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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, TO THE EUROPEAN PARLIAMENT AND TO THE ECONOMIC AND SOCIAL COMMITTEE

The Future Evolution of Social Protection from a Long-Term Point of View : Safe and Sustainable Pensions

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1. INTRODUCTION

Pension systems comprise both public and private schemes and are usually built on three pillars: basic public schemes, occupational schemes and individual pension plans. Each of these pillars has its specific advantages and drawbacks. However, in all Member States, the largest share of older people's income is provided through public pension schemes. The combination of the three pillars making up pension systems offer an unprecedented degree of prosperity and economic independence to older people in Europe. The prospect of population ageing and the retirement of the 'baby boomer' generation represents a major challenge to this historic achievement. Population ageing will be on such a scale that, in the absence of appropriate reforms, it risks undermining the European social model as well as economic growth and stability in the European Union. Member States are therefore invited to set out clear strategies for ensuring the adequacy of their pension systems without destabilising public finances or over-burdening the economy.

While each Member State remains responsible for its pension system, it is clear that they also have much to learn from each other. Furthermore, the sustainability of pension systems will determine to a significant extent the European Union's ability to achieve the promotion of a high level of social protection which is one of the fundamental objectives defined in Article 2 of the Treaty establishing the European Community. This is why the European Council has called for a co-operative exchange on the future sustainability of pension systems. The present communication proposes a framework for taking this work forward.

At its meeting in Lisbon on 23-24 March 2000, the European Council decided to "*mandate the High Level Working Party on Social Protection, taking into consideration the work being done by the Economic Policy Committee, (…)as its first priority, to prepare, on the basis of a Commission communication, a study on the future evolution of social protection from a long-term point of view, giving particular attention to the sustainability of pensions systems in different time frameworks up to 2020 and beyond, where necessary.*"[1] The Lisbon conclusions, referring to the need to modernise social protection, spoke of how "*the challenge can be better addressed as part of a co-operative effort*".

The European Council discussed pension systems again at its meeting in Santa Maria da Feira on 19-20 June and stressed that "*particular attention should be given to the sustainability of pension schemes through defining two action lines aimed at improved forecasting of future trends and at obtaining in-depth knowledge of recent, actual or expected national pension reform strategies*".

[1] By Council decision of 29 June 2000 (2000/436/EC) a Social Protection Committee has been created. This Committee will replace the High Level Working Party.

This communication responds to these requests by addressing the issue of sustainable pensions. Sustainability of pension systems refers to their ability to meet social objectives on an ongoing basis while maintaining other important policy goals, such as sound public finances and intergenerational equity. Sustainability cannot be ensured by one or various elements in isolation. High rates of economic growth and employment increases are crucial and will strongly contribute to sustainability. Together with that, reforms of pension systems as such will contribute to ensuring their sustainability, even more so given the uncertainties linked to the long-term nature of the issue. Such reforms may concern the parameters of public pension schemes as well as the structure of the pension system, i.e. the contributions of three pillars.

The communication is intended to inform the work of the High Level Working Party on Social Protection on the long-term evolution of pensions. It recalls the principal challenges that pension systems will be facing and proposes a framework for analysis of the challenges and policy responses.

Issues relating to pension reform are already high on the agenda in many Member States (see appendix for an overview of pension systems and reforms). A number of Member States have already started reforms which may involve all three pillars of pension systems. Reforms of public pension schemes mainly focus on controlling the growth of expenditure, whereas improvements in occupational and personal pension schemes are often necessary to allow them to play a greater role in income provision for older people. As the systems are different in each Member State a standard EU-wide response is neither desirable nor appropriate. Sustainable systems and safe pensions can only be secured when each Member State has identified the policy changes required and established the necessary consensus for their implementation.

Despite the substantial differences in approach, Member States share crucial problems. As a result of population ageing, public expenditure could rise dramatically. Without reforms, the level of expenditure of state pension schemes could, in some Member States, reach 15-20% of GDP in 2030. Unfunded pension liabilities could, in some cases, represent up to 200% of GDP.[2] A large growth in the share of pensioners will inevitably require an increase in the resources set aside by the active population. The employment rates and productivity levels of the active generations will therefore be important determinants of the living conditions of the retired. All Member States have a need to modernise or adjust pensions systems and labour market practices so that they become mutually supportive and more conducive to the promotion of economic growth and social cohesion.

As the employment strategy has shown, a collective reflection at the EU level can help Member States to place the issues firmly on their internal policy agenda. An open exchange of experiences and ideas capturing the diversity of practices across the EU will broaden the range of policy options. Finally, by showing how adequate pension provision can be made sustainable, such co-operation, involving all actors, will help strengthen public confidence in pension systems.

Modernising and reforming pension systems is a complex process involving a broad range of interests and actors. The livelihood of a large and potentially vulnerable share of the

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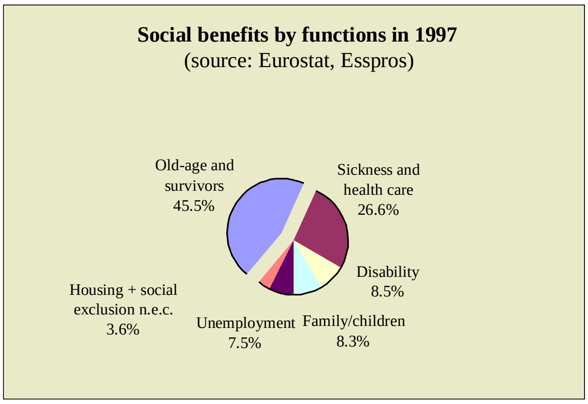
[2] Commission communication "Towards a single market for supplementary pensions", COM(99) 134 final. More up-to-date figures on public expenditure implications of ageing will shortly be presented by the Economic Policy Committee.

