growing poverty among pensioners, especially older women. The Lithuanian authorities should consider adopting transparent indexation rules protecting elderly from the risk of poverty, while not creating risks for sustainability of the system. There exists a wide diversity in pension generosity between the main workforce and some privileged groups. Special pension regimes and retirement ages should be made transparent and reviewed. Early retirement provisions should also be revised to increase the effective retirement age and to improve future sustainability and adequacy of the system.

The main crisis impacts on the Lithuanian pension system concern the weakening of public finances. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation containing and reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances. In this context the Lithuanian government should also assess carefully the balance between the amount of prefunding they can afford and the additional long-term costs they will face if they reduce prefunding permanently. The level of prefunding should be based on realistic long-term growth expectations.

Background statistics

Current adequacy (2008)	Lithuania			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	18	18	19	16	16	17
At-risk-of-poverty rate 65+	29	17	36	19	16	22
At-risk-of-poverty rate 75+	34	20	40	22	18	24
Income inequality 0-64	6.2			5.1		
Income inequality 65+	4.1			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.71	0.8	0.68	0.85	0.88	0.83

Adequacy projections: LT	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	66.0	61.6	-4.4	49.0	48.0	-1.0
TRR 3 years unemployment	50.4	48.2	-2.2	37.6	37.6	0.0
TRR 3 years childcare break	49.9	44.4	-5.5	37.3	34.6	-2.7
TRR 10 years career break	50.5	47.6	-2.9	37.6	38.9	1.3
TRR shorter working (retirement at 63)	54.3	52	-2.3	40.7	40.5	-0.2
TRR longer working (retirement at 67)	78.6	72.1	-6.5	58.8	56.2	-2.6
TRR 10 years after retirement	61.3	57.5	-3.8	46.9	44.9	-2.0
TRR low earner (66% average)	82	76.7	-5.3	63	61.2	-1.8
TRR high earner (100-200% rising profile)	45	38.9	-6.1	33.0	29.7	-3.3
Benefit ratios: social security pensions 2007/2060				33.1*	27.70	

Current sustainability	Lithuania			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	7.8	6.3**	6.6*		12.0**	11.8*
Employment rate 15-64	59.6	64.3	60.1	62.2	65.9	64.6
Employment rate 55-64	41.2	53.1	51.6	36.9	45.6	46.0
Employment rate 55-64 women	33.5	47.8	48.3	27.4	36.8	37.8
Employment rate 55-64 men	51.4	60.2	56.0	47.1	55.0	54.8
Effective labour market exit age***	58.9	:	:	59.9	61.2	61.4
Public debt	23.7	15.6	29.3	61.9	61.6	73.6
Budget balance	-3.2	-3.3	-8.9	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	23	35	66	25	38	53
Public pension expenditure, % of GDP	6.8	8.2	11.4	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	9.6	8.7
Employment	0	-0.7
Eligibility	-2.4	-2.6
Level of benefits	-1.8	-2.5
Total (including residual)	4.6	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Luxembourg

Description

The **statutory pension system** consists of a general scheme for private sector employees and the self-employed and a special scheme for civil servants. Pension benefits are related to earnings and survivors and invalidity pensions are also provided.

The general pension scheme is organised as a pay-as-you-go defined-benefit system based on a financial model with a contribution rate fixed for a period of 7 years and determined on the basis of an actuarial evaluation. Currently it is financed through a contribution on wages of 24% which is paid in equal shares by employers, employees and the state budget. Pension benefits are calculated on both the length of contribution periods and the accumulated lifetime amount of contributions. Up to 2008 a reserve fund of the general pension scheme accumulated assets corresponding to three years of expenditure (25% of GDP).

The monthly old age pension consists of two parts:

- a basic part, equivalent to around 12% of average earnings, subject to 40 years' coverage and an 'end-of-year allowance'. For incomplete insurance, these benefits are reduced proportionally. Coverage periods include contributory periods as well as non-contributory periods (educational training or child education).
- an income related part with an accrual rate of 1.85%. The earnings measure used in the formula is lifetime average pay valorised in line with nominal earnings. The accrual rate is higher for older workers and those with longer contribution periods. For each year of work after age 55, the accrual rate is increased by 0.01 percentage points. Furthermore, each year of contributions beyond 38 also attracts an additional accrual of 0.01 percentage points. The maximum accrual rate is 2.05% per year.

Under current legislation, pensions in payment are automatically adjusted to price evolution each time prices increase by more than 2.5%. In addition, pensions are reviewed every two years in the light of the evolution of real wages. Whereas price indexation is automatic, the adjustment of pensions to wage development is to be decided by government and approved by parliament.

With the completion of a 40-year insurance period (including voluntary and additional periods), a pension is not allowed to be below 90% of a minimum income of EUR 1.683 in 2010. If an individual pension amounts to less than the minimum, the pensioner gets a supplement for the missing residual.⁷⁷ In any case, the means-tested guaranteed minimum income (RMG) scheme ensures a basic income for those without adequate pension entitlements or other resources. The monthly amount for a single person is EUR 1.199 per month (2010).⁷⁸

Occupational pension schemes are voluntary for employees and have developed mainly in foreign or very large industrial and commercial companies, as well as in the banking sector. They are fully funded and their assets amount to about 1% of GDP. Private pension plans are offered as financial products to individuals, but they are not very popular.

⁷⁷ Social parameters,2010, www.mss.public.lu

⁷⁸ Social parameters,2010, www.mss.public.lu? NSR 2008, 9 and 64

Current performance

Compared to international standards, the system ensures adequacy with low at-risk-of-poverty rate and very high aggregates replacement ratios. The at-risk-of-poverty rate of population aged 65 and more at 5% in 2008 was much below the EU-27 average, and below the rate for population younger than 65. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (89.8%) is high compared to the EU average. The net rate even amounts to 95.8%.

Employment rates of older workers (55-64) in Luxembourg are below the EU-average with 38.2% in 2009. The employment rate of older men is almost 20 percentage point higher than that of older women. There is also a substantial gap between the official retirement age (65 years) and the real retirement age (59.2 years for men⁷⁹). Nevertheless, Luxembourgish pension expenditure is lower than the EU-27 average (LU: 8.2% of GDP in 2007, EU-27: 11.8%).

Impact of the crisis

Luxembourg has experienced a severe recession with the economy heavily exposed to the financial crisis especially because of its role as a financial centre. After having stagnated in 2008, the Luxembourgish economy contracted by 3.4% in 2009. In 2008 the inflation rate reached its highest level (4.1%) since the early 1990s, driven by sharp increases in global energy and food prices. The state of public finances has deteriorated considerably and the public budget deficit widened in 2009.

Unemployment rose from 4.9% in 2008 to 5.4% in 2009 and will broadly stabilize at about 6% in 2010. The recession led to an explosion in part-time employment, which was encouraged by the government in order to limit lay-offs. Employment remained buoyant for the larger part of 2008, rising by 4.7% over the year. Due to a drop in activity since the autumn 2008 it came to a standstill in job creation but employment has been stagnating rather than declining.

In 2009, the employment rate of persons aged 15-64 reached 65.2%, up by 1.8 percentage points (pp) compared to 2008 (EU: down by 1.3 pp to 64.6%) due to short-time working arrangements recently implemented in the context of the crisis. The male employment rate rose by 1.7 pp, as compared to the 1.9 pp rise to 57% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) rose too by an astonishing 7.8 pp. to 46.5% (EU: down by 0.2 pp to 54.8%), while the employment rate of older women remained almost constant at 29.4% (EU: up by 1 pp to 37.8%). High increases in employment rates of older workers are also a result of cohort effect, where in a given age band more numerous younger generations with higher employment rates replace less numerous older generations.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.9 p.p of GDP in the 'lost decade' scenario⁸⁰) also in the long-term unless corrective action is taken.

⁷⁹ <http://www.oecd.org/dataoecd/3/1/39371913.xls>

⁸⁰ See Table 76 in the 2009 Ageing Report.

Outlook

Developments in the old-age dependency ratio (comparing the size of population aged 65 and more to population aged 15-64) will be less pronounced in Luxembourg relative to the EU-27 average (LU: 21% in 2007, 39% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to expand by 37%, compared with a drop 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in Luxembourg over the long-term, especially for women and older workers, but less than in the EU-27. The participation rate was below the EU average in 2007 (66.4% in 2007, EU: 70.6%), and is projected to remain broadly unchanged by 2060 (LU: 66.8%, EU: 74.1%).

Luxembourg is in the group of Member States where the increase in public pension expenditure is projected to be very significant. The level of expenditure in 2007, at 8.7% of GDP, is below the EU average 10.2%, but the projected increase is larger in Luxembourg, with 15.2 percentage points of GDP for the period 2007-2060 (EU: +2.4 p.p.). The projected increase is the highest of all Member States on current policies. At the end of the projection period (2060) the expenditure to GDP is expected to be 23.9, in fact 11.4 percentage points above the EU average.

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure by 8.4 pp of GDP between 2007 and 2060. A significant strain on pensions spending is also projected to come from the change in the number of pensioners in relation to the number of older people. Moreover, the benefit effect, which is the contribution to the change in the average pension benefit in relation to GDP per worker, adds to the increase of public pension expenditure increases, in contrast to the EU as a whole.

Relatively advantageous demographic dependency ratio can be worsened in the future if cross-border workers are taken into account. Despite the existence of the reserve fund, with a decreased rate of employment of the non-resident workers, an ageing population would have to finance not only the resident pensioners' pensions, but also those of a large number of pensioners outside Luxembourg.

The benefit ratio, which compares an average public pension benefit to an average wage, is projected to decline slightly from 45.8% in 2007 to 44.1% in 2060. The net replacement rates for a worker on about average earnings after 40 years of insurance under the general scheme are high, reaching 95.8% of the pre-retirement income. Gross replacements are only slightly lower and not expected to change much in 2048.

The negative effect of 3 years of unemployment which came to 3.90% of the NRR in 2008 will be the same in 2048. In the same period the effect of a 3 year childcare break will stay at 0%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, is skewed towards a higher malus. Working longer improves the NRR only slightly to 96.5 and is thus not stimulating for working longer. The NRR for low earners is and stays 100.6% while the NRR for high earners is and stays 73.3. The effect of a 10 year career break on the NRR amounts in 2008 and 2048 to a loss of about 16.4%. There is no decrease in the NRR 10 years after retirement, both in 2008 and 2048.

Challenges

Currently the Luxembourgish pension system is still in a relatively good financing position and it delivers very well on adequacy. In the absence of present shortcomings there has so far been little pressure for reforms. However, certain risks on sustainability suggest that major problems will be on the horizon. These risks are caused by the rather negative combination of low participation rates of older workers, a low real retirement age, a declining dependency ratio and net replacement rates close to 100%.

Luxembourg thus faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population and was assessed to be at medium risk in this regard by the Commission/Council.⁸¹ The projected increase in pension expenditure over the long-term will amount to 15.2%. This is significantly higher than in other Member States.

Implementing reforms to the pension system that would contain the high projected increase in pension spending would contribute to put the government budget on a more sustainable path. While experiencing strong growth in employment of cross-border workers for a number of years, taking measures that increase participation rates, which are currently below the EU average, would provide an important contribution to sustainability and adequacy. Notably the participation rates of women and older workers would have to be significantly raised. Furthermore an appropriate balance between working life and life in retirement needs to be found and maintained. Installing mechanisms so that the parameters of pensions are adjusted in line with developments in life expectancy could make a major contribution to this. But underpinning pension reforms with labour market and work place measures to enable people to work longer would also be important to bolster the basis for adequate benefits..

The low debt ratio and the significant assets accumulated in social security, contribute to offsetting the projected long-term budgetary impact of ageing populations. However, this is not sufficient to cover the sizeable increase in age-related expenditure. Moreover, the budgetary plans until 2014 imply that the structural primary surplus would no longer make a contribution to addressing the budgetary cost of ageing. Prudent budgetary policies including further consolidation would therefore still be called for to secure the basis for financing future increases in public pension expenditure.

⁸¹ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

Current adequacy (2008)	Luxembourg			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	15	14	16	16	16	17
At-risk-of-poverty rate 65+	5	5	6	19	16	22
At-risk-of-poverty rate 75+	7	4	8	22	18	24
Income inequality 0-64	4.2			5.1		
Income inequality 65+	2.9			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.97	0.96	0.97	0.85	0.88	0.83

Adequacy projections: LU	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	95.8	95.8	0.0	89.8	89.8	0.0
TRR 3 years unemployment	93.3	93.3	0.0	86.5	86.5	0.0
TRR 3 years childcare break	95.8	95.8	0.0	89.8	89.8	0.0
TRR 10 years career break	80.1	80.1	0.0	70.7	70.7	0.0
TRR shorter working (retirement at 63)	91.5	91.5	0.0	84.3	84.3	0.0
TRR longer working (retirement at 67)	96.5	96.5	0.0	90.6	90.6	0.0
TRR 10 years after retirement	95.8	95.8	0.0	89.8	89.8	0.0
TRR low earner (66% average)	100.6	100.6	0.0	95.4	95.4	0.0
TRR high earner (100-200% rising profile)	73.3	73.3	0.0	64.8	64.8	0.0
Benefit ratios: social security pensions 2007/2060				45.8*	44.10	

Current sustainability	Luxembourg			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	9.4	8.6**	8.2*		12.0**	11.8*
Employment rate 15-64	62.7	63.4	65.2	62.2	65.9	64.6
Employment rate 55-64	27.2	34.1	38.2	36.9	45.6	46.0
Employment rate 55-64 women	16.8	29.3	29.4	27.4	36.8	37.8
Employment rate 55-64 men	37.9	38.7	46.5	47.1	55.0	54.8
Effective labour market exit age***	56.8			59.9	61.2	61.4
Public debt	6.2	13.7	14.5	61.9	61.6	73.6
Budget balance	6.0	2.9	-0.7	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	21	31	39	25	38	53
Public pension expenditure, % of GDP	8.7	14.2	23.9	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	8.4	8.7
Employment	0	-0.7
Eligibility	5.2	-2.6
Level of benefits	1.2	-2.5
Total (including residual)	15.2	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Hungary

Description

The Hungarian mandatory pension system consists of a pay-as-you-go financed public scheme (3/4 share) that is supplemented by a mandatory fully funded tier (1/4 share). The first part provides an earnings related benefit. The second part of the mandatory scheme is on an individual basis and is operated by private pension funds. It is expected to pay out benefits from 2013. Members pay contributions on individual accounts and receive benefits based on defined-contribution. The benefit consists of lifetime savings increased by the investment yield and is converted into an annuity at retirement. The mandatory scheme covers all people engaged in employment including self-employed.

The mandatory funded tier, introduced in 1997, was voluntary for those who had already been on the labour market and obligatory for new entrants. The number of participants in the new mixed system has been steadily increasing and currently reaches approximately 80% of the insured. However, government measures taken in 2009 allow a particular group of fund members to return into a clean PAYG system and restore their full eligibilities in the first pillar, which led to a loss of some 62.000 members for private funds. Private pension funds are required to offer different investment options whereby members can choose between 'secure' or more 'risky' portfolios.

Occupational schemes are uncommon in Hungary. Voluntary individual schemes do exist but are marginal and numbers of participants are declining.

Indexation rules have been reformed in 2001 and 2009. In 2001, wage indexation was replaced by a 50/50 mix of price and wage indexation resulting in a lower rate of pension increase. From 2010 onwards pensions will be price-indexed in years of economic growth below 3% and partially indexed on wages in case of higher growth.

The statutory retirement age is 62 for men and was gradually increased to the same level (from the former 55) for women by 2009. However, a great majority of people (94% in 2004) retired earlier, so that the effective retirement age is 3-5 years lower (58.6 in 2007) than the statutory age, although rising. As a result of the 2009 reform, the statutory retirement age will be increased further from 62 to 65 between 2014 and 2022.

Rules of early retirement were tightened, including introduction of a financial punishment (malus system) from 2011. Furthermore, 13th month pension benefit was cancelled in July 2009. The arrangements to lower the level of initial pensions have a direct positive effect on the sustainability of the system and, together with other measures on the labour market side, also make early retirement less attractive.

Current performance

The relative median income of people aged above 65 in relation to the age group 0-64 was 100% in 2008, far higher than the EU-27 average (85%). The net theoretical replacement rate is also at 100%. However, the aggregate replacement ratio (median gross individual pensions of retired persons aged 65-74 relative to median gross individual income from work of persons in-work aged 50-59) was in 2008 at 59% (EU average 49%). The rate of poverty risk

of the 65+ population (4.3%) has declined by 1 percentage point since 2005 and is significantly lower than the EU average (18.9%). The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (64.6%) is low compared to the EU average. However, the net rate amounts to 105.4%, which is substantially above the EU-average⁸². In terms of adequacy, the Hungarian pension system protects from poverty and helps to maintain living standards after retirement.

The employment rate of older workers (55-64) is low in Hungary. Although figures have shown some increase in recent years, there is still room for improvement in this field. In 2009, only 32.8% of the elder population worked, split up in 39.9% for men and 27% for women. In 2009, Hungary had the lowest employment rate at the age of 60 for men (28.6%) and the fourth lowest for women (15.3%) amongst the EU-27 countries.

Pension expenditure increased in recent years from 8.5% of the GDP in 2000 to 10.4% in 2007.

Impact of the crisis

Hungary has been severely hit by the financial crisis. Due to the size of the public debt, as well as the high tax and interest rates, the country faced serious capital withdrawals and credit shortages. GDP fell by 6.3% in 2009. In spite of the fact that GDP fell largely the headline deficit widened only marginally, however, public debt remained high. Unemployment standing at 7.6% in the third quarter of 2008 grew to 11.3% by the first quarter of 2010. Gross wages, which still grew by 1.2% in real terms in 2008, decreased by 3.6% in 2009. This reduced the amount of the contributions and membership fees for the social insurance funds and mandatory private pension funds more difficult to collect. Hungary had one of the lowest employment rates in Europe which have worsened somewhat after the crisis. As a consequence, a growing number of people risk having a reduced build-up of pension entitlements.

The mandatory private pension funds mostly recovered from the losses of 2008 caused by the unfavourable financial developments of the crisis. However, they also lost membership contributions due to the relapse in the labour market.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure somewhat (by 1.6 pp of GDP in the 'lost decade' scenario⁸³)

Outlook

As most European countries Hungary will experience an adverse demographic transition. The old-age dependency ratio (population aged 65 and over as a percentage of the population aged 15-64) will start to rise from 2030 onwards. By 2060 Hungary will experience a dependency ratio that is with 0.58 slightly above the EU average (0.53).

⁸² The interpretation of net and gross replacement rates should take into account that the Hungarian system does not tax pensions currently, but they will be taxed in the future. Also it should be considered that the theoretical replacement rate exercise is based on assumptions about a hypothetical worker (ie basecase: male worker retiring at 65 after 40 years full career) which do not correspond to the standard career in Hungary. Statutory retirement age is 62, and people retiring at 65 (which is a rare exception) are entitled to 18 per cent bonus.

⁸³ See Table 76 in the 2009 Ageing Report p. 239.

In 2007, Hungary spent 10.4% of its GDP on pensions. This amount has been rising over the years but expected to remain under control in the next decades. In consequence of the 2009 reform steps (less generous indexation, abolition of the 13th month pension bonus, increase of the statutory retirement age), future sustainability improved and net social security pension expenditure should reach 10.%⁸⁴ of the GDP in 2060 instead of 13.2% projected by the pre-reform scenario of the 2009 Ageing Report.

Nevertheless, changed indexation rules and abolition of the 13th month pension benefit will have a negative impact on the adequacy of pensions. According to the 2009 Ageing Report, the benefit ratio (comparing an average pension benefit from public and mandatory private scheme to an average wage) is projected to decrease from 39% in 2007 to 38% in 2060. The benefit ratio is projected to drop to 32.6% in 2060 in the reformed system.

As a result of recent pension reforms, the net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after a 40-years career is projected to decrease from 105.4% in 2008⁸⁵ to 71.2% in 2048. The negative effect of 3 years of unemployment which came to 3.5% of the NRR in 2008 is projected to decrease to 2.5% by 2048. In the same period the negative effect of a 3 year childcare break would be substantially increased from 0% to 4.5%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 (+15.7% bonus and -13.5% malus in 2008), would be largely maintained over the period (+16.5% bonus and -12.8% malus in 2048). The NRR for low earners would be reduced from 106.7% to 71.2% while the NRR for high earners would drop from 89% to as little as 54.2%. The effect of a 10 year career break on the NRR would increase from a loss of about 13% to a loss of 25%. Due to revised indexation rules, the decrease in the NRR 10 years after retirement would become more serious for those retiring in 2048 at 21.4%.

Although current NRR's are high, the changes are nevertheless quite substantial. What also stands out is the fact that the NRR sees a 15 percentage point decline during the first 10 years in retirement.

Challenges

Hungary has reformed its pension system in major ways when in 1998 it introduced a mandatory funded provision. Further reform measures followed in 2006 and 2009, in the latter case as in the wake of economic and budgetary difficulties, the government tried to reduce the level of pension expenditure in order to make the system more sustainable in the long-term. Presently the Hungarian pension system performs quite well on adequacy indicators. Replacement rates are high and the risk of poverty is low. Current and longer-term sustainability aspects are less impressive. Moreover, future entitlements relative to wages would be substantially lower than today unless employment rates increase considerably and people work substantially longer.

