

5<sup>th</sup> International Research Conference  
on Social Security

Warsaw, 5-7 March 2007



"Social security and the labour market: A mismatch?"

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**Labour flexibility and pension schemes  
in the European Union**

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## **Labour flexibility and pension schemes in the European Union**

### **Abstract**

Labour flexibility seems to play an important part in the future labour market, although this flexibility has not involved adapting pension schemes (1st and 2nd pillar) to changes. The aim of this paper is to present some suggestions with regard to these problems. Due to labour market flexibility and (macro) pension finance sustainability, changing the pattern of the 1st pillar to guarantee minimum and universally available anti-poverty pensions (that would be probably means tested) rather than up-keeping the current high standard retirement based on a fixed condition (i.e. period of contribution) is proposed. In the case of the 2nd pension pillar, instead of attempts to homogenize current highly diversified pension schemes, the approach should focus on creating a pan-European pension market.

### **Introduction**

The concept of labour flexibility has been very popular in recent years in the European Union due to its positive impact on labour market, especially on the unemployment rate and labour force movement within the Member States. Flexibility allows also to adjust one's professional career to individual life profile and strengthen efficiency (productivity) of the European labour market. Although labour flexibility seems to play important part in future labour market this flexibility didn't not involved adapting pension schemes (1<sup>st</sup> and 2<sup>nd</sup> pillar) to changes .

Two problems may arise because of labour flexibility with regard to pension schemes. The first one concerns the different character of pension "assets" (entitlements in PAYG and capital in full-funded schemes) and transfer ability of these entitlements (or capital) between countries which are not necessarily members of the European Union. The second problem lies in contributions to pension schemes in the case of non-standard employment and pension provision both for migrant workers and for citizens of the European Union. The problems will arise and possible solutions are strongly awaited. The aim of the paper is:

- identify the main problems concerning labour flexibility and pensions schemes in the European Union,
- propose possible solutions for pension schemes in the case of non-standard employment in the European Union.

## Labour market flexibility

Labour market flexibility understood as “the extent and speed of adaptation or adjustment to external shocks or labour market conditions” (Standing, 1999; Cazes and Nesporova 2004) can be achieved and categorized in many ways. The most known distinction was made by Atkinson (1984): external numerical flexibility, internal numerical flexibility, functional (organizational) flexibility, and financial (wage) flexibility. Many other interesting approaches can be noticed such as: locational flexibility (flexibility of place) (Reilly, 1998; Wallace 2003); flexible working patterns, geographical mobility (CBI, 1997).<sup>1</sup> In this paper special attention will be paid to:

- flexible working patterns
  - non-standard hours of work (part-time work, shift work, annualised hours)
  - and non-standard type of employment (fixed term and seasonal contracts)
- geographical mobility.

Since 1970s the standard employment relationship has become to unravel (Rubin 1995, Cappelli at al 1997, Cappelli 1999), especially in Europe (Klau and Mittelstädt, 1986: 38-39). However, flexible working patterns were used widely before the Second World War. It was the prosperity of 1950's and 1960's that ceased the wide usage of flexible form of employment. The demand for non-standard employment has been increasing significantly since that time (Bielenski, Bosch and Wagner A., 2002: 54-55; EFILWC, 2003: 54-55). One observed internal reasons (change in demographic structures, i.e. married work women, elderly people) and external (the effect of globalisation, i.e. growing competitiveness) (Kalleberg, 2000). Now the phrase ‘flexibility’ seems to become the most popular collocation for labour market.

Flexibility of labour market grants a lot of profits for both sides of the contract.<sup>2</sup> Nevertheless, historically the main reason for flexible working patterns were gains of employer such as (Houseman, 2001; Nesbit, 2005): reduction of labour hired, affording more flexible working schedule and production, provision of lower wages and benefits for workers not covered by the collective agreement, and decreasing the overall labour costs, escalated by social security contributions. Although now-a-days flexibility, due to different lifecourse preferences (family responsibilities, training, leisure or civic activities and work-life balance (ILO, 1997; Millar, Ridge and Bennet, 2006: 17-18), is becoming more important for employees.<sup>3</sup>

One of the most important form of flexibility seems to be non-standard employment. Non-standard employment can be defined in opposition to full employment (regular job) (ILO, 1993; OECD, 2002: 170-179). There are different forms of non-standard employment such as: temporary help agency workers, short-term hires, regular part-time workers, temporary employment, on-call workers, contract worker (Housman, 2001; Kalberg, 2000). Part-time employment is a subject of special interest of the European Union (EC, 1998; EU, 2005a; EU, 2006), because it can contribute among others to growth of labour activity among graduates,

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<sup>1</sup> Interesting discussion on a concept of flexibility was presented by Meulders and Wilkin (1991).

