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Volume Title: Social Security Pension Reform in Europe

Volume Author/Editor: Martin Feldstein and Horst Siebert, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-24108-4

Volume URL: http://www.nber.org/books/feld02-2

Conference Date: March 20-21, 2000

Publication Date: January 2002

Title: Introduction: A European Perspective

Author: Horst Siebert

URL: http://www.nber.org/chapters/c10667

Introduction
A European Perspective

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The Issue

In the major continental countries of Europe, as the population ages, a larger proportion of gross domestic product (GDP) will have to be spent to finance pay-as-you-go systems. In Italy, which other than Germany has the most acute expected population decline (see appendix table A.1), the share of expenditures for the pay-as-you-go (PAYGO) system in relation to GDP is expected to reach a peak of 15.8 percent in 2032 (Organization for Economic Cooperation and Development [OECD] 2000, fig. 27). This figure holds even after the Dini and Prodi reforms, and while assuming constant contributions (see fig. 1 in this introduction). The gap between expenditures and (constant) contributions and the budget deficit in proportion to GDP illustrated the issue of financial viability. For Germany,[1] earlier estimates indicate a peak of 17 percent (OECD 1995, fig. 13; these estimates do not include the pension reform of 2001). For France, where the population decline will be somewhat less pronounced, the Charpin Report (Charpin 1999) expects the share of social security expenditures in GDP to rise to 15.8 or 16.7 percent in 2040, based on two different scenarios, both assuming constant contributions.

The required contributions to a mandatory public PAYGO system place a high burden on the young, who must also accumulate private funds for their old age because the official systems have lost the credibility regarding

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The author appreciates critical comments from Klaus-Jürgen Gern and Jens Oliver Lorz.

1. The figures for Germany exclude statutory transfers from the federal government.

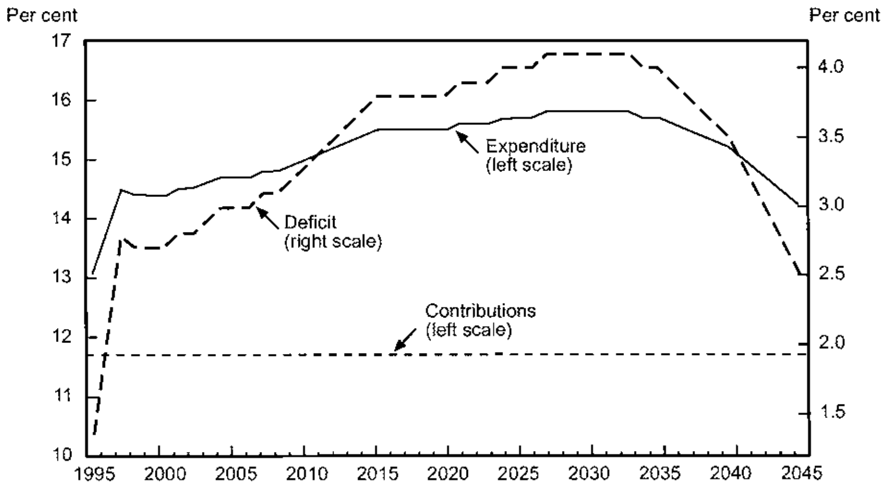

Fig. 1 Italy, postreform expenditures
Source: OECD (2000, Figure 27).

their ability to deliver their promised payments in the future. This situation does not appear to be sustainable. The younger generation are unlikely to be willing to give up such a large part of their income in the form of required contributions, and they are likely to renege on their generation's contract. This means that the existing old age systems are not politically viable. Moreover, the international competitiveness of jobs in countries having large future burdens because of required contributions to pension systems is severely affected, because, with the linking of system financing to the work contract, labor costs will be relatively high. All this implies that changes in the status quo are necessary.

The problem in Europe is more acute than anywhere else in the world, except Japan. There are two reasons for this: The aging of the population is more pronounced in Europe than elsewhere, and the welfare state has been extended throughout Europe more than in other parts of the world. Within Europe, the pension crisis is a continental problem; it is less a problem for the United Kingdom (with estimated social security expenditures of 6 percent of GDP by 2030; OECD 1995, fig. 13). Some smaller countries have old age assistance systems that are less prone to problems (for example, Denmark, the Netherlands, and Switzerland), whereas others (Sweden, for example) have introduced some of the necessary changes to their systems already. In Eastern Europe, some countries have made the same mistakes as Western European countries, and thus are under even greater pressure to change their systems.

