The need for pension reform

IMF Economists, Subhash Thakur and Valerie Cerra, discuss the options for pension provision in Norway…

Norway's population is expected to age steadily over the coming century. The proportion of the population over the age of 80 will likely double by 2050. Birth rates have been falling and the average lifespan getting longer, leading to fewer young workers available to replace and support those retiring. This trend is broadly similar in scope to that faced by many other advanced countries and will present difficult challenges to policymakers trying to ensure adequate supply of labour and manage the strains on public finances.

Petroleum resources

Norway's substantial petroleum resources place it in a favorable position relative to other countries in adjusting to the fiscal shock of the demographic transition. The production and exports of oil and gas have increased significantly over the past three decades, and petroleum exports now contribute significantly to economic activity. The government's net income from the petroleum sector has also been substantial. The state receives ongoing revenue from oil enterprises through taxes, fees and income from state oil interests. Oil revenues are currently at high levels due to peak years of extraction and high oil prices. However, this boom in oil revenue is not expected to last, as the extraction of oil falls dramatically over the coming decades.

The Norwegian authorities took a commendable decision to establish the Government Petroleum Fund (GPF) in 1990, with the goal of gradually transforming the nation's oil wealth into foreign financial assets. The GPF is also aimed at avoiding excessive spending of petroleum revenues and accumulating public savings to help cover the expected increase in pension and health care costs related to the looming demographic shock, coming at a time when oil revenues are expected to taper off. Contrary to some popular perceptions, however, the GPF assets are not sufficient, to cover the expected rise in pension costs, let alone the total costs associated with an ageing population.

Intergenerational equity

Norway, like the other Nordic countries, has a strong and widely admired concern for equity and social protection. The public sector provides most of the education and healthcare services and manages a variety of transfer programmes. Most transfers and welfare benefits, including the public pension system, are financed on a pay-as-you-go basis.

The Norwegian ideal of equity extends to generations not yet born. Successive governments have declared that the nation's oil wealth must be used in a manner consistent with equity across generations. The current generations have already consumed a significant amount of oil income over the past three decades to fund non-oil public budget deficits. Therefore, achieving intergenerational equity will require saving a large part of the oil wealth beyond the next several decades. This would mean choosing between competing uses of the oil wealth: satisfying current demands for spending, financing the demographic bulge in pension and healthcare costs – a choice that would also favour current generations and save the wealth for future generations.

The current pension system

All persons residing or working in Norway are insured compulsorily under a pay-as-you-go National Insurance Scheme (NIS). The NIS is financed by contributions from employers, employees and general tax revenues and is integrated into the government budget rather than as a separate account with contribution rates tied to outlays, as in many other advanced industrialised countries. In the past ten years, pension benefits have been growing at rates at least as fast as wages.

The principal NIS benefits are old-age and disability pensions. Old-age pensions consist of a basic pension and a supplementary pension that depends on the number of pension earning years and income as measured by 'pension points'. The distribution of old-age pension benefits is relatively flat, effectively entailing a transfer of wealth from high income earners to low income earners. Disability pensions are available to working-age people whose capacities are permanently impaired due to illness, injury or defect. The level of benefits and eligibility requirements are both relatively liberal. The state also finances a contractual early retirement scheme, with benefits comparable to disability benefits. Central government workers and teachers are covered by a pay-as-you-go government occupational pension, which guarantees a total income replacement rate of 66%.

Why reform is needed

Costs of these social insurance programmes are expected to rise rapidly in the coming decades. Most strikingly, spending on national insurance pensions may increase by approximately 10% of GDP by 2050, reflecting both the demographic transition and the full phasing in of benefits. This rise in costs is almost three times more than the average rise for other OECD countries. In the 1990s, a number of these have undertaken reform measures such as increasing the pensionable age, promoting longer employment, increasing the contribution rate or the required contribution period, or reducing the benefit rate. In addition, a number of countries have increased reliance on funded schemes, as well as promoting privatised pension schemes. Norway, by contrast, has yet to start a serious reform of its pension system.

Unless the pension system is reformed, the goal of ensuring intergenerational equity will be difficult to achieve. Current fiscal projections suggest that government wealth, which accrues largely from oil wealth, is expected to be consumed in its entirety by the middle of the century, due to the rising costs of pensions and other age-related expenditure. This implies that the current generations will end up consuming more than the permanent portion of the income from oil wealth. Indeed, there may be no oil wealth remaining for future generations to consume, beyond the first half of this century.

