# 2007 European Pensions Barometer

## Report: Measuring the pressure on EU pensions systems

**Aon Consulting Limited**
**11 Devonshire Square**
**London, EC2M 4YR**

**enquiries@aonconsulting.co.uk**

# Contents

# Introduction

With the implications of the worldwide credit crunch still playing out across the globe, Aon Consulting Limited (Aon) has released the latest version of its European Pensions Barometer (the Barometer).

Pensions remain a key issue across Europe, with pension reforms making their slow but steady progress across the continent. New evidence about our ever-increasing life expectancy continues to emerge, while future legislative changes continue to evolve almost as fast as the previous set can be absorbed.

This year's study is the third carried out by Aon and the second that contains analysis for 25 of the 27 member states of the European Union (EU), EU25. Our plans to include the two new members, Bulgaria and Romania, have been hampered by a lack of comparable data but the report does provide some commentary on the state of those systems.

We have refined the measures to take advantage of reliable data sources, but for the most part the analysis is consistent with previous years. This year's report also contains information on the nature of the data and the sources we have used.

As highlighted in previous reports, the analysis aims to be entirely objective, and therefore reflects pension reforms only in so far as they impact on the statistics being produced. As reforms come into effect the impact on the measures used can be slow. However, the mix of current and projected measures aims to ensure that sufficient weight is given to such change programmes.

While the Barometer produces just a snapshot of the pressures facing each country, we believe that it provides a helpful analysis of the pressures facing the EU and its member states. We hope that you find it interesting and useful.

# Executive Summary

The story of European pensions is a complex and varied one; one best told not by anecdotes and examples but by statistics:

- Between 2006 and 2007 European population growth slowed from 0.165% to 0.149% according to the data collected for the Barometer. The main change was a higher rate of deaths in 2007 than in 2006, and this reflects a population that is continuing to age. For the first time since the Barometer's inception the rate of deaths in 2007 (10.36 per 1000 population) was higher than the rate of births (10.3) and positive population growth only exists due to continued immigration to Europe.

- Reflecting the ageing population and the challenges that economies face, pension reform continues to be popular across Europe. Most reforms do not impact on the short-term cost of state pensions but are reflected in future, forecasted costs. For example, between 2006 and 2007 the average projected spend across Europe reduced marginally from 13.3% of Gross Domestic Product (GDP) to 13.2% GDP and we would expect this to continue to fall gradually as reforms are implemented. However, this is still substantially higher than the current average of 9.6%.

- As state schemes cut back, private schemes take up the slack. Between 2006 and 2007 the average workforce participation rate in private schemes increased from 40.2% to 41.9%. Ten countries revised the estimates of pensions participation upwards while only one country, Cyprus, revised its estimate downwards. As various forms of compulsory participation become more popular across Europe, this trend is likely to continue.

- Finally, the average retirement age across Europe also increased in the last year, from 60.5 to 61.0. This is a substantial change over a single year and is unlikely to represent a long-term trend of that magnitude. If this trend did continue then it would mean that, on average, every year that someone worked they would only get half a year closer to their retirement age.

The broad theme across Europe is therefore one of dealing with the ageing population. The 2005 Turner Report on the future of UK pensions concluded that the ageing population left the UK with four choices: lower pensions, higher retirement ages, higher member contributions or higher taxes. Assuming that the first is unacceptable, some combination of the latter three must be arranged.

As our report will show, with a combination of increases in pension costs as a percentage of GDP (to be funded by taxes), private pensions coverage (and hence higher contributions) and the average retirement age, this is precisely what Europe is already seeing and, with continued reforms, will continue to see.

