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Supporting Member States' efforts to securing the long-term adequacy of pensions: The Open Method of Coordination

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Policy Brief:

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The Open Method of Coordination on Pensions

Social protection policies remain a responsibility of the Member States and there is a consensus that this should not change. However, over recent years, Member States have accepted to look closely at each other's pension policies to find out how well prepared they are to cope with the demographic challenge of the coming decades. It has now become widely accepted that the success or failure of pension reforms in one Member State is likely to have repercussions on other Member States. There is concern about inflation risks that might be caused by increased government deficits in other Eurozone countries with unsustainable public pension systems. But even more dangerous would be political and economic instability that could arise if pension systems are steered into a financial crisis. This could slow down economic growth not just in the Member State where such instability occurs, but also elsewhere through the close trading links that result from economic integration. But this increased interdependence of national pension systems and policies does not only have a macroeconomic dimension. As people move more freely across borders within the European Union, more pensioners living in one country will depend on the income they receive from pension schemes in other Member States. If pension payments from other Member States become insufficient, then means-tested benefits paid by the country of residence will have to fill the gap.

These are significant interdependencies that justify scrutinising each other's policies aimed at maintaining adequate and sustainable pensions. But this does not imply that there will be attempts to harmonise national pension systems. The spill-over effects remain small compared to the national impact of a pensions crisis. So each Member State will remain responsible for its pension system and the diversity of national pension systems is here to stay, with its different mixes of financing through pay-as-you-go or funding mechanisms, with different roles for first (statutory), second (occupational) and third (individual) pillar provision and with more or less emphasis on collective agreements concluded by the two sides of industry, to name just a few of the areas in which national pension systems can differ.

While there are no serious calls for a transfer of powers from the Member States to the EU level, it is accepted that the interdependencies outlined above do call for some form of coordination of national policies. This was first accepted in the economic policy sphere where an attempt has been made to gauge the impact of demographic ageing on future public finances (see the presentation by Aino Salomäki). However, it soon became clear that it is not sufficient to look only at financial sustainability. If adequacy of pensions is not taken into account as well there is a risk that, at some point in the future, strong political pressures to increase public spending on pensions will arise. This may well turn a pension system that was previously regarded as financially sustainable into an unsustainable one.

Thus a new approach to policy coordination was developed at the Lisbon European Council in March 2000: the Open Method of Coordination. In Lisbon, the European heads of government set the ambitious goal for the EU to become the most competitive and dynamic knowledge-based economy. This requires determined policy efforts in all Member States and a better coordination of national policies with a view to promoting economic and employment growth, but also greater social cohesion. The tools for policy coordination in the areas of economic and employment policy were already in place at the time of the Lisbon European Council. The open method of coordination was defined as a new, complementary policy tool at EU level that could be used in areas where no other policy coordination tools are currently foreseen in the Treaty.

The open method of coordination involves setting common objectives, asking Member States to present their policy strategies for achieving them, measuring progress with the help of common indicators and joint assessments of progress by the Commission and the Council. In the area of pensions, agreement on a comprehensive set of objectives was reached in December 2001 at the Laeken European Council. In September 2002 the Member States presented their national strategies. The Commission presented a synthesis report in December 2002 which was the basis for the joint report by the Commission and the Council that went to the Spring European Council in March 2003.¹

Common objectives

The common objectives cover three broad areas: adequacy, financial sustainability and modernisation. The main purpose of pension systems is to deliver adequate incomes to older people. This means more than just providing minimum incomes to keep the elderly out of poverty. Pension systems, through differing combinations of public and private provision, should also enable people to maintain, after retirement, the living standard achieved during their working life. And they should promote solidarity both within and between generations.

The ability to maintain pensions adequacy depends on the two other areas. Benefits will only remain adequate if they are also financially sustainable, and the modernisation of pension systems is necessary to ensure that pension systems cater for changing needs related to more flexible labour markets and family structures.

