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COMMISSION STAFF WORKING DOCUMENT

Annexes to the

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

Joint Report on Social Protection and Social Inclusion 2006

- Synthesis report on adequate and sustainable pensions -

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EXPLANATORY NOTE FROM THE COMMISSION

Subject: Commission Staff Working Document - Synthesis report on adequate and sustainable pensions – SEC (2006) 304

On 27.2.2006 the Commission adopted the Commission Staff Working Document - Synthesis report on adequate and sustainable pensions – SEC (2006) 304. This document has been adopted as an annex to the Communication from the Commission: Joint Report on Social Protection and Social Inclusion 2006 {COM (2006) 62}.

It is a synthetic analysis of the National Strategy reports on pensions submitted in the summer of 2005 and it has served as a preparatory document for the Commission Communication COM (2006) 62. It deepens the analysis and substantiates the conclusions contained in the 2006 Joint Report on Social Protection and Social Inclusion.

It remains, however, a Commission Staff Working Document, and it is not expected that it be adopted by the Council in any form. The Commission, however, considers it useful that the delegations have access to the more complete information available in the Commission Staff Working Document SEC(2006)304 - Synthesis report on adequate and sustainable pensions.

COMMISSION STAFF WORKING DOCUMENT

Synthesis report on adequate and sustainable pensions

1. INTRODUCTION

1.1. The pension challenge

One of the main achievements of social policies in the second half of the last century is that being old is no longer synonymous with being poor or being dependent on the support of one's children. This success has mainly been achieved through the provision of public pensions.

While recognising the achievements of pension systems, the challenges of the ageing populations, in particular the financial strains on pension systems, have already long been high on the agenda of the European policy making. Most recently, the informal European Council in Hampton Court asked Europe to reflect in more depth on the consequences of demographic trends on economic and social policies and Commission's first annual progress report 'Time to move up a gear' of 25 January 2006 identifies responding to globalisation and ageing, and in particular reforming of public pension systems, as one of the main actions to be undertaken in Europe. As highlighted in the Joint report by the Commission and the Council on adequate and sustainable pensions of 2003, the pension challenge in an ageing society is to continue the increase of effective retirement ages. While in the 1960s it was normal to retire well after 60, employment of older workers declined in the 1970s and 1980s in many countries and only recently started to increase: average ages of leaving the labour market are still below the levels of the late 1960s.

This decline in average effective retirement age (accompanied by an increase in the age of entering the labour market) runs contrary to the substantial increase in life expectancy in the same period. Life expectancy at 60 for EU25 increased by 4 years from 1960 to 2000 (from 15,8 years to 19,3 years for men and from 19 years to 23,6 years for women). The most recent Eurostat projections see life expectancy in the EU25 at 65 to increase by another four years from 2004 to 2050 (4,4 years for men and 3,9 years for women). Even in the context of a favourable demographic situation where the active population was increasing, the increase of life expectancy over the second half of the 20th century would still need to be partly accommodated through increases in contribution rates.

To sum up, contribution years have decreased while years in receipt of benefits have increased, putting pressure on the financing of pension systems. Reforms are now needed to ameliorate past reductions in the effective retirement age and increases in the dependency ratio and to cope with the retiring of the baby-boom generation and future increases in life expectancy.

Pension reforms require long term strategies. The process of reform itself is lengthy as pensions reforms are usually built on broad consensus as they are a fundamental part of our social protection systems and of social cohesion. Furthermore, States dedicate significant amounts of public expenditure to old age provision, which in light of demographic trends is set to grow significantly. Therefore reforms of pensions systems should be seen both in the context of ensuring adequate and sustainable retirement provision, and in the context of sustainable public finances as a whole and sustainable growth across the EU.

The Stockholm European Council outlined a three-pronged strategy to tackle the budgetary implications of ageing populations:

– Member States should reduce public debt levels at a faster pace;

– Member States should undertake comprehensive labour market reforms, including tax and benefit systems, in order to achieve higher employment rates, in particular among older workers and women;

– Member States should undertake appropriate reforms of pension systems in order to contain pressures on public finances, to place pension systems on a sound financial footing and ensure a fair intergenerational balance.

A dominant proportion of total pension provision in almost all Member States is organised within the general government sector and, thus, affects the public finances to a great extent. It is necessary to ensure that rising public spending on pensions due to the ageing of the population does not jeopardise sustainable public finances and that appropriate strategies are in place for ensuring that the long-term commitments of pension systems can be met. At the same time, sound management of public finances can provide room for manoeuvre as regards the budgetary pressures of ageing populations.