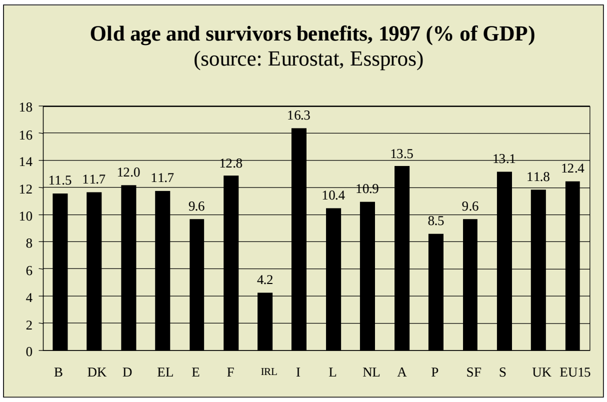
population depends on this. It is necessary to respect legitimate expectations and to maintain an equitable and sustainable balance between rights and obligations. Reforms should be sufficient to meet the challenges ahead, credible, transparent and clear in their impact and should allow enough time for people to adjust. The reform process will require that all relevant actors be involved and committed to change. This makes it urgent to design comprehensive reform strategies long before acute financing problems will materialise.

The aim is, thus, to stimulate a joint effort which identifies practical ways of making adequate pension provision sustainable while maintaining sound public finances and intergenerational fairness. It is of considerable importance to the achievement of the overall strategic goal articulated at Lisbon that the Commission and the Member States should succeed in this objective. Conversely, by addressing all the factors, such as employment and economic performance, that influence pension systems, and not confining itself to the parameters of pension design, this Communication reaffirms that it is by means of the Lisbon strategy of mutually reinforcing social and economic policies that Europe can best hope to provide safe pensions and sustainable pension systems in the future.

2. CHALLENGES TO PENSION SYSTEMS

Most of the resources available to older people are provided by pension systems. In the overall package of support to people after retirement, pensions represent the largest share, and the main source of pension income is public pension schemes. Old-age and survivors' benefits together represent nearly 45 per cent of total social protection spending in the EU, or around 12 per cent of GDP (see charts below).[3] Most of the expenditure for old-age and survivors comes out of statutory pension schemes and is financed out of social insurance contributions and general taxation. In addition, as they are also the largest beneficiaries of health and long-term care, older people are the segment of society who are most dependent on social protection systems. The second largest item of social protection expenditure is health care which represents more than 7 per cent of GDP.





Over the past decades, Europe's pension systems have been remarkably successful in meeting their social objectives. Public pension provision has brought about a transformation in the income security and relative income position of old age pensioners. It has made older people independent and allowed them to enjoy a prolonged period of leisure after their working lives.

[3] These figures do not take account of taxes and contributions levied on social benefits. Such net social expenditure figures are difficult to calculate and are not yet widely available.

The risk of poverty in old age, once widespread, has been greatly reduced, and so has the number of people who have to rely on their descendants or means-tested social assistance benefits. Pension systems have achieved this in spite of a marked increase in life expectancy and in the number of pensioners over the past decades.

The biggest and most certain long-term challenge that confronts today's pension systems is demographic ageing. However, the need for reform of pension systems is not only related to the changing demographic balance. There is a critical interaction between financial sustainability of pensions, economic growth and employment which should not be neglected. On the one hand, higher economic growth and employment could open up new opportunities. Increasing the number of people in work is fundamental in order to stabilise or even reduce economic dependency ratios. On the other hand, pension systems need to perform better, both in terms of meeting their social objectives and supporting Europe's employment and growth objectives.

2.1. The implications of demographic change

Over the coming decades the number of older people will rise sharply in relation to people of working age. No reasonable policy measures will be able to counteract this change in the demographic structure of the European Union. However, it is not the demographic old-age dependency ratio that matters for the sustainability of pensions, but the economic dependency ratio.

Higher life expectancy due to higher welfare standards, better medical treatments and lower fertility rates are the driving forces behind a secular trend towards population ageing. This trend is not new and is set to continue. Medical progress shows no signs of decelerating, and past demographic forecasts have tended to underestimate the rise in life expectancy. Fertility rates are currently well below the level needed for a full replacement of the current population. A rise could occur if some of the existing barriers and disincentives to family formation and child bearing (related notably to labour market, housing and child care) are removed. Fertility rates tend to be higher in Member States implementing a sound policy of reconciliation of family and working life. However, they remain too low to prevent population ageing.

The major new development over the coming decades will be the large baby-boomer cohort, born after the end of World War II, reaching retirement age. This demographic bulge will initially be reflected in an ageing workforce, then, from 2010 onwards in a sharp increase in pensioner numbers and later in increased needs for health and long-term care.

The old-age dependency ratio will rise considerably over the next 30 to 40 years. According to Eurostat's long-term demographic projections, the number of working-age people per pensioner will halve by the year 2050 going from 3,5 to 1,8 at EU level (see table 1). The demographic effect of the post-war baby boom will start decreasing at around 2030 and is expected to disappear not earlier than the middle of the century[4].

The rise in the number of older people will be such that the increase in the demographic old-age dependency ratio can neither be halted by a sudden increase in fertility nor by any

[4] The Economic Policy Committee's working group on the public expenditure implications of ageing, is currently engaged in developing projections of national public pensions expenditure relative to GDP up until 2050. Once ready, these will serve as broad indicators of the size of the demographic challenge as it affects public pension systems.

