Prospects

Aperiodic – N°20/022 – 6 February 2020

FRANCE – Pension reform

What impacts will the reform have? What issues are still unresolved?

- **A number of changes were made to the French pension system in 1993, followed by the Fillon reform in 2003 and another reform in 2010. All these measures were introduced in a bid to head off the risk of ever-deeper deficits as a result of the greying of the population and the 2008-2009 financial crisis. The reforms pushed out the qualifying age for pensions from 60 to 62, extended the contribution period from 40 to 41.5 years currently, increasing to 43 years in 2035, and changed how entitlements and pensions are indexed. However, they left the very complex architecture of the system untouched. Essentially financed on a pay-as-you-go basis, there are 42 different pension schemes, further complicated by the mix of defined-benefit and point-based models. These reforms curbed the risk of a steep rise in the pension system deficit.**
- **The latest proposed overhaul to introduce a universal system based on points is still a pay-as-you-go approach. By melding 42 different regimes into a single method for calculating pensions, the reforms would simplify the system. Redistributive effects would also be more significant as the focus switched from solidarity within a category to broader inter-sector solidarity. The proposals also seems to give more weighting to carreer changes and spells outside active employment (maternity, unemployment, accident or sick leave).**
- **Introducing what is known as the "equilibrium" age, or the age for full retirement benefits, (65 in 2037 in the impact assessment) means the first cohorts of workers paying into the universal pension system will be able to retire earlier, as the age at which the reduction in pension entitlements applies – currently 67 – is withdrawn. Ultimately, the government wants to encourage people to work longer in the new system.**
- **The proposals include long and very gradual transition periods for the switch from the special schemes to the new universal system.**
- **The "golden rule" of the overhaul is a financially balanced pension system over a period of five years on a rolling basis.**
- **However, this target clouds people's understanding of the universal pension system and challenges the assumptions such as indexing the value of a point against wage growth and indexing pensions to inflation for the period 2030-2050, although these are the assumptions used in the impact assessment.**
- **Many questions remain, despite the publication of the impact assessment by the government. How the transition will be funded and the possible impacts of the compensatory measures on public spending (raising teachers' pay, for example) are not addressed.**

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Current pension system

Long-term demographic and economic projections

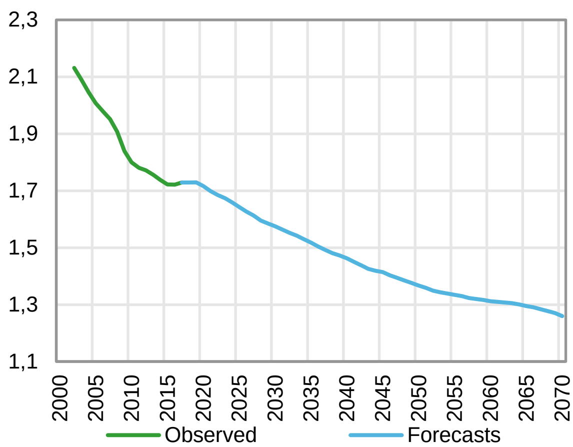
There key factors underpin the financials of the current pension system: the dependency ratio (in other words, the ratio of contributors to pensioners), the ratio of average pension payment to average earned income, and the rate of deductions from earned income. We note that the contribution rate is assumed to be stable at 28.12% in the draft pension reform, which is close to the current contribution rate in the general private sector scheme.

Projections produced by the Pensions Advisory Council (COR, *Conseil d'orientation des retraites*)[1] show the number of contributors remaining almost stable, growing by an average of just 0.2% per year, to 29.5 million in 2032 and 30.7 million in 2070, from 27.9 million in 2017. Demographic shifts are responsible for the pattern, despite people actually retiring later. The retirement age should increase from 61.8 in 2017 to 64 in 2040, reflecting the higher number of quarters' contributions required to be entitled to a full pension and later entry to the labour market.

The number of pensioners is set to rise sharply, from 16 million in 2017 to 24.3 million in 2070. This gives an average annual increase of 0.8%, with a more pronounced rise in the period to 2035 (pushed up by the "Grandpa boom").

As a result, there will be 1.5 contributors for every pensioner in 2035 and 1.3 in 2070, compared with 1.7 in 2017.

