ESPN Thematic Report:

Assessment of Pension Adequacy in Norway

2017

Axel West Pedersen
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Directorate-General for Employment, Social Affairs and Inclusion
Directorate C — Social Affairs
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European Social Policy Network (ESPN)

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The European Social Policy Network (ESPN) was established in July 2014 on the initiative of the European Commission to provide high-quality and timely independent information, advice, analysis and expertise on social policy issues in the European Union and neighbouring countries.

The ESPN brings together into a single network the work that used to be carried out by the European Network of Independent Experts on Social Inclusion, the Network for the Analytical Support on the Socio-Economic Impact of Social Protection Reforms (ASISP) and the MISSOC (Mutual Information Systems on Social Protection) secretariat.

The ESPN is managed by the Luxembourg Institute of Socio-Economic Research (LISER) and APPLICA, together with the European Social Observatory (OSE).

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Summary / Highlights

- While a major pension reform in 2011 was meant to strengthen the link between pension benefits and lifetime earnings, a number of redistributive components have been maintained including a targeted Guarantee Pension fixed at a comparatively high level.
- The median incomes of the elderly have risen in the last decade to approach the overall population median, but female pensioners living in single households continue to suffer from a high incidence of relative income poverty.
- Consideration should be given to adjusting pension ages rather than benefit levels to cope with changes in population longevity, in order to maintain the relative level of the Guarantee Pension and shield former disability pensioners from the effects of the adjustment.
- In order to combat poverty among female pensioners and further reduce the gender gap in economic well-being in retirement, consideration should be given to introducing a flat-rate benefit supplement for all pensioners living in single-member households

1 General description of the national pension system

The National Insurance (NI) old-age pension system is the main provider of income security in old age. Due to a major reform that started to take effect in 2011 two versions of the system are currently in operation. The old NI system that is being phased out is a traditional defined-benefit (DB) scheme introduced in 1967 and consisting of three benefit components: a flat-rate universal benefit; an earnings-related second tier requiring 40 years of contributions to receive full benefits; and a special supplement that is offset krone-for-krone against the pensioner's earnings-related benefits, creating an effective minimum benefit floor for individuals with little or nothing in the way of earnings-related benefits. The overall benefit profile of the old system is strongly progressive due to the comparatively generous level of minimum protection and a decreasing replacement rate for earnings above the average annual wage. A full-time worker with a 40-year contribution record can expect to enjoy a gross replacement rate of 54% and a net replacement rate of about 67%, while the value of the minimum pension (which is not taxed) is about 50% of the net average salary. Before 2011 the statutory retirement age was 67, with benefits being subject to a relatively mild earnings test for three years before they became universally available from the age of 70.

The new, reformed NI system that is gradually taking over from the old system consists of two parts. The backbone of the new system is a Notional Defined Contribution (NDC) scheme providing income smoothing over the life-cycle from the economically active life-phase to the retirement phase, while an individually targeted Guarantee Pension takes care of minimum protection. For each year in gainful employment an amount equivalent to 18.1% of yearly earnings is credited to an individual NDC account, and deposits in the accounts will be converted to a life annuity upon retirement (sometime between age 62 and 75). Yearly earnings (and self-employment income) count up to a ceiling set at NOK 665,000 (approx. €70,424), and pension accrual can start from the age of 13 and continue to the age of 75. Accrued pension rights in the notional accounts are automatically indexed to average wages. The level of the Guarantee Pension is fixed at the same (comparatively high) level as the minimum benefit in the old system, and benefits are tested against NDC pension rights with a taper of 80%.

Pension rights are also secured for individuals who do not participate in gainful employment for particular (politically sanctioned) reasons. Parents (read: mothers) with small children (under the age of 6) are guaranteed a minimum pension accrual equivalent to that for a modest full-time wage. Young people doing obligatory military service will receive pension rights equivalent to about half those for an average full-time wage. Social security benefits (but not social assistance benefits) are as a rule counted as earnings, while recipients of unemployment benefits and disability pensions have their annual pension accrual calculated on the basis of their annual earnings prior to becoming unemployed or disabled.

Individuals born after 1963 have their pension rights fully decided by the rules of the new system, while individuals born before 1954 are fully covered by the old system. Individuals born between 1954 and 1963 will have their pension rights decided by a weighted average (according to the year of birth) of the benefits accrued under new and old rules.

