EU-CHINA

Social Protection Reform Project

中国欧盟社会保护改革项目

1.3.6. - EUROPEAN BEST PRACTICES

RELATED TO INDEXATION OF PENSION BENEFITS

Component 1

Among the parameters of the pension schemes for which changes are being considered, indexation of pension benefits (benefits in award and rights in course of acquisition) give raise to extended discussion within the various Chinese stakeholders. The present Note, prepared by Mr Koen Vleminckx on the occasion of a mission to China conducted under the auspices of the SPR project. Summarizes recent European experience in this respect.

With regards to the indexation in pension systems, one should make a distinction between:

- indexation mechanism after retirement: The method with which pension benefits are adjusted to take into account changes in the cost of living (e.g. prices and/or earnings.
- revalorization of contributions before retirement

1. Indexation mechanism after retirement

Because pension benefits are paid over a long period, they need to be protected against inflation. Benefits can be protected against price or wage inflation:

Price indexation: pension benefits are adjusted taking into account changes in prices. Usually, the consumer price index (CPI) is used to adjust pensions to the evolution of prices.

Wage indexation: pension benefits are adjusted taking into account changes in wages. Usually, average wage growth is used to adjust pensions to the evolution of prices.

Price indexation is most common in the EU and among the members of the consortium. The Czech Republic uprates benefits with a mix of inflation and wage growth. Some countries have progressive indexation, giving larger increases to low pensions. For instance, in Italy indexation is fully to prices for low pensions, 90% of prices or 75% of prices for higher pension.

During the last decade many countries have reformed pension indexation mechanisms, although the goals and effects of such action vary across countries and income levels. Some new indexation rules move towards less generous benefits, an especially sought-after effect in countries grappling with fiscal problems. For example, the Czech Republic, Hungary and Norway no longer index pensions to wage growth, while Austria, Greece, Portugal and Slovenia have frozen automatic adjustments for all but the lowest earners. In Finland, by contrast, the freezes on pensions and changes in indexation rules were meant to offset the drop in benefit levels that the standard, inflation-based index would have involved.

A switch in indexation from wages to prices leads to the logical conclusion that there is a fall in pension wealth (and the purchasing power of pensioners).

2. Revalorization of contributions before retirement

In DB plans is necessary to protect the value of pension entitlements when benefits are based on earnings over a longer period. More specifically, earnings need to be adjusted to take account of changes in living standards between the time pension rights accrued and the time they are claimed (sometimes called pre-retirement indexation). The notional interest rate notional-accounts systems is the exact corollaries of valorisation in DB plans.

The most common practice is to revalue earlier years' pay with the growth of average earnings. Belgium, France, Greece and Spain, revalue earnings only with price inflation and 25 years enters the benefit formula in the French public scheme compared with lifetime average in Belgium and the French occupational plans. Estonia, Finland and Portugal revalue earlier years' earnings to a mix of price and wage inflation.

Related best practices

In China, the urban basic pension in payment is currently indexed to a mix of wages and prices, which may be between 40% and 60% of average earnings growth. As most EU countries only adjust their pensions in payment to the evolution of prices, one could say that the Chinese indexing mechanism better protects pensioners.

A switch in indexation from a mlix of prices and wages to prices only would lead to a fall in pension wealth (and the purchasing power of pensioners). Among the consortium members, the Czech Republic has made a switch from wage indexation to price indexation.

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