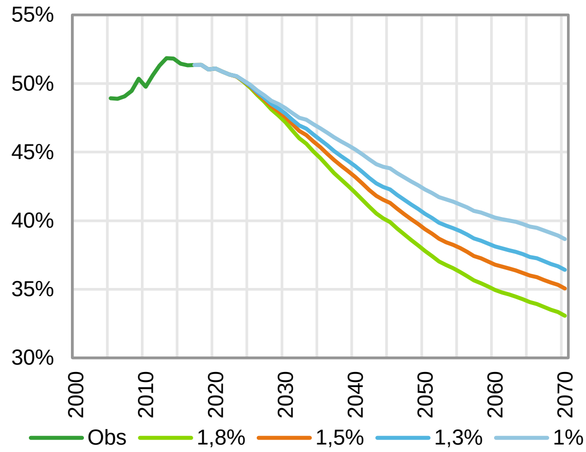
Ratio of contributors to pensioners



Sources: COR (June 2019), INSEE, Crédit Agricole SA ECO

As things stand, the Pensions Advisory Council projects that the average pension, expressed in constant euros, will nudge up slightly by 2070 (turnover effect, in other words the effect of older generations being replaced by pensioners on higher pensions). But the relative pension (the ratio of gross average retirement income to gross earned income) – which has risen for many years – will fall fairly sharply in all productivity scenarios: from 51.4% in 2015 to roughly 37% under the baseline scenario (1.3% annual productivity gains). This is primarily because since the recent reforms, both earned pension rights over a working life and pensions are indexed to inflation, whereas earned income moves faster, more or less in line with nominal wages.

Average pension as % of gross wage (4 productivity hypothesis)



Sources: COR (June 2019), INSEE, Crédit Agricole SA ECO

At financial equilibrium, we have:

$$\begin{aligned} Average\ Pension \times Number\ of\ pensioners \\ = Number\ of\ contributors \\ \times Average\ earned\ incomen \\ \times Contribution\ rate \end{aligned}$$

Remember that the pension system was in surplus from 2002 to 2007, before the impacts of the economic and financial crisis pushed it into the red in 2009-2010. The deficit was gradually eliminated in subsequent years.

The system was more or less balanced in 2017. It is forecast to stay that way in the short term before slipping into a slight deficit in 2022, equivalent to -0.2% of GDP. **What happens after this point depends on two shifts: a higher dependency ratio (pensioners to contributors) and a lower ratio of gross average pension to gross average earned income.** This second ratio is highly dependent on economic assumptions. If we take the "optimistic" scenarios (1.5% and 1.8% annual productivity gains), the deficit should start to be

[1] COR, June 2019, *Évolutions et perspectives des retraites en France*

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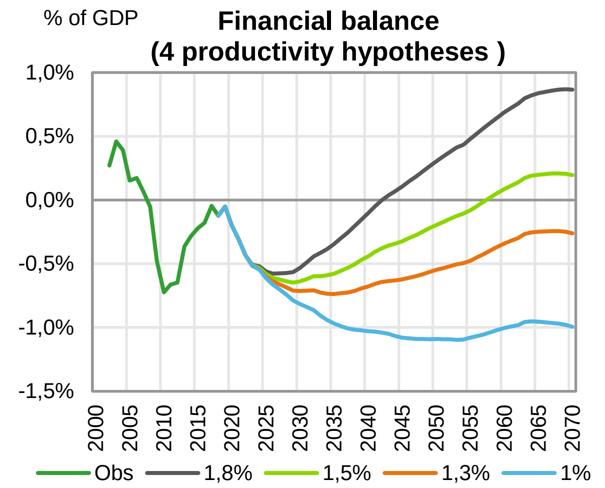
absorbed between 2025 and 2030 and balance would gradually be restored to the system.

Under the two pessimistic scenarios, the system would remain in deficit. Taking the baseline scenario of 1.3% annual productivity gains, the situation would fluctuate between -0.6% and -0.3% of GDP per year, as of 2025. In the "1%" scenario, it would deteriorate markedly, -1 to -1.5% of GDP per year in the period 2040 to 2070.