<sup>2</sup> Among others when shifting to principle of full employment (not full-wage employment) one should remember of a political argument, that such a move lowers unemployment.

<sup>3</sup> Wider discussion see: Godart (1991) and EFILWC (2005).

women after maternity leave, and elderly people, just before retirement (Gasparini, 2006; Lilja and Hämäläinen, 2006).

In spite of positive impact on labour activity, there are a lot of inevitable negative consequences of flexibility, which makes non-standard employment a kind of worse job (ILO, 1997; Vielle and Walthery, 2003: 56; Millar, Ridge and Bennet, 2006: 18-28). Among numerous consequences the most important are: lower wages; worse work conditions (what may caused health problems); lower security (instability of the workplace, although this argument is falsified by some research); lower social security.

Lower level of social security can be explained by the concept of transitional labour market (TLM) created by Schmid (Schmid, 1993, 1995, 1998; Schmid and Schömann, 2003) and “professional state” and “social drawings rights” ideas attribute to Supiot (Vielle and Walthery, 2003: 81-82). Both concepts concern a certain phase of professional career and transitional points between them: training – employment, part-time employment – full time employment, salaried employment – self-employment, reproduction and care activities – paid employment, non-employment – employment, disability – employment, employment – retirement (Vielle and Walthery, 2003: 81-82). Smooth movement through particular transitional points and sufficient security level for different stages of professional state will be the main challenge for the welfare state in the post-Fordist labour market (Koch, 2006: 155-164; Fine, 1998: 77-80).<sup>4</sup>

Mobility (migration), the other aspect of labour market flexibility is well known from the history of industrialization. Even though one may have observed changes in periods/duration of migrants’ employment, the case of labour movement within the Member State of the European Union. Article 39 of the EC Treaty gives the right to look for a job in another Member State, to work in another Member State, to reside and remain there for that purpose as well as it provides equal treatment in respect of access to employment and working conditions (EC, 2002). But the idea and process of globalization results in perceiving a broader perspective of migration, i.e. the global one. The migration from developing countries concerning the most valuable, well-educated citizens can be a major problem for small and isolated countries (World Bank, 2006) and the new Member States in certain area like health care (Zajac, 2004). Skilled migrations can have positive effects, if experienced migrants come back to homeland (World Bank, 2003 and 2005). Short time migrations would be much more likely and have positive effects, but require, among other things, transferable pension rights and capital.

Flexicurity<sup>5</sup> (Wilthagen, 1998; Withagen and Rogowski, 2002) is one of the solutions, which confront the problem of labour market flexibility. Although the European Union legislation covers some cases of pension rights transfer between the Member States, there are still problems which remain, especially in case of non-standard employment and migration. They are easy to be pointed out within pension schemes, for example: crediting the socially useful activities, universality vs conditionality of the 1<sup>st</sup> pillar (chosen vs. imposed flexibility), a level of income guarantee and moral hazard.

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<sup>4</sup> The concept of post-Fordism concerns not only labour market but much broader socio-economic dimension (Amin, 1994).

<sup>5</sup> “A policy strategy that attempts, synchronically and in a deliberate way, to enhance the flexibility of labour markets, work organization and labour relations on the one hand, and employment security and social security – notably for weaker groups in and outside the labour market, on the other hand.” (Wilthagen, 1998).

## The 1<sup>st</sup> pension pillar

The above mentioned issues require a wider discussion in the context of pension schemes and pension reforms. Pension schemes are very often presented in three-pillar models. Because there are a lot of differences resulting from diverse aims and ways of satisfying the need, one may distinguish three main presentations established by the International Labour Organisation, the Organization for Economic Co-operation and Development (applied by the European Union)<sup>6</sup> and the World Bank<sup>7</sup>.

### Scheme 1. Taxonomy of pension plans by Organization for Economic Co-operation and Development (applied by the European Union), the World Bank, International Labour Organisation

	<b>Organisation for Economic Co-operation and Development (the EU)</b>	<b>The World Bank</b>	<b>International Labour Organization</b>
<b>1<sup>st</sup> pillar</b>	Publicly managed pension scheme with defined benefits and PAYG finance, usually an payroll tax.	A relatively small (means tested, minimum pension guarantee or flat benefit), publicly managed, PAYG, defined benefit pillar.	A minimum anti-poverty pension, universally available but means tested, financed possibly directly from general revenues and indexed
<b>2<sup>nd</sup> pillar</b>	Privately managed pension which are provided as part of an employment contract.	A privately managed (personal savings plan or occupational plan), mandatory, regulated fully funded, defined contribution, pillar.	A mandatory public PAYG social insurance pension which would provide a reasonable replacement rate. It would be fully indexed against inflation. Also, it would be subject to a ceiling.
<b>3<sup>rd</sup> pillar</b>	Personal pension plan in the form of saving and annuity schemes.	Voluntary, individual account (personal savings plan or occupational plan), privately managed.	A fully funded contribution scheme, perhaps privately managed, which would supplement the public scheme. This would include occupational as well as individual schemes. Their operation would need to be closely monitored and regulated.