The challenge Hungary faces with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed as at 'medium' risk by the

⁸⁴ Given the fact the Hungarian pensions do not include tax currently, net pension expenditure is a better indicator.

⁸⁵ It is important to note that currently only a fraction of the workforce retires at the age of 65, so their replacement rates are usually lower than presented above.

Commission/Council.⁸⁶ The projected decrease in pension expenditure over the long-term at 0.4% of GDP is below the EU average increase. Total replacement rates are projected to be reduced in the future, and to get closer to the EU average.

Implementing further reforms to the pension system would contribute to put it on a more sound footing. Taking measures that increases participation rates, which is considerably below the EU average notably for older workers, would provide an important contribution to adequacy. Recent reforms have been aimed at discouraging early retirement. However, additional determined efforts to close the gap between the official and the real retirement age are needed. In particular, an appropriate balance between working life and life in retirement needs to be found and maintained. Making the parameters of pension entitlements adaptable to future increases in life expectancy would enhance the stability of the pension system. Unsolved issues like the transition of accumulated savings into annuities in the mandatory private funds and the taxation of benefits after 2013 also call for further decisions. Moreover, it would be important to not to subject the pension system to ad hoc changes and to build a broad stable consensus about its main design features.

The crisis aggravated pre-existing imbalances in public finances. The high public debt continues to be a source of concern though deficit has been reduced in recent years. The government continued to implement its austerity package in 2009 backed by financial assistance facilities provided by the EU and the IMF. The higher pensionable age, the cancellation of the 13th month pension benefit and the stricter indexation rules are elements that improve the sustainability of pension provision. Further budgetary consolidation would be essential in order to reduce public debt and to secure the foundation for financing the future public pension expenditure.

⁸⁶ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

	Hungary			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	14	14	14	16	16	17
At-risk-of-poverty rate 65+	4	3	5	19	16	22
At-risk-of-poverty rate 75+	4	2	5	22	18	24
Income inequality 0-64	3,8			5,1		
Income inequality 65+	2,6			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	1	1,07	0,98	0,85	0,88	0,83

Adequacy projections: HU	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	105,4	71,2	-34,2	64,6	59,1	-5,5
TRR 3 years unemployment	101,8	69,4	-32,4	61,8	57,6	-4,2
TRR 3 years childcare break	105,4	68	-37,4	64,6	56,4	-8,2
TRR 10 years career break	92,1	53,3	-38,8	56	44,3	-11,7
TRR shorter working (retirement at 63)	91,5	62,1	-29,4	55,6	51,6	-4,0
TRR longer working (retirement at 67)	121,5	83	-38,5	73,8	68,9	-4,9
TRR 10 years after retirement	106	56	-50,0	64,4	46	-18,4
TRR low earner (66% average)	106,7	71,2	-35,5	69,4	59,1	-10,3
TRR high earner (100-200% rising profile)	89	54,2	-34,8	50,2	45,1	-5,1
Benefit ratios: social security pensions 2007/2060				38,9*	29,5	

	Hungary			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	8,5	10,0**	10,4*		12,0**	11,8*
Employment rate 15-64	55,9	56,7	55,4	62,2	65,9	64,6
Employment rate 55-64	21,9	31,4	32,8	36,9	45,6	46,0
Employment rate 55-64 women	13,0	25,7	27,0	27,4	36,8	37,8
Employment rate 55-64 men	33,0	38,5	39,9	47,1	55,0	54,8
Effective labour market exit age***	57,6			59,9	61,2	61,4
Public debt	55,0	72,9	78,3	61,9	61,6	73,6
Budget balance	-3,0	-3,8	-4,0	0,6	-2,3	-6,8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	23	34	58	25	38	53
Public pension expenditure, % of GDP	10,9		10,7	10,1	11,4	12,5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency				8,7		
Employment				-0,7		
Eligibility				-2,6		
Level of benefits				-2,5		
Total (including residual)	-0,2			2,4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Malta

Description

In Malta the statutory earning related pension scheme covers old-age pensions, survivor's pensions and invalidity pensions for employed and self-employed persons. The scheme is often referred to as the "two-third pension" because the benefits at the moment of retirement so far have been calculated as two-thirds of the average income of the best three consecutive years during the ten last years prior to retirement, after a contribution period of 30 years. For self-employed people the income averaging period is extended to the last ten years. The contribution base is basic wage capped at €16,813.16 (2009).

The system is funded through contributions by employers and employees, which are partially matched by the state. The government-run "Consolidated Fund" adds 50% of the contributions paid for each individual to the system. Contributions are calculated per week, and amount to 10% of weekly wages for employers and employees, and 15% of annual net earnings or income for self-employed (with minimum and maximum contributions).

In 2006 there has been a big overhaul of the pension system. Changes included the gradual increase in the retirement age from 60 for women and 61 for men prior to the reform, to 65 for both by 2026. Parallel to the increase in the statutory retirement age, the required contribution period to be entitled to the full two-thirds pension is gradually lengthened from the current 30 years, to 40 years by 2026. The lower the number of years of contribution, the lower the pension will be. At least nine years of contributions is required.

So far voluntary **occupational pension schemes** and **individual provision** have been rudimentarily developed although occupational schemes did exist before the "Two-Thirds-Pension" was introduced in 1979.

Persons whose pensionable income is lower than the established Minimum Pensionable Income are entitled to a National Minimum Pension. The Minimum Pension Guarantee used to be calculated as a percentage of the National Minimum Wage. With the 2006 reform, this was improved so beneficiaries now receive not less than 60 percent of the national median income (persons born on or after the 1 January 1962).

In addition, there is a non-contributory means-tested assistance, called "age pension" which is payable to those aged more than 60 with little or no other means of support.

Current performance

The relative median income of people aged 65+ compared to the general population amounted to 75% in 2008⁸⁷. The aggregate replacement ratio reached 45%⁸⁸. The benefit ratio came to 42.3%. All three are below the EU-27 average. The at-risk-of-poverty-rate of population 65+ at 22% is 3 percentage points above the EU average. The poverty risk for women (20%) is lower than for men (24%). For 2008, the net and gross replacement rates for a theoretical

⁸⁷ The indicator is based on equivalised household disposable income.

⁸⁸ The indicator is based on individual income.

worker retiring at 65 after a 40 years contribution career came to 78.9% and 66.7%, respectively. Pension expenditure in Malta is below the EU-27 average (MT: 7.2% of GDP vs. EU:10.1% in 2007).

The employment rate of older workers (55-64) has declined from 28.5% in 2000 to 28.1% in 2009, and is far below the EU average of 46%. At 11.2% employment rates, for older women are around 30 percentage points below that of men at 45.3% in 2009. Shorter female careers contribute to income inequality between men and women. The average age at retirement from the labour market in Malta is 59.8 years (2008) which is almost 2 years below the EU average (61.4).

Impact of the crisis

The very marginal importance of funded schemes meant that the financial crisis had no immediate impact on the pension system.

The Maltese economy contracted by 1.5% in 2009, less than the EU on average. The employment situation in Malta has held up relatively well despite of the crisis compared with the EU. Unemployment increased from 5.9% in 2008 to a forecasted 7.3% in 2010. In 2009, the employment rate of persons aged 15-64 reached 54.9%, down by 0.4 percentage point (pp) compared to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 1 pp to 71.5%, in contrast to the 0.3 pp rise to 37.7% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) fell too by 1.1 pp to 45.3% (EU: down by 0.2 pp to 54.8%), and the employment rate of older women declined by 1.3 p. to 11.2% (EU: up by 1 pp to 37.8%).

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.9 p.p. of GDP in the 'lost decade' scenario⁸⁹) also in the long-term unless corrective action is taken.

Outlook

Developments in the old-age dependency ratio will be much more pronounced in Malta than in the EU-27 on average (MT: 19% in 2007, 59% in 2060, EU: 25% in 2007, 53% in 2060). By 2060 the working-age population (15-64) is projected to have dropped by 22%, compared with 15% for the EU as a whole.

Labour market participation rates are projected to increase in Malta over the long-term, also for women and older workers, but less than in the EU-27. The participation rate was well below the EU average in 2007 (59.5% in 2007, EU: 70.6%), and is projected to remain in that position also in 2060 (MT: 64.4%, EU: 74.1%).

Malta is in the group of Member States where the increase in public pension expenditure is projected to be very significant. The level of expenditure in 2007, at 7.2% of GDP, is below the EU average 10.2%, but the projected increase is larger in Malta, with 6.2 percentage points of GDP for the period 2007-2060 (EU: +2.4 pp). At the end of the projection period (2060) the expenditure to GDP is expected to be at 13.4%, or 1 ¾ percentage points above the EU average.

⁸⁹ See Table 76 in the 2009 Ageing Report.

The change in public pension expenditure is the net effect of several factors. The demographic transition to an older population is the main driver. This effect alone would push up expenditure significantly in Malta, by 11.3 percentage points of GDP (compared to 8.7 for the EU as a whole). Tighter pension eligibility will reduce pressure on expenditure (-3.1 pp of GDP). It is due to the gradual introduction of higher pensionable ages. The benefit effect will reduce expenditure by 0.5 pp of GDP as results of changes in the calculation base and indexation which will lower the benefit ratio (comparing an average public pension benefit to an average wage) from 42.3% in 2007 to 40% in 2060.

From 2008 to 2048 the total net replacement rate (NRR) is projected to drop from 78.9% to 69.6% while the gross rate will decline from 66.7% to 59.2%. The expected decline might raise political pressure for higher pension benefits unless improved opportunities for building compensating entitlements in occupational and voluntary schemes are developed.

Three years of unemployment have effect on NRR, which in 2008 stood at 79% and will be lower in 2048, at 70%. In the case of career-break of three years of childcare the situation is identical. Currently there is no bonus/malus effect of retiring 2 years after or before age 65, while in the future early retirement will be penalised with a NRR declining from 79% in 2008 to 67% in 2048 than in case of retirement at 65 (while there would be no improvement of NRR for late retirement). The NRR for low earners would be slightly reduced from 77% to 70%, while the NRR for high earners would drop from 46% to 38%. A 10 year career break would result in a NRR of 79% in 2008, and 53% in 2048, a loss of 26pp. of the NRR. In 2018 (10 years after retirement) the NRR would be the same as in 2008 (the year of retirement) 79%, while for those retiring in 2048 it would reach 70% and decline further to 67% in 2058.

Challenges

With the 2006 reform which raised and equalised the pensionable age, extended the contribution period and improved the minimum pension Malta made important progress towards a better balance between adequacy and sustainability concerns in its pension provision. Still the relatively low participation and employment rates for people of working age and women and older workers pose challenges to the economic basis for the pension system. The opportunity costs of this are particularly high in the long term where Malta is facing relatively larger and faster ageing than the average for EU27.

The challenge Malta faces with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed to be at 'high' risk by the Commission/Council.⁹⁰ The projected increase in pension expenditure over the long-term at 6.2 percentage points is significantly higher than the EU average. Total replacement rates are projected to fall over the long-term but remain fairly close to the EU average.

Implementing further reforms to the pension system that reduce the very high projected increase in pension spending would put it on a more sustainable path. Strong efforts in collaboration with the social partners to raise participation and employment rates of women and older workers and achieve much higher exit ages could help Malta ease the transition from larger to smaller cohorts in the labour market and moderate the unsustainably large increase in public pension expenditure. Achieving and maintaining an appropriate balance

⁹⁰ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

between working years and years spent in retirement would greatly improve both the adequacy and the sustainability of Maltese pension provision. While ideas for pension system designs should be considered from a country specific perspective it is noteworthy that experience from other Member States demonstrates that linking benefit calculations or pensionable ages to developments in longevity represent a powerful way to strengthen this balance if it is underpinned by sufficient measures in labour markets and work places to enable and encourage people to work longer.

At present the 65+ at-risk-of-poverty rates are higher than the EU average with ARPR of men being higher than that of women. The new minimum pension guarantee above the poverty risk level represents an important improvement. To compensate for falling replacement rates in the public schemes Malta may also have to improve opportunities for people to build supplementary entitlements in occupational and voluntary personal schemes.

Moreover, the economic recession has resulted in an increase in the budget deficit thus compounding the budgetary impact of population ageing, budgetary consolidation would be essential in order to contain public debt and strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

Current adequacy (2008)	Malta			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	14	12	15	16	16	17
At-risk-of-poverty rate 65+	22	24	20	19	16	22
At-risk-of-poverty rate 75+	22	25	19	22	18	24
Income inequality 0-64	4			5.1		
Income inequality 65+	3.5			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.75	0.74	0.76	0.85	0.88	0.83

Adequacy projections: MT	2008			2008		
	net	net	difference	gross	gross	difference
Theoretical replacement rates (TRR) base case	78.9	69.6	-9.3	66.7	59.2	-7.5
TRR 3 years unemployment	78.9	69.6	-9.3	66.7	59.2	-7.5
TRR 3 years childcare break	78.9	69.6	-9.3	66.7	59.2	-7.5
TRR 10 years career break	78.9	53.2	-25.7	66.7	44.4	-22.3
TRR shorter working (retirement at 63)	78.9	66.6	-12.3	66.7	56.2	-10.5
TRR longer working (retirement at 67)	78.9	69.6	-9.3	66.7	59.2	-7.5
TRR 10 years after retirement	78.9	66.9	-12.0	66.7	56.7	-10.0
TRR low earner (66% average)	76.6	70.4	-6.2	66.4	61.1	-5.3
TRR high earner (100-200% rising profile)	45.9	38.3	-7.6	35.4	29.6	-5.8
Benefit ratios: social security pensions 2007/2060				42.3*	40.00	

Current sustainability	Malta			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	8	9.1**	9.1*		12.0**	11.8*
Employment rate 15-64	54.5	55.3	54.9	62.2	65.9	64.6
Employment rate 55-64	28.6	29.2	28.1	36.9	45.6	46.0
Employment rate 55-64 women	8.2	12.5	11.2	27.4	36.8	37.8
Employment rate 55-64 men	51.3	46.4	45.3	47.1	55.0	54.8
Effective labour market exit age***	57.6	.	59.8	59.9	61.2	61.4
Public debt	55.9	63.7	69.1	61.9	61.6	73.6
Budget balance	-6.2	-4.5	-3.8	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	19	39	59	25	38	53
Public pension expenditure, % of GDP	7.2	9.3	13.4	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	11.3	8.7
Employment	-0.7	-0.7
Eligibility	-3.1	-2.6
Level of benefits	-0.5	-2.5
Total (including residual)	6.2	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Netherlands

Description

The **statutory (state) old age pension (AOW)** provides all residents of the Netherlands at the age of 65 with a flat-rate pension benefit that in principle guarantees net benefits of 50% of the net minimum wage for each partner in couples or 70% for singles. All residents of the Netherlands between the ages of 15 and 65 are insured by the AOW. During the period of insurance entitlement is accrued by 2% every insured year. This leads to a 100% entitlement when reaching the age of 65, provided there are no gaps in the period of insurance. By its linkage to the minimum wage the AOW benefit profits also from the indexation of the minimum wage to the contractual wage increases. Deviation from this indexation is only possible in case of wage increases or rises in social security contributions that harm economic growth and employment. The pay-as-you-go financed AOW has a contribution rate of 17.9% that applies to the lowest two income tax brackets (€32,738 in total). People who are entitled to a partial AOW benefit and who have, together with other sources of income, a total income below the subsistence level are entitled to social assistance.

Private occupational pension schemes are well developed in the Netherlands. The scheme can either be arranged company-specific, or industry wide. Occupational pensions are subject to negotiations between social partners and are financed by capital funding. In principal participation in an occupational pension scheme is not mandatory, but in practice it almost always is, either by the employer, or by the government.⁹¹ This leads to coverage of over 90% of all employees.

Characteristically, the total pension benefit could result in around 70% of the final career salary or 80% of the average career salary. The final pay schemes usually have an accrual rate of 1.75% each year, while the rate amounts to around 2% for the average pay schemes. Occupational pension schemes are considered supplementary to the AOW. The AOW benefit is therefore included in most calculations of occupational pension schemes in order to achieve the 70% or 80% target after 40 years of contributions. This also applies to the contributions that are levied on the salaries minus a franchise in order to reckon with the AOW benefit. On average the contribution rate on the salary minus the franchise is around 20%. The way contributions are divided among social partners varies from one pension scheme to another.

The supplementary occupational pensions are indexed to wages or prices if the financial position of the pension fund allows doing so. Likewise, the yearly adjustment of the acquired rights of active participants to the contractual wage increases is frequently (i.e. in case of average pay schemes) also conditional to the funds position. Usually, if the funds assets cover less than 125% of the liabilities, the indexation of both pensions and acquired rights will be less than 100%. And it will drop to 0% if the coverage rate becomes 105% or less.

Besides the capital funded occupational pensions there also exists private pay-as-you-go financed **early retirement schemes**, founded by the social partners in the aftermath of the first oil crisis. Around 1995 social partners started to reform those schemes with a gradual transition to funded early retirement schemes and an immediate application of more actuarial

⁹¹ Mandatory participation in a branch pension scheme or in a pension fund for professional groups is imposed by the Ministry of Social Affairs and Employment after a request from representative parties in the branch.

fairness in case of working longer. By 2006 the government ended the favourable fiscal treatment of the pay-as-you-go financed early retirement schemes with a transition period up to 2015. This reform forced social partners to integrate the early retirement schemes in the traditional occupational pension schemes.

In response to the previous crisis most schemes shifted from final pay to average pay pension schemes.

The Dutch pension system also includes individual pension provisions, through annuity insurance, encouraged by tax rebates up to certain limits (annuity contributions are tax deductible and the pension payments are taxed).

The last crisis induced the government to install three commissions that have published their analyses on the sustainability of the Dutch pension system early 2010.

On 4 June 2010 social partners reached an agreement on increasing the pension age in accordance with increases in life expectancy⁹².

- The state pension age should be increased to 66 years from 2020, and expected to be raised to 67 years from 2025. This results from a formulae by which the pension age would be adjusted to life expectancy every five year. Any change in the pension age would be announced 10 years ex ante. The fiscal retirement age for occupational pension schemes will follow the state pension age.
- Flexibility in the pension age should also be introduced for the state pension from the age of 65, with actuarial adjustments in the pension level. So, if the statutory pension age becomes 67, one can still obtain a state pension at age 65 with an actuarial reduction.
- In the agreement it is also stated that occupational pension schemes should become more shockproof against events on the financial markets including adjustments in short term contributions and benefits, while maintaining stable contribution rates over time.

This agreement is under discussion with the Dutch government in order to determine which amendments in regulation can contribute to realise the desired new balance between ambition, security, solidarity and costs and forms a part of the new government's coalition agreement.

Current performance

The current relative median income level of people aged 65+ compared to the general population amounts to 84%⁹³. The benefit ratio of the average gross public pension to the average gross wage equals 43%. The first is at the EU-27 average, the latter is slightly below the EU-27 average. [The benefit ratio also includes disability and survival pensions obtained by people below the age of 65. The ratio equals to 28.3% if only the AOW benefits are taken into account. Together with the private pensions the ratio raises to 58.6% in 2007.] The at-risk-of-poverty-rate of population 65+ at 10% is nine percentage points lower than the EU average, and slightly lower than for the population below the age of 65. In terms of adequacy, the Dutch pension system provides good protection against poverty and with a high replacement rate helps older people to maintain their living standards after retirement. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (92.4%) is high compared to the EU average. The net rate amounts to 103.8%.

⁹² There are expectations that the agreement will become part of negotiations for a new government coalition. National elections were held on 9 June 2010.

⁹³ The indicator is based on equivalised household disposable income.

The employment rate of older workers (55-64) has risen from 38.2% in 2000 to 55.1% in 2009, and is above the EU average of 46%. At 44.7% employment rates for older women are almost 20 percentage points below that of men at 65.4%. The average exit age from the labour market in The Netherlands is 63.2 years (2008) which is above the EU average (61.4).

Impact of the crisis

The employment situation in the Netherlands has held up relatively well in spite of the crisis compared with the other EU countries. In 2009, the employment rate of people aged 15-64 declined compared to 2008 by only 0.2 percentage points to 77% (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 0.8 pp to 82.4%. Despite the crisis the female employment rate increased with 0.4 pp to 71.5% (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) increased by 1.7 pp to 65.4% (EU: down by 0.2 pp to 54.8%), while the employment rate of older women managed to grow by 2.5 pp to 44.7% (EU: up by 1 pp to 37.8%).

Dutch pension funds experienced considerable asset losses due to the crisis. At the end of 2007 their amount of assets was equal to € 684 billion (120% of GDP). During 2008 they fell to € 578 billion (97% of GDP). The average coverage ratio declined in this period from 144% to 95%. This caused pension funds to refrain from full or even to withhold indexation and, in some cases, to raise contributions in 2009 and 2010.

The Dutch government acted by introducing less tight demands on pension funds to restore their coverage ratios (they now have five instead of three years to restore the minimum required ratios of 105), to prevent that too drastic measures are taken in the process. Within fifteen years all funds have to reach coverage ratio of about 125%. In 2009 the pension funds benefited from the rebound on the stock markets by which total assets could raise to € 666 billion (120% of GDP) at the end of 2009. The average coverage ratio climbed to 109%. However, two factors became detrimental to a continued recovery: an unexpected rise in life expectancy and a further fall in the interbank swap rate. Both factors boost the liabilities of pension funds in 2010 by which the coverage ratio falls again. In view of these developments the government had to recall an earlier permission to postpone necessary measures. Therefore, 14 pension funds where the coverage ratio is far below the solvency requirements might have to cut pension benefits from January 1, 2011. This will affect approximately 150,000 pensioners.

