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Bent Greve

Old age and pensions

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Introduction

In modern societies old age is synonymous with retirement. It describes a third stage in the life course which is no longer bound to gainful work because earned income is replaced with (public) pensions and accruals from former savings. Ongoing increases in life expectancy have extended the retirement period, and while a lengthened life span is regarded as a blessing for the individual, a concomitantly prolonged average period of pension receipt poses substantial challenges for public and private pension schemes. Public pensions account for the largest spending item of most developed welfare states and, in view of the demographic aging process, measures to moderate the growth of pension expenditures rank high on OECD countries’ political agenda since about the 1990s. Old age not only means pension payments; the elderly are also the main consumers of health and long-term care, thus further increasing the old age bias in welfare spending. Along with their rising electoral weight, reforms that attempt to contain the growth of social expenditure relating to the elderly may become an ever more difficult exercise in democratic politics.

In this chapter we will first glance at the changed meaning of old age, centrally shaped by the development of pension systems. The subsequent section deals with the different functions and designs of pension systems, with a focus on developed welfare states. We then discuss the outcomes of pension policy, in particular the economic situation of the elderly. After briefly looking into the results of demographic projections, the main part of the next section will deal with reforms of pension systems and the problems for present or future retirees that may arise from the (non-)adjustments. Giving private pensions a larger weight in the public–private mix of retirement income has been an important element of recent reform activities. These pre-funded components are exposed to fluctuations of financial markets which possibly threaten income security in old age. The final section reviews the impact of the global crisis of financial markets in 2008 and its aftermath upon present and future pensioners.

The changing face of old age

During the pre-industrial era, “old age” was hardly a separated phase of individuals’ life in Europe. There was no such thing as retirement; rather, one worked until death or disability.
However, really old people, understood as above 60 years of age, were very few. In England, Germany and Austria, until the end of the nineteenth century their share always amounted to much less than 10 percent (Ehmer 1990, 206; Laslett 1995, 13).

An ordered, tripartite life course (see also Chapter 9), organized around gainful employment and separated by chronological markers, emerged not before the state intervened in the labor market and, next, introduced public pension schemes (Kohli 1986). Prohibition of child labor and compulsory schooling created a childhood/youth phase, preparing for employment, whereas access to (initially meager) public pensions relieved the pressure to continue working under all circumstances. A true “third age” – a post-employment phase free from work obligations – had two preconditions. First, the definitive withdrawal from the labor force requires sufficient means for maintaining the accustomed standard of living or, at least, for not becoming impoverished. In Western welfare states, this precondition for universal retirement became realized only after the Second World War when the overage and generosity of pension systems were expanded. Second, a “third age” anchored in the plans for life of individuals presupposes a high probability to actually live well beyond a fixed retirement age. Improved hygienic conditions, better nutrition, more effective safety at work and general access to healthcare have contributed to a survival curve becoming ever more “rectangular,” i.e., reaching old age is no longer an exception but rather an expectable phase of one’s life (Laslett 1989, chs V and VI, 1995, 22–25 and 50–55).

The gradual institutionalization of the life course with regularized transitions and events related to chronological age may be read off from the declining labor force participation rates of men aged 65 and older – in the 1920s still, between 50 and 60 percent of male over-65s were economically active in France, Germany, the UK and the United States (Ehmer 1990, 137), while in 1970, when the expansion of pension systems was largely completed in all but a few countries, the rate had fallen to (far) less than 30 percent in most developed welfare states (Table 36.1).

The return of high unemployment in Western welfare states in the late 1970s and 1980s, and the shift towards post-industrial economies, however, implied a de-standardization and differentiation of the tripartite life course, showing up in more varied (“fuzzy”) pathways into retirement and, on average, a lowered age of exit from the labor market. This is indicated by decreased labor force participation rates in the age bracket 60 to 64 between 1970 and 1990 (Table 36.1). In addition, further gains in life expectancy, predominantly occurring after age 65, have resulted in a prolonged third age. For example, a male Australian who actually stopped working at normal retirement age (65) in 2013 can expect 19.2 further life years (plus 7.3 years compared to 1970), and a Spanish women, 23.4 years (plus 7.4 years: OECD 2015b, 195). The advancing disconnection of biological and social age has led to proposals for differentiating between a “third” and a “fourth age” (Laslett 1989, 152–154). An ever longer retirement phase is regularly spent in good health up to age 75 or 80. Here we find the “new old” or “best agers” endowed with the potential for “active aging” and self-fulfillment, whereas the subsequent “fourth age” is characterized by increasing frailty and dependence. It is only after age 80 when the need for long-term care increases steeply (OECD 2015b, 201; see also Chapter 43, this volume).