Source: Yermo (2002), p. 16-17; Gillion (1999), p. 8; World Bank (1994), p. 15-16.

When comparing these different attitudes to pension one may give a special attention to more prescriptive character of the ILO plan, which - in opposition to OECD and WB plans - shows more different level of guarantees instead of different organizational stages. For recent reforms in the Member States the most appropriate for description of pension schemes are

<sup>6</sup> OECD noticed a need for revision of its three pillar presentation (Yermo, 2002).

<sup>7</sup> The World Bank use now five-pillar presentation (Holzmann et al, 2005: 10), but many the New Members States reformed in the way suggested by the WB, employ modified three-pillar presentation.

typologies developed by the OECD (for most of the old Member States) and WB plans (for some of the new Member States).

The 1<sup>st</sup> pillar in the OECD presentation includes social minimum and specified higher standard. According to the EU Member States schemes one may indicate that social minimum can be universalized on a resident base or preconditioned on length of contribution periods, while higher standard require specific level of contribution. The aspect of universality of minimum pension shows the level of guarantee granted by the public scheme. Within the Member States one may distinguish three attitude towards this issue (EC, 2006; OECD, 2005). The first attitude indicates no such a category like minimum pension (i.e. Germany). Benefits for poor elderly are granted within social assistance schemes. The second approach shows a differentiation of minimum pension level depending on the length of contributory periods. There are two ways of defining minimum pension benefit: the shorter contribution period the smaller minimum pension (for example: Finland, Latvia) or fixed when minimum criteria are met (Greece, Poland). The third attitude is based upon citizenship or sufficient residence period and offers flat-rate pension (non-contributory pension) (Estonia, Ireland, Portugal). The best solution for flexible labour market is the third approach or the second one with a small differentiation of minimum pension level, and low entering minimum contribution period. One should point out the risk of moral hazard, though.

Conditionality of minimum pension takes place in most of regimes, mainly because of moral hazard. Most of recent pension reforms, especially in the old Member States and some of the new ones (Kawinski, 2006) tried to keep high standard level while not changing or changing very little rules of social minimum guarantee (EU, 2005b). According to the World Bank typology one may notice that there are two types of reforms: *parametric* and *paradigmatic* (Holzmann, MacKellar and Rutkowski 2003). Parametric reforms tend to rationalize the existing mandatory PAYG (mainly - defined benefit) pension scheme by reducing expenditures and increasing revenues. The decline in expenditures can be achieved by raising the retirement age, lowering pension indexation, and restricting privileges. The revenues growth would require an increase of pension contribution which are already quite high by now. Paradigmatic reforms tend to incline to introduce a mandatory funded pension pillar, along with the reformed PAYG pillar. A shift from defined benefit to defined contribution provision is also characteristic for deep change (Rutkowski, 2004). Such fundamental reforms were mainly carried out in the new Member States.

Regardless of the type of pension reforms, more strict rules within DB scheme or shifting to DC scheme lowers the level of social security for future pensioners, especially in the case of non-standard employment. First because of shorter contribution periods, second due to lower level of contributions (caused by lower wages). DB schemes in most cases (especially in the EU) would be generally more profitable than DC for flexible labour force, however part-time employees could find it more beneficial if wages would be higher then minimum. It is only the reason why flexicurity, one of the consequence of non-standard employment, may offer relatively lower social security level in spite of new incentives (Kallenberg 2000: 342). Lower social security level becomes evident when comparing minimum pension requirements for part-time job and full-employment, considering non-discrimination principle (*pro rata temporis* rule) introduced by the EU (EC, 1998).

Setting up non-contributory based universal social minimum, as in the ILO plan, could help to introduce pensions schemes which would be much more favourable for non-standard employment. However, in some countries the scale of moral hazard could be dangerous for

social security and financial sustainability. Furthermore, in the case of social-useful activities more generous crediting stage is required, which causes direct effects within full-funded schemes and postponed within PAYG schemes.