In Europe, the problem of the PAYGO system is an issue not only of financial sustainability, but also of labor market distortions and resulting

unemployment. Contributions to the pension system have an incidence similar to an explicit tax on labor; they weaken the demand for labor, which in turn implies a lower net wage. Where trade unions succeed in keeping the wage rate high, unemployment follows. The tax wedge between the producers' wage and the consumers' wage differs among European countries: Contributions are low in countries using tax finance (creating another tax wedge), but contributions paid by firms run as high as 64 percent of financing costs in France and 80 percent in Italy. As an additional distortion, there is an implicit tax on work before retirement, especially in the age group between 58 and 65; that distortion creates an incentive to retire early. This further aggravates the pension crisis.

The Illusionary Way Out: Other Avenues of Financing

As one way out of the looming crisis, European governments have attempted to find new sources of financing their public systems without really attacking the root of the pension crisis.

Because contributions to defined benefit (DB) types of systems are already high and cannot be increased without major opportunity costs, one of the practices followed is to enlarge the group required to contribute in the hope of increasing the financial means available—for instance, to include the self-employed. However, this forces more people into the governmental system to claim benefits in the future. It also means reducing the chances for a voluntary, privately funded system (i.e., for individual [retirement] saving).

In the search for new sources of finance, another option is general taxation. In this case, the future generation will have to carry the burden in the form of taxes. However, tax financing weakens the links between contributions and benefits in the pension system. It therefore represents a larger distortion of incentives and implies a larger deadweight loss if the given level of benefits is sustained. Shifting to a tax-financed general basic pension system (as in Denmark) or to a flat-rate benefit system with flat-rate contributions (as in the United Kingdom) would imply reducing the benefit level drastically. Even if it were desirable, it would not be politically feasible.

A related approach is to introduce into the public schemes a new basic pension for everyone, as a lower floor for old age income. Such a pension would be financed by general taxes. The motivation for a basic pension is to prevent old age poverty, especially for those who have not been regularly employed during their lifetimes and thus have "broken biographies." As discussed in Germany, this would introduce both an income floor and means-tested social welfare benefits. It could be expected to have distortionary effects that are stronger than those discussed for the existing PAYGO system financed by contributions.

An ecological tax is another alternative. The motivation behind it is to tax activities straining the environment and to use the tax receipts to finance pensions, thus lowering mandatory contributions and reducing the tax on labor. The theoretical hope is for a double dividend that could come from reducing the tax wedge that exists because we do not pay to use the environment. In Germany, such an ecological tax has been introduced by the new government, although it is merely an increase in the existing oil tax and a new tax on electricity, not a carbon dioxide emissions tax designed to help solve the global warming problem. Thus, its link to the environmental problem is weak. Moreover, the tax affects productivity negatively and lessens the competitiveness of environmentally intensive industries when applied unilaterally by only one country. Consequently, in Germany, exemptions were made for very pollution-intensive activities. Furthermore, it is questionable whether a country should link the financing of its pension system to the receipts of taxing a factor input that must be imported. All in all, making energy more expensive (by "fueling up for pensions") does not seem to be a promising way to solve the pension crisis.

The Mitigating Way Out: Changing the Supply of Labor

Another approach to mitigating the pension crisis is to change the supply of labor effectively.

Because the implicit tax on labor prior to retirement provides an incentive to retire early, doing away with this tax would help reduce the magnitude of the pension crisis by lowering expenditures and increasing the receipts from the tax system. This implies increasing both the statutory and the effective ages of retirement, in some countries by at least five years. Eligibility rules for early retirement would have to be tightened. In a number of countries (e.g., Germany, Italy, United Kingdom) this approach is already being applied.

Another realistic avenue for developing new financial proceeds for the PAYGO system is to increase immigration. Immigration of young people will add to the work force, and immigration of workers with high skills will raise productivity. This will increase the base for contributions to a pension system.