There are strong grounds based on equity and efficiency for government involvement in pensions, be it provision, financing or regulation. This is in particular linked to basic social objectives, such as securing adequate income in the old-age. This requires making choices today for the long term, despite uncertainties resulting from the unpredictability of economic and social trends. At the individual level, such choices would be extremely difficult and are likely to lead to under-provision for most people, in particular for people with low incomes or with difficulties engaging in long term financial planning. Also private insurance has great difficulties dealing with uncertainties involved in long-term commitments. Pension systems based on universal coverage have the largest ability to cover uncertainties related to long-term commitments to provide adequate old-age income.

Public provision plays a central role in national pension systems, which are very diverse among EU25, highlighting that there is no one-size-fits-all solution. While the basic goals of access, adequacy and financial viability are universal to all systems, there is considerable degree of variation in design at national level, as a result of historical differences and reflecting differing preferences for redistribution or for leaving choices to individuals.

1.2. The open method of coordination in the field of pensions in the context of the Lisbon Strategy

The Laeken European Council of December 2001 recognised that there could be significant benefits by enhancing dialogue and co-operation on issues related to the reform of pension systems. It endorsed common objectives of adequacy, financial sustainability, adaptability, and a working method based on the open method of co-ordination (hereafter OMC).

Subsequently, a first wave of National Strategy Reports (hereafter NSRs) described in 2002 how the 15 Member States intended to meet these objectives. On the basis of these NSRs the Commission and the Council adopted a Joint Report on adequate and sustainable pensions in March 2003.

The 2003 Joint Report concluded that 'Most Member States see pension reform as a continuous process rather than a one-off, discreet event […] The momentum behind reform process to secure the sustainability of adequate pensions must be maintained.'

Responding to the Joint Report on Pensions, the European Council of March 2003 called on Member States to ensure the implementation of further reforms and for continued application of the OMC in the field of pensions. The Council asked for progress to be presented in 2006, and for the new Member States to be included. This is presented in the Commission's proposal for the Joint Social Protection and Social Inclusion Report of 2006.

In 2005, the Commission proposed and the Council endorsed the revision of the Lisbon strategy for Growth and Jobs and revised Integrated Guidelines[1]. It is recognised that the OMCs on social protection and social inclusion feed in to the Lisbon strategy. The Commission also intends to make the EU level coordination in the area of social protection more effective by streamlining the OMCs on pensions, social inclusion and healthcare and long-term care starting in 2006. This aims to create a stronger, more visible OMC with a heightened focus on the modernisation of policies and policy implementation and which will interact positively with the revised Lisbon strategy, while simplifying reporting and expanding opportunities for policy exchange.

Separate reporting as part of the OMC will continue along Member States' national reform programmes that present an overall review of reforms contributing to the objectives of growth and employment. Similarly, reporting at EU level via the Joint Report on Social Protection and Social Inclusion will feed into the EU annual progress report.

Within this framework, this document provides the necessary analysis as an input for the pension aspects of the Social Inclusion and Social Protection Report of 2006. To this end, Member States presented their second NSRs in the summer of 2005. The NSRs were discussed in a peer review in mid September 2005, involving the Social Protection Committee (hereafter SPC) and the Economic Policy Committee (hereafter EPC). This report presents a synthesis of this new wave of reports.

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1 See in particular guideline 2: 'Member States should […] reform pension and health-care systems to ensure that they are financially viable while being socially adequate and accessible, and take measures to raise employment rates and labour supply'. And Integrated guideline 18: 'Promote a lifecycle approach to work through […] modern pension and healthcare systems, ensuring their adequacy, financial sustainability and responsiveness to changing needs, so as to support participation in employment and longer working lives, including appropriate incentives to work and discourage early retirement.'

2. MAIN LESSONS FROM THE SECOND ROUND OF OPEN METHOD OF COORDINATION IN THE FIELD OF PENSIONS

2.1. Main developments in pension reforms in the Member States

The 2003 Joint Report on Pensions underlined the interdependency between the financial sustainability and adequacy of pensions in the context of ageing societies and the need for comprehensive reforms with the aim of securing adequate, accessible and financially sustainable pension systems. In particular, the Joint Report called on Member States to improve incentives for older workers to remain longer in the labour market, to strengthen the link between contributions and benefits and to increase public and private funding, especially in light of the long-term implications for pension expenditures of increased life expectancy.

Europe's population will be slightly smaller, but significantly older in 2050. There will be two workers per elderly citizen as opposed to the current ratio of four to one. Recent long-term projections show that pension costs will lead to significant increases in public spending in most Member States by 2050. On the basis of current policies, public expenditure on pensions is projected to increase on average by 2.2 percentage points for the EU-25, with a large dispersion among Member States.