Financial sustainability requires looking beyond the design and parameters of pension systems alone. Raising the level of employment ensures a better balance between the active and the

Common objectives for pension systems

ADEQUACY

- Ensure a decent living standard so as to prevent poverty and social exclusion in old age
- Provide access to appropriate pension arrangements necessary to maintain one's living standard
- Promote solidarity between and within generations

FINANCIAL SUSTAINABILITY

- Achieve a high level of employment
- Offer effective incentives for labour market participation of older workers
- Ensure sustainability of public finances
- Strike a fair balance between the active and the retired
- Ensure the financial sustainability of funded pension schemes

MODERNISATION

- Ensure compatibility with labour market flexibility and mobility
- Promote gender equality
- Increase transparency of pension systems and their capacity to adapt to changing circumstances

¹ All documents relating to the open method of coordination applied to pensions, including the national strategy reports, can be found on:

http://europa.eu.int/comm/employment_social/soc-prot/pensions/index_en.htm

retired. Encouraging people to stay longer on the labour market has the same effect, but also reduces the number of people who depend on pension benefits. Another objective recalls that pension systems must not destabilise public finances, but also that sound public finances today will result in lower public debt and hence reduced interest payments tomorrow, leaving more public resources for paying for pensions and health care. It is also necessary to ensure that the financial consequences of ageing are shared equitably between the active and the retired. Finally the financial sustainability of private funded pension schemes must be secured through better regulatory frameworks and sound management, after all funded pension schemes will also be affected by demographic change.

The third area of common objectives is the modernisation of pension systems. Pension systems need to be adapted to more flexible labour markets and increased labour mobility. They also have to take account of gender equality. On the one hand, women are more likely than before to earn significant pension rights of their own; on the other hand, they continue to sacrifice their professional careers to a larger extent than men; and they are more likely than men to live on their own in old age than men. So pension systems have to be designed in such a way that they meet the needs of older women as well as men. Finally there is a need for greater transparency and adaptability of pension systems. Reliable information on the long-term perspectives of pension systems is a precondition for a well-informed public debate and for the development of a broad consensus on reforms. Moreover, individuals should have confidence in their pension systems and a clear idea about what they can expect in terms of pensions so that they can make any additional provision for retirement that they may consider necessary.

These common objectives sketch out a strategy for reconciling adequacy and financial sustainability in the context of dramatic population ageing. However, they do not represent a blueprint for pension reform: the objectives can be achieved in different ways. What matters are outcomes, particularly in terms of sustainable pension adequacy.

The first joint report on adequate and sustainable pensions presented by the Commission and the Council in March 2003 was welcomed by the European Council which asked for momentum to be maintained, notably by carrying out studies of certain key issues. One topic that has been examined are incentives in pension and other social protection systems for extending working lives, in line with the ambitious Barcelona objective (March 2002) of raising the average age at which people withdraw from the labour market by 5 years by 2010. Other topics will be the role of private pensions and the gender impact of pension systems.

Measuring adequacy

An essential ingredient of the open method of coordination are commonly agreed indicators to measure to what extent the common objectives are achieved. The first joint report on adequate and sustainable pensions used indicators derived from the European Community Household Panel (ECHP) to measure current adequacy with the following indicators:

- Objective 1 (decent living standard for all older people) – ratio of people aged 65+ living in households with less than 60% of equivalised median income.
- Objective 2 (maintain pre-retirement living standard) – median income of people aged 65+ as a percentage of median income of people aged 0-64.
- Objective 3 (solidarity between and within generations) – same as for objective 2 and a measure of income inequality (S80/S20 income quintile share ratio)

The corresponding figures from the joint report can be found in the table below. However, these indicators are not regarded as fully satisfactory and Member States insisted on an explanation of the main methodological issues in the joint report (see box below). Moreover, the ECHP measures household income and thus lumps together pensions with other incomes (e.g. income from work of younger household members). Some Member States therefore feel that further indicators measuring the specific contribution of pension systems to the incomes of older people are required.

