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Pension sustainability in the euro area – fiscal risks associated to demographic and macroeconomic uncertainties and policy options

- Issues note -

(Note for the attention of the Eurogroup)

Pension sustainability in the euro area – fiscal risks associated to demographic and macroeconomic uncertainties and policy options

Introduction

Significant progress has been achieved in terms of pension sustainability, but risks remain in many euro area countries, especially over the medium-term. The increase in government debt since 2008, together with the budgetary pressures posed by population ageing, including pension expenditure, compound each other in raising the challenge for fiscal sustainability. There has been considerable progress with structural reforms in the field of pensions: according to the latest long-term projections of the 2015 Ageing Report, the public pension expenditure ratio is projected to be broadly stable in the euro area between 2013 and 2060 (around 12% of GDP).

Nonetheless, pension expenditure still poses fiscal sustainability risks in the medium- and the long-term for eleven euro area Member States, while there are often long phasing-in periods of the pension reforms, implying a continued increase in pension expenditure over the next two decades in the euro area. The 2009 financial and economic crisis, as well as some pension measures, ⁽¹⁾ also translated into a higher level of public pension expenditure ratio in 2013 compared to past projections.

Uncertainties surrounding pension projections must be appropriately grasped and adequate policy options further explored. The Eurogroup at its meeting of 7 December 2015 acknowledged both the considerable progress achieved with structural reforms in the field of pensions as well as the remaining fiscal sustainability risks associated to population ageing. It pointed to the need to complement these reforms with flanking policies, to ensure social acceptability and therefore durability of pension reforms.

Bearing in mind the considerable uncertainty as to future developments of pension expenditure, the Eurogroup invited the Commission to prepare alternative projections with more downside assumptions to stress test the resilience of Member States pension systems. The Eurogroup Working Group was also invited to look into additional policy measures, especially regarding the labour markets, to complement pension reforms, and more generally support productivity, employment, potential growth, and hence sustainable public finances.

Main upward risks to pension expenditure under less favourable underlying assumptions

⁽¹⁾ For example, some countries shifted their private pensions to the public pillar (e. g. Slovakia). Planned future increases of the retirement age, as well as tightening conditions to access early retirement, can also lead in the short-term to "a run for retirement" for those persons who are currently eligible to retire.

Less favourable demographic or macroeconomic assumptions would entail a higher increase of public pension expenditure in the euro area over the long-term. Given the uncertainties surrounding any long-term projection exercise, the Commission and the Member States agreed on a series of sensitivity tests that have been carried for the 2015 Ageing Report, regarding both demographic and macroeconomic assumptions.

Specifically, it is found that at the euro area aggregate level, assuming higher life expectancy gains (of two years compared to the baseline) would entail a higher increase in pension expenditure over the long-term (+0.4 pp. of GDP). Similarly, assuming lower productivity growth (the 'TFP risk scenario' entailing labour productivity growth of 1.2% instead of 1.5% annual growth rate assumed in the baseline) would result in a higher pension expenditure ratio by 2060 (+0.5 pp of GDP). Indeed, as pensions are not fully indexed to wages in a number of countries (but generally evolve in line with inflation), slower growth translates into a growing gap between pensions in payment and current salaries (hence, an increase of the benefit ratio). ⁽²⁾

Not all Member States are exposed in the same way to upward risks due to different public pension system characteristics.

- Countries with in-built automatic adjustment mechanisms in their pension systems, mainly acting on the expenditure side (such as automatic balancing mechanisms, sustainability factors and / or retirement age linked to life expectancy), present much less sensitive projections to more adverse demographic or macroeconomic developments. For instance, in five euro area countries (Cyprus, Slovakia, Latvia, the Netherlands and Spain), the impact of higher life expectancy gains on public pension expenditures would be limited (less than +0.2 pp. of GDP), all having legislated automatic adjustment mechanisms.
- Regarding the effect of lower productivity growth, on one hand, it is found to be negligible in countries applying indexation rules connected to wage growth (e. g. in Ireland, Lithuania and the Netherlands).
- On the other hand, another group of countries, which project substantial decreases of pension spending, appear to have pension systems that are quite sensitive to such macroeconomic assumptions (e. g. Italy and France, which apply price-indexation).
- Some countries, which already project substantial increases of public pension expenditure in the baseline scenario, exhibit in addition a significant sensitivity to adverse shocks (e. g. Slovenia, Malta, Belgium and Luxembourg).