From 1 January 2011 three important changes were made to the old-age pension that are applied to the old and new systems alike:

- Benefits can be drawn fully or partially between age 62 and 75 on actuarially neutral terms. The introduction of actuarial neutrality is combined with a complete removal of all earnings and work tests. It is now possible to draw a full old-age pension from age 62 while continuing to work full time, and an almost continuous range of options to draw a partial pension are available.
- Pension rights (including the Guarantee Pension) are subject to a life-expectancy adjustment implying that old-age benefits for each new cohort of pensioners will be reduced in proportion to the observed increase in longevity compared with the situation in 2010 (the estimated longevity of the cohort born in 1943 serves as a baseline).
- NDC benefits in payment are indexed to wages minus 0.75 percentage points. Just before the reform was implemented, the Stoltenberg government decided to partly shield former disability pensioners from the effect of the longevity adjustment and the ground that they do not have the option to compensate for the decline in annual benefits by working longer.

The new NI system is (as before) fully integrated in the general state budget, and financed through a mixture of general social security contributions, payroll taxes and general taxation, where the pension contribution of each wage earner is not specified.

Both in the public and the private sector, occupational pension schemes exist that supplement benefits from the NI scheme. All public sector employees are covered by rather generous DB schemes that are integrated with the NI scheme to achieve a more or less proportional compound benefit profile with compensation levels at 66% of the previous wage (before tax). In the private sector coverage by occupational pensions became obligatory from 2006. The law requires private employers to establish occupational pension schemes (of either the DB or the defined-contribution (DC) type) with a minimum contribution rate of 2% of annual earnings.

In the private sector a former negotiated early-retirement scheme (the AFP scheme) covering about 50% of the workforce has been transformed into a supplementary old-age pension scheme where benefits can be drawn on actuarially neutral terms from the age of 62. For those wage earners covered – mostly in the unionised sectors – the scheme adds a significant component to their total pension wealth. The transformation of the private sector AFP scheme means that all subsidised early exit options have been effectively closed in the private sector, and no special schemes are in place to cater for employees in particularly hazardous or arduous occupations, except for two small early-retirement schemes covering respectively seamen and fishermen (see Pedersen 2016b for a closer description of these schemes).

In the public sector, however, the old AFP scheme has been maintained, offering a strongly subsidised early-retirement option from age 62 without actuarial penalties. In addition, a number of occupations in the public sector are subject to special regulations that give them the right and the duty to retire early, such as policemen, fire workers and military personnel.

Individual retirement saving in Norway mainly takes place through the ordinary capital market or (even more importantly) through the accumulation of housing wealth. A tax-favoured option for individual retirement saving with insurance companies or portfolio managers does exist, but both the degree of tax subsidy and the take-up of this option are fairly modest According to OECD Global Pension Statistics the coverage of voluntary individual retirement insurance/savings schemes was 27% in 2015 (OECD 2017), and presumably this figure refers to all individuals who had contributed to this kind of scheme at some time during their life.

2 Reform trends

Policy developments over the last three years have mainly been concerned with adjustments and adaptations to the major reform that took effect in 2011.

Improved minimum benefits for married pensioners

The Norwegian pension system has traditionally operated with an inbuilt equivalence scale offering higher basic benefits to single vis-à-vis married pensioners. From the 1950s onwards, the ratio between the basic pension of single versus married pensioners was 1:0.75. In recent decades the legitimacy of this differentiation of benefits according to marital (household) status has increasingly been called into question, particularly by the Progress Party, which is now in government together with the Conservative Party (Høyre). In the 2000s the basic pension of married pensioners was raised to 85% of the benefit offered to single pensioners, and the present government took the initiative to raise it further to 90% from 2016. The government has declared that full equalisation is the ultimate goal, but it remains to be seen if this will be prioritised in the annual budgets over the coming years.

The change will also have repercussions for younger cohorts covered by the new system of pension accrual. The Guarantee Pension in the reformed system uses the same differentiation according to marital (cohabitation) status, and therefore the minimum protection promised in the long run to married pensioners is correspondingly higher. In order to get the improvement from 85 to 90% accepted by Parliament in the budget for 2016, the government had to also grant a (temporary) improvement in the minimum benefit of single pensioners.

