CONSEIL D'ORIENTATION DES RETRAITES
Plenary session October 18, 2018 at 9:30
"Pension system steering"

Brief

Prepared by the General Secretariat of the Council, under the direction of the President of the COR

Summary: As part of the debate on the announced pension reform, this dossier looks at the steering of a pay-as-you-go pension system that consists of choosing and adjusting the levers at the disposal of the pension authorities in order to achieve the objectives assigned to the system and to deal with economic and / or demographic hazards. The first part reviews the challenges involved in steering a pension system. The second part focuses more particularly on the ways of steering a defined-return system (where pensions are the actuarial equivalent of contributions). Finally, the third part describes the steering of the pension system in Sweden and Germany.

I. Pension system steering and challenges

- **What are the different steering options?** It is possible to classify pension systems according to the form of commitment that underpins them and according to the steering procedures that result from them (*document n° 2*). Pension system managers can commit to specific rules, which then constrains them in their management. Three categories can be distinguished: "defined-benefit" systems where the commitment relates to the amount of pension and the adjustment is made by contributions; "defined-contribution" systems, where the commitment concerns the contribution rate and the adjustments are made to the retirement age or the amount of pension; and "defined-return" systems where the commitment concerns the return on contributions in order to ensure that each generation receives the actuarial equivalent of its contributions. Managers may, on the contrary, choose not to be bound by any *a priori* rule; they then have all the levers (age, insurance record, contribution rate, replacement rate, indexing rules, etc.) to steer the pension system even if, at least in the long term, they have to ensure that the system is balanced.
- **How is the French pension system currently managed?** The law of January 20, 2014 set up a steering process: a shared diagnosis by the COR with the publication of monitoring indicators in its annual report, decision-making assistance through the formulation of recommendations by the Pension Monitoring Committee (CSR), and decision-making by the legislator for basic schemes and by the social partners or professions representatives for supplementary schemes. However, there are no *a priori* rules binding decision-makers and steering remains fragmented and shared (*document n° 3*).

II. Managing a defined-return pension system

- **What is a defined-return pension system?** This system aims to ensure for each generation the actuarial equivalence between the sum of the contributions paid and the sum of the pensions received on the basis of the pay-as-you-go return. The financial equilibrium of such a system is by construction guaranteed (*document n° 5*).
- **How are rights accrued in such a system?** During their career, each insured person accrue rights that are calculated directly from the contributions paid. These rights are expressed in units of account, which may be euros or points. The unit of account does not change the nature of the system and serves as a calculation intermediary. Even expressed in points, this defined-return system differs from the AGIRC-ARRCO system through the rules that determine the setting of the parameters (purchase value and service value of a

point) (*document n° 5*).

- **Which principles should a defined-return system abide by?** Two principles must be respected (*documents n° 4 and n° 5*). On the one hand, entitlements and pensions must be revalued according to an index taking into account the implicit return on PAYG, which is equal to the earnings growth rate (holding constant the contribution rate). The return is therefore not fixed per generation but depends on the economic and demographic conditions of the generation during its life cycle. This principle makes the pension system insensitive to growth. It is possible to prefer other revaluation indexes close to earnings, such as the average earning per capita, corrected or not by the evolution of the active population. The financial balance is then less automatic but this choice can be justified by considerations of equity or macroeconomic stabilization. On the other hand, the expected length of retirement must be integrated in the calculation of the pension at the time of settlement. For a given amount of points at pension claiming and at a given claiming age, the pension level will decrease over generations as life expectancy increases. For an individual, within a generation, the pension level increases as soon as he/she retires later.
- **Can pensions be increased on settlement?** If it seems appropriate to limit the loss of income on retirement, the amount of the pension on settlement may be increased with, as counterpart, a lower indexation of the pension paid during retirement (wage bill growth - X %). This choice favors people with short life expectancies (*document n° 5*).
- **Is the system rigid?** It is possible for a generation to increase their contributions to benefit from higher pensions in the long term or vice versa. These two operations generate either reserves or a need for long-term funding. The first is therefore, *a priori*, easier to consider than the second is (*document n° 5*).
- **What are the strengths and limitations of such a system?** The use of the pension system to immediately improve the situation of pensioners (increase in contributions to improve current pensions) or that of working population (decrease in pensions to lower current contributions) is prohibited in such a system. This steering method is therefore not flexible, but it does protect the socially insured against opportunistic decisions by providing them a real guarantee (benefiting from the actuarial equivalent of their contributions in the form of pension benefits). This system, because of its steering requirements, entails a strict discipline on the part of decision-makers, which can be difficult to maintain and can appear relatively complex for the socially insured (*document n° 2*).

III. Foreign examples

- **How is the Swedish mandatory public pay-as-you-go pension system managed?** Since the 1998 reform, the system is a defined-return one. The pension entitlements accrued in notional accounts, based on a contribution rate of 16%, are revalued according to the average earnings growth rate. The pension at settlement is calculated on the basis of an annuity divisor, which depends on life expectancy and which takes into account a subsequent indexation (average earnings growth rate - 1.6%) (*document n° 6*).
- **And in Germany?** The managers of the German mandatory pension system are not bound by an *a priori* rule even if they are assigned many adjustment rules and have defined various thresholds to respect. Thus, there is a contribution rate that should not be exceeded in the medium term. The revaluation of pensions takes into account the evolution of ratio of retirees to contributors, with a safeguard clause guaranteeing that pensions cannot fall in nominal terms. In addition, the legislator has defined minimum replacement rate thresholds not to be crossed in the medium term. The legal retirement age is the preferred adjustment variable for steering the system (*document n° 7*).