Such a realistic perspective of a long life nevertheless implies a challenge for individuals in “work societies” meaningfully to structure everyday life for 20 or more years of retirement. A further aging population, which is the combined result of below-replacement fertility and declining mortality rates at higher ages, will also have grave societal consequences. The population share of those aged 65 years and older is highest in Japan and Germany and, according to projections carried out by the United Nations (UN), this will also be the case in 2030 and 2050 (Table 36.2). In the past (between 1950 and 2010) the growth was strongest in Japan, but in the future the increase will be steepest in China where the share of elderly will triple between 2010 and 2050. This foreseeable development puts substantial pressure on social security schemes. In
order to cope with rising social expenditure, almost all developed welfare states have already legislated and partly implemented reforms of their public pension schemes (see below). The increasing proportion of elderly people will also change the appearance of societies (in the streets, in enterprises) and, moreover, shift political power along the age axis. Voting power of
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the elderly will increase inexorably, and the rising age of the median voter has raised fears that, eventually, reforms violating vested interests of the older part of the population are no longer enforceable in democracies (Bovenberg 2008). Others have criticized the notion of a coming gerontocracy and argue instead that the elderly are not outright greedy; rather, they are responsive to the needs of the young generation and support political attempts aiming at intergenerational equity (see contributions in Vanhuysse and Goerres 2012).

Functions, designs and development of pension systems

Fully developed national pension systems perform four different functions (Barr and Diamond 2008, 25–33). First of all, they aim to alleviate poverty when flat rate benefits are paid to all individuals above a certain age or are targeted at those with insufficient resources. In a number of countries state responsibility is limited to this function. Income smoothing is a further objective in order to avoid a steep decline of resources after withdrawal from the labor market and, thus, to keep up the attained standard of living during retirement (“earnings replacement”). Furthermore, pensions insure against biometric risks. As annuities they protect retired individuals from above-average longevity so that they do not run the risk of outliving their savings. Survivors’ pensions cover the risk of work incapacity before reaching regular retirement age. Finally, linked to poverty prevention is the objective of redistributing income. Pension systems may be redistributed vertically (e.g., by means of a progressive benefit formula that replaces a higher percentage of previous earnings for low-wage workers than for higher earners), or horizontally when certain facts or events produce higher entitlements (e.g., redistributing towards families through a spouse supplement, as in the U.S. Social Security system), by granting caregiver credits, and between males and females when applying unisex mortality tables.

Basically, all four functions may be performed by only one public scheme – social pension insurance (see Table 36.3, second tier of first pillar). In reality, however, national pension systems are more complex and consist of several components which are assigned different functions and display different properties. For example, most national pension systems have separate schemes for basic security (first tier of the first pillar) and earnings-related pensions (second and/or third tier of first pillar). Moreover, one finds arrangements with functions divided between public and private components whereby the private pension schemes aim at income smoothing (third tier of first pillar, second and third pillar). “Private” means that pension schemes are administered by non-governmental organizations, but are state-regulated in order to protect

Table 36.3 Design of pension systems

<table>
<thead>
<tr>
<th>Pillar</th>
<th>Type</th>
<th>Membership</th>
<th>Financing</th>
<th>Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>3rd</td>
<td>Individual savings</td>
<td>Voluntary</td>
<td>Fully funded</td>
<td>Private</td>
</tr>
<tr>
<td>2nd</td>
<td>Occupational pension</td>
<td>Voluntary or (quasi-)mandatory</td>
<td>Fully funded</td>
<td>Private</td>
</tr>
<tr>
<td>1st</td>
<td>3rd tier</td>
<td>Earnings-related</td>
<td>Mandatory</td>
<td>Fully funded</td>
</tr>
<tr>
<td></td>
<td>2nd tier</td>
<td>Earnings-related</td>
<td>Mandatory</td>
<td>PAYG (contributions)</td>
</tr>
<tr>
<td>1st tier</td>
<td>Universal/targeted basic pension</td>
<td>(Citizenship right)</td>
<td>PAYG (taxes)</td>
<td>Public</td>
</tr>
</tbody>
</table>