In sum we can say that the generosity of minimum protection offered to married and cohabitating pensioners has been permanently improved, while it has also been temporarily improved for single pensioners.

Employment protection age limit extended from age 70 to age 72

In Norway, employees enjoy comparatively high protection against discriminatory and arbitrary dismissal, but under previous legislation (Employment Protection Act § 15-13) this protection was removed at age 70. Hence, employers could routinely and without further justification terminate an employment contract when an employee turned 70. In addition, companies were allowed to apply age limits as low as 67, if these were supported by a sufficiently generous occupational pension scheme, if the rule was applied consistently for all employees, and if the existence of the rule had been made known to the staff. These regulations were seen to conflict with the aims of the pension reform to encourage people to postpone retirement beyond the previous normal retirement age of 67, and therefore in 2015 a broad coalition in Parliament decided to amend the Employment Protection Act so that the general age limit was raised to 72. In addition, the new legislation strongly limits the possibility for employers to operate with lower, company-specific age limits. Lower company-specific age limits are now only allowed if they are motivated by special concerns for health and safety, and they cannot be fixed lower than age 70 (see Pedersen 2015).

Introduction of a new middle-of-the-road option for tax-favoured occupational pension schemes

Since 2001, two distinct types of tax-favoured occupational pension schemes have been available for private sector employers: traditional, pre-funded DB schemes in which all financial risks rest with the employer; and DC schemes where these risks have been transferred to individual employees. The traditional DB schemes are losing ground due to the high costs and risks they entail for the employer, and DC schemes have been gradually taking over since they were first allowed in 2001, particularly since occupational pension provision was made obligatory for private sector employers in 2006. The Norwegian DC regulations are, however, comparatively extreme in terms of allowing schemes in which demographic and financial risks are completely individualised. Most of the schemes that have been established since 2006 are pure savings schemes with individual investment choice and no sharing of longevity risks. Therefore both unions and policy-makers have started to look for middle-of-the road alternatives ‘between’ DC and DB schemes – so-called hybrid schemes. In 2014 legislation was passed to allow also the establishment of tax-favoured hybrid schemes offering lifelong benefits, and including a possibility for employers to guarantee the indexation of pension rights to wage increases.

Introduction of a new scheme for tax-favoured individual retirement savings

Norway has over time had a range of different schemes for tax-favoured individual retirement savings. In 2017 the government proposed the establishment of a new scheme with stronger incentives/subsidies for retirement savings than previous schemes, and the new regulations took effect from 1 November 2017. The scheme offers a tax rebate on contributions of 23% of the saved amount, while benefits will be taxed at the same rate when they are eventually paid out. Returns are not taxed in the accrual period. A maximum amount of NOK 40,000 (approx. €4,240) can be saved each year and the accrued pension wealth can be taken out as annual benefits starting at age 62 at the earliest and continuing at least until age 80. Both pure savings schemes and insurance schemes are allowed under the regulation.

In addition to these already adopted measures a number of proposals and initiatives are likely to be adopted in the near future:

Abolition of survivors’ benefits in the NI system[1]

A government-appointed commission published its report in February 2017 with a proposal to abolish survivors’ benefits under the Norwegian NI system. For surviving spouses below the age of 67, income protection will be limited to a transitional allowance. In addition the commission proposes to remove the existing possibility for surviving old-age pensioners to take over part of the old-age pension rights of a deceased spouse. During the preparation of the pension reform it has been taken for granted that there would also be, under the reformed system, some possibility for spouses to “inherit” pension rights from each other. The issue was postponed before it was finally decided to let an expert commission consider the need for such a possibility and the detailed nature of the regulations in the reformed pension system. In its report the commission rejected the need for this kind of provision. It showed that the existing provisions under the old pension system tended to have rather strange and perverse distributive consequences – such as favouring couples with an unequal record of labour force participation and lifetime earnings. It further argued that the need to provide women with incentives to work should take precedence over distributive concerns, and that the granting of deferred pension rights will tend to have negative effects on the former. In conclusion the commission advocated a completely individualised pension system that takes no account of the family/household situation of the pensioner. The government has not yet signaled its position on this issue and whether a proposal in line with the commission’s recommendation will be presented to Parliament. Judging by the lack of critique and public debate on the issue, it seems quite likely that the proposal will be adopted in the not-too-distant future. If it is, and if the differentiation in the level of minimum

[1] see Pedersen 2017a.

protection is also abolished in accordance with the government's declared intention, the Norwegian pension system will become entirely individualised, and all insurance against being or becoming a single pensioner will have been removed.

