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Issue 2
Employer retirement pension schemes

PENSION SCHEMES

by François Lequiller

Issue 2. Pension schemes

Additional paper to the AEG

By François Lequiller (OECD), December 2005

I. Executive summary

This paper to the AEG comes as an annex to the paper presented by the Task Force on Pension Schemes. It has been drafted by François Lequiller, acting as member of the Task Force. This paper does not propose any change to the recommendations of the Task Force. It only intends to clarify two important issues that the Task Force did not have the time to cover but requested that clarifications should be brought to the AEG (see the conclusions of the Task Force). The ISWGNA mandated François Lequiller to cover these two issues.

a) Exchanges of explicit pension obligations between units.

It may happen that some units exchange a pension obligation against a financial instrument. The SNA 93 did not give any recommendation when this exchange occurs with a unit for which the SNA does not record pension liabilities. It is proposed to clarify this point by recommending that a pension liability should be recognised in all such cases.

Question 1 to the AEG*: does the AEG agree to add a specific recommendation in the SNA recognizing as pension liabilities those pension obligations that are exchanged in an explicit transaction between two units, even if the SNA does not record specifically pension liabilities for one or several of these units?*

b) Borderline cases between social security and employer schemes.

The main recommendation of the Task Force on Pension Schemes is to treat all *employer* pension schemes (including for government as an employer) as a "saving scheme"[1] even if these schemes are Pay-as-you-go (or unfunded). This recommendation shifts the criterion to be used in the SNA to recognise a pension liability from the opposition "funded/unfunded" to the opposition "employer scheme/social security". The present paper proposes several clarifications on the definition of social security and on borderline cases between employer or funded schemes and social security schemes, leading to the following questions to the AEG:

[1] The task force presents its proposal in terms of "recognizing pension liabilities". The present paper prefers to qualify the treatment proposed for employer schemes as being similar to a "saving scheme". The two terminologies will be employed in a synonymous way in this paper. The qualification as "saving scheme" is, in my view, more adapted, as it immediately expresses that a whole set of transactions, partly imputed, is involved with the new treatment, and not only the recognition of a liability. Indeed, the saving of households is affected; there is an imputation of property income; etc…

Question 2 to the AEG*: does the AEG support that the definition of social security pension schemes mentions the existence of "collective multi-employer schemes" and of funded social security schemes?*

Question 3 to the AEG: *does the AEG confirm that (1) only the unfunded schemes that are directly sponsored by an employer can be treated as saving schemes and, (2) any unfunded multi employer schemes, including collective multi employer schemes, are to be treated as current transfer schemes?*

Question 4 to the AEG*: does the AEG support to treat all funded pension schemes as saving schemes, even if they are organized under the label of a social security scheme?*

Question 5 to the AEG*: Does the AEG support that government pension schemes for their own employees should always be shown as an employer scheme and thus as a saving scheme, even if the scheme is labeled or organized under a more general social security scheme?*

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II. Explicit exchanges of pension obligations between schemes

This first issue concerns exchanges of pension obligations between systems. The report of the Task Force notes that the updated SNA should include recommendations regarding the treatment of exchanges of (explicit or implicit) liabilities between different types of schemes. The present paper proposes such an additional recommendation.

In the recent years, a number of countries experienced large one-off transactions between pension systems and the government linked to pension reforms or to partial privatizations of public corporations. In Europe, at least three transactions of that type occurred in the last decade (France: *France-Télécom, EDF*; Belgium: *Belgacom*) involving amounts of several decimal points of GDP. In Japan, a large transaction (called '*Daiko Henjo'*: "Pay Back" or "Return"[2]) occurred in 2004, amounting to 0.6% of GDP. The European transactions occurred in the context of government opening public enterprises to the stock market. These public enterprises had specific pension systems that they wanted to reform so that to be financially more attractive. The reform implied the transfer of part of the pension obligation of these firms to the government, against a lump sum. In Japan, the transaction occurred on the occasion of a more general reform of the pension system: in April 2002, corporate pension funds were allowed to abandon their responsibility in the management of the public part of the pension reserves which they had managed on behalf of the Japanese government, in exchange of a lump-sum paid to the general government.

In all these cases, the transaction is clearly (and officially) presented as an exchange (in principle a *balanced* exchange) of a pension obligation for the future against a lump-sum today. This transaction is therefore not supposed to change the net wealth of the units

[2] *Daiko* means to carry out something on behalf of someone, *Henjo* means to return.

involved in the transaction: cash is paid or received on one hand, but a financial obligation is passed on the other hand.

The difficulty raised with the SNA is when these transactions occur between schemes for which the SNA may not recognize a pension liability, for example