There has been substantial progress in reforming pension systems since the 2003 Joint Report. Member States have also reported on reforms to their pension systems in the context of the national reform programmes, assessed in the Commission's annual progress report. Disincentives to work longer have been reduced and incentives strengthened, links between contributions and benefits have been tightened and life expectancy has been further taken into account in pension systems. Moreover, the provision of supplementary pensions has been promoted and legislative frameworks improved. Furthermore, some Member States have also tackled old age poverty by increasing the levels of guaranteed minimum pensions. Reforms have made steps regarding all three key objectives: providing adequate retirement income, ensuring financial sustainability and adapting systems to changing labour market and societal conditions.

Some Member States have introduced major reform packages. **Germany,** in addition to 2001 reforms (which led to a lower increase of first pillar pension levels and the creation of state supported, funded, (voluntary), second and third pillar pensions), undertook measures through the Sustainability Act of 2004, which are aimed at aligning the importance of the levels of contribution rates and the levels of benefits paid out. It also introduced a sustainability factor to the pension indexation formula, requiring additional adjustments if the ratio between contributors and beneficiaries worsens. In **France,** the 2003 reform improved long-term sustainability via an increase in the number of contribution years required for a full pension (this will be further increased in line with future increases in life expectancy), as well as via strengthened incentives to work longer. Members of the public and private schemes are now also treated more equitably. In **Austria**, the 2004 and 2005 reforms make a major step towards a more sustainable pension scheme through a stronger link between contributions and benefits as well as an increase of the contribution years needed for a full pension. Incentives to work longer were also increased and incentives to take up early pensions decreased through a so-called bonus/malus system. It also introduces a much more uniform pension system across the public and the private sector and introduces the indexation of pensions to prices as of 2006. The **Finnish** pension reform, implemented mainly in 2003-2005, increased incentives to work by providing a higher accrual of pension rights for older workers and overhauling early retirement arrangements. It will also introduce a "life-time coefficient" with the affect of adjusting future pensions to increases in life expectancy. **Lithuania** (in 2004) and **Slovakia** (in 2005) introduced a funded tier to their social security pension system, which will strengthen the sustainability of the statutory pay-as-you-go old-age pension scheme in the long run while allowing individuals to accrue additional pension rights through privately-managed funds.

Concerning occupational and private pension schemes, the legislative framework was improved notably by the Netherlands and the United Kingdom. In **the Netherlands**, the principles for a new Financial Assessment Framework for supplementary pensions were established in 2004. It sets tighter requirements, in particular for the size of reserves for collective private pension arrangements. It also sets requirements for the break-even contribution rate and consistency between commitments regarding indexation, financing and related communications. In **the United Kingdom**, the provision of private pensions has been promoted by a streamlined and simplified regulatory regime (overseen by the new Pensions Regulator), a simplified tax regime for pension funds and greater protection for final salary schemes (by the establishment of the Pension Protection Fund).

Other Member States have continued adapting their existing system. For example, **Spain**, **Portugal**, **Belgium** and **Ireland** increased the levels of their guarantee minimum pensions beyond the statutory index adjustments, while the **United Kingdom** implemented Pension Credit. **Portugal** strengthened incentives to work longer and fostered more equitable treatment of members of different schemes**.** Incentives to work longer were also developed in a number of Member States including **Luxembourg**, **the Netherlands** (favourable tax conditions for the take-up of early pensions have been reduced and an innovative life course arrangement, replacing early retirement arrangements, will be introduced in 2006) and **Italy** (the 2004 reform plans a gradual increase of the age requirements for seniority pensions). In **Denmark** collective agreements will see increases in contribution rates. **Sweden** further developed information provision through a broad pension Internet portal established in 2004.

The new Member States were not covered in the 2003 Joint Report on Pensions. In most Central and Eastern European Member States pension systems were transformed substantially in the 1990s establishing a new architecture combining a public pay-as-you-go scheme and a mandatory private funded scheme for people below a certain age and voluntarily available to older persons while maintaining the old system for those who did not want or were not obliged to join the new system. Private schemes are mandatory for new entrants to the labour markets in **Estonia, Latvia**, **Poland**, **Hungary** and **Slovakia** and voluntary in **Lithuania**. Furthermore, in **Latvia** and **Poland**, the public pay-as-you-go scheme has been reformed into a notional defined-contribution (NDC) scheme. In a number of Member States a serious examination of the pension system has been commissioned by groups of experts or organised through social dialogue. Some pension laws provide for periodic reviews as a basis for next steps in the reform process. For example, **Spain** renewed the Toledo Pact underlining the importance of dialogue with the social and economic players involved, when it comes to monitoring present and future reform measures.