A Realistic Way Out: Reduce the Benefit Level

The PAYGO system is an implicit public debt, that should be made explicit. However, to consider explicitly the existing pension debt under an intertemporal budget constraint is not sufficient to solve the pension crisis. An automatic mechanism must be established that prevents an excessive rise in the implicit debt. That is, the system must adjust its benefits in accordance with the intertemporal constraint. This is the most important

implication for ameliorating the future pension crisis in Europe: a reduction in the benefit level. Toward this end, governments so far have used an ad hoc approach, such as increasing the period of earnings referred to in the calculation of benefits (Belgium, Finland, France, the Netherlands, and Spain). Indexation rules also have been changed.[2]

The more systematic task, however, is to find a formula that expresses the intertemporal budget constraint. This requires a calculation of future contributions to and future payments by the system, one that links benefits to contributions with some smoothing between periods. This approach necessitates a forecast of the demographic development of a country. For instance, introducing a demographic factor for life expectancy into the pension formula will lower the increase in pensions in an aging population. Alternatively, a "generation factor" specific to each cohort can be selected so that reductions will apply only to new cohorts of pensioners. Either way, the benefit level of the PAYGO system is reduced.

This approach also requires a political decision about the acceptable level of the future burden.[3] In Germany, for example, the pension reform of 2001 reduces the benefit level of the PAYGO system from 70 percent of the previous net wage to 67 percent, while at the same time raising the overall benefit level (including private benefits) to 75 percent. Thus an aging society, amazingly, ends up with a higher benefit level. It is obvious that the political process has attempted to postpone the necessary marked reduction of benefits in the PAYGO system until far into the future.

The Attractive Way Out: Introduce a Funded Pillar

Reducing the pension level by making explicit the intertemporal budget constraint is not an appealing political solution because it only implies that pensioners will receive relatively less than they do today. A more appealing political solution would also make the old age insurance system more attractive. The answer, therefore, is to introduce a "funded pillar."

There are different ways to introduce a funded pillar (see the papers in this volume). Although in principle it can be achieved in a centrally funded governmental system, a privately organized system would be more robust against political seizure (see below). The continental countries are unlikely to switch to a completely funded system. As of now, a major shift (of, say, 20 percentage points or more) to covering a larger share of pensions will not likely occur. In either case, a mandatory funded insurance system would be required. Rather, the European countries probably will undertake only a marginal shift, so that the funded private pillar will account

2. Basic benefits have been made subject to an income test (Finland, Sweden; Gern 1998).

3. How far the pension will have to fall depends on the other instruments (such as increases in contributions and in the effective retirement age) being applied.

for a smaller percentage of the pension,[4] and will be built up by a voluntary additional private insurance, with a favorable tax treatment for contributions. Pensions then would be taxed as ordinary income. To make such insurance mandatory would be necessary only if a major shift occurred.

If Europe were to undertake a privately organized and funded system only marginally, then the pension crisis would not be solved in the most effective way. Europe would not get the full premium from making the systems more actuarially fair (Lindbeck, chap. 1 in this volume), and thus could not reduce its costs for financing old age pensions considerably. Thus, it can only be hoped that the comparison between the PAYGO system in the first pillar and the funded system in the second pillar eventually will prove that the funded system has higher efficiency. In the end, political pressure will work in favor of a funded system.

In changing partially to a funded system, maintaining clear-cut private property rights on the pension claims of individuals has an important advantage. For example, in the case of bankruptcy, such legally protected accounts strengthen the interest of individuals in their pension system and represent a safeguard against political seizure. Notional accounts within the PAYGO system are a first step in the direction of legally protected claims.

There are other risks, as well: Politicians are tempted to work for the benefit of the current generation and to neglect future generations. They may have specific groups of the electorate in mind, wanting to maximize political support for their own parties. For instance, they might want to ease the unemployment problem by using the revenues of the pension system. Finally, there is another relevant risk: Funds put aside for pensions can be used for industrial policy and for controlling the economy. At the extreme, funding pensions thus would lead to the socialization of firms.

Privately managed occupational pension schemes may represent another important avenue for helping to solve the pension crisis. In order to prevent political influence, they must be privately managed. They cannot be mandatory, either for firms or for employees, because they would otherwise represent a tax on labor. Finally, portability of the claims in such systems would have to be insured. Otherwise, labor mobility would be reduced.

One important aspect of shifting to a (partially) funded system is the uncoupling of the financing of the pension system from the work contract.[5]

4. Nevertheless, the intended 4 percent of the gross wage contribution in Germany (in 2008) for which favorable tax treatment is envisioned amounts to an increase in the benefit level of 8.5 percentage points of the previous wage in 2030 of the pensioners' cohort (and to 16 percent in 2050), assuming an interest rate of 4 percent.

5. Another implicit assumption was a single earner in a family with insurance coverage for the whole family. In this case, family breakups are a problem; furthermore, the labor participation rate of women has risen. The issue is to what extent insurance claims must be defined for the individual.