Adaptation of public sector occupational pension schemes to the reform

In 2009 the Stoltenberg government failed to persuade the public sector unions to accept an adaptation of their occupational pension schemes and the public sector AFP scheme to the main principles of the general NI reform. Instead public sector unions managed to maintain the existing AFP scheme as a subsidised early-retirement option and to hang on to the traditional final-salary DB schemes. However, the unions were in 2009 forced to accept that the principle of a longevity adjustment should also be applied to the public sector occupational pension schemes, and it has become increasingly clear to all parties involved that this will seriously undermine the pension rights of younger cohorts of public sector employees. The problem is that the possibility of mitigating the effects of this by working longer is not open to the same extent to public sector employees because of the heavy implicit taxation on continued employment after age 62. In 2015 an informal agreement was reached with the public sector unions on a rough sketch for a solution in line with the original proposal by the Stoltenberg government, but since then the process has come to a halt due to disagreements over procedural issues. However, it now seems likely that the consultations will be resumed and that a solution can be expected in the spring of 2018.

Improved portability of occupational pension rights

The trade unions in the private sector have for some time been demanding changes in the regulations for occupational pension schemes allowing workers to collect pension rights obtained from different employment spells in an individual account, and to make it obligatory for employers to vest pension rights from the first day of employment (instead of after one year of employment under the existing regulations). In November 2017 the government delivered on this issue by publishing a proposal that is to be considered by Parliament in the spring of 2018. There is good reason to believe that the proposals will be adopted with support from a broad majority in Parliament.

3 Assessment of adequacy

3.1 Current adequacy

3.1.1 General assessment of current adequacy

Over recent decades the median incomes of old-age pensioners have increased faster than the median incomes of the general population. While the median real income of the entire population increased by 63% between 1996 and 2015, the median real income of old-age pensioners (individuals living in households with at least one recipient of NI old-age pensions) increased by 121% in the same period.[2] The continued maturation of the (old) NI system, and the higher historical labour force participation rates of the new cohorts of females entering retirement are the main drivers of this development.

A study of income dynamics in later life, conducted some years ago, showed that retiring is associated with a rather modest drop in incomes on average (Epland and Kleven 2005) and there is reason to believe that this conclusion still holds. Today roughly 70% of the gross incomes of the elderly comes from the NI scheme, while another 17% comes from occupational pensions. The rest is earnings and capital income (Claus et al. 2013).

In 2014 the median equivalised household income of pensioner couples (those where the older partner is aged 67 or above) was 103% of the median for the entire population, while the median income of single elderly people (aged 67 or older) was 74% of the

[2] Source: Own calculations from data obtained from Statistics Norway "Databank".

population median (Pensjonspolitisk arbeidsgruppe 2016). This corresponds to Eurostat figures showing that the median income ratio among the elderly (65+) in 2015 was 0.91 overall, and 0.96 and 0.86 for males and females respectively.

The incidence of low income among the elderly, as measured by the at-risk-of-poverty (AROP) indicator has declined sharply in recent decades. The AROP rate among the population aged 65+ has come down from around 20% in the late 1990s to 9% in 2015, which coincides with the level found among the general population in Norway. In addition to the factors already mentioned as being responsible for the general increase in the median income of the elderly, the decline in poverty rates among the elderly has been further accelerated by successive improvements in the relative generosity of minimum protection offered by the NI system.

The gender gap in individual pension income has been declining as well, but it is still sizeable. In 2014 the gender gap in individual benefits received from the NI schemes was 27% and in total gross income it was 33%. The gender gap in benefits received from occupational pension schemes was slightly lower at 26%, due to the fact that women have worked predominantly in the public sector where the coverage by generous occupational pension schemes has been almost universal for decades. The resulting difference in AROP rates between the male and female elderly is quite dramatic, with a rate of 3.3% among males and 14.0% among females.