The Parliament is reviewing progress and future reform measures every five years. Spain will create a Permanent Observatory to monitor the evolution of the social protection systems and is designed to carry out analysis and make proposals for necessary changes. The Pensions Commission (Chaired by Lord Turner) in the **United Kingdom** delivered recommendations for reform in its second report at the end of November 2005. The Government has committed to consider these and other recommendations before bringing forward proposals in spring 2006. The **Czech Republic** reformed its existing system adapting some of the parameters such as retirement age and years of service but left several other elements untouched (retirement age in relation to number of children non-contributory periods). These features have been examined by a multi-party Expert Group that advocates further reforms. All major parties have committed themselves to translate these recommendations into legislation before the next election campaign starts in 2006. **Malta** adopted a "White Paper" on a pension reform strategy, which is currently under discussion. In **Denmark**, the government has set up a Welfare Commission charged with submitting specific proposals before the end of 2005 for reforming the Danish welfare model, including pensions and in particular early retirement provisions. In the light of the analysis from the Welfare Commission and with a view to maintaining the long-term economic targets, the Government will (in spring 2006) present a new economic multi-year plan, covering at least the period up to 2015. In **Ireland,** the Pension Board is expected to submit its review on the pension system with proposals for measures for reform at the end of 2005. In particular, proposals concerning the promotion of occupational pensions are awaited. Regular reviews on the development of the pension system will also be carried out in **Germany**, **France** and **Austria.**

2.2. Key issues emerging from the National Strategy Reports

The OMC on pensions is based on 11 specific objectives grouped around the areas of adequacy, sustainability and modernisation. The detailed analysis of progress towards these objectives, as presented in the second round of NSRs, appears in the technical annex. The NSRs also report on the contribution made to pension sustainability by reducing public debt (BE, DK, NL) providing room for manoeuvre when making resources available to pension systems.

Four issues, already highlighted in the 2003 Joint Pension Report still remain a priority:

- Strengthening incentives for working longer;
- Developing a life-cycle approach and strenthening the link between contributions and benefits while ensuring adequate income replacement and managing increasing longevity;
- Making pension systems more adaptable to structural changes;
- Strengthening the role of minimum pensions and of solidarity in pension systems.

Two other issues emerge more forcefully in the light of recent reforms:

- Secure private pensions complementing and partially replacing public pension provision;
- Strengthening the governance of pension systems.

2.2.1. *Strengthening incentives to extend working lives*

As already highlighted in the 2003 Joint Report, it is crucial that people work longer, but in some countries starting work earlier is also important. Working longer is an explicit European target in the Lisbon context, both through the objective of increasing the employment rate of older workers (aged 55-64) to 50% and through the objective of an increase of 5 years of the effective age of exit from the labour market. Longer working lives result in more contribution years and fewer benefit years, thus contributing directly to the adequacy and sustainability of the pension system. Pension systems are an important part of labour market institutions through the provision of benefits. Therefore, it is of utmost importance that the incentive structure embedded in the pension system is supportive to employment.

Box: Evolution of dependency ratios

According to the latest demographic projections, old age dependency ratios (population aged 65 or more related to population aged 15-64) will more than double from 2005 to 2050 (from 24 to 51, an increase of around 110%).

The economic dependency ratio (population aged 65 and more related to the number of persons employed) is projected to increase by roughly 90%, (from 37 to 70) according to the Ageing Working Group 2005 projections, despite a projected increase of the general employment rate from the current 63% to 71% in 2050. This would mean that while there are currently almost three workers per each pensioner, in 2050 there would be only 1.4 workers per one pensioner.

Employment rates of young people (15-24) in the EU are on average 37%, but with variations between Member States of 20% to 60%. Although it is an explicit EU objective to increase participation rates in education, this difference suggests that greater efforts are needed to integrate young people into the labour market and to support them as they pursue 'non linear' careers alternating between employment and study. Earlier working contributes to longer working lives and a higher accrual of pension rights, thereby enhancing welfare both at society’s and individual level..

Employment rates of older workers have increased in recent years, reversing a long declining trend. Indeed, the employment rate of older workers has increased from 36% in 1995 to 42% in 2004 for EU15, while the increase for EU25 ranges from 36% in 2000 to 41% in 2004. In spite of recent improvements, in a number of Member States, the employment rate of older workers lies below or around 30% (BE, IT, LU, HU, MT, AT, PL, SI, SK), or between 30% and 45% (CZ, DE, EL, ES, FR), while it lies between 45% and 55% in some others (LV, LT, NL, EE, IE, CY, PT, FI), and exceeds 55% only in a few (DK, SE and UK).

