

# Purchasing power of pensions in Europe





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## *Table of contents*

<b>Introduction</b>	<b>3</b>
<b>1. Methodology</b>	<b>4</b>
<b>2. General aspects</b>	<b>5</b>
<b>3. Pensioner incomes</b>	<b>6</b>
3.1 Earnings-related pensions	6
3.2 Minimum pensions	9
<b>4. Pensions in the maintenance of living standards</b>	<b>10</b>
<b>5. Pension indexation</b>	<b>12</b>
5.1 Choices of indexation criteria	12
5.2 Indexation/valorisation of past earnings up to the first pension in payment	13
5.3 Indexation of minimum pensions	13
5.4 Indexation of pensions in payment: the mechanisms and criteria	14
5.5 Social partner and especially trade union, involvement in indexation procedures	14
5.6 The figures of indexation	16
5.7 Effective protection of pension purchasing power: wage-linking and the social implications	18
<b>6. Conclusions: pensioner poverty</b>	<b>20</b>
References	23
Web sites	24
On line documents	24



# Introduction

FERPA and its member organisations recently decided to collect data on the purchasing power of elderly and retired people's incomes received as old-age pensions.

What prompted this move by the national and European union organizations was an awareness of the problems that older people are having meeting the rising costs of daily living.

It is a particularly complex issue involving both technical and social considerations.

The rising cost of pensions to public budgets has led many governments to reform (or try to) their pension systems in recent years, perceived as necessary to address population ageing in Europe. These reforms have been diverse and complex. But the clear underlying trend is towards a lower pension promise for today's (and tomorrow's) workers and pensioners than that of past generations. An OECD<sup>1</sup> study of the impact of the recent reforms on pension benefits finds that since 1990, average first pillar pension promise has suffered a cut of 22%<sup>2</sup>. For women, the reduction is larger: more than 25%.

In addition to the general concern that old age pensions might not be able to guarantee an adequate living income, quantitative indicators like elderly poverty rates, showing the percentage of older people at risk of poverty in Europe, bear out FERPA's fears, especially where women are concerned.

In these circumstances, the focus is on index-linking of pension incomes: some systems may erode the purchasing power of pensions year-over-year. This is not just about the *ability to buy the same basket of goods* year after year. It is also about retirees and elderly people being part of broader society – i.e., full citizens – who must be granted a *decent standard of living* on a par with that of the in-work population.

The figures show that pensioner living standards are steadily declining, year after year.

Trade unions see a need to assess the situation, raise the issue and draw political conclusions, and this is what this report sets out to do.

It lays no claim to be a scientific contribution to the economic debate on pension purchasing power trends across Europe. It does not seek to make a scientific assessment of the several strategies adopted by the Member States through the Open Method of Coordination in the field of pension systems in order to apply the guidelines set at the European level. The specific literature and reports of the appointed bodies already monitoring the situation at European level look at many more aspects of this than can be considered here.

This report is a measure of the commitment given by national trade unions of older and retired people to pension purchasing power as an issue that affects millions of pensioners across Europe.

It aims to bring these key issues, long recognised in the European Social Agenda, into the public arena, reflect the concerns expressed, and prompt an essential revamp of the policy debate

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<sup>1</sup> Pensions at a glance, OECD 2007

<sup>2</sup> Average pension promise fell from 10.7 times annual earnings to 8.4 times for men; for women from 13 times annual earnings to 9.7 times.

# 1. Methodology

**D**ata was collected to assess whether and how the purchasing power of pensions has changed over the past five years. The aim is to produce an information resource to support and lead awareness-building and other possible policy actions.

The survey was done in all the countries in which FERPA has members. A questionnaire compiled by the FERPA Secretariat was sent out in early July 2007, and the replies were received at the end of 2007.

Much of the data was collected directly from FERPA's member unions, who sifted through their national legislation and assessments to provide reliable, up-to-date information. This chosen methodology also delivered the policy aim of securing national trade union involvement: value is added to the bald figures by such things as the description of the processes by which pensions are index-linked.

The feedback received bespeaks the interest in the issue and the urgent need for a policy response. Replies were received from Austria, Belgium, Cyprus, France, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Poland, Spain, Portugal, the UK and Croatia. Other EU countries were looked at to give a broader picture and better assessment of the outcomes of different policy approaches to the issue.

The data were compared to that produced by the EU and other institutions, like the ILO and especially the OECD.

The data were also gender-disaggregated so as to clarify certain aspects like the higher at-poverty-risk of women on pensions.

The difficulties inherent in cross-country comparison of many different systems means that the focus has been put on earnings-related pensions and especially minimum pension schemes (first pillar).

Data was also collected on general economic aspects to contextualize the situation. This includes the public spend on pensions, legal and actual retirement ages, and the existence of early retirement schemes.

Other indicators refer to the financial position of people living on pensions in order to assess how far their monthly income provides them with the same living standard as before retirement: this includes legal minimum pensions (where provided), the length and measure of earnings related to pensions. These data were compared to average wages and replacement rates, and show the level of pensions as a percentage of previous individual earnings at the moment of pension take-up. This ratio of pre-to-post retirement disposable income leads to the specific central issue of this report - the index-linking and preservation of pension purchasing power. The factors of between-country comparison are GPD growth rates, wage growth rates, inflation rates and average real indexation percentages of pensions (data for 2001-2006). The first element is indexation of contributions built up over the course of working life. The second - and main - issue addressed is the methods used in the different countries to index-link pensions in payment. Indexation of minimum pensions is addressed separately, as some countries use different methods to that for old age pensions due to the specific purpose of these benefits, which are mainly to provide a subsis-



tence income and so involve different indexation principles. The indexation criteria used were considered: different indicators (prices, wages, a combination of both) may be used as the basis for uprating pensions, the choice of which goes beyond merely economic to involve political considerations. The figures collected and compared also include additional information on the processes by which these methods are applied. In a number of countries (BE, CH, CY, DK, FR, HU, IT, LU, PT, SP, UK) it is an automatic statutory requirement. Elsewhere (AT, BE, IT, FR, LU, PT, SP), automatic statutory uprating includes scope for the government to involve the social partners in this delicate phase. Even in some countries that have statutory procedures (BE, NL), indexation may be *de facto* suspended, such as in an economic crisis. And even where there is no statutory automatic indexation, it may still occur by other means (NL, IE, AT).

The poverty risk and percentage of pensioners living below the poverty line are also considered. The conclusions make the case that elderly people, especially elderly women, may be living in hardship, and that indexation methods must be set with a view to providing them with a decent and fitting standard of living.

## 2. General aspects

One preliminary issue lies in the difficulty of making between-country comparisons of the different systems in use across Europe.

There are numerous typologies of old-age retirement-income systems. As well as public earnings-related schemes based on contributions built up over working life, there are non-contributory schemes aimed at alleviating poverty among older people. As stated earlier, this survey is concerned only with first pillar pension schemes.