Hence, using a prudent projection of 1% or 1.3% productivity gains, that is to say a potential GDP growth between 1.1% and 1.5% (its current level), the French pension system would run a considerable deficit in the period 2030-2070. Balance would not be ensured in the medium term.



Sources: COR (June 2019), Crédit Agricole SA ECO

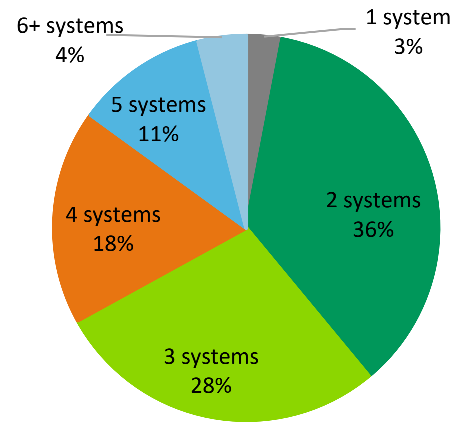
A sprawling system that generates inequality and a glaring lack of transparency

There are number of disadvantages to a defined-benefit scheme (like the current general scheme in the private sector). It can appear relatively unfair since the pension essentially depends on the reference salary. It is uncoupled from the contribution rate, which may have fluctuated substantially over time. Two retirees with the same cumulative total contributions and two different career paths will not have the same pension. Nor does a defined-benefit scheme take into account a person's full working life; only part of the quarters contributed is used to calculate the pension entitlement. It smooths over career ups and downs by using only the best 25 years in the calculation. This method of the best 25 years favours the upwardly mobile over people with a flatter career curve.

The diverse range of systems is also a problem for solidarity. Solidarity measures in the current system are within a pension scheme, which in many cases are specific professional or sector schemes. As work changes and some jobs disappear, some pension schemes will have to grapple with the problem of balancing their system, while others will enjoy a surplus.

Lastly, the plethora of different systems creates problems of legibility when it comes to estimating pension amounts. Contributors are often enrolled in two schemes (a general scheme and a supplementary plan, like the AGIRC-ARRCO in the private sector, for example). They may very easily have chosen to contribute to even more pension schemes if they have more than one job (both an employee and self-employed) or if they switched careers.

Contributors by the number of systems they contribute to



Sources: GIP union Retraite, Annuaire droits à l'information 2017

For more information on the French pension system, see "*France – Pensions: The state of play and future reform issues*", December 3, 2018.

The reform, principles and impacts

Measures aimed at simplifying the system

Introducing a universal points-based contribution system aims to simplify the current architecture and make it easier to understand. Solidarity in the overhauled system will be founded on a broader principle and risks will be pooled, unlike now where solidarity is within the scheme, and therefore in many cases within a category (self-employed, civil servants) or a profession.

But, for many people enrolled in special schemes, the reform means losing some of their benefits, such as the right to early retirement or higher pensions – sometimes won at the expense of wage concessions (this is the SNCF's argument). Other schemes, like the one for lawyers which has been in surplus until now, would have to contribute in solidarity with the national scheme. Above and beyond defending their entitlements, opponents focused their ire on certain measures initially

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included in the reform package (pivot age, transition, etc.), sparking strikes and social unrest.

The points-based system would still be pay-as-you-go. The active population would continue to fund the pensions of today's pensioners. What's more, €1 paid in at a given time would give entitlement to the same pension rights for all workers.

Up to 3 PASS (the annual social security income ceiling; 1 PASS is roughly €40,000) of annual income, the same contribution level applies to everyone (28.12%, including employees' and employers' share of the contributions). The solidarity principle applies to income in excess of 3 PASS but not allows contributors to accumulate more points. Slightly different contribution rules will apply to the self-employed with a very gradual increase in contributions, offset by a reduction in the CSG (Generalised Social Contribution) to cushion the impact on net income.