In nearly all Member States, recent reforms have strengthened incentives to extend working lives (especially for statutory schemes), and reduced access to early retirement. Working longer is generally encouraged by pension supplements and leaving earlier discouraged by actuarial reductions. Furthermore greater flexibility is provided in the timing of retirement, for example combining employment and partial retirement. In addition access to disability, sickness and incapacity schemes are being reviewed to eliminate other paths to early exit. While in defined contribution schemes, effective incentives are inherently imbedded, some defined benefit schemes may require adaptation of eligibility rules and pension parameters (such as age limits of access to early or specific schemes, bonus/malus coefficients, etc.).

Moreover, as illustrated by the work carried out on replacement rates by the Indicator Sub-Group, reforms of statutory schemes have often led to a decrease of individual replacement rates, measured at the time of a given retirement age. However, many Member States have increased the accrual of pension rights if people work longer and these should act as incentives to work longer.

A key question for the future is whether the reforms carried out are sufficiently thorough to ensure efficient incentives to work longer so that the Lisbon targets for employment rates and the increase in effective retirement age can be achieved. Important differences can be observed among Member States according to the strength of incentives to work longer, depending on the design of the pension system. This suggests that the structure of incentives could be further revised in a number of Member States. In particular, attention still needs to be paid in a number of Member States to paths of early exit (before the standard retirement age) from the labour market.

Pension reforms give strong incentives to work longer and when well designed they reward doing so with adequate pensions. However there is a need to ensure that people can work effectively longer as is underlined in Integrated Guideline for growth and jobs 18 (promoting a life-cycle approach to work). As analysed in the First Commission Report on the National Reform Programmes opening up employment opportunities for older workers through accelerating labour market reforms is essential (ref to COM Annual Lisbon Progress Report). Pension systems can facilitate later retirement, but without suitable access for older workers to appropriate employment, they are unlikely to be particularly effective.

2.2.2. Developing a life cycle approach and strenthening the link between contributions and benefits, while ensuring adequate income replacement and managing increasing longevity

The issue of the balance and the link between contributions and benefits as well as the transparency of this link are important, both for defined-benefit pensions systems (that are common among statutory pay-as-you-go systems), and for defined-contribution schemes, for which it is inherent in the system. Pension reforms have to deal with demographic developments and in particular increased longevity, which is a key driver for increasing pension expenditure in the future. This increase in a financially balanced scheme would require either higher contributions by workers or lower benefits for pensioners, if the increase in life expectancy were spent in retirement. However, increases in life expectancy can be shared between the years in employment and retirement, thereby resulting in a better balance between life-time contributions and benefits. As a response to future increases in life expectancy, a number of reforms are designed to stabilise pension systems through automatic adjustment mechanisms (as in SE, FI, PL, LV or DE) or periodically required reviews and adjustments (like in AT, IT or FR). These adjustments will also promote a life-cycle approach.

Weak links between contributions made to pension schemes and benefits received may lead to inequitable and inefficient outcomes both within and between generations. In particular, people may see contributions more as general taxation, rather than as a build-up of their own pension rights. Reforming such pension provision together with other benefit systems may encourage them to work longer or to move out of the black economy.

A number of recent reforms have strengthened the benefit/contribution link of pension systems. Funded and notional defined contribution schemes establish a strong link. Also in many defined-benefit schemes, links have been strengthened. This has occurred firstly, through the introduction of longer contribution periods required for a full pension. Secondly, by calculating full pensions on the basis of life-time earnings instead of final salary, thus reflecting more accurately contributions over an entire career, rather than just wage progression in later years. Thirdly, applying actuarial reductions/increases for early/deferred retirement also contributes to a culture in which early retirement is less prevalent (this has occurred in a number of Member States, like AT, FR, FI, ES, PT, NL or IT), while the link was strengthened by previous reforms in many Member States, such as DE, BE, or LU, HU, EE, LV, LT, PL, SK, SI or SE).

However, reinforcing the link between contributions and benefits has to be combined with a careful monitoring of the accrual of pension rights during breaks in careers such as child care, other caring responsibilities, unemployment, sickness or education leaves to ensure both adequacy and equity in retirement.

2.2.3. *Modernising pension systems by making them more adapatable to structural change*

New labour supply structures require adaptable pension systems. Due to increases in participation rates and societal changes more and more people do not follow the standard career of full-time, life-long employment. Career-breaks and part-time work are becoming more frequent, and more and more people, at least for part of their professional career, are self-employed. These trends make adjustments of pension systems necessary in order to encourage activity and ensure adequate pension entitlements for all, even if this may make the system less transparent.

