



OECD ECONOMIC SURVEY OF AUSTRIA 2003: PENSIONS

This is an excerpt of the OECD Economic Survey of Austria, 2003, from the section on issues in fostering labour force participation and employment, chapter 3.

Pensions

Austria's public pension system encouraged early retirement and discouraged higher labour supply over the life cycle more generally. The system is also fiscally costly. Recognising the threat of demographic developments to the fiscal sustainability of the system, consecutive governments implemented pension reforms for the general scheme for workers and salaried employees (ASVG) in 1993, 1997 and again in 2000. Although containing important elements, these reforms remained partial. Without further action the system was set to come under stress, and steeply rising pension contribution rates would have increased non-wage labour costs with adverse effects on employment. Simulations made by the Pension Reform Committee, appointed by the federal government, indicated that without further reform pension outlays, net of those for civil servants, would increase from 10½ per cent of GDP in 2000 to between 14.2 and 15.6 per cent in 2035, depending on assumed employment rates.¹ Against this background, the government has tabled a far reaching reform, which was adopted by Parliament in June 2003 (see Box 3). The reform marks substantial progress in securing the sustainability of general government finances. Some important elements are still missing, however, and need to be implemented soon.

A key element of the reform is the phased increase -- until 2028 -- in the number of years that count for the wage base of the pension claim (*Durchrechnungszeitraum*) from the current best 15 years (18 years in case of early retirement) to 40 years. The former regulation favours employees with minimal employment contracts beyond the "best" 15 years relative to those with more steady (full-time) employment. The latter pay *ceteris paribus* greater pension contributions over their life time than the former while both groups receive the same level of pensions. This discourages labour supply over the life cycle. In addition there is an incentive to maximise pension claims by pushing up wages with seniority, with potentially negative implications for the firms' labour demand for older employees. Basing the level of pensions on 40 years of earnings largely removes these distortions. Moreover, strengthening the link between contributions paid and benefits received allows employees to consider their contributions as savings rather than a tax, improving the base for their saving and consumption decisions. The reduction in the annual accrual rate for pension claims reduces incentives to retire early.² Both measures combined imply that for a given length of a person's work history replacement rates will be lower than prior to the reform, the more so the more variable the shape of the earnings curve over the life cycle.

Box 3. Pension reform 2003

Parameters of Austria's general public pension scheme for workers and salaried employees (ASVG)

Within the ASVG the size of a pension for the transition year into retirement is determined as follows

$$B = W * (S + A) \text{ with}$$

B = Level of monthly pension,

W = Pension base: average -- revalued -- monthly earnings over the past 15 years of highest earnings (in case of early retirement: period extended up to the best 18 years)

S = Sum of annual percentage point accruals per year of insured work history, added over 40 years (*Steigerungsbetrag*),

A = deduction (premium) for every year of earlier (later) retirement than the statutory retirement age; A is negative with early retirement and positive otherwise (*Abschlagsfaktor* or *Zuschlagsfaktor*).

Earnings in the wage base (W) are revalued by a pension adjustment index (*Aufwertungszahl*) so as to express earnings in terms of constant prices. Child care periods without employment increase W by a fixed monthly amount (€ 640 in 2003), for a maximum period of four years per child. In the accruals sum (S) 12 insured months (including qualifying periods) account for 2 percentage points. The accruals sum is reduced by a deduction (A) of three accrual points per year retired earlier than the statutory retirement age (65 and 60 years for males and females, respectively). The maximum replacement rate is 80 per cent of past real wages (W) after an insurance history of 40 years or more. The maximum deduction (A) amounts to 10.5 accrual points or 15 per cent of all accrual points. For each year of later retirement over the regular age S is increased by a premium of 4 percentage points. When a premium is granted the maximum replacement rate is 90 per cent, instead of 80 per cent, of the pension base. Once retired, current pensions are adjusted annually. The size of adjustment is decided by a commission -- comprising the social partners, the Ministry of Social Security, Generations and Consumer Protection, the Ministry of Finance, the political parties represented in Parliament, and economic research institutes (*Kommission zur langfristigen Pensionssicherung*) -- and has kept pensions growing moderately in real terms.