Source: author’s elaboration based on OECD (2015a, 125).
employees’ or savers’ claims. In fact, all old age pension systems feature a “public–private mix.” However, the mix ratio varies between countries and changes over time. Private components are usually fully funded which means that they are backed by assets, invested in pension funds. In contrast, the pay-as-you-go (PAYG) principle applies to public pensions (first and second tier of first pillar): benefits are paid out of current revenues (taxes or contributions). Furthermore, the components differ as to how pensions are calculated – either they are determined by a benefit formula that somehow takes into account past earnings and length of insurance/service (second tier of first pillar and, to a less extent, second pillar) (defined benefit – DB) or they are dependent on the value of assets accumulated in individuals’ accounts at retirement, i.e., assets accruing from contributions and the performance of their investments (third tier of first pillar, third pillar and, increasingly, employer-sponsored occupational pension plans) (defined contribution – DC). Regularly, private schemes contain no redistribution beyond actuarially fair risk balancing.

Today’s pension systems in developed welfare states evolved from two different starting points – either the Bismarck or the Beveridge approach. The former is characterized by a public contributory social insurance scheme being the central institution for providing earnings replacement in old age. This approach is employment-centered, links benefits to previous earnings, and implies a priority of status maintenance (“consumption smoothing”) over poverty relief. Germany’s pioneering legislation of 1889 was followed in a number of countries of the European continent (e.g., Austria, France and Belgium) at the end of the nineteenth or early twentieth century and in the United States in 1935/1939. A larger number of countries embarked on a different path, mostly around the same time (e.g., Denmark in 1891). They followed the Beveridge approach, so named after the architect of a universal, basic security welfare state in post-Second World War Britain had presented his plan in 1942. These were the Anglo-Saxon nations (minus the US) and all of the Nordic countries. Here the focus is on poverty alleviation via universal flat rate pensions based on citizenship and financed out of taxes or tax-like contributions. These pension schemes were generally means-tested when first introduced, with some, but not all, later developing into universal “people’s pensions.”

Except for the Netherlands, all countries starting from the social insurance approach stayed on the same path, at least until the most recent reforms (Hinrichs 2000; Weaver 2010). They expanded their public schemes within the original framework: coverage was broadened to almost the entire (working) population, eligibility criteria for enjoying a pension became liberalized (e.g., flexible retirement), the range of PAYG benefits was expanded (e.g., survivors’ pensions) and, most importantly, the generosity of benefits was substantially increased and facilitated true retirement without additional private pensions. Significant changes have occurred since the late 1950s in countries that followed the Beveridge model. Their pension systems became more complex when they supplemented their basic pension schemes in two main ways. In light of favorable economic and demographic conditions at that time, Sweden (1959), Finland (1961), and, somewhat later, Canada (1965) and Norway (1966) topped up their “people’s pensions” with a second public tier that displayed all the features of a defined benefit social insurance scheme (Gordon 1988, 44–55). De facto, these countries joined the traditional Bismarck countries during the course of the early 1960s.

In contrast to these early birds, countries that provided only a basic flat rate pension as late as the early 1970s were the latecomers. They took a different route to achieving status maintenance in old age on a large scale. An earnings-related topping-up, and, hence, an expansion of the system, was accomplished via occupational pension schemes that were either mandated by law (Switzerland in 1985, Australia in 1992) or arose through collective agreements and eventually achieved almost universal coverage (Netherlands, Denmark). In any case, in latecomer countries, the second pillar is private, fully funded and regularly enjoys certain tax privileges (“fiscal
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welfare”; see Chapter 3). The UK pension system represents something like an eternal construction site having led to a complex building of different schemes. The new single-tier, flat rate State Pension (nSP) replaced the basic State Pension and the earnings-related State Second Pension (S2P) in 2016. This will be the foundation of future pensioners’ income (Pensions Policy Institute 2017). Occupational pension plans – increasingly of the DC type – and personal pension schemes are widespread, but many present and future retirees are left reliant on still meager state pensions and additional means-tested benefits. The 2007/2008 reforms (effective since 2012) attempt to broaden coverage with supplementary private pensions through soft mandate (“auto-enrolment”: Bridgen and Meyer 2011). In Ireland and New Zealand, the remaining countries that followed the Beveridge approach, provision for supplementary pensions is still left to voluntary actions of private actors, but is also encouraged through automatic enrollment in newly founded pre-funded schemes.