Member States have started to review pension provision for workers with atypical careers and for the self-employed, with a view to easing access to statutory and supplementary pension schemes. For example, some Member States, in particular where the link between contributions and benefits have been strengthened, allow people to acquire pension credits for periods of short-term contracts, part-time and voluntary work as well as for some breaks in the work career such as child and old-age care, education and unemployment. The purpose of such provision is to ensure that working part time or on fixed term contracts combined with periods of other activities or unemployment should not harm pension entitlements disproportionally. Against the overall trend to reduce future pension benefits in the pay-as-you-go schemes, several Member States are improving credits for child care and have introduced similar provisions for old-age care. Progress in this area of modernisation seems to be difficult to achieve and this may relate to tensions between incentives to accrue original pension rights through paid employment and recognising non-paid labour.

Most of the Member States are gradually phasing out differences in legal retirement ages between men and women. Other Member States appear to be retaining different retirement ages on gender grounds, at least for the next two decades. Some Member States still provide early retirement provisions for women with children. It is notable that the design of survivors' pensions is changing as the traditional widow's pension will become less and less frequent, due to rapid increases in employment opportunities for women.

Generally workers who change employers frequently are better served by statutory schemes, and many statutory schemes have moved towards accommodating short-term contracts, while supplementary pension schemes (notably those which are linked to an individual employer), can disadvantage mobile workers with regard to pension rights in comparison to long-term employees (notably due to waiting and vesting periods). Given the rising importance of supplementary schemes some Member States (DK, DE, NL, UK) have improved the portability of supplementary pension rights which pose obstacles to worker's mobility – a growing feature in labour markets today and in the future. In order to improve the overall conditions of portability of supplementary pension rights and accompany the initiatives already taken by some Member States, the European Commission has recently adopted proposals for a directive designed to improve portability.

2.2.4. *Guaranteeing minimum retirement income provision and solidarity*

In some Member States, in response to the need to provide decent retirement income for older people, guaranteed minimum pensions have been recently increased by more than statutory indexation requirements (like in BE, ES, IE, IT or PT). In 2003, the UK implemented an improved income-related benefit 'pension credit', in order to increase incentives to save for one's retirement.

An issue raised by these reforms of minimum pensions and more generally minimum benefits for older people is how they affect incentives for the accrual of pension rights. In this respect, the links between minimum benefits, indexation rules and incentives should be carefully considered.

Another issue is whether minimum pensions or minimum benefits are indexed differently from earnings-related pensions and whether this can have unintended effects on the income distribution among pensioners. Recent developments show that more and more countries have switched to price or close to price indexation both for earnings-related schemes and for minimum pension schemes. However, indexation of guaranteed minimum pensions on prices usually means that the income of those being dependent on minimum pensions lags behind the general evolution of income and may raise the risk of increased relative poverty among older pensioners even though it preserves their purchasing power. In order to prevent poverty increasing, governments are often required to take discretionary corrective measures (which is at odds with the provision of a long-term, secure and stable system, which individuals can have confidence in). Indeed, this issue should be considered in the broader context of promoting inclusion of older people. Some Member States address this by providing minimum income guarantees and others benefits in cash and kind, for example healthcare and care services, housing and transport.

2.2.5. Secure private pensions complementing and replacing partially public pension provision

Many Member States place greater emphasis on the contribution private funded provision can make in ensuring adequate retirement incomes, emphasising the positive role of diversification of the demographic risk between public and private schemes. Ageing populations, notably the retiring of the baby-boom generation, means that the financial sustainability of pay-as-you-go systems requires close attention as the dependency ratio changes substantially. However, funded systems will also be affected by population ageing.

The NSRs have captured much better than in the last exercise the issue of supplementary pensions. Several countries see a role for the private pension provision as part of the total pension provision. This has traditionally been the case in some Member States (like DK, NL and UK). Moreover, the importance of private pension provision has essentially been increased by the introduction of a funded tier of statutory schemes in a number of Member States like in SE, PL, HU, EE, LV, LT, andSK. Furthermore, a great number of countries have increased provisions for occupational or private schemes that complement public pensions (DE, IT, AT).

