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The inheritance from the past

Even if social security schemes belong – on the basis of the subsidiarity principle – to the field of intervention of individual member states, the pension problem is assuming higher and higher relevance at the European Union level, not only because of its connection to public finance issues conditioning the compliance with the Stability Pact, but particularly for the important effects pension policy exerts on employment, growth and, more generally, on the wellbeing of individuals and families.

The specific configuration of today's social security systems in the various European countries is the result of quite different national histories and political choices, so that heterogeneity is more frequent than convergence and a variability of rules and situations prevails over uniformity. In particular, there exist differences with regards to the mix between public and private component in the supply of pensions; the resulting combination of pay-as-you-go and funding in the system; the formulae adopted for the calculation of benefits – with a predominant role of insurance features in some cases and of redistributive features in others; the source of the financial assets, to be gathered either through social contributions or through general taxation, in both cases with important implications for savings and for the job market.

More generally, following Esping-Andersen's sociological analysis[2] – which considers not only pension systems, but also the other items of social protection expenditure – different social security "models" can be distinguished: the "liberal model" (represented by Great Britain and Ireland), basically less generous in establishing both eligibility rules and the level of benefits; the "corporativist model" (represented by France and Germany) in which the welfare is typically more generous, differentiated between categories, tied to employment and financed via social contributions on labour income; and, finally, the "social-democratic model" (represented by Sweden and Denmark),

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[2] Gøsta Esping Andersen, *The Three Worlds of Welfare Capitalism*, London: Polity Press, 1990.

featuring a universalistic regime, relying on greater financial support from general taxation and less stringent eligibility conditions.

Even when the analysis is restricted to pension schemes, some countries, such as Italy and Spain, appear to be characterised by quite generous public schemes financed through the pay-as-you-go (PAYGO) mechanism, whilst other countries (such as Great Britain, the Netherlands and Ireland) also greatly resort to a second pillar (company or occupational pension funds) and even to a third pillar (insurance policies), both characterised by the accumulation of savings and by investment of reserves in the financial market. Some countries use (or, at least, did it in the past) pension schemes for redistribution purposes (between categories and generations), without however redistributing always in the fair direction, i.e. from rich to poor; or for purposes of industrial policy, for example making recourse to early retirement, thus charging the social security system with the costs of restructuring companies and sectors in difficulty; or for patronage reasons, e.g. when, in view of an electoral campaign, promises of new benefits are made without an accurate check on resulting costs. On the other hand, in some countries the system is less invasive and distorted, with not too high payroll tax rates and pension formulae that pay more attention to the correlation between contributions and benefits.

One might reasonably ask whether the above mentioned differences represent more a source of welfare than a burden for Europe, more a resource that enhances the spaces of autonomy and freedom of each member country (indeed, why should all countries have the same social security system?) rather than a constraint that conditions the overall performance of the old continent, creating inefficiencies that reduce its growth potential.

Indirect sources of "convergence"

Although answering the above question would imply considering greater philosophical and social issues, it is possible, under at least two perspectives, to maintain that such a difference represents more a cost than an advantage and that a certain harmonisation should be pursued, maybe only through the mild "open coordination" method, already adopted for other important items of social expenditure policy and recently extended to pension systems. Because of its mild and not-coercive nature, this instrument should not irritate too much national susceptibilities.

The first perspective is macroeconomic. All over Europe, population is experiencing – although with different levels of intensity – an ageing process, caused by a sharp reduction of birth rates and a significant increase in life expectancy, particularly at the intermediate and old ages.

The demographic transition exercises a strong pressure on traditional social security schemes, based on direct financing of expenditure via contributions by active workers. Pay-as-you-go schemes, in fact, function well in young demographic systems, characterised by a low "dependency ratio" (a lower number of elderly with respect to young citizens), while supplying the necessary resources to pay the benefits becomes difficult in "mature" schemes, where the same ratio assumes comparatively high values. The resulting financial imbalance calls for reform, that, although assuming specific contents (according to the subsidiarity principle) cannot but follow a common strategy: the strategy of limiting expenditure (particularly in the countries where the scheme is already

financed through high payroll taxes), if only by reducing the dead-weight looses resulting from the present inefficiencies of the systems.

This common strategy thus results in the adoption of *convergent*, if not *similar* measures, such as those encouraging job prosecution at retirement and promoting the development of supplementary pension schemes to alleviate public budget from the growing burden that will be imposed by population ageing. Therefore, the correction of the financial imbalances requested by the stability pact is an indirect step towards greater pension uniformity, that would result from strengthening the long-term *sustainability* of each single system.