During past decades, a number of low-income countries have followed the Beveridge model and provided easy to administer universal flat rate pensions to their elderly population. Among others, these schemes have been established in Namibia, Botswana, Nepal, Brunei, Bolivia and Mauritius (already in 1958) (Willmore 2006). In a number of Southeast Asian countries (e.g., Singapore, Hong Kong, Malaysia, Sri Lanka and the Fiji Islands) but also in Swaziland, an alternative to both the Bismarck and Beveridge model has been established: provision for old age works via provident funds. These are (mostly) state-run compulsory savings schemes to which employees and employers contribute. After retiring from employment the funds accumulated in individual accounts are paid out as a monthly withdrawal, life annuity or, sometimes, also in part as a lump sum.

Pension systems in developed welfare states: outcomes

The expansion of pension systems in developed welfare states up until about the 1980s has substantially improved the income situation of the elderly population. Table 36.4 (column 3) shows the ratio between the median disposable income of persons aged 65 or over and all younger persons. In 2015, it varied between 0.8 and 1.0 in most European countries. Exceptions are Denmark where occupational pension schemes have not yet fully matured, and Belgium whose pension system is comparably less generous. Regularly, among the older population those below age 75 are better off than people of higher age (OECD 2015a, 168–169) because in the upper age brackets (widowed) women in single households are over-represented who mostly dispose of lower own-pension entitlements. Moreover, indexing of pensions at less than wage growth increasingly cuts the very old off from real income gains experienced by the working-age population.

A somewhat different picture emerges if one looks at the poverty risk rates (Table 36.4, columns 1 and 2). In about half of the countries a higher percentage of the elderly population is at risk of poverty compared to people of working age. In Switzerland the difference is most extreme, and no other European country shows such a high share of elderly people with a disposable income of less than 60 percent of the median. Apart from the Netherlands, the poverty risk rate is lowest in Hungary and the Czech Republic where the present generation of retirees is not (much) affected by pension reforms that have been legislated. The latter point is quite important because the income situation of today’s elderly results from institutional arrangements and individual behavior oriented to those rules, incentives or obligations as well as from the employment situation when they were of working age. Thus, figures presented in Table 36.4 (columns 2 and 3) do not inform about future pensioners’ income situation which for many will be shaped by atypical employment careers and the effects of past and ongoing pension reforms,
Table 36.4 Income situation of the elderly population, net pension replacement rates and pension expenditure in selected OECD countries