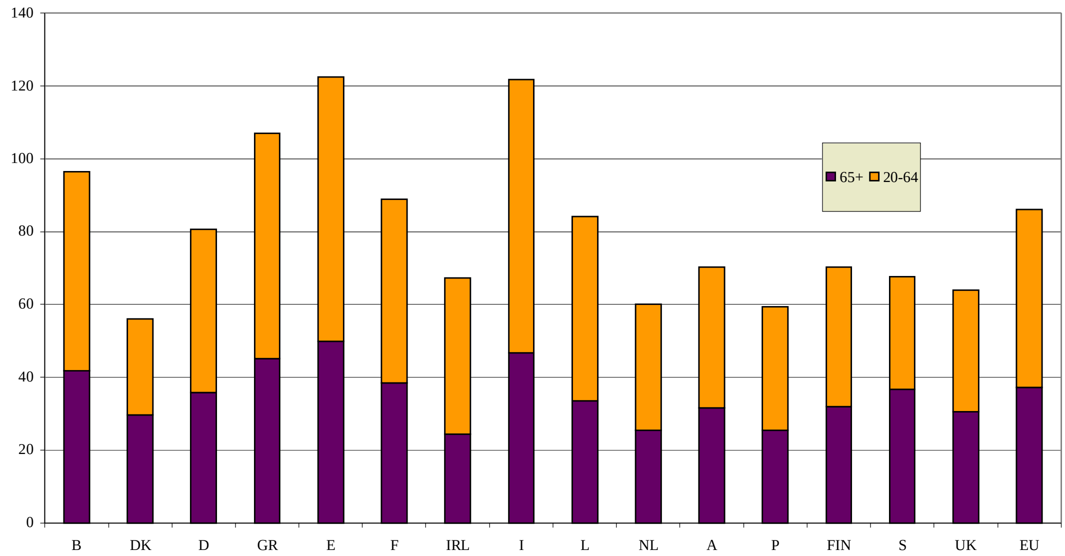
realistic level of immigration. Changes in fertility only start having an impact on the labour market twenty years later. However, immigration can contribute towards raising the level of employment, –but its positive impact depends on the extent to which migrants can be sufficiently integrated into the labour market.

Table 1: Baseline projections of old age dependency ratios in EU Member States (65+ over people aged 20-64 years)

%	2000	2010	2020	2030	2040	2050
B	29.5	31.1	38.0	48.8	53.5	52.0
DK	25.5	29.6	35.7	42.0	47.0	43.7
D	28.0	34.1	38.6	50.3	57.0	56.1
EL	30.2	33.6	38.0	44.4	54.7	61.6
E	28.7	30.7	35.2	44.7	59.8	68.7
F	28.5	29.5	38.1	46.4	52.1	53.2
IRL	20.3	20.5	26.2	32.1	38.4	46.6
I	30.7	35.5	42.1	52.9	67.8	69.7
L	24.8	27.6	33.0	42.5	47.2	43.5
NL	23.1	26.2	34.7	44.2	50.1	46.9
A	26.3	30.1	34.5	47.0	57.0	57.7
P	26.7	28.5	32.2	37.2	46.3	50.9
SF	25.9	29.7	41.4	49.5	49.7	50.6
S	30.9	33.8	39.8	45.4	48.9	48.5
UK	27.8	28.5	33.9	43.1	49.1	48.5
EU-15	28.3	31.4	37.3	46.8	55.0	55.9

However, the sustainability of pensions depends not on the demographic dependency ratio but on how this translates into the economic dependency ratio (which is significantly higher) and transfer payments. It is therefore much more relevant for an assessment of the prospective sustainability of pension systems to consider the actual number of people in employment in relation to people who do not work. Currently, the economic dependency ratio (people aged 20 and over not in work as a proportion of total employed) is 0,86 in the European Union, which means that there are nearly as many working-age people who are not in work as people who are. Within the group of non-working adults nearly 6 out of 10 are below the age of 65, many of whom are in receipt of benefits of various kinds. The economic dependency ratio can be expected to be negatively affected by the rising old-age dependency ratio, but by reducing the number of inactive among the working-age population it will be possible to alleviate the financial burden of ageing that will have to be supported by the employed. Thus a crucial question is: to what extent it will be possible to counteract the impact of ageing on economic dependency rates by raising the overall employment rates?

Economic dependency ratios in 1999
Population 20 and over not in work as % of total employed



2.2. Political and economic dimensions of pensions reform

Reforms to make pension systems sustainable may well be politically difficult. They will need to achieve as large a consensus as possible. They must be comprehensive, not confined exclusively to pensions. A successful strategy for economic growth will be a major element of this. Maintaining sustainability of pensions in the face of rapid ageing implies a balance between contributions and entitlements and between the active and the retired populations. This presents a major political challenge.

A comprehensive strategy for securing adequate pensions in the face of demographic change can only be developed and implemented on the basis of consensus between and within generations. It is important that all relevant stakeholders be involved and committed. Such agreement should lead to more stability and predictability in pension systems.

Confidence in, and widespread acceptance of, pension systems are of crucial importance for their sustainability. Public, pay-as-you-go financed pension schemes have become the focus of widespread concern because the impact of ageing on these schemes is very direct and clear, whereas in the case of funded schemes the impact will be much more difficult to predict. Governments can alleviate these concerns by setting out a clear and credible strategy to ensure the sustainability of pension systems.

Sound macroeconomic policies and growth-enhancing structural reforms creating a favourable economic and business environment are critical for the future sustainability of pension systems. The integrated strategy articulated at the Lisbon Summit provides an excellent context for Member States to address this challenge.

Economic growth is a crucial determinant of public finances. Although many public pension schemes have dedicated sources of revenue in the form of social insurance contributions, general government contributions to all social protection schemes[5] generally represent nearly

5 Data on general government contributions to pension schemes only are not available.

ten per cent of GDP for the EU as a whole. This link between general government budgets and the specific financing systems of pension schemes means that an uncontrolled rise in pensions expenditure might destabilise public finances. Conversely, the ability of governments to support pension schemes depends on other factors determining the soundness of public finances.

On the revenue side, a continued ability of governments to collect taxes and contributions is crucial. This may be affected by tax evasion, by cross-border differentials or by a higher mobility of tax bases and hence the possibility for economic activities to move to countries where the best balance between taxes/contributions and public services can be found. The reduction of the overall tax burden, in particular on labour, to provide incentives to growth and employment is also to be taken into account. On the expenditure side, the evolution of other claims on public budgets will be important. In a context of sound macroeconomic policies and budgetary discipline the challenge will be to ensure that any rise in pension expenditure does not crowd out other legitimate claims on public budgets. One major current expenditure item is interest on government debt which should be reduced in preparation for ageing related cost. Sufficient preparations for a rise in ageing related costs should therefore be made.