The duration aspect of adequacy is difficult to assess in the Norwegian case, particularly since the 2011 reform allowed NI benefits to be taken out on actuarially neutral terms from age 62. The remaining life expectancy at 62 is currently 20.5 years for men and 23.6 years for women (Borgan and Texmon 2015).

However, the right to take out pensions early is limited to individuals with sufficiently large accumulated pension rights. The actuarially adjusted benefit must exceed the minimum benefit guaranteed from age 67 in order for individuals to be allowed early take-up. This means that currently only a minority of female 62-year-olds are allowed to start drawing old-age benefits from this age (Pensjonspolitisk arbeidsgruppe 2016). Another complication follows from the fact that the take-up of benefits can otherwise be freely combined with continued working. It has turned out that a surprisingly large fraction of the eligible population (particularly among men) have chosen to start drawing their pension rights at the earliest possible date, while continuing working full time. In fact, while the reform has clearly produced a sizeable increase in the age of withdrawal from the labour market, it has at the same time produced a lowering of the age at which old-age pensions are first taken (Pensjonspolitisk arbeidsgruppe 2016), and as a result the duration of the retirement phase has become increasingly blurred.

3.1.2 Redistributive elements of public pension schemes

The old NI scheme contains a number of redistributive mechanisms and most of them have been included in (or added to) the new NDC scheme that is currently being phased in.

The most important is the minimum benefit, which in the old system consists of a universal basic pension and a targeted benefit supplement, and which in the new system will be replaced with a targeted Guarantee Pension. The annual minimum NI benefit in 2017 amounted to NOK 188,766 (approx. €20,000) for single pensioners and NOK 181,744 (approx. €19,000) for married and cohabitating pensioners.

In order to receive a full minimum pension, the recipient must have at least 40 years of residence in the country before reaching 67. Migrants with a shorter residency period will have their minimum benefits proportionally reduced. Since the mid-2000s, however, a special strictly means-tested scheme for pensioners with a shorter residency period has been in place that secures the same minimum benefit level as in the general scheme.

Both the old and the new system offer child credits to parents (read: mothers) who withdraw wholly or partially from the labour market to care for small children. The credits take the form of a guaranteed minimum pension accrual for parents with children under the age of 6, corresponding to the accrual rate for a full-time worker in a low-wage job.

In the old system a provision allowed survivors with low earnings-related pension rights of their own to take over part of the pension rights of a deceased spouse (or partner). This has helped to close the gender gap in pensions and to insure against the risk of a serious drop in economic well-being when losing a spouse, which is particularly important for women. As discussed above, it is proposed to abolish this provision in the new system.

Pensioner taxation in Norway has traditionally been relatively mild and highly progressive. Old-age pensioners who only receive the minimum benefit do not pay any income tax, with the tax rebate gradually tapered off against increases in an individual's total income. These features have been adapted to the reformed system and are likely to be maintained in the future.

3.2 Retirement conditions for the self-employed and for people in non-standard employment

In the NI old-age pension system, all types of earnings, including self-employment income and earnings from a freelance contract, are treated equally. The type of work contract, whether it is temporary or permanent, full-time or part-time, does not make any difference. Also the guarantee benefit providing minimum protection in old age is available to the self-employed and wage earners alike (see Pedersen 2017b).

However, the self-employed can be said to be disadvantaged in terms of access to supplementary occupational pension schemes. While occupational pension schemes are encouraged and subsidised by favourable tax rules and have become obligatory from 2006 for the entire private sector labour market, the self-employed are excluded. As mentioned above, a new scheme for tax-favoured individual retirement saving was introduced in November 2017. Self-employed people are a natural target group for this scheme: but access to the scheme is not restricted exclusively to the self-employed and individuals who are not covered by generous occupational schemes; and the degree of subsidy is lower than that of employer contributions to occupational pension schemes. Also workers on temporary contracts tend to be disadvantaged in occupational pension schemes. In public sector occupational pension schemes pension rights are only vested after three years of public sector employment. In the private sector vesting requires only one year of employment with the same employer. As mentioned above, the government has suggested tightening regulations for private sector schemes and requiring immediate vesting from the first day of employment.

The self-employed are also disadvantaged by being excluded from the so-called AFP scheme that has been established by collective agreements and receives significant subsidies from the state budget. From 2011 this scheme has in the private sector taken the form of a kind of occupational pension scheme offering supplementary lifelong benefits on top of benefits from NI and from traditional occupational pension schemes. The scheme, however, only covers about half of private sector employees and pension rights are not vested at all.