In view of the problems that the Dutch pension funds face in meeting the solvency requirements, it should be noted that the liquidity is not in danger because the total contributions still exceed the expenditure on pension benefits.

Outlook

Developments in the old-age dependency ratio (defined as the number of people over 65 to the number of people aged 15-64) will be slightly less pronounced in the Netherlands relative to the EU average (NL: 21% in 2007, 47% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to drop by 13%, compared with 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in the Netherlands over the long-term, especially for women and older workers, but less than in the EU-27. The participation rate was well above the EU average in 2007 (3rd highest at 78.8% in 2007, after Denmark and Sweden, EU: 70.6%), and is projected to remain in that position also in 2060 (NL: 80.2%, EU: 74.1%).

The Netherlands is in the group of Member States where the increase in gross public pension expenditure is projected to be significant. The level of expenditure, as defined in the 2009 Ageing Report, at 6.6% of GDP in 2007, was below the EU average 10.2%, but the projected increase is larger in the Netherlands, with 4 percentage points (pp) of GDP for the period 2007-2060 (EU: +2.4 pp). At the end of the projection period (2060) the expenditure to GDP is expected to be at 10.6% of GDP, 2 pp below the EU average.

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure significantly in the Netherlands, by 6 ½ percentage points of GDP (compared to 8.7 pp for the EU as a whole).

Impact of demographic factors on public pension expenditure will to a certain extent be counterbalanced by restricted pension eligibility. The coverage ratio, which is the ratio of the number of pensioners under the public scheme (all ages) divided by the number of people aged 65 years and above is projected to fall less in the Netherlands than in the EU as a whole. Tighter eligibility rules should contribute to a reduction of public pension expenditure by 1.5 pp between 2007 and 2060. These calculations do not take into account the June 2010 agreement on increasing the pensionable age. Occupational pension provision also plays a significant role in the Netherlands, amounting to 5.2% of GDP in 2007. It is projected to more than double in the period to 2060, when it is projected to be 12.1 % of GDP. This provides an important contribution to adequate pensions. Total pension expenditure (statutory and occupational pensions) should then be above 20% of GDP in 2060.

The benefit ratio, which compares an average pension benefit from both statutory and occupational tiers to an average wage, is projected to increase from 74% in 2007 to 81% in 2060, although it dropped by more than 1 pp due to lower indexation of supplementary pensions in 2009. Nevertheless it may remain one of the highest results in the EU (the public pension benefit ratio is projected to drop from 43.8% to 40.5%, especially as a result of lower disability pensions; the ratio for old age pensions only remained constant in recent years). In the next 50 years the system should thus protect against poverty and maintain living standards of retired people.

The current net theoretical replacement rate (for a worker retiring at 65 after 40 years of contributions with average earnings) is 103.8% and the gross replacement rate 92.4%. Provided that the pension fund returns develop as expected, replacement rates may remain constant the coming four decades. The negative effect of 3 years of unemployment came to 2.05% of the NRR in 2008. The negative effect of a 3 year childcare break is 3.74%. Working longer has a significant effect on the NRR: working 2 years longer increases the NRR with 7.72%. Vice versa there is a substantial malus on early retirement of 10%. Both stimulate working longer. The NRR for low earners equals 112.9%, while the NRR for high earners is 77.9%. The effect of a 10 year career break on the NRR would increase from a loss of about 12.46% to a loss of 18.69%. The decrease in the NRR 10 years after retirement stays 0%.

Challenges

The Dutch pension system stands out as a well-consolidated combination of a good, basic public pillar supplemented by a resilient, well performing occupational system that has found a balance in sharing risks and responsibilities between pensioners and the working population and it would be well-placed to achieve a good balance between adequacy and sustainability concerns in delivery. But projected increases in the already comparatively high replacement rates will strain financial sustainability. The country is also some distance from achieving a fully appropriate balance between working years and years in retirement.

The challenge which the Netherlands faces with regard to ensuring the long-term sustainability of the public finances on the back of its ageing population was assessed as at 'high' risk by the Commission/Council.⁹⁴ The projected increase in pension expenditure over the long-term, at 4 percentage points of GDP, is significantly higher in than the EU average.

Implementing reforms to the pension system that contain the high projected increase in pension spending while increasing efforts to raise participation and employment rates would be important for putting it on a more sustainable path. The already high levels of labour market participation rates of older workers give good ground to increase the pensionable age. It is therefore encouraging that the Dutch social partners have agreed on raising the pensionable age and to secure future adequacy and sustainability. However, the new government has to discuss with the social partners on how the envisaged adjustment mechanisms to cope with both the increasing life expectancy and the volatility on the financial markets has to be put into legislation.

The existing focus in the financial supervisory framework on guaranteeing nominal rights should indeed be refocused on the ability of the pension funds to provide real, indexed pensions in order to bridge the gap between pension expectation and pension realisation. The public and political reactions to the likelihood that pensions might be cut suggest that the workings of the existing adjustment mechanisms are less well understood than they could be. The present reviews of these adjustment mechanisms is therefore important in necessary further efforts to improve both the solidity of the system and the public understanding of it. If future pensioners are to plan and respond well to incentives in the pension system access to information about already accumulated and simulated future pension entitlements would be called for.

Following the crisis induced weakening of the Dutch public finances budgetary consolidation would be essential in order to contain public debt and strengthen the basis for financing the future increase in public pension expenditure. The budgetary position in 2009 compounds the budgetary impact of population ageing. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

⁹⁴ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

Current adequacy (2008)	Netherlands			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	11	11	11	16	16	17
At-risk-of-poverty rate 65+	10	10	9	19	16	22
At-risk-of-poverty rate 75+	11	13	10	22	18	24
Income inequality 0-64	4.1			5.1		
Income inequality 65+	3.2			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.84	0.85	0.84	0.85	0.88	0.83

Adequacy projections: NL	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	103.8	103.8	0.0	92.4	92.4	0.0
TRR 3 years unemployment	101.7	101.7	0.0	89.9	89.9	0.0
TRR 3 years childcare break	100	100	0.0	87.8	87.8	0.0
TRR 10 years career break	90.9	90.9	0.0	76.8	76.8	0.0
TRR shorter working (retirement at 63)	93.3	93.3	0.0	79.7	79.7	0.0
TRR longer working (retirement at 67)	111.9	111.9	0.0	102.1	102.1	0.0
TRR 10 years after retirement	103.8	103.8	0.0	92.4	92.4	0.0
TRR low earner (66% average)	112.9	112.9	0.0	97.2	97.2	0.0
TRR high earner (100-200% rising profile)	77.9	77.9	0.0	66.7	66.7	0.0
Benefit ratios: social security pensions 2007/2060				43.8*	40.50	

Current sustainability	Netherlands			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	12.5	12.3**	12.1*		12.0**	11.8*
Employment rate 15-64	72.9	77.2	77.0	62.2	65.9	64.6
Employment rate 55-64	37.9	53.0	55.1	36.9	45.6	46.0
Employment rate 55-64 women	25.8	42.2	44.7	27.4	36.8	37.8
Employment rate 55-64 men	49.9	63.7	65.4	47.1	55.0	54.8
Effective labour market exit age***	60.9	63.9	63.2	59.9	61.2	61.4
Public debt	53.8	58.2	60.9	61.9	61.6	73.6
Budget balance	2.0	0.7	-5.3	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	21	40	47	25	38	53
Public pension expenditure, % of GDP	6.6	9.3	10.5	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	6.6	8.7
Employment	-0.2	-0.7
Eligibility	-1.5	-2.6
Level of benefits	-0.6	-2.5
Total (including residual)	3.9	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Austria

Description

The public pension system in Austria is earnings-related and organised on a PAYG-basis. It covers all employed except civil servants and most categories of self-employed. Contributions amount to 22.8% of gross earnings. The current pensionable age is 65 years for men and 60 years for women. Between 2024 and 2033 the pensionable age for women will gradually be increased by 0.5 year-steps per year to equal the pensionable age for men. Early retirement (pensioning) is possible on the grounds of disability, of long-term insurance contributions,⁹⁵ of physically hard work⁹⁶ and at the age of 62 with a deduction of 4.2% per year between 62 and 65 (“corridor-pension”).

Pension benefits are indexed to consumer prices. There is no mechanism in the public scheme that adjusts entitlements automatically in line with growth in life expectancy. Every third year there is a reporting of the Austrian Pensions Commission concerning the long term sustainability of the public pension system on the basis of the economic and demographic development as well as the growth in life expectancy for the next 50 years.

The pension system underwent several reforms in the last 10 years. In 2005 the pension system was harmonised through the introduction of a uniform pension law covering people in all occupations born on 1 January 1955 or later. Those who enter the labour market after 1 January 2005 are only affected by the new Pension account: this means an annual accrual rate of 1.78%, lifetime earnings as basis for the pension calculation and 4.2% bonus for deferred and 4.2% malus for early pension take up. Persons, who are born on 1 January 1955 or later and have already pension contributions are part of both the old and the new pension system: the pension is calculated as the weighted sum of the two pensions according to the contribution periods in these two systems (“Parallel calculation”).

According to the old calculation system, the annual accrual rate has been reduced stepwise from 2% in 2003 to 1.78% by 2009, and the assessment period will be increased from the best 15 to the best 40 years by 2028. Possibilities for early pension take-up due to reduced capacity to work or unemployment were abolished in 2000. But early pension take-up without deductions is still possible on account of long-term insurance contributions⁹⁷. This type of early retirement was originally planned to expire in 2010, but was prolonged by three years in 2008, and a further prolongation with a stepwise phasing out after 2013 is currently under consideration.

Private schemes have a rather limited role in overall provisions, although coverage and the accumulated funds have increased somewhat in recent years.. In 2008 about 26% of the dependent employees were entitled to receive an additional pension from an occupational scheme in the future, and 2.4% of pensioners are already beneficiaries. The second pillar was strengthened by the introduction of the new severance pay scheme in 2003. Employers are obliged to pay 1.53% of the monthly gross salary to a staff provision fund set up especially

⁹⁵ *Hacklerregelung für Langzeitversicherte (phased out in 2013: retirement age 60 for men, 55 for women) and Vorzeitige Alterspension bei langer Versicherungsdauer (phased out in 2017: retirement age in 2010: 63 for men, 58 for women)*,

⁹⁶ *Schwerarbeiterpension (retirement age: 60 for men, 55 for women).*

⁹⁷ “Hacklerregelung”

for this purpose. Employees have the option to withdraw their savings in case of termination of a work contract (if specific preconditions are fulfilled) or keep them until retirement age. The latter option, however, does not seem to be widely used at the moment.

Current performance

The current relative median income level of people aged 65+ is close to that of the general population (92% relative median income ratio and aggregate replacement ratio of 0.68%, both well above the EU27 average). The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (68%) is slightly above the EU average. The net rate amounts to 84%. However, people aged 65+ face a higher risk of poverty than the overall population (15% vs. 12% overall). Women are at a particularly high risk of poverty at pensionable age (17%), as their pension outcomes are significantly lower than those of men.

The employment rate of older workers (55-64) has risen sharply from 29.2% in 2000 to 41.% in 2009, but is still below the EU average of 46%. At 30.8% the employment rates for older women are almost 20 percentage points below that of men. The average effective retirement age in Austria is 60.9 years, which is well below the statutory retirement age and slightly below the EU average. Early retirement is still a widely used option. Around 28% of all new pensions granted in 2009 (except survivors' pensions) were early pensions for the long-term insured ('Hacklerregelung'); 9% were early pensions on grounds of long-term insurance records, 5% other early pensions with deductions, and 31% invalidity pensions.

Impact of the crisis

Due to the large PAYG-part in the Austrian pension system and the immaturity of third pillar funded schemes their losses as an immediate effect of the financial crisis had little direct effect on current pensioners and are unlikely to affect future pensioners in major ways. This however can not be said for the occupational funded scheme where there were some major losses. These losses were laid mainly with the pensioners.

Compared to 2007 (71.4%) the employment rate of population aged 15-64 has remained constant in 2009 (71.6%), but has declined compared to the all time high in 2008 (72.1%). With female employment rates even higher in 2009 than in 2007 women appear less affected by the crisis. The employment rate for older workers also continued the increasing trend despite the crisis. The increase in unemployment from 4.4% in 2007 to 4.8% in 2009 has been less pronounced than in many other EU Member States, but has hit young people in particular. With the exception of young people unemployment has therefore so far affected the accrual of pension rights in a relatively limited way. Still government finances have deteriorated strongly following the crisis.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.7 p.p of GDP in the 'lost decade' scenario⁹⁸) also in the long-term unless corrective action is taken.

⁹⁸ See Table 76 in the 2009 Ageing Report p. 239.

Outlook

Austria spends about 13% of its GDP on pensions (the pension scheme for civil servants is included), an amount rather stabilised over the last years, but high in EU comparison (2007, EU average 11.8%). According to the budgetary projections made by the AWG in 2009, public expenditure on social security pensions will increase to 14% in 2030, and fall back only slightly in 2060. This projected growth is below the EU-27 average, but expenditure levels are still expected to be among the highest in Europe.

Austria is expected to face an adverse demographic trend in the coming decades, which is comparable to the EU average. Between 2008 and 2060 the old-age dependency ratio (according to the latest figures from Eurostat) is expected to increase from 27% (EU27 average:25%) to 53% (EU27 average:53%).

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is projected to grow from 84% in 2008 to 89% in 2048. The negative effect of 3 years of unemployment which came to 0.83% of the NRR in 2008 will be three times larger in 2048 (2.25%). In the same period the negative effect of a 3 year childcare break would be reduced from 2.4% to just 1.1%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, will become symmetrical because of a substantial increase in the bonus. The NRR for low earners would be slightly increased from 83.8% to 85.7% while the NRR for high earners would drop from 76% to 71.8%. The effect of a 10 year career break on the NRR would increase from a loss of about 17.4% to a loss of 19.3%. The decrease in the NRR 10 years after retirement which in 2018 for workers retired in 2008 amounts to 13% would be more pronounced for those retired in 2048 at 15.3% (value for the NRR in 2058). What stands out is the fact that the NRR for a low income worker is in fact lower than the base case scenario, and thus questioning the adequacy of the pension system for that group.

Challenges

The Austrian pension system has undergone large-scale structural reforms which will help to improve long-term financial sustainability, and the employment rate shows a positive trend. This gives ground to deal with the challenge Austria faces with regard to ensuring the long-term sustainability of the public finances in light of its ageing population which was assessed as at '*medium*' risk in this regard by the Commission/Council. The projected increase in pension expenditure over the long-term at 0.9 percentage points of GDP between 2007 and 2060 is lower than the EU average. The long transition periods and a number of special arrangements that limit the effect of reforms make it questionable whether these provisions will be enough to cope with the already high levels of public spending on pensions. Recent measures, e.g. the prolongation of the early retirement scheme for people with long insurance records undermine signals to the public about the importance of working longer.

The employment rate for older workers and the effective retirement age are still well below the EU average, despite of recent increases. This causes additional pressure on the sustainability of the system and it is extremely important to reduce the gap between effective pension take up and the pensionable age. There is an urgent need to review policies to promote employment for older workers. A good mix of strengthened incentives in tax-benefit structures incl. pensions, enhanced participation in life-long learning, re-integration of people dependent on benefits and improvements in age management practices in work places in

collaboration with the social partners could help to keep people longer in employment and contribute to sustainability and adequacy.

The poverty risk of especially female pensioners presents another challenge. This is mainly a result of women who receive only a survivor's pensions and have no pension entitlement of their own, but also of high gender pay gap and gender difference in the retirement age. Despite some improvements in the last years (e.g. child care periods count for the pension calculation as well as for the entitlement of a pension), there is a need to take measures to raise employment rates of women, to further facilitate the reconciliation of work and family, and to improve women's life-time earnings. Furthermore, efforts should be directed at ensuring that the equalisation of the pensionable age for women with that for men is sped up. This is important, not only in the light of financial sustainability, but very much to avoid that women are exposed to a disproportionate risk of poverty in old age.

Last, it is important to apply a new and more precise sustainability mechanism ("Pension monitoring") with regard to the current and future expenditure for public pensions and the public expenditure for occupational and private pension schemes as well as for civil servants (as it is pointed out in the Government's programme).

The main crisis impacts on the Austrian pension system concern the weakening of public finances. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

	Austria			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	12	11	13	16	16	17
At-risk-of-poverty rate 65+	15	12	17	19	16	22
At-risk-of-poverty rate 75+	16	12	18	22	18	24
Income inequality 0-64	3.7			5.1		
Income inequality 65+	3.6			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.92	0.97	0.9	0.85	0.88	0.83
Adequacy projections: AT	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	84.1	88.8	4.7	68.6	68.6	0.0
TRR 3 years unemployment	83.4	86.8	3.4	67.8	66.7	-1.1
TRR 3 years childcare break	82.1	87.8	5.7	66.2	67.7	1.5
TRR 10 years career break	69.5	71.7	2.2	51.4	51.5	0.1
TRR shorter working (retirement at 63)	76.5	80	3.5	59.7	59.7	0.0
TRR longer working (retirement at 67)	87.6	98.2	10.6	72.7	80	7.3
TRR 10 years after retirement	73.2	78.9	5.7	58.1	58.2	0.1
TRR low earner (66% average)	83.8	85.7	1.9	68.6	68.6	0.0
TRR high earner (100-200% rising profile)	76	71.8	-4.2	62.7	51.7	-11.0
Benefit ratios: social security pensions 2007/2060				54.9*	38.50	
	Austria			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	14.3	14.1**	13.8*		12.0**	11.8*
Employment rate 15-64	67.9	72.1	71.6	62.2	65.9	64.6
Employment rate 55-64	29.2	41.0	41.1	36.9	45.6	46.0
Employment rate 55-64 women	17.8	30.8	31.7	27.4	36.8	37.8
Employment rate 55-64 men	41.4	51.8	51.0	47.1	55.0	54.8
Effective labour market exit age***	59.2	60.9		59.9	61.2	61.4
Public debt	66.5	62.6	66.5	61.9	61.6	73.6
Budget balance	-1.7	-0.4	-3.4	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	25	38	51	25	38	53
Public pension expenditure, % of GDP	12.8	13.8	13.6	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	9.9			8.7		
Employment	-0.5			-0.7		
Eligibility	-2.6			-2.6		
Level of benefits	-5			-2.5		
Total (including residual)	0.8			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Poland

Description

The **statutory pension system**, implemented in 1999 consists of two elements, both of which are mandatory and universal (there are special schemes for farmers and some civil servants such as the military, police, judges and prosecutors, and special rules for miners): a pay-as-you-go notional defined contribution (NDC) scheme, administered by the Social Insurance Institution (ZUS) and a fully funded scheme, managed by independent private investment companies (open pension funds, OPFs), supervised by the State. The statutory scheme is financed by the old-age pension contributions (the contribution rate is equal to 19.52% of gross salary) collected by ZUS and divided into the contribution for the NDC pensions and for the statutory funded scheme (ZUS transfers 7.3% of gross salary to OPF).

The retirement age is 65 for men and 60 for women. Current pensioners still receive pensions from the old pay-as-you-go defined-benefit system. First beneficiaries from the new system retired in 2009 (women) or will retire in 2014 (men).

Additionally to the mandatory funded accounts, there are options for voluntary savings in the form of occupational pension schemes and/or voluntary individual accounts. Occupational pension schemes are established through the cooperation of employers and representatives of the employees. The government encourages people to save in both schemes (occupational and individual) by giving a tax exemption on income from the investment.

According to the assumptions of the reform, the entitlement to the early retirement under the old retirement pension system was granted to people meeting special conditions and was kept until the end of 2008. After that date the bridging pension (temporary solution) scheme has replaced early retirement provision for some categories of workers. The new law is applied to individuals born after 1948. In 2009 a ceiling for administrative fees charged by open pension funds has been lowered, forcing OPFs to reduce the fees.

The government has discussed conditions for pay-out phase in the mandatory funded scheme.

Further pension reforms are currently underway in order to reduce the impact on the ESA95 deficit of the 1999 reform, and avoid reaching a government debt threshold of 55% of GDP, which would force the government to implement corrective fiscal measures according to the Polish fiscal rules. While too early to assess, the overall direction of the political discussion introduces uncertainty as to the composition of pension provision in the future.

Current performance

The pension system in Poland currently provides a high degree of adequacy of pensions that is clearly not sustainable in the long run. The aggregate replacement ratio is above the EU average and the poverty risk among older people is significantly lower than that of the population below the age of 65, but is around a third higher for women than for men. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (59%) is close to the EU average. The net rate amounts to 68%.

The effective retirement age is still much lower than the pension eligibility age and in 2007 equalled 57.5 years for women and 61.4 years for men. It is expected that effective retirement age will increase as a result of withdrawing possibility to early retirement.

Although some increase in the employment rate has been recently observed, it is still almost the lowest among all age groups in relation to other EU Member States. In 2009 the indicator was at 59.3% for those aged 15-64 (66.1% for men and 52.8% for women) which still puts Poland far below the EU average (64.6%, 70.7% and 58.6% respectively). The relatively high increase of employment rate among women observed since 2005 (around 2 pp per year) has been stopped and in result only 0.4 pp increase is noted between 2009 and 2008. Employment rates of older workers are also very low. In 2009 the employment rate of male workers aged 59 was at 47% and of males aged 60 only at 30% and of women correspondingly at 20.6% and 16.7%.