The second perspective is microeconomic. In the absence of real "harmonisation policies" towards a single pension design, the reform programmes must in fact take into account some principles which are at the base of the unification process. First, the principle of competition: it must be applied, above all, to private pension plans, that cannot bear restrictions, neither for investing resources in any country of the Union, nor as far as the supply of financial and insurance services by operators in a different EU country from the purchaser is concerned. Second, but strictly connected to the first, the principle of mobility of the production factors, i.e. work and assets: the application of this principle has profound implications both on the public and on the private component of pensions schemes. Finally, although not being one of the constituent principles of the Union, the non-discrimination of workers on the basis of age is starting to gain ground; this principle is in clear contrast with a retirement age fixed by law.

Although they have different scope and effects on many aspects of pension systems, these principles lead to a very innovative interpretation of social security on which *"the flexible and portable European pension"* could effectively be founded.

Indeed, they build upon the same "basic philosophy" as pension architecture, markedly different from the mere "welfare-based" concept and from the rules of the past. As already mentioned, these rules not only used to consider social security as an instrument for ensuring an income in old age, but also as a vehicle to realise redistributive, industrial, employment-related policies. This plurality of aims – at times in contradiction with the main objective, in a sort of "institutional ambiguity" – although certainly having contributed to the prevention of poverty among the elderly (particularly women), also facilitated an attribution of benefits without clearly identifying costs. Furthermore, it created a conspicuous "implicit debt" and a variety of negative collateral effects: the redistribution of benefits often followed directions opposed to equity; the industrial policy made use, not always correctly, of early retirement to favour production restructuring; in the job market some interventions, such as fiscal reduction on social contributions and lowering of payroll taxes were required to lighten, at least temporarily, labour costs and enhance employment.

The new pension architecture: mixed systems, actuarial formulae and true solidarity.

If this is the inheritance of the past, still existing beneath European pension systems, what is the new architecture under establishment? First of all, it is based on the concept of *social security* as a scheme designed to impose or to stimulate individuals to transfer, under a life-cycle perspective, resources from an active period to an inactive

period and to assist them in this endeavour, offering the possibility to access an efficient system, both on the whole and in its single components. This should be an instrument that *insures* the basic consumption of goods in the old age and not a form of *assistance* given by active population to the inactive classes. Assistance must certainly play a role, but in addition to the insurance-based nature of the system, and only in favour of less fortunate persons who, because they had a less prosperous and discontinuous working life, could not accumulate sufficient pension saving to guarantee for an adequate annuity[3].

A direct consequence of this approach is a change in the formulae for calculating pensions, that will be mainly based on actuarial mathematics, i.e. on a double strong correlation, between contributions and benefits, so that higher contributions correspond (as in any saving scheme) to higher benefits; and between benefits and life expectancy at retirement, so that, given the same accumulated pension wealth, lower retirement ages correspond to lower pensions. There should be, consequently, few exceptions to this rules, always matching an equity principle[4] and certainly not aiming at the creation of privileged areas. This is the case, for example, of such workers whose jobs imply below-average health conditions and life expectancy (the so-called "wearing activities") which, according to this principle should be eligible to some extra compensation, in terms of higher benefits (with the same contributions) and/or a lower retirement age.

It is worth remembering how these criteria are widely neglected in the (typically Italian) case of seniority pensions, but also in the various forms of early retirement schemes, widespread in various European countries.

The new approach, consequently, involves assimilating social contributions to a form of saving, meant to satisfy the needs of old age and to do it in an efficient way, i.e. through a good contributions/benefits ratio. In the public component of welfare systems this is considered a "forced" kind of saving; nevertheless, one should not ignore its features of return and risk, typical of any saving scheme; on the contrary, it is from a comparison to other possible saving schemes (for example, in conjunction with political pressures towards the so-called "privatisation" of the social security system) that the opportunity for maintaining the public component could emerge. It is in this light of integration between schemes with different characteristics (in terms of return, risk, solidarity approach and individual flexibility) that the idea of a mixed system has gained consensus, particularly at the European level. A mixed system combines in various proportions the public pay-as you-go component with the private funded component, which generally offers a higher return than the former, but implies higher risk and greater

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[3] The term "accumulate" in the text does not in any way refer to financing by the funding instead of the pay-as-you-go mechanism. In the latter case, it is sufficient that the benefits are in some way correlated to contributions, according to the so-called "Bismarckian" system, or that they are the actuarial equivalent, according to the "notional capitalisation" system (known by the acronym NDC: Notional Defined Contribution) that was the basis of the Italian and Swedish reforms in 1995, as well as for the reforms in various East European countries.