# Results

## Overall Rankings

The table below summarises the results for the four measures – demographics, adequacy of state pension, affordability and sustainability, and private pensions – and a final, overall ranking is given to each country. Each category ranks 1-25, where 1 is recognised as the top ranking with favourable conditions and 25 as the lowest in comparison to other European countries. The arrows represent movements since the 2006 report.

| Country | | Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions | Overall Rank 2007 | Change over year | Overall Rank 2006 |
|---|---|---|---|---|---|---|---|---|
| Denmark | DK | 4 | 15 | 10 | 2 | **1** | = | 1 |
| Netherlands | NL | 7 | 17 | 8 | 1 | **=2** | ↑↑↑ | 5 |
| Sweden | SE | 5 | 16 | 9 | 3 | **=2** | ↑↑↑↑↑ | 7 |
| Irish Republic | IE | 1 | 24 | 4 | 5 | **4** | ↓ | 3 |
| United Kingdom | UK | 3 | 25 | 3 | 4 | **5** | ↑ | 6 |
| Estonia | EE | 6 | 22 | 2 | 6 | **6** | ↓↓↓↓ | 2 |
| Latvia | LV | 12 | 11 | 1 | 13 | **7** | ↓↓↓ | 4 |
| Spain | ES | 14 | 3 | 13 | 11 | **8** | = | 8 |
| Luxembourg | LU | 10 | 1 | 18 | 21 | **9** | ↑↑↑↑ | =13 |
| Lithuania | LT | 16 | 20 | 5 | 10 | **10** | ↓ | 9 |
| Poland | PL | 24 | 9 | 11 | 8 | **11** | = | =11 |
| Czech Republic | CZ | 22 | 7 | 11 | 14 | **12** | ↓↓ | 10 |
| Germany | DE | 13 | 19 | 16 | 7 | **=13** | = | =13 |
| Slovakia | SK | 19 | 10 | 7 | 19 | **=13** | ↑↑↑↑ | 17 |
| Finland | FI | 8 | 17 | 15 | 17 | **15** | ↓↓ | =13 |
| Cyprus | CY | 2 | 21 | 13 | 22 | **=16** | ↓↓↓↓↓ | =11 |
| Hungary | HU | 20 | 2 | 20 | 16 | **=16** | ↑↑ | =18 |
| Austria | AT | 18 | 6 | 19 | 15 | **=16** | ↑↑ | =18 |
| Malta | MT | 17 | 12 | 6 | 24 | **19** | ↑↑ | 21 |
| Portugal | PT | 9 | 8 | 24 | 20 | **20** | ↓↓↓↓↓↓↓ | 13 |
| France | FR | 11 | 13 | 21 | 18 | **21** | ↑ | 22 |
| Greece | EL | 15 | 5 | 25 | 24 | **22** | ↑ | =23 |
| Belgium | BE | 21 | 23 | 17 | 9 | **23** | ↑↑ | 25 |
| Slovenia | SI | 25 | 14 | 21 | 12 | **24** | ↓ | =23 |
| Italy | IT | 23 | 4 | 23 | 23 | **25** | ↓↓↓↓↓↓↓ | =18 |

## Areas of Concern

Within each of the four areas we measure, we highlight a number of countries whose statistics suggest the most concerning position. These are shown in the table below and on the Barometer map.

| Country | | Overall Rank 2007 | Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions |
|---|---|---|---|---|---|---|
| Denmark | DK | 1 | | | | |
| Netherlands | NL | =2 | | | | |
| Sweden | SE | =2 | | | | |
| Irish Republic | IE | 4 | | Risk | | |
| United Kingdom | UK | 5 | | Risk | | |
| Estonia | EE | 6 | | Risk | | |
| Latvia | LV | 7 | | | | |
| Spain | ES | 8 | | | | |
| Luxembourg | LU | 9 | | | | Risk |
| Lithuania | LT | 10 | Risk | Risk | | |
| Poland | PL | 11 | Risk | | | |
| Czech Republic | CZ | 12 | Risk | | | |
| Germany | DE | =13 | | Risk | | |
| Slovakia | SK | =13 | Risk | | | Risk |
| Finland | FI | 15 | | | | |
| Cyprus | CY | =16 | | Risk | | Risk |
| Hungary | HU | =16 | Risk | | | |
| Austria | AT | =16 | Risk | | | |
| Malta | MT | 19 | Risk | | | Risk |
| Portugal | PT | 20 | | | Risk | Risk |
| France | FR | 21 | | | Risk | Risk |
| Greece | EL | 22 | | | Risk | Risk |
| Belgium | BE | 23 | Risk | Risk | | |
| Slovenia | SI | 24 | Risk | | Risk | |
| Italy | IT | 25 | Risk | | Risk | Risk |

# Key Findings

Compared to the results shown in 2006, there have been some noticeable movements in the relative positions of the countries analysed.