⁽²⁾ On the contrary, in case of faster growth, average pensions do not fully benefit from the effects of growth and the benefit ratio tends to decrease.

- If implementation risks were to materialize (e.g. through the reversal of planned increases of the retirement age or tightening rules in pension benefits' calculation and indexation), pension expenditure trends would be particularly worsened in countries projecting high increases of the old-age dependency ratio (e. g. Slovakia, Portugal, Greece, Slovenia and Cyprus).
- At the same time, the risk of reform reversal may be more pronounced in those Member States where, based on current legislation, future pensioners are projected to experience the strongest decreases of the benefit ratio and the replacement rate (e. g. Cyprus, Portugal and Spain). ⁽³⁾

Under such more adverse demographic or macroeconomic assumptions, fiscal sustainability risks would be significantly increased. In particular, under a less favourable combined scenario in terms of TFP growth and longevity risk, the long-term fiscal sustainability gap (S2) would be increased in most of countries (with some of the biggest increases projected in Belgium, France, Luxembourg and Italy). At the aggregate level, S2 would increase by ¾ pp. of GDP in the euro area, reaching a level signalling *medium* long-term fiscal sustainability risks (against *low* risks under the baseline scenario).

Policies to address adverse risks / sustainability challenges

Further policy actions are needed to ensure the lasting success of past pension reforms, strengthen the resilience of public pension systems to adverse demographic and / or macroeconomic developments and support more generally fiscal sustainability. The Council reaffirmed the need in March 2016 to continue appropriate policy action on all age-related areas taking into account country-specific situations and avoiding measures that reverse sustainability-enhancing reforms already undertaken.

Complementing pension reforms with flanking policies, especially on the labour market, so that workers can continue in employment as retirement ages go up is necessary in order to ensure the social acceptability and therefore the durability of enacted pension reforms.

Furthermore, given the uncertainties surrounding pension projections, a particular attention should be put on resilience-enhancing measures, ensuring that public pension system sustainability can be preserved even under adverse conditions.

⁽³⁾ The benefit ratio is the ratio between average public pension benefits and the economy-wide average wage. The replacement rate is the ratio between the average first public pension (old-age earnings-related part) and the average wage at retirement. In Cyprus, Portugal and Spain, the benefit ratio is projected to decline by around 20 pp. over the period 2013-60 (against -9.5 pp. on average in the euro area). The replacement rate is projected to decrease by more than 30 pp. in Spain, and close to 27 pp. in Portugal over the same period (against around -9 pp. on average in the euro area). Other income than public pensions (e.g. private pensions and savings) also need to be taken into account when assessing risks related to declining benefit ratios.

Finally, ensuring the sustainability of pension systems involves more generally the adoption of policies supporting productivity, employment and potential growth.

Specifically, different policies are needed to address these future challenges:

(i) In order to ensure the social acceptability of enacted pension reforms and reduce the risk of reform reversals, they should be complemented by flanking policies so as to support retirement incomes. In particular, these policies should seek to:

- boost retirement incomes by extending working lives, e.g. through measures aiming at increasing older people employability, and
- provide other complementary means of retirement incomes, e.g. through additional pension pillars.

Extending working lives entails enabling older people to continue working, through appropriate flanking policies, including by putting in place the right incentives to work, life-long learning aimed at maintaining and expanding their skills (i.e. vocational training), adaptations in the work place and flexible working arrangements to cater for the heterogeneity of the work force.

Such policies are all the more needed in those Member States lagging behind the euro area average in terms of participation and employment rates of older workers (e. g. Slovenia, Luxembourg, Malta, Greece and Belgium where the participation rate of the age group 55-64 remained 10 pp. or more behind the EA average in 2015).

Increasing the employment rate of older people (by 10 pp. compared to the baseline for the age group 55 – 74) would significantly decrease the public pension expenditure ratio in a number of countries (e. g. by more than 0.5 pp. of GDP in Belgium, Slovenia, Austria and Portugal).