Contribution rates in the post-reform system

	For employees and civil servants		
Wage	Contributive rate	Non contributive rate (solidarity)	Total
0-3 PASS	25,31%	2,81%	28,12%
Above 3 PASS	-	2,81%	2,81%
	For self employed workers		
Wage	Contributive rate	Non contributive rate (solidarity)	Total
0-1 PASS	25,31%	2,81%	28,12%
1-3 PASS	10,13%	2,81%	12,94%
Above 3 PASS	-	2,81%	2,81%

Sources: Impact assessment of the pension reform; Crédit Agricole S.A ECO

Along the lines of current supplementary schemes like the AGIRC ARRCO plan, each euro contributed will be converted to points according to a purchase value on the contribution date. The points accumulated are then converted to euro at a benefit value on the retirement date. The purchase value and benefit value go up or down "by default" according to wages. During retirement, the benefit value is indexed to inflation "by default" to keep pensioners' purchasing power stable. In response to demands, the government announced that the benefit value and the cash value of pensions could not reduce over time. This makes calculating pensions much simpler. We've put "by default" in quotes, since, as we'll see later in this paper, the criteria for changes in the value of a point and indexing pensions against inflation could be amended to bring the system into balance.

Calculating the average gross pension under the new system

PM: *average pension*

NP: *number of points*

VS: *benefit value on the retirement date*

VA_i: *purchase value of a poin in period i*

S_i: *gross annual salary in period i*

TX_i: *contribution rate in period i*

n: *number of years contributed*

$$PM = NP * VS$$

Where $NP = \sum_{i=1}^{n} \left(\frac{TX_i * S_i}{VA_i}\right)$

Assuming a constant contribution rate over the contribution period, and also that the wage rises at the same pace as the average wage, gives us $NP = n * \frac{TX*S}{VA}$ because the wage and the purchasing value changed at the same pace, so the ratio between them is constant.

Hence: $PM = n * \frac{TX*S}{VA} * VS$

With a 43-year contribution period, a 28.12% contribution rate of which 90% is expected to grant pension benefits (the solidarity contribution being 2.81% of the wage), a €10 point purchase price and a benefit value of €0.55 at the start of the career (under assumptions made in the Delevoye report), we get:

$$PM = 0{,}599 * S$$

The average gross pension therefore comes out at 59.9% of the wage at the end of the career, i.e. a gross replacement rate of 59.9%.

Who will be concerned by the reform?

The reforms will not affect those born in 1974 or earlier as they are considered to be too close to retirement age. People born between 1975 and 2003 will contribute to the universal pension system as of 2025, with their pension rights up to 2025 still being calculated under the old system. Only people born after 2004 will be directly concerned by the reforms as of 2022, when they start to enter the labour force.

In order to ensure a gradual transition to the new pension system, arrangements are also being made for people whose statutory retirement age is currently 52 or 57. In these schemes, the overhauled pension system will apply to those born in 1985 and 1980, respectively.

Minimum pension to be revised on the upside

Starting in 2022, anybody on the minimum wage (the SMIC) throughout their working life will be entitled to a minimum pension of €1,000. This minimum will be reviewed subsequently and set at

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85% of the SMIC in 2025. 20% of pensioners are currently on the minimum (MICO), which is less than €1,000 and varies from scheme to scheme. They receive a full pension, but at a low rate. Pensions for these beneficiaries would have fallen under the old system, as the MICO is pegged to inflation, which moves at a slower pace than the statutory minimum wage, the SMIC.

These minimum pension payments will also be extended to farmers and the self-employed, who will see significant gains from this increased minimum.

In the new system, approximately one-quarter of pensions will be raised to the minimum, which will increase the share of minimum pensions in the total pensions paid between now and 2050. These pensions will mostly be funded by the non-contributory share of all workers' contributions.

Uneven career trajectories and job hardship

Points will be awarded for periods of unemployment, lengthy sick or accident leave and for each child to compensate for the impact of new arrivals and education on parents' careers. For people changing career path – which could mean switching pension scheme under the present system – the reform should simplify the assessment of their future pension.

Workplace stress or hardship rules will be extended to the public sector and to employees covered by special schemes. According to the government's study, 200,000 more people could earn additional points in their prevention account (C2P). The hardship thresholds for working at night have also been lowered. Exposure to stress or hardship criteria will give entitlement to significant extra points on top of their contributions.

Early retirement for public servants in certain dangerous positions (police, fire service, prison wardens, etc.) will be retained. Early retirement will be very gradually phased out throughout the rest of the civil service and in special schemes. As a result, the share of early retirement pensions paid will fall from 7% today to just 3% in 2050.