<table>
<thead>
<tr>
<th>Country</th>
<th>At-risk-of-poverty rate (60% of median) (2015)</th>
<th>Relative median income ratio, 65+/&lt;65 years (3)</th>
<th>Net replacement ratio (average earnings)</th>
<th>Pension expenditure, % of GDP (2011)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Age 18–64 (1)</td>
<td>Age 65+ (2)</td>
<td>Age 18–64 (1)</td>
<td>Age 65+ (2)</td>
</tr>
<tr>
<td>Australia</td>
<td>13.0</td>
<td>13.2</td>
<td>0.98</td>
<td>85.1</td>
</tr>
<tr>
<td>Austria</td>
<td>13.7</td>
<td>13.2</td>
<td>0.79</td>
<td>78.6</td>
</tr>
<tr>
<td>Belgium</td>
<td>13.4</td>
<td>13.2</td>
<td>0.81</td>
<td>69.5</td>
</tr>
<tr>
<td>Canada</td>
<td>13.8</td>
<td>13.2</td>
<td>0.77</td>
<td>68.4</td>
</tr>
<tr>
<td>Denmark</td>
<td>12.7</td>
<td>13.2</td>
<td>0.87</td>
<td>57.0</td>
</tr>
<tr>
<td>Finland</td>
<td>13.4</td>
<td>13.2</td>
<td>0.99</td>
<td>80.2</td>
</tr>
<tr>
<td>France</td>
<td>17.3</td>
<td>13.2</td>
<td>0.89</td>
<td>114.0</td>
</tr>
<tr>
<td>Germany</td>
<td>19.8</td>
<td>13.2</td>
<td>0.92</td>
<td>69.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>17.3</td>
<td>13.2</td>
<td>0.83</td>
<td>62.2</td>
</tr>
<tr>
<td>Italy</td>
<td>15.7</td>
<td>13.2</td>
<td>0.88</td>
<td>100.8</td>
</tr>
<tr>
<td>Japan</td>
<td>15.7</td>
<td>13.2</td>
<td>0.81</td>
<td>74.2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>15.7</td>
<td>13.2</td>
<td>0.83</td>
<td>62.2</td>
</tr>
<tr>
<td>New Zealand</td>
<td>16.4</td>
<td>13.2</td>
<td>0.88</td>
<td>100.8</td>
</tr>
<tr>
<td>Norway</td>
<td>9.0</td>
<td>13.2</td>
<td>0.92</td>
<td>69.3</td>
</tr>
<tr>
<td>Sweden</td>
<td>9.0</td>
<td>13.2</td>
<td>0.81</td>
<td>74.2</td>
</tr>
<tr>
<td>Switzerland</td>
<td>15.5</td>
<td>13.2</td>
<td>1.01</td>
<td>74.2</td>
</tr>
<tr>
<td>UK</td>
<td>17.6</td>
<td>13.2</td>
<td>0.99</td>
<td>69.3</td>
</tr>
<tr>
<td>USA</td>
<td>17.6</td>
<td>13.2</td>
<td>1.01</td>
<td>74.2</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>8.9</td>
<td>13.2</td>
<td>0.99</td>
<td>69.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.0</td>
<td>13.2</td>
<td>1.01</td>
<td>74.2</td>
</tr>
<tr>
<td>Poland</td>
<td>10.8</td>
<td>13.2</td>
<td>1.01</td>
<td>74.2</td>
</tr>
</tbody>
</table>

Sources: EU-SILC database (columns 1, 2, 3); European Commission (2015, 118 (column 4a = Base Case I: working from age 25 to 65) and 206 (column 4b = Base Case II: working 40 years until reaching standard pension age)); OECD (2016, 193 (columns 5a, 5b)).
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endangering their income security after retirement in several European countries (see contributions in Hinrichs and Jessoula 2012).

Another way to grasp the impact of pension systems upon retirees’ income position is to look at the percentage of former earnings that is replaced with (public) pensions. The European Commission (2015) has calculated the net replacement rate for workers who retired in 2013 after an employment career of 40 years at age 65 (Table 36.4, column 4a). The figures show quite considerable variance between European countries: Hungary and the Netherlands top the list while Germany clearly ranks lowest. Both the European Commission (2015) and the OECD (2015a, ch. 6) have also modeled the net replacement rate for future retirees who started employment in the 2000s and included the rules of the respective pension (and tax) system valid in 2008 or being implemented over the next decades. The figures presented in Table 36.4 (column 4b) assume a single male worker entering the labor market 40 years before reaching standard pensionable age in 2053 and earning an average wage. The replacement rates vary widely between countries and, where it is possible to compare the figures in columns 4a and 4b, the effects of already legislated retrenchments show up (e.g., for Finland, France, Hungary or Poland) as well as improvements due to the maturing of second-pillar schemes (Denmark). However, the calculated replacement rates reveal nothing of how representative the average earner pursuing a standard career actually is in the respective country. Further estimations for workers earning a multiple of the average wage (0.5 or 1.5) and different career profiles (e.g., breaks in employment or early/delayed retirement) show the progressivity and other distributive effects of the pension and tax system (European Commission 2015, 216–219; OECD 2015a, 144–151). Nevertheless, those calculations can hardly provide an adequate comparison of pensioners’ economic well-being because they leave out important features. For example, are pensioners exempted from health insurance contributions or co-payments for medical treatment? Are most elderly people homeowners and so do not have to pay rent, or do they have easy access to housing allowances? Is there free or heavily subsidized transport for pensioners and are there further rebates?

Finally, the different design of pension systems shows up in the figures on pension expenditure (Table 36.4, columns 5a and 5b). Public spending is very high in countries with a mature and (still) generous PAYG pension insurance scheme and a comparatively large share of people aged 65 and older, like Italy, Austria and France. In contrast, Australia, merely providing resource-tested basic security, spends much less. Private expenditure on second-pillar pensions was already on the same level in 2011 and will grow further in the course of these occupational schemes maturing. The same is true for other latecomer countries.

