Iceland: 2018 reversal of previous reforms in the state old-age pension system

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Parliament passed new legislation on state old-age pensions in October 2016 (effective from January 2017), simplifying the benefit structure and toughening the income-testing rules. This reduced the work incentive of old-age pension beneficiaries and swiftly became very unpopular. Unexpected early elections in October 2017 facilitated a reversal of the previous reforms on income-testing, effective from January 2018.

Description

To recapitulate the context, the Icelandic pension system has three pillars: the first comprises public old-age and disability schemes; the second covers mandatory occupational pensions from the Occupational Pension Funds, run by the labour market partners; and the third consists of voluntary funded Individual Pension Accounts. Iceland's governments have been trying since 2005 to simplify the state pension system, with a view to improving the interaction between state pensions and occupational pensions, i.e. the first and second pillars. This interaction has been characterised by controversial income-testing rules in the public pension system (first pillar). Three task forces have delivered proposals for such changes, in 2009, 2013 and the latest in February 2016 (Velferðarráðuneytið 2016). These proposals have been based on somewhat different policy premises. The last is the only one to make it through parliament. It was passed on 13 October 2016.

The changes adopted apply only to public old-age pensions (disability pension reforms were supposed to follow later).

The main aims of the new legislation were the following:

1. To simplify the public old-age pension system by unifying three pension components into one old-age pension (basic pension + income supplement + minimum pension guarantee). On top of that a home supplement (*heimilisuppbót*), a benefit for keeping one's own home, will still be paid to single pensioners (as in the previous system).
2. To abolish the three income bracket exemptions (*frítekjumörk*), i.e. the exemptions from income-testing for income from employment, income from Occupational Pension Funds and financial earnings (that is what pensioners could earn without reducing the public pension). Instead, one free income bracket was introduced, i.e. the amount of non-pension income that does not affect the income-testing, involving a much lower allowance than before. This was expected to achieve further simplification of the system, in addition to the simpler benefit structure.
3. To increase the state statutory pensionable age gradually from the present age of 67 to 70, over a period of 24 years. This was delayed until equal pension rights in the public and private sectors of the labour market are achieved (due by the end of 2018).
4. To increase flexibility for the effective retirement age. People will be able to take up a state pension at age 65 (with reduced entitlement), instead of at 67, as now.

The change to the income-testing mechanism became the main issue of concern (point 2 above). The new universal exemption from income-testing applied to around 25,000 I. Kr. per month (€202). This replaced the three income bracket exemptions: an allowance for employment earnings, previously about 109,000 I. Kr. (€880); an allowance for occupational pension income, about 27,400 I.Kr. (€221); and a small allowance for financial earnings. The biggest change was the reduction of the allowance for employment earnings (from 109,000 to the universal 25,000 I.Kr., i.e. from €880 to €202).

In addition to abolishing the three bracket allowances, income-testing **rate** of public pensions with reference to other income was increased across the board, i.e. the potential reduction due to other income was increased from 11%-38.3% for different benefit types, up to a universal reduction rate of 45%. This ran counter to a long-standing demand from pensioners to reduce the degree of income-testing in the public system (Ólafsson 2012).

The reform of the income-testing mechanism was immediately very unpopular and was eventually reversed – but only partly. In the run-up to the election in October 2017, candidates of all parties promised to re-instate the free bracket for employment earnings, and many retained the sum of 100,000 I.Kr. (€806) – about 10% below the previous value (I.Kr. 109,000 [€880]). The new government (which took office on 30 November 2017) implemented this, to take effect from 1 January 2018. Hence this aspect of the changes was reversed exactly one year after implementation.

Outlook & commentary

Most of the overall changes were well received, except for the changes to the income-testing mechanism. These involved reduced support from the public pension system for those who have significant earnings from the Occupational Pension Funds and those who have employment earnings while receiving a pension. This measure reduced the work incentive of old-age pension beneficiaries; hence it went directly against the stated aim of increasing work incentives and encouraging higher retirement ages. When this dawned on politicians and representatives of pensioner organisations, there was a wave of criticism against these changes and a call to re-implement the free bracket for employment earnings (previously 109.000 I. Kr. per month [€880]).

The policy aims underpinning these controversial changes to the income-testing mechanism emphasised simplification of the system. But this was done at the cost of work incentives, and the change reduced the earnings capacity for those working while receiving a pension, as well as for those who had accumulated rights in the Occupational Pension Funds. This was, however, partly offset by an increase in the basic public pension rate for the majority (around 86%) of pensioners. Those having significant employment earnings while receiving a pension were however generally worse off.

While the reversal was swiftly achieved, the net effect is now a lower allowance for employment earnings (and hence less of a work incentive), but also a generally higher rate of reduction of the public pension due to other incomes. This is still a cause for concern, and it will most likely take some years to return fully to the standard that prevailed before January 2017.

A comparable reform for disability pensioners is in the pipeline. This may lead to further changes in the employment earnings allowance for those also receiving a pension, since work incentives are significantly more important for that group than for the elderly.

Further reading

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