

Discussion paper #3

Pension reform – How long will a majority be in favour?

The winners and losers of
pensions automatically linked to
life-expectancy.

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Agenda
Austria

Where we find ourselves today

Does the Austrian state pension system need to be reformed? Is the current system financially sustainable and fair to different generations? Are the previous reforms enough? The intensity with which these questions are debated may vary periodically, but they are always on the agenda – as they have been for decades.

Many politicians think that the pension system can be revived with a few minor modifications, but a range of studies¹ suggest that it's high time for root-and-branch reform. Even some politicians, some of them from the government, have come out in favour of fundamental changes.

Pension system reform is not very popular. The prospect of having to work longer, paying higher contributions or receiving lower pensions isn't exactly greeted with cheers. But life expectancy is increasing steadily and baby boomers are now going into retirement: this demographic change will undeniably put the state pension system under increasingly severe financial pressure.

This raises the question of whether pension reform is actually possible from a political perspective. Won't parties who are committed to a less generous system just lose the next election? If this is the case, is it because the majority of voters don't want to have to work for longer or end up with a lower pension? This is exactly what this study set out to investigate. For the first time in Austria, it looked into **where voters' interests lie with respect to pensions: who would the winners and losers be in a fundamentally reformed system?** This system would link the age of retirement to increasing life expectancy as in Sweden (automatic adjustment).

In the Austrian pension system, there is no link between pensions and life expectancy (and consequently the length of time that pensions are paid out). As we are living for longer and longer on average, a **widening funding gap** has opened up – every year the government has to find more and more money to keep the pension system afloat. In 2014 the sum was more than EUR 8 billion².

This is **more than the Hypo Alpe Adria banking scandal will cost us annually in the years ahead**. And by the way, in real terms the cost to the state of subsidising the system will increase threefold by 2045.³

¹ Marin (2013), Felderer, Komean and Schuh (2005), Knell (2005), Knell (2013), Schuh (2010) and most recently Christl und Kucsera (2014), who compiled this study.

² The federal funding that comes out of the government's budget. The government also pays out about EUR 2 billion a year to cover the cost of pension contributions for specific groups of people such as citizens who are doing their civilian national service.

³ See Christl and Kucsera (2014).

In Sweden on the other hand, there is a direct relationship between pensions and forecast life expectancy at the point in time when pension entitlement begins – so increasing pension payment periods are automatically factored in. It is also very simple to calculate your expected pension: total contributions credited to your individual account are divided by the official figure for life expectancy. Costs are therefore more transparent because no additional government funding is required to cover the shortfall. Sweden also has a basic minimum pension that is about the same as Austria's: nobody has to worry that their income will fall below the minimum level set by parliament. And that's the only way that Swedish (party) politics gets when it comes to pensions – in contrast to Austria, where it's a recurring key theme in election manifestos.

The study deals with more than just voters' vested interests with respect to pension reform involving changes to the retirement age. It also shows how Austria's ageing population is affecting the political feasibility of pension reform. **When will the winners under such a reform make up the majority at the ballot box? And when will the losers?**

The authors of the study looked at what would happen if the current pay-as-you-go pension system (Umlageverfahren) was maintained, but the age of retirement was linked to life expectancy (automatic adjustment/Pensionsautomatik). They then compared this solution to other plausible alternatives, contrasting it with the government's preferred subtle modification: raising the average age of retirement to 61.1 years by 2030, and also with raising the age of retirement to 65 for both men and women by 2020 – a much more accelerated approach. The authors wanted to answer the question: how appealing is the Swedish model to voters – **a financially sustainable system which is fair to younger generations** – compared to the alternatives? The answer provides the solution to a fundamental issue for policy makers: the best political strategy for reforming the pension system to make it financially sustainable and equitable to all generations.

Findings

How would Austrians react to pension reforms that take life expectancy into account? Who would be the winners and losers under a system with an automatic link between the age of retirement and life expectancy? **In 2014, 72.3 percent of voters would have been expected to vote against a reform, because for these people the current Austrian system puts more money in their pockets than a financially sustainable alternative.** They would be better off – but at the expense of others. The remaining 27.7 percent would benefit from switching to a life-expectancy-linked retirement age. In other words, decision makers motivated by election success rather than generational equity would, if acting only in their best interests, be opposed to reform, because it would be less popular with voters.

By the Austrian pension system, we are referring to its present incarnation, and assuming the gradually increasing average effective age of retirement (61.1 years by 2030) used in pensions reform commission and government projections. The fact that only about a quarter of the electorate would prefer a fair and financially sustainable pension system is a **warning sign that the age of retirement in Austria is too low for the system to function sustainably, and the planned rate of increase is too slow.**

But what would the outlook be if the winners under the current model looked beyond their own interests and voted for a sustainable approach? Studies show that about 20 percent of the population have altruistic motives. For a majority in favour of reforms including a life-expectancy-linked age of retirement, this figure would have to be more than 30 percent (see Fig. 6, p. 35). The long-term trend is obvious: **the longer politicians postpone reforms along Swedish lines, the lower the proportion of people who would benefit from such a reform. Reform will become politically more and more difficult – a reason for action to be taken as soon as possible.**

We have already established that the average effective age of retirement is too low. But **what would be the case if this figure were to increase at a quicker rate than the government projects? More precisely, if by 2020 both men and women were to retire at 65?** Would this make reform politically feasible? **The number of winners and losers would then depend on who would end up footing the bill for the additional government spending required to subsidise the pension system:** the workers (through higher pension contributions and/or taxation) or also pensioners (through pensions that do not keep pace with inflation or higher taxation).