There is an inevitable conflict between promotion of labour market flexibility and financial sustainability of pension scheme. Flexibility is expensive by itself and would be much more costly if minimum pensions were unconditionalized (universal) and relatively high. The way to follow may be shown by best practices (findings on balance of social and financial security) within the Open Method of Coordination. Notwithstanding, when tracking best practices in certain area, broader analyses of effects which take into consideration whole social security are required. There are two things, which occur to be crucial for labour market flexibility from the pan-European perspective. The first thing is a deep coordination of the social security schemes while the second is the changing pattern of the 1<sup>st</sup> pillar to guarantee a minimum anti-poverty pension, universally available (probably means tested) instead of high standard retirement based on fixed condition (i.e. period of contribution).

Mobility and migrants workers from the third countries seem to be less problematic if they will come back to the homeland before retirement. But one should think about some form of shifting the pension capital of to migrants homeland as an equivalent of pension.

### **The 2<sup>nd</sup> pension pillar**

The 2<sup>nd</sup> pension pillar in the European Union comprises of occupational retirement pensions. Particularly in the Western Europe (Holland and the UK) this segment has long tradition and has been providing workers with considerable part of their overall pension benefits.

With regard to non-standard employers, such as part-timers or fixed-term workers, there is no particular provision at the pan-European level but a general protection only, derived from a principle of equal treatment. The Council Directive 97/81/EC of 15 December 1997 applies to part-time workers, while the Council Directive 1999/70/EC of 28 June 1999 deals with fixed-term workers. Both of the documents stipulate that the treatment of those employees should not be less favourable than comparable permanent workers.

Differences in rules governing various pension schemes and tax obstacles have detrimental effect on the mobility of workers. Therefore, several laws at the pan-European level were prepared to mitigate the problem. Amongst the most important documents are: the Council Directive 98/49/EC, the IORP Directive and the project of Portability Directive.

The first document, i.e. Council Directive 98/49/EC of 29 June 1998 laid the background towards creating pension mobility framework by granting employed and self-employed persons the right to move within the European Union. According to this law, a worker who leaves a scheme and moves to another Member State cannot be treated differently with regard to his vested pension rights than as in the situation he or she changed a pension scheme within the country. Also the cross border payments of benefits must be allowed, i.e. a worker should be able to receive a pension benefit from a scheme situated in another Member State if he or she is entitled to (in line with Article 56 EC of the Treaty enabling free movement of payments and capital). The Directive requires also that appropriate information must be presented to pension scheme members to enable them taking an informed decision about changing the workplace and its possible consequences on their pension situation.

The second Directive - on the activities of Institutions for Occupational Retirement Provision (IORP Directive) entered into force on 23 September 2003 and was implemented by 23 September 2005 although not without difficulties. This Directive creates a system of mutual (host and home country) recognition. An IORP that is willing to operate in another country must meet a set of certain minimum common for all Member Countries rules regarding prudential matters such as: organization, structure and operating conditions, investment rules, technical provisions and regulatory own funds, information disclosure (EFRP, 2003). The Directive creates therefore a possibility for occupational supplementary pension providers to operate at the pan-European level. It also drafts a framework for the prudential regulation of funded occupational pension schemes which are not covered by the Directive 1408/71.

The European Federation for Retirement Provision (EFRP), representing occupational collective pension schemes put a proposal for so-called EIORP framework that would be an extension of the current IORP system and that would not require tax harmonisation. Differences in tax regimes are one of the most considerable obstacles towards the pan-European pension markets. As an illustration of this issue can serve 26 complaints tabled by the EFRP to the European Commission on 2 December of 2005 against discriminatory taxation of dividends and interest payments. Therefore, the EFRP proposal is based on the idea that within each EIORP there would be national sections applying tax rules of its corresponding Member States which would guarantee tax neutrality (EFRP, 2003).

Whereas the above-mentioned laws give some space for creating the pan-European pension landscape and therefore increase workers' mobility, one important aspect yet needs to be addressed. The Council Directive 98/49/EC does not cover so-called "portability" of occupational pensions, i.e. the possibility to transfer pension entitlements that had been already acquired in a pension scheme of a previous employer to another pension scheme organized by a new employer. Lack of such portability creates the situation when a worker loses part of his income deferred in pension entitlements which in consequence creates a disincentive to workers mobility, particularly to the elderly ones.

