Toward a Pan-European Pension Reform Approach:
The promises and perspectives of unfunded individual account systems*

by Robert Holzmann

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The need for a rapid and comprehensive reform of the pension systems in most old and new member countries of the European Union is increasingly acknowledged by pension scholars and politicians. While a few countries have recently undertaken major reforms to make their pension systems financially sustainable, in the majority of European countries the reform efforts are still insufficient. While national efforts can now draw support from intensified EU cooperation based on the Open Method for Coordination, this method takes the diversity of European pension design as a given, and much of the reform debate is still limited to fiscal issues at national levels. There is little discussion about a reform need beyond fiscal consideration. There is no discussion (anymore) about a reform move toward a more coordinated pension system within the European Union, and how such a system may look and come about. That is the topic of this policy note.

The note argues that a pension system with an unfunded individual account system (also known as non-financial or notional defined contribution system – NDCs) at its core, supported by social pensions and funded pensions at its wings is a reform approach that would allow Europe to address the multiple reform requests inside and outside pension systems: First, NDCs are able to handle the different reform needs of public retirement schemes that go well beyond fiscal considerations such as socio-economic changes and the challenges of globalization. Second, it is an approach able to comply with the generic and specific objectives of a Pan-European pension reform. Last, but not least, it is a reform approach capable to be implemented within a short period in most EU countries.

The structure of this short note is as follows: The next section outlines the main characteristics of an NDC system, including key design and implementation elements to be respected. This is followed by a review of the central reform needs of European pension systems and how NDCs would be able to deliver on

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* This policy note draws on Holzmann (2006) that presents the arguments in detail. The full range of pros and cons of NDCs is assessed by 24 papers published in Holzmann and Palmer (2006).

system objectives and reform needs. The last section outlines how a pan-European NDC scheme with social and funded pension wings would operate.

Key characteristics of an NDC system

An individual account system on PAYG basis operates like an illiquid life-time cash balance plan. Individuals (and their employers) pay contributions on earnings during their whole career. These contributions are recorded on an individual account that grows with the contributions as well as with a rate of return credited to them. At retirement the notional capital is converted into an annuity that takes account of the remaining life-expectancy as well as the expected future rate of return. The pension in payment can be price or wage indexed with the initial pension adjusted accordingly in order to comply with (inter-temporal) budget constraint

The structure of an NDC system is extremely simple and transparent – what you pay in (or is paid in on your behalf) you get out in quasi-actuarial terms, but not more. As a result, the commitments at individual or macroeconomic level can be easily calculated. However, as the system remains essentially unfunded it needs to respect a few basic rules to deliver on fiscal sustainability, and the three key components are the following. First is the selection of the system-consistent "notional" interest rate that can be credited in an unfunded system. Such an interest rate is broadly equivalent to the growth rate of the contribution basis (equal to wage and GDP growth in steady state) but some adjustments do apply. The remaining life expectancy must be cohort specific and take account of expected changes throughout the remaining lifetime of the cohort. Second, a politically acceptable system requires a reserve fund and a balancing mechanism to deal with demographic or economic shocks. Otherwise individual benefits in each period would exhibit quite likely main fluctuations in real and nominal terms that would be difficult to sustain in political terms. Last but not least, this reform approach requires a financing mechanism that makes it possible to finance the legacy costs when moving toward the new system, in particular when the new contribution rate is lower than under the old system that is being transformed.

Reform needs of existing systems – promises of NDC approach

The need for reform of pension systems in Europe is essentially threefold:

(i) The current and future budgetary pressure resulting from population aging in addition to too generous pensions provided at a too early age;

(ii) the ongoing socio-economic changes that render most current system designs inadequate; and

(iii) the challenges and opportunities of globalization that require portability of pension benefits across professions, countries, and regions.

Against such reform needs, further outlined below, the reform options of typical European pension systems are quite limited due to

(a) high implicit pension debt of the mostly unfunded schemes that would not allow a full or even major shift toward defined benefit or contribution schemes on a funded basis;

(b) the low credibility and limited success of parametric reforms tinkering with accrual factors, indexation or retirement age; and

(c) doubts about the ability of financial markets to deliver adequate rates of return (net of costs) on a sustained basis at acceptable risks in an aging world.

Against this background of reform needs and reform options, the NDC approach offers many promises.

Dealing with fiscal sustainability: An NDC system establishes long-term financial sustainability by enforcing the financing rules that applies to any (unfunded or funded) pension systems: The present value of liabilities cannot exceed that of assets. While the actual mechanism how to do this (or how it is proposed to do this) may, at times, be complicated, the underlying principle is easy: With a fixed contribution rate, the balancing variable to deal with economic or demographic shocks is the benefit variable through the interest rate credited to the individual account and the indexation of pensions in payment. Individual adjustments to the benefit level require changes in retirement behavior and/or saving efforts in the funded pillar to compensate for the lower unfunded benefit level. Any reserve fund smoothes the impact of shocks across cohorts and generations but does not eliminate the need of a well designed balancing mechanism working through the notional interest rate and indexing mechanism.

Dealing with short-run fiscal pressures requires short-run instruments best in the form of key parametric changes, such as decreases in annual accrual rates, increases in the retirement age, or changes in indexation. They should be done before the full conversion toward NDC scheme takes place as this serves to reduce the magnitude of the legacy costs. For example moving from wage to price indexation can reduce the implicit pension debt by some 20 percent and possibly eliminate any legacy costs even if real wage growth is as moderate as 2 percent p.a.

Dealing with socio-economic changes: Since the original pension systems have been designed toward the end of the 19th or early 20th century a number of socio-economic changes have taken place to which the current design of most pension systems is not yet adjusted. And three changes stand out: Increase in life-expectancy, increase in female labor force participation, and increasing divorce rates. These changes would require a major overhaul of any Bismarckian-type pension system independently of fiscal considerations.