Reliance on private, funded provision through occupational or personal pension schemes can be a useful tool to alleviate the burden on public finances. As a result the performance of financial assets becomes a more important determinant of older people's living standards. Financial market dynamics will be affected by demographic change with demand for financial assets increasing as a large cohort saves for retirement.

In many Member States, the process of reform is already well underway. A balance is being sought between the aim of providing sufficient and safe income to the elderly and that of making systems sustainable. While the measures introduced differ in detail, in practice, their common emphasis is on limiting the future transfers which will be necessary, particularly those which governments are responsible for, or increasing the finance available. They include increasing the official age of retirement or the number of years of contributions required to qualify for a full pension, reducing the pension paid in relation to past earnings, or relating it more closely to contributions, creating special funds to finance future transfers or encouraging the development of private, funded pension schemes.[6] These reforms could often benefit from being integrated in a more comprehensive strategy covering social protection reform, employment promotion and macroeconomic policies. The current healthy economic climate should be used as an opportunity for introducing comprehensive reforms.

2.3. The link between pensions sustainability, the Lisbon strategy and employment promotion

Current pension systems tend to encourage early exit from the labour market and are frequently used to reduce staff levels while avoiding redundancies. They often do not take into account differing individual needs. Some pension schemes offer insufficient coverage for the most mobile and flexible members of the workforce. More generally, the incentive structure of pension schemes needs to be reviewed to ensure that they become employment-friendly.

[6] The Commission publishes regular reports on Member States' policies in the area of social protection. The latest one is: *Report On Social Protection In Europe 1999* (COM(2000) 163 final).

The European Council in Lisbon formulated an overall strategy for sustainable economic growth with more and better jobs and greater social cohesion. Demographic change means that a large workforce has to be achieved in a context of an ageing and shrinking population of working age. This will impose additional challenges across the entire range of economic, labour market and social policies cited by Lisbon. Pension systems need to be compatible with, and capable of, contributing positively to the realisation of all the elements of this strategy. The main challenges for pension systems in this regard relate to their interaction with labour markets. Pensions sustainability, but also the prospect of tightening labour markets and skill shortages in the future, makes it urgent to develop a strategy for mobilising society's full employment potential.

The conclusions of the Lisbon European Council established that, on the basis of a sustainable economic growth of 3% of GDP, Member States should move towards a total average employment rate of 70%, and over 60% for women, in 2010. Employment growth of the sort we need to meet these objectives has a crucial role to play in ensuring the sustainability of pension systems. Clearly, other parameters may need to be adjusted at the same time (e.g. retirement age, level of contributions or the relative levels of pensions). Increasing the current levels of activity among women and older workers will be crucial. Reform of pension systems has a key role to play in this respect through the provision of better employment incentives.

Women's participation is clearly one key issue. Women still have particular problems in gaining equal access to the employment market, in career advancement, in earnings and in reconciling professional and family life. Although the net additional jobs created over the past decade or so have virtually all gone to women, this job growth has failed to keep pace with the increasing number of women who want to work and employment rates for women remain lower than for men. One reason for this are career interruptions to provide care. Such periods could receive a better recognition in pension systems. Adjustments should also be made to strengthen the incentives for women to enter, re-enter and remain in the labour market. Finally, the issue of individualisation of pension rights has to be considered in this context.

Another key issue is the premature exit of the older workers from the labour market. Today in most Member States the effective retirement age is well below the normal eligibility age in statutory pension schemes. One of the main reasons for this trend is that pension systems continue to offer substantial incentives for early retirement. In most pension systems, continuing to work beyond the first opportunity to retire entails having to pay social contributions without gaining extra pension rights. In addition, income from work may be taxed at a higher rate than pensions. Tax/benefit structures which subsidise early labour market exit while punishing people who work longer, undermine the principle of making work pay. Such structures not only lead to a waste of human resources and undermine the European Union's employment objectives, they also raise the cost of retirement systems substantially.

Table 2: Employment rates by age group in 1999

	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	SF	S	UK	EU15
50-54	60.3	80.4	73.4	60.1	57.2	74.1	62.1	57.2	64.6	70.2	72.7	71.4	78.9	84.2	75.9	69.2
55-59	36.9	70.9	55.1	47.4	44.8	46.8	50.5	36.6	38.2	49.6	41	59.1	54.6	77.8	62.1	50.7
60-64	12.9	34	19.6	30.4	24.7	10.1	35.9	17.9	12.9	18.6	11.7	43.6	22.2	47.9	35.6	22.3
65-69	3.8	6.2	5	11.5	3.9	2.1	14.3	6.2	n.a.	5.2	4.9	24.8	4.4	10.7	11.6	6.5

Source: Eurostat Labour Force Survey

The problem of early labour market exit is aggravated not only by the objective difficulties (such as out-dated skills) which older workers experience in finding reemployment after redundancy, but also by management practices which discriminate against them in the workplace and on labour markets. Under these conditions, early retirement schemes have often been regarded by employers, unions and workers as the only socially acceptable way of reducing staff levels. This age bias is often mirrored in practices within employment policies: older workers may find that they are barred from the placement, activation and training offers that are available to younger workers.

With ageing, pension systems will no longer be able to support the cost of shedding older workers whose skills are out-dated or because unhealthy working practices force them to retire early. Moreover, workers are increasingly fit enough to continue working until the official retirement age or even beyond if they so wish.

Reversing the trend towards early labour market exit will require providing stronger employment opportunities for older workers, reducing the disincentives for working longer in the form of early retirement options and other tax benefit structures while putting more emphasis on maintaining their employability. Pension systems will need to be adjusted in several ways to support working longer.