The OECD, for example, has chosen to classify pension plans, pension funds and pension entities consistent over a range of countries with different retirement-income systems by distinguishing between a *redistributive* part and an *insurance* part. Redistributive components of pension systems are designed to ensure that pensioners achieve some absolute, minimum standard of living. Insurance components are designed to achieve some target standard of living in retirement compared with that when working. This is a different approach, defining two categories which are only partially superimposable on the above-mentioned schemes belonging to the first, second or third pillar<sup>3</sup>.

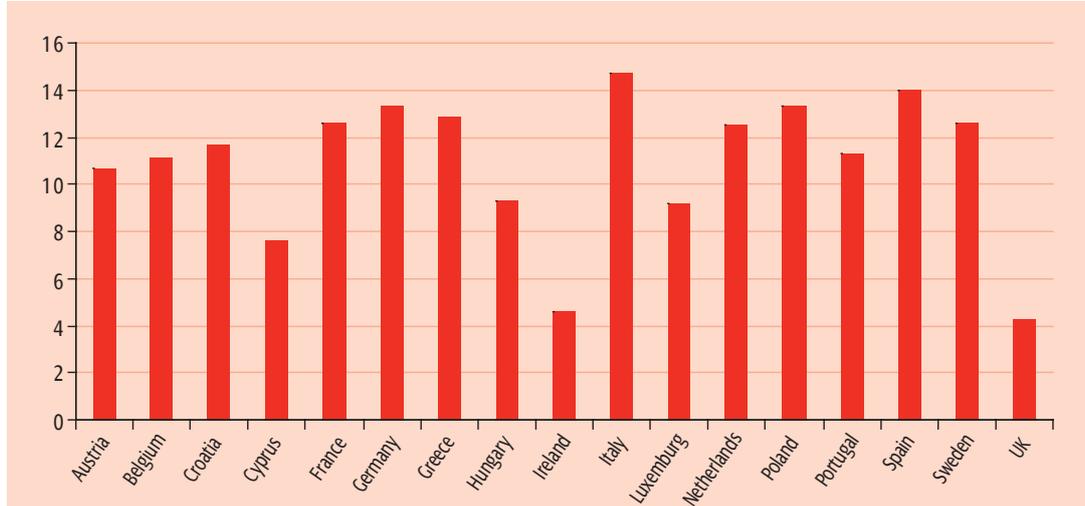
The OECD classification is one approach towards finding common ground for a comparison across such a wide range of realities between the survey countries.

One general aspect to be considered is the distribution of resources within a country and the amount of those resources allocated to social protection. As Table 1 shows, there are striking differences here also.

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<sup>3</sup> The OECD divides “redistributive schemes” into four different types: social assistance, separate targeted retirement-income programmes, basic pension schemes and minimum pensions within earnings-related plans. The second tier in this typology of pension schemes plays an “insurance” role. It aims to ensure that retired people have an adequate replacement rate (retirement income relative to earnings before retirement) and not just a poverty-preventing absolute standard of living.

**Table 1 Percentage of GDP expenditure on pensions, source EUROSTAT**



The bulk of this budget spend goes on old-age pensions<sup>4</sup>.

The share of GDP allocated to finance pensions is an important indicator on two counts: the *adequacy* of pensions, but also their *sustainability*. The current challenges of ageing populations, in particular the financial strains, cannot ignore the interdependency between these two aspects, in the context of ageing societies and the need for comprehensive measures with the aim of securing adequate, accessible and financially sustainable pension systems<sup>5</sup>.

## 3. Pensioner incomes

It bears repeating that only first pillar pension schemes are considered here. Second and third pillar schemes are referred to only where relevant to the final result of the calculations on retirees' total incomes.

### 3.1 EARNINGS-RELATED PENSIONS

One source of pension system financing in most European countries is contributions levied on incomes. The long-term implications for pension expenditures of increased life expectancy has prompted the European institutions to call for better incentives for older workers to remain longer in the labour market.

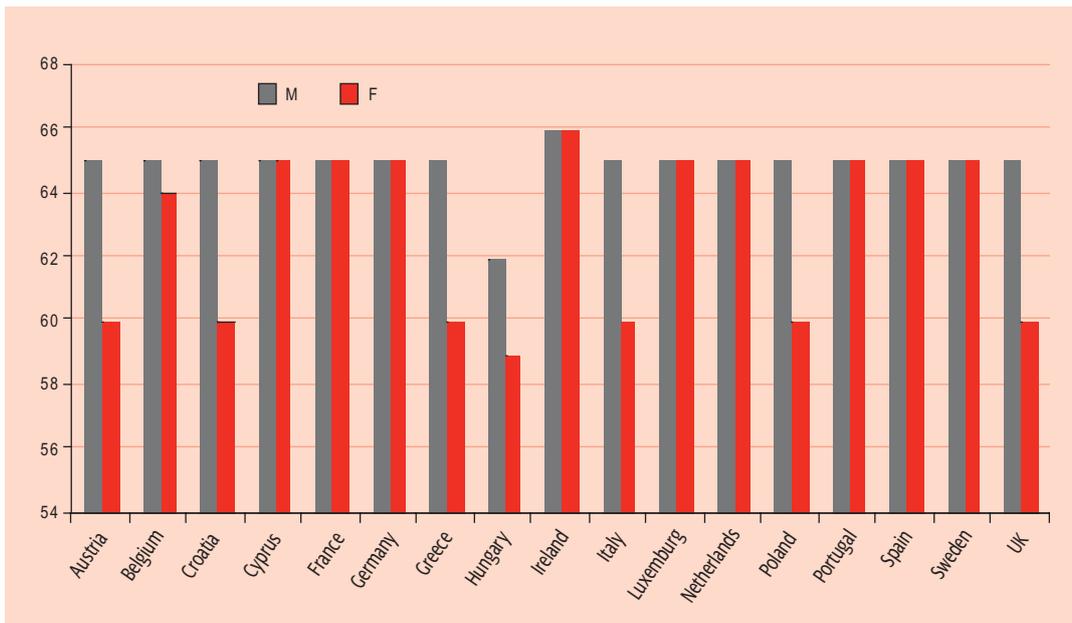
<sup>4</sup> It is important to bear in mind, however, that "pension expenditure" is the sum of seven different categories of benefits: disability pension, early retirement benefit due to reduced capacity for work, early old-age pension, partial pension, survivors' pension and early retirement benefit for labour market reasons. Some of these benefits (for example, disability

<sup>5</sup> 2003 Joint Report



The qualifying period of contribution years for a pension varies widely from country to country. The legal retirement age is a pointer to the total contributions that the government expects to collect from a worker during their working life.

