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BELGIUM PENSION OUTLOOK

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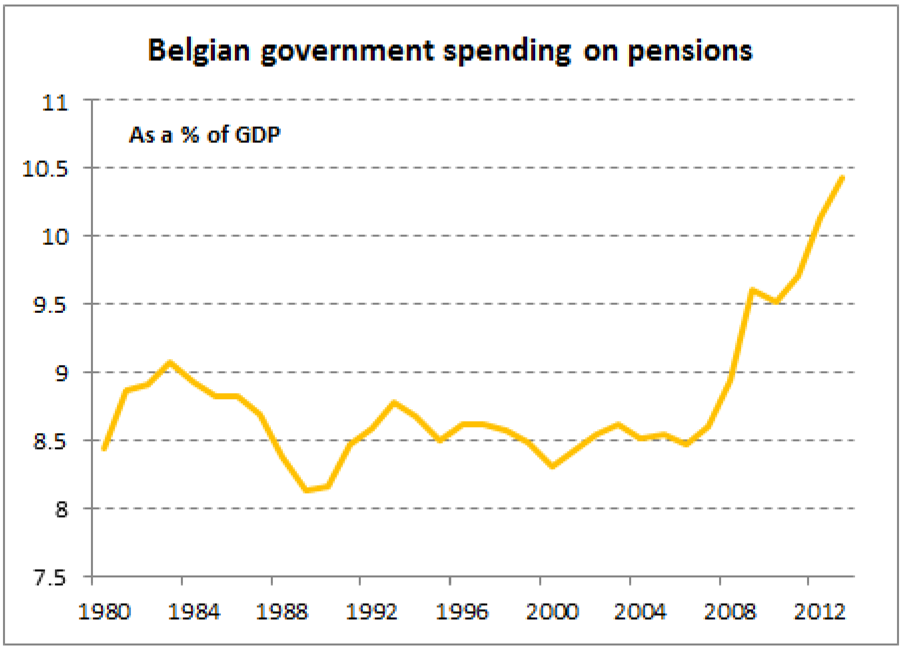
June 2014

Towards a more balanced pension system

The aging population and its impact on public spending on pensions and health care have been signalled for more than 20 years now as one of the greatest future challenges for our economy. Already in the first half of the 1990s, the first wave of serious analyses on this subject were published (for Belgium, by the Federal Planning Bureau, among others). The invariable conclusion of these analyses was that the challenge was enormous, but not impossible if we would just start taking precautions in good time. A constantly recurring point here was that the aging of the population in Belgium would only really begin to have an impact from 2010 onwards…

In spite of those warnings, the focus of policymaking in recent years has mainly been on other matters. True, a number of measures were taken, the most important of which being the gradual raising of the retirement age for women from 1997 onwards and the 'Generation Pact' of 2005, but a thorough approach to the problem of retirement was not forthcoming. The present minister continued this tradition with a number of limited interventions and the establishment of a 'Commission for Pension Reform 2020-2040'. Even in the current election campaign, the issue is not a major theme. After all, the Commission will not be issuing its conclusions until after the elections. Nevertheless, the impact of aging on government spending is gradually becoming clear. Spending on pensions is clearly on the rise: after being fairly stable for some 25 years at 8.5% of GDP, it has climbed to 10.1% since 2007. A real response to the aging challenge is becoming increasingly urgent.