In this regard, today's fixed statutory retirement ages look increasingly inappropriate. They do not take account of rising life expectancy and the improved health status of most older people. Systems of flexible or gradual retirement had already been recommended by the Council in 1982[7]. They could be used to promote increased labour force participation and hence higher employment, thereby contributing to the long-term sustainability of pension systems.

Furthermore, promoting active participation should take account of the different categories of disadvantaged groups. In fact, an inclusive strategy does not only reduce the waste of human resources, it also helps containing some of the economic and social costs related to social exclusion liberating financial resources and helping the overall sustainability.

Pension systems must also be adapted so that they cater better for the needs of a more mobile and diverse workforce. In particular, any penalties for irregular career patterns or for mobility, either geographical or occupational, should be eliminated. Many occupational pension schemes, in particular, tend to impose substantial costs on people who change jobs or interrupt their careers.

In the longer term, Europe's job creation potential need not be limited by her current population size. It would be possible to attract immigrants, including well-qualified people, from third countries. Employment could rise further if birth rates went up again. While the determinants of fertility rates are clearly complex, more family-friendly workplaces and public policies that make it easier for parents to reconcile a professional career and family responsibilities could certainly play a positive role.

Mobilising society's full economic and social potential is the overriding policy requirement in the face of ageing. An integrated policy of technology driven productivity growth, more and better jobs and greater social cohesion, as articulated at Lisbon, provides the necessary framework for this mobilisation.

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[7] Council Recommendation of 10 December 1982 on the principles of a Community policy with regard to retirement age (82/857/EEC), OJ L357, 18/12/1982, p. 27-28.

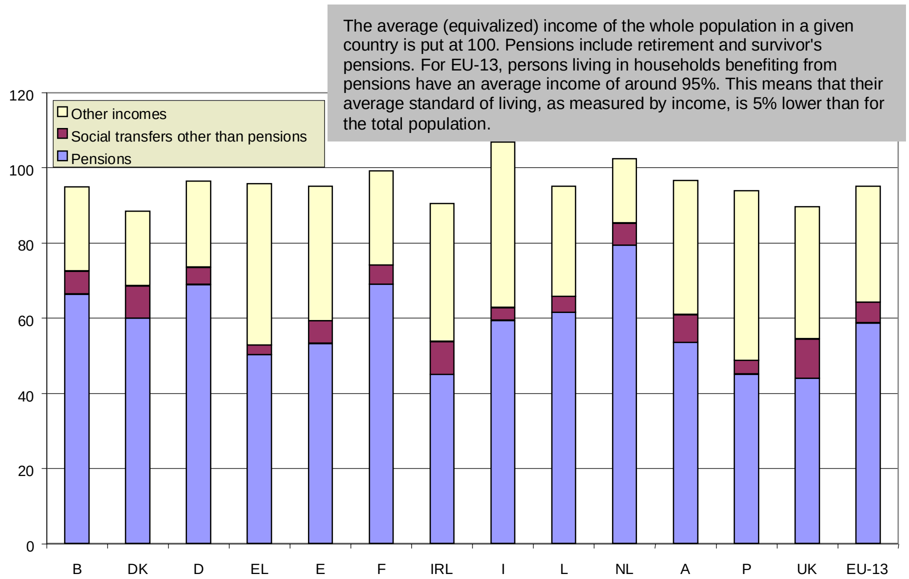
2.4. Ensuring adequacy and fairness in pension provision

Pensions have ensured that older people now enjoy reasonable living standards. However, there are still some gaps in income provision for older people. Poverty rates, especially among older women are higher than average. Granting pension rights for bringing up children or providing care is therefore an important element of solidarity in pension systems, as are lower contribution rates for low-paid workers. Present gaps in the adequacy and fairness of pensions call into question the Lisbon objective of creating greater social cohesion. It will be necessary to address such inadequacies which otherwise risk being aggravated in the context of ageing.

The average net adjusted[8] income of persons living in households receiving at least one pension (retirement or survivor's pension) is very close to average incomes of the population as a whole. Pension systems contribute around 60 per cent of the total net income of such persons. Other incomes include social transfers other than pensions, income from property and income from work (especially in those cases where pensioners share a household with people who are still in employment).

Relative equivalised income of persons living in households receiving pensions

(100 = all persons in a given country)



Source: European Community Household Panel, 3rd wave, 1996 (Eurostat, Statistics in Focus, Theme 3 – 9/2000, Social benefits and their redistributive effect in the EU)

Despite this success, there are still cases in which pension systems fail to provide adequate minimum resources to the elderly. Older women, who constitute 2/3 of pensioners above the age of 75, are particularly prone to the risk of poverty in many Member States. In some countries, poverty rates are still higher among older people than in the total population, although the difference has narrowed. In the absence of minimum pension provision, short employment spells and career breaks often lead to inadequate pension provision, particularly in the case of women without adequate derived rights.

[8] The net income is adjusted per "adult equivalent" to take account of differences in household size and composition: the income received by a household is divided by its "equivalent size" computed using the modified OECD equivalence scale. Any member of a given household, child or adult, is assigned the same equivalized income.

Growing labour market participation of women should result in a better protection in old age. However, women are still more likely to compromise their careers for family reasons and hence accumulate lower pension entitlements than their partners. As long as families are stable, pension systems may provide adequate protection through derived benefits.With increased family instability, the issue of sharing pension entitlement between spouses becomes more and more important.

Pension reforms will need to be carried out bearing in mind such inadequacies. In particular, expenditure cuts may not turn out to be as financially advantageous as expected if they lead to increased reliance on means-tested social assistance, thus shifting expenditure from pension systems to other social protection schemes. Surely, increased reliance on means-tested social assistance may contribute to expenditure cuts. However, means-tested social assistance and reliance on support from relatives may also undermine incentives to work (part-time after retirement from one's main job, or to earn income to meet the needs of elderly relatives) and to provide for one's own retirement (people on low incomes may not expect a pension above the social assistance level).