- Among the 'winners' this year, Sweden has moved up five places to gain a spot in the top three. This is due to improvements in statistics relating to average retirement age and the deterioration in other countries' figures. Luxembourg and Austria have also seen substantial jumps in their positions as a result of improved participation rates in company pensions, with more people contributing to private pension schemes, as well as an increase of 2% of older workers (55-64) employed.

- Some of the larger falls this year are for Estonia (which loses its top three spot) and Cyprus. Portugal drops seven places this year, mainly on account of a far higher projected cost of state pensions by 2050. However, the largest fall this year, as well as the unwelcome position at the bottom of the table, is for Italy, which has seen a substantial worsening of demographics, with a decline in growth of the population and projections for the old-age dependency ratio increasing yet further.

The stories behind the statistics in each country are complex and varied and this report could not do all of them justice. However, we have picked a sample of countries to provide a flavour of the issues across the continent, as follows:

- Denmark – in the top slot for the second year running

- United Kingdom – the source of the analysis, with the largest funded pension system in Europe but the worst state pensions

- Portugal – a dramatic change of fortunes from first in 2005 to 20th in 2007

- Belgium – onwards and upwards away from the bottom of the table

- Italy – the joint largest faller and bottom of the table this year

In addition, we have provided comments on the two EU countries where insufficient data was available to include them in our full analysis:

- Romania

- Bulgaria

## Denmark

| Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions | Overall Rankings |
|---|---|---|---|---|
| 4/25 | 15/25 | 10/25 | 2/25 | 1/25 |

Denmark tops the rankings for the second year running. Much of the system is fully funded and is complemented by individuals saving via private pensions. Once again Denmark achieves this position through a balance of factors.

Overall the pension system in Denmark is stable in terms of both adequacy and sustainability for the future. With its pension system reportedly being one of the very few systems (worldwide) in surplus, there is flexibility to contribute to future schemes and undertake reforms. The key characteristic is that the majority of the pension structure is fully funded and based on employer or employee contributions. Coverage of first and second pillar pensions is almost universal and the demographics are also strong.

Importantly, with the expansion of occupational schemes and compulsory contributions into the pension system, this should ensure net replacement rates rise in the future.

The gross replacement rate for the average earner in Denmark is approximately 75% which is significantly above the EU average of 58.7%. According to OECD statistics, Denmark boasts an astonishing replacement rate of 120% for lower earners, which means that lower earners can expect a higher income in retirement than in work.

Average retirement age is a respectable 61 years and the projected life expectancy of 81 years in 2040 is once again below the EU average.  While lower life expectancy is not good news generally, it is helpful for the pensions system.

Finally, Denmark could become vulnerable in future if reforms do not flow through smoothly.  The pension age is expected to rise from 65 to 67 by 2027 and then the retirement age should change in accordance with life expectancy.  There is much resistance from unions to raising the retirement age any further.

## United Kingdom

| Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions | Overall Rankings |
|---|---|---|---|---|
| 3/25 | 25/25 | 3/25 | 4/25 | 5/25 |

The UK has improved its position gradually this year, now making the top five of the Barometer rankings. However, the adequacy of the state pension is still ranked the worst in the EU25.

The basis of the UK pension system for many years has been a gradual shift away from the state and towards employers and individuals. This incremental reduction in state benefits, while showing the UK system to be the least adequate in Europe, has meant that it is among the most affordable in the long term. Plans to increase the state pension age from 65 to 68 over the next thirty years should help to maintain affordability. The focus on means-testing means replacement ratios for the lowest earners are respectable compared to other countries.