Source: NBB

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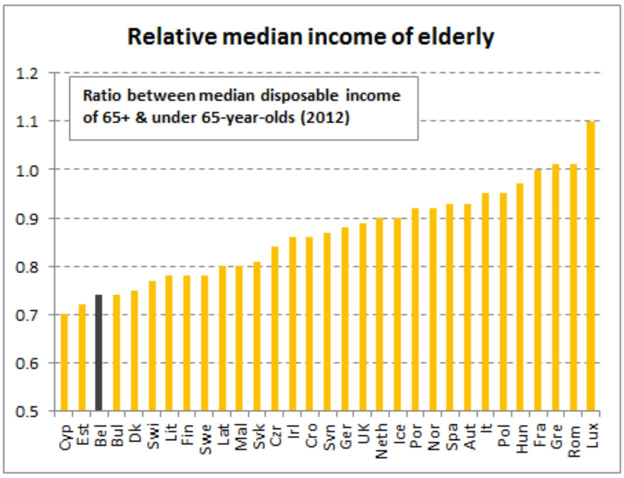
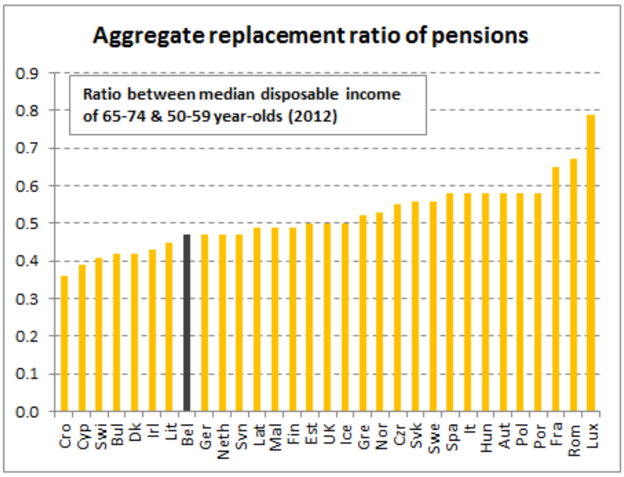
The statutory pension in Belgium is low

There are three pillars supporting the Belgian pension system: the statutory pension, financed on a pay-as-you-go (PAYG) basis, and two additional pillars whereby pension reserves are built up in funded schemes through the employer (2nd pillar) or the individual (3rd pillar). The supplementary pillars have been gaining ground over the last few years, but Belgian pensioners are still mainly dependent on the government transfers. In addition, it is striking that pensions in Belgium are fairly low (especially when compared with the income of the active population). This is confirmed by various indicators:

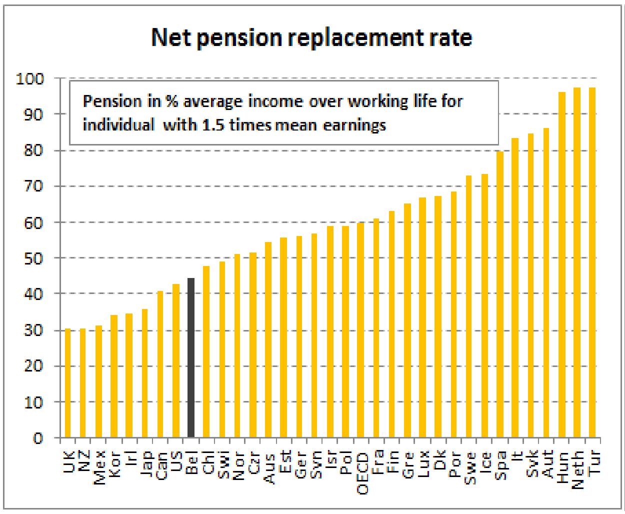


Source: Eurostat

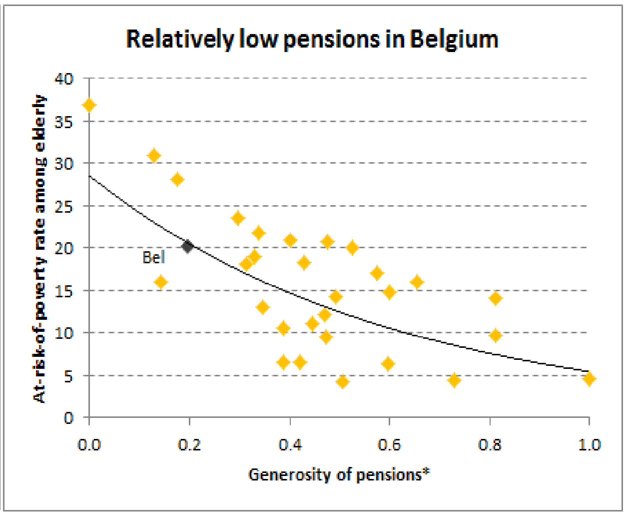


Source: Eurostat

- The median disposable income of those aged 65 and over amounts to 74% of the income of those under 65.
- The median gross pension of those aged 65 to 74 amounts to 47% of median income in the 50-59 age-group
- The net pension of someone who earned 1.5 times the average income amounts to 45% of the average income over his/her career. For a normal career, with income rising with age, that means 37% of the income at the end of their career.