**Table 2 Legal retirement age, FERPA affiliates, source OECD, 2006**



The legal retirement age seems to show a positive correlation between the lengths of time people spend in work and in retirement, in line with rising life expectancy. Lengthening life spans arguably suggest that extending working lives may be a socially acceptable way to address the issue of *financial sustainability*. Working longer means building up contributions, which are an “insurance” on the future. In this connection, FERPA’s members reported that workers in almost all the countries surveyed can continue working after legal retirement age<sup>6</sup>, albeit under certain conditions<sup>7</sup>, in some cases with limitations<sup>8</sup>, and subject to payment of income tax<sup>9</sup>.

However, trends over the past few decades have run precisely counter to what is needed to make pension systems sustainable. While average life expectancy at age 65 has risen steadily by more than one year per decade, the average effective retirement age has been falling even more rapidly. This has produced a substantial gap between statutory pension ages and the real average age at which people stop working.

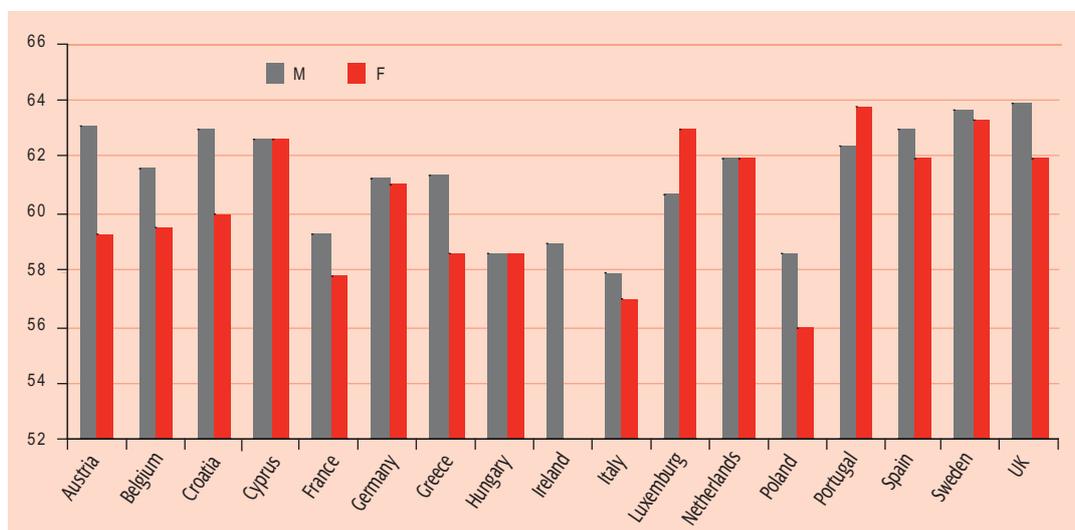
<sup>6</sup> SP, Romania, IE, CY, NL

<sup>7</sup> FR; in Luxembourg, income is capped at one-third of the minimum wage for early retirees; in Italy, workers can continue working up to the maximum statutory retirement age; in Croatia working pensioners can temporarily defer their pension incomes

<sup>8</sup> Portugal’s “flexibilisation regime” does not allow pensioners to work in the same company or group as before retirement

<sup>9</sup> UK, HU

**Table 3. Real average retirement age, sources FERPA members, EC-ISG 2006, ILO 2004**



Particular groups, like **women**, may be penalised by contribution record systems. Generally, female labour market participation is lower: their career patterns are shorter than men's; family obligations often prevent their uninterrupted, long-term labour force participation, such that a final shorter contribution record yields them a lower average pension. As shown in the figures above, women in almost all countries still retire earlier than men (except in Luxembourg and Portugal), notwithstanding the trend of recent reforms in many countries to raise women's legal retirement age to equal men's. The Irish affiliates highlighted issues with raising the real average retirement age of women, as many work from home even after 65, but undeclared.

But even then, extending working lives does not necessarily entail raising statutory retirement ages if the age of effective withdrawal from the labour market is well below statutory retirement age. Some countries are moving towards greater flexibility. Individuals have different needs and preferences<sup>10</sup>. The early retirement schemes that exist in several countries attest to this need for flexibility - old age pensions are combinable with contribution plus age-based early retirement provision. Early retirement may also derive from collective bargaining (as in Belgium, Spain and the UK), incapacity for work (Hungary, France, Belgium, Ireland, Italy and the Netherlands), disability (Portugal, Hungary, France, Belgium, Italy, the Netherlands, Portugal and Croatia). Specific early retirement provision may be made in particular sectors or for categories of workers (e.g., those in health-damaging jobs), and may also be an alternative to redundancies in restructuring (Belgium, Italy, Ireland).

Where earnings-related systems are concerned, another key element to be considered, partially connected to career duration, is the measure of the individual worker's past earnings (contributions) used to calculate the pension amount. Pension entitlements are calculated in relation to the earnings accumulated during working life. So the criteria

<sup>10</sup> See also the Recommendation of the Council of 10 December 1982 'on the principles of a Community policy with regard to retirement age'.



used may significantly influence the level of benefits that pensioners will eventually receive. The way past earnings are measured differs between countries, and also yields different results. The pension amount might, for example, be calculated on the level of contributions accumulated in a final salary period (SP, GR). Other systems refer to the lifetime average (BE, DE, IT, LU, UK) or number of best years' earnings (FR, AT, PT). The pension calculation formula used in Portugal since 2007 – aggregated lifetime salary – is deeply detrimental to workers.

The social effects of these choices are quite clear: for example, when individual earnings increase over a worker's career, as is often the case, using only a few final years' earnings will yield a higher benefit than taking into account the early years of the career when earnings were much lower. By contrast, extending the period over which benefits are measured will tend to cut pension benefits.

It is clear that governments' choices either way are cost-driven, to achieve financial sustainability of the pension system. Even so, the social consequences should not be underplayed when considering the possible outcomes of using different methods. Once again, some methods used to calculate pension entitlements may produce negative consequences on the retirement incomes of some groups: women and low-skilled workers, for example, are often penalised by final salary schemes.

### 3.2 MINIMUM PENSIONS

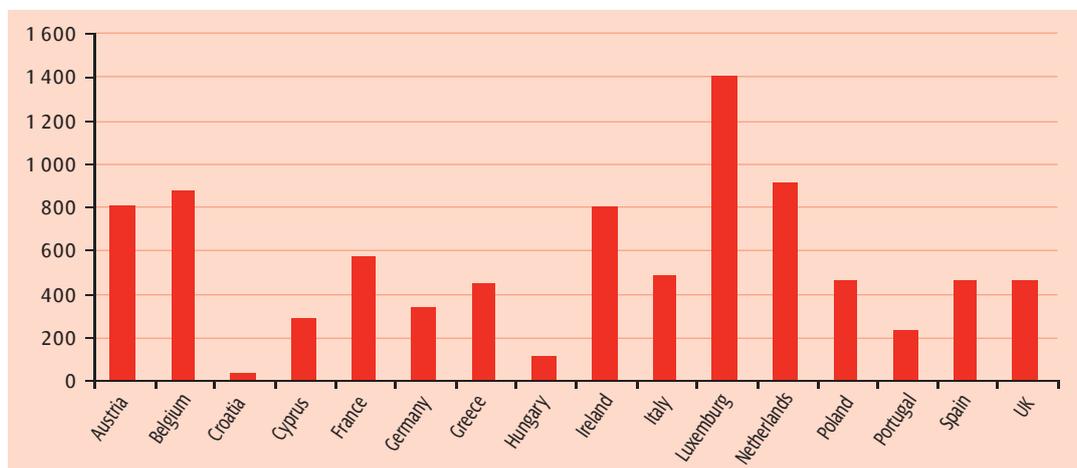
An important feature of European welfare systems is the existence of provisions to guarantee **minimum pensions**, which reflect the growing attention given to providing adequate incomes in retirement and reducing poverty amongst older people. Monthly pensioner disposable income can be regarded as an indicator against which social exclusion can be evaluated.