Though challenging in the present economic and fiscal climate, encouraging complementary private pension pillars could support retirement incomes, through a higher accumulation of non-public pension rights, as well as provide, to some extent, a buffer against adverse shocks, by diversifying pensioners' sources of income. Such policies should be put into place sufficiently early as the build-up of supplementary savings takes time. Based on the 2015 Ageing Report, private pension pillars are expected to play a significant part in retirement income provision in less than 10 countries in the long-term (e.g. Estonia, Latvia, Lithuania and the Netherlands for euro area members).

(ii) For countries that have not yet done so, the introduction of automatic pension adjustment mechanisms should be favoured as a way to cater for the massive but slow-moving increases in life expectancy in the future and to enhance the resilience of pension systems to adverse shocks. Such a promising avenue has been already explored by several euro area countries (e.g. in Italy, Portugal, the Netherlands, Cyprus, Slovakia, Spain and Finland) - for example, it entails linking the retirement age to gains in life expectancy, or introducing a sustainability factor,

according to which the pension benefit is adjusted to reflect changes in life expectancy.

Specifically, the introduction of an automatic link between the retirement age and gains in life expectancy, presents the advantage of supporting pension adequacy, by increasing the benefit ratio, in addition to enhancing fiscal sustainability and resilience to longevity risks. At the euro area aggregate level, introducing a link between the retirement age and life expectancy would decrease the public pension expenditure ratio by 0.5 pp. of GDP, while increasing the benefit ratio by around 1½ pp. by 2060. The adoption of such a policy tool would have particularly substantial impacts (above 1 pp. of GDP) in Luxembourg, Belgium, Malta and Austria, in line with the 2015 country-specific recommendations.

(iii). Measures favouring higher employment rate, especially for older workers, are key ingredients contributing to improve pension system sustainability.

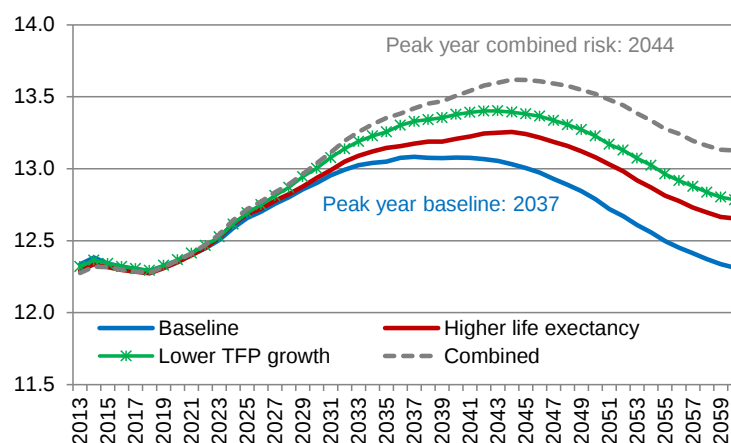
Even if unemployment has started to decrease against the backdrop of a gradual recovery, it remains historically high, and job creation should remain a key focus of reform efforts. Effective labour market policies, entailing putting the entire work force including older workers to full use, are particularly important in the euro area to help convergence across Member States. Specifically, and in line with the Council recommendation 2 for the euro area, these policies should combine:

- flexible and reliable labour contracts that promote labour market transitions and avoid a two-tier labour market;
- comprehensive lifelong learning strategies;
- effective policies to help the unemployed re-enter the labour market;
- modern social protection systems that support those in need and provide incentives for labour market integration;
- a reduction of the tax wedge on labour, particularly on low-wage earners, in a budgetary-neutral way to foster job creation.

Moreover, continuing emphasis should be put on the improvement of wage setting frameworks so that real wages and productivity developments are properly aligned over time.

Annex

Graph A.1: Projected public pension expenditure ratio in the euro area under different scenarios
(% of GDP)



Source: AR 2015

Table A.1: Classification according to projected change in pension expenditure in baseline scenario and sensitivity to adverse demographic and macroeconomic shocks

Baseline scenario - public pension expenditure ratio change (2013-60, pp. of GDP)	Sensitivity to adverse shocks	
	Small to moderate (< 0.5)	Moderate to high (>= 0.5)
Increase above 2 pp. of GDP	DE*, SK*	LU, SI, MT
Increase between 0.5 and 2 pp. of GDP	IE+, NL*+, CZ, UK+	BE
Increase between 0 and 0.5 pp. of GDP	LT+, FI*	AT
Decrease between -0 and -1 pp. of GDP	HU, CY*, RO, BG, PL*, ES*	PT*
Decrease between -1 and -2 pp. of GDP	EE, SE*+, EL*	IT*
Decrease larger than -2 pp. of GDP	LV*, DK*+, HR	FR*

Source: AR 2015, updated for BE (November 2015)

* Countries with legislated automatic balancing mechanisms, sustainability factors and / or retirement age linked to life expectancy. + Countries with wage indexation (by law or used in the projections in the absence of a fixed rule).