Pension reforms seeking to bolster the role of occupational and personal pension schemes will also need to address certain weaknesses of these schemes. Long vesting periods in occupational pension schemes make it difficult for people who are not part of a company's core workforce to earn sufficient pension entitlements. High management fees for personal pension plans can make them very unattractive to low-paid workers, and the practice of levying charges on initial contributions (front loading) imposes a high costs on scheme leavers. At EU level, the lack of coordination between such schemes, notably in the area of taxation, needs to be addressed to remove obstacles to cross-border mobility.

Strengthening the actuarial link between contributions and benefits (a measure which would strengthen the employment incentives in pension schemes) does not necessarily weaken solidarity. Many pension systems have redistributive elements in favour of the less-well off, for instance when they guarantee a mininum pension regardless of employment and contribution records or when contributions are levied on all incomes, but benefits are capped. On the other hand, pension systems may penalise manual workers (from an actuarial point of view) if pensions are calculated on the basis of final earnings or a number of years with high earnings without taking account of all contribution years and shorter life expectancy.

2.5. Managing Finance and Expenditure

A strategy for making pensions sustainable should focus on mobilising society's full potential[9] *as well as on reforming pension systems themselves. By raising the employment rate of the working age population we can counter to a large extent the effect of demographic ageing on economic dependency ratios. This would ease the financial pressure on public pension schemes resulting from ageing and reduce the need for painful cuts in benefits or rises in contributions and taxes. A reform of pension systems is, however, necessary to make them conducive to employment creation and, in particular, encourage older workers to remain in the labour force. Implementing the Lisbon strategy will boost the ability of pension systems to respond to the challenges of adequacy.*

[9] The possible content of such a strategy in relation to ageing in general was discussed in COM(99)221 final "Towards a Europe for all ages – Promoting Prosperity and Intergenerational Solidarity", which focussed on active ageing policies.

In its progress report to the Feira European Council, the High Level Working Party on Social Protection suggested that an analysis of pension reform strategies should also consider how to manage finance and expenditure.

As pointed out before, this issue interacts with employment. On one hand, an effective way of raising more finance for pension schemes is to increase the number of contributors to them by increasing employment levels. On the other hand, reforming pension systems to improve labour market incentives will help to raise employment levels. Raising the real retirement age can result in very large savings provided increased expenditures in other areas can be avoided.

The study on sustainability of pensions will have to further analyse the various ways to secure a broader and stronger revenue base for pension schemes through diversification to alternative sources of finance, through the accumulation of fund assets and via the reduction of public debt. It will have also to analyse how to contain the rise in pension costs by improving efficiency and adjusting benefits while maintaining the social objectives.

Responding to the challenge of ageing calls for a comprehensive policy. In addition to sound macroeconomic policies and comprehensive structural reforms conducive to growth, higher employment and balanced public finances, the structure of public expenditure needs to be reassessed in order to ensure future growth and a generational balance in the distribution of public expenditure. In this context, reforms of current pension arrangements which secure adequacy and financial balance, while making schemes more employment-friendly are necessary. Reforms should result in durable solutions to the long-term problems and not just in stop-gap responses to imminent problems.

2.6. Guiding principles and objectives for pension reforms

It is for Member States to decide what pension system they want and what policy mix is required to maintain adequate incomes for older people without jeopardising the stability of public finances, undermining employment incentives or squeezing out other essential public expenditures. However, despite the considerable diversity within the European Union, Member States face common challenges which were analysed above. They also share common objectives with regard to pension systems and are committed to a number of principles, amongst which are equity and social cohesion which characterise the European social model. The Commission therefore invites Member States to co-ordinate their efforts and exchange views and information on practices and reforms in progress or at a planning stage. National choices and priorities in the strategies and detailed reform process do, however, remain the responsibility of Member States.

This cooperation among Member States can be made easier if common objectives and principles are made explicit. Clearly, tensions do arise between some of these objectives and principles, and Member States will have to strike a balance. Within the process set by the Lisbon Summit, the Commission presents the following principles and objectives to the discussion:

1. *Maintain the adequacy of pensions*: The three pillars of pension systems, operating in combinations decided by the Member States, should enable people to remain financially autonomous in old age and, within reasonable limits, to maintain the living standard achieved during their working life.

2. *Ensure intergenerational fairness*: The efforts needed to cope with demographic ageing should be shared in an equitable way between the active, be they employees or entrepreneurs, and the retired generations.

3. *Strengthen solidarity in pension systems*: No-one should be excluded from pension systems because of low-income or an unfavourable risk profile. Pension systems should have a redistributive element in favour of people with poor labour market opportunities or who had to provide care to children, disabled or frail elderly people.

4. *Maintain a balance between rights and obligations*: Benefits should reflect an individual's contributions to a pension system. In particular, postponing one's retirement should result in higher benefits.

5. *Ensure that pension systems support the equality between men and women*: In particular, adjustments are needed to strengthen the incentives for women to enter, re-enter and improve their position in the labour market.

6. *Ensure transparency and predictability*: It should be clear to pension scheme members what they can expect in terms of benefits under various circumstances.

7. *Make pension systems more flexible in the face of societal change*: Pension systems should be able to adjust to foreseeable changes in their economic and demographic environment.

8. *Facilitate labour market adaptability*: Pension systems should accommodate professional and geographic mobility and allow a degree of individual choice, for instance regarding the retirement age and the organisation of learning, working and leisure phases.

9. *Ensure consistency of pension schemes within the overall pension system*: Pension pillars should be mutually supportive and well co-ordinated.

10. *Ensure sound and sustainable public finances*: Reforms must ensure that the tax burden arising from public pensions is set at an appropriate level and that other essential public expenditures are not crowded out.

3. NEXT STEPS

3.1. Commission initiatives

In addition to the framework presented in this communication, the Commission will undertake the following initiatives to underpin this co-operative exchange on pension sustainability:

– In order to gauge public awareness and expectations regarding the modernisation of social protection systems, carry out, in the year 2001, a Eurobarometer survey on pensions and pension reform.