It is important to stress the subsidiary nature of many of these schemes. Pension systems are generally designed to *prevent*, rather than *alleviate*, poverty in old age by ensuring that everyone builds up sufficient entitlements in public and/or private schemes to remain financially independent from their relatives or public social assistance. Very often, minimum guarantee pensions tend in fact to act as an ultimate social safety net for those with incomplete careers (e.g., women) or very low earnings during their working lives.

Germany, France and Austria stress that the number of people relying on minimum provisions declined substantially over recent decades as a result of better pension entitlements earned in the pension system. Greece and Italy report the opposite trend.

Table 4 below illustrates the diversity of minimum pensions guaranteed in some Member States; however, comparisons are difficult in view of the different set-ups of such mechanisms — sometimes even within a given country.

**Table 4 Legal minimum pension (euros/month), source FERPA affiliates, EC, Special Pension Study, December 2006**



In some countries (like BE), the level of minimum pensions has been increased more rapidly than general indexation rules require, and especially in some cases more quickly than the general evolution of pensions or wages (as in IE, ES, PT). Other Member States have recently introduced new benefits, while some have also introduced supplements to existing benefits (in Hungary, supplements for those aged 75 or more were introduced in 2006) or given easier access to them (Basic Protection for the elderly in Germany).

Most Member States deliver minimum pensions upon claim at retirement. Eligibility generally is at 65, and is automatically checked after examination of general pension rights when minimum provision is embedded in general pension schemes.

The effects of minimum pensions are reflected in the general lower *poverty gaps* of older people in comparison to the general population, although relative poverty<sup>11</sup> is still more likely among the elderly than among their younger counterparts.

## 4. Pensions in the maintenance of living standards

Pension systems should not only aim to ensure that older people do not live in poverty. More generally, they should enable the living standard achieved during working life to be maintained to a reasonable degree. Public pensions are essential in this respect. The European Commission has recently reported the *living standards of older people* as being relatively close to that of the general population, mostly ranging between 75% and 90% of that of the 0-64 population (see figure<sup>12</sup>)

<sup>11</sup> Relative poverty risk ratio of the elderly, calculated by dividing the at-risk-of-poverty rate of the elderly by that of the population aged 16-64



**Table 5 Indicators on current adequacy of pensions, Eurostat 2004**



However, not only is this an average figure, it also has to be remarked that in some Member States (Ireland and Cyprus) the level is significantly below 75%, reflecting relatively low pension entitlements as well as rapid economic growth which mainly benefits people in the economically active age group.

By contrast, other Member States (France, Germany, Luxembourg, Austria, Hungary and Poland) report levels higher than 90%, whereas in other countries, the relative income of older people is only close to 75% (Belgium, Denmark, Spain, Portugal, Sweden and United Kingdom).

Pension entitlements generally provide around 70% of this retirement income (in particular statutory pension schemes and widely developed private ones, such as those based on binding collective agreements). Therefore the conclusion of the Commission is that pension schemes currently manage *on the whole* to ensure adequate income in most Member States.

However, in certain cases, current average pension levels turn out to be low compared to current earnings, reflecting a low replacement rate from statutory schemes as well as maturing pension systems, incomplete careers and / or under-declaration of earnings.

<sup>12</sup> Note: Relative income of 65+: relative median equivalised disposable income of people aged 65 and more compared to those aged 0-64. Aggregate replacement rate: median individual pension income of retirees aged 65-74 in relation to median earnings of employed persons aged 50-59 excluding social benefits other than pensions, based on gross income, except for some Member States (EL, ES, IT, LV, PT), for which it was calculated with net income as only net income were available for the first wave of EU-SILC. This indicator is thus not (yet) completely comparable across countries. It should also be noted that these calculations are by nature different from those of theoretical replacement and that for a great majority of Member States, the respective levels are different (see for instance ISG report on replacement rates 2006). Source: Eurostat, data (income year 2004). Commission Staff working document, Joint report on social protection and social inclusion, Supporting document, 2007, SEC(2007) 329, available on line [http://ec.europa.eu/employment\\_social/spsi/docs/social\\_inclusion/2007/joint\\_report/sec\\_2007\\_329\\_en.pdf](http://ec.europa.eu/employment_social/spsi/docs/social_inclusion/2007/joint_report/sec_2007_329_en.pdf)

Another empirical indicator taken into consideration by the European Commission with regards to the adequacy of pensions is the *median pension relative to median earnings*<sup>13</sup>. It represents the rate of income replacement of pensioners in relation with the median work earnings of people aged 50-59. This yields evidence that the replacement incomes provided by first pillar pensions in some countries is dramatically low: in Cyprus, for example, where pensioners receive 42% of their final salary in retirement, Austria (48%), and Belgium, where the 61% median pension is just above what is considered to be the at-risk-of-poverty level.

What both the above indicators show in any event is that retirees' average incomes are everywhere lower than those of workers. This reflects the approach to pensioners as having lesser needs than the younger working population. As the economy expands, and living standards rise, pensioners are always one step behind.

## 5. Pension indexation

### 5.1 CHOICES OF INDEXATION CRITERIA

Indexation refers to the policy for up-rating the value of the payment from the point of claim of the pension benefit onwards. This is an important feature for *avoiding increased poverty rates* within older pensioner cohorts relative to younger ones. Many Member States have reformed their indexation systems in recent years in order to improve either the financial sustainability of the pension system or the adequacy of benefits.

There are different parameters on which to base pensions indexation. The method most used is to index-link pensions to consumer prices (ICP), to growth in inflation rates. This addresses the requirement of *avoiding increased poverty rates*, as it should enable pensioners to maintain the same living standard, understood as the ability to buy the same basket of goods through the years.

A second parameter is growth in average wages (nominal or real). This is a more “generous” criterion, as wages – normally – rise more rapidly than prices. This criterion embodies a different approach that has more to do with *living standards* than to poverty risk.

Economic growth – and consequently the living standards of society generally - is measured by average wages. And as economic growth mainly benefits the economically active age groups, linking pensions to wage growth not only ensures the ability to buy the same goods, but also gives pensioners a share in the overall increase in national well-being and living standards. Index-linking pensions to wages is an indicator of pensioners being seen as active economic agents, contributing to the growth and movement of wealth as consumers through the demand for goods and services.