Challenges and recent reforms of pension systems

Population aging poses the most important challenge for all developed welfare. Increasing old age support ratios create problems of financial sustainability and generational equity as more elderly will have to be supported by fewer people of working age. The rising share of the population aged 65 and older (Table 36.2) appears even more dramatic if it is seen in relation to the total labor force. For example, in Japan there are currently about three elderly for every ten members of the labor force. The OECD estimates that in 2050 it will be an almost one-to-one ratio between elderly people and the gainfully employed. In other countries listed in Table 36.2 the change will be relatively less severe; the old age dependency ratio will roughly double between 2010 and 2050, except for China where it quadruples. Only a steep increase in the employment ratio (mobilizing more women and elderly), massive immigration or a reversal of declined birth rates could moderate this development. The foreseeable aging population has
triggered pension reforms in all OECD countries. The timing, patterns and intensity of reforms, however, are not directly related to the magnitude of imminent population aging. Rather, these features vary with the structural attributes of a given type of pension system and the established (or changed) politics of pension policy.

The latecomer countries (plus Ireland and New Zealand) have pursued reforms within the given structures of their pension systems (Table 36.5). Here the pressure on their public schemes is less pronounced because they are regularly on a smaller scale than in Bismarckian countries. Nevertheless, they have attempted to contain the rise of expenditure on basic pensions by introducing an eligibility age above 65 (e.g., in Denmark, the UK, Ireland and Australia), gradually lowered and – sometimes – more targeted benefits, and less fiscal support for private pensions. In order to still ensure adequate earnings replacement, these countries bank on further broadened coverage of private pensions (in particular for employees with fixed-term contracts, working part-time or holding other atypical jobs) and the maturing of these funded schemes which means higher private pensions.

Adjustments of Bismarckian pension systems may be divided into parametric and structural reforms. The latter are systemic changes that move established systems “off path,” while the former constitute incremental adjustments to the system’s “parameters.” They aim to stabilize or contain a further rise of pension contribution rates by altering the worker/pensioner (= system dependency) ratio, the wage replacement (= benefit) ratio, or by adding new sources of funding. It is possible to distinguish five main types of parametric reforms that have occurred since about 1990 (Table 36.5).

1 A higher retirement age limits the implicit expansion of pension systems due to lengthened life expectancy. Closing pathways into premature retirement (e.g., special pre-retirement schemes, granting disability benefits for labor market reasons) attempts to reverse the former
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Early exit trend and will lower the system dependency ratio. Furthermore, legislation raising the standard retirement age has been underway in a number of countries (e.g., the USA, Germany, Italy, Denmark and Ireland), and where women and public employees previously enjoyed a lower eligibility age it will be aligned to the age of men and/or private sector workers. In addition, a number of countries have introduced or extended options for flexible retirement. Claiming a public pension before reaching the standard retirement age regularly implies permanent (and more or less actuarial) benefit deductions, while working beyond the standard age is rewarded with a corresponding bonus. The steep increase of men aged 60 to 64 still participating in the labor market in a number of countries after 1990 (Table 36.1) should largely result from the legislated (dis-)incentives and bans as well as from improved employment opportunities for elderly workers.

The contribution/benefit link has been tightened in various ways. Where previously a certain number of years in covered employment sufficed to attain a “full” pension, and the benefit level was determined by earnings achieved during a number of “best years” or “last years” prior to retirement, benefit formulae have been changed so that earnings over the entire employment career are taken into account (e.g., in Austria or Finland). The strictest (and most transparent) link between lifetime contributions and benefits, which eliminates all internal redistribution, was established in so-called notional defined contribution (NDC) schemes (e.g., in Sweden, Italy or Poland), which mimic fully funded plans (with the growth rate of covered wages defining the “interest rate”) but actually operate on a PAYG basis. Other variants to scale down redistributive features were to abolish entitlements not earned out of contributions on own earnings (e.g., in Germany).

In almost all countries indexing formulae have been modified. Past earnings, which determine the level of the first claimed pension entitlements, are less often valued in line with average earnings growth, and increasingly adjusted to match the inflation rate (e.g., in France). Elsewhere, demographic parameters – further life expectancy at retirement age, as in all Nordic countries and Austria, or the changing contributor/pensioner ratio in Germany – have been incorporated into the formula by which the benefit level is determined at the time of retirement. Finally, pensions in payment are increasingly adjusted to consumer prices instead of previous wage development. This programmatic retrenchment yields a substantial long-run saving effect.