The analysis of national strategy reports showed that Member States are trying to maintain or even improve basic income protection (typically means-tested minimum pensions), while pension reforms also tend to reduce the level of replacement rates for a given career length and profile. Moreover, the expenditure projections carried out under the auspices of the Economic Policy Committee's Working Group on Ageing showed that benefit reductions play a major part in decoupling public pensions expenditure growth from the increase in the old-age dependency ratio.

This raises the question of future adequacy of pensions. There are several factors that will determine future adequacy, and the 'generosity' of public pension schemes is only one of them. Increased female labour force participation will lead to higher pensions for women, but this may be offset by lower survivors' benefits. Longer careers (later retirement) could allow people to earn adequate pension rights even in less 'generous' pension schemes. Supplementary private pensions may make a larger contribution to old-age income. And finally, accumulated wealth – particularly home ownership – is a major determinant of living standards in old age. Unfortunately, it is not possible to assess the long-term impact of these factors on total incomes of older people and the distribution of incomes.

The Indicators Sub-Group of the Social Protection Committee tried to respond to the need for prospective adequacy indicators by developing a methodological framework for calculating theoretical replacement rates. First results of this work have been presented to the Council in March this year (paper distributed separately to workshop participants). This set of results includes current replacement levels for workers with different earnings levels and profiles and prospective rates up to the year 2050, taking into account reforms that have already been decided. The various components of income (first, second pillar, means-tested benefits, impact of taxation) are clearly separated. It should be noted, however, that the results are not suitable for direct cross-country comparisons. Replacement rates may be high in a given country because the underlying assumptions are not representative (e.g. actual career lengths are shorter than those assumed for the calculations) or because there remains a need for significant further pension reforms that are likely to reduce replacement rates in the future. It is therefore recommended to examine the results country by country, taking into account in particular information on financial sustainability.

Relative poverty risks and relative income situation of older people in 1998 (ECHP sixth wave data collected in 1999)

	(a) At-risk-of-poverty rate, people aged 65 years and over							(b) At-risk-of-poverty rate at 60 % of median income: People aged 0–64, 65 years and over and 75 years and over			(c) At-risk-of-poverty rate at 60 % of median income: Difference between people aged 65 years and over and people aged 0–64			(d) Income of people aged 65 and over as a percentage of income of people aged 0–64			(e) Inequality of income distribution ⁽¹⁾	
	50 % of median			60 % of median				0–64	65+	75+	Men	Women	Total	Men	Women	Total	0–64	65+
	Men	Women	Total	0–64 years	Men	Women	Total											
B	11	12	12	6	20	22	22	11	22	25	10	9	11	77	76	76	4.1	4.3
DK ⁽²⁾	10(3.7)	14(6.0)	12(5.0)	5(3.3)	26(23.4)	35(25.9)	31(24.8)	7(6.8)	31(24.8)	42(31.0)	19(16.8)	27(18.9)	24(18.0)	70(77)	66(73)	68(74)	2.9(2.7)	3.5(2.6)
D	5	6	6	6	9	13	11	11	11	12	-1	2	0	98	96	97	3.5	3.6
GR	24	25	25	12	34	33	33	18	33	39	17	15	15	74	74	74	5.8	7.0
E	7	7	7	14	16	16	16	19	16	17	-3	-4	-3	94	88	91	6.0	4.2
F ⁽³⁾	8	12	10	8	16	21	19	14	19	23	2	6	5	94	88	90	4.4	4.1
IRL	7	19	14	10	26	41	34	17	34	42	10	24	17	74	65	69	4.9	4.5
I	7	9	8	13	12	16	14	19	14	14	-7	-3	-5	98	94	96	5.1	4.2
L ⁽⁴⁾	3	4	4	6	6	10	8	14	8	14	-7	-4	-6	101	98	99	4.0	3.2
NL	4	5	4	6	7	7	7	11	7	8	-4	-5	-4	98	89	93	3.7	3.7
A	8	12	10	6	15	29	24	10	24	31	6	18	14	90	81	84	3.6	4.1
P	18	25	22	12	30	36	33	18	33	39	12	17	15	80	73	76	6.4	5.8
FIN ⁽⁵⁾	1	8	6	5	9	23	17	10	17	20	0	13	7	86	74	78	3.4	2.9
S ⁽⁶⁾	2	3	3	5	6	10	8	10	8	12	-4	1	-2	92	78	83	3.2	2.9
UK	7	13	11	12	17	25	21	19	21	26	-1	5	2	81	75	78	5.4	4.1
EU-15	7	10	9	10	15	19	17	15	17	19	0	3	2	92	86	89	4.6	4.1