– Examine the relevant Community-wide statistical surveys with a view to ensuring that social protection issues in general and pension issues in particular are adequately covered.

– Propose an exchange of information on the issues covered in this Communication with the accession countries and, in the framework of its bilateral co-operation, the United States and Japan.

The Commission will also pursue its efforts to contribute to a better functioning of supplementary pension schemes:

– The proposal for a directive on the coordination of laws, regulations and administrative provisions relating to institutions for occupational retirement provision will allow private funded pension schemes to make the best use of investment opportunities, set high standards for the protection of beneficiaries and pave the way towards the cross-border management of occupational pension schemes. Enhancing the security and efficiency of these institutions and allowing them to fully benefit from the Single Market should contribute to the safety and sustainability of pension systems.[10]

– Further to its Communication *Towards a Single Market for Supplementary Pensions* of 11 May 1999 (COM(99) 134 final) the Commission will put forward an initiative dealing with the taxation of cross-border supplementary pensions early next year.

– The Pensions Forum, created following a suggestion by the High Level Panel on Free Movement, will consider how barriers to cross-border labour mobility related to supplementary pensions can be addressed.

Finally the Commission will take further initiatives on the future evolution of social protection with a view to supporting the co-operative effort on all objectives for the modernisation and strengthening of social protection as approved by the Council on 17 December 1999 (OJ 2000/C 8/7).

3.2. Setting up the framework of the study: The Lisbon request

As said in the introduction, the European Council at Lisbon requested the High Level Working Party on Social Protection "*to prepare a study on the future evolution of social protection from a long-term point of view, giving particular attention to the sustainability of pensions systems drawing on this communication*". The High Level Working Party on Social Protection will submit a progress report on its work to the Nice Summit of December 2000.

The Commission proposes that the presentation of the challenges and policy responses discussed in this Communication should be used by the High Level Working Party on Social Protection as a framework for its ongoing work of analysis and exchange on pension reform issues.

The analysis to be carried out in this framework should be based, as far as possible, on harmonised data sources and hypotheses. In this context, the work undertaken by the Economic Policy Committee will be of a particular importance.[11]

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[10] Reference to COM document to be included (adoption foreseen for the same date as this communication).

[11] The Economic Policy Committee is working on the public finance implications of ageing. The aim is to provide a quantitative assessment of the public finance and economic consequences of ageing. Existing national expenditure projections have been reviewed and projections using common indicators and macroeconomic and

Wherever possible, the approach should use longitudinal data taking into account all the related dimensions (demographic, economic, employment, social) and the interactions between them. In analysing future trends, the study should also take account of all the relevant policy objectives set at the EU level including the employment objectives set in Lisbon and the conclusions to be agreed in Nice.

The analysis should also benefit from the experience accumulated in the ongoing process of multiple reforms implemented in the Member States. The Commission suggests that the study serves as a basis for regular updating of information relating to pension reform in the Member States.

Finally the analysis should progressively include the candidate countries. The effectiveness and sustainability of schemes in new Member States integrating into the Union will be of common concern in economic and social terms. The reforms underway in candidate countries are of interest. These issues need to be given closer attention as the enlargement approaches while stressing that pension systems remain the responsibility of national authorities.

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demographic assumptions are being developed in co-operation with the OECD. Results will be submitted to the ECOFIN Council in November and made available to the High Level Working Party on Social Protection.

Appendix: Overview of national pension systems and recent reform measures*

Country	Main features of pension systems (Pillars 1, 2 and 3)	Recent reform measures
Belgium	**1.** Earnings-related scheme **2.** Voluntary, mainly company-based schemes covering about 31% of the working population **3.** Personal pensions available from life insurance companies or banks under favourable tax conditions	Building on important reforms introduced in 1997 for private sector employees, the new government together with social partners is reflecting upon further reforms to cover for public sector employees and the self employed. Consideration is also being given to promote private funded pensions.
Denmark	**1.** Flat-rate public scheme based on residency/employment and contribution financed supplementary scheme with benefits linked to duration of employment (ATP) **2.** Mainly sector-wide schemes based on collective agreements covering about 80% of the working population **3.** Personal pensions available from life insurance companies or pension funds under the same tax conditions that apply to 2nd pillar schemes	The transformation a largely unfunded system to one with a much higher degree of funding has been underway for some years. 1999 saw a temporary contribution to the ATP (Labour market supplementary pension) amounting to 1% of the average wage made permanent and a tightening up of early retirement rules.
Germany	**1.** Earnings-related pension scheme **2.** Voluntary, mainly company-based schemes **3.** Personal pensions available from life insurance companies	Pension reform was very high on political agenda. A tax reform package was agreed enabling increased revenues from energy taxes to partially offset a reduction in the contribution rate to pensions by employees and employers. Changes were also agreed for 2000/2001 linking increases in public pensions to inflation rather than the evolution of net wages. However, important reforms agreed in 1998 and due to come into force in 1999 were suspended by the new Government for two years, pending important reforms due to be announced in 2000.

* Sources: DG MARKT, *Study on pension schemes of the Member States of the European Union, May 2000*, for the column 'main features of pension systems', *Report from the Commission on the implementation of the 1999 Broad Economic Policy Guidelines* (COM(2000) 143 final) for the column 'recent reform measures. More detailed information is available in *Report on Social Protection in Europe 1999* (COM(2000) 163 final) and *MISSOC – Social protection in the Member States of the European Union*, DG EMPL, annual publication.