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<sup>13</sup> An empirical measure of income replacement evaluates individual pensions for a cohort of people over the retirement age relative to individual work earnings using household survey data. This measure takes individual median earnings of people aged 50-59 years as the denominator. Individual median pensions (excluding other social benefits) received by people aged 65-74 are the numerator. Source [http://ec.europa.eu/employment\\_social/social\\_protection/docs/2006/rapport\\_pensions\\_final\\_en.pdf](http://ec.europa.eu/employment_social/social_protection/docs/2006/rapport_pensions_final_en.pdf)



Another indexation method used is the mixed uprating of benefits to a combination of price inflation and wage growth, or GDP growth (as in the case of Portugal, below).

However, a growing number of countries have recently switched to price or close-to-price indexation (and both for earnings-related schemes and minimum pension schemes).

Many countries moved from earnings to prices indexation during the 1980s and 1990s as a cost-cutting measure (given that wages have grown faster than prices in nearly all countries). The consequences are that with price indexation, the purchasing power of pensions is preserved. But the standard of living of individual retirees over time falls behind that of workers.

## 5.2 INDEXATION/VALORISATION OF PAST EARNINGS UP TO THE FIRST PENSION IN PAYMENT

Beside the measure of individual earnings used in the benefit formula (see above, para. 3.1), there is another important mechanism in earnings-related schemes that greatly influences the level of benefits that pensioners will eventually receive, that it is important to consider with regard to indexation. This mechanism is *valorisation* of past earnings, of the contributions accumulated during working life.

Past earnings are “valorised” - which means indexed - to take account of changes in living standards between the time pension rights accrued and the time they are claimed<sup>14</sup>. The indexation methods used for this have a big impact on pension entitlements. In the cases of Germany, Hungary, Luxembourg, the Netherlands, Sweden and the UK, past earnings are valorised in line with earnings growth. In Italy, adjustments are linked to a measure of GDP growth.

Valorisation is purely price-based in Belgium, France (both the public scheme and occupational plans) and Spain. Poland and Portugal valorise with a mix of earnings and prices.

Valorisation policy can have a very major effect on pension entitlements. On the baseline economic assumptions used by the OECD<sup>15</sup>, prices valorisation for a full career (between ages 20 and 65) yields a pension 40% lower than a policy of full adjustment of earlier years’ pay in line with economy-wide average earnings.

## 5.3 INDEXATION OF MINIMUM PENSIONS

Another issue is whether minimum pensions or minimum benefits are indexed differently from earnings-related pensions and whether this can have unintended effects on income distribution among pensioners. Less favourable indexation rules for minimum income provision than other pension benefits also translate into a worsening of the relative situation of the poorest and oldest pensioners. A growing number of countries have recently switched to price or close-to-price indexation both for earnings-related schemes and for minimum pension schemes. However, indexation of minimum pensions on prices usually means that the income of those living on minimum pensions lags behind the general evolution of incomes and may raise the risk of increased relative poverty among older pensioners even if it preserves their purchasing power.

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<sup>14</sup> There is obviously no need for valorisation in final-salary schemes, but it is common in schemes where benefits are based on earnings over a longer period.

<sup>15</sup> i.e., real wage growth of 2% and price inflation of 2.5%. Pensions at a glance, 2006 and 2007

In order to prevent poverty increasing, governments are often required to take discretionary corrective measures with regard to minimum pensions (which is at odds with the provision of a long-term, secure and stable system, which individuals can have confidence in). In most Member States, adjustments of minimum pensions are the same as for general pensions. In a few countries, however, adjustments of minimum benefits are more favourable: for instance higher pensions are adjusted on lower rates (CY, IT, AT, PT); in other countries, adjustments are less favourable (SE) as minimum benefits are indexed on prices only, but general pensions at least partly take into account increases in wages.

It should be noted that some Member States have made ad hoc increases by more than statutory indexation requirements in the levels of minimum benefits in recent years, in particular among those who have less favourable indexation rules (BE, ES, IE, IT, PT).

This is an issue that needs to be looked at in the broader context of promoting inclusion of older people. Some Member States address this issue by providing minimum income guarantees, and others benefits in cash and kind, for example health care and care services, housing and transport. But this might not be enough to ensure retirees' confidence in the future.

#### **5.4 INDEXATION OF PENSIONS IN PAYMENT: THE MECHANISMS AND CRITERIA**

In most EU countries, indexation rules and procedures are fixed by law. The parameters are chosen by governments, and adjustments are automatically made in terms of both timing and methods: such is the case in Belgium, Croatia, Cyprus, France, Hungary, Italy, Luxembourg, Portugal, Spain, the UK.

That notwithstanding, the realities may belie the provisions of written law. The Belgian affiliates, for example, point out that the supposedly automatic indexation has in fact been very sporadic, partial and selective in the last five years, producing deeply unsatisfactory results.

Automatic adjustment is not universally the case. In Austria, a commission for pension security makes annual proposals to the responsible Ministry on the amount of pension adjustment, which will normally be accepted. Adjustments in the Netherlands depend on the coverage of funds. Adjustment of pensions in payment may be suspended or allowed to lag behind inflation or earnings if this is required by the financial situation of the scheme. Neither the timing nor the criteria of indexation rules in Ireland are statutorily-prescribed.

One issue of particular importance is the choice of parameters to which pensions are index-linked.

As mentioned earlier, while some Member States adjust pensions broadly in line with price inflation, others chiefly index-link to wage growth, or a mix of prices and wages.

Most indexation is *fully price-linked*, both for earnings-related schemes and for minimum pension schemes (AT, BE, GR, ES, FR, IT, PL, UK)<sup>16</sup>.

Austria, Greece, Italy and Portugal have adopted progressive indexation mechanisms, which give higher increases to low pensions than to higher benefits. Italy provides full price adjustment for low pensions and 90% or 75% of price inflation to higher pensions.

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<sup>16</sup> Austria has changed its indexation formula towards price indexation. This change is expected to lead to long-term savings and thus change the balance between the active and the retired. Price indexation in Poland is seen as combining the protection of pensioners against inflation, with a reduction of the burden on those who work.



The members in Portugal emphasised that the system is particularly bad for pensioners: in 2008, only those on very low incomes will receive a significant index-linked adjustment. Pensioners not in the lowest income bracket will receive no index-linked uprating, and their purchasing power will fall noticeably.

In Germany, indexation is based on *wages*, and curbed by a sustainability factor reflecting changes in the ratio between contributors and pensioners. In Sweden, the earnings-related pension from the pay-as-you-go system is indexed to *average wages*.

Some countries have *mixed uprating* of benefits, to a combination of price inflation and wage growth (CY, HU, NL). Hungary has recently introduced the "Swiss" indexation formula on pensions (50% consumer price increases and 50% increases in net average earnings) as an important component of the reform. The indexation is expected to lead to a drop of 8-10 p.p. of average pensions to average wages by 2050.