Pension reform measures

The government's pension reform bill (*Pensionssicherungsreform 2003*), initially faced stiff opposition in the public policy debate. In the process, some provisions were softened. The law came into force in August, and contains the following major elements:

- The accounting period (*Durchrechnungszeitraum*) for the pension base (W) will be gradually increased to the best 40 years of earnings for which contributions were paid (instead of the best 15 years). The extension is phased, with 12 months annually, starting in 2004 and finalised in 2028. The crediting of child care periods in the pension base (W) will rise from € 640 by 50 per cent in 25 years. Times for caring for dying relatives or seriously ill children are taken into consideration in the accruals period (*Familienhospiz*).
- The annual accrual rate (contained in S) will be reduced to 1.78 per cent (instead of 2 per cent), so that the full replacement rate of 80 per cent of past real wages (W) will be reached after an insurance history of 45 years or more (instead of 40 years).
- Early retirement on account of unemployment will be abolished.
- The minimum age (61.5 for men and 56.5 for women) for early retirement on account of long-term insurance contributions (35 contribution years for both men and women) will be increased in steps until 2017 to the statutory retirement age of 65 for men and 60 for women. Within the transition period, the deduction (A) for every year of earlier retirement will be increased to 4.2 per cent (instead of 3 per cent), up to a maximum of 15 per cent of the pension.
- The premium for later retirement will be increased by the same amount (instead of 3 per cent), up to a maximum of 10 per cent. Starting in 2004, maximum losses implied by the transition to the new system are capped such that they cannot exceed 10 per cent at the maximum.

Regarding the pensions of tenured civil servants the bill foresees the following steps:

- Extension of the pension base to 40 years (instead of the last salary). The transition period will last until 2028.
- A reduction in the annual accrual rate.
- Stepwise increase in the retirement age to 65 years.
- For civil servants with long-term tenure, early retirement at age 61.5 is only possible with discount.
- Increase of pension contributions by 1 percentage point.
- Increase of the percentage deduction for early retirement from 3 to 3.36 per cent.

Likewise key is the ending of early retirement on account of unemployment, and the introduction of larger discounts for early retirement on account of long insurance histories. Up to now retirement prior to the statutory retirement age has been the rule rather than the exception (see Figure 8 above). As has been argued in previous *Economic Surveys*, income replacement for the unemployed should be dealt with within the unemployment insurance and placement system rather than within the pension system. This preserves incentives to stay in the labour market, while early retirement represents workers dropping out of the labour force and is hard to reverse. Maintaining labour force participation, in turn, can increase the pressure to set wages and employment conditions in a way that accommodates re-employment. Overall, closing the channels into early retirement under preferential conditions is vital to relieving the general government budget and reducing the cost of inactivity to society more generally.

With such reform, care needs to be taken that no other channels into early retirement act as substitutes for those that are being closed. Previous *Surveys* on Austria found that inflow into other types of early retirement increased when eligibility conditions for one particular channel were tightened. While the previous pension reform in 2000 has reduced the scope for this type of substitution by abolishing early retirement on account of disability within the old age pension system, there is still a risk that the invalidity retirement scheme outside the old-age pension system could act in a similar way. To avoid this, it needs to be ensured that eligibility conditions within the invalidity scheme are strictly conditional on health reasons only and tightly controlled. Moreover, there should be regular follow-up checks of health conditions, and re-entry into the labour force should be required if the degree of invalidity improves sufficiently. Several countries within the OECD follow this standard.³ Other channels into effective early retirement outside the pension system also should be closed (see further below).