This attitude to state pensions has been sustainable as the slack is being taken up by the private sector – the UK has the largest (in absolute terms) funded private pension system in Europe. However, a spate of scandals, crises and legislative reactions have jeopardised this position, generating lack of confidence in the system amongst both employers and individuals.

While private pensions remain strong at the present time due to momentum, the transition from defined benefit (DB) schemes to defined contribution (DC) schemes continues, alongside a general reduction in the generosity of company provision. Countering that, the pending introduction of Personal Accounts, with auto-enrolment and mandatory employer and employee contributions, is set to increase coverage of private pensions, although there is a recognised risk that this may result in a levelling-down so that existing provision is reduced.

Looking at specific measures, the UK's demographics are strong. Relatively high immigration (2.17% compared to an EU average of 1.5%) is boosting the working-age population, while an average retirement age of 62.6 is among the highest in Europe, as is the 57% of the 55-64 age group that are actively at work.

The inadequacy of the state system is beyond question, with the system showing last at almost every level of earnings. For an average earner retiring in 2007 the UK replacement rate of 17% is far below the average of 57%. Even the second lowest ratio of 30% for the Netherlands is almost double the UK figure. Only for the lowest earners, where the Labour government has specifically targeted benefits, do the replacement rates start to approach other countries.

A consequence of this system is that the UK is one of only seven countries whose spend on state pension is forecast to remain below 10% of GDP.

## Portugal

Portugal has seen a major slide in its ranking since the introduction of the Barometer in 2005. It toppled from top spot in 2005 to 13 in 2006, due in part to additional measures being included in the Barometer. Since 2006 it has fallen further, to 20. Changes in its position in the four measures have been as follows:

| | Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions | Overall Rankings |
|---|---|---|---|---|---|
| **2007** | **9/25** | **8/25** | **24/25** | **20/25** | **20/25** |
| **2006** | **7/25** | **8/25** | **20/25** | **19/25** | **13/25** |

The greatest change is in relation to projected cost of state benefits. The latest statistics suggest that Portugal's expenditure on state pensions will be over 20% by 2050 – the second highest in Europe. Almost single-handedly, this change has caused Portugal's further fall in the rankings.

On the positive side, retirement age is impressive at 63.1, and the proportion of older workers employed (55-64) stands at just over 50%. However, a concern for Portugal is the old-age dependency ratio, which is projected to be just over 58% in 2050 – ie. there are expected to be 58 pensioners for every 100 workers – this is the fourth highest ratio in Europe.

Finally, while many countries are expanding the penetration and size of their private sector pension savings, Portugal's position remains fairly stable, which means other countries have overtaken them. Since 2005 the total pension funds in the private sector have increased by less than 1% of GDP, while certain countries' savings are increasing rapidly and starting to overtake them.

# Belgium

| Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions | Overall Rankings |
|---|---|---|---|---|
| **21/25** | **23/25** | **17/25** | **9/25** | **23/25** |

After two years of languishing at the bottom of the rankings, Belgium has risen two places to 23. With major reforms in January 2006, the figures are now beginning to show the effect of strict controls on early retirement and employment of older workers.

A key cause of Belgium's poor ranking is its demographic position and, in particular, the low degree of participation in the workforce of those aged between 55 and 64. With only 32% of that age group employed, only Malta and Poland have lower employment amongst older workers.

At the end of 2005, the government published its *Generatiepact* (Generation Pact), which included a number of measures to improve the state pension dynamics with the intention of creating economic growth through skilled employment and to protect the Belgian social security system. The changes introduced by the *Generatiepact* included a pension bonus for older employees who continue to work, and a tax advantage for second pillar retirement benefits for those who stay at work until age 65. In addition, the criteria for early retirement programmes have been tightened.

As a result, Belgium's demographic ranking has improved a little this year. Within a year of the reforms, the number of older workers employed has increased by 2% and average retirement age is above 60 for the first time. However, this is not necessarily all down to the *Generatiepact*: reforms during the 1990s and other external factors will also have had a bearing on these results.