The increase in life expectancy, in particular the more then doubling of the life expectancy of an adult during the last century requires major changes for individuals and society, in particular longer labor force participation which will be facilitated if individuals remain healthy and well trained. The imperative of life-long learning requires a pension system that abolishes any artificial separation between education, work, and (retirement) leisure and allows for distortion-free individual movement between these states. An NDC system is able to deliver as it does not punish sabbaticals or return to work after drawing a pension.

The stark increase in life expectancy strengthens the need to separate old-age from disability benefits. The initial old-age pensions could be considered as a generalized disability pension as only a small share of insured reached retirement age. The others died before this age or became eligible for a disability pension. Nowadays the vast majority survives to retirement in good health and the risks covered are fully dis-linked: Uncertainty of age of death and incapacity to work. If risks are separated and can be separately priced it is efficient to do so. An NDC system strengthen this logic and allows to do so in an incentive oriented manner. E.g. for a disabled who receives disability benefits, the latter include continued contributions to the NDC account till disability benefits are discontinued (and people re-start work and earn contributions) or a stipulated retirement age is reached.

The original old-age benefit design is based on a working husband and a housekeeping spouse taking care of the children. In case of death of the breadwinner prior or after retirement, the spouse receives a survivor's pension typically till her own death (and children till adulthood). Two key changes have taken place since: Female labor force participation has increased and rivals in a number of countries for key age cohorts with that of men. And divorces have increased reaching in a number of countries already 50 percent and more for every marriage. This requires changes in survivors pensions in order to avoid issue of double pensions (including also for men), or benefit shortfalls as in the case of multiple surviving divorcees. NDC offers a very simple and incentive-oriented solution as it allows for establishing own pension rights for all based on own contributions when single and split contributions accounts at time of separation. If in case of a divorce the house, car and dog can be split, why not the accumulated NDC account during the period of marriage? For young surviving spouses with children, a generous but time-bound benefit can be disbursed to ease re-integration into the labor market.

Dealing with globalization: In order to reap the benefits of globalization but also to deal with challenges that include profound shocks resulting from technical innovations and shift in the demand and supply of goods and factors, more flexibility across labor markets, improved financial markets, and life-long learning are essential. The more flexible and adjustable an economy is in reacting to such shocks, the better it will fare. Such flexibility comprises mobility of individuals across professions, countries and regions. At professional level and within countries, mobility continues to be severely hampered due to different schemes, in particular between the public and private sector. While the mobility between European member states is, in principle, eased for the general private sector schemes, the reality is often different as individuals cannot assess the future pension benefit that they are entitled to. Furthermore, within the Euro area labor mobility gained importance in order to deal with asymmetric shocks as country-specific monetary and exchange rate policy have been lost while the scope for fiscal policy is restricted by the Maastricht criteria. NDCs offers to establish such mobility between professions and across countries in a simple manner. Different sector schemes, including that of civil servants can be easily converted into a common NDC scheme by calculating the accumulated individual pension rights and assigning the amount to the individual account. In case of moving between member countries, the accumulated amount can be easily transferred.

Demands on a reformed and coordinated Pan-European pension system

What objectives should such a reformed system fulfill? Two sets of objectives are suggested: generic objectives that all modern pension systems worldwide should fulfill, and specific objectives that result from the EU background.

The primary goal of a pension system should be to provide adequate, affordable, sustainable, and robust old-age income, while seeking to implement welfare optimizing schemes in a manner appropriate to the individual country. The secondary goal of mandated pension provisions (and their reform) is to create positive output effects by minimizing negative impacts, such as on labor markets, while leveraging positive impacts, such as on financial market development (Holzmann and Hinz 2005).

The suggested specific objectives of a Pan-European pension system, to be used as criteria for selection and choice, are: mobility, national preferences, solidarity, and feasible transition.

- First, the system should allow for *easy, even better unrestricted mobility* between professions, sectors, and regions and also between stages of the life cycle (school, work, and leisure) and family structures.

- Second, the system should be consistent with the (European) concept of *solidarity*, understood as a mechanism of risk sharing among and between generations, redistribution of income from the life-time rich to life-time poor, and open risk coverage.
- Third, the system should allow for *national preferences* of target levels of (mandated) benefits or contributions, and the redistributive allocation of resources toward the poor or specific groups or activities.
- Finally, the proposed future system should involve a *feasible system transition* from the current national systems for the largest possible number of member-countries.

An NDC system, supplemented with a social pension plus a funded pension is well suited to deliver on both the general as well as Europe-specific requests. To achieve the latter does not require a harmonized system but a coordinated approach similar to the valued added tax that Europe spear-headed. As sketched, an NDC system can deliver essentially unrestricted mobility across Europe. The country-wide notional rate of return and annuity calculation supplemented by the reserve fund and balancing mechanism allows for risk sharing among and between generations. Matching contributions for low income groups and contributions for periods of maternity or unemployment financed by budget transfers give ample room for distributive purposes. Contribution rates can differ across countries, as the level of social pension and the level of contributions towards funded pillars. Last but not least, the approach allows for an easy transition for most countries in the European Union: Italy, Latvia, Poland and Sweden have already introduced. The French and German point systems are similar to NDCs. The Bismarckian systems of Austria, Belgium, Czech Republic, Portugal or Spain can be easily converted. Only countries such as Denmark, Ireland, the Netherlands, and UK, with their specific basic provisions and funded pillars are likely to escape a full coordination. But even in their case would the suggested approach of unfunded individual accounts in combination with social and funded pillars facilitate the coordination across member countries. What is left is to find a political mechanism to make it happen.

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This article is one in a series about the Swedish pension reform.

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