PENSION NOTES

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Demographic reality forces European countries to introduce individually funded pension systems

Executive Summary

Reality is inevitable: the countries with PAYGO pension systems that have not introduced reforms to include robust individually funded systems, will have to live with a very substantial reduction of pensions in the future, solely due to the parametric adjustments they will have to make to avoid the bankruptcy of the public systems, as a result of demographic evolution. That is why the individually funded systems will become ever more relevant in the countries that are still running PAYGO systems.

This Pension Note provides evidence of the crisis facing the public PAYGO systems, in which the pension debt has risen to impressive levels in some countries (in Greece it is almost 9 times the GDP, in Portugal almost 5 times, in Italy around 4 times, and in Spain 2.5 times the GDP). In order to make their fragile public pension systems sustainable, European countries have been introducing two types of reforms.

On the one hand, parametric reforms to the public pension systems, which include: (i) delaying the official retirement age; (ii) approximating the effective retirement age to the official retirement age by increasing the minimum early retirement age, increasing the number of years of contribution required for accessing a pension and introducing incentives for prolonging working life; (iii) calculating pensions based on complete working-life data; (iv) updating pensions based on price indexes and wage rates; (v) incorporating sustainability factors in order to adjust pension benefits to changes in life expectancy, or other economic factors.

There are also structural reforms, involving the introduction of individually funded systems with different types of schemes. Because of the high cost entailed in any transition that would fully replace the existing public PAYGO systems with individually funded systems, the European countries have opted for introducing the individually funded systems as a complement to their public PAYGO systems.

Introduction

The PAYGO systems are based on a population pyramid that no longer exists, due to the increase in life expectancy and the drop in birth rates. Thus, it is impossible to maintain a mechanism based on active workers (ever fewer) financing the benefits of pensioners (ever more). It is due to this lack of structural sustainability that they have been described as a "Ponzi pyramid scam." So, when today’s young people reach retirement age, there will be insufficient young people entering the labor market to pay their pensions.

What have countries done to address their unviable and derelict PAYGO systems? First of all, they have had to address the underfunding of pensions with public resources, due to which the pension debt has become unsustainable (e.g. in Greece it is almost 9 times the GDP; in Portugal almost 5 times ; in Italy almost 4 times, and in Spain 2.5 times the GDP).

Because fiscal contributions were insufficient for financing pensions, they were forced to carry out parametric reforms. According to FIAP (2018), 78 countries increased the contribution rate in their PAYGO programs between1995 and June 2018; 55 had to increase the retirement age, and 61 adjusted the formula for calculating benefits, cutting or freezing old-age pension amounts. Despite all of the above, however, contribution rates in those countries almost double those of the Latin American individually funded systems, in addition to having higher levels of coverage than Latin America.

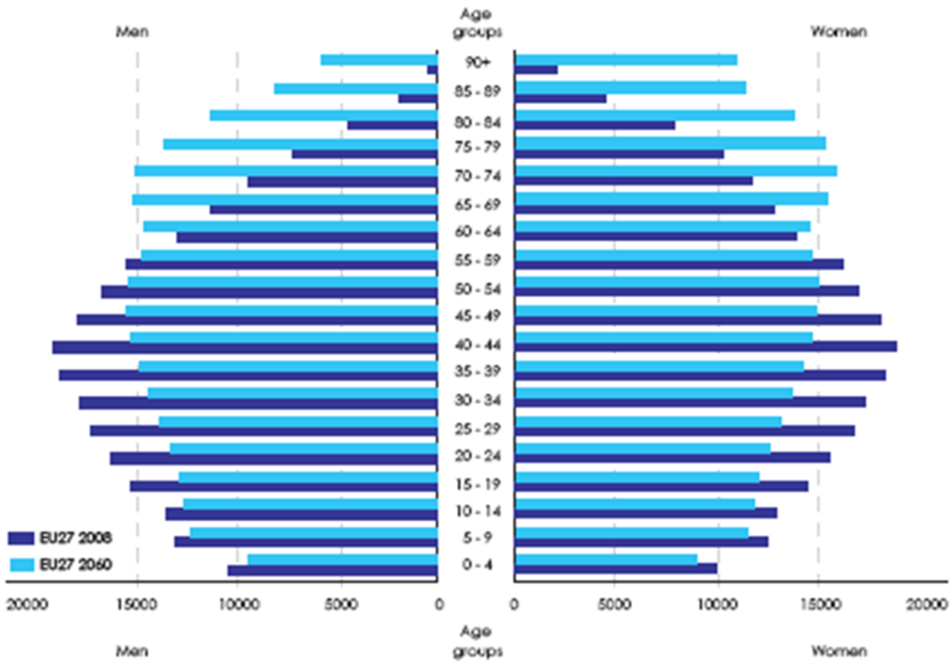
European countries have also been introducing private individually funded systems. Given the delicate situation of the public PAYGO systems, one can safely assume that they will become more relevant by the day.