New sources of funding, meant to contain the contribution rate, have been injected into public pension schemes. Tax-financed subsidies cover redistributive features like caregiver credits or (improved) minimum pensions. Moreover, public schemes normally operate on a pay-as-you-go basis, holding reserve funds of varying amounts. In a number of countries these reserves have been temporarily augmented through a variety of means: by charging a higher contribution rate than is necessary to meet current expenditures (USA, Canada and Finland), by setting aside revenues from privatizing public enterprises or state budget surpluses in earmarked funds to be incorporated into the pension system at a later date (Belgium and France), or by drawing upon other publicly owned funds (Norway).

The only expansionary type of reform that has occurred in Bismarckian countries since the 1990s is the insertion of caregiver credits into the benefit calculation. Unpaid family work, like raising children or taking care of frail elderly, may now result in (higher) pension entitlements and, thus, improve benefit adequacy for women in particular. The procedures for crediting carework and the benefits that accrue from it vary widely across countries. A few countries have also improved minimum protection in old age, either inside the pension insurance or as a separate scheme, in order to cope with lower earnings-related benefits in future (Goedeme and Marchal 2016).
Beyond these incremental changes, *structural reforms* have been implemented in almost all Bismarckian countries that previously relied on earnings-related public schemes as the sole or predominant source of retirement income. International organizations, the International Monetary Fund, the OECD and notably the World Bank have pressed for such changes. The World Bank’s seminal publication (1994) founded the “new pension orthodoxy,” and the Bank became a very influential player in pension reform worldwide. In particular, it pushed for a new (or extended) mandatory, employment-related and funded component within the pension system (the third tier of the first pillar in Table 36.3) which was supposed to be less vulnerable to population aging than PAYG schemes. The strengthened role of pre-funding was also meant to increase national savings as a vehicle for enhanced economic growth in emerging welfare states, and the World Bank became directly involved in the reform process in some Latin American and Central and East European transition countries which set up mandatory funded second-pillar schemes (Müller 2003; Orenstein 2008).

Although the World Bank’s advice was less directed towards welfare states with mature PAYG schemes, it nevertheless contributed to weakening the prevailing pension policy paradigm in Bismarckian countries. Until about the 1990s, this paradigm had rested on cognitive and normative beliefs in the superiority of the social insurance approach *vis-à-vis* multi-pillar arrangements. It was widely shared among political and social actors. The apparent exhaustion of this single-pillar approach in light of long-term financial problems, however, has allowed the competing multi-pillar approach to gain ground in these countries. Real path departure occurred when privately funded pillars were introduced or substantially expanded in order to compensate for lower replacement ratios caused by the parametric reforms mentioned above. Participation in those supplementary schemes became either mandatory (Sweden and numerous MOE countries: Wang et al. 2016) or voluntary but stimulated by tax advantages (Germany, Belgium, France) and auto-enrollment (Austria, Italy). By embracing the multi-pillar approach, pension systems in almost all Bismarckian countries have come closer to the structure implemented in *latecomer* countries.

Both parametric and paradigmatic pension reforms have proved to be difficult, and often involve serious political conflicts (Hinrichs 2000; Myles and Pierson 2001; Schludi 2005). Because pension systems bridge extended time spans – from the start of an earnings career until the receipt of the final pension payout – and because the capacity of individuals to adjust to institutional changes decreases with proximity to retirement age, reforms regularly include long phasing-in periods. Moreover, public schemes have created large constituencies for whom pensions are of vital significance, and governments’ reform efforts may be risky undertakings if they aim at cutbacks of vested rights of current and future pensioners. In order to mitigate the political risks of pension reform, governments have chosen a variety of strategies, including forming coalitions with opposition parties to create oversized majorities in Parliament, seeking out cooperation with major stakeholders, notably labor unions and interest organizations of seniors, and/or forming expert commissions to furnish advice that can help legitimize painful decisions.