Note: the sensitivity tests considered are the 'higher life expectancy', the 'lower migration', and the 'lower TFP growth' scenarios.

Table A.2: Impact of unfavourable sensitivity tests on public pension expenditure change over 2013 – 2060 (deviation from baseline change, pp. of GDP)

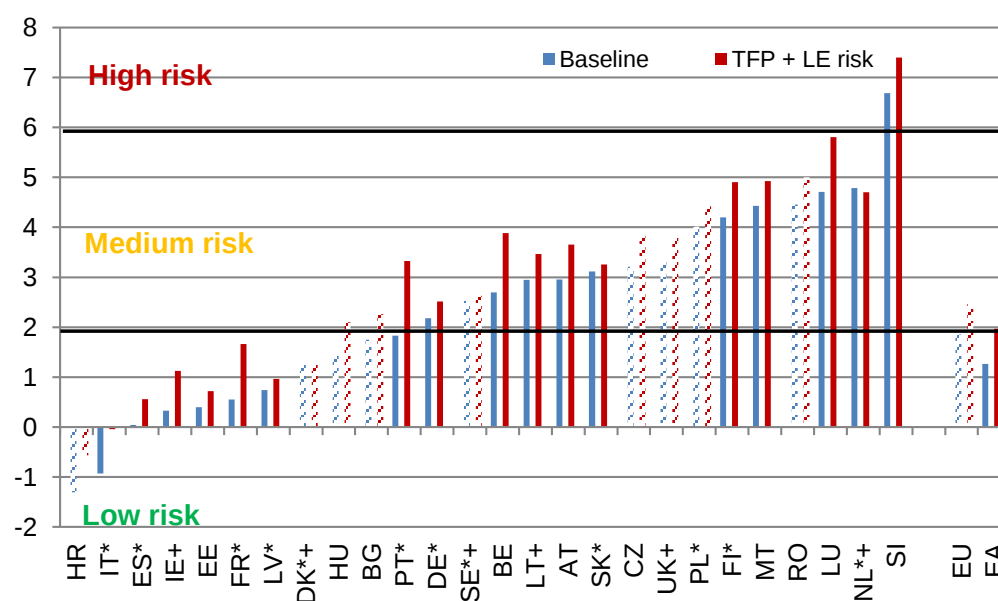
Countries	Change 2013-60 baseline	Impact of			
		Higher life expectancy	Lower migration	Lower TPF (risk scenario)	Lower employment rate
LU	4.1	0.4	0.8	1.1	0.1
SI	3.5	0.9	0.5	0.3	0.4
MT	3.2	0.6	0.6	0.4	0.1
DE*	2.7	0.4	0.2	0.1	0.1
SK*	2.1	0.0	0.1	0.4	0.3
BE	1.3	0.7	0.5	0.9	0.3
IE+	1.1	0.4	0.3	0.0	0.2
NL*+	0.9	0.1	0.1	0.0	0.2
CZ	0.7	0.6	0.3	0.4	0.2
UK+	0.7	0.5	0.2	0.0	0.1
AT	0.5	0.4	0.8	0.6	0.3
LT+	0.3	0.6	0.3	0.0	0.2
FI*	0.1	0.3	0.4	0.6	0.0
HU	-0.1	0.5	0.2	0.4	0.0
CY*	-0.1	0.0	0.6	0.3	0.1
RO	-0.1	0.4	0.0	0.4	0.2
BG	-0.4	0.6	0.1	0.3	0.1
PL*	-0.7	0.3	0.2	0.4	0.1
PT*	-0.7	1.0	0.3	1.2	0.3
ES*	-0.8	0.1	0.2	0.2	0.1
EE	-1.3	0.4	0.1	0.1	0.0
SE*+	-1.4	0.2	0.2	0.1	0.1
EL*	-1.9	0.2	0.1	0.9	0.1
IT*	-1.9	0.4	0.4	0.7	0.1
FR*	-2.8	0.5	0.2	0.8	0.2
LV*	-3.1	0.1	0.1	0.1	0.0
DK*+	-3.1	0.2	0.2	0.0	0.1
HR	-3.9	0.5	0.1	0.3	0.2
EU	-0.3	0.4	0.2	0.5	0.1
EA	-0.1	0.4	0.3	0.5	0.1