Source: OECD



(*) Standardised indicator based on the relative median of incomes of the elderly and the replacement ratio of pensions Source: Eurostat

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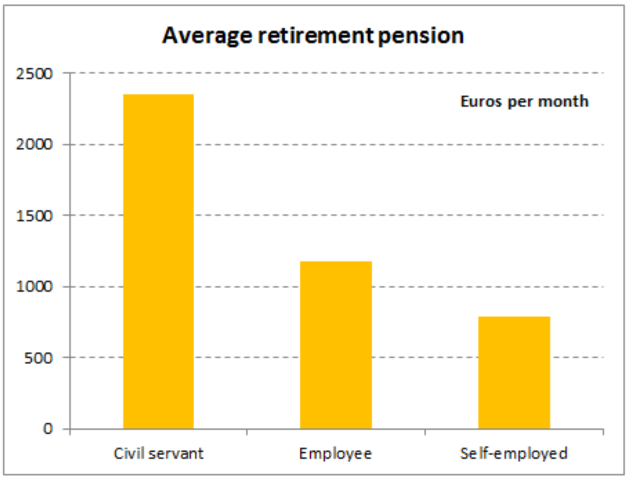
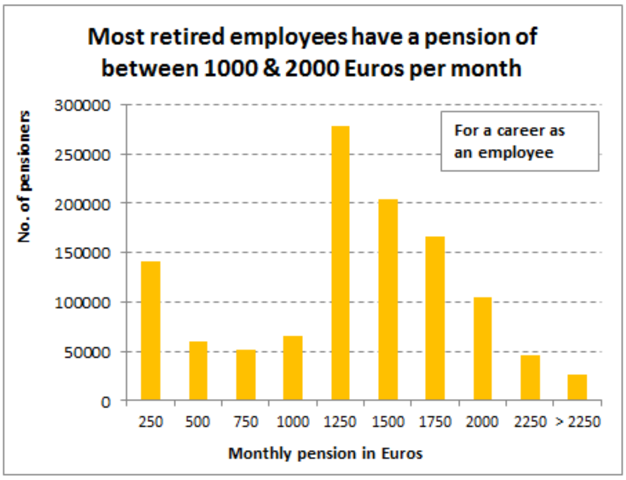
Payments data of the Pensions Department for the Government sector and the Department for Pensions show that the average gross amount paid out each month for retirement pensions (survival pensions are usually lower) in 2013 amounted to €2,349 for civil servants, €1,177 for employees and €791 for the self-employed – in each case for a career without switches between the respective categories. These are average amounts with, among other things, differing durations of careers (for a complete career the amounts should be higher). Of all the present pensions (retirement and survival) for a career in the employee status, two-thirds of the gross pensions are between €1,000 and €2,000 per month (as many as 27% were under €1,000, whereby insufficient working years is a major factor).