Source: ECHP-UDB, Eurostat, version December 2002. Based on net disposable household income (excluding collective households). See box 'European income data: methodology and limitations'.

The income concept used is the equivalised disposable income. This is defined as the household's total disposable income divided by its 'equivalent size' to take account of its size and composition. The equivalence scale is the OECD modified scale, which counts the first adult (i.e. person aged 14 or over) as 1, each other adult as 0.5 and each child aged under 14 as 0.3. For instance, a household of one adult is equivalent to 1, a household of two adults is equivalent to 1.5, and a household of two adults and two children (under 14 years) is equivalent to 2.1. It must be noted that income generated from owner-occupied housing or housing at below-market rents — i.e. imputed rent — as well as income in kind are not included in the definition of income. Moreover, while income from capital is taken into account, interest payments are not deducted from disposable income. This tends to understate the income situation of older people at least in Member States with high rates of home ownership.

⁽¹⁾ Ratio of total income received by the 20 % with the highest income within a given population (top quintile) to that received by the 20 % of the same population with the lowest income (lowest quintile).

⁽²⁾ In the case of Denmark, calculations using national register-based data and the same income definitions as for ECHP data yield significantly lower poverty rates. National Danish data are derived from an official register-based sample of 176 626 individuals of which 26 322 persons are aged 65 years and above, whereas the ECHP data for Denmark are based on a sample of 3 983 individuals of which 642 are aged 65 years and over. Figures derived from the register-based sample and calculated according to the same methodology and income definitions used for ECHP data are included in brackets. According to national Danish calculations using an income definition including imputed rent and interest payments, the at-risk-of-poverty rates at 50 % of median income are: 1.1 (men), 0.9 (women) and 1.0 (total); at 60 % of median income: 4.3 (men), 3.0 (women) and 3.5 (total). For the age group 0–64, the at-risk-of-poverty rate would be 9.4, for the age group 65+, it would be 3.5 and for the age group 75+ it would be 3.1. Differences between at-risk-of-poverty rates for people aged 0–64 and 65+ are now negative when calculated using national register-based data: – 5.4 (men), – 6.3 (women) and – 5.9 (total). Relative incomes calculated on the basis of national data would be 91 % (men), 90 % (women) and 90 % (total), whereas income inequality would be 3.2 for the age group 0–64 years and 2.6 for people over 65.

⁽³⁾ Due to differences in the scope of surveys, sample attrition and sampling errors in the ECHP, national survey results using ECHP income definitions indicate different at-risk-of-poverty rates: 4.2 % for people aged 65+ at 50 % of median income (7.5 % for people aged 0–64) and, at 60 % of median income, 10.2 % for people aged 65+ (13.5 % for people aged 0–64).

⁽⁴⁾ Luxembourg's national strategy report indicated at-risk-of-poverty rates of 5 % at 50 % of median income and 10.3 % at 60 %; relative income was estimated at 94 %.

⁽⁵⁾ The Finnish national strategy report presents national calculations of at-risk-of-poverty rates for people over 65 of 3 % at 50 % of median income and 10.9 % at 60 %. The relative income is estimated at 90 %.

⁽⁶⁾ Data for Sweden only cover persons aged less than 85 and may therefore slightly underestimate at-risk-of-poverty rates of older people and overestimate relative incomes of older people.

National data indicate at-risk-of-poverty rates for people over 65 of 3.5 % at 50 % of median income and 10.5 % at 60 %. The relative income is estimated at 81 %.

