EU Communication

DEMOGRAPHIC CHANGE

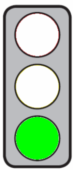
Status: 29.06.2009

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Communication: The Commission is urging for structural reforms in Member States in order to stay abreast of the impact of demographic change.

Parties Affected: Almost all sectors of the economy.



Pros: (1) Fundamental structural reforms of social security systems are absolutely necessary to ensure a solid and sustainable financial basis for them.

(2) In principle, it should be left to the employees to decide for themselves when to enter retirement.

Cons: The call to politicians to provide "prudent management of people's retirement savings" does not exclude the direct intervention in the business of retirement pension institutions. However, politics should merely ensure the effective monitoring of pension systems.

CONTENT

Title

Communication COM(2009) 180 of 29. April 2009: Dealing **with the impact of an ageing population in the EU**

Brief Summary

► **Objective of the Communication**
On the one hand, the Commission concedes that combating the current economic downturn must be given top priority in the short run and is aware of the ensuing debt for Member States. However, regardless of this it refers to the high future burden on public budgets resulting from the ageing population. It calls for "urgent" reforms and regards the crisis as being "the right time for social innovation" (p. 11).

► **Expected demographic trends in the EU by 2060**
Assuming that the basic parameters remain the same (projection), the Commission expects the following trends:
– The population of the EU as a whole will increase slightly from 495 million (in 2008) to 505 million people due to a higher life expectancy and continuous immigration flows (2009 Ageing Report, p. 19).
– The proportion of the number of people aged 15 to 64 ("working age people") and the number of people older than 65 will fall from 4:1 (in 2008) to 2:1.
– The number of employees will fall by 19 million, although the overall employment rate will increase from 65.5% to approximately 70%.

► **Expected budgetary impact of the demographic trend**
– By 2060 the Commission expects that due to the population getting older there will be an increase in public spending of an average 4.75 percentage points of gross domestic product (GDP) in the EU-27 and of 5 percentage points of GDP in the eurozone. In Member States which have already introduced reforms the increase will be below the average.
– In detail the Commission projects that
  - the demographic trend will push up public pension expenditure "very significantly" in all Member States,
  - relative pensioners' income will decline "substantially" in a number of Member States,
  - public expenditure in healthcare is projected to grow by 1.25 percentage points of GDP in the EU, despite the supposition that technical progress could even end up lowering costs in the long run,
  - public expenditure for the long-term care of elderly people will increase by 1.25 percentage points of GDP, especially as care provided by relatives – currently very common – will increasingly have to be replaced by external service providers in future,
  - a reduction in the amount of GDP spent on public education is not to be expected, despite a fall in the number of pupils, since it is necessary to increase education spending in order to achieve the desired "substantial improvement in the quality of education".

► **Political fields of action for Member States**
– **Pension policy:** Despite the current financial crisis, the Commission favours that existing "pay as you go" pension systems be supplemented by funded pension "to secure adequate and sustainable private pension provision in Member States" (p. 10). At the same time it invites "policymakers, regulators and supervisors to promote prudent management of people's retirement savings" (p. 6). Moreover, it demands that:

- eligibility requirements for receiving public pension be tightened and incentives for early retirement abolished,
- pension schemes be designed in a flexible manner so that employees can decide for themselves when to enter retirement and that "employment obstacles" be removed, such as a statutory retirement age.

– **Family policy:** The Commission recommends that Member States take action for demographic "renewal". So, for example, top "priority" should be given to the possibility to combine family life and work as well as to gender equality. According to the Commission, investing in high-quality childcare and in the employability of parents can represent "investments with huge potential returns" (p. 7). The Commission further considers options for:
  - tax reductions on second earners as this might increase labour market participation.
  - the improvement of the "work-life balance", in particular through better conditions for parental leave.
– **Labour market policy:** The Commission is of the opinion that the main must be to increase labour market participation and to take full advantage of the human capital potential. Therefore it proposes measures, that
  - enable young people to enter into and older unemployed workers to return to the labour market in order to avoid a (possibly permanent) dependency on social benefits,
  - make work a more attractive option than drawing social benefits, thereby removing disincentives to work. Beneficiaries should be encouraged "with targeted activation policies" to actively seek work, especially the low-skilled (p. 8).
– **Healthcare and long-term care policy:** The Commission sees "considerable" potential in national healthcare systems for boosting efficiency. Regarding long-term care, it recommends favouring professional "care provision at home" (p. 10).
– **Education and research policy:** According to the Commission, labour productivity will be of crucial importance for future economic growth and therefore the education level – in particular that of low-skilled workers – and the institutional environment of research and development must be improved.
– **Immigration policy:** Although the Commission believes that a "well organised" immigration policy can fill the expected labour shortages, it also points out that immigrants are often badly educated or have difficulties making full use of their professional skills in the immigration country. It therefore calls on Member States to take action to improve the integration of immigrants.