The old system has as its premise the full-time worker. This premise is no longer valid, however; socioeconomic change is affecting the basis of the European social insurance systems. Part-time workers are more typical; the time profile of the working life varies; and the self-employed play a more important role than before. Income from labor is not the only source of income, with personal wealth becoming more widespread. These sorts of change would suggest raising the net wage by the amount that firms pay and then giving individuals more choice in how much insurance they want.

Two major questions for Europe are: Which role should actuarial equivalence between contributions and benefits play, and which weight should be given to redistribution (from higher market income of individuals to lower market income) within the pension system? Redistribution has distorting incentive effects; a stronger link between contributions and subsequent pensions reduces these negative incentive effects and builds a strong vested interest in a funded system. If more equivalence is accepted as the guiding principle for the reorganization of the pension system, then distributional concerns will have to be taken care of outside the pension system by the tax-transfer mechanism (for instance, families with children may receive a tax break). When the pension level is not satisfactory at the end of a working life, welfare payments would fill the gap.

If the income floor of social welfare benefits cannot be reduced, the scope of European governmental maneuvering to lower the basic pension of the PAYGO system is limited. It seems difficult to reduce the public PAYGO system below the level defined by social welfare payments. However, the funded portion of pensions could be organized as a mandatory substitution for some of the current PAYGO portion.

Thus, restricting the PAYGO system in some of the European countries is related to rearranging the income floor provided by social welfare. However, this is a highly complex issue. We might redefine the criteria of eligibility for social welfare, not for the elderly, but for those who are able to work. We could reduce the benefit level for them, make it more difficult to receive social welfare, or reduce their option to say “no” to jobs offered. This would have no direct effect on welfare as an income floor for the pension system, however, but it would represent a psychological redefinition of the income floor and thus of the income level that individuals require from the government. This could have an indirect effect on behavior, by emphasizing the importance of self-reliance in preparing financially for retirement.

If the income floor of social welfare benefits could not be reduced, then European governments would have only a limited space within which to lower the basic pension under the PAYGO system. As a consequence, there would be little room for a funded system.

Some Additional Specific European Issues

There are also some specific issues of the pension system in an increasingly integrated Europe. The existing systems have developed as national insurance schemes. They differ considerably with respect to the levels of benefits, the rates of contribution, and the means of financing (contributions versus tax financing, and the role of funding relative to the PAYGO system). The issue is how these national systems cope with higher labor mobility in Europe. Moreover, national systems will be under pressure in a single market with higher capital mobility if the labor costs they generate impede the competitiveness of firms and reduce returns to mobile capital.

One basic question is whether membership should be mandatory, and if so, how mandatory membership in the different pillars should be defined—in other words, who must be a member of which system? Should membership be by nationality (where one was born) or by residence (where one works, where one lives)? Or should membership in old age insurance be left to individual choice? This issue corresponds to the problem of how to organize the systems.

It might be tempting to apply the country-of-origin principle (the Casis-de-Dijon verdict of the European Court of Justice) to the first pillar and to give individuals a choice of which national system they wish to join; thus national systems would compete with each other, which would put pressure on the national systems to adjust. With noticeable differences between existing national systems, however, huge (and unpredictable) adjustments would occur. It is unlikely that this approach will be taken.

The Europeanization of pension systems, that is, a harmonized European first pillar, may be considered by some as part of a social union. However, it does not appear to be realistic. It would have the severe disadvantage of introducing even more redistribution into the system, along with less equivalence and a greater risk of political seizure of accounts by a centralized Europe.

The pension system in Europe therefore must rely on the territoriality principle (*"cuius regio eius religio"*) for insurance, with residency being the criterion for membership in the first pillar.[6] To move toward a Europe-wide system is simply not a policy option.

One practical problem that must be addressed is portability; that is, what happens to the claims of individuals if workers switch from one national system in the first pillar to another because of cross-border mobility? European integration implies that we must move toward portable claims in the national systems. For example, a Belgian who has moved to

6. This would be in line with uncoupling social insurance from the work contract. Otherwise the workplace may be the criterion for membership.

France either continues to be covered by his original Belgian insurance, or his claim is made transferable to the French system.

The issue of portability is linked to the question of how much the PAYGO system can be pushed back and a privately organized, funded system introduced in its place. The more actuarial equivalence is established, the easier it is to solve the problem of portable claims. Therefore, the practical requirement of portability is yet another reason that it might be necessary to introduce more actuarial equivalence and to uncouple the financing of old age insurance from the work contract.

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