EUROPEAN INCOME DATA: METHODOLOGY AND LIMITATIONS

The relative income situation of older people in the European Union and their risk of living in relative poverty are analysed in this report on the basis of data collected through the European Community Household Panel (ECHP). These data need to be interpreted carefully. They do not capture some important determinants of older people's living standards such as benefits in kind, home ownership (imputed rent) and wealth. This may particularly affect comparisons of poverty risks between younger and older people. The limited sample size and the fact that data are collected through interviews may also lead, in some cases, to significant discrepancies between ECHP data and national data. These are presented in footnotes where appropriate. It should also be noted that people living in institutions — most of whom are elderly — are not covered by the ECHP.

Sampling

The ECHP is a survey based on a standardised questionnaire that involves annual interviews of a representative panel of households and individuals in each country, covering a wide range of topics: income, health, education, housing, demographics and employment characteristic, etc. The total duration of the ECHP was eight years, running from 1994 to 2001. In the first wave, i.e. in 1994, a sample of some 60 500 representative households — i.e. approximately 130 000 adults aged 16 years and over — were interviewed in the then 12 Member States. Austria (1995) and Finland (1996) joined the project since then. Data for Sweden are available from 1997, and were derived from the Swedish living conditions survey and converted into ECHP format. In the United Kingdom, Luxembourg and Germany, the ECHP survey was stopped in 1997 and data from an existing national panel (i.e. BHPS, PSELL and SOEP respectively) were converted into the ECHP format to provide data for all subsequent waves.

The sample for the latest available year, i.e. 1999, included nearly 64 000 private households (approximately 131 000 persons) in the now 15 Member States. The sample sizes vary considerably from country to country, ranging from 2 552 interviewed households in Luxembourg to 5 418 in Greece and 5 847 interviewed households in Germany. Attrition, i.e. the loss of respondents over the life of a survey, was quite high in Ireland, Denmark and Spain, where the sample sizes between 1994 and 1999 fell from 4 048 to 2 378 interviewed households in Ireland, 3 482 to 2 387 interviewed households in Denmark, and from 5 523 to 3 986 interviewed households in Spain. Thus, the sample size of the ECHP survey may not yield an accurate reflection of the situation of smaller subgroups.

Income measurement

The income concept used in the analysis below is the equivalised disposable income. This is defined as the household's total disposable income divided by its 'equivalent size' to take account of its size and composition. The equivalence scale is the OECD modified scale, which counts the first adult (i.e. person aged 14 or over) as 1.0, each other adult as 0.5 and each child aged under 14 as 0.3. For instance, a household of one adult is equivalent to 1, a household of two adults is equivalent to 1.5, and a household of two adults and two children (under 14 years) is equivalent to 2.1.

Limitations

ECHP data on disposable income are based on information provided by respondents, rather than from administrative registers or other sources. The ECHP income data do not reflect the positive impacts of home ownership (as imputed rent) or negative impacts of interest payments on mortgage and other loans on disposable income, nor do they include benefits in kind. Thus, they do not capture several major determinants of living standards. Only positive capital income other than imputed rent is included in net disposable income. This distorts income comparisons between households with debt and those with positive wealth. If younger households are more likely to be indebted, the omission of interest payments will tend to overestimate their income compared to that of older households. In addition, the omission of imputed rent, i.e. the money that one saves on rent by living in one's own accommodation, is also likely to result in underestimated living standards of older households who will appear poorer than younger households and more at risk of poverty. For Denmark, it has been shown that the estimated risk of poverty among older people is up to four times greater when imputed rent and interest payments are not taken into account. People living in institutions are not covered by the survey. This may lead to higher poverty risks being observed in countries where frail elderly people are being cared within their families.

In view of these limitations of the ECHP data, reliable conclusions on the adequacy of pension systems cannot be drawn. The quality of income data and their timeliness must therefore be improved as a matter of priority. A new survey instrument, EU-SILC (survey on income and living conditions) is currently being developed.

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