The adequacy of Belgian State pensions is questionable, with replacement ratios among the lowest five across Europe. Despite this, State pension is also forecast to be expensive, with expenditure on public pensions projected to increase to over 15.5% of GDP by 2050, compared to an EU average of 13.3%.

The apparent contradiction in these figures derives from the poor demographics mentioned earlier, and the fact that Belgium is forecast to have one of the highest ratios of retired to non-retired populations in Europe. In that sense, Belgium's problems are much like the rest of Europe's.

The state of private pensions in Belgium is healthier than that of many European countries, with 45% participating in private schemes. With the state system under continued pressure, real estate, private pensions and other savings will provide some welcome support to the overall pension system.

# Italy

| Demographics | Adequacy of State Pension | Affordability and Sustainability | Private Pensions | Overall Rankings |
|---|---|---|---|---|
| 23/25 | 4/25 | 23/25 | 23/25 | 25/25 |

Italy has replaced Belgium as the lowest ranked country in our survey. Severe pension problems appear to exist here, with radical changes required to safeguard the Italian pension system.

Pension reforms have become a stumbling block for the Italian government, with criticism from dominant unions and opposition parties. For years the pension debate has raged on, yet minimal changes have taken place. The financial crisis, through high national debts, is hindering the progress of the pension system and is a barrier when initiating changes to the system.

Italians can currently retire from the state scheme at 57 with 35 years' service. But while other countries have similarly low average retirement ages, the demographics of Italy compound this issue. The birth rate in Italy, at only 1.29 children per woman, is the second lowest in Europe. Combined with a lower-than-average growth rate, projected figures show that by 2040 there will be more people in the country over age 60 than in the working population.

These figures clearly indicate an elevated threat to the sustainability of the state system, and it is only a matter of time before the need for change can no longer be ignored. Upcoming reforms will increase the retirement age to above 60 in the next 10 years, but the antagonism against change could cause continued problems with the pension system.

The lack of a credible private pensions system (only 11% of the population have such savings) will not help the change process, although if plans adopted by other countries are a model for the Italians then this is likely to be an area that will be the target for future reform.

## Romania

Romania is one of the latest new members to the EU, forming part of the EU27. Like its fellow countries, it faces similar demographic problems, in that it has an ageing population along with low fertility rates.

The number of pensioners in Romania now reportedly exceeds the number of contributors. A high emigration rate of working people in search for better-paid jobs is one of the reasons behind this and it is widely believed that almost 10% of Romania's population is now out of the country. This trend could continue in future years.

In Romania the transition from a state controlled economy to a market economy has been slow compared to other countries in the region. The first steps towards reforming the pension system were taken in 2000 with reforms in retirement age, longer contribution period and the introduction of an annual points based-system (linking national average salary with contributions paid during the whole active life).

Legislation for the second and third pillar systems was passed in 2004 and 2006. The third pillar system is operational since the second quarter 2007 and contributions to the second pillar will start in early 2008.

## Bulgaria

Bulgaria, along with Romania, has recently been allowed to join the EU after some fairly strict entry requirements were met. Bulgaria shares the demographic issues of Romania in that it has an ageing population with high emigration numbers and a falling fertility rate. These factors can cause problems for the pension system since state pensions rely on the working population to support those in retirement.

The Bulgarian pension system consists of a social security pension, a mandatory individual account system, voluntary pension schemes and – since 1 January 2007 – voluntary occupational schemes. However, there has yet to be much interest in voluntary occupational schemes.

The state retirement age is being raised to 59.5 in 2008 and then -to 60 in 2009, provided that the sum of the person's age and the number of years of participation in the publicly-managed social security scheme is not less than 100 for men (37 years of coverage) and 93 for women (34 years of coverage).

There are also some potential areas of upcoming reform in the pension system. One of these is that the present system is fairly conservative and there is no scope for individuals to choose how their funds are invested.

# Methodology and Data Sources

The Barometer provides an overall assessment of the pension risks that EU countries face, and focuses on the impact or strains that pension systems place on the economy, employers and the citizens of each EU country.