The situation in Europe

The common denominator in the current situation of the European public pension systems is the challenge posed by ongoing population ageing. As can be seen in Graph No. 1, the European population pyramid altered its shape due to the widening of the upper part (older cohorts) and the narrowing of its base (younger cohorts). This has entailed a significant increase in public pension expenditure. In fact, average pension expenditure in the European Union in 2007 was 10.2% of GDP, and it is expected to rise to 12.6% by 2060 (see Table No. 1).

Latin America is expected to have a demographic evolution similar to Europe's, although with one fundamental difference: the shorter period of time in which low levels of fertility, high life expectancy and considerable levels of aging will be achieved, with the aggravating circumstance that this demographic transition will occur while Latin America is still a region with limited resources.

Graph No. 1
European population pyramid



Source: UN Population Division.

Table No. 1
Public pension expenditure in Europe: Projection of public expenditure by 2060, without reforms
(Percentage of GDP)

Countries	Pension Expenditure (% GDP)		
	2007	**2060**	**Variation**
Luxembourg	8.7	23.9	15.2
Greece	11.7	24.1	12.4
The Netherlands	6.6	10.6	4.0
Spain	8.4	15.1	6.7
Belgium	10.0	14.8	4.8
United Kingdom	6.6	9.3	2.7
Germany	10.4	12.7	2.3
Portugal	11.4	13.5	2.1
France	13.0	14.0	1.0
Denmark	9.1	9.2	0.2
Sweden	9.5	9.4	-0.1
Italy	14.0	13.6	-0.4
European Union	10.2	12.6	2.4

Source: European Commission (2010).

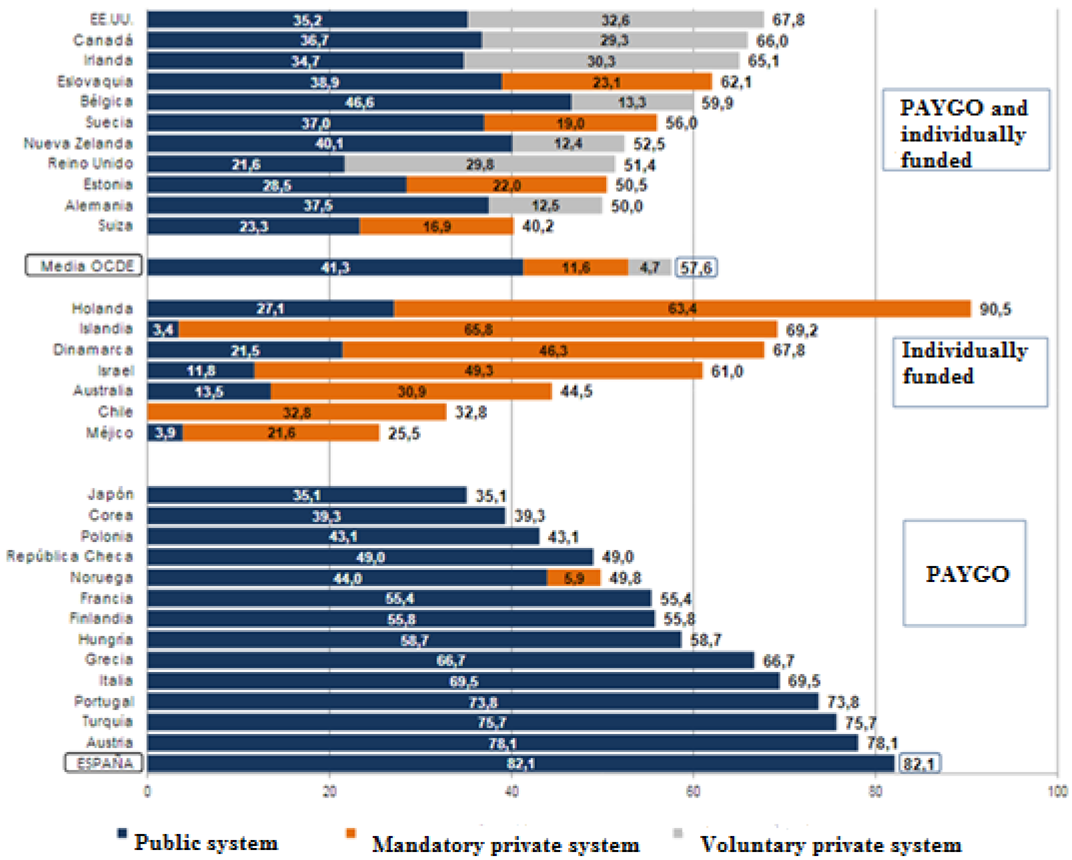
Given the difficulties the public PAYGO pension systems are going through, a significant number of OECD countries have introduced individually funded systems (through employment plans - collective savings under the auspices of the employer - or voluntary individual savings plans). Thus, pension models in the OECD countries are mixed, offering an average replacement rate of 41% of wages in the public PAYGO systems, whereas the mandatory and voluntary individually funded systems have managed to raise replacement rates to an average of 58% (see Graph No. 2). I.e., in the OECD countries, the individually funded systems finance 30% of pensions, on average.