The **most likely option in Austria** is that it would have to be paid for by both groups in equal measure. And if this were the case, there **would only be a majority in favour of reform until 2018**, because the number of voters who would benefit is steadily decreasing. This only holds true if, as already pointed out, it is possible to increase the average effective age of retirement at a significantly faster rate than has been the case up to now.

Not particularly good news for the politicians who, for the greater good, want to do something about the year-on-year increases in government subsidies and the heavy burden this is placing on younger generations.

To minimise the political fallout at the ballot box, the injustice and costs inherent in the current system must be laid bare for everyone to see. The individual benefits also have to be highlighted, so that the people who will profit from reform are aware of the fact. This doesn't seem to be the case in Austria. In 2014 over EUR 8 billion had to be found from government coffers to subsidise the pension system. An abstract number that in concrete terms means **for each working person EUR 151 has to be found to finance the pension funding gap every month. This must be achieved through taxation or burdening future generations with debt.**

The objective must be to convince the electorate of how urgently reform is needed. If this is possible, politicians will not be punished at the polls. This has been proven in Sweden and Canada as well as in Austria. The Austrian party responsible for the legislation to gradually increase the age of retirement in 2000 performed excellently at the subsequent election. People need to be supplied with detailed and comprehensible information. According to a survey published in the Kurier daily newspaper, about 77 percent of under 30s questioned in November 2014 were against automatically linking the age of retirement to life expectancy – they obviously didn't realise it would actually benefit them personally.⁴

If this objective can be achieved, there would be a variety of options for structuring the reform. The most prudent choice would be the 45-65-80 plan. **A mechanism has to be introduced to automatically factor in increasing life expectancy.** This could be accomplished by legislation to automatically increase the current age of retirement from 65. This would also involve increasing the pension input period to over 45 years. People would get the same pensions – which would be claimed for longer – but in return they would also have to work longer, and the pressure on the system would be relieved.

⁴ Karin Leitner, Mehrheit der VP-Wähler gegen Mitterlehners Pensions-Pläne (Majority of Austrian People's Party voters against Mitterlehner's pension plans), <http://kurier.at/politik/inland/kurier-ogm-umfrage-mehrheit-der-evp-waehler-gegen-mitterlehners-pensions-plaene/98.940.808>, accessed on 28 Jan. 2015 (German only).

Another option would be to pay lower pensions by reducing the replacement rate from 80 percent. At the moment, if you have paid 45 years of pension contributions, you get a pension equal to 80 percent of your average career earnings – one of the highest rates amongst OECD countries. **The most transparent option is to automatically link the age of retirement to life-expectancy.**

As mentioned above, pension reform is necessary for the greater good and its prospective implementation is becoming more and more unpopular. But there is also another reason why it would be **politically judicious to act soon: the sooner the system is reformed, the sooner the electorate will reap the rewards**, as the population is ageing.

Overview of options for reform

The study made forecasts for two different scenarios. Scenario 1 uses pension reform commission projections predicting that the average age of retirement will rise to 61.1 years by 2030. Scenario 2 assumes a rapidly increasing age of retirement, so the figure reaches 65 years for both men and women by 2020. For both scenarios, five different reform variations were considered, in which the burden of paying for the increasing cost of supporting the pension system would fall either on people currently paying pension contributions or on pensioners.

The table below shows the number of “altruists” that would be necessary to make up a majority in favour of a reform including life-expectancy-linked pensions.

How many “altruists” would be required to make up a majority in favour of a reform including a retirement age linked to life expectancy?

Required number of altruists in 2015	30.9%	25.7%	25.0%	18.5%
	1,618,000	1,254,000	1,206,000	822,000
Required number of altruists in 2030	33.6%	27.4%	26.9%	23.2%
	1,980,000	1,476,000	1,443,000	1,181,000
Assumptions	Scenario 1 (rise in the average effective age of retirement in line with pension reform commission 2014 projections) + Variation 5 (pension cuts)	Scenario 2 (rapid increase in average effective age of retirement to 65) + Variation 2 (progressive – those with higher incomes pay proportionally more)	Scenario 2 (rapid increase in average effective age of retirement to 65) + Variation 3 (flat-rate – every pensioner and pension contributor has to pay the same)	Scenario 2 (rapid increase in average effective age of retirement to 65) + Variation 4 (50-50 between pensioners and pension contributors)
Graphics	See Fig. 6	See Fig. 11	See Fig. 12	See Fig. 10

Table 1

Source: Agenda Austria calculations

The following example helps to explain the contents of the table. In 2015 a majority in favour of a reform including pensions linked to life expectancy would require at least 1,618,000 altruists, or 30.9 percent. But this is only true if the average effective age of retirement rises to 61.1 years by 2030 (as the government projects) and pensioners are asked to finance the necessary additional government spending through cuts to their pensions. In 2030, 1.98 million would have to vote against their own financial interests to achieve a majority in favour of life-expectancy-linked pensions based on these assumptions.