[4] See Erik Schokkaert and Philippe Van Parijs, *Social Justice and the Reform of Europe's Pension Systems*, in: 'Journal of European Social Policy', vol. 13, no. 3, August 2003, pp. 245-264.

costs.[5] Like any other form of saving, also the diversification of pension wealth must comply with criteria of good management.

Even if these principles are already widely affirmed in theory, their practical realisation is still imperfect and is meeting various forms of opposition, so that a multifaceted scenario dominates at the European level. Apart from the financial imbalances and the lack of a funding component in many countries, public pensions are still of the pay-as-you-go type and generally calculated by taking into account an average of the last wages, with an implicit "present" in favour of higher-earning categories and the youngest retirement ages. As a consequence, the system creates some distortions, both in terms of equity of treatment and of penalisation of job prosecution by older workers, therefore worsening the financial burden by reducing the contributors base (early leavers often turn to black economy, with related fiscal evasion). This is a vicious circle that politicians in many countries find difficult to break.

As far as the lack of harmonisation at European level is concerned, three aspects hold a certain importance: the presence of very differentiated payroll taxes in the public schemes, the different fiscal treatment of pensions and the "portability" of pension rights.

As for the first aspect, since there is a lot of difference in payroll taxes among European countries, one could reasonably consider this as an obstacle to the competition between the companies of the Union. Since this disparity cannot be simply ascribed to a different pension saving approach, is it correct to assume that very high contributions imply inefficiency and "hidden taxes" which do not bear short-term, nor obvious, but anyway burdensome consequences for the society.

The second aspect concerns the *fiscal treatment of pensions*. While the taxation of public pensions is connected to the budget policy of each member state, the taxation of the supplementary, funded component directly affects the issue of fiscal competition between the various countries; indeed, it is possible to find cases of double taxation in certain countries and tax havens in others. Since it is meant to finance needs for the old age, pension saving is normally considered to deserve more encouragement than other forms of saving, and is normally treated more favourably. Notwithstanding the general pronouncements in favour of the taxation of consumption and the exemption of savings, the harmonisation of fiscal systems is a long way from being realised. Therefore, taxation still constitutes a further constraint to the creation of European pensions.

The third, interesting aspect specifically concerns the *portability* of pension rights, i.e. the lack of obstacles to the mobility of workers, who can be limited by the prospect of loosing their pension rights by moving from one company to another and even from one country to another[6]. The portability issue implies different aspects: the possibility of cross

[5] The funded component is normally divided into two segments or pillars: the second pillar is connected to the employment (in certain cases compulsory with a defined benefit formula; in others, voluntary with a defined contribution formula); and the third pillar, based on individual pension schemes that can be freely purchased in the finance market; these are more cut out for individual needs and preferences, but also more expensive. See, Elsa Fornero and Elisa Luciano (eds), *Developing an Annuity Market in Europe,* Cheltenham: Edward Elgar, 2004.

[6] See "Cross-border portability of pension rights: An important condition for an integrated market for pension provision", CEPS Report, Task Force on Pension Portability, January 2003.

border transfer of accrued pension rights, when moving from one country of the Union to another; the possibility of maintaining the pension scheme of the country of origin; the creation of Pan-European pension funds. Today, there is full portability of pension rights as far as public pension systems are concerned (Regulation 1408/71), while a directive is awaited for private pensions of the second and third pillar. Again, under this perspective, the contributory pension appears to be better than the retributive pension, which usually carries much higher "transfer costs" and therefore could be an obstacle to workers' mobility.

Flexible pensions, i.e. overcoming the rigid demarcation between work and retirement

The same principles aimed at enhancing and ensuring the portability of pension rights also help overcoming the imposition of a rigid demarcation between working age and retirement age. Indeed, "portable" pensions are also compatible with a more flexible definition of working hours and free time, because the correlation between contributions and benefits prevents the consequences of individual choices from damaging (as happens now with pay-as-you-go pensions, particularly when they are only anchored to a seniority requirement and not to age) or advantaging the community[7]. They do not reward early retirement choices penalizing job prosecution, not oblige workers to retire at a fixed age, established by the state.

Also this change represents a big break from a past when the predominant philosophy saw a double advantage for workers in having retirement age fixed by law:

- in terms of safeguarding the workers against the need of continuing working at retirement to obtain a decent pension level.
- as an instrument to favour the replacement of old with young workers, more effective when combined with the prohibition of cumulating pension and earnings, that imposes an heavy taxation (up to 100%) on pension in case of job prosecution.