In Portugal, pensions are adjusted to a mix of price inflation and GDP growth; the exact increases depend both on the level of pensions and on GDP growth rates.

In Ireland, indexation rules are not formalised and adjustments to pensions are not related to benchmarking.

## 5.5 SOCIAL PARTNER, AND ESPECIALLY TRADE UNION, INVOLVEMENT IN INDEXATION PROCEDURES

As mentioned above, indexation procedures may be laid down by law and be automatic. In some countries – Croatia, Cyprus, Hungary and the UK excepted - the social partners, and especially the trade unions, may have a legally-prescribed role even in the automatic procedure. The indexation methods and extent of trade union involvement are shown in the table below.

**Table 6 Indexation procedures and trade union participation in them, source FERPA affiliates**

	Method of indexation	Trade union involvement in the procedure
<b>Austria</b>	Not Automatic (ICP)	Participate in the Pensions Commission
<b>Belgium</b>	Automatic (ICP)	Make proposals on allocation of welfare benefits
<b>Croatia</b>	Automatic (W+ICP)	None
<b>Cyprus</b>	Automatic (W+ICP)	None
<b>France</b>	Automatic (ICP)	Adjustments in conference (every 3 years)
<b>Hungary</b>	Automatic (W+ICP)	None
<b>Ireland</b>	Not Automatic (CONS)	TUs and organisations make submissions
<b>Italy</b>	Automatic (ICP)	Intervene for further adjustments
<b>Luxembourg</b>	Automatic (n.d.v.+ICP)	Social partners negotiate indexation methods
<b>Netherlands</b>	Not Automatic (W+ICP)	Sit on the board of company funds
<b>Portugal</b>	Automatic (ICP+GDP)	No, but social partners negotiate indexation methods
<b>Spain</b>	Automatic (ICP)	Can negotiate on minimum pensions
<b>UK</b>	Automatic (ICP)	None

The opportunity is therefore open to trade unions to intervene in the procedure, at least through giving opinions and recommendations. That said, the evidence of FERPA's members is that such involvement is often a paper exercise, and that even where it is not, trade union intervention may not have a real influence on the final indexation decisions made by governments.

But effective trade union participation would ensure transparency and scope for raising pension issues other than those related to the financial sustainability that tends to be government's first concern. In countries with no automatic index-linking (AT, IE, NL), there is an added necessity for trade union intervention at governmental level to prevent arbitrary decisions.

In the Netherlands, trade unions sit on the board of branch-wide pension funds, and employees on the boards of company funds. In Ireland, pensions should rise in line with government policy *and* the recommendations of older people's organisations at each budget. As stated, however, while trade union involvement in this balancing act may be a positive sign, the reality is that their views are not always heeded. In Ireland, for example, while recent years' index adjustments have been above average earnings and pension increases have been at above-inflation rates, FERPA's affiliates argue that this owed more to the baseline being objectively very low than to trade union intervention.

## 5.6 THE FIGURES OF INDEXATION

The impact of index-linking can be seen from the percentage increases of the different indicators considered.

Table 7 shows the five-year inflation, GDP and real average earnings<sup>17</sup> growth for each country relative to indexed pension adjustments.

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<sup>17</sup> Inflation rates already factored into average real compensation, i.e., the percentages shown represent above-inflation wage growth.

**Table 7 Annual inflation, GDP and average real individual compensation growth relative to pension indexation rates, sources: FERPA affiliates, Eurostat, 2007**

		2001	2002	2003	2004	2005	2006	Total
<b>At</b> <sup>18</sup> (ICP)	% Pension indexation	n.a.	n.a.	n.a.	1,5	1,5	1,5	4,4
	% Inflation change	(+3,2)	(+2,1)	(+1,3)	2,1	2,3	1,5	7
	% GDP Growth	(+0,8)	(+0,9)	(+1,2)	2,3	2	3,3	5,7
	% Change real Compensation	(-0,48)	(+0,88)	(+0,22)	-0,23	0,85	0,85	1,5
<b>Be</b> (ICP)	% Pension indexation	6	1	1	2	2	2	13,3
	% Inflation change	2,5	1,6	1,5	2,1	2,8	2,3	12,2
	% GDP Growth	0,8	1,5	1	3	1,1	3,2	10,2
	% Change real Compensation	1,34	2,52	-0,02	-0,57	-0,85	0,67	3,1
<b>Cy</b>	% Pension indexation	3,27	5,21	3,04	3,73	5,44	3,14	21,9
	% Inflation change	1,97	2,81	4	1,9	2,56	2,2	14,6
	% GDP Growth	4	2	1,8	4,2	3,9	3,8	18,3
	% Change real Compensation	1,36	2,45	3,35	0,08	-1,06	-0,35	5,8
<b>Fr</b> (ICP)	% Pension indexation	1,58	1,78	1,91	1,7	1,8	1,8	10,2
	% Inflation change	3,7	1,9	2,2	2	1,9	1,9	12,9
	% GDP Growth	1,9	1	1,1	2,5	1,7	2	9,08
	% Change real Compensation	0,27	2,06	0,94	1,55	1,32	1,18	7,1
<b>Hu</b> (d)	% Pension indexation	15,9	15,8	13,1	9,6	9,5	7,6	58
	% Inflation change	9,2	5,3	4,7	6,8	3,6	3,9	29,9
	% GDP Growth	4,1	4,4	4,2	4,8	4,1	3,9	23,3
	% Change real Compensation	7,21	8,61	5,6	6,48	3,16	-0,59	27,6
<b>ie</b>	% Pension indexation	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	% Inflation change	4,9	4,6	3,5	2,2	2,5	2,9	47,6
	% GDP Growth	6	6,9	3,6	4,9	5,5	4,9	14,8
	% Change real Compensation	3,05	0,18	2,26	4,67	3,29	2,23	
<b>It</b> (ICP)	% Pension indexation	2,6	2,5	2,4	2,2	2	1,7	12,6
	% Inflation change	2,7	2,6	2,8	2,3	2,2	2,2	14
	% GDP Growth	1,8	0,3	0	1,2	0,1	1,9	5
	% Change real Compensation	0,51	-0,14	0,92	0,66	0,68	-0,18	2,4
<b>Lu</b>	% Pension indexation	n.a.	3	n.a.	3,5	n.a.	1,9	n.a.
	% Inflation change	2,5	2,1	2,5	3,2	3,8	3	16
	% GDP Growth	5,1	5,1	5,1	5,1	4	6,2	27
	% Change real Compensation	1,48	2,5	0,09	1,33	0,92	1,54	7,6
<b>Nl</b>	% Pension indexation	4	3	1,5	1	0,5	1,5	11
	% Inflation change	3,6	3,9	1,9	1,4	1,4	1,5	13
	% GDP Growth	1,9	0,1	0,3	2,2	1,5	3	8,7
	% Change real Compensation	0,88	2,14	1,82	2,53	-0,49	0	6,7
<b>Pt</b> (ICP)	% Pension indexation	5,9	5,5	4	5,5	4,2	3	25,4
	% Inflation change	4,4	3,7	3,3	2,4	2,3	3,1	17,9
	% GDP Growth	1,8	0,8	-1,1	1,5	0,4	1,3	4,6
	% Change real Compensation	2	0,96	-0,16	0,12	0,37	-0,92	2,4
<b>Es</b> (ICP)	% Pension indexation	2,7	4	2,6	3,5	3,4	2,6	17,5
	% Inflation change	2,7	4	2,6	3,5	3,4	2,6	17,5
	% GDP Growth	3,6	2,7	3,1	3,4	3,6	4	18,9
	% Change real Compensation	0,15	0,48	0,48	-0,55	-0,54	-0,38	-0,4
<b>UK</b> (ICP)	% Pension indexation	1,1	7,4	4,2	2,5	2,7	3	19,4
	% Inflation change	1,8	1,7	2,9	3	2,8	3,2	14,5
	% GDP Growth	2,4	2,4	3,4	3,3	1,8	3,1	15,4
	% Change real Compensation	0,41	0,87	0,69	0,4	-0,04	0,23	2,5