Nonetheless, as can be seen on the same graph, there are many differences with respect to the importance of the individually funded systems in the OECD countries. Whereas the individually funded system accounts for almost 70% of the replacement rate in the Netherlands, in countries such as Spain and Italy the weight of the individually funded system in the replacement rate is virtually non-existent. This same trend is observed when considering the funds managed by the private pension systems as a percentage of GDP. As can be seen in Graph No. 3, the funds managed by private pensions in the Netherlands are almost double the country's GDP, whereas in countries such as Greece and France, they are less than 1% of GDP.

Graph No. 2

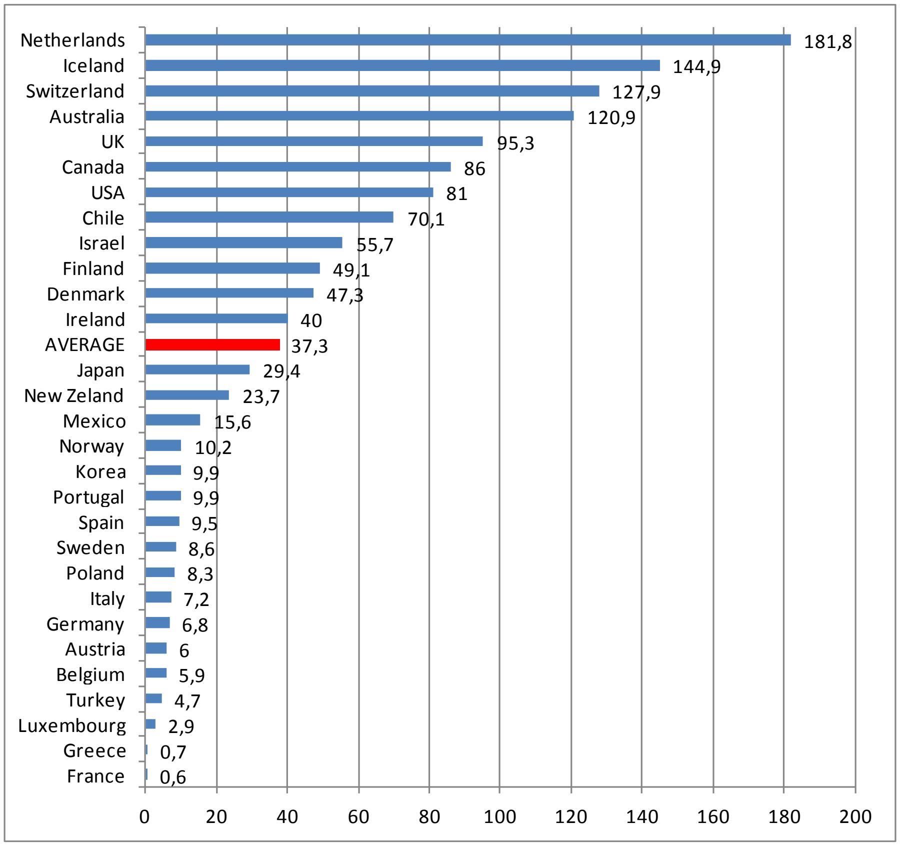
Replacement rates in the public and private pension systems (OECD - 2015 data)

(Percentage of wages)



Source: INVERCO on the OECD database.