Despite recent increase, the coverage rates of the third pillar are low. Members of the occupational schemes represented 3.8% of the workforce in 2007, and 11.3% of the workforce held individual pension accounts in the same time. Moreover, an average holder of the individual third pillar account saved 1700 PLN in 2007. This represents only 40% of the amount that is tax exempted. In addition, the number of these accounts has decreased in 2009 by 4.5% in comparison to 2008, mainly due to the economic slowdown. Nevertheless, the government recognizes the fact that supplementary pension provision should be promoted.

Impact of the crisis

Economic slowdown has worsened the balance of social insurance schemes and has added to the transition costs of introduction of mandatory funded pension scheme. In consequence fiscal position of the country was weakened further. Despite the fact that Poland avoided negative growth during the global economic crisis, the state of public finances has deteriorated considerably and the public budget deficit widened in 2009.

The financial crisis had an influence on OPFs' assets which may particularly affect the small group of those pensioners who are to retire soon. In 2007 accounting unit values by open pension funds increased by 6.2%. There was a negative change in 2008 (- 14.3%) and renewed increase in 2009 year by 13.7%. This is backed-up by a deteriorated perception of the OPF in society and may result in a significant decrease in the inflow of people willing to open voluntary individual retirement accounts.

In light of the recent fluctuations in the value of the OPF assets, the government considers different options for OPFs' members nearing retirement age to reduce risk of the changes in the value of assets.

The crisis has animated the debate on pension policy. Nevertheless, some proposals aired in the discussion (e.g. voluntary character of insurance, introduction of lump-sum payments instead of periodic benefits/annuities) could undermine basic principles of social insurance.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.9 pp of GDP in the 'lost decade' scenario⁹⁹) also in the long-term unless corrective action is taken.

⁹⁹ See Table 76 in the 2009 Ageing Report p. 239.

Outlook

The Polish population is relatively younger than in the EU on average. In 2010 the old-age dependency ratio comparing the number of those aged 60 and more to the working age population aged 20-59 is equal to 32% in Poland and 42% in the EU-27. According to the demographic projections¹⁰⁰, in 2060 Poland will be one of the oldest of the EU-27 Member States and the ratio will rise to 100% (79% in the EU-27).

Despite accelerated population ageing the AWG's 2009 projections show a considerable drop in gross public social security pension expenditure from 11.6% of GDP in 2007 to 8.8% in 2060 (and 10.8% of GDP when the mandatory funded tier is taken into account). The projected drop in expenditure results from an assumption of considerable decrease in the number of pensioners relative to older people and from projected decrease of the value of pension with respect to the average wage. The pay-as-you-go tier is projected to remain in deficit until the mid-2030s due to transition costs.

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is projected to decrease from 68% in 2008 to 51.2% in 2048. While all but a few Member States will experience a decline in replacement rates, the decline in Poland is amongst the highest. This decrease in NRR can be partly explained by the fact that:

- the period of individual earnings used to calculate the pension entitlement has been extended to encompass life-time earnings,
- the value of pension benefit takes into account a life expectancy adjustment factor putting the longevity risk fully onto the individual.

In the mixed NDC-DC system the link between contributions and benefits is considerably strengthened, so that people with short working lives risk to receive inadequate income in the old age. The negative effect of 3 years of unemployment which came to 2.9% of the NRR in 2008 will increase by more than a factor of two by 2048 (7%). In the same period the negative effect of a 3 year childcare break would be maintained around 3.2%. As a result of a stronger link between contributions and benefits, the relative bonus/malus effect of retiring 2 years after and 2 years before age 65 (+2.9% bonus and -2.9% malus in 2008), would be strengthened over the period (to a 13.6% bonus and -4.6% malus in 2048).

According to these projections, low-wage earners can expect the lowest net replacement rate in the EU-27 in 2048. The NRR for low earners would be reduced from currently 79% to 51.4% in 2048. The NRR for high earners would drop from 58% to as little as 39.8%. Replacement rates of people with incomplete careers are also projected to be very low. The effect of a 10 year career break on the NRR would increase from a loss of about 16% to a loss of 24%. Partial wage indexation has been recently introduced, so a replacement rate of a full career worker 10 year after retirement would at 41.1% in 2048 also be one of the lowest in the EU-27. The decrease in the NRR 10 years after retirement was in 2008 17.7% and would become more serious in 2048 at 19.7%. The benefit ratio, which is the average benefit of mandatory public and private pension as a share of the economy-wide average wage is projected to drop even more than the NRR, from 56% in 2007 to 31% in 2060. Low value of projected benefit ratio reflects:

¹⁰⁰ Europop 2008 projections.

- difference in the retirement age for men and women and in consequence lower level of pension benefits received by women (women form the majority of retired population),
- decreased pension entitlements of people with short or broken careers and low-wage earners,
- inclusion in the ratio of benefits other than old-age pensions, which are usually lower (e.g. survivors pensions),
- inclusion in the ratio of different pension schemes (e.g. farmers' scheme),
- assumption of a higher wage growth in the calculations of benefit ratio.

Given the current lower retirement age and shorter participation in the labour market, the NRR for women is 13 percentage points lower compared with men retiring at the legislated retirement age in 2048. This is amongst the biggest differences compared with those Member States that have different retirement ages for men and women.

Challenges

With the fundamental reform of 1999, which established strong contributory principles and working incentives by introducing a NDC supplemented by a mandatory, fully funded scheme Poland took crucial steps towards achieving a much better balance between sustainability and adequacy concerns in its pension provision. Further important reforms have followed but the full elaboration of the pension reform into rules for the pay-out phase of the funded scheme is lacking. Smaller parts of the older edifice of pension provisions (e.g. special schemes) still need to be reformed.

Poland faces a challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population. The country was assessed to be at 'medium' risk by the Commission/Council.¹⁰¹ The projected decrease in pension expenditure over the long-term at 2.8% of GDP is below the average projected increase in the EU. But total replacement rates and benefit ratios are projected to fall over the long-term and are projected to become among the lowest in the EU even though the mandatory funded scheme to some extent is projected to offset the decreasing replacement levels in the first pillar.

It remains to be seen whether the pension system will be sustainable from the social point of view unless people work much longer than today. Reaching the good balance between sustainability and adequacy concerns, that Poland is aiming for, will crucially depend on raising participation and employment rates of all of working age, older workers and women in particular. The country is also still quite a distance from achieving an appropriate balance between working years and years in retirement.

Poland would benefit from continuing reforming the pension system, especially the heavily subsidised farmers' scheme and the disability scheme. A review of special pension regimes (e.g. for police and armed forces) is also needed so that privileges become transparent and the effective retirement age is increased.

Following the projected decline in the theoretical replacement rate, the adequacy of pensions may become an issue in the future, notably for low-wage earners and those with short careers, predominantly women. This highlights the urgent need to equalise the retirement age for both genders. Greater safety of retirement savings can be achieved in the mandatory funded

¹⁰¹ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

scheme (e.g. via life-styling). It is positive that administrative fees charged by pension funds in the mandatory scheme have been lowered. The government should also carefully design the pay-out phase in the mandatory funded scheme. Proposed solutions should not create disincentives to stay in the labour market after the retirement age and should not expose older pensioners to higher risk of poverty.

Moreover, 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 public pension expenditure. Recent reforms, however, tend to raise expenditure in the long-term. Ensuring higher primary surpluses over the medium term, as already foreseen in the latest convergence programme, would contribute to reducing risks to the sustainability of public finances.

The Polish government has been contemplating the changes to the pension system for the last two years so as to limit the negative impact on the government budgetary position (deficit and debt) of the 1999 pension reform. While too early to assess, the overall direction of the political discussion introduces uncertainty as to the composition of pension provision in the future and conceivably this could have a negative impact on the long-term sustainability of public finances. In this context the Polish government should carefully assess the balance between the amount of prefunding they can afford and the additional long-term costs they will face if they reduce prefunding permanently.

Background statistics

Current adequacy (2008)	Poland			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	18	18	17	16	16	17
At-risk-of-poverty rate 65+	12	9	13	19	16	22
At-risk-of-poverty rate 75+	10	6	12	22	18	24
Income inequality 0-64	5.4			5.1		
Income inequality 65+	3.4			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.97	1.05	0.92	0.85	0.88	0.83

Adequacy projections: PL	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	68.0	51.2	-16.8	59.0	43.7	-15.3
TRR 3 years unemployment	66	51.2	-14.8	57	43.7	-13.3
TRR 3 years childcare break	61	36.8	-24.2	53	30.9	-22.1
TRR 10 years career break	57	38.5	-18.5	49	32.4	-16.6
TRR shorter working (retirement at 63)	66	48.9	-17.1	57	41.6	-15.4
TRR longer working (retirement at 67)	70	58.2	-11.8	61	50	-11.0
TRR 10 years after retirement	56	41.1	-14.9	48	34.7	-13.3
TRR low earner (66% average)	79	51.4	-27.6	68	43.7	-24.3
TRR high earner (100-200% rising profile)	58	39.8	-18.2	50.0	32.9	-17.1
Benefit ratios: social security pensions 2007/2060				56.2*	25.80	

Current sustainability	Poland			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	12.6	12.5**	11.6*		12.0**	11.8*
Employment rate 15-64	55.1	59.2	59.3	62.2	65.9	64.6
Employment rate 55-64	29.0	31.6	32.3	36.9	45.6	46.0
Employment rate 55-64 women	21.8	20.7	21.9	27.4	36.8	37.8
Employment rate 55-64 men	37.4	44.1	44.3	47.1	55.0	54.8
Effective labour market exit age***	56.6	59.3		59.9	61.2	61.4
Public debt	36.8	47.2	51.0	61.9	61.6	73.6
Budget balance	-3.0	-3.7	-7.1	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	19	36	69	25	38	53
Public pension expenditure, % of GDP	11.6	9.4	8.8	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	13.4	8.7
Employment	-1	-0.7
Eligibility	-6.3	-2.6
Level of benefits	-7.1	-2.5
Total (including residual)	-2.8	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Portugal

Description

The Portuguese pension system is characterised by a statutory regime, which is a general scheme mandatory for the private sector. Special schemes exist for civil servants (but the system for government employees has been closed to new entrants since the end of 2005 and is being phased out) and the financial sector¹⁰². There are also voluntary schemes that are open to residents in Portugal and to Portuguese nationals who reside or work abroad.

Social expenditure is financed on a pay-as-you-go (PAYG) basis mainly by social contributions and complemented by a small fraction of the "social" value added tax (IVA "social")¹⁰³, both earmarked revenues for the contributory system. Non-contributory branches and benefits are fully financed by state transfers. In the general social security regime the global contribution rate is 34.75% of gross earnings (11% paid by the worker and 23.75% by the employer) for employees. Despite the PAYG system basis, a share of the Social Security contributions' General Regime is annually transferred to the Social Security Trust Fund (FEFSS).

In the general statutory scheme, the legal retirement age is 65 for both men and women, for pension increase purpose the working age limit is 70 (this limit is applied only for civil servants). There is also a special pathway for long-term unemployed older workers that are eligible for early retirement without penalty at the age of 62 if unemployment occurs after the completion of 57 years. In the context of retirement age flexibility, it is possible for workers who had 30 years of insurance to anticipate the legal retirement with a penalty at the age of 55. The public administration sub-system, under which the legal pension entitlement age used to be 60, is now converging to the general regime.

To be entitled to an old-age pension, social security beneficiaries need to have completed a qualifying period of 15 years of insurance. Since 2002, the earnings over the whole insurance career are taken into account for the calculation of the pension level, subject to a maximum of 40 years. The transitional clauses adopted in order to safeguard accrued rights will postpone the full implementation of this new pension formula to those whose contributive career started in 2002.

In order to promote the development of supplementary pension schemes, a comprehensive legal framework was introduced in 2000 covering management and investment rules, as well as the tax regime for such private provision. In 2002, further tax benefits were introduced and a supervisory framework was defined for supplementary pension schemes. The Institutions for Occupational Retirement Provision (IORP) directive was transposed in 2006, while some efforts are projected to improve portability.

In the banking and telecommunications sectors occupational schemes substitute the general scheme. However the recent trend is the integration of these substitute schemes under the

¹⁰² Police, the military and lawyers have specific sub-schemes.

¹⁰³ One p.p. was permanently added to the standard rate of the value added tax (VAT), labelled "social" VAT.

social security public scheme¹⁰⁴. There are also other companies that provide complementary retirement benefits for their employees. Occupational schemes cover roughly 3.7% of the labour force. The liabilities for future pensions are covered by independent pension funds, whose assets currently amount to 14% of the GDP, although the pension fund market is almost inactive. A major liability of these occupational schemes is the prevalence of defined benefit pension plans. Due to the winding-up of several pension funds (particularly in the last years) and reductions of the number of employees in several sectors, membership has been declining. About 1.5 % of the population in employment is covered by individual provisions, which can take different forms including the subscription to life insurance policies or voluntary membership in a pension fund or in an investment fund.

For beneficiaries with no coverage from the mandatory contributory scheme, non-contributory old-age and disability, means-tested pensions are provided. These can be applied to people aged +65 years, aged +18 years who have a permanent incapacity, and the gross monthly income does not exceed 40% of the "*Indexante de Apoios Sociais*" (IAS) or (60% for a couple). Due to the short contributory careers as well as low reference wages, statutory pensions often fall below minimum pensions leading to a significant group of pensioners receiving the minimum pension. In order to reduce the poverty among the elderly a means-tested benefit ("Solidarity Supplement for the Elderly") was implemented in 2006, benefiting 262.000¹⁰⁵ elderly people.

The last general reform of the pension system entered in force in 2007. The main measures included extending the assessment period to cover the entire career, diminishing the transition period (instead of just considering the best 10 out of the last 15 working years)¹⁰⁶, the introduction of a "sustainability factor" that automatically adjusts benefits to changes in remaining life expectancy-at-65 years, financial penalties for early retirement (up from 4.5% to 6% on an annual basis), incentives for postponing retirement and a new indexation rule for updating pensions. Instead of *ad hoc* annual updates, indexation is now a function of the consumer inflation and takes into account the real GDP growth and the pension amount (benefiting persons with lower pensions).

A key element of the reform in order to improve sustainability has thereby been that each citizen is given the choice to increase his contribution (to public schemes or to private individual pension plans) or to increase the pension by working beyond the age that entitles workers to a complete pension (with the corresponding incentives).

Current performance

The relative median income ratio for people aged 65 years and over relative to the income of the age group 0-64 was 83% in 2008, higher than in the two former years (79%), but slightly lower than the EU-27 average (84%). The rate of poverty risk of population 65+ (22% in 2008 and 20.1% in 2009¹⁰⁷) is still higher than the EU-27 average (16%) but it has fallen significantly over the last years (it had reached 29% in 2004), due to the improvement of

¹⁰⁴ The integration of the banking occupational scheme into the social security public scheme is under discussion.

¹⁰⁵ Data updated in September 2010.

¹⁰⁶ In 2005, **changes to the pension scheme for government employees** were adopted, resulting in its convergence to the less generous general scheme for private-sector workers. This will be accomplished through step increases until 2015 in the retirement age and eligibility periods as well as changes to the benefit formula.

¹⁰⁷ 2009 figure according to national data (INE – National Statistics Office).

minimum old-age pension, a major priority over the last years and also due to the introduction of an extraordinary benefit, the Solidarity Supplement for the Elderly.

The net theoretical replacement rate in 2008 was among the highest in the EU (93.8%) and gross replacement rate 76.4%. Net replacement rates are always higher than gross replacement rates because pension benefits are exempt from any income tax to a higher level than wages. The fiscal system is being reformed in a way that pension benefits and wages will be progressively taxed in the same way.

Portugal spent about 13% of its GDP on pensions in 2007 (ESSPROS data), an amount slightly higher than the EU-27 average (12%). The average effective retirement age was 62.6 years in 2008, which is above the EU average of 61.4. The employment rate of older workers (55-64) has been high over the last years (around 50%, above the EU-27 average of 46%). The gap in 2009 between employment rate of older men (57.5%) and women (42.7%) remains large.

Impact of the crisis

Because the Portuguese pension system is prominently a public PAYG system and the weight of the private provision is limited, the financial crisis had no direct effect on present or future pensioners. The value of assets in voluntary pension saving schemes were affected by the drop in asset values (and partly recouped during 2009/2010), this also happened with FEFSS, although to a minor extent. The financial crisis may have diminished the public confidence in private funded schemes, as membership in pension funds have been declining particularly in the last years.

The subsequent economic crisis caused a decline in GDP that reached -2.6% in 2009 and a hike in unemployment levels. Further impacts of the crisis on current and future pensioners may be expected as the budget position has deteriorated considerably.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 1 p.p of GDP in the 'lost decade' scenario¹⁰⁸) in the long-term up to 2060 unless corrective action is taken.

The employment rate of the population aged 15-64 fell down to 66.3% in 2009 (67.8% in 2007 and 68.2% in 2008), but still above the EU-27 average (64.6%) The decline was 2.9 pp for men and 0.9 pp for women. The men employment rate (71.1% in 2009) is higher than women record (61.6%). The employment rate of older workers (55-64) has fallen continuously since 2007: from 50.9% in 2007 down to 50.8% in 2008 and 49.7% in 2009. The gender pay gap (9.2% in 2008) is among the lowest in EU (18%).

The March 2010 Stability Programme update accelerates the convergence between the public and private pension schemes and points to a cut in spending on social benefits other than pensions in relation to GDP. Tax relief on savings in privately run defined-contribution pension plans and in the State-run complementary pension scheme along with other tax benefits are to be limited by a global ceiling according to the taxable income (lower income tax payers are excluded from this new rule).

¹⁰⁸ See Table 76 in the 2009 Ageing Report p. 239.

Outlook

According to the calculations carried in the framework of the ISG, net theoretical replacement rates (NRR) are projected to fall sharply over the long-run. For the case of a worker retiring at 65 after 40 years of career at the average wage, the NRR would fall from 93.8% in 2008 to 69.3% in 2048 (the EU average will be around 74% in 2048). Gross replacement rate declines from 76.4% to 53.9% over the same period. This means drops of 26% (NRR) and 30% (gross) in the next 40 years, which are among the largest falls in the EU for this time span. Replacement rates in 2048 would however still be close to the EU-27 (unweighted) average.

The sharp drops in replacement rates would occur not only for the basecase male worker retiring at 65 after 40 years career, but also for most other "variant cases" careers. 3 years of unemployment only affect NRR in a minimal way in 2008 but protection would be slightly worse in 2048 (-1.1% loss in NRR). In the same period the negative effect of a 3 year childcare break would be substantially increased from 2.5% lower NRR in 2008 to 6.8% lower NRR in 2048 (in both cases with respect to a female without children). The NRR for low earners would remain around 94% of the NRR of the average earner, while the NRR for high earners would drop from 96% to 84% of the average earner. The effect of a 10 year career break on the NRR would reduce from a loss of about 25% in 2008 to a loss of 19% in 2048 (with respect to NRR for a full career). The decrease in the NRR 10 years after retirement compared to the year of retirement, which in 2008 amounts to 15%, would be more serious in 2048 at 20%.

The fall over time of replacement rates is the result of changes introduced in the pension benefit formula, namely, full length consideration of the workers' career and the introduction of a sustainability factor related to life expectancy. However, the effect of the sustainability factor can be countered through postponing the retirement decision with the new legislation incentives. In 2010 workers can retire two (for 40 or more career years) to five months later (15 to 24 career years) and obtain no cut resulting from the sustainability factor. Thus, TRR calculations reveal that while currently the bonus/malus effect of retiring 2 years later/earlier is symmetric (ie retirement at 67/63 entails 16% higher/lower NRR than retirement at 65), in the future late retirement will be relatively more rewarded (21% higher NRR than retirement at 65) than early retirement is penalised (3.3% lower NRR), illustrating the effects of the recent reform incentivating postponement of retirement.

According to the EPC Ageing Working Group (AWG) projections in 2009 the public pension expenditure is projected to reach 13.4% in 2060 (i.e. increase of 2.1 p.p. with respect to the 2007 initial level used for the projection exercise). The old age dependency ratio in Portugal is slightly higher than the EU-27 average: 26% in 2008 (EU-27 average, 25%) and is projected to increase to 55% by 2060 (EU-27 average, 53%). This is mainly due to a rather low fertility rate, below EU average, and increased life expectancy (84.1 and 88.8 years for men and women in 2060 respectively).

Challenges

With the 2007 pension reform which established career average earnings as calculation base, introduced a sustainability factor tied to developments in remaining life-expectancy, strengthened incentives to work longer and improved minimum pensions, Portugal took major steps towards achieving a better balance between sustainability and adequacy concerns in its

pension provisions. Yet, in the longer term, adequacy risks could increase so significantly that they would have to be addressed.

Pension spending has been a major driver of rising government expenditure in Portugal since the mid-nineties. The maturing old-age pension schemes caused by the significant growth in the number of pensioners and simultaneously in the average pension outlay due to the longer career contribution of new retirees were responsible for the increased spending on pensions.

Portugal addressed the need of curbing public expenditure through the most recent pension reforms, particularly by strengthened incentives to work longer, a more equitable treatment of members of different schemes (i.e. civil service scheme and general scheme) and a comprehensive active ageing strategy. As a result of these reforms, progress has been made in meeting the financial challenge of the pension system.