<sup>18</sup> Aggregate rates calculated only for 2004, 2005 and 2006, for which data are available for all the elements taken into account

The first thing to say is that the increases are not all consistent and also relate to second and third pillar pensions.

The immediately striking fact is that almost nowhere are increases fully-inflation adjusted.

The sharp rises in Hungary stem from a general overhaul of the pension system preparatory to its recent accession to the European Union.

The situation on in Luxembourg (as far as can be told from the annual data) is fairly poor, as pensions are not index-linked to price growth at all.

Elsewhere (e.g., Italy, Austria, Spain, the UK), the index link to prices has been more favourable than that to average earnings, where six-year growth has been very low .

Uprating pensions by even fractions of a percent below inflation growth adds up to a significant loss of purchasing power over time, reducing the ability even to buy the same basket of goods year on year. But less than full uprating is only the headline issue, and the problem in several countries is incorrect index-linking. Where this occurs (as in Spain), price-linked increases do not properly preserve living standards. In Portugal, by contrast, mixed indexation takes into account both inflation and GDP growth. While the social partners in Portugal have no say in the indexation process, however, they can negotiate with government and influence the decision on index-linking methods.

The aggregate percentages show how far below average wage growth pension indexation lies.

This is the key fact to bear in mind if pensioners are to enjoy the same living standards as working society. The main issue here is how the widely-used system of linking pensions to consumer prices denies most pensioners the benefit of general economic growth and trends. The key element, therefore, is the choice that underpins the entire system.

Other indicators to be looked at for a clearer assessment of the situation are current and theoretical replacement rates.

## **5.7 EFFECTIVE PROTECTION OF PENSION PURCHASING POWER: WAGE-LINKING AND THE SOCIAL IMPLICATIONS**

The indicators considered in the first part of this report (median equivalised income of people aged 65 and over relative to those aged 0-64, median pension relative to median earnings) use pre-retirement earnings as a gauge of whether living standards are being maintained. For this, *average wages* can be used to analyse and expand on the situation of pensions from different angles by making the link between the incomes of workers and retirees. Introducing this indicator as a parameter for pensions is a political choice that maximises the ability to maintain relative pre-retirement living standards. Economic growth mainly benefits working age people, and the living standard of society as a whole is wage-dependent. Applying the same parameter and measure to pensions will give pensioners their rightful share of economic growth and the general well-being of society.

Average wages – either nominal or real - normally grow at a faster rate than prices. As a consequence, with price indexation, the purchasing power of pensions is preserved, but the standard of living of individual retirees over time falls behind that of workers.

**Table 8 Replacement rate 1<sup>st</sup> pillar, 2006, source EC <sup>20</sup>**

	Total net	Total gross	Gross 1 <sup>st</sup> pillar
AT	80	64	64
BE	67	43	39
CY	52	46	46
DK	71	49	45
FR	80	66	66
DE	63	43	43
GR	115	105	105
HU	102	66	66
IE	78	67	31
IT	88	79	79
LU	98	91	91
NL	92	71	30
PO	78	63	63
PT	91	75	75
SP	97	91	91
SW	71	68	53
UK	82	66	17

Wages underlie one of the key indicators for measuring not only living standards, but also the future purchasing power of pensions: replacement rates. They show the level of pensions as a percentage of previous individual earnings at the time of pension take-up<sup>29</sup>.

The figures show that the replacement rate in some countries does not enable the same living standard to be maintained. Leaving aside countries like the UK, Ireland and Sweden, where the low replacement rates of first pillar pensions are meant to be offset by the other two pillars, the situation of pensioners in other countries, like Cyprus, Germany and Belgium, is markedly worse.

As seen earlier, Member States apply a range of rules on indexing earnings related pensions to consumer prices. While pension indexation on prices can be argued on the grounds that

pensioners' consumption needs may be stable or even decline with age, it should be noted that it translates into a worsening of the relative income situation of pensioners, and particularly for those on lower incomes.

**Table 9 Theoretical pension replacement rates compared to 2006 rates (the decline is measured relative to the total replacement rate, including the three pillars), source EC**

	Gross replacement rates 1 <sup>st</sup> pillar 2006	Gross replacement rates 1 <sup>st</sup> pillar in 10 years	Decline in the gross replacement rate 1 <sup>st</sup> pillar 10 years after retirement (in percentage points)	Decline in the gross replacement rate 1 <sup>st</sup> pillar 10 years after retirement (in percentage points)
AT	64	58,3	-8,9	-10
BE	39	35	-10,2	-4
CY	46	40	-13	-7
DK	45	44,3	-1,55	-3
FR	66	55,9	-15,3	-12
HU	66	56,8	-13,93	-13
IE	31	34	+9,6	-1
IT	79	67,6	-14,43	n.d.
LU	91	90,4	-0,65	1
NL	30	29,6	-1,33	-10
PO	63	43,5	-30,95	-26
PT	75	64,6	-13,86	-10
SP	91	81,7	-10,21	-15
SE	53	49,6	-6,41	-10
UK	17	15	-11,76	-6

The fact is that index-linking pensions to prices induces a rising gap between pension levels and average incomes, affecting particularly the oldest and poorest pensioners. This kind of effect can be assessed through the calculations of *theoretical* replacement rates. These indicators suggest that the negative effect described above can be substantial, as for instance, replacement rates for a standard career generally decrease by around 5 to 10 percentage points 10 years after retirement (see below).

The calculations of theoretical replacement rates after ten years bear out the argument that **low indexation of pensions** in payment increases inequalities in the **incomes of older pensioners compared to the population as a whole**.