Graph No. 3
OECD countries: The importance of private pensions
(Percentage of GDP)



Source: INVERCO on the OECD database.

Nonetheless, overall replacement rates in the public pension systems in the European Union are expected to drop from an average of 42.5% in 2013, to an average of 36% in 2060, i.e., a drop in the replacement rate of almost 7 percentage points over four decades is expected. Spain, Poland and Portugal especially stand out due to the drop in their replacement rates. This means that, due to demographic pressure, the weight of the private individually funded pension systems will necessarily increase in the long term.

Table No. 2
Evolution of the replacement rates in public pensions in Europe

	2013	2020	2040	2060	Variation 2013-2060
Belgium	39.5	41.6	41.0	38.8	-0.7
Denmark	39.7	36.5	33.5	32.8	-6.9
Germany	42.5	41.9	35.9	35.5	-7.0
Ireland	31.2	29.3	29.3	28.7	-2.5
Spain	79.0	73.6	56.1	48.6	-30.4
France	50.6	50.3	42.9	39.2	-11.4
Italy	59.9	61.2	52.3	51.8	-8.1
The Netherlands	29.8	29.7	28.2	28.3	-1.5
Austria	51.0	49.1	49.9	44.7	-6.3
Poland	53.0	53.8	39.4	28.7	-24.3
Portugal	57.5	50.7	36.1	30.7	-26.8
Finland	46.0	51.3	45.7	44.1	-1.9
Sweden	35.6	33.7	31.2	29.0	-6.6
Norway	43.7	41.0	36.7	36.2	-7.5
European Union	**42.5**	**42.7**	**37.7**	**35.9**	**-6.6**
Eurozone	**46.3**	**45.9**	**40.3**	**38.6**	**-7.7**

Source: European Commission (2016).

Hence, reality is setting in: countries that have not introduced reforms or robust individually funded systems, will have to accept a very substantial reduction in the pensions of their workers in the future, merely due to the effects of the parametric adjustments they will be forced to make to avoid the financial collapse of their public systems, as a result of demographic evolution. This is why the individually funded pension systems will be increasingly more significant in countries that still run public PAYGO systems.

In recent years, the European countries with PAYGO systems whose public finances prevent them from assuming the cost of the transition from a PAYGO to an individually funded system, and have not introduced structural reforms, as in Latin America, have been strengthening their private pension plans through different mechanisms, such as automatic enrollment, tax incentives, voluntary schemes, etc. These are some examples of the mechanisms used:[1]

1. **Automatic enrollment in private pension plans.** The United Kingdom, New Zealand and Ireland have implemented a mechanism for the mandatory automatic enrollment of workers in individually funded pension savings plans. In the United Kingdom, the replacement rate of the public pension system is only 29%, and the government has no intention of increasing its pension expenditure. So, in 2012, the government introduced the mandatory automatic enrollment employment plans, which consist in all companies with five or more employees being obligated to subscribe to a

[1] In Japan, employers and employees can obtain exemption from contributing to a part of the first PAYGO pension pillar, by outsourcing to substitute pension plans offered by the private individually funded accounts system, thus obtaining a reduction in the respective contribution rates to the public system.

collective employment pension fund for employees over 22 years of age. The employer's contribution started off at 2% of wages (until April 2018). As of April, 2018, the employer's contribution increased to 5%, and will rise to 8% in April, 2019, with which the implementation of the reform will be completed. Employees, on the other hand, are obligated to contribute 4% of their salaries, as long as they do not opt out of the plan.

2. **Severance pay for termination of employment** The "Trattamento di fine rapporto" (TFR) was implemented in Italy, whereby severance pay is automatically paid into a complementary pension, becoming part of a fund for such purposes, unless the employee explicitly objects.

3. **Second and third individually funded pillars.** Although the Swedish multipillar system offers a universal pension to all its workers, 90% of workers are enrolled in employment plans (individually funded accounts in the second pillar), which offer tax incentives to their members. Furthermore, 50% of workers have voluntary savings plans (third pillar). In Sweden, approximately 30% of pensions are financed through private pension funds (second and third pillar).

In summary, to the same extent that the PAYGO systems of developed countries have deteriorated, the individually funded savings systems have become stronger, and will play an ever increasing role in the financing of pensions. This seems to be the way things are going, although some insist on going against the grain.

References

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