In response to the adequacy challenge, a major priority over the last years has been to improve the level of the minimum old-age pension, which should alleviate poverty risks of the elderly. To reduce further old age poverty, a new tax financed social benefit – Solidarity Supplement for the Elderly – has been implemented. As it is focussed on poverty alleviation, the benefit represents a step forward in the social support to the elderly. Besides, more complete insurance careers in better-paid employment should result in higher pensions for new generations of pensioners.

The challenge Portugal faces with regard to ensuring the long-term sustainability of public finances at the back of its ageing population was assessed to be at "medium" risk by the Commission/Council¹⁰⁹. The projected increase in pension expenditure over the long-term at 2% of GDP is somewhat lower than the EU average; however the initial expenditure level was already quite high in 2009. And it is achieved because total replacement rates, currently relatively high compared with the EU average, are projected to suffer significant drops over the long-term, going down to around EU-27 (unweighted) average by 2048.

Implementing further reforms by containing the projected increase in pension spending or adjusting its financing would contribute to put it on a more sustainable path. Taking measures that increase participation rates further, though being above the EU average including for older workers, would provide an important contribution to sustainability and to adequacy.

Further harmonisation of the pension system and measures to promote longer working lives should contribute to strengthen adequacy and sustainability in the future. An immediate challenge is also to comply with the current legal retirement age set at 65 years.

The Government has also tried to create incentives towards the development of supplementary pension schemes. It remains to be seen whether this modernisation of the legal framework for private pensions will be sufficient to allow meeting expectations that the occupational pension schemes could play a significant role in order to ensure future adequacy. In the sense that replacement rates in public provision is dropping markedly, there seems to be a need for the development of private pension provision which could allow people to compensate by building supplementary entitlements.

¹⁰⁹ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

The main crisis impacts on the Portuguese pension system concern the weakening of public finances. According to the European Commission 2010 Spring Forecast, the level of general government gross debt is set to rise by 27.5 p.p. of GDP from 2007 until 2011 and thus go beyond the Treaty reference value. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure.

Background statistics

	Portugal			EU-27		
	Total	Men	Women	Total	Men	Women
Current adequacy (2008)						
At-risk-of-poverty rate 0-64	18	18	18	16	16	17
At-risk-of-poverty rate 65+	22	19	24	19	16	22
At-risk-of-poverty rate 75+	25	24	27	22	18	24
Income inequality 0-64	6,2			5,1		
Income inequality 65+	5,3			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0,83	0,89	0,77	0,85	0,88	0,83

Adequacy: projections PT	2008 net	2048 net	difference	2008	2048	difference
				gross	gross	
Theoretical replacement rates (TRR) base case	93,8	69,3	-24,5	76,4	53,9	-22,5
TRR 3 years unemployment	93,7	68,5	-25,2	76,4	53,2	-23,2
TRR 3 years childcare break	88,4	64,6	-23,8	73,8	49,9	-23,9
TRR 10 years career break	70,4	56,1	-14,3	57,4	43,3	-14,1
TRR shorter working (retirement at 63)	78,4	67,0	-11,4	63,9	51,9	-12,0
TRR longer working (retirement at 67)	108,6	84,2	-24,4	88,5	66,8	-21,7
TRR 10 years after retirement	79,2	55,2	-24,0	64,6	42,5	-22,1
TRR low earner (66% average)	88,3	65,5	-22,8	76,4	54,5	-21,9
TRR high earner (100-200% rising profile)	89,8	58	-31,8	71,7	41,4	-30,3
Benefit ratios: social security pensions 2007/2060				46,3*	32,70	

	Portugal			EU-27		
	2000	2008	2009	2000	2008	2009
Current sustainability						
Esspros pension expenditure	10,5	13**	13,1*		12,0**	11,8*
Employment rate 15-64	68,2	68,2	66,3	62,2	65,9	64,6
Employment rate 55-64	51,3	50,8	49,7	36,9	45,6	46,0
Employment rate 55-64 women	41,8	43,9	42,7	27,4	36,8	37,8
Employment rate 55-64 men	62,0	58,5	57,5	47,1	55,0	54,8
Effective labour market exit age***	61,9	62,6		59,9	61,2	61,4
Public debt	50,5	66,3	76,8	61,9	61,6	73,6
Budget balance	-2,9	-2,8	-9,4	0,6	-2,3	-6,8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	26	37	55	25	38	53
Public pension expenditure, % of GDP	11,4	12,6	13,4	10,1	11,4	12,5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	9,8			8,7		
Employment	-0,6			-0,7		
Eligibility	-1,7			-2,6		
Level of benefits	-4,5			-2,5		
Total (including residual)	2			2,4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Romania

Description

Romanian pension system consists of the public pension system (PAYG scheme, based on intergenerational solidarity), privately administered pension funds (defined contribution scheme, part of the individual contribution from the public pension system is accumulated in individual accounts) and voluntary private pensions (defined contribution scheme, voluntary participation, individual accounts).

Benefits under the PAYG scheme are calculated on the basis of individual's accumulated points, which are determined by contributor's wage relative to the average wage. The mandatory funded scheme was introduced in 2007, and was compulsory for all persons below the age of 35 at 1st January 2008 and optional for the age group 36-45. The contribution rate over the first year was set at 2% of gross income and was supposed to rise to a maximum of 6% by the end of 2016 (increase by 0.5% per year). In 2009 the government decided to freeze contributions at 2% but starting with 2010 the calendar of raising the contribution diverted to 2nd Pillar by 0.5% per year was reintroduced. The amount of contributions to the voluntary funded scheme is limited to the equivalent of 15% of the gross wage. The procedures governing the payout of benefits in the funded schemes are yet to be established.

In the beginning of 2009, the Romanian Government introduced the minimum guaranteed social pension, entirely financed from the state budget. The social pension is currently granted to about 645 thousand persons in the country, but in the coming years it is expected that the number of beneficiaries will increase significantly. Starting with July 2010, the term "minimum guaranteed social pension" has been replaced by "social indemnity for pensioners". According to the legislation in force, in 2015 the statutory retirement age is supposed to reach 65 years for men and 60 years for women. In the second quarter of 2010 it was at 63 years and 10 months for men and 58 years and 10 months for women.

A new pension law was drafted by the Government in 2010 and is now under adoption procedure. The draft law stipulates the standardisation of the retirement age (65 years) for men and women by 2030, the equalisation of contribution conditions for various categories and regimes, the re-calculation of special pensions for certain public sector workers, the reduction of incentives for early retirement, and the improvement of the disability assessment process. Apart from the new pension law, the Government envisaged other reform measures in the field.

Current performance

In the transition to the market economy the early retirement policy was designed in Romania to solve the problem of growing unemployment. Consequently, the average age of receipt of first pension decreased and the number of contributors per retired person (system support ratio) fell considerably. Number of recipients of disability pensions also increased considerably in the last decade. Only around 43% of elderly population (55-64) were in employment in 2009, compared to 49.5% in 2000. Pension system became unsustainable and inadequate, and the government tried to solve the problem *inter alia* by increasing contributions rates.

Pension expenditure in Romania is lower than the EU-27 average (RO: 6.4% of GDP in 2007, EU-27: 11.8%). The at-risk-of-poverty rate of population aged 65 and more at 26% in 2008 was 7 percentage points (pp) higher than the EU-27 average, and 3 pp higher than for the population aged 0-64. Moreover, a considerable gender gap in at-risk-of-poverty is observed, with elderly women (65+) more exposed than elderly men. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (33.7%) is low compared to the EU average. The net rate amounts to 45.3%.

Impact of the crisis

After growing by 7.3% in 2008, Romanian GDP recorded a drop of 7.1% in 2009. Labour market was affected by the downturn, with unemployment increasing from 5.8% in 2008 to 6.9 % in 2009 and a forecasted 8.5% in 2010. In 2009, the employment rate of persons aged 15-64 reached 58.6%, down by 0.4 percentage point (pp) compared to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 0.5 pp to 65.2%, similar to the of 0.5 pp decrease to 52% for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) fell by 0.7 pp to 52.3% (EU: down by 0.2 pp to 54.8%), and the employment rate of older women declined by 0.3 pp to 34.1% (EU: up by 1 pp to 37.8%).

Apart from a decline in economic activity, the crisis has also enhanced the problem of contribution and tax evasion. General government deficit deepened in 2009, and the government adopted a set of consolidation measures, e.g. a reduction in social protection expenditure, lay-offs in the public sector, and cuts in public wages and pensions. In June 2010, the legislation introducing a 15% reduction in pensions was declared unconstitutional by the Romanian Constitutional Court.

Estimates in the 2009 Ageing Report surprisingly reveal that the crisis would decrease pension expenditure (by a 0.1 p.p of GDP in the 'lost decade' scenario¹¹⁰) also in the long-term.

Outlook

Developments in the old-age dependency ratio (comparing the size of population aged 65 and more to population 15-64) will be more pronounced in Romania relative to the EU-27 average (RO: 21% in 2007, 65% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to drop by 40%, compared with 15% for the EU-27 as a whole by 2060.

Labour market participation rates are not projected to increase in Romania over the long-term, in contrast with the EU-27. The participation rate was below the EU average in 2007 (63% in 2007, EU: 70.6%), and is projected to remain in that position also in 2060 (RO: 61.3%, EU: 74.1%).

Romania is in the group of Member States where the increase in public pension expenditure is projected to be very significant. The level of expenditure in 2007, at 6.6% of GDP, is below the EU average of 10.2%, but the projected increase is larger in Romania, with 9.2 percentage points (pp) of GDP for the period 2007-2060 (EU: +2.4 pp). At the end of the projection

¹¹⁰ See Table 76 in the 2009 Ageing Report p. 239.

period (2060) the expenditure to GDP is expected to be at 15.8%, or 3 ¼ pp above the EU average. Demographic transition, change in pension eligibility conditions and evolution of an average benefit level stand all behind the overall change in expenditure.

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure significantly in Romania, by 13.6 percentage points of GDP (compared to 8.7 for the EU as a whole). Demographic factors will be partially counterbalanced by tighter pension eligibility. In consequence relative number of pensioners to the population aged 65 and more will decline and will help to cut the expenditure by 4.9 pp of GDP.

According to projections an average public pension benefit to an average wage (benefit ratio) will increase from 29.4% in 2007 to 37% in 2060. Higher benefits will translate into additional 1.7 pp of GDP in pension expenditure. Mandatory funded pension scheme should also get mature with time and add 1.9% of GDP in expenditure in 2060. In consequence, an average pension benefit including the PAYG and the mandatory funded tier should be at 41% of the average wage in 2060.

Pension benefits for workers with full careers should also increase in the future. The gross replacement rates for a worker at the average wage retiring at 65 after 40 years of contributions in 2008 was at 33.7% (45.3% net). By 2046 this is expected to be 66.2% (88.6% net), a considerable increase by around 96% in both cases.

According to projections, a worker with a 3-year career break due to unemployment can expect in 2048 a net replacement rate 7.3% lower than a worker without unemployment break. The negative effect of a 3-year child care break would amount to 8.4% in 2048. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 would be equal to +5.9% and -4.9% in 2048. The negative effect of a 10 year career break on the NRR would be at 24.4% compared to a worker without break. In 2058 the NRR of a retiree 10 years after retirement, will be 27.2% lower than in the moment of retirement in 2048.

Challenges

The pension system in Romania has been reformed in 2007 with introduction of mandatory funded scheme based on strong contributory principle. As a response to the crisis, which caused a decline in economic activity and enhanced the problem of contribution evasion, the Romanian government intends to implement further measures aimed at a better balance between adequate and sustainable pension provision.

Romania faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.¹¹¹ The projected increase in pension expenditure over the long-term at 9.2% is significantly higher in Romania than the EU average. Total replacement rates are projected to increase significantly over the long-term in Romania from being the lowest in the EU to above the EU average.

While reform measures have been taken in 2009-10, implementing further reforms to the pension system by containing the high projected increase in pension spending or adjusting its

¹¹¹ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

financing would contribute to put it on a more sustainable path. Currently many pensioners are exposed to poverty, especially elderly women. There is also a visible gender gap in terms of employment rates. It is essential to encourage and enable people to work longer. Increases and gender equalisation of the pensionable age are important options and should be introduced before ageing of population is the most visible. In particular, an appropriate balance between working years and years spent in retirement need to be found. Linking pensionable ages and/or benefit calculations to future increases in life expectancy would contribute substantially to this. But underpinning pension reforms with labour market and work places measures to enable and encourage people to work longer would also be necessary.

It is positive that life-styling is to be introduced for mandatory pension funds. Legal provisions for the pay-out phase of the mandatory funded scheme are still to be determined. Annuities are the best option from the point of view of protection against poverty in the old-age. In designing details of the pay-out phase, the authorities should take into account gender preoccupations (e.g. unisex mortality tables). A review of special pension regimes is also needed so that privileges become transparent, benefits calculated over life-time earnings and the effective retirement age is increased.

The government should look closer at the conditions of awarding disability pensions as the number of recipients increased considerably in recent years. It is also important to note that pension systems need stability over the long term if they are to have the necessary credibility among citizens. Hence, transparency and long-term planning are important.

Though the pension funds suffered negative returns as an immediate effect and subsequently a decline in public confidence and interest, the main crisis impacts on the Romanian pension system concern the weakening of public finances. Though present debt levels are low by EU averages the budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances. In this context the Romanian government should also carefully assess the balance between the amount of prefunding they can afford and the additional long-term costs they will face if they reduce prefunding permanently. The level of prefunding should be based on realistic long-term growth expectations.

Background statistics

	Romania			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	23	23	23	16	16	17
At-risk-of-poverty rate 65+	26	21	30	19	16	22
At-risk-of-poverty rate 75+	30	23	34	22	18	24
Income inequality 0-64	7.4			5.1		
Income inequality 65+	4.9			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.85	0.93	0.8	0.85	0.88	0.83

Adequacy projections: RO	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	45.3	88.6	43.3	33.7	66.2	
TRR 3 years unemployment		82.1			61.3	
TRR 3 years childcare break		77.8			58.1	
TRR 10 years career break		67			50	
TRR shorter working (retirement at 63)		84.3			62.9	
TRR longer working (retirement at 67)		93.8			70.6	
TRR 10 years after retirement		64.5			48.2	
TRR low earner (66% average)		85.4			66.1	
TRR high earner (100-200% rising profile)		65.3			49.7	
Benefit ratios: social security pensions 2007/2060				29.4*	37.00	

	Romania			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	6.1	6.0**	6.4*		12.0**	11.8*
Employment rate 15-64	64.2	59.0	58.6	62.2	65.9	64.6
Employment rate 55-64	52.0	43.1	42.6	36.9	45.6	46.0
Employment rate 55-64 women	47.3	34.4	34.1	27.4	36.8	37.8
Employment rate 55-64 men	57.4	53.0	52.3	47.1	55.0	54.8
Effective labour market exit age***	59.8			59.9	61.2	61.4
Public debt	22.5	13.3	23.7	61.9	61.6	73.6
Budget balance	-4.7	-5.4	-8.3	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	21	30	65	25	38	53
Public pension expenditure, % of GDP	6.6	10.4	15.8	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	13.6	8.7
Employment	0.3	-0.7
Eligibility	-4.9	-2.6
Level of benefits	1.7	-2.5
Total (including residual)	9.2	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Slovenia

Description

A **mandatory earnings-related scheme** financed on a pay-as-you-go basis covers the risks of old-age, disability and survivors. All employees and self-employed persons are covered, while specific categories of inactive persons may join the system voluntarily during periods defined by law. There is no ceiling for the contributions paid, while there is a limit on the maximum value of pension, which implies a high degree of redistribution.

The statutory pension scheme has been considerably modified by the 2000 reform. First, accrual rates have been reduced and a standard 1.5% accrual rate per year has replaced the general 2% accrual rate and special 3% accrual rate for women with short careers. Second, statutory retirement age has been increased to 63 years for men and 61 years for women. Third, conditions for early retirement and the minimum contributory periods have been tightened. Workers with long careers (40 years for men and 38 for women) can retire at 58. The period for calculating the pension base is set to best consecutive 18-year average of (net) wages. Pensions are indexed on wages, which is the result of changed indexation rule in 2005 making pensions more generous. In response to the crisis, the indexation of pensions is temporarily reduced to 50% of wage growth in 2010 with continued reductions possible in 2011 and 2012.

The 2000 pension reform has also introduced two types of supplementary funded pension insurance: compulsory for workers in arduous occupations and workers in professional activities which cannot be successfully performed after attaining a certain age, and a voluntary scheme for other categories of people insured under mandatory scheme. Voluntary scheme is divided into a collective insurance, where employer and employees participate together, and an individual insurance. Inclusion into these two kinds of schemes is stimulated by tax relieves for employers and the insured persons who participate in them. Managing companies of pension funds have to guarantee a minimum yield determined by law.

Pensioners who receive low pensions can apply for a means-tested pension income supplement. Moreover, a state pension, a means-tested benefit that can be granted to a person who is not receiving any pension, was introduced in 2000.

A further comprehensive pension reform has been proposed, with the aim of ensuring sustainable and adequate pensions, increasing transparency and establishing a closer correlation between rights and contributions, and is currently subject to consultation with different stakeholders.

The draft act presented in August 2010 aims at gradually increasing the statutory retirement age from 61/63 (women/men) to 65 for both women and men with a minimum 15 years insurance period. It proposes a gradual increase of the minimum pensionable age from 58 to 60 with a minimum pension period of 38/40 years (women/men), which will, at the end of transition period, represent the conditions for the acquisition of the early pension, that will be reduced by 0,3 % for every month a person retires before the age of 65. All transitional periods will be finished by 2025. The period for calculating the pension base would be gradually extended from 18 to 34 years. However, the act foresees the accrual rate for the pension period of 38/40 years for women/men to be established at 80% to counterbalance the

decrease of pension benefits. Incentives for longer working would also be strengthened (through, for instance, a more transparent bonus/malus system, partial retirement). Pensions would be indexed 60 % to wages and 40 % to prices. Some modifications to the compulsory supplementary occupational provision are also foreseen, e.g. reduced list of eligible occupations and replacing the DB regime with a DC scheme from which benefits will be disbursed between the age of early retirement and the statutory retirement age.

The aim of the modifications in the voluntary supplementary pension insurance is to improve transparency and efficiency, increase the long-term return on assets for those savers who prefer less conservative investment policies, increase the average premiums and establish efficient supervision. In the context of less conservative investment policies, life-cycle funds will be established.

Initially there were intentions to continue with the modernisation of the pension system by establishing a system consisting of two mandatory (universal pension, NDC pension) and two voluntary funded DC pillars. No concrete legislative act has been proposed yet.

Current performance

Pension expenditure as percentage of GDP has decreased in Slovenia over the last decade and in 2007 was below the EU-27 average (9.7% vs. 11.8%). Average exit age from the labour market is still low (SI 59.8 and EU-27 61.2 years in 2006). Even though the employment rate of older workers has been increasing in the past decade, Slovenia still lags behind the EU average considerably. In 2009 only 37.4% of men and 13.7% of women aged 60 were still at work.

In 2008 21% of people aged 65 and more were exposed to the risk of poverty, 10 percentage points more than for the population below the age of 65. A considerable gender gap was also recorded in this respect with 28% of women and 12% of men over the age of 65 at-risk-of-poverty. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (42%) is low compared to the EU average. The net rate amounts to 61%.

A growing percentage of the workforce is covered by voluntary supplementary pension provision, with 59.67% of all persons insured under statutory pension insurance covered. However, past trends show that the contribution rates and the return on investment will not be sufficient to compensate the reduction of replacement rates in statutory pension provision. This was the case even before the crisis.

Impact of the crisis

With a drop in GDP of 7.8% in 2009, Slovenia was one of the Member States most adversely affected by the crisis. The employment situation has held up slightly better compared with the EU. In 2009, the employment rate of persons aged 15-64 reached 67.5%, down by 1.1 pp compared to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 1.7 pp to 71%, a considerably stronger decline than the 0.4 pp decline to 63.8% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) actually rose by 1.7 pp to 46.4% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of older women still managed to grow stronger by 3.7 pp to 24.8% (EU: up by 1 pp to 37.8%), even during the crisis. Nevertheless, according to the

Spring 2010 Economic Forecast, unemployment is forecasted to increase further to 7.3% in 2011 (from only 4.4% in 2008).

The state of public finances has deteriorated considerably and the public budget deficit widened in 2009. Due to the increased pressure on public finances, pensions will only be indexed to 50% of wage growth in 2010.

Estimates in the 2009 Ageing Report surprisingly reveal that the crisis would decrease pension expenditure (by an 0.2 p.p of GDP in the 'lost decade' scenario¹¹²) also in the long-term.

Outlook

Developments in the old-age dependency ratio (defined as number of people aged 65 and more to population 15-64) will be much more pronounced in Slovenia relative to the EU average (SI: 23% in 2007, 62% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to drop by 32%, compared with 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in Slovenia over the long-term, especially for older women, but less than in the EU-27. This should decrease the relative difference between average pensions for men and women. The participation rate (including for women) was above the EU-27 average in 2007 (71.4% in 2007, EU: 70.6%), but is projected to fall below the EU average in 2060 (SI: 71.9%, EU: 74.1%).

Slovenia is in the group of Member States where the increase in public pension expenditure is projected to be very significant. The level of expenditure in 2007, at 9.9% of GDP, is below the EU average (10.2%), but the projected increase is much larger in Slovenia, with 8.8 percentage points of GDP for the period 2007-2060 (EU: +2.4 pp). At the end of the projection period (2060) the expenditure to GDP is expected to be at 18.6%, or 6 percentage points above the EU average. Several factors lie behind the projected increase in public pension expenditure.