▸ **Political action fields for the EU**

The Commission will to gather positive "best practices" experience from the single Member States. In detail it will:

– to extend its surveillance – as defined in the stability and growth pact – "beyond fiscal policy" to reforms of social expenditure programmes that offer better income protection and strengthen incentives to work ("flexicurity").
– to take measures for a "proper functioning of financial markets", in particular to make sure that financial assets for "supplementary" pension schemes and health insurance are protected.
– to promote "efficient and equitable" education and training systems in Member States to boost productivity. Moreover, it wishes to work with Member States to assess which skills are needed in future.

Statement on Subsidiarity

The Commission's Communication does not address the issue of subsidiarity.

Political Background

In March 2001 the European Council decided to meet the economic and budgetary challenges posed by the demographic change by means of debt reduction, higher employment rates, raised productivity and reforms of pension schemes, healthcare and long-term care systems. In 2006 the Commission resumed this strategy by presenting its latest projections of future demographic trends, adding concrete recommendations for action to Member States (Communication COM(2006) 571). Now the Commission still explicitly adheres to these recommendations, though tolerating temporarily higher public debt in view of the financial crisis (the same issue appears in the Communication COM (2008) 800).

Options for Influencing the Political Process

Leading Directorate General: DG Economic and Financial Affairs

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The Commission is quite right in pointing out the negative impact demographic change entails on public budgets and social security systems **and in urging necessary structural reforms in Member States.** Despite

the fact that this demographic trend and its consequences have been foreseeable for decades, many Member States have failed to provide a solid and sustainable financial basis for their social security systems, i. e. for retirement, healthcare and long-term care.
The current system of financing the welfare system through pay-as-you-go schemes, in which running expenses are financed through running contributions of the working population, meets its limits when the number of beneficiaries is increasingly growing compared the number of employees. For then, either the contribution rates must be increased or benefits must be cut. Since benefit cuts are normally not politically enforceable, the contribution rates of employees must rise. As this is generally viewed as a form of tax-increase, such increases either lead to a cutback in employment or to people escaping to non-contributory employment – in other words, to moonlighting.
In funded financing, however, own contributions are first invested in the capital market and paid out not before the service has been received. **It is to be welcomed that the Commission recommends a supplementary funded pension in addition to the pay-as-you-go schemes,** for **a complete switch to funded pension would be unrealistic** due to the double burden on the currently employed population. If a funded pension was introduced as supplementary, further increases in contribution rates calculated according to personal wages could be avoided, or at least reduced, without one's own pension level being necessarily dropping. Although contributions for the supplementary pension also restrict the financial scope of contributors, unlike an increase in contribution rates they are not perceived as taxes as these contributions are really saved and are individually attributable.
It is even possible to justify the obligation to enter a supplementary private pension fund. For simply relying on the community to grant basic social care to all retired citizens in future might generate disincentives to consume instead of investing in retirement provisions. However, from an ordoliberal standpoint, it would be a mistake to introduce special promotions for supplementary funded retirement schemes, as is the case in Germany with the so-called "Riester-Rente". Since in the end even this promotion must be financed through taxes. Moreover, there is a risk that only certain financial assets are promoted. This can lead to distorted investment decisions.
In the interest of the security of their managed assets **providers of funded pensions must be monitored by a supervisory authority.** Politics has to secure such effective surveillance. **It is only in this sense that the Commission's statement that policymakers should promote "prudent management of people's retirement savings" is acceptable**. However, even an effective surveillance cannot fully exclude capital market risks.
The demanded transition to a more flexible management of retirement entry in pay-as-you-go systems **is to be welcomed,** since every single person should be free to choose when to cease working. **However**, in the case of drawing an early pension, the respective **deductions – or** in the case of later entry into retirement, the respective **surcharges – must be calculated correctly and financed accordingly to make sure that the insurance community is not worse off by this decision**. Yet the Commission does not address these concrete issues.
The Commission's call for low-skilled workers to participate more in the labour market is to be supported. However, under ordoliberal aspects it would be wrong to 'buy' the unemployed out of unemployment through publicly financed "working incentives" – as is the case with combined wages schemes. Anyone who is able to work owes it to the community to take up work in order to reduce its payments of social benefits to a minimum. For many unemployed people, the lack of incentives to take up work is not decisive; they would like to work but cannot find a job. Therefore, politicians and wage contractors should remove all barriers to employment, especially in the lower wage segment such as regular or agreed minimum wages.