**The world of pensions after the financial market crisis**

The general trend of pension reforms in all developed welfare states has been a shift from defined benefit (DB)-type schemes towards a larger role of defined contribution (DC) schemes. The partial privatization of pension provision and stronger reliance on pre-funded pension schemes goes along with a “risk shift” (Hacker 2006): future pensioners will bear as individuals the risks of exposure to financial markets and increasing longevity because accumulated assets
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have to be “stretched” over a longer period of retirement and imply a lower annuity. In addition, in countries that have created or expanded those welfare markets for retirement income, the retreat of states from the responsibility to ensure social security and social justice leads to different outcomes: welfare markets for private pensions serve the same purpose (income smoothing), but, being void of redistributive features and accruing pensions depending on the performance of investments, they rather increase income inequality in old age.

The risks of private, funded DC schemes became painfully clear in 2008 when financial markets (almost) collapsed. Pension funds in OECD countries, on average, lost almost a quarter of their assets in 2008. This event was preceded by a smaller although substantial global downturn of stock markets during the early 2000s in the wake of the “dotcom crisis.” The pension funds recouped some of their losses in 2009 and 2010, but it was a “lost decade” for participants in welfare markets. In view of the sovereign debt and euro crisis, starting in 2010, financial markets still remain volatile. Future pensioners may see their old age security thwarted as (real) interest rates are at a trough so that, ultimately, fewer than expected assets will be available for conversion into a monthly pension payment.

The recent financial market crisis meant a serious backlash for the protagonists of pre-funded pensions (Table 36.3, third tier of first pillar). It fed the perennial debate about the suitability of funded schemes as a mechanism for funding old-age security and [...] brought to the fore the risk that pension systems face when cash benefits of individuals are linked to the fluctuations of financial markets.

(Pino and Yermo 2010, 7)

In contrast, contributory PAYG pension schemes have only been affected by the economic recession in the wake of the financial market crisis when lower wage growth and higher unemployment meant lower revenues. Despite the “perfect storm” for the protagonists of funded pensions, they are anxious that individuals and policy-makers may “overreact” and dismiss the idea of diversification, or concede to demands for abrupt policy change. Instead, they ask for better governance, improved regulation, portfolios that increase conservative investments with the individual proximity to retirement (life cycle funds) and better minimum protection (World Bank 2008; Holzmann 2013).

Nevertheless, the declining appeal of a shift towards funded pensions has triggered the next wave of pension reform. Some countries which envisioned funded schemes as a core component of a modernized pension arrangement have completely abolished this pillar (e.g., Argentina, Hungary, Poland), shifted to voluntary participation (e.g., Slovakia), or (temporarily) reduced the contribution share diverted for individual accounts (e.g., Latvia) (Wang et al. 2016). Several European countries, having run into a sovereign debt crisis and therefore being forced to ask for financial aid from supranational organizations (IMF or EU) in 2010 and later have had to enact pension reforms in order to regain room for fiscal maneuver (e.g., Greece, Portugal, Ireland). The measures taken may be considered as “rapid policy change” because they passed swiftly through the legislative process and were implemented at short notice. Moreover, they were large and thus caused a substantial and immediate impact upon the living conditions of current and future retirees – sometimes even altering the hitherto pursued policy direction (Hinrichs 2015). For example, benefit formulae were changed, generally leading to lower benefit levels; indexation of pensions in payment was suspended; and harmonization of different public pension schemes was accelerated. However, among the reform components those aiming at a longer working life, namely a higher retirement age, figured most prominently. Rebalancing the ratio of years spent in employment and in retirement is a quasi-natural response to
increasing longevity and a most effective strategy to ensure pension schemes’ financial sustainability. When they are able to stay on in the labour market, older workers continue contributing to a country’s economic output, they usually earn higher entitlements to public and private pensions and receive retirement benefits for a relatively shorter period. For that reason, a number of other Bismarckian and latecomer countries (e.g., Italy, Finland, Denmark, the UK) have also put fresh emphasis on a standard retirement age above 65, sometimes linked to the development of life expectancy, and/or have broadened older workers’ options to decide when to (fully) retire – albeit with an impact upon the level of their pension (e.g., Germany, Norway).

Note

1 In Germany, when it compulsorily insured almost all employees against income loss due to disability and old age through legislation in 1889, the declining abilities of older workers were the main social problem. Thus, disability pensions predominated (even up until the early 1960s). A statutory retirement age (initially 70) served as a marker for generally assumed disability at which an old age pension was granted without a medical examination of fitness for work. It already embodied the concept of a work-free phase of “retirement,” which was realized only decades later.

References