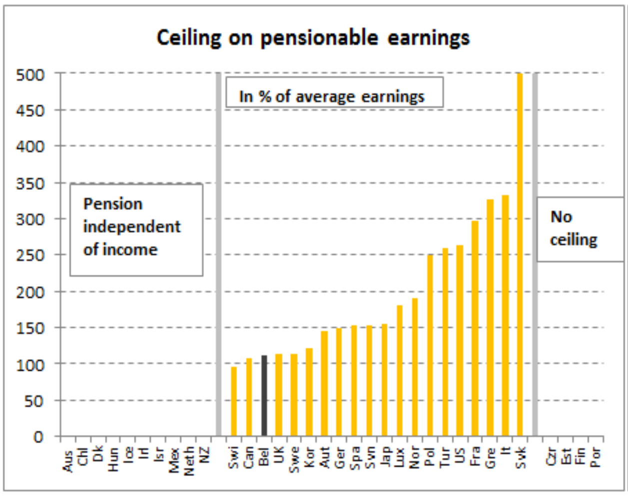


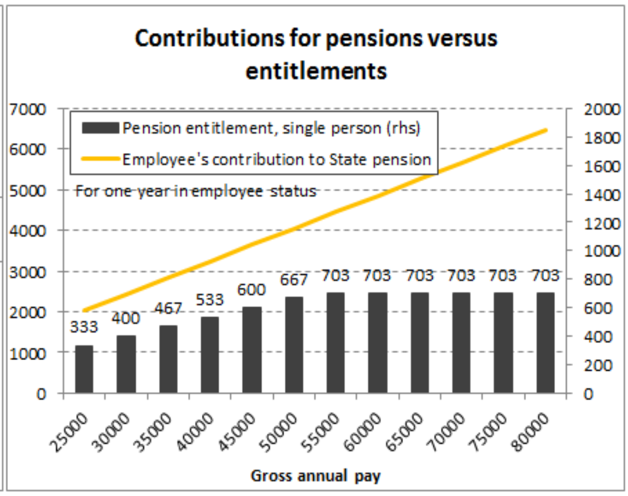
Source: PDOS, RVP



Source: RVP

Moreover, for employees there is a *de facto* maximum pension under the present pension calculations. The pension is calculated on the basis of gross annual earnings. For each year worked, the gross earnings provide 1/45th of the pension entitlements (i.e. 45 years of working will provide a full pension). However, there is a ceiling per year for the earnings taken into consideration for the pension. If the person's earnings are higher than that ceiling, the extra earnings (and contribution paid on these) give no further pension entitlements. Someone who throughout their working life had a gross salary that was at least as high as the earnings ceiling in every year will *de facto* be entitled to a maximum pension. The maximum pension today amounts to €2,724 per month for a head of household, €2,179 for a single person.





Source: OECD

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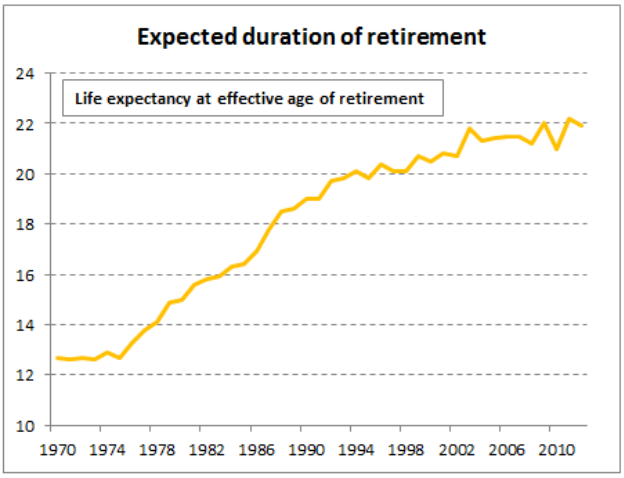
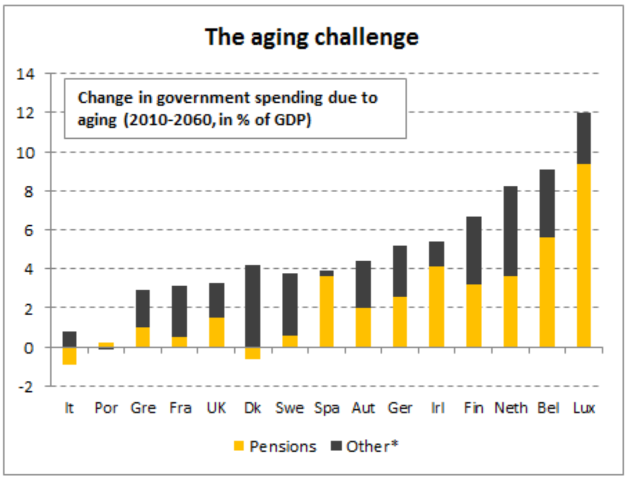
Incidentally, the pensionable earnings ceiling is fairly low in Belgium. For 2013 it was €52,761, or 111% of average annual earnings. This puts Belgium among the lowest of the industrialised countries that have similar pay ceilings in their pension calculations. That implies that for many employees the link between their earnings – and therefore their contributions as well – and their final pension is becoming weaker and the pension for many is actually sliding down towards a basic pension.