However, as underlined by the special study of the SPC on privately managed pension provision, while the expected contribution of privately managed pension schemes is projected to increase in the coming decades, in all but a few Member States, the public pay-as-you-go pension scheme are expected to remain the principal source of income of pensioners. This will allow Member States to maintain a degree of redistribution and solidarity that is necessary to provide fair incomes to all older people and to diversify risk at the individual level in an appropriate manner. In any case, the provision of guaranteed minimum pensions remains not only a State responsibility but is provided everywhere through public schemes. Moreover, the trend towards a broader use of privately managed pension provision does not allow public policy to retreat from the area. Monitoring and regulating private pension provision is becoming an important and complex task for public policy. Moreover, transparency and competitive markets for financial intermediaries should be promoted.

If private pensions are to provide retirement incomes for people with lower incomes it is therefore essential that Member States invest in good governance structures for them. Some Member States provide relatively favourable incentives for low-income people (DE, CZ) to participate in privately managed pension provision, but this may not be sufficient. This also explains the debate in some Member States about making private savings mandatory, in particular if a major part of the pension provision should be based on private saving (as is the case in many new Member States). As far as private pensions are based on a wider use of voluntary private pensions, they are generally used more frequently by higher income groups. This could exacerbate the impact of reductions to the level of individual replacement rates in statutory pension systems especially for older pensioners.

It is important for Member States to monitor whether the actual development of private pension provision matches needs, by assessing levels of coverage and benefits and their distribution by age and socio-economic status. Moreover, privately managed schemes, as well as reserve funds of pay-as-you-go schemes have to operate at a sufficiently high level of security and efficiency. Rules on acceptable investment risks and prudent assumptions about future returns are important safeguards if their implementation is well enforced and monitored, while efficiency also means ensuring that administrative charges are kept low.

Finally, the translation of individual accounts into safe and secure annuities will become more and more important, in particular for the regimes recently introduced that will begin to provide first, partial benefits in a few years and often before the end of the decade (like in PL, EE, HU, LV, LT or SK).

2.2.6. Strenthening the governance of pension systems

Periodic or ad-hoc reviews of pension systems, as well as automatic or semi automatic adjustement mechanisms already mentioned in 2.2 contribute to a better governance of pension systems. In many cases they deal indeed with longevity but also with other changes in pension parameters such as employment and growth. NSRs outline developments of independent institutions responsible for monitoring pension systems. Such reviews make clear the need to balance the length of active life and of retirement, the income replacement and the total contribution required in view of the fundamental objectives of maintaining pension adequacy and sustainability. This is indeed an interesting trend as it increases the general transparency of pension systems and facilitates more consensual decision-making.

The introduction of more flexibility for retirement ages in statutory pension schemes, the development of a closer link between contributions and benefits as well as the development of privately managed provisions all imply greater and more complex choices for future beneficiaries.

As underlined in a number of Member States (like UK, IT, NL, DK, SE or IE), this trend should be accompanied by apropriate information on future pension levels and more generally by promotion of awareness of pension issues and a better understanding of financial services. Although it is important to recognise the limits of information when expecting populations to make complex individual decisions about retirement provision. Major efforts to provide information and to increase financial literacy are described in most reports and it is indeed important to define the rights of members and beneficiaries through high quality information.

3. CONCLUSION

3.1. Adequacy, sustainability and modernisation should be considered jointly

The second round of NSR confirms that the three main objectives of pensions adequacy, sustainability and modernisation are appropriate to guide the reform strategies necessary to address the pension challenge in Europe.

The NSRs highlight the interlinkages between the three broad objectives and the synergies and trade-offs between them. For reform strategies to be succesful, all three elements must be present and considered together.

If society does not develop an integrated approach linking adequacy and sustainabilty the risks are substantial. Unsustainable promises for future pensions jeopardise the possibility of adequate incomes in retirement. Inadequate accrual of pensions and delivery of low levels of income (or reducing pension provision previously promised) would create unforeseen pressures for the sustainability of public finances, as an increasing demand for ad-hoc revaluations of pensions and possible unexpected demands for other (even means-tested) social benefits can result in higher public expenditure. These situations could lead to sharp conflicts concerning the credibility of the pension system.

Increasing transparency in pension systems is important for both individuals (who need information and clarity in order to make long-term decisions) and governments (which need to develop monitoring tools for the long-term management of pension systems). A particularly interesting new feature of recent pension reforms is the introduction of automatic or semi-automatic mechanisms that contribute to a periodic monitoring of various sources of uncertainties - in particular demographic trends - and promote the likelihood of proportionate and timely reforms.

3.2. Contribution of pension reforms to employment and growth

As underlined in many NSRs, pension reforms have to be considered in the broader context of society and the economy. The reform efforts outlined by Member States in their National Reform Programmes can be supported by pension reforms, while stronger economies can also deliver better pensions**.** Increasing employment opportunities for older people is vital for both achieving Lisbon employment goals and supporting sustainable growth, thereby allowing the maintenance of a high level of social protection in an ageing society. Pension reforms, employment and growth are therefore interdependent.

