THE SUSTAINABILITY OF PENSION SYSTEMS.

The sustainability and adequacy of pension systems depends on the degree to which they are underpinned by contributions, taxes and savings from people in employment. Financing arrangements, eligibility conditions and labour market conditions must be calibrated such that a balanced relation between contributions and entitlements, and between the number of actively employed contributors and the number of retired beneficiaries, can be achieved.

In the last decade, there has been considerable progress in reforming pension arrangements. A majority of Member States have adapted pension systems so as to put them on a more sustainable footing and enable them to weather the demographic changes that are set to take hold.

However, further reforms are in many cases necessary and the financial and economic crisis has made the demographic changes harder to cope with, as well as highlighting further weaknesses in some pension systems. So further adjustments on the expenditure side will be unavoidable in many Member States together with enhanced efforts to boost employment rates and productivity. A credible fiscal strategy needs to be rigorously implemented in line with the fiscal framework in the Stability and Growth Pact, taking due account of the net cost of implementation of a pension reform. Regarding the challenge of population ageing, the Stockholm European Council defined a three-pronged strategy in 2001, comprising: 1) public debt reduction, 2) increasing employment, notably of older workers, and productivity and 3) reforming social security systems.

Pensions – mostly from public schemes – are the main source of income of older Europeans, who are a significant and growing part of the EU population (120 million or 24%). Indeed, the basic purpose of pension systems is to deliver adequate retirement incomes and to allow older people to enjoy decent living standards and economic independence and pensions also play a role as automatic stabilisers. Broadly speaking, this has been achieved across the EU, although important gaps remain. People over 65 have an income of almost 94% of that of the average for the total population, yet about 22% of women over the age of 75 fall below the at-risk-of-poverty threshold.

While recent public pension reforms have tended to improve or maintain their poverty protection, most of these reforms will result in lower replacement rates (pensions relative to previous earnings) in the future.

The expected reduction in replacement rates is, however, based on the assumption of an unchanged retirement age. Working to a higher age may help maintain or even increase the future level of replacement rates.

Complementary retirement savings can also help secure adequate replacement rates in the future. Some countries have introduced measures to complement their public pay-as-you-go pension schemes with private funded schemes, but there is much scope for further development of complementary pension savings opportunities in many Member States. This would require, though, that funded private pension schemes become safer and more cost effective, as well as more compatible with flexible labour markets and mobility.

The ageing challenge is often illustrated by the doubling of the old age dependency ratio (population 65+ to population 15-64) from 26% in 2010 to 50% in 2050. Yet the real issue is the economic dependency ratio, defined as *the unemployed and pensioners as a percentage of the employed*. If Europe achieves the employment goal of the Europe 2020 strategy of 75 % employment rate in the age group 20-64 and further progress is made in the period 2020-2050 the economic dependency ratio will only increase from the current level of 65 % to 79 % in 2050.

Pension systems influence retirement patterns, and hence the supply of labour and the economic dependency ratio. Key parameters are the normal and early pension eligibility ages. Currently, about one third of adult life is spent in retirement and, with unchanged policies, this share would increase in line with future gains in life expectancy. Moreover, early labour market exit pathways result in employment rates of older workers (aged 55-64) below 50% in 2010 in the EU.

The trend in recent decades towards earlier retirement has, however, been reversed. The employment rate of the 55-64 age group increased in the EU-27 from 37.7% in 2001 to 46.3% in 2010. Moreover, pension reforms already adopted in Member States, which will often be phased in over time, could result in significant increases in participation rates of older workers. But more needs to be done. Labour force participation is currently still too low in the age groups just below the retirement age and progress too limited. A fixed retirement age in combination with easy early labour market exit options will create growing imbalances between active years and years in retirement. Reforming pension systems to increase the labour market participation rate will be crucial to enhance economic growth and to lay a solid foundation for sustainable and adequate pensions.