<sup>20</sup> [http://ec.europa.eu/employment\\_social/spsi/docs/social\\_protection/2006/rapport\\_pensions\\_final\\_en.pdf](http://ec.europa.eu/employment_social/spsi/docs/social_protection/2006/rapport_pensions_final_en.pdf)

The data referring only to first pillar incomes ten years on give some idea of the loss of purchasing power of public and compulsory pensions, which should provide more stability and security. Ten-year projections for all three pillars combined show rates in some cases that are less dramatic than those for the first pillar alone, indicating that private and voluntary pension schemes, where developed, might partly compensate the loss of purchasing power of the others.

Pensions paid out in 2006 lost several percentage points in some countries. Poland is a signal case in point: the 63% of final salary represented by the first pillar pension in payment in 2006 will decline steadily to 43% of final salary ten years before. For first pillar incomes alone the loss of purchasing power will be 30%. The decline in the net total replacement rate - the aggregated incomes from all three pillars 10 years after retirement - shows that within ten years, a Polish pensioner's total pension income will lose a quarter of its purchasing power.

Poland may be a case apart, but almost all countries register a marked loss of purchasing power in their pension provision. Taking the figures for the three pillars combined, France, Greece, Hungary and Spain all show significant percentage decreases. The social implications of this are cause for deep concern.

It therefore owes nothing to chance that the percentage declines of those countries that index-link to wages (DK, NL, SE and UK) are among the lowest (less than 10 percentage points).

## 6. Conclusions: pensioner poverty

This analysis of the purchasing power of pensions cannot be brought to a close without considering some figures on the consequences of the policy choices, and how they have been implemented for the situation of many pensioners and elderly people. Governments should bear these figures in mind when assessing the purchasing power of pensions.

The indicator considered here is the at-risk-of-poverty rate. This is defined as the share of persons with an equivalised disposable income below an at-risk-of-poverty threshold, set at 60% of the national median equivalised disposable income.

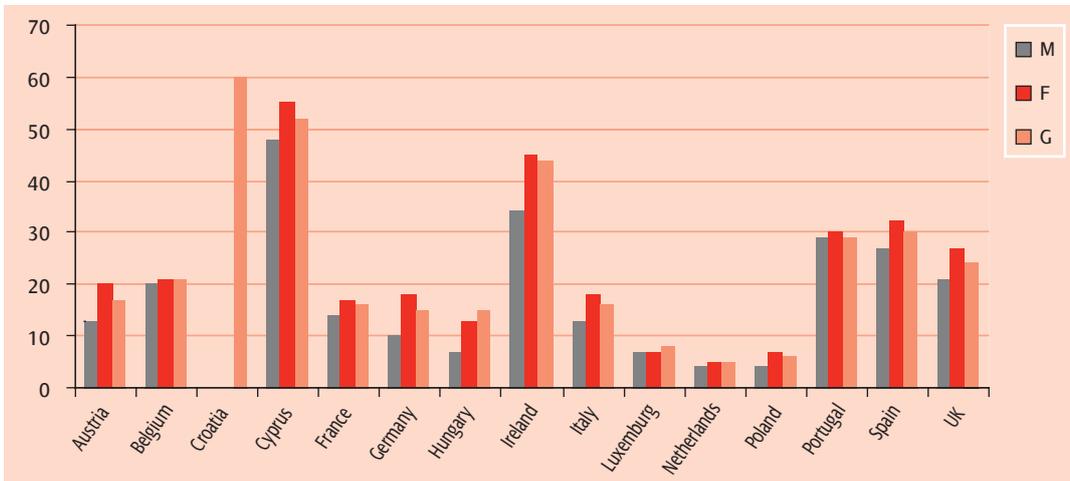
Equivalised disposable income is defined as the household's total disposable income divided by its "equivalent size" to take account of its size and composition<sup>21</sup>.

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<sup>21</sup> Following the indicators used by the European commission  
[http://ec.europa.eu/employment\\_social/spsi/docs/social\\_protection/2006/sec\\_2006\\_304\\_horizontalanalysis\\_en.pdf](http://ec.europa.eu/employment_social/spsi/docs/social_protection/2006/sec_2006_304_horizontalanalysis_en.pdf)



**Table 10<sup>22</sup> At-risk-of-poverty rate, EC, 2007**



In the early years of the 21st century, about 13 million elderly people are at risk of poverty in 25 EU Member States, amounting to as many as one in six of all 74 million elderly people living in the EU.

As Table 10 shows, Cyprus, Ireland, Spain, Portugal and the United Kingdom are identified as the countries with the highest poverty risk for the elderly population<sup>23</sup>.

In the majority of countries, the poverty risk is markedly higher for older women, and in particular for women aged 75+. This is related to the high proportion of widows in this age group. To the extent that younger cohorts of females will be more likely to be entitled to pensions related to their own earnings once they retire, the high poverty risk in this group may gradually become a thing of the past. Obviously, whether or not this will happen depends on the national pension systems as well as the long-term trends in the country-specific labour market participation patterns.

The results outlined so far also point to problems linked to the adequacy of survivors' benefits that are currently available in the national pension systems.

Moreover, index-linking pension benefits to prices (rather than earnings) in the majority of countries also leads to an erosion of the value of pension benefits relative to the median. This problem is not confined to population of female retirees, but since women live longer than men, erosion of the value of pensions during old age will affect women more than men. One significant policy development is that many countries have recently embarked on a further strengthening of their targeted minimum pension and social assistance schemes, and this will have a positive impact on the reduction of poverty amongst the elderly.

<sup>22</sup> Data supplied by EUROSTAT, which makes every effort to use harmonised methods so as to ensure maximum comparability between definitions and concepts used in the different countries. As a result, these poverty statistics provide the best possible comparative information on elderly poverty at the EU25 level.

<sup>23</sup> The above findings should be viewed with an understanding that the poverty thresholds against which the poverty situation in a country is measured are derived from the value of the national median income (standardised so as to take account of household compositions).

In their national responses, FERPA's member organisations have highlighted the plight of elderly people in their countries. They merit a mention: in Belgium, 24% of women over 65 on pensions live in poverty; in Austria: 230 000 people over 65 are at risk of poverty; in Spain the at-risk-of-poverty condition affects 149 000 men and 1 697 000 women; in Croatia 40% of pensioners - 10% of the whole population - live in poverty on monthly incomes below 260 euros; in Hungary, 50% of pensioners live in poverty on under 244 euros a month; in Ireland 27.1% of pensioners live at risk of poverty, and 3.3% in constant poverty.

A word of caution here is that the current pension reforms in most EU countries are being driven mainly by heightened concerns about the impact of ageing. A common trend is that the pension benefits drawn from public pension systems are on the decline, and so the average public pension benefit ratio has dropped in the majority of countries. Moreover, systematic reforms have changed the nature of pension provision from defined benefit type provisions to defined contribution type provisions. In general, the changes are resulting in a more restrictive redistribution in favour of lower income individuals. Accordingly, the risk of poverty for future elderly populations in EU countries will increase.

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