On a deeper reflection, however, both considerations appear based on questionable assumptions. The first is that the number of job places is fixed and therefore the work made by an old person can be substitutive (and not complementary) of the work made by a young person. The second is that the pension is, in some way, a "present" and the beneficiary must, in turn, renounce other labour incomes. The first assumption is weak for a number of reasons connected to the functioning of the market economy: job places are created in variable quantity and according to qualification, geographical area, full or part-time and several other characteristic of the workers; considering these elements implies that often the alternative is not between an old worker and a young worker, but between different costs and different opportunities. The second reason, that is founded on the scarce correlation between benefits and contributions of the pay-as-you-go formula, loses

[7] This means that the pension formula should be neutral with respect to the retirement choice. The notional defined contribution system, in principle, accomplishes this. In practice things may be different, as they are for example in Italy, where - with the full application of the Dini reform - job prosecution after age 65 will be penalised, given that no adjustment is granted, after this age, of the conversion coefficient of the "accrued pension" into an annuity.

value with the full application of actuarial fairness, a principle that is the basis of the contributory method.

Will "open coordination" be enough?

Even if the reform process along the above-mentioned lines takes place at single country level, the *open method of coordination* could represent an important instrument to indirectly realise some form of convergence of social security policies.

The first mention at European level to using the open coordination method to deal with the pension issue was made by the European Council in Stockholm (March 2001). Further steps were made on the occasion of the Gothenburg (June 2001) and Laeken (December 2001) Council, with the identification of three *common objectives* that, in turn, are divided into intermediate instruments and objectives:

i. *Adequacy of pensions*, intended as protection against social exclusion, accessibility to social security schemes that guarantee a satisfying standard of living; solidarity between and within generations;

ii. *Financial sustainability of public and private pension schemes*, to be reached through high employment levels, lengthening of working life, rebalancing of relationships between the generations, compliance with the inter-temporal budget constraints in fiscal policy;

iii. *Modernisation of the overall architecture of social security*, to be realised through pension formulas that are compatible with workers' mobility and labour market flexibility; clear regulations, more suitable to keep up with social changes and less gender-discriminatory.

The recent proposal[8] by the European Parliament on the Commission's Communication for a "Support of national strategies that guarantee secure and sustainable pensions via an integrated approach"[9] is focused on the open method of coordination, with the adoption of "indicators" to evaluate the effects of the proposed measures with respect to the three objectives; the appeal to a common work method, as well as the definition of a working calendar are indicators of a new awareness: it is inappropriate to allow each country to proceed on her own on an issue of such great social and economic relevance, that involves present and future generations.

Indicators of sustainability and adequacy

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[8] A5-0071/2002 session document. See also the "Joint report by the Commission and the Council on adequate and sustainable pensions" (6527/2/03 REV 2; March 2003), based upon the "Report on national strategies for future pension schemes" elaborated by each member of the European Union. The documents are accessible on the Commission's website via the link:
http://europa.eu.int/comm/employment_social/soc-prot/pensions/index_en.htm

[9] COM (2001) 362.

Building good indicators is a key instrument both for the overall design of the social security system and for assessing the convergence of each member country towards the common objectives.

Like for inflation, that is normally measured not through a single index but through several indicators, to evaluate the sustainability of social security systems it is useful to build a set of indicators, each one reflecting a particular aspect of the issue (and the same aspect under different viewpoints). The totality of these indicators enables us to perform a less-partial evaluation of the problem, for the present, and, above all, with regards to the future. Given the long-term nature of pension systems, it is essential that the indicators are projected in the future by the construction of adequate simulation models, incorporating the evolution within reasonable demographic and economic scenarios.

Amongst the sustainability indicators we can list:

i) the ratio of pension expenditure to GDP;

ii) the equilibrium tax rate;

iii) the coverage index;

iv) the ratio of deficit to GDP.

The first item probably represents the main indicator from a macroeconomic point of view, as it measures the absorption of resources by the pension system. Indeed, the political objectives are often expressed in terms of *stabilisation of expenditure with respect to GDP*; obviously, maintaining the ratio at a constant level in the presence of demographic ageing could already constitute an ambitious goal.