Firstly, pensions constitute a major part of public expenditure in almost all countries. A financially sound public pension system is essential to the sustainability of public finances as a whole, which in turn supports the overall growth and economic performance. On the other hand, a successful implementation of the Lisbon strategy leading to improved competitiveness and productivity can create room for manoeuvre for pension reform.

Secondly, pension systems and labour market performance have close ties. Pension systems embed incentives that affect the labour supply of older workers, while a high level of employment also ensures high levels of contributions into the system. Contributions required for the financing of pension systems also affect labour costs and, consequently, labour demand. Higher contribution rates can result in reduced labour demand, while overly generous benefits can reduce labour supply, thereby aggravating labour market imbalances. Both benefits and contributions need to be considered in the context of their impact on the functioning of labour markets.

3.3. Key issues to be monitored

Since 2003, many Member States have engaged in substantial pension reform, often against public opinion. Some Member States seem to have established comprehensive reforms, others have strengthened their efforts, while some remain at an early stage of the reform process. While in the latter countries the momentum for reform needs to be accelerated, in most Member States the momentum should be maintained.

Across the NSRs the following points emerge as requiring careful monitoring:

- Pension reforms need to continue to support the good functioning of labour markets by correcting and strengthening incentives for working longer and reviewing both the levels of contribution rates and benefits. Progress in labour market reform, including a culture shift among employers concerning retaining and reemploying older workers, is necessary;

- Pension reforms need to promote adjustment of systems for the management of changes in life expectancy and the introduction of a life-cycle approach in their design;

- Modernisation needs to take better account of new forms of employment, flexible working, career breaks, care, and systems that allow women to build up their own pension rights;

- Measures to ensure future adequate minimum pension gain importance but care must be taken over indexation rules and creating disincentives to work or save;

- The financial sustainability of public pensions systems and their effect on government budgets need careful monitoring while taking into account the impact private pension systems may have on public finances. Furthermore, public debt should be reduced in order to make room for manoeuvre for expected increase in age related expenditure;

- Development of private provision can complement or partially replace public pension provision, and thus diversify risk at the individual level, but security and equity need to be ensured;

- Transparency and the promotion of better education and understanding of pension issues among the public needs to be enhanced;

- Regular reviewand adjustment mechanisms are important innovations not only to adapt systems over time but also to promote a better understanding of the need for reform in the face of demographic challenges.

3.4. Further steps within the Open Method of Coordination

The OMC on pensions has proved to be a good tool for the Union and Member States to advance their understanding of pension reform by defining common objectives, reviewing progress and promoting a learning process. The new OMC as outlined in the Commission's Communication of 22 December 2005: 'Working together, working better: A new framework for the open coordination of social protection and inclusion policies in the European Union' could, because of its integrated structure and its closer links to the Lisbon Strategy for Growth and Jobs, enhance Member States' efforts to progress pensions reform. Future work should follow two methodologies:

(1) continue the overall monitoring of progress made towards the common objectives without overburdening reporting requirements from Member States. As outlined in the Commissions' communication, there will be alignment with the Lisbon three year cycle (2005-2008). Member States will not be required to deliver national strategies in intervening ("light") years. The OMC in light years will concentrate on in-depth analyses of specific issues; on disseminating policy findings; and on assessing indicators of progress towards the common objectives.

(2) focus policy analysis and exchange of best practices on key issues. In addition to the ongoing work on replacement rates, in the light of the challenges identified in this document, future horizontal work could focus on the following issues:

- the design of minimum income provisions for older people (including the link between pensions and other benefits provided to people in retirement);
- the strengthening of the link between contribution and benefits (to be conciliated with non contributory credits and taking into account gender issues);
- the link between the flexibility in the age of retirement and longer working lives ;
- key issues in the development of private pensions (efficient legal framework, inequality in coverage, security, information, transition costs, contribution private pensions can make to financial sustainability) ;
- developing regular review and adjustment mechanisms.

This could be achieved via special studies and workshops. The Peer Review methodology successfully used in the social inclusion strand could also be applied for some of the priority topics. The outcome of such work could be reported in an appropriate way to the SPC and EPC. The SPC may wish to consider submitting reports on some of the issues to the Commission and Council. Both working methodologies, national reporting and horizontal studies, provide important inputs into future Joint Reports on social protection and social inclusion and allow an effective contribution of the OMC to the Lisbon Strategy for Growth and Jobs.