3.3 Future adequacy and challenges

The main retrenchment measure of the 2011 reform was the introduction of a longevity adjustment and the indexation of pension benefits to average wages minus 0.75 percentage points. The longevity adjustment will, in particular, seriously reduce the future generosity of NI benefits, unless younger cohorts respond by working longer – beyond age 67 and eventually beyond age 70.

The introduction of mandated occupational pension schemes with minimum contribution requirements will also to some extend help compensate for declining benefit levels from the NI scheme in the coming decades. Particularly for workers who are covered by one of the more generous occupational pension schemes and in addition are covered by the AFP scheme, total benefit levels are likely to be fully adequate.

It should be noted that the longevity adjustment will also affect the level of the Guarantee Pension, which is supposed to be indexed to wages less the effect of the longevity adjustment. This means that although the minimum protection offered to old-age pensioners is presently comparatively generous and close to the AROP threshold, the gap can be expected to widen significantly over the coming decades, and hence relative poverty among the elderly could once again be expected to increase.

A source of worry is the tendency observed since 2011 for senior workers (particularly males) to start taking out full benefits from age 62 (even if they continue working full time) and thereby expose themselves to a very significant reduction in the annual benefits they will receive over the retirement phase. For those who have taken advantage of increased flexibility in this way, and have failed to set aside some or most of the pension benefits received while still working, there is a real danger that they end up with very low incomes in the later stages of their retirement.

A particularly vulnerable group will be those wage earners who have left the labour market via the disability system. The former Stoltenberg government decided to partly shield this group from the full effects of the life-expectancy adjustment, but with increasing longevity over the coming decades the income protection for this group will gradually deteriorate. The process will be faster and more consequential if the Solberg government decides to follow up on its stated intention (in the government platform issued in 2013) to abolish the partial shielding of disability pensioners.

The gender gap in pensions is expected to decline in the future due to increased female labour supply and to the continued existence in the reformed system of “women-friendly” redistributive mechanisms such as child credits and the Guarantee Pension. For the 1963 cohort it is estimated that the gender gap in average annual pension benefits received over retirement will be 7% if the present provision for inheriting pension rights is preserved, and 10% if it is removed (Halvorsen and Pedersen 2018). It is, however, a source of worry, particularly from a gender equality perspective, that both the NI system in general and the minimum protection offered are about to become completely individualised without protection against the lack or loss, respectively, of economies of scale for single and surviving pensioners. The remaining income poverty among old-age pensioners in Norway is almost exclusively concentrated among pensioners living in single households (widows and never-married males and females), and yet policy developments in recent years have continued to favour pensioner couples.

4 Main opportunities for addressing pension-related challenges

Public sector occupational pension schemes should be reformed in line with the general principles of the pension reform (lifelong accrual of benefits and a flexible retirement age with incentives to prolong working life).

The private sector AFP scheme needs to be basically revised. The scheme only covers about half of the private sector labour force while it receives large subsidies from the state budget. In addition the lack of vesting rights means that the scheme plays no serious social function in providing income security in old age. The fact that participation in this scheme is restricted to workers in companies with a collective wage agreement, and that eligibility is further restricted to those workers who remain in employment with an affiliated company at age 62, clearly raises issues about fairness and labour market distortions. Similar issues can also be raised against the AFP scheme in the public sector, which has continued as an early-retirement scheme but with a similar lack of vesting rights.

The main mechanism for longevity adjustment is currently that benefits are reduced in line with increases in longevity while the relevant age limits in the system (such as the age of early take-up at 62 and the “normal retirement age” when disability pensioners are transferred to old-age benefits) are kept constant. Concerns for future adequacy suggest that one should in addition let the relevant age limits be raised in line with longevity developments. Such a move would prevent a gradual increase in the gap between minimum benefits and the poverty threshold and it would give full shielding of disability pensioners against the longevity adjustment (Pedersen 2013).

In order to prevent poverty problems among pensioners living in single households, consideration should be given to reintroducing measures to compensate this (predominantly female) category of pensioners for the lack/loss of economies of scale – for instance in the form of a flat-rate pension supplement payable to all pensioners living in single households.

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