COMMENTS ON SESSION 4
PENSION REFORM AND FISCAL POLICY

Per Eckefeldt[*]

1 Comments on "The Reform of the Portuguese Public Employees' Pension System: Reasons and Results" by Vanda Cunha, Helder Reis, Ariana Paulo and Nuno Sousa Pereira

In their paper, Cunha, Reis, Paulo and Pereira analysed the 2007 reform of the Portuguese public employees' pension system. In doing so, they described the reasons behind the reform and notably the underlying demographic trends, the main aspects of the 2007 reform and its implications for fiscal sustainability. As a result of the reform, they estimate that the reform measures taken in 2007 significantly reduce the projected increase in pension expenditure as a share of GDP, by 4 percentage points of GDP by 2060. Consequently, the risks to public finance sustainability are markedly reduced.

A reform of the public pension system in Portugal was motivated by the demographic change in the coming decades, which is shared by the other EU Member States. The demographic trends in Portugal are close to the EU average, as measured by the development of the old-age dependency ratio. However, the long-term budgetary impact of ageing was somewhat higher than on average in the EU. The 2007 reforms have reduced significantly the projected increase in pension expenditure in Portugal.

The main channel through which the lower increase in pension expenditure over the long-term materialises is the introduction of the sustainability factor. The sustainability factor automatically adjusts new pensions to changes in life expectancy. Another interesting feature of the pension reforms is the introduction of a new pension indexation rule. The new rule depends on the level of the benefit as well as on economic growth (see Table 1). Relatively small pensions (from the beneficiaries' point of view) are indexed in part to GDP, while relatively large pensions are indexed on prices, and the top pension income bracket in fact is not indexed at all. This will decrease the inequality in income distribution of pensioners as far as public pensions are concerned. It would be interesting to see what effect this feature would have on the total pension expenditure ratio as compared to a more standard type of indexation rule, like for instance 100 per cent price indexation, or 50 per cent wage and 50 per cent price indexation.

One aspect of the sustainability-enhancing reforms is a strong decline in the benefit ratio (*i.e.*, the average pension in relation to the average wage) over the long-term. In the assessment of long-term fiscal developments by the European Commission under its multilateral budgetary surveillance, this introduces a risk element. Looking at pension for public employees (CGA pensions), the decline in the benefit ratio is even more pronounced than for the general social security pensions. But it is worthwhile noting that despite the 2007 reforms, the benefit ratio remains high at 66 per cent in 2040 for CGA pensions, compared with 39 per cent for general social security pensions. The relative generosity of the CGA pension system is also evident from higher replacement rates as compared with the general social security pensions. In addressing possible risks related to reductions over item of pensions in relation to wages, a key aspect will be expanding labour supply and the number of contributors. For this to materialize, the incentive to postpone retirement needs to be in place. It would be interesting to see further analysis of labour force participation.

[*] Directorate General for Economic and Financial Affairs, European Commission, Belgium..

Table 1

Rule for Updating Pensions

	GDP real variation rate less than 2%	**GDP real variation rate from 2% to 3%**	**GDP real variation rate equal or greater than 3%**
Pensions under 1.5 IAS	CPI change rate	CPI change rate + 20% GDP real variation rate (minimum: CPI change rate + 0.5 percentage points)	CPI change rate + 20% GDP real variation rate
Pensions 1.5 to 6 IAS	CPI change rate – 0.5 percentage points	CPI change rate	CPI change rate + 12.5% GDP real variation rate
Pensions 6 to 12 IAS	CPI change rate – 0.75 percentage points	CPI change rate – 0.25 percentage points	CPI change rate
Pensions above 12 IAS	no update	no update	no update

In conclusion, the large pension reforms Portugal goes a long way towards enhancing fiscal sustainability. It includes some aspects that are likely to contribute to the long-term stability of the pension system (e.g., the sustainability factor). Moreover, it adds some interesting and innovative features (e.g., the income level and GDP growth dependent indexation scheme post-retirement). However, as for several other countries, there are some potential risks present in Portugal related to the relative decline of pensions. To ensure the lasting success of these important reforms, further steps are likely needed. In particular measures that effectively will lead to longer working lives would appear as one route that will be need to be explored further in light of the projected continuous gains in life expectancy, hopefully in good health, in the coming decades.

1 Comments on "Pension Plan Revision and Fiscal Policy of Japan" by Monotobu Matsuo

In his presentation, Motonobu Matsuo analysed the prospects for the public finances in Japan in a long-term perspective, with particular emphasis on the fiscal consequences of the 2004 reform of the pension system. In doing so, he described the reasons behind the reform and notably the underlying demographic trends, the main aspects of the 2004 reform and its implications for fiscal sustainability. Moreover, a medium-term fiscal consolidation plan initiated by the government was foreseen to get the public finances on a more sustainable path. As a result of the reform, he concludes that the pension system will: (i) introduce certainty as regards pension contributions; (ii) better balance the intergenerational equity in view of demographic changes; (iii) secure a targeted benefit level (vs. the active working population), but this will require an increase in the governments contribution to public pensions. This latter aspect is crucial and it is planned to be financed by a major tax reform, including a consumption tax.

A reform of the public pension system in Japan was motivated by the demographic change in the coming decades, which is ageing much faster than in other parts of the world, including in Europe. The old-age dependency ratio is projected to rise from an already high level of 33 per cent today to as much as 83 per cent in 2050 (compared with the average in the EU, starting at 26 per cent and rising to 52 per cent by 2050). As regards the medium-term fiscal policy strategy aimed at supporting fiscal sustainability, a successful consolidation programme (pre-crisis up to

2008) contributed to a stabilisation of the debt level. The authorities were committed to further consolidation over the medium-term.

The pension reform of 2004 enhances the sustainability of the pension system and at the same time it safeguards pension remaining adequate in the future, which is a positive outcome in light of the already old and rapidly ageing Japan. The pension benefit is secured through the targeted basic pension replacement rate of no less than 50 per cent. It takes into account changes in life expectancy and changes in the labour force as a proportion of the population such that increases in public pension expenditure are curbed automatically. A cap is introduced on contribution rates by 2017, entailing an increase of some 5 percentage points as compared to 2005. Nonetheless, as pension post retirement are indexed (at the most) to prices, a relative decline of pension as compared to workers would materialize (assuming positive wage growth), which could raise concerns of pension adequacy over time for pensioners. It would be interesting to evaluate the pertinence of such political sustainability risks in the case of Japan. Another factor is the planned increase in the stares share of financing basic pension, rising from 33 to 50 per cent by FY2009. While state financing may be considered as well-founded for a social security insurance scheme without earnings requirements, there is still a potential political risk in the sustainability of this financing model and it would be interesting to highlight the extent to which such risks are present in the case of Japan.

In conclusion, the Japanese pension reform enhances sustainability and at the same time safeguards replacement rates. As it introduces more transparency and a more effective allocation of pension funds, the "political sustainability" could be enhanced. The improved information to workers on their accrued pensions will raise awareness of retirement incomes and could lead to increases in private savings. Moreover, the reform seeks to strengthen the reconciliation of work and family life, which could in fact have a positive impact on fertility rates, something that would a welcome development in rapidly ageing Japan. Nonetheless, there are challenges in Japan, including the financing of the pension expenditure under the 2004 reform as well as reducing the elevated debt level, being considerably above the OECD average even before the onset of the global economic crisis.