The demographic transition to an older population is the main driver. This effect alone would push up expenditure significantly in Slovenia, by 13.7 percentage points of GDP, the highest impact of all EU Member States (compared to 8.7 for the EU as a whole). However, restricted eligibility of pensions is a trend that will partly counterbalance increase in public pension expenditure. It will help to reduce spending by 3.5 pp of GDP between 2007 and 2060.

Lower pensions relative to wages is another trend that will cut 0.7 pp of GDP from public pension expenditure and it should be reflected in a decrease in the benefit ratio (comparison of an average public pension benefit to an average wage) from 40.9% in 2007 to 38.6% in 2060. Future evolution of theoretical replacement rates, calculated for a male worker retiring at 65 after 40-years career show more mixed result as gross values are projected to increase from 41.8% in 2008 to 59.7% in 2048, while net from 60.8% to 76.6%.

The negative effect of 3 years of unemployment which came to 1.9% of the NRR in 2008 will be more pronounced in 2048 (4.2%). In the same period there would be no negative effect of

¹¹² See Table 76 in the 2009 Ageing Report p. 239.

a 3 year childcare break. The relative bonus effect of retiring 2 years after age 65 will be weakened (14.3% increase in the NRR in 2008 and a 5.3% increase in 2048), while malus effect of retiring 2 years before age 65 would be largely maintained over the period (8.1% reduction in 2008 and 9.6% reduction in 2048). The NRR for low earners would be reduced from 90.2% to 76.6% while the NRR for high earners would increase from 48.5% to 54.3%. The effect of a 10 year career break on the NRR would induce a loss of about 18.5% in 2008 and 20.7% in 2048. The decrease in the NRR 10 years after retirement which in 2018 for workers retired in 2008 amounts to 6.8% would be maintained for those retired in 2048 at 6.8% (value for the NRR in 2058).

Although the statutory pension provision will remain dominant, Slovenia is also intending to rely on private pension provision in the future (private non-mandatory pensions). Currently the assets managed in the pension funds amount to approximately 4.3 % GDP. The government's intention is that in the long-term the supplementary pension covers 10 % of the replacement rate. This provides a certain contribution to future pensioners' income.

Challenges

With the 2000 reform Slovenia took the first steps towards bringing a proper balance between adequacy and sustainability in its pension system. Plans for further reforms have for some years had difficulty finding sufficient political backing. But recently the government announced that further important reforms would come in the near future. These are necessary and should aim at curbing the projected substantial increase in pension spending while expanding the economic base for adequacy.

Slovenia faces a significant challenge with regard to ensuring the long-term sustainability of the public finances given its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.¹¹³ The projected increase in pension expenditure over the long-term at 8.8 p.p. of GDP is significantly higher than the EU average. Total replacement rates are projected to increase and remain above the EU average over the long-term.

Slovenia needs to increase considerably participation and employment rates of older workers, being considerably below the EU average. Early effective exit age from the labour market results in relatively high at-risk-of-poverty rates, especially for women. Introducing an active aging strategy and changes to the employment policy to encourage longer working lives, including through a higher statutory retirement age and minimum pensionable age or a longer statutory contribution period, would notably contribute to sustainability of public finance, adequacy of pensions and providing necessary insurance against poverty. In particular, making the pension system adaptable to future increases in life expectancy would enhance its stability.

Greater transparency regarding income from pensions for future pensioners should be also achieved. Despite large coverage, the voluntary supplementary pension insurance remains shallow. Measures to increase the attractiveness of voluntary schemes are required to enable people to build supplementary entitlements to help maintain their standard of living after retirement.

¹¹³ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

The main crisis impacts on the Slovenian pension system concern the weakening of public finances. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

	Slovenia			EU-27		
	Total	Men	Women	Total	Men	Women
Current adequacy (2008)						
At-risk-of-poverty rate 0-64	11	11	11	16	16	17
At-risk-of-poverty rate 65+	21	12	28	19	16	22
At-risk-of-poverty rate 75+	26	12	32	22	18	24
Income inequality 0-64	3.3			5.1		
Income inequality 65+	3.6			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.84	0.91	0.79	0.85	0.88	0.83

Adequacy projections: SI	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	60.8	76.6	15.8	41.8	59.7	17.9
TRR 3 years unemployment	59.6	66.4	6.8	41.08	51.7	10.6
TRR 3 years childcare break	60.8	69.3	8.5	41.8	54	12.2
TRR 10 years career break	49.5	60.8	11.3	34.1	47.3	13.2
TRR shorter working (retirement at 63)	55.8	69.3	13.5	38.4	54	15.6
TRR longer working (retirement at 67)	69.5	80.7	11.2	47.8	62.8	15.0
TRR 10 years after retirement	56.6	76.6	20.0	39.01	59.7	20.7
TRR low earner (66% average)	90.2	76.6	-13.6	62.1	59.7	-2.4
TRR high earner (100-200% rising profile)	48.5	54.3	5.8	41.8	42.3	0.5
Benefit ratios: social security pensions 2007/2060				40.9*	38.60	

	Slovenia			EU-27		
	2000	2008	2009	2000	2008	2009
Current sustainability						
Esspros pension expenditure	11.1	10.3**	9.7*		12.0**	11.8*
Employment rate 15-64	62.7	68.6	67.5	62.2	65.9	64.6
Employment rate 55-64	22.3	32.8	35.6	36.9	45.6	46.0
Employment rate 55-64 women	14.3	21.1	24.8	27.4	36.8	37.8
Employment rate 55-64 men	31.0	44.7	46.4	47.1	55.0	54.8
Effective labour market exit age***				59.9	61.2	61.4
Public debt	:	22.6	35.9	61.9	61.6	73.6
Budget balance	-3.7	-1.7	-5.5	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	23	41	62	25	38	53
Public pension expenditure, % of GDP	9.9	13.3	18.6	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	13.7	8.7
Employment	-0.1	-0.7
Eligibility	-3.5	-2.6
Level of benefits	-0.7	-2.5
Total (including residual)	8.7	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Slovakia

Description

The Slovak mandatory pension system consists of two tiers: one being **defined-benefit (DB) pay-as-you-go financed**, the other a **funded defined-contribution (DC) scheme**. Each of these tiers receives a contribution rate of 9% of wages; an additional 6% is collected for disability benefits into the first tier. First tier is administered by the Social Insurance Agency (SIA). Fully funded scheme is managed by pension fund management companies (private joint-stock companies) and supervised by the National Bank of Slovakia. There is a special scheme of social security for police, military, etc.

There is also a **voluntary supplementary DC pension saving scheme** administered by the supplementary pension companies (private joint-stock companies) consisting of contributions from employers and employees (could exist also sole contributions from saver, for example in case of self employees). Since 2005 contributions to supplementary pension scheme are tax deductible up to 398.33 € a year.

For each year of contributions, an insured person in DB scheme receives “earnings points” depending on individual income position in relation to the average wage. The earning point value is adjusted annually by an index which is based on average wage for a certain period. The minimum period for the pension entitlement is set at 15 years (valid both for the first and the second tier). There is no guarantee of a minimum old-age pension. People with very low or without pensions may apply for a social assistance benefit.

Statutory retirement age is set at 62 years for men and will reach 62 years for women in 2024. First beneficiaries from the new mixed system (first + second tier) will be at the earliest in the year 2020.

Pensions in payment are indexed to the arithmetic average of earnings growth and price inflation. This method is so-called as “Swiss indexation”. The date of pension valorisation is from January 1st.

Major reforms were implemented in 2004 and 2005: parametric and systemic changes in the DB scheme, introduction of the mandatory funded DC scheme and transformation in voluntary supplementary DC scheme. With almost 1.6 million entrants to the newly created DC scheme, transition costs (equal to 1.2% of GDP every year)¹¹⁴ exceeded projected expenditures needed to cover the shortfall in PAYG revenues.

Since 2005 until now there have been some modifications in the reform such as voluntary entry for the new entrants to the labour force to join the funded DC scheme from 2008 (they have six months to decide whether they will stay exclusively in the first tier or if they want to be enrolled in the new two-tiered system), tightening the access to early retirement, increasing the minimum period for the pension entitlement from 10 to 15 years. In 2008 and 2009 the DC scheme was opened, meaning that workers already in the DC scheme were allowed to opt out of it and to return to the PAYG scheme and workers willing to join the DC system were allowed to join it. In 2009 the ceilings for administrative fees charged by pension funds have

¹¹⁴ ASISP reporting.

been reduced. Pension funds have been also obliged to compensate possible negative returns in half-year intervals what led to a *de facto* exclusion of high-risk investment from their portfolios. Pensions will be available in forms of life annuity and programmed withdrawal combined with life annuity in the pay out phase.

Current performance

In 2007 pension expenditure amounted to 7.3% of GDP (ESSPROS data), less than the EU-27 average of 11.8%. In 2009 only 7.4% of women aged 60 were at work, the second worst result for all EU-27 Member States. Despite progress in the last decade, employment rate for older workers (55-64) was at 39.5% in 2009, still below the EU average of 46% and the EU target of 50%.

In 2008 4% of men and 13% of women over the age of 65 were at-risk-of-poverty. For women aged 75 and more, the at-risk-of-poverty rate reached even 17%. This poverty gender gap can be explained by the fact that women in Slovakia retire much too early, have too short careers and receive lower salaries. The gross theoretical replacement rate in 2008 for a male average-earner retiring at 65 after a 40-year contribution career (58%) is close to the EU average. The net rate amounts to 75%.

Since 2008, when participation in the funded DC scheme became optional, around 12 % of young people decided to join a two-tier system. At the end of 2009, the funded scheme counted approximately 1.4 million savers and assets equal to EUR 3 billion, i.e. 4.7% of GDP.

In 2009 the number of savers in the voluntary pension pillar dropped, probably due to the crisis, by 2 % to 799 thousands savers (i. e. 29,7 % of economically active population). Assets in the voluntary pillar amounted to 1.6% of GDP in 2009.¹¹⁵

Impact of the crisis

The financial crisis has reduced the value of assets in the funded schemes. With the 2009 reform, pension funds have been legally obliged to compensate individual accounts for possible negative returns in half-year intervals. The reform created incentives to reduce proportion of riskier assets in funds' portfolios when financial markets were bottoming out. With lower proportion of shares, pension funds have been unable to profit from a recovery in the financial markets in the second half of 2009 and in 2010. DC scheme (second tier) has been launched in 2005, so it means it is still in the accumulation phase. Assets accumulated in the scheme have been equal to approximately €1.7 bn (2.7 % of GDP) in 2007. First beneficiaries from the second tier will be at the earliest in the year 2020, so the crisis has not directly influence pensioners from the second tier currently.

The economic crisis led to a contraction of the Slovak economy by 4.7% in 2009, but growth has resumed in 2010 and is forecasted to reach 2.7%. In 2009, the employment rate of persons aged 15-64 reached 60.2%, down by 2.1 pp compared to 2008 (EU-27: down by 1.3 pp to 64.6%). The male employment rate fell by 2.4 pp to 67.6%, a stronger decline than the 1.8 pp. decline to 52.8% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of older men (55-64) fell too by 1.8 pp to 54.9% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of older women still managed to

¹¹⁵ ASISP reporting.

grow by 1.9 pp to 26.1% (EU: up by 1 pp to 37.8%), even during the crisis. Labour market was affected with unemployment rising from 9.5% in 2008 to 14.1% in 2010. The crisis impacted hardest on youth unemployment rate which increased from 19% in 2008 to 27.3% in 2009. A drop in social contributions has an adverse impact on the value of accrued rights of future pensioners. The state of public finances has deteriorated considerably and the public budget deficit widened in 2009.

Lower contributions have already aggravated the deficit in the public pensions system. On the top of transition costs of introduction of the DC funded scheme equal to 1.2% of GDP every year, the public system recorded a deficit of around 0.3% of GDP in 2008 and 1.1% in 2009.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.3 p.p of GDP in the 'lost decade' scenario¹¹⁶) also in the long-term unless corrective action is taken.

Outlook

Developments in the old-age dependency ratio (comparing population aged 65 and more to population 15-64) will be much more pronounced in Slovakia relative to the EU-27 average (SK: 16% in 2007, 68% in 2060, EU: 25% in 2007, 53% in 2060). The working-age population (15-64) is projected to drop by 38%, compared with 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in Slovakia over the long-term, especially for women and older workers, but less than in the EU-27. The participation rate was below the EU average in 2007 (at 68.8% in 2007, EU: 70.6%), and is projected to remain in that position also in 2060 (SK: 71.2%, EU: 74.1%).

Slovakia is in the group of Member States where the increase in public pension expenditure is projected to be above the EU average in the period 2007-2060. The level of expenditure in 2007, set at 6.8% of GDP in these simulations, is below the EU average (10.2%), but the projected increase is larger in Slovakia, with 3.4 percentage points (pp) of GDP for the period 2007-2060 (EU: +2.4 pp). At the end of the projection period (2060) the expenditure to GDP is expected to be 10.2%, or 2 ½ pp below the EU average. Several factors lie behind the projected increase in public pension expenditure.

The demographic transition to an older population is the main driver. This effect alone would push up expenditure significantly in Slovakia, by 11 ¾ percentage points of GDP (compared to 8.7 for the EU as a whole). However, demographic pressure on expenditure will be counterbalanced by restricted pension eligibility and lower level of benefits relative to wages (especially without benefit from second tier). Lower number of pensioners relative to older people (result of an increase in the statutory retirement age and closing down early exit paths from the labour market) will help to restraint expenditure by 3.9 pp of GDP between 2007 and 2060. Lower public pension benefits will contribute to a reduction in expenditure by 2.4 pp of GDP over the same period and will be reflected in a decrease in benefit ratio, which compares an average public pension benefit (without benefit from second tier) to an average wage from 45.2% to 33.1% in 2060.

¹¹⁶ See Table 76 in the 2009 Ageing Report.

Pension expenditure from the mandatory funded scheme was projected to amount to 2.2% of GDP by 2060. This would provide a certain contribution to adequate pensions, as the benefit ratio which includes benefits from the funded scheme is projected to reach 40% in 2060. There is, however, some uncertainty as to the correctness of the projections, as the authorities have allowed people to opt-out from the funded scheme and join the public scheme instead.

Future evolution of net theoretical replacement rates, comparing value of the first pension benefit as percentage of the last wage for a male worker retiring at 65 after 40-years career also show a drop from 75.3% in 2008 to 68.8% in 2048. Gross replacement rates are projected to decline from 58.4% to 53.1% over the same period.

The drop in replacement rates is less pronounced than in the case of benefit ratio, as the latter indicator compares situation of an average pensioner to an average wage-earner. Meanwhile, workers with career breaks due to childcare or unemployment (in case a person does not use the possibility set in the law to pay the premium on pension insurance additionally for the period of unemployment) and low-wage earners are also expected to receive lower replacement rates in the future.

The negative effect of 3 years of unemployment, which in 2008 came to 8,3% lower NRR than in case of a full career, will be slightly reduced by 2048 (to 7.9%). In the same period the negative effect of a 3 year childcare break would increase from 0% to 2.9% lower NRR than a female without children. A 10 year career break has a negative effect on the NRR, reducing it by 25% (with respect to the NRR corresponding to a full career) both in 2008 and 2048. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 (which is respectively around 16% higher and 14,5% lower NRR than retirement at 65), would be largely maintained over the period. The NRR for low earners would be reduced from 108% to 95% of the NRR of the average earner, while the NRR for high earners would improve slightly from 75% to 78% of the average earner NRR. The decrease in the NRR 10 years after retirement, which for a pensioner retired in 2008 would amount to 6% in 2018, would be much more visible for those retiring in 2048 (with a NRR lower by 17,2% in 2058 as compared to the NRR in the year of retirement).

Challenges

With the 2004 and 2005 reform where Slovakia modified the pay-as-you-go scheme and introduced new mandatory and transformed voluntary funded components it sought to find a better balance between adequacy and sustainability in pension provision. However significant risks on both aspects remain and as transition costs of introduction of the funded scheme turned out to be higher and less manageable than expected, participation to the DC pension has since been made voluntary.

Slovakia faces a significant challenge with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population, and was assessed to be at 'high' risk in this regard by the Commission/Council.¹¹⁷ The projected increase in pension expenditure over the long-term at 3.4% is higher than the EU-27 average. Total replacement rates are projected to decline slightly over the long-term but remain close to the EU average. Situation of workers with career breaks (especially due to unemployment) and low-wage earners needs more attention.

¹¹⁷ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

The role of funded schemes in pension provisions has been highly contested. Reaching a consensus on the main tenets of pension provision would be important to give it sufficient stability for people to plan their work and lives around. The situation could call for a review of overall provisions which among other things would focus on how funds are supposed to allow people to supplement income from the public scheme and whether the design of funded schemes are sufficiently optimal to offer appropriate risk mitigation. Such a review could also carefully assess whether a possibility of claiming capital from individual account in the second tier in a form of life annuity and programmed withdrawal combined with life annuity payment would not expose future older pensioners to an increased risk of poverty.

Implementing further reforms to the pension system by containing the high projected increase in pension spending or adjusting its financing are needed to put it on a more sustainable path. Taking measures to increase participation rates, which is below the EU average notably for younger and older workers, would provide an important contribution to sustainability and to adequacy. Very low effective exit age from the labour market, especially for women, is resulting in a substantial gender gap in poverty rates. Introducing mechanisms that automatically adjust pensionable age and benefit calculations in line with future increases in remaining life expectancy by introducing parametric adjustments of both PAYG (i.e. increasing the pensionable age) and DC (i.e. re-introduce compulsory participation for new labour market entrants) schemes would enhance the stability of the pension system. Nevertheless, a stable regulatory and legal environment without frequent changes would be necessary to provide pension savers with certainty and trust in the system. But underpinning adjustments to the pensionable age with labour market and work places measures to enable and encourage people to work longer would also be necessary.

While the financial crisis negatively affected assets and shook public confidence in the supplementary pension funds the main crisis impacts on the Slovakian pension system concern the weakening of public finances. The budgetary position in 2009 compounds the budgetary impact of population ageing. Budgetary consolidation reducing public debt would therefore be essential in order to strengthen the basis for financing the future increase in public pension expenditure. Achieving primary surpluses over the medium term would contribute to reducing the high risks to the sustainability of public finances.

Background statistics

	Slovakia			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	11	11	11	16	16	17
At-risk-of-poverty rate 65+	10	4	13	19	16	22
At-risk-of-poverty rate 75+	12	4	17	22	18	24
Income inequality 0-64	3,5			5,1		
Income inequality 65+	2,3			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0,79	0,83	0,77	0,85	0,88	0,83
Adequacy projections: SK	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	75,3	68,8	-6,5	58,4	53,1	-5,3
TRR 3 years unemployment	54,3	49,7	-4,6	42	38,4	-3,6
TRR 3 years childcare break	52,7	52,4	-0,3	40,8	40,4	-0,4
TRR 10 years career break	56,5	52,3	-4,2	43,8	40,3	-3,5
TRR shorter working (retirement at 63)	64,3	58,7	-5,6	49,8	45,3	-4,5
TRR longer working (retirement at 67)	87,1	80,1	-7,0	67,5	61,8	-5,7
TRR 10 years after retirement	70,7	57	-13,7	52,5	43,8	-8,7
TRR low earner (66% average)	81,8	65,7	-16,1	61,6	53,1	-8,5
TRR high earner (100-200% rising profile)	56,2	53,8	-2,4	41,7	39,9	-1,8
Benefit ratios: social security pensions 2007/2060				45,2*	33,10	
	Slovakia			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	7,5	7,3**	7,3*		12,0**	11,8*
Employment rate 15-64	56,3	62,3	60,2	62,2	65,9	64,6
Employment rate 55-64	21,5	39,2	39,5	36,9	45,6	46,0
Employment rate 55-64 women	10,2	24,2	26,1	27,4	36,8	37,8
Employment rate 55-64 men	35,2	56,7	54,9	47,1	55,0	54,8
Effective labour market exit age***	57,5	58,7		59,9	61,2	61,4
Public debt	50,3	27,7	35,7	61,9	61,6	73,6
Budget balance	-12,3	-2,3	-6,8	0,6	-2,3	-6,8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	16	32	68	25	38	53
Public pension expenditure, % of GDP	6,8	7,3	10,2	10,1	11,4	12,5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	11,7			8,7		
Employment	-0,6			-0,7		
Eligibility	-3,9			-2,6		
Level of benefits	-2,4			-2,5		
Total (including residual)	3,4			2,4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Finland

Description

In Finland the statutory pension provision comprises an earnings-related pension scheme that aims to maintain the attained income level to a reasonable degree and a basic national pension scheme that aims to guarantee a minimum income for pensioners with low wage or short working career. These schemes are closely linked as the amount of national pension depends on the size of the earnings-related benefit.

The national scheme provides a minimum pension based on the length of residence and can, after 40 years of residence, reach a monthly amount of approximately 584€ for a single person (about 21% of the average wage). The amount decreases as the person's earnings-related pension increases with a phasing-out rate of 50%. Above a defined level of earnings-related pension, the national pension ceases to be paid. The pensionable age for the national basic pension is 65 but on certain conditions is possible to retire early from age 62. The share of pensioners receiving only national basic pension is declining. As from 1 January 2010 national pensions are financed solely from general taxes. Before employer contributions financed part of the cost.