The increase in the actuarial adjustment factors for early retirement on account of long insurance spells is a welcome move towards actuarial fairness. This points to an important option for further developing the public pension system after the present phase of reform. There is no need to restrict retirement to a certain age or contribution period. Instead, a high degree of flexibility in the individual retirement decision could be secured if pension benefits were adjusted such that the expected discounted value of pension income at retirement would not increase with earlier retirement once a minimum pension level is achieved. Actuarially fair adjustment of pension claims would in principle allow employees to determine the length of their working life taking into consideration the trade-off between shorter life-time employment and lower pensions, while securing that early retirement would not raise the fiscal burden for the pension system. Policy makers could define financially viable replacement rates for a certain reference contribution period (such as 45 years), and deviations in both directions of actual contribution periods from the reference period would be associated with the actuarial reductions or bonuses. In practice, widening the choice to employees along this line also requires that the system is set up in a way that allows the insured to identify their claims, given their elapsed employment and contribution histories. This would be facilitated by establishing individual retirement accounts, which would also remove the distortions of the current system in favour of steeper earnings curves over the employment history. The government has expressed the intention to introduce such accounts in the next phase of reform. This should be implemented and associated with actuarially fair adjustment.

Introducing individual retirement accounts would tend to move the system toward a defined contribution system, although it still might have defined benefit elements. Benefits that are unrelated to individual contributions by the recipients are best financed out of general tax revenues rather than wage-based contributions. Hence, the size of redistribution -- such as minimum pensions -- should be identified and tax financed, to the extent the redistribution is not yet covered by transfers out of the federal budget, in order to promote actuarial fairness and tackle Austria's high level of non-wage labour costs.

Harmonisation across Austria's different public pension schemes is still to be achieved. As has been outlined in Chapter II above, harmonisation of the pension schemes for civil servants with the general

pension system for workers and salaried employees (ASVG) should be an important part of public sector reform. While the pension reform law contains adjustments of the system for federal civil servants, harmonisation is not complete yet. The pension systems for the civil servants of the states are not included in the reform and remain dispersed. Apart from the ASVG, which represents the largest part of Austria's public pension system, there are also branches for special occupational groups such as notaries, self-employed and farmers. At present the responsibility for administering the different insurance schemes is split accordingly. This fragmentation is non-transparent and provides incentives to pressure groups to lobby for more favourable benefits -- involving state subsidies -- for their respective clienteles. Setting the same standards across the different branches of the public pension system is important to improve the efficiency of labour allocation in the economy overall.

Strengthening the funded layer of the pension system

In the public debate surrounding the design of the present reform, transition periods to the revised system have been criticised as too short. However, stretching out the adjustment of the pension parameters too far into the future would increase the upward pressure on contribution rates and shift the fiscal burden to the next generation while reducing incentives to adapt private saving plans. In fact, this is similarly true for the capping of losses that has been legislated over a transitory period. However, efforts need to be made to ensure that efficient instruments are available to support private retirement savings as a supplement to the pay-as-you-go part.

The almost universal coverage of public pensions in combination with income replacement ratios that are high by international comparison have implied that private pension savings are among the lowest in the OECD. In January 2003 a new private pension scheme was introduced that is associated with a tax preference (*Zukunftsvorsorge*). The scheme not only aims to promote private pension provisions but also the Austrian capital market. To this end, the scheme requires that at least 40 per cent of the funds' capital needs to be invested in European countries with a low stock market capitalisation.⁴ However, restraining the diversification of pension investments across developed capital markets could increase the risks of Austrian pension fund portfolios. In the same vein, it is conceivable that a boost in the supply of funds would not be readily absorbed by the narrow Austrian market. In the longer run, the provision could also restrain the funds' potential returns and make it more costly to meet the additional requirement that the savers' contributions be guaranteed in nominal terms. Hence, the thin-market provision should be dropped, and broader diversification of portfolios should be allowed as in other countries with large retirement savings. Regulation should allow for maximum returns on assets while at the same time minimising the risks for the long-term solvency of the funds⁵.

The last *Survey* highlighted the adverse implications of Austria's severance pay system for labour market flexibility and described the plans to turn the system into a tool supporting the development of funded company pensions. Meanwhile, the system underwent thorough reform. In the new system (*Abfertigung neu*), which became effective in January 2003, the management of severance pay is attributed to retirement accounts, which are legally independent from the employers (*Mitarbeitervorsorgekassen*) and funded by employers via a monthly untaxed payment of some 1.5 per cent of gross wages. Accumulated entitlements rest in the employee's account until retirement, unless the work contract has been terminated by the employer, which makes cash payments admissible under certain conditions. Upon retirement, employees can either claim a cash payment or convert their entitlement into an annuity. While the former is taxed at a rate of 6 per cent, annuities remain untaxed. Investment rules under this regime are the same as they are for pension and life insurance funds.⁶