Measures for long careers will remain unchanged. The legal retirement age for beneficiaries of this plan stays at 60, and the retirement conditions will be the same as those for a worker not covered by the long career measures who is 2 years older. In other words, the pivot age for long careers will be two years below the age set by the system's governance.

Equilibrium age: a clear incentive to work longer.

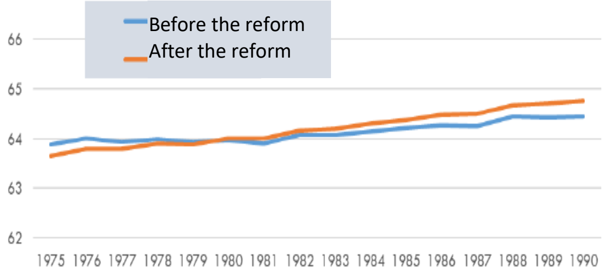
Introducing a equilibrium age is an encouragement to work longer, even if the legal retirement age stays at 62. The incentive value of the equilibrium age is one of the assumptions in the government's impact study. People retiring before the equilibrium age lose 5% of their pension per year. People leaving after this age will get a bonus of 5% per year. Under the governance framework for the future "national universal pension fund", the equilibrium age will be decided by the social partners.

According to the impact assessment, about 20% of people will stay in work longer than under the current system, while 30% will retire earlier and benefit from the removal of the age at which the pension reduction is cancelled (currently 67).

For the first cohorts concerned by the reform and paying into the universal pension system for at least part of their working lives, the retirement age will tend to be lower than before the reform. This is due to removing the age at which the pension reduction is cancelled – 67 at present – while the equilibrium age would be 65 (at least according to the study's assumptions).

The retirement age for subsequent cohorts would rise gradually, especially since the equilibrium age would rise as life expectancy increases (by two-thirds of the increase in life expectancy).

Average retirement age by generation



Source: Impact assessment of the pension reform

This measure would seem to benefit short, uneven careers. The poorest deciles tend to retire later and are the most likely to have to wait until age 67 for a full pension. Even with the current counterbalancing measures, 20% of women, who took breaks have and raise children, will have to wait until they are 67 to retire.

How can the levers be adjusted to achieve a balanced system?

The government's draft bill sets out a "golden rule" on the financial balance of the new system: a balanced pension system over a period of five years on a rolling basis, as of 2027. It initially planned to introduce the pivot age in 2022 to bring the system

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into balance by 2027. But, the trade unions won a concession and the very contentious measure was temporarily shelved pending a solution to be hammered out in a newly-established pension financing conference. The meetings kicked off at the end of January to provide a forum for the social partners to propose solutions to address the deficit in the pension system from 2027. It will be up to the government to decide if their proposals hold water. If not, the pivot age will be back on the books from 2022 and apply to all workers, even those born before 1975 and who will not be contributing to the universal pension system.

An equilibrium age will be introduced in the longer run and for cohorts paying their pension contributions at least partially into the new system. This age is 65 in the impact assessment simulations.

That said, it will be up to the governance (comprised of representatives of both contributors and employers) of the new "national universal pension fund" to keep the aim of a balanced system on track by juggling four parameters:

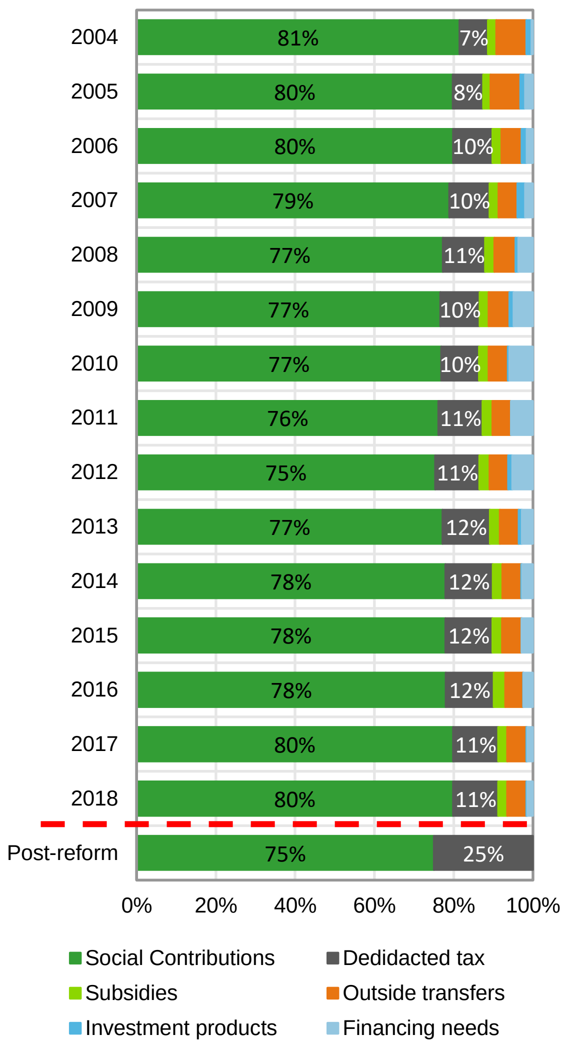
- ✓ **The equilibrium age**, which should rise at the rate of two-thirds of the gains in life expectancy, could be pushed back by the fund's governance to reduce the deficit.
- ✓ **Contribution rates** could be increased if the system runs a deficit (or reduced if in surplus). While both the government and employers' organisations have thus far rejected higher contributions, this nonetheless remains one of the options available to the pension system governance.
- ✓ **The value of a point** could be reviewed. The purchase price and the benefit value of a pension system point are pegged "by default" to wages, but both values could be used as a lever to bring the system into balance. While it's true that government has stated clearly that the benefit value of points cannot fall, it is possible nonetheless it could be frozen or increased at a lower pace than wage growth.
- ✓ **The cash value of pensions** should be indexed to inflation, but could grow at a lower rate or be frozen (as with the value of a point, the reform proposals rule out a fall in the value of pensions paid out), which would be tantamount to making pensioners shoulder the cost of balancing the system.

A Universal Reserve Fund will be set up to cope with possible drops in revenue in the event of a shock. It will initially be endowed with the €35 billion Pension Reserve Fund. However, surpluses available in schemes running a surplus will be used to finance the transition of these schemes and will not go to the Reserve fund.

Funding comparable to the current pension system funding

How the overhauled pension system will be funded is not detailed in the impact assessment on pension reform. However, it indicates a state contribution of "roughly 25%", which is close to its current share. The remaining 75% will be funded by social contributions. In reality, a quarter of the pension system's expenditure will go to financing solidarity measures (minimum pension, career bumps, maternity leave, etc.), which will be funded by the national solidarity contribution (levied at 2.81% of income) and by tax resources allocated annually in the social security budget bill, as is currently the case. Thus, the State's contribution would probably be slightly less than 25% – as it is now. All in all, this would make its contribution (via the allocation of tax revenues) to funding the pension system comparable to what it currently is.

Funding of the pension system



Sources: CCSS 2002-2019 ; SG-COR; Impact Assessment of the pension reform; Crédit Agricole SA / ECO

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Uncertainties remain, despite the impact assessment

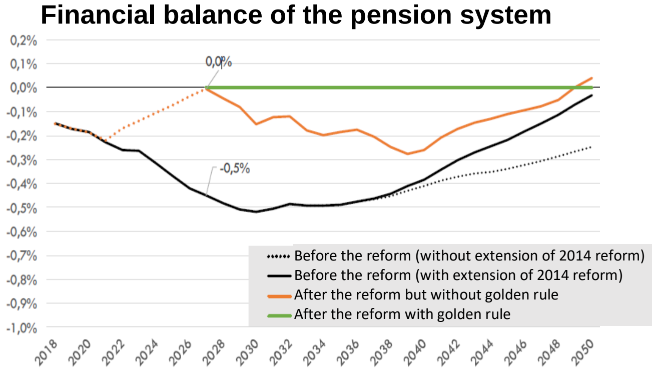
The Conseil d'Etat, France's highest administrative court, has pointed to gaps, inconsistencies and the failure to address some issues in the pension reform bill and accompanying impact assessment.