The pension system will not go bankrupt

The problem of aging is to a large extent linked to the baby-boom generation, which swelled the population pyramid after the Second World War. That generation contributed to a boost in the economy when it became active in the 1960s and 70s. The economic growth was partly used at that time to expand the welfare state. And so, for instance, the pension duration was allowed to increase as the actual retirement age did not follow the rise in life-expectancy. And so, the expected duration of retirement climbed from 12.7 years in 1970 to 22 years today.



Source: Eurostat, OECD



(*) Health care, care of the elderly, education, unemployment

Source: European Commission

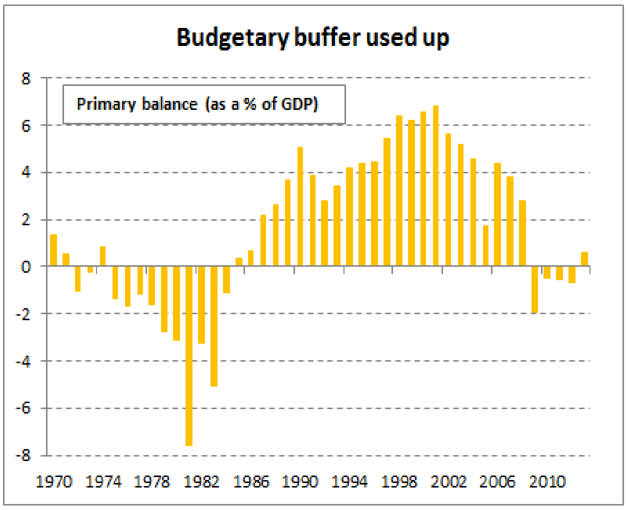
In the meantime we have entered the period in which the earlier demographic bonus is turning into a demographic challenge. The latest analysis of the European Commission indicates that government spending on pensions in 2060 will be 5.6% of GDP higher each year in 2060 than the level in 2010. In today's euros that amounts to 22 billion. Taking account of health and other types of care, education and unemployment, aging will push up annual government spending by 2060 by as much as 9.1% of GDP or about 36 billion (in today's Euros).

There are various ways to deal with these extra expenses:

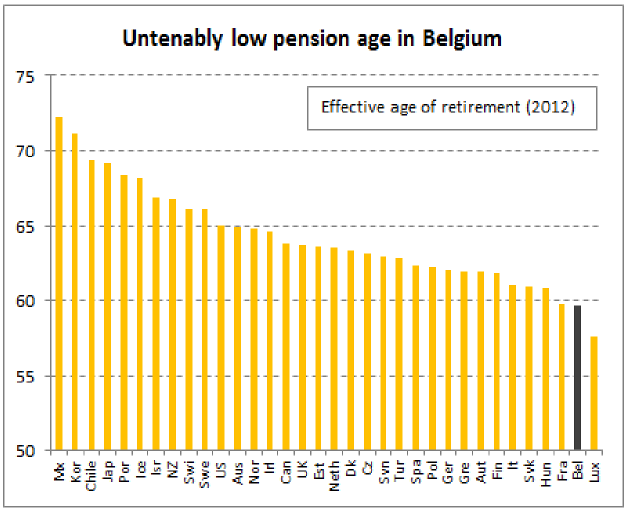
- ***Extra revenue***: the total tax burden today amounts to 46% of GDP; in order to collect an extra 9.1% of GDP an increase of 1/5th on all taxes would be needed. That would tip the total government revenues (including non-fiscal revenues) above 60% of GDP. It is extremely unlikely that our economy could support that.
- ***Financial buffers***: the government could have built up a buffer in the form of a primary surplus and then been able to finance the extra spending from a gradual run-down of that surplus. In 2001, the Belgian government had built up a surplus of 6.8% of GDP, but that has been completely used up in the meantime. Since aging has meanwhile come fully into play, it is unlikely that a new buffer could

be built up.