Country	Main features of pension systems (Pillars 1, 2 and 3)	Recent reform measures
Greece	**1.** Earnings-related schemes **2.** Voluntary schemes mainly in large companies covering about 5% of the working population **3.** Personal pensions available from life insurance companies	A two phase reform strategy was announced in 1998. The first phase was largely organisational, involving for example the introduction of single social security number. The second phase requires a major overhaul of public pensions, and could involve the consolidation of retirement ages in different pension regimes, adjusting contribution and eligibility rates to sustainable levels, and the introduction of compulsory occupational pension scheme. Announcements on the second phase are still being awaited.
Spain	**1.** Earnings-related scheme **2.** Voluntary, mainly company-based schemes covering about 15% of the working population **3.** Personal pensions available from life insurance companies and pension funds	Important reforms were introduced in 1997 (based on the 1995 Pacto de Toledo) which placed public pensions on a more sustainable footing. Further reforms are scheduled for 2000. They will need to address measures to increase the effective retirement age and discourage early retirement, and special pension regimes (e.g. covering self-employed, agricultural workers). In 2000, minimum pensions will increase by between 5.4 and 16 per cent depending on the type of pension, though on average by only slightly above 5.4 per cent. In 2000 a Social Security fund reserve has been created to address the problem of the ageing population . The initial fund amounts to 0.1% of GDP and there is a commitment in the updated Spanish Stability Programme to further increase this fund reserve.
France	**1.** Earnings-related schemes **2.** Compulsory, pay-as-you-go financed occupational scheme based on cross-sectoral collective agreement, some additional, mainly company-based voluntary schemes **3.** Personal pensions available from life insurance companies under favourable tax conditions	After postponing reforms adopted in 1997, a report was presented in 1999 to serve as a basis for dialogue between authorities and social partners which is now taking place. Reforms are scheduled for 2000 and could include measures to raise the effective retirement age, whether special pension regimes need to be brought in line with the 'general regime', and possible strengthening of a Social Security reserve fund which was established in the 1998 budget.
Ireland	**1.** Flat-rate scheme based on contributions **2.** Voluntary, mainly company-based schemes covering about 50% of the working population **3.** Personal pensions available from life insurance companies under similar tax conditions to those that apply to 2nd pillar schemes	In May 1998, the Government outlined its plans for creating a fully developed pension system. As part of the 1999 budget, an annual provision of 1% of GDP will be made to pre-fund future public pension costs. This fund was supplemented with part of the proceeds from the privatisation of the State telecom company. Part of the proceeds were also use to buy-out the State's future pension liabilities to pre-privatisation staff.

Country	Main features of pension systems (Pillars 1, 2 and 3)	Recent reform measures
Italy	**1.** Earnings-related scheme **2.** Schemes based on collective agreements for a company, a group of companies or an industry **3.** Personal pensions available from open pension funds and from life insurance companies under favourable tax conditions	A series of reforms in the 1990s, the last one in 1997, have contributed to stabilise the ratio of pension expenditure to GDP in the medium term, but it remains high. The main weaknesses of past reforms are excessively long transition periods, 'excessive' generosity, and uncertainty about future reforms. No reforms were undertaken in 1999.
Luxemburg	**1.** Earnings-related scheme **2.** Voluntary, mainly company-based schemes covering about 17% of the working population **3.** Personal pensions available from life insurance companies	Reforms were introduced in 1998 to align the pension regime for new public servants with that applying to the private sector.
Netherland	**1.** Flat-rate scheme based on residency/employment **2.** Mainly sector-wide schemes based on collective agreements covering about 90% of the working population **3.** Personal pensions available from life insurance companies under favourable tax condition	With a large proportion of pensions already funded, the impact of ageing populations is being addressed via the reduction of public debt and measures to increase employment rates.
Austria	**1.** Earnings-related scheme **2.** Voluntary, mainly company-based schemes covering about 11% of the working population **3.** Personal pensions available from life insurance companies	Large reform packages were adopted in 1993 and more recently in 1998. The latter reform addressed incentives for early retirement, tightened up eligibility for disability pensions, and aligned the pension system for civil servants to the general system. Also an annual adjustment formula was introduced making an adjustment for the financial impact of increased life expectancy. This was, however, suspended in 1998 and 1999 and must be addressed in 2000.

Country	Main features of pension systems (Pillars 1, 2 and 3)	Recent reform measures
Portugal	**1.** Earnings-related scheme **2.** Voluntary, mainly company-based schemes covering about 7% of the working population insured under the general social security system **3.** Personal pensions available from life insurance companies and pension funds	A new framework law was presented by the new Government in late 1999 in response to a White Paper presented in 1999. Reforms are therefore expected to be adopted in 2000. Inter alia, it will need to address the creation of a compulsory second pillar contributory based scheme, and tackling early retirement.
Finland	**1.** Flat-rate public scheme based on residency **2.** Compulsory occupational schemes (pay-as-you-go and funded) and additional voluntary schemes **3.** Personal pensions available from life insurance companies	During 1999, agreement was reached between labour market organisations on measures to postpone early retirement and extend active participation. Together with a large primary balance, this will make it easier to meet increased age-related expenditures in coming years. However, questions remain about the long-term sustainability of existing public pension schemes, and further reforms are likely to be required to tackle imbalances at source.
Sweden	**1.** Earnings-related scheme **2.** Mainly sector-wide schemes based on collective agreements covering about 90% of the working population **3.** Personal pensions available from life insurance companies or banks or through direct capital market investment	Reforms adopted 1998 are currently being phased in. They are increasing the degree of funding pensions. They also establish a closer link between contribution paid and benefits received, and indexation clauses were adjusted.
United Kingdom	**1.** Flat-rate scheme based on contributions and state earnings related pension scheme (SERPS) **2.** Voluntary, mainly company-based schemes. Can be used as a substitue for SERPS and cover about 46% of the working age population. **3.** Personal pensions available from life insurance companies. Can be used as a substitue for SERPS.	Projections released in 1999 show a broadly sustainable long-term position for the UK's public finances. Extensive reforms were proposed in late 1998 and adopted in 1999. They provide for a 'minimum income guarantee' and a replacement of SERPS (state earnings related pension scheme) with a second flat rate pension.