Private provisions are analysed, along with the changing demographics and government policies on state pension, to determine whether the overall pension system is likely to be adequate. State pensions are further investigated to examine whether they are affordable and sustainable in the long term.

Details of the methodology and data sources are set out below, in the four main areas that we analyse:

- Demographics
- Adequacy of the State Pension
- Affordability and Sustainability of the State Pension
- Private Pensions

# Demographics

Demographics relates to the changes and characteristics of the size and structure of the population. It is widely believed these are natural factors, which cannot be influenced by human interference. However, it is apparent that governments can be involved through legislation and other means.  The degree of interference has varied throughout the world from countries imposing immigration controls to restricting the number of births.

Pensions involve the transfer of resources from a) the working population to the retired population and b) an individual's working lifetime to their retirement.  The former takes place through unfunded social security systems, while the capital markets and funded pension systems typically deal with the latter.  In practice there is overlap in both areas.

The demographics of a country influence the effectiveness and sustainability of the transfer of resources and our analysis looks at the impact of demographics on both types of transfer.

At a macro level, the ratio of the retired population to the working population is a key measure, as it influences the affordability of the population transfer.  This ratio varies substantially across Europe, and while it is expected to increase in all European countries, the rate of increase remains highly variable.  A number of different factors, including mortality and fertility rates, the age of retirement and the effects of migration, influence the ratio.

At the personal level, factors such as average retirement ages are relevant, as individuals need a certain number of years to save enough to facilitate their transition to retirement.

Factors analysed in reaching an overall assessment on this measure include the following:

| Data | Source |
|---|---|
| Total population growth (from births, deaths and immigration) | CIA World Factbook |
| Fertility rates | CIA World Factbook |
| Average retirement age of the labour force | Eurostat |
| Percentage of older workers employed (between 55 and 64) | Eurostat |
| Projected old age dependency ratios | European Commission Synthesis Report |

## Adequacy of the State Pension

The state pension will be the primary source of retirement income for many Europeans. If this is inadequate, political pressure could be brought to bear on European governments. As older people form an increasingly large proportion of the population and may have a higher propensity to vote in elections, this pressure may be difficult to resist.

Adequacy has been assessed on a relative basis within each country – for example, we have compared the average state pension with the average wage. This assumes that pensioners primarily compare their income with those of their younger compatriots, and not with pensioners in other EU countries. Such a comparison means that differences between the cost of living in different countries are not taken into account.

Factors analysed in reaching an overall assessment on this measure include the following:

| Data | Source |
|---|---|
| Poverty rates | Eurostat |
| Income of over 65s. | Eurostat |
| Pension replacement rates | Report by ISG of the Social Protection Committee (SPC) |
| Total gross replacement figures | OECD |

## Affordability and Sustainability of the State Pension

In most European countries, state pensions are the single largest item of government expenditure. Moreover, this expenditure is set to rise significantly as a percentage of GDP. The increasing cost of pensions will require governments to cut back on other areas of -expenditure or to increase taxes. Neither option will be an easy or a popular choice.

Factors analysed in reaching an overall assessment on this measure include the following:

| Data | Source |
|---|---|
| Pension expenditure as a percentage of GDP | European Commission – 2005 EPC Projection of Age-Related Expenditure |
| Forecasted 2050 figures. | European Commission – 2005 EPC Projection of Age-Related Expenditure |

## Private Pensions

Private pension savings help to finance pensions that would otherwise be unaffordable or unsustainable. Because they involve savings, they mitigate the demographic problem of today's large population of workers relying on tomorrow's smaller population of workers to pay their pensions. In addition, substantial pension savings can help to ensure the adequacy of future pension provisions, although this also depends on how the savings are distributed across the population.

Factors analysed in reaching an overall assessment on this measure include the following:

| Data | Source |
|---|---|
| Size of company pension funds as a percentage of GDP | European Commission – A & S Pensions (Technical Annex) |
| Percentage of the population contributing to private schemes. | OECD |