Although important, this indicator is not sufficient to evaluate the overall performance of the system, above all when it is fragmented into various schemes. In this case, from the equation that describes the financial equilibrium of each scheme, we can obtain the equilibrium tax rate, that expresses the contributory load that should weigh on the active population of the scheme to allow a full coverage of pensioners' benefits; equally, from the ratio between the real tax rate and the equilibrium tax rate one can obtain the coverage index, that measures the level of financial autonomy of each scheme. These calculations are relevant for analysing the functional distribution of income, i.e. the distribution of productive factors; however, for the medium-long term, they require quite complex evaluations, given that they are based on assumptions concerning the distribution of workers by sector (for example, between employees and self-employed) that are generally more uncertain and arbitrary than demographic forecasts. Consequently, a certain caution must be used in the interpretation and they must be considered jointly with the indicator of pension expenditure.

The same caution must be applied to the deficit indicator; it derives, given the real tax rate, from the two preceding indicators and measures the contribution of pension expenditure in each scheme to the overall imbalances of the public finance (or to the reduction of its surplus).

Furthermore, since the European strategy for sustainability is promoted above all through increasing employment rates (particularly in the old age and for women), the sustainability indicators should also include the so-called "implicit tax rate", i.e.

the implicit tax to the continuation of work that is hidden in the pension formulae; this indicator expresses the constraint imposed by the system itself on reaching its objectives.

Other sustainability indicators, also suitable to assess the adequacy of the system, can be constructed by applying to the pension system some concepts used for the financial evaluation of a saving scheme, which are meant to measure the economic advantage in participating in the scheme[10]. These are, in particular, pension wealth and its derivatives (such as the internal return rate) that can be applied to sample cohorts, to single categories of workers or to single individuals in a category or in a group. For example, in a balanced system the pension wealth of an individual, evaluated at the start of her/his working life by recording her/his contributions and benefit flows at the same instant through the sustainable return rate of the system (i.e. the growth rate of the contributory mass, approximately equal to the sum of employment growth rate and productivity growth rate), should be zero. If so, the system would not have sustainability problems; on the contrary, a pension wealth systematically above zero for all cohorts considered on the projection horizon would imply the creation of a burden on future generations, i.e. the formation of "pension debt" and the potential non-sustainability of the system.

A similar reasoning can be made for the "internal return rate", i.e. the rate that, given the real contributions and benefits of the system, makes the value of the pension wealth equal to zero: if this is systematically higher than the pay-as-you-go equilibrium rate (that is, the growth rate of the contributory mass), the system is "excessively" generous, still based on the transfer of debts to future generations, and hence difficult to sustain.

This set of indicators – being the above mentioned ones only examples, although particularly meaningful –, measured for the present and projected for the future, enables performing a financial sustainability diagnosis of a pension system. For example, it is easy to claim that a system characterised by a steadily growing ratio of pension expenditure to GDP, an equilibrium tax rate permanently higher than the real tax rate, a structural deficit and a return rate higher than the growth rate of the contributory mass for all groups considered, cannot be considered sustainable.

Obviously, a system does not necessarily have to be in equilibrium year after year, but it should be at least in the long run, or in the steady state.

It is also obvious that these indicators are not free of flaws. In particular, they appear inadequate in catching the various forms of uncertainty (different from the uncertainties concerning life expectancy) and the several market imperfections. Consequently, it appears fundamental integrating these with other indicators, specifically addressed at "capturing" the aspects of solidarity, non-marginalisation and safeguard of the standard of living.

One may object that overstressing the sustainability issue could sacrifice the other objective, the adequacy of benefits. This is indeed a weak objection, since the indicators, applied at microeconomic level, can offer important information also under the adequacy profile, through the comparison between different generations, genders, professional categories and individuals; moreover, this objection implies a debateable sort of hierarchy

[10] Cfr. Elsa Fornero and Onorato Castellino (eds), *La riforma del sistema previdenziale italiano*, Bologna: Il Mulino, 2001.

between the two objectives, while there is rather an explicit trade off between them. A greater adequacy could in fact be pursued first of all via efficient schemes that do not waste resources (in particular, those that do not dissipate work, pushing it towards the "submerged" black economy), are transparent and do not hide privileges, fulfil solidarity objectives towards the weak and not "pseudo-solidarity" in favour of more influential categories, closer to the political system or simply richer. Consequently, the solidarity framework must be built on and be largely compatible with a sustainable system.

As a conclusion, portable and flexible pensions are a premise for a more dynamic, but also more liveable Europe, capable of matching citizenship and solidarity goals on the one hand, with individual responsibility, risk-taking and flexibility on the other. Actually, the technical jargon of pension economics hides the appeal for a better quality of life and a higher productive efficiency, two objectives that are not always easily compatible, but also often simply neglected by politicians.