The earnings-related scheme covers all employees (without income ceiling) and the self-employed. The pensionable age is flexible between 62 and 68 years, accompanied by higher accrual rates for the last years of work: 1.9% a year between 53 and 62 years and 4.5% between 63 and 68 years instead of the standard accrual rate of 1.5%. The pension is calculated on the basis of the wages received during the whole professional career (from the beginning of 2005).

The benefit formula includes a life expectancy coefficient that reduces the monthly value of pension benefit in line with increases in longevity. Individuals from cohorts with higher life expectancy need to work longer to compensate for the impact of the life expectancy coefficient.

The financing of earnings-related pensions is a combination of a PAYG system and a prefunded system based on pension contributions from both employers and employees. Approximately three quarters of the earnings-related pensions are financed through PAYG, with the pre-funded scheme covering the rest. The market value of the pension funds' assets amounted to 73% of GDP in 2009.

National pensions are indexed with the consumer price index, while earnings-related pensions are indexed with a weighted index comprising 20% of wage and 80% of price developments

Early retirement has been very widespread but recently access to early retirement schemes and unemployment pensions has been significantly tightened. But presently it is possible to retire at 60 by receiving an unemployment pension¹¹⁸, or by receiving a partial old-age pension.

¹¹⁸ The unemployment pension, available to those born before 1950, has become less important as an avenue into retirement and will be phased out altogether by 2014. Disability is the most frequent cause of early retirement (with ca. 215 000 recipients).

Recently the government and the social partners have agreed that additional measures must be taken to raise the average effective retirement age by at least three years by 2025. To underpin incentives in the pension system the government has set up tri-partite committees to propose measures to improve well-being at work and the transition from school to work as well as further reforms of remaining early exit pathways in unemployment and disability benefit schemes.

Due to comprehensive coverage of the statutory schemes, the relatively high replacement rate and the absence of a pension ceiling (neither contribution nor accrual), the supplementary pension coverage is modest even if the number of individual plans has been increasing in recent years.

Current performance

At 10.8% of GDP in 2008, pension expenditure is currently slightly below the EU-27 average. Due to Finland's relatively young earnings-related system, low basic pension and the low participation rate of older women in the labour market, the result is that at-risk-of-poverty rate of people aged 65 is higher than the EU average (23% vs. 19%) and than for the population under the age of 65 (23% vs. 12%). Moreover, there is a large gender gap in at-risk-of-poverty rates of those over 65, and especially older pensioners (75 years and older).

For 2008, the net and gross replacement rates for a theoretical worker retiring at 65 after a 40 years contribution career came to 69.5% and 61.5%, respectively.

The employment rate of people between 55 and 64 years old has been increasing in recent years and is currently with 55% above the EU average. To a certain degree it is the result of a cohort effect, as the baby boom generation gets closer to the retirement age. More numerous cohorts of people aged 55 replace less numerous cohorts of those aged 64. It is also due to changes in legislation (e.g. raising the lower age limit to the unemployment pipeline) and cyclical reasons. Employment rates of men and women are almost equal. Despite increasing employment rate of older workers, the average exit age from the labour market at 61.6 has not progressed in recent years and is relatively low compared to the lowest pensionable age of 63 in the earnings-related pension or 65 in the national basic pension.

Impact of the crisis

In its immediate impact the financial crisis reduced the value of assets in the pension funds of the earnings-related system by 16.4% (negative rate of return) in 2008. To avoid that funds would have to lock in their losses by selling assets parliament relaxed solvency rules until the end of 2010 and recently extended this temporary measure till 2012. If un-recouped losses would have required contributions to have been raised by about 1 p.p. . However, an average return rate of about 15% in 2009 enabled funds to recover most of the losses. Still the impact brought home the sensitivity of the public pension system to the volatilities of financial markets. Until the crisis high returns have helped lower the need for higher contributions as one extra p.p. in long term return is equal to about two p.p.'s in contributions. As foreseen contributions will now be raised by 0.4% p.p. annually between 2011 and 2014.

The Finnish labour market, that had already reached an employment level of 70%, has experienced more significant decline due to the crisis compared to the EU on average. In 2009, the employment rate of persons aged 15-64 reached 68.3%, down by 2.43 pp. compared

to 2008 (EU: down by 1.3 pp to 64.6%). The male employment rate fell by 3.5 pps. to 68.8%, a considerably stronger decline than the 1.0 pp. decline to 67.9% recorded for women (EU: men down by 2.1 pp to 70.7%, women down by 0.5 pp to 58.6%). The employment rate of men over 55 years fell too by 2.5 pp. to 54.6% (EU: down by 0.2 pp to 54.8%), whereas the employment rate of women over 55 years still managed to grow by 0.5 pp. to 56.3%, thus surpassing that of men (EU: up by 1 pp to 37.8%), even during the crisis. The crisis hit first the export oriented sectors which are mostly male dominated. The female dominated social and health care sectors which depend on public sector funding are expected to be affected as the economic downturn deteriorates public finances, with the public budget deficit increasing in 2009 and in 2010.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.8 p.p of GDP in the 'lost decade' scenario¹¹⁹) also in the long-term unless corrective action is taken.

Outlook

In the long-term developments in the old-age dependency ratio (expressed as a size of population aged 65 and more relative to the population aged 15-64) will be slightly less pronounced in Finland than the EU average (FI: 25% in 2007, 49% in 2060, EU: 25% in 2007, 53% in 2060). However, with the second highest old-age dependency ratio projected for 2030 in the EU-27, Finland will face ageing even earlier than other Member States. The working-age population (15-64) is projected to drop by 13%, compared with 15% for the EU as a whole by 2060.

Labour market participation rates are projected to increase in Finland over the long-term, especially for women and older workers, but at a slower pace than in the EU-27. The participation rate was well above the EU average in 2007 (5th highest at 75.6% in 2007, EU27: 70.5%, but since the economic crisis declined to 7th place at 75% in 2009, EU27 71.1%), and is projected to remain in that position also in 2060 (FI: 79.1%, EU: 74.1%).

In spite of the increasing employment level, the older female age cohorts are likely to gain smaller pensions accruals than their male peers because of shorter working careers and the gender pay-gap. In 2008, women earned on average 20% less than men. The gap is even greater for over 55-year old women. Furthermore, women are engaged more often in part-time work than men (18.2% of women compared to 8.9% of men in 2008. In order to improve the income of persons living on the lowest pension incomes it has been decided to introduce a guarantee pension, which will be applied as from 1 March 2011.

Finland is in the group of Member States where the increase in public pension expenditure is projected to be significant. The level of expenditure in 2007, at 10% of GDP was slightly below the EU average (10.2%), but the projected increase is larger in Finland, with 3.9 percentage point of GDP for the period 2007-2030 and 3.3 pp. for the period 2007-2060 (EU: +2.4p.p.). At the end of the projection period (2060) the expenditure to GDP is expected to be 13.4, or $\frac{3}{4}$ percentage points above the EU average.

The demographic transition to an older population is the main driver behind the projected increase in public pension expenditure. This effect alone would push up expenditure

¹¹⁹ See Table 76 in the 2009 Ageing Report p. 239.

significantly in Finland, by 8 $\frac{3}{4}$ percentage points of GDP, but will be partially offset by tighter eligibility criteria and higher employment rates. According to the projections, the coverage ratio, which is the ratio of the number of pensioners under the public scheme (all ages) divided by the number of people aged 65 years and above is projected to fall more in Finland than in the EU as a whole. Hence the coverage effect (tighter pension eligibility) has a relatively larger effect in moderating expenditure in Finland (by 3.1 pp of GDP between 2007 and 2060) than the EU-27 average (2.6 pp).

The benefit effect, which is the contribution to the change in the average pension benefit in relation to GDP per worker, by contrast contributes less to the moderation of public pension expenditure increases relative to the EU. It is reflected by a slight projected decrease in the benefit ratio, which compares an average public pension benefit to an average wage, from 49.1% in 2007 to 46.9% in 2060.

Also gross and net theoretical replacement rates are expected to decline between 2008 and 2048, but by about 11%. The NRR would reduce from 69.3% (gross 61.5%) to 61.3% (gross 53.9%). Declines are mainly due to the application of the life-expectancy coefficient.

The negative effect of 3 years of unemployment which came to 5.48% of the NRR in 2008 will be halved by 2048 (2.75%). In the same period the negative effect of a 3 year childcare break would be substantially reduced from 6.6% to just 0.8%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65, which is symmetrical, would be largely maintained over the period. The NRR for low earners would be reduced from 67% to 62% while the NRR for high earners would drop from 65% to as little as 46.4%.¹²⁰

The effect of a 10 year career break on the NRR would reduce from a loss of about 22% to a loss of 17%. The decrease in the NRR 10 years after retirement which in 2008 amounts to 13% would be slightly less serious in 2048 at 12%.

Challenges

With the comprehensive reform of 2005 that a.o. brought in the life expectancy coefficient and strong financial incentives to work longer Finland established a solid base for achieving a good balance between adequacy and sustainability in pension provision. But the country is still a distance from an appropriate equilibrium between working years and years spent in retirement and long-term success will hinge on significant rise in the effective retirement age.

The challenge Finland faces with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed as at 'medium' risk by the Commission.¹²¹ The projected increase in pension expenditure over the long-term at 3.3% is higher than the EU average (2.4%). Enacted pension reforms have helped to contain the increase in expenditure. Moreover, large assets accumulated in the public pension system offset in part the long-term budgetary impact of ageing. Still to maintain benefit levels while the baby boomers retire contribution rates may have to rise from the present 22% to about 27% by 2025. Containing the need for contribution hikes is therefore emerging as a priority which has brought possibilities for extending working life further into focus.

¹²⁰ The value of the NRR for high wage earner is preliminary.

¹²¹ In the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report, Finland was assessed to be at 'low' risk.

Despite impressive improvements over the last decade employment rates of older workers and the effective exit age are low by Scandinavian standards. The use of early exit pathways in unemployment and disability benefit systems is still too widespread. It is therefore encouraging that the government with the social partners have discussed measures for raising the effective retirement age and that further measures to extend working life are to be underpinned by improvements in work life well-being and better transitions from school to work. If the implied employment challenge can be tackled further limiting the access to early withdrawal including a rise in the pensionable age in earnings-related pensions could be considered.

Replacement rates for people with earnings-related pensions are good but the level of national pensions is below 60% of the median income wherefore the present poverty rate is relatively high. Total replacement rates are projected to fall over the long-term, given future developments of employment, wages and mortality rate. Monitoring of developments in adequacy will be called for.

The budgetary position in 2009 and 2010 compounds the budgetary impact of population ageing on the sustainability gap. Ensuring budget consolidation through high primary surpluses over the medium term would contribute to limiting the risks to the sustainability of public finances.

Background statistics

Current adequacy (2008)	Finland			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	12	12	11	16	16	17
At-risk-of-poverty rate 65+	23	16	28	19	16	22
At-risk-of-poverty rate 75+	31	22	35	22	18	24
Income inequality 0-64	3.7			5.1		
Income inequality 65+	3.1			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.71	0.77	0.68	0.85	0.88	0.83

Adequacy projections: FI	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	69.3	61.3	-8.0	61.5	53.9	-7.6
TRR 3 years unemployment	65.5	59.7	-5.8	57.5	52.2	-5.3
TRR 3 years childcare break	64.7	60.8	-3.9	56.8	53.3	-3.5
TRR 10 years career break	54	50.9	-3.1	46	43.1	-2.9
TRR shorter working (retirement at 63)	62.2	54.7	-7.5	54.2	47.1	-7.1
TRR longer working (retirement at 67)	76	67.7	-8.3	68.8	60.5	-8.3
TRR 10 years after retirement	60	53.9	-6.1	52	46.4	-5.6
TRR low earner (66% average)	67	62.2	-4.8	61	53.9	-7.1
TRR high earner (100-200% rising profile)	65	46.4	-18.6	58.0	37.7	-20.3
Benefit ratios: social security pensions 2007/2060				49.1*	46.90	

Current sustainability	Finland			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	10.6	11.0**	10.8*		12.0**	11.8*
Employment rate 15-64	68.1	71.1	68.7	62.2	65.9	64.6
Employment rate 55-64	41.2	56.5	55.5	36.9	45.6	46.0
Employment rate 55-64 women	40.7	55.8	56.3	27.4	36.8	37.8
Employment rate 55-64 men	41.8	57.1	54.6	47.1	55.0	54.8
Effective labour market exit age***	61.4	61.6		59.9	61.2	61.4
Public debt	43.8	34.2	44.0	61.9	61.6	73.6
Budget balance	6.8	4.2	-2.2	0.6	-2.3	-6.8

Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	25	44	49	25	38	53
Public pension expenditure, % of GDP	10	13.9	13.4	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	8.7	8.7
Employment	-0.6	-0.7
Eligibility	-3.1	-2.6
Level of benefits	-0.9	-2.5
Total (including residual)	3.4	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: Sweden

Description

Introduced in 1999 the Swedish public, social insurance pension scheme consists of three parts:

- income pension, a notionally defined-contribution system (NDC);
- premium pension a fully funded, mandatory DC scheme, and;
- guarantee pension, a guaranteed minimum defined benefit pension financed from general taxes.

In the NDC and DC part of the scheme, all income earned, up to a certain ceiling, influences the pension. The contribution rate is permanently fixed at 18.5% of the gross wage, up to a ceiling. 16 Percentage points finance the pensions on the pay-as-you-go basis through the mechanism of notional accounts (income pension) and 2.5 percentage points are invested in one or more funds selected by the individual (premium pension). The NDC of the scheme is normally wage indexed.

In addition to wage from regular employment, income from self-employment, benefits for sickness, disability and unemployment are considered as income in the pension system. Studies (with national study assistance) and years with children up to four years of age are also credited.

The public pension system is supplemented by sector-wide occupational pension schemes.

If the income pension is too low – because of low wages or little number of working years – a guarantee pension supplements the pension. In addition there is a housing supplement for pensioners with low pensions and high housing costs. The guarantee pension is consumer price indexed. To receive a full guarantee pension, a person must have lived in Sweden or in another EU/EES country for 40 years.

Occupational pension are complementing the pensions from the social insurance system for most people in Sweden. More than 90% of employees are covered by occupational pensions established by collective agreements. Separate schemes cover white and blue collar workers in the private sector and those that are employed in the state sector or in municipalities and counties. All four schemes have moved from DB to DC designs for new entrants. The schemes in the private sector are entirely DC-plans, but most white-collar workers in the private sector currently employed will get a pension according to an earlier DB plan. The occupational pension schemes for public sector employees are DC plans up to the income ceiling in the social insurance pension system, and for income above that ceiling a combination of DB and DC plans. Contributions are tax deductible as long as certain conditions are met.

Last, there are three different forms of personal pensions; traditional insurance, fund insurance and an individual pension saving in a bank. Contributions are tax deductible as long as certain conditions are met.

The lowest possible age to receive an income pension and premium pension is 61. There is no upper limit from when a pension has to been drawn. An employee has the right to work until

67 and may work longer if the employer allows it. From 65 guarantee pension may be obtained by those with a low-income pension. Since the pension system works on an actuarial basis, and at the time of the retirement an annuity is calculated, early pension take up reduces benefits while postponing retirement leads to a higher pension benefit.

In the NDC (income pension) scheme the financial sustainability of the system (balance ratio) is determined each year. Assets of the system (defined by the flow of contributions and the duration within the system and position of a buffer fund) are compared with current liabilities. As the contribution rate is fixed adjustments are taken on the indexation of accumulated accounts. If the value of the balance ratio is less than one, indexation of pensions and earned pension entitlements are reduced in order to restore the equilibrium between assets and liabilities in the following year. This calculation is regulated by law.

The adjustment mechanism was triggered in 2010. The Swedish government has recently decided to re-evaluate the calculation performed for the balancing mechanism and the proposal that has been adopted by the Swedish parliament is one that smoothens out the volatility of the buffer funds by incorporating a three year moving average of their values into the calculation of the balance rather than the current annual value of the funds. This will have the effect of sharing the burden of the financial downturn over more years. Instead of a 4% decline (in nominal terms) in the income pension in 2010, benefits will be reduced gradually over the next years, but annual adjustment will be less pronounced. This strategy may increase the counter-cyclical nature of the mechanism.

Current performance

The relative median income of people aged above 65 in relation to the age group 0-64 amounted to 75% in 2008, lower than in 2005 (80%), and lower than the EU27 average (84%). The rate of poverty risk of population 65+ (16) has increased since 2005 but is still three percentage points lower than the EU average. Women above 65 are at a particularly high risk of poverty (21%) compared to men (10%). For 2008, the total net and gross replacement rates (including statutory and occupational schemes) for a theoretical worker retiring at 65 after a 40 years contribution career came to 65.0% and 66.0%, respectively.

Relative to EU-levels the employment rate of older workers (age 55-64) was already at a high level in Sweden. Still increased between 1998 and 2009, and is now at the highest level in EU with 70% (women: 66.7%; men: 73.2%). However, a current challenge for Sweden is the relative late age of establishment in the labour market, defined as when 75% of an age cohort is employed in the labour market. This age is 27 according to the NSR, and the issue needs to be addressed in order to secure economic growth and adequate pensions in the future.

At 63.8 years the effective retirement age in Sweden is well above the EU average (61.4).

The lower employment rate, the gender pay gap (17.1% in 2008) and the high percentage part time work (women: 41.4%, men: 13.3%, 2008) may affect pensions for women negatively in the future. The higher risk of poverty for elderly women today is primarily the result of the fact that the women already retired often have had shorter working lives and thus qualified for relatively low income pension. In the future the problem is projected to decrease to a certain degree as women currently in active ages work and earn pension rights in parity with men. On the other hand the risk of poverty will increase in the future for both sexes as an effect of increased longevity, unless they work to higher ages before pension take up. While the

financial sustainability of the pension system is guaranteed by the design which amid ageing retains cost at the same relative level, benefits are likely to decrease as a result of the balancing mechanism.

Impact of the crisis

The financial crisis reduced the value of assets in all funded schemes. Losses in personal schemes affected pension entitlement and pensions in payment in 2009. In occupational schemes effects will fall on future pensions as presently benefits in payment come from DB schemes while in the future all schemes will be DC. In 2009 funded schemes tended to recoup a large part of their losses.

The Swedish economy is mainly export oriented and was thus affected by the decline in external demand as the financial crisis developed into an economic crisis. GDP contracted by 4.9% in 2009 and unemployment is projected to increase from 6.2% in 2008 to 9.2 in 2010. Partly due to prudent pre-crisis budgetary policy, Sweden's general government deficit in 2009 was relatively limited in an EU perspective.

Public pensions were affected in 2 ways. First, the balance ratio of the NDC scheme was negatively influenced by decline in the value of the buffer fund and adverse developments in the labour market which reduced revenue from contributions. Second, spells of unemployment and lower pay will impact negatively on pension accruals in the first (income pension) and second (premium pension) part of the Swedish public pension system.

As an effect of these first impacts the automatic adjustment mechanism required pensions – accruing entitlements as well as those in payment - to be reduced. But to mitigate the magnitude of adjustments required as result of the unusually high loss in asset values in 2008 new legislation was adopted to smooth the impact of market volatilities by calculating the effect on the basis of a moving three year average instead of any single year. Still Sweden stands out as the only Member State where the automatic self-balancing mechanisms introduced have been allowed to function in accordance with its principles. In 2010 pensions in payment were reduced by 3% and entitlement accruals by 1.4%. As this coincided with a reduction of progressive income taxes for retirees the average net effect for pensioners amounted to a reduction of about 1%.^{122 123}

The second effect is mitigated as unemployment benefit counts towards pension entitlement. But if youth unemployment becomes entrenched and long term unemployment grows it will reduce pension adequacy for these groups as it is calculated on life time contributions.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.7 p.p of GDP in the 'lost decade' scenario¹²⁴) also in the long-term unless corrective action is taken.

¹²² Settergren, O.: Impact from the Financial Crisis and the Economic Recession on the Swedish Pension System, Stockholm 2010.

¹²³ For 2011 the reduction would be 4.3%, but parliament may decide to mitigate the impact through further reductions in the income tax rate for pensioners.

¹²⁴ See Table 76 in the 2009 Ageing Report.

Outlook

The demographic transition to an older population in Sweden will be slightly less pronounced than in the EU-27 on average. The old-age dependency ratio (population aged 65 and over as a percentage of the population aged 15-64) is projected to increase from 27% in 2008 (EU27: 25%) to 47% in 2060 (EU27: 53%).

Sweden spends about 12% of its GDP on pensions. Expenditure has stabilised over the last years and is close to the EU average. According to the budgetary projections of the 2009 Ageing Report, public expenditure on social security pensions will remain stable in the coming decades (9.5% of GDP in 2007 and 9.4% of GDP in 2060). This is due to the fact that demographic factors are projected to be counterbalanced by higher employment, slightly restricted pension eligibility and a significant drop in the relative level of public pension benefits. The benefit ratio, which compares the average public pension benefit to an average wage, is projected to decline from 49.3% in 2007 to 30.1% in 2060. Growing importance of the mandatory funded DC scheme (premium pension) and occupational pension provision will cushion the drop: the benefit ratio that includes premium and occupational pensions is projected to decrease from 64% in 2007 to 46% in 2060.