Impact on Efficiency and Individual Freedom of Choice

Reforms which – as in the case of a supplementary funded pension – lead to a decoupling of social insurance contributions from wages lead to an increase in overall economic efficiency. For wages can then reflect actual scarcities in a clearer manner and thus better fulfil their allocating function within an economy.

Impact on Growth and Employment

The increase in overall economic efficiency that accompanies reforms fosters growth. The less wages are burdened with social insurance contributions, the more attractive employment that is subject to social insurance contributions becomes compared to moonlighting.

Impact on Europe as a Business Location

In as far as the separation of social insurance contributions from wages results in lower wage demands of employees, the costs for the production factor labour are reduced, which enhances the attractiveness of Europe as a business location.

Legal Assessment

Legal Competence

Member States are responsible for the basic principles of social security systems and their financial equilibrium. Regarding pensions and other social insurances, the EU can only support and complement national actions (Art. 137 (1) lit. k TEC). A surveillance of the reforms of social spending schemes is therefore only admissible to a limited extent: in particular, "the Council shall, on the basis of reports submitted by the Commission, monitor"

economic developments in Member States in order to ensure a closer coordination of economic policies of the Member States (Art. 99 (3) TEC). For this purpose the Member States submit stability and convergence programmes describing economic measures and larger structural reforms on an annual basis covering three to four years (Art. 3 (2) and Art. 7 (2) of the Regulation (EC) No. 1466/97). If, as a result of these reports, it becomes obvious that a Member State is in danger of running up excessive public deficit, the EU may advise the Member State of this and recommend taking the required measures. If the considered extension of supervision remains within this given scope it is admissible.
In the field of education any form of harmonisation is strictly excluded while "fully respecting" national responsibility (Art. 149 (1) TEC). However, the EU may adopt "incentive measures" (education) or "measures" (vocational training) (Art. 149 (4) and 150 (4) TEC). In addition, it may make recommendations concerning education policy (Art. 149 (4) TEC). The EU can base most of the measures for stabilising the financial markets on its legal competence for implementing the internal market (Art. 95 TEC). For measures in the field of "flexicurity", with regard to unemployment pay Art. 137 (1) lit. c TEC is applicable.

Subsidiarity

An evaluation of subsidiarity is currently not yet possible.

Proportionality

An evaluation of the principle of proportionality is currently not yet possible.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

Private pension schemes may not restrict the freedom of movement unjustifiably (Art. 18 TEC and for employees in particular Art. 39 TEC and Art. 7 of the Regulation (EEC) No. 1612/68). In Germany this is questionable in view of the so-called "Riester-Rente" (§§ 79–99 Income Tax Act – *Einkommenssteuergesetz/ EStG*). If, in the case of moving away from Germany, repayments of statutory supplementary pays and tax abatements are required (§ 95 EStG in conjunction with § 93 (1) EStG), this constitutes an infringement of the freedom of movement. The same applies if the investment of assets from the Riester-Rente is limited to the acquisition of real estates within Germany (§ 92a EStG). The question of whether or not such an intervention is justified is currently being judged by the European Court of Justice (ECJ, Case C-269/07).

Possible Future EU Actions

The Commission has already announced a number of measures for the regulation of financial markets (COM(2009) 114).

Conclusion

In view of the future demographic trend in the EU the Commission is quite right in urging the necessity of structural reforms in the Member States. It makes sense to introduce supplementary funded pension schemes since a full switching would lead to a double burden on the currently employed population. However, the requested "prudent management of people's retirement savings" by policymakers should be restricted to an effective surveillance of private pension funds. It should be left up to the employees to decide when to enter retirement as proposed by the Commission. A flexible handling of the retirement entry age in "pay-as-you-go" pension funds is therefore to be welcomed. Yet this decision may not have a negative impact on the remaining contributors; to this end, new models for calculating pension deductions and additions need to be developed.