Main obstacles to pension mobility in the area of supplementary, occupational pensions relate to the conditions of acquisition, preservation and transferability of pension rights (Jacob, 2003). With regard to the first group, occupational schemes tend to set up requirements related to the time of employment in a particular company necessary before being admitted to the employer's pension scheme (waiting period), required period of membership in a plan after which an employee obtains a right to a pension benefit (vesting period) as well as the minimum age of a candidate wishing to enrol a pension scheme. Rules concerning the preservation of obtained rights in case of changing a job and protection of these rights against inflation during the whole saving period make up the second group of factors that can reduce the mobility of workers. Finally, the risk of double taxation that emerges in the case of cross-border mobility must be taken into account.

Jacobs (2003) notices that while any change of pension scheme can reduce pension benefits, it is even more likely in the case of cross-border mobility. Under such a scenario transfer of rights that had already obtained can be impossible or more complicated, while tax systems in different countries "may clash".

As a consequence of these problems, on 20 October 2005 the European Commission issued a proposal for the Portability Directive. The Directive seeks to improve portability of supplementary pension rights. Initially, it proposed to set up conditions in four main areas:

conditions governing the acquisition of pension rights, preservation of acquired but inactive rights (dormant rights, i.e. entitlement to deferred benefits), transferability of capitals or entitlements and proper information standards.

However, the proposal contains elements that have been criticized by various social partners. It has been argued that so-called dynamic sampling (i.e. requirement of regular indexation of dormant rights against the inflation) or shortening of the vesting period (from 5 to 2 years) are too expensive for the employers. In the global economy, costs induced by this legislation could lead to closing occupational pension schemes, in particular the ones operating under the defined-benefit formula. Alternatively, it might substantially lower the level of the EU competitiveness. Another problem relates to transferability of pension entitlements between two schemes when one is based on so-called book reserves (*Direkzusage*) and another is funded. For this reason, the European Commission excluded book reserve schemes from the scope of the Portability Directive (c.f. IPE news, 3 May 2006). Therefore, the current shape of proposed Directive (as of beginning of 2007) concentrates only on vesting criteria and a fair treatment of dormant rights and is likely to abandon the transferability issue.

It is quite doubtful whether one should expect prompt and serious improvements with regard to pension mobility. The statutory pension systems are highly diverse and – what is most important – are subject to sovereign decisions of governments under the Directive 1408/71. Thus, the unification will be done gradually, perhaps in result of common coordination of social security systems. The situation in the second pillar is far from homogeneity either. It is obvious that the mobility between “incompatible” book reserve and fully-funded occupational schemes is practically impossible. However, the attempts for unification of requirements in each class of schemes also brings about a threat of their winding up due to increased costs or at least generate an “arbitrage” at the labour market with employers seeking workers in the countries with minimal, i.e. the cheapest, requirements.

Governments are gradually reducing their direct involvement in pension provision from their statutory pension systems in favour of supporting supplementary pensions and individual private pensions. Therefore it seems that instead of attempts to homogenize current highly diversified pension schemes, the approach should be focused on creating the pan-European pension market. With regard to collective pension framework one may expect that the IORP Directive will help to create international pension schemes that will offer similar or identical conditions for all participants with no regard to their location or the nature of their employment. Workers should also be given the opportunity to save and move their additional pension resources within institutional investors. The European Financial Services Round Table (EFR) launched an initiative (still highly theoretical, though) called “26<sup>th</sup> regime” to establish a single EU market for personal pensions. These products, approved at the pan-European level would be sold independently on local products. Potential pension providers would encompass mutual funds, banks, insurance companies and pension funds. Thus, multinational pension providers such as UCITS and alike should be developed which would be with benefit for irregular or part-time workers. A separate issue concerns immigrants. The solution of their pension status is based upon the initial decision the Member States will take up with regard whether the immigration is useful for their economies or not.

## **Conclusion**

The idea of flexibility is very important for the European Union labour market and the significance of non-standard employment for increased labour activity is crucial. That is why

flexibility desired special treatment also in pension area. Nevertheless, one should avoid hybrid pension schemes for standard and non-standard employment. Due to labour market flexibility and (macro) pension finance sustainability there is a proposition to change the pattern of the 1<sup>st</sup> pillar to guarantee a minimum and universally available anti-poverty pension (that would be probably means tested) rather than keeping up high standard retirement based on fixed condition (i.e. period of contribution).

In the case of the 2<sup>nd</sup> pension pillar, instead of attempts to homogenize current highly diversified pension schemes, the approach should be focused on creating the pan-European pension market. Workers could be also given the opportunity to save and move their additional pension resources within institutional investors. An initiative to establish a single EU market for personal pensions seems to be reasonable and helpful for mobility of EU citizens.

In the near future migration from the third countries may give a start to an international discussion about shifting the pension capital to migrants homeland, as an equivalent of pension. The usefulness of immigration for the Member States economies should include the analysis potential social security transfers.

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