The net theoretical replacement rate (NRR) for a hypothetical male worker retiring at 65 after 40-years career is projected to decline considerably from 65.0% in 2008 to 48.2% in 2048. These declines reflect that younger cohorts due to increases in longevity and thus more years spent in retirement would receive a lower annual replacement rate than older cohorts. The negative effect of 3 years of unemployment which came to 7.7% of the NRR in 2008 will be decreased by 2048 (5.4%). In the same period the negative effect of a 3 year childcare break would be substantially increased from 0% to just 3%. The relative bonus/malus effect of retiring 2 years after and 2 years before age 65 (which is now 15% / 11% higher/lower than the NRR with retirement at 65), will become symmetrical by 2048 (at around 11% higher/lower NRR than retirement at 65), mainly because of a decrease in the bonus for working longer. The NRR for low earners would be reduced from 143% to 115% of the NRR compared to the average earner, while the NRR for high earners would drop from 109% to as little as 73% compared to the average earner. These results stem from the different relative weight of taxation of pension income and work income of the different earning profiles¹²⁵. The effect of a 10 year career break on the NRR would reduce from a loss of about 17% in 2008 to a loss of 11% in 2048.

As a result of the assumption about a fixed retirement age at 65 the benefit ratio in Sweden will decrease from 49% in 2007 to 30% in 2060 the risk of relative poverty among elderly in Sweden will increase. The annex's section on current adequacy (2008) shows that Sweden is currently roughly on par with average adequacy in EU-27. Yet, the projected decreases in the Swedish benefit ratio and replacement rates are much more substantial than in other comparable EU Member states, such as DE, DK, FI and NL.

Challenges

With the well-prepared, innovative and consensually introduced 1999 reform, which was fully in place by 2003, Sweden has attained a financially stable, transparent public pension system

¹²⁵ Pension income taxed at around 38% for the high, 30% for the average and 27% for the low earner; work income taxed at around 42% for the high, 28% for the average and 22% for the low income earners.

with strong work incentives and good minimum protection as it combines NDC and FDC principles with a capacious guarantee pension. Since the public system is supplemented by occupational schemes with very high coverage the overall Swedish pension system presently exhibits a commendable balance between adequacy and sustainability concerns.

The challenge Sweden faces with regard to ensuring the long-term sustainability of the public finances given its ageing population was assessed to be at 'low' risk in this regard by the Commission/Council.¹²⁶ The projected decrease in pension expenditure over the long-term at 0.1% of GDP is markedly lower than the projected increase in the EU average of 2.4%. Total public pension replacement rates (when retiring at 65), currently slightly below the EU average, are projected to fall significantly over the long-term to become among the lowest in the EU.

Real retirement ages have increased impressively in recent years even though levels were already exceptionally high by EU standards. The employment rate of older workers is also the highest in the EU. Both facts give good ground for further increases in the effective retirement age as the population will grow older and dependency ratios will worsen. However, it is also key that more people start working at earlier ages. The transition from school to work is at this moment too deferred. Full inclusion of women on the labour market and narrowing the gender pay gap would improve financial sustainability even further and reduce the risk of poverty for women in old age. Tackling youth and long-term adult unemployment is important to avoid gaps in entitlements for the affected.

Strong automatic adjustment mechanisms maintain the financial sustainability and with its four components (income, premium, guarantee, and occupational pensions) the Swedish pension system seems to provide a good protection against a risk of inadequate pensions.

Yet the difference in indexation between the guarantee pension (indexed on consumer price index) and the NDC income pension (indexed on wages) is likely to reduce the relative value of the guarantee pension in the long-term.

Moreover, in the longer run TRR scenarios suggest that unless people compensate by working longer financial stability would tend to be secured at the cost of adequacy. Since the contribution rate in the public scheme is fixed all automatic adjustments for longevity growth and declining dependency ratios will reduce benefit levels. Over time reductions may become significant and political pressures for compensation may arise. Rising average exit ages could mitigate some of the reductions. Working more and longer when living longer will make up for the reduction and still leave room for longer periods in old-age retirement than ever before.

As the need for budget consolidation is moderate and the public pension scheme fully financially, sustainable fiscal consolidation may be achieved without affecting pensions.

¹²⁶ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

Current adequacy (2008)	Sweden			EU-27		
	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	11	12	11	16	16	17
At-risk-of-poverty rate 65+	16	10	21	19	16	22
At-risk-of-poverty rate 75+	22	13	28	22	18	24
Income inequality 0-64	3.5			5.1		
Income inequality 65+	3.4			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.75	0.8	0.71	0.85	0.88	0.83

Adequacy projections: SE	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	65.0	48.2	-16.8	66.0	47.9	-18.1
TRR 3 years unemployment	60	50.2	-9.8	61	50.2	-10.8
TRR 3 years childcare break	65	46.7	-18.3	66	46.3	-19.7
TRR 10 years career break		42.8	42.8		41.8	41.8
TRR shorter working (retirement at 63)	62.2	42.8	-19.4	54.2	41.9	-12.3
TRR longer working (retirement at 67)	76	53.8	-22.2	68.8	54.2	-14.6
TRR 10 years after retirement		43.5			42.5	
TRR low earner (66% average)	93	55.2	-37.8	99	55.1	-43.9
TRR high earner (100-200% rising profile)	71	34.9	-36.1	66.0	28.8	-37.2
Benefit ratios: social security pensions 2007/2060				49.3*	30.10	

Current sustainability	Sweden			EU-27		
	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	11.3	12.0**	11.8*		12.0**	11.8*
Employment rate 15-64	71.1	74.3	72.2	62.2	65.9	64.6
Employment rate 55-64	64.3	70.1	70.0	36.9	45.6	46.0
Employment rate 55-64 women	61.7	66.7	66.7	27.4	36.8	37.8
Employment rate 55-64 men	67.0	73.4	73.2	47.1	55.0	54.8
Effective labour market exit age***	62.1	63.9	63.8	59.9	61.2	61.4
Public debt	53.6	38.3	42.3	61.9	61.6	73.6
Budget balance	3.7	2.5	-0.5	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	26	37	47	25	38	53
Public pension expenditure, % of GDP	9.5	9.5	9.4	10.1	11.4	12.5

Factors determining the evolution of public pension expenditure 2007-2060

Demographic dependency	5.6	8.7
Employment	-0.4	-0.7
Eligibility	-0.4	-2.6
Level of benefits	-4.3	-2.5
Total (including residual)	-0.1	2.4

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years

Country profile: United Kingdom

Description

Following a sequence of reforms starting in 2006 the UK pension provision consists of the following three elements:

- The flat-rate **Basic State Pension (BSP)**, receipt of which is based on National Insurance contributions and on credits given for periods of care, unemployment and disability. Early access to the BSP is not possible, but individuals can opt to defer receipt of the BSP and receive a higher weekly pension or a lump sum.
- The **State Second Pension (S2P)**, an additional pension which is earnings-related but following reform will increasingly become a flat-rate addition to the BSP. All employees (but not the self-employed) are required to either be members of S2P or to make equivalent private savings in a contracted-out private pension.
- **Private pension provisions** through fully funded occupational and personal pension schemes play a large role in the overall system.

Pensioner poverty is addressed via **Pension Credit**, which tops up other insufficient income to a minimum income for elderly people. It is intended to secure a minimum standard of living¹²⁷. Its value relative to earnings has been maintained over time, and at present the rate for singles exceeds the poverty threshold.

The majority of employees of working age contribute to an occupational or personal pension. The state provides tax incentives for retirement savings and regulates private pensions.

To address low coverage rates, the government plans to require employers to automatically enrol their employees into a company pension scheme or the newly established **National Employment Savings Trust (NEST)**, with the possibility to opt out. Phased implementation is planned between 2012 and 2016. Further measures to increase private pension saving include legislative and taxation simplifications for occupational pension schemes.

The BSP has been reformed to make it simpler, more generous, and easier to access. Entitlement is based on the number of qualifying years built up through National Insurance Contributions. Currently, 11 million people in the UK receive the BSP (nearly the entire Population above state pension age) but only 85% of men and 35% of women qualify for the full amount. Following a reduction in the required contributory period in 2010, entitlement to a full BSP is expected to rise to over 90% among both men and women by 2025. Another change, which will help increase entitlement, is the removal of the **de-minimis rule**, under which one before needed to have at least 25% of the required qualifying years to get some BSP. Furthermore, more generous crediting arrangements for periods spent caring for children or the severely disabled will improve entitlement to BSP and S2P.

State pension ages are increasing. The state pension age for women is being gradually equalised with that of men, rising from 60 to 65 between 2010 and 2020. Between 2024 and 2046 the pensionable age will increase from 65 to 68 years for both men and women.

¹²⁷ The central criticism of the means-testing aspect of the pension credit is that it discourages saving because people close to the threshold can suffer high withdrawal rates.

The UK has also introduced a number of other measures that encourage people to work longer, including raising the earliest possible age at which a private pension can be drawn from 50 to 55, promoting longer working lives by increasing the deferral rate of the state pension (from 7.4% to 10.4%) and allowing people to receive their state pension while continuing to work. The UK emphasises supportive measures to help people to stay in the labour market such as a new plan to remove employers' right to require employees to retire at 65, the active labour market policy 'New Deal 50 Plus', legislation to outlaw age discrimination in employment and vocational training and the Age Positive initiative, which promotes the benefits of employing older workers.

In 2005, the UK set up the **Pensions Regulator**, which has regulatory powers to deal with risks to pension schemes and members' benefits, and the **Pension Protection Fund**, which provides compensation where a defined benefit scheme's sponsoring employer becomes insolvent and the scheme is underfunded.

The overall direction of recent pension reforms commands political consensus and is supported by the social partners. Reforms have sought to improve the poverty alleviation function of the state pension and increase gender equality among pensioners.

Current performance

Over the last decade, the UK state pension system has made significant progress towards addressing adequacy and improving equity¹²⁸. The median income of pensioners has improved significantly relative to that of working-age individuals, particularly when one looks at those on lower incomes, such as single older female pensioners. Most of this improvement has been due to state pension measures, such as the introduction of S2P and Pension Credit.

Despite the progress, at-risk-of-poverty rate for people aged 65 and more has been on increase between 2005 and 2007. Moreover, in 2008 the rate, at 30%, was still substantially higher than the EU average of 19% and higher than the rate for the rest of the population (17%). By contrast the difference between the poverty risk for women (32%) and men (28%) was low by EU standards. For 2008, the net and gross replacement rates for a theoretical worker retiring at 65 after a 40 years contribution career came to 73.3% and 61.0%, respectively.

The BSP and S2P together provide good replacement rates for those on low incomes, but for medium-to-high earners they just provide a base on which to build private retirement savings that enable them to maintain their living standards in retirement, mainly through occupational and personal pensions. There are concerns that coverage of private pension savings is low (only 56% of working age employees are contributing to a private pension) and has been declining. Participation in private pension schemes varies greatly by earning level and gender¹²⁹ but as indicated above recent reforms are attempting to address these problems.

The UK employment rates for older workers aged 55-64 (66.2% for men and 49.2% for women in 2009) are among the highest in Europe (EU27: 54.8% and 37.8%). The average age

¹²⁸ Eurostat data indicate that the median income of the 65+ in the UK has risen significantly during the last decade), from being 85% of EU-15 average in 1997 to 109% in 2007, although the largest increases took place in late 90s.

¹²⁹ Country fiche 2009, p.325. According to the 2009 Theoretical Replacement Rate Report 74% of male contrasted to 39% of female new retirees receive occupational or private pensions.

of exit from the labour market was 63.1 years in 2008 (EU-27: 61.4 years)¹³⁰. This is below the pensionable age in the state pension scheme. Still, the increase in the state pension age is likely to increase the effective retirement age and thus the sustainability of the system.

Impact of the crisis

The impact of the financial and economic crisis on present pensioners has so far been limited. Despite the trend from defined-benefit (DB) to defined-contribution (DC) pension schemes, for those retiring today, DB schemes are predominant and those members' pension rights have generally not been affected. Flexibilities applied by the Pensions Regulator on scheme solvency and recovery plans has meant that short-term asset value declines alone did not push employers into insolvency. Where sponsoring employers became insolvent and the combined assets of the pension scheme and the employer could not meet the liabilities, the Pension Protection Fund took over the schemes and provided benefits at a replacement rate of approximately 90%.

DC schemes saw declines in asset values of 20% on average during the financial crisis. However, asset values of typical DC schemes have since at least partially recovered. Few people who retired during the crisis were negatively affected by this short-term fluctuation, as majority of DC schemes are not yet mature and the use of risk mitigation strategies, such as lifestyling (gradually moving assets from high risk to low risk in the years preceding retirement), have reduced the effect of asset value fluctuations.

While the crisis thus largely confirmed the appropriateness of scheme design, entitlement protections and regulatory arrangements it also suggested some limits of the adopted shock absorption mechanisms – namely the fact that costs fall on the scheme sponsoring employer instead of being shared more equally among stakeholders, by distributing adjustments on contributions, the value of accruing entitlements as well as benefits in payment.

Measures aimed at increasing coverage of private pensions such as auto-enrolment and the NEST need to be monitored for their success, as the financial crisis could have affected the willingness of both workers and employers to participate in funded schemes.

The UK economy faces difficult times as a result of the financial crisis and the economic downturn. Unemployment rose from 5,3% in 2007 to 7,6% in 2009 and is forecast to reach 7,8% in 2010. Moreover, the state of public finances has deteriorated considerably and the public budget deficit widened significantly in 2009.

As a consequence of the unfavourable economic climate and the dire public finances, the new coalition government of Conservative and Liberal Democrats which took office in May 2010 has put public pensions on the agenda in a number of areas. So far the government has announced plans to review the increase in state pension age to 66, remove the requirement to secure a pension income by age 75, phase out the default retirement age of 65 and address the cost of pension provision for public sector workers. As from April 2011, the BSP will be guaranteed to rise in line with the higher of the increase in earnings, prices or 2.5%, instead of prices. The government, however, switched the indexation for public and private DB schemes from the Retail Price Index to the Consumer Price Index (which is expected to reduce the State's pension liabilities as the latter index tends to grow more slowly over time).

¹³⁰ Eurostat.

Estimates in the 2009 Ageing Report reveal that the crisis would increase pension expenditure further (by an additional 0.3 p.p of GDP in the 'lost decade' scenario¹³¹) also in the long-term unless corrective action is taken.

Outlook

The deteriorating support ratio and the lengthening of the time spent in receipt of pensions caused by rising longevity puts pressure on the affordability and sustainability of the pension system. These pressures are compounded by a decline in active participation in private pensions which endangers the overall adequacy of UK pension provision. .

The UK is expected to face a smaller challenge from demographic trends than most EU Member States. The old-age dependency ratio, even if growing from 24% in 2007 to 42% in 2060¹³², is still projected to be among the lowest in the EU. Due to improvements in state provision the rise in gross social security spending on pensions at 2.7% pp will be slightly higher than EU27 average (2,4%) while the overall GDP share at 9,3% will be markedly lower (EU27:12,5%)¹³³. The proportional increase in gross social security spending is higher than the proportional increase in pensioner numbers in total population¹³⁴.

From 2008 to 2048 the total net replacement rate - including statutory and occupational schemes - is projected to increase slightly, as a result of improvements in the state pension. This is also reflected in the evolution of the benefit ratio from 35% in 2007 to 37% in 2060. The reduction in the qualifying conditions required and better crediting provisions is projected to improve net replacement rates by more for those with career breaks – particularly if these are because of caring responsibilities. The trend in the net replacement rate is very positive for those on low incomes, but there will be a decline in generosity for high earners. Estimates of replacement rates suggest that the decline in replacement rates after retirement could increase in the UK – but this ignores the recent improvement in uprating of the BSP. Similarly estimates of the replacement rate achievable when people retire at 67 do consider that the state pension age in 2046 will be higher than 67, and thus may underestimate the financial incentives to defer receipt of the state pension.

Challenges

With the last decade of reforms the UK has put itself on track towards achieving a better balance between adequacy and sustainability concerns in its pension system. The coverage and adequacy of public provision is set for significant improvements that are likely to bolster poverty protections by substantially enhancing access and entitlement accruals for women and people on low earnings and incomplete careers. However despite slightly above average growth in long-term expenditure UK state pensions should still result in one of the lowest statutory replacement rates in the EU27. The overall adequacy of UK provision will therefore continue to depend crucially on having strong and resilient private retirement income provision.

¹³¹ See Table 76 in the 2009 Ageing Report.

¹³² Ageing Report 2009, Annex I, p.280.

¹³³ Ageing Report 2009, Annex I, p.282.

¹³⁴ Ageing Report 2009, Annex I, Tables A8, A53, A63.

The combined impact of the financial and the economic crisis caused a serious deterioration of public finances. Budgetary consolidation is therefore essential in order to reduce public debt and to secure the base for financing future increases in public pension expenditure. Moreover while confirming the solidity of entitlement protections and regulatory arrangements, the financial crisis suggested the need to search for improvements in the shock absorption mechanisms in funded schemes.

The challenge UK faces with regard to ensuring the long-term sustainability of the public finances at the back of its ageing population was assessed to be at 'high' risk by the Commission/Council.¹³⁵ The projected increase in pension expenditure over the long-term at 2.7% of GDP is somewhat higher than the EU average, though starting from and ending at a relatively low level. While the benefit ratio of public pensions should remain significantly below the EU average, it is projected to remain broadly constant, as against the declines forecast across the EU27.

Though employment rates for older workers and the average exit age are above the EU average, to ensure adequacy and sustainability, strong efforts need to be maintained to increase participation rates further and to extend working lives. The plan to move forward the upward adjustment of the pensionable age in public schemes can play a positive contribution. But pensionable ages in occupational schemes would also need to be raised, to help maintain an appropriate balance between working years and years spent in retirement.

Despite marked improvements, particularly in the level of median income, older people are currently still exposed to significant at-risk-of-poverty rates and it may take some time before present reform measures change this. Resolving the conundrum of how to use means testing to target benefits on the poorest and most vulnerable pensioners while minimising the extent to which people of working age are discouraged from saving by the prospect of losing means-tested benefits in retirement is a difficult but important challenge which the UK should continue to try to address. This challenge is likely to become more significant as the opportunity of participating in a workplace pension scheme is extended to all employees.

Assuring adequacy in overall pension provision will rest crucially on the success of efforts to significantly increase the coverage rate of work place pensions. Since higher participation in occupational and private pensions will have a significant impact on benefits only after years of savings, low replacement rates for big groups of workers will persist for some time. Moreover, with the decline in occupational pension coverage over the last decade, the UK might witness cohort effects as the proportion of people retiring with high amounts of occupational pensions decline over time.

¹³⁵ See the Council opinions on the 2009/10 stability and convergence programmes and the 2009 Sustainability Report.

Background statistics

	United Kingdom			EU-27		
Current adequacy (2008)	Total	Men	Women	Total	Men	Women
At-risk-of-poverty rate 0-64	17	16	18	16	16	17
At-risk-of-poverty rate 65+	30	28	32	19	16	22
At-risk-of-poverty rate 75+	33	31	34	22	18	24
Income inequality 0-64	5.7			5.1		
Income inequality 65+	4.6			4		
Income of people aged 65+ as a ratio of income of people aged 0-64	0.71	0.72	0.71	0.85	0.88	0.83
Adequacy projections: UK	2008 net	2048 net	difference	2008 gross	2048 gross	difference
Theoretical replacement rates (TRR) base case	73.3	74.9	1.6	61.0	62.3	1.3
TRR 3 years unemployment	73.9	74.9	1.0	61.5	62.3	0.8
TRR 3 years childcare break	71.2	76	4.8	59.4	63.4	4.0
TRR 10 years career break	58.2	64.1	5.9	47.2	52	4.8
TRR shorter working (retirement at 63)	70.5	72.7	2.2	58.3	60.2	1.9
TRR longer working (retirement at 67)	76.9	77.2	0.3	64.2	64.5	0.3
TRR 10 years after retirement	66.3	67.6	1.3	54.2	55.3	1.1
TRR low earner (66% average)	80.6	90.1	9.5	68.3	76.4	8.1
TRR high earner (100-200% rising profile)	51.5	48.8	-2.7	41.0	38.9	-2.1
Benefit ratios: social security pensions 2007/2060				34.6*	37.10	
	United Kingdom			EU-27		
Current sustainability	2000	2008	2009	2000	2008	2009
Esspros pension expenditure	11.9	10.8**	10.5*		12.0**	11.8*
Employment rate 15-64	71.0	71.5	69.9	62.2	65.9	64.6
Employment rate 55-64	50.4	58.0	57.5	36.9	45.6	46.0
Employment rate 55-64 women	41.4	49.0	49.2	27.4	36.8	37.8
Employment rate 55-64 men	59.8	67.3	66.2	47.1	55.0	54.8
Effective labour market exit age***	62.0	62.6	63.1	59.9	61.2	61.4
Public debt	41.0	52.0	68.1	61.9	61.6	73.6
Budget balance	3.6	-4.9	-11.5	0.6	-2.3	-6.8
Sustainability: projections	2007	2030	2060	2007	2030	2060
Old-age dependency ratio	24	33	42	25	38	53
Public pension expenditure, % of GDP	6.6	7.6	9.3	10.1	11.4	12.5
Factors determining the evolution of public pension expenditure 2007-2060						
Demographic dependency	4.2			8.7		
Employment	-0.3			-0.7		
Eligibility	-1.4			-2.6		
Level of benefits	0.5			-2.5		
Total (including residual)	2.7			2.4		

* - data for 2007; ** - data for 2006; *** - data for 2001, 2007, and 2008 - not available for all years