Several features of the revised system make it suitable to strengthen the funded pillar of the pension system. In contrast to the former system, entitlements now commence almost immediately (after one month of employment) and are portable across employers. Moreover, eligibility is extended to almost

all employees by including the cases where contracts are terminated by the employees, and allowing seasonal workers to accumulate entitlements. These features combined extend employer based savings schemes to the vast majority of employees, independent of their occupation and length of employment spells. Moreover the reallocation of funds via the capital market -- rather than the retaining of funds that was widely applied under the predecessor scheme -- should improve the role of the capital market in supporting growth. On the other hand, the fact that employees are forced into savings reinforces the need to encourage competition among providers while minimising the risks of insolvency.

Old-age part-time employment and unemployment benefits

As outlined in Chapter I, the old-age part-time scheme (*Altersteilzeit*) has failed to deliver increased hiring of younger people, and has opened a highly utilised and fiscally expensive channel into early retirement outside the statutory old age pension system.⁷ While early retirement fell steeply in 2001, when the disability scheme was abolished, inflow into *Altersteilzeit* surged, pointing to a certain degree of substitution between both schemes (see Figure 8 above). This undermines policies to raise the effective retirement age. Accordingly, the government revisited the scheme. From 2004 onwards working full-time during the first years covered by the scheme and ceasing work entirely in the remainder of this period will only be possible if another part-time employee is recruited. Also, financial support is halved without a new recruitment. This change makes it more difficult to enter “full-time” early retirement. However, the reform preserves financial incentives for those who have worked full-time to cut down their number of hours worked. This adverse labour supply effect might also strengthen resistance to reform of seniority wage schedules that would be conducive to higher labour demand. Hence, it should be considered to abolish the *Altersteilzeit* scheme entirely.

Unemployed aged 60 and older enjoy an extended eligibility period for unemployment insurance benefits of 78 weeks (subject to a certain contribution period). This preference, which has been introduced in 2001, is set to expire at the end of 2003. However, new legislation lifts unemployment benefits by 25 per cent for older persons so as to grandfather the termination or phasing out, respectively, of early retirement. For similar reasons, this measure should be phased out so that incentives for job search are increased and extending a road into factual early retirement is avoided.⁸

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1. Both scenarios differ in assumed employment rates. The baseline scenario, which yields a more favourable spending path, assumes that the employment rate increases from 67 per cent in 2000 to 76 per cent in 2035, while the less favourable scenario assumes that the employment rate increases to only 72 per cent. See Kommission zur langfristigen Pensionssicherung (2002).
 2. This measure re-installs the situation prevailing until 1997, when the rate was lifted to its present level.
 3. See OECD (2003c).
 4. European countries that qualify for investment consist of the EU and the EFTA. Eligible stock market capitalisations must not exceed 30 per cent of GDP. This advantages holdings of Austrian stocks whose capitalisation is low by international comparison
 5. For an account of company based pension funds see Url (2003).
 6. Administrative costs are limited to a maximum of 3.5 per cent of contributions plus a maximum of 1 per cent of administered funds. Additional expenses have to be stated in the contract.
 7. At present, part-time employment can be distributed over an admissible time span of up to 6½ years such that the employees work full-time in the first years and cease working in the remainder of this period. Working time reductions up to 60 per cent of the previous level qualify for financial support. At least

50 per cent of the income loss due to working time reductions is compensated by the government. The scheme can be utilised by males and females from 55 and 50 years onwards, respectively. If part-time employment is taken in blocks of full-time and no work, participants in the scheme are statistically accounted as employed during the no-work phase.

8. Econometric evidence for Austria indicates a significantly negative effect of the duration of extended eligibility periods for receiving unemployment benefits on the transition out of unemployment for the long-term unemployed, both male and female. Moreover, longer benefit duration might also lead to higher unemployment entry. See Winter-Ebmer. (2003). The relevance of this relationship is also evident from various studies for other OECD countries. For references see OECD (2003d).