Moreover, there is growing evidence that the generosity of social insurance schemes may be contributing to a decline in the labour supply, which is a key determinant of economic growth and tax revenues. Sickness absences have been growing rapidly, as have the number of disability pensioners and early retirees. Indeed, at some income levels, the current system encourages early retirement by penalising continued employment.

Pension reform options and issues

In March 2001, the government appointed a commission of representatives of the political parties and independent experts to present recommendations for pension reform by October 2003. In its preliminary report, the commission has suggested two main alternatives for pension reform. The first option would be a system that links pension benefits to lifetime wage income. The second option would be a flat pension system. As the debate on pension reform continues, several issues and options would need to be considered:

Financial sustainability. Additional annual financing of 3% of GDP is needed to make the pension system viable, given demographic changes. This entails a combination of higher contributions to the system, containment of benefits, and postponement of retirement. In a rapidly globalising world, with greater opportunities to invest and find employment abroad, the scope for tax increases is likely to decline. A reduction in pension benefits, such as by indexing benefits to prices rather than wages, or an increase in the retirement age by several years will be required to ensure financial sustainability of the system.

Labour supply incentives. Flexibility in choosing the retirement age is desirable, but reform should ensure that those retiring later are financially rewarded. Schemes which link contributions to benefits may help stimulate labour supply by increasing the future benefits that accrue from work. Using the entire lifetime of earnings to determine the level of pension benefit – rather than just the 20 highest years of income, as in the current system – will also improve work incentives. For those opting for early retirement, the benefit level can be reduced for both the lower number of years of accrual and the additional length of drawing the pension benefit. The age at which workers become eligible for early retirement benefits can be indexed to economic and demographic conditions and tax measures designed to discourage early retirement.

Distributional concerns. Pension reform options will have different effects on the income distribution. The income-related option could imply a redistribution of benefits from middle wage earners to those with high lifetime incomes, relative to the current system, while increasing work incentives. An alternative is to scale down the system, which

currently implies large transfers to the middle class, part-time workers and those working fewer years. The benefits to these groups might also be reduced by the flat pension alternative. While public attention has so far focused on the effects on the income distribution within pension cohorts, intergenerational equity is tied to ensuring a viable system that does not shift the burden to future generations.

Funding. An explicit earmarked fund for future pension benefits could draw attention to the need for actuarially sound pension finances and therefore could increase support for greater public saving. Linking costs to benefits could help ensure intergenerational equity. It would probably be necessary to provide initial funding from the GPF, so as to avoid current generations having to pay both for the current generation of seniors under the unfunded schemes, as well as funding their own future pensions. New private supplemental schemes or publicly-provided notional accounts, such as in Sweden, could be introduced. Funded schemes that provide investment choice may be invested more efficiently as private sector funds compete for business. This can also contribute to the development of financial markets in Norway. On the other hand, individuals would bear increased risk from investment returns and schemes allowing individual choice could be more costly to administer. A large, abrupt increase in domestic investment may also be difficult to absorb.

Use of the GPF. There are many options for using the GPF to fund pensions. Accumulated assets of the GPF could be used to partially finance existing accrued obligations, with a shift to defined contribution plans going forward. Alternatively, new oil revenue could be set aside in a pension fund linked to new pension rights and the current GPF could be used to meet other priorities. This option would still require reform to ensure the sustainability of the system, such as a reduction in benefits. GPF assets could provide initial funding for a system designed, as in Sweden, with contributions and benefits linked to smooth contribution rates and adjusted for demographic and other factors that affect the system's viability.

Other issues. Reform of the NIS would need to be co-ordinated with the public service pension system, including ensuring transferability between the public and private sectors. The reform would need to consider transitional arrangements to safeguard the accrued pension rights of current pensioners and individuals close to retirement. The disability retirement scheme also needs reform. Liberal access to it contributes to disincentives to work for those at peak earnings. Reform could also aim at reducing poverty among people born with disabilities and preventing abuse of the scheme through experience rating or requiring severance pay even if an employee were to become disabled.

Concluding remarks

Norway faces challenges of a major demographic change in the coming decades. Given its generous social security regime, the transition towards an older and smaller working-age population is likely to have far-reaching effects on economic growth and public finances. In order to ensure a smooth transition and preserve Norway's high living standards, a reform of social security arrangements needs to encompass, first and foremost, a comprehensive pension reform. While oil wealth provides a welcome cushion, it should not be a cause for complacency. It is to be hoped that the Pension Commission will provide the impetus and a roadmap for reform.

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