Source: AR 2015, updated for BE (November 2015)

* Countries with legislated automatic balancing mechanisms, sustainability factors and / or retirement age linked to life expectancy. + Countries with wage indexation (by law or used in the projections in the absence of a fixed rule).

Note: The following thresholds are used for the heat map: *green* when the impact is lower than 0.2 pp. of GDP (lower impact); *dark green* when the impact is between 0.2 and 0.5 pp. of GDP; *orange* when the impact is between 0.5 and 0.8 pp. of GDP; *red* when the impact is between 0.8 and 1.1 pp. of GDP and *dark red* when the impact is above 1.1 pp. of GDP (stronger impact).

Graph A.2: Long-term sustainability indicator S2 – baseline versus more adverse combined TFP and longevity risk scenario (pp. of GDP)

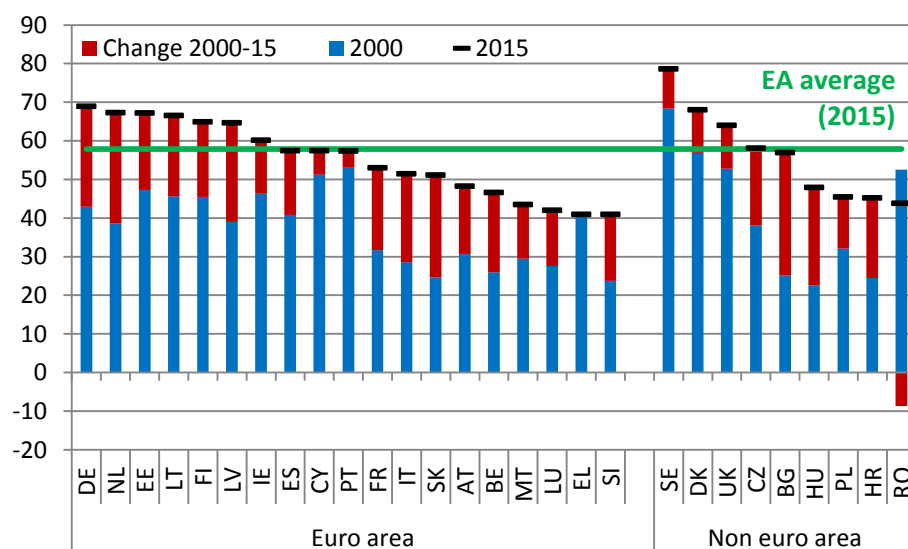


Source: Commission services

* Countries with legislated automatic balancing mechanisms, sustainability factors and / or retirement age linked to life expectancy. + Countries with wage indexation (by law or used in the projections in the absence of a fixed rule).

Note: ageing costs have been updated in November 2015 for BE compared to the 2015 AR to reflect recent pension reform; calculations are based on latest Commission Winter 2016 forecasts.

Graph A.3: Participation rate 55-64, by country
(% and pp. change)



Source: Eurostat

Table A.3: Countries with automatic balancing mechanisms, sustainability factors and / or links to life expectancy in pension systems

Country	Automatic balancing mechanism	Sustainability factor (benefit link to life expectancy)	Retirement age linked to life expectancy	Legislated
Italy		X	X	1995 & 2010
Latvia		X		1996
Poland		X		1999
Sweden	X	X		2001 & 1998
France*		X		2003
Germany	X			2004
Finland		X	X	2005 & 2015
Portugal		X	X	2007 & 2013
Greece			X	2010
Denmark**			X	2011
Netherlands			X	2012
Cyprus			X	2012
Slovak Republic			X	2012
Spain	X	X		2013 & 2011

Source: AR 2015, updated for FI

*Pension benefits evolve in line with life expectancy, through the coefficient of 'proratisation'; it has been legislated until 2035 and not thereafter.

**Subject to parliamentary decision.