Assumptions (very) much open to question

First of all, **the assumptions used in the impact assessment are debatable.** Whereas assuming long-term productivity gains of 1.3% per year and a long-term unemployment rate of 7% are justifiable, the long projection horizon makes these forecasts uncertain and subject to many unknowns. The assumptions for the reform parameters also seem questionable and not very compatible with the "golden rule" of a balanced system over a five-year period. As they are specified in the impact assessment, the parameters of the reform will not meet this gold standard in the medium term. In other words, the government's assumptions for the pivot age and changes in the value of a point (in line with wages) (overly optimistic in our view) will be reviewed by the system's governance in 2027 to reach the financial balance.

The following graph, taken from the impact study, clearly shows that while the financial position of the universal pension system (based on the assumptions used in the impact study) would be better than the counterfactual (extending the current system), it would only break even by about 2050. **Therefore, from 2027, the system's governance would be forced to adjust the parameters of the current system:** it could raise the pivot age, adjust the purchase price or benefit value of a point (the most likely option being to moderate the increase in the benefit value to quickly rebalance the system), or slow the rate of increase of the pensions paid out to below inflation.

Financial balance of the pension system



Source: Impact assessment of the pension reform

The five-year financial balance target clouds the picture and complicates getting a read on the future system. It also dents the credibility of the projections in the impact assessment, even though the deficit would have been minimal without the "golden rule".

All the projections are built around assumptions that may not hold up after 2027. In particular, while under current assumptions the replacement rate should be similar to its current level (around 60%), a change in the parameters could have a significant impact on future pension levels.

How will transitions be funded?

One of the most glaring omissions from the impact assessment is how the transitional measures for special schemes, the self-employed, the liberal professions and civil servants will be funded, since it is not strictly speaking part of the pension system but a direct consequence of it. We're simply told that they will be handled on a case-by-case basis by *ordonnance.* Yet, some measures have already been announced and could prove very costly.

To cushion the negative impact of higher contributions on net salaries for civil servants, especially for teachers, the government plans significant hikes in salaries throughout the transition period – with a sizeable impact on public expenditure. In 2018, spending on education was 5.2% of GDP with 80% of this amount going on salaries (i.e. 4.2% of GDP). Wage increases would therefore have a significant impact on public expenditure. How will these wage increases be financed? How will they affect the deficit? These questions are not addressed in the impact assessment, but will almost certainly generate debate when the next budget bill is tabled.

The study glosses over the issues, merely mentioning that the reserves from the existing surplus systems would be allocated to the professions that accumulated them to fund the transition to the new universal system.

The funding of solidarity remains blurry

In its impact assessment, the government indicates that about one-quarter of the pension system's expenditure will go to financing solidarity measures and that these resources will be funded by the non-contributory share of contributions and tax revenue.

The projected tax allocation to the pension system for 2025 is €46 billion, including €20 billion in CSG, a levy specifically to fund solidarity measures, including pensions. Yet, CSG tax revenues are likely to fall in line with the compensation for the increase in contributions for the self-employed. How will this effect be offset? Will there be other repercussions for the social security budget? For the public deficit?

How will pension rights accrued under the old system be paid out?

Some uncertainty remains about how people born between 1975 and 2003, who paid part of their

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pension contributions into the old system, will claim their pension entitlements. The unions are demanding a clause for all workers along the lines of what was agreed in Italy, which already applies to RATP and SNCF employees. The so-called Italian clause safeguards the pension entitlements in the old system until retirement and not at the time of the transition to the new system. For the most part, pensions in the old system are calculated on a number of years' salary. Since workers' earnings are likely to be higher towards the end of their working life than at mid-career or the transition date, the clause benefits workers. The price tag is difficult to calculate and it also seems to be left out of the government's impact assessment.

To sum up, despite the heft (more than 1,000 pages) of the government's impact assessment, many doubts remain, especially about how the compensatory measures will be funded. While they remain unanswered, we consider these questions of funding to be more relevant than a financial balance forced march from 2027 onwards. All the more so as the system's financial balance should improve with a deficit of 0.2% to 0.3% of GDP per year by 2050, based on the underlying assumptions.

Moreover, any adjustments that may be made to the purchase value and benefit value of a point in the event of an imbalance in the system would affect the replacement rate (pension/end of career salary), giving rise to uncertainty and the risk of lower than expected future pensions. ■

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