- ***Lower benefits****:* an easy way on paper to keep down extra spending in the future would be to lower pension entitlements. However, that would be more difficult in practice, given the already pretty low state pension. However, in the relatively generous civil service pension there might be possibilities in this regard. Gradually bringing the civil service pension into line with employee status could hold down the steep rise in the cost of civil service pensions (from 2.8% of GDP in 2005 to 3.8% in 2013) considerably.
- ***Other savings***: government spending that is not affected by aging is about 20% of GDP today. And so, the room for savings in this category is limited. On the other hand, current primary government spending (excluding pensions) have increased spectacularly in recent years from 31% of GDP in 2000 to 38% today. A return to the level of spending of 2000, albeit difficult, would cover an important part of the additional ageing costs.
- ***Working longer***: the official age of retirement is 65, but the average effective pension age is 59.6 for men and 58.7 for women. Jacking up the effective age of retirement to the official age would contribute towards compensating for the rise in spending due to aging. That could be done by making pension entitlements actuarially neutral. As such, the financial implications of the decision to stop working earlier (fewer contributions, more benefits) would be fully set off in the pension entitlements. In this way, stopping work earlier would no longer be encouraged by the government (which is the case today), but a decision whose financial implications would be borne only by the person concerned. In addition, much more needs to be invested in lifelong learning and the link between pay and length of service breached.



Source: NBB



Source: OECD

The challenge for the coming decades is extensive, not least because it will more than likely be in a climate of low economic growth. Nevertheless, it should be possible to keep the present pension system afloat with a combination of the measures listed above. In this respect, allowing pensions to develop in line with earnings growth will be quite challenging. It is highly unlikely that there will be room on top of that for a significant increase in pensions.

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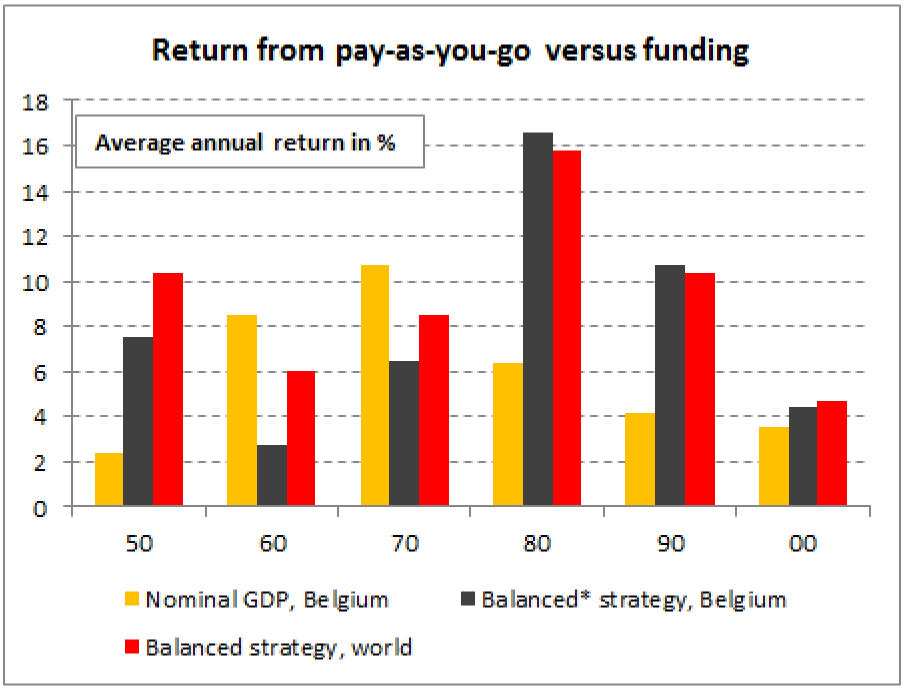
Towards more balanced pension financing

Pensions can be financed in two ways:

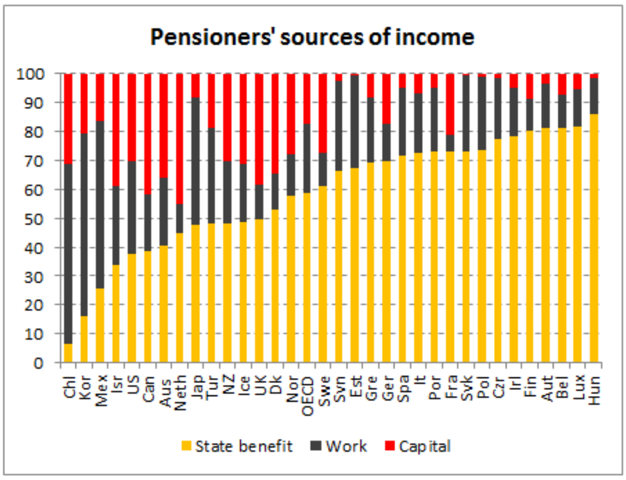
- On a pay-as-you-go basis (PAYG), whereby the current pensioners are paid with the contributions of those currently in employment.
- Via funded schemes, whereby individual or collective reserves are saved in order to pay out the benefits of the current savers later.

Both forms of financing have their own advantages and are vulnerable to their own specific risks. PAYG works well in periods of strong economic growth, and especially when the active population increases sharply. That was mainly the case in the 1960s and 70s. On the other hand, a system like that runs into difficulties during periods of low economic growth and when the active-age population stagnates or shrinks. The results of funded financing are of course mainly dependent on the dynamic on the financial markets. Such a system is vulnerable to turbulence in financial markets, but on the other hand offers an opportunity to respond to economic growth opportunities in other parts of the world.

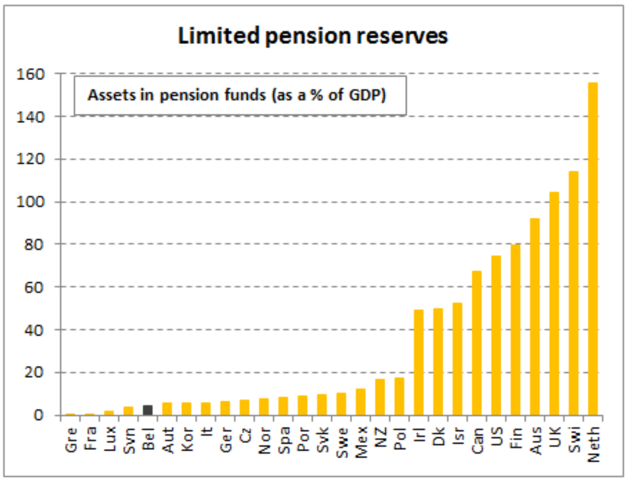


(*) Balanced investment strategy: 50% shares and 50% bonds

The graph above illustrates the 'return' from both forms of financing in the previous decades. Since both forms have their own specific risks and advantages, a safe approach would suggest that a combined financing strategy is the way to go. That was more or less acknowledged in Belgium with the promotion of the 2nd and 3rd pension pillars –which are funded schemes – in addition to the 1st pillar, which is PAYG system. However, we are still a long way from a balanced financing in our pension system. Belgian pensioners still count for more than 80% of their income on the 1st pillar. In addition, the accumulated pension reserves remain modest.

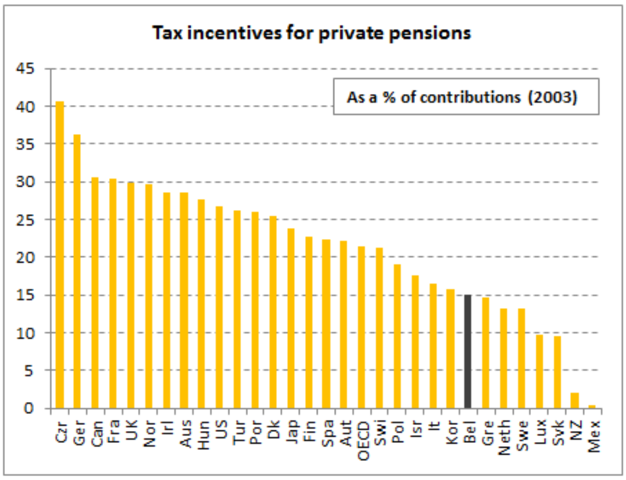


Source: OECD

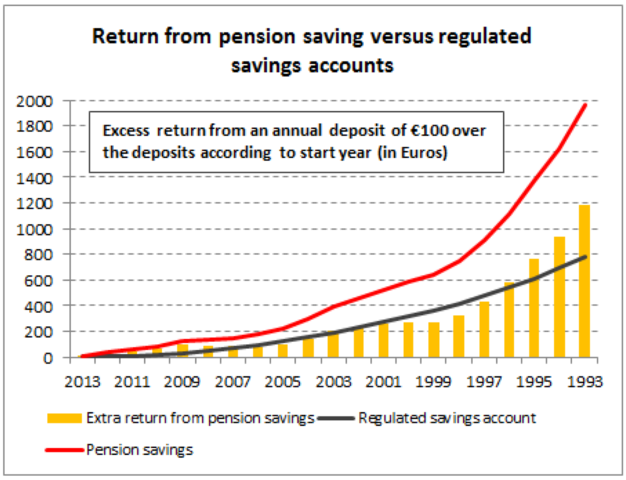


Source: OECD

Moreover, the prospects for PAYG financing are not exactly rosy. As with the rest of Europe, Belgium is facing a rather long period of pretty meagre economic growth, while the earlier demographic bonus is increasingly turning into a demographic challenge. The prospects for funded schemes are more difficult to gauge. However, in a world economy that is steadily growing (and clearly faster than the Belgian economy) there are opportunities to invest. A more positive outlook for funding versus PAYG, and especially the current uneven financing would suggest that there is considerable room to strengthen the funded part of Belgium's pension financing.



Source: OECD



Source: NBB, BEAMA

Belgian households are, in fact, already saving up for retirement, but in a rather inefficient manner. At the moment, Belgian households have just under €320 billion (or 83% of GDP) in all kinds of savings deposits. It is not very likely that this is all intended as short-term precautionary savings. This is at the very least partly a form of long-term saving, but at a yield that hardly compensates for inflation, if at all. The interest on a savings account has crashed over the last 20 years from 5.6% in 1993 to 1.3% today, and over the whole period averaged 3% per year. The average return from a pension saving fund endured major fluctuations during those 20 years, from a profit of 35.3% in 1998 to a drop of 25.8% in 2008. The average annual return over the whole period was 7.1%. With a fixed annual deposit the average pension saving fund provided more return than a savings account in the last 20 years, regardless of the starting-point. That will very likely be the case in the future too, certainly since pension savings would be built up over a person's entire working life. The long investment horizon limits the impact of short-term volatility. In that sense, it would

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be more efficient to direct some of the deposits towards genuine long-term savings products. That would strengthen the pension system and also provide higher returns, which could make an enormous difference in the long term. Efforts by the government to expand the funded pillars have proved their use in the past. Today, 75% of employees and 45% of the self-employed are paying into a supplementary pension via the 2nd pillar – and the fiscal advantage for pension-saving has resulted in wide participation in the 3rd pillar. Given the still limited share of funding in pension financing, the government would do well to expand its efforts in this field.

A more balanced pension system

The aging of the population is confronting the Belgian government with an enormous challenge. The efforts to prepare our economy and social security for that challenge would, however, suggest that this challenge is still being underestimated. Now that aging is really beginning to hit hard, the next government must urgently get down to work on devising a more balanced pension system.

1. Acknowledge the reality that the state pension is, for many people, sliding down to a pretty modest basic pension, and that it is not very realistic to hope that there will be sufficient resources over the coming decades to make any real change to that situation.
2. The Belgian pension system continues to be based too much on PAYG financing, in spite of the gloomy prospects for that form of financing. Meanwhile, funding remains under-used.
3. The necessary extension of pension entitlements to supplement the statutory basic pension can best be done via the additional funded pillars, whereby participation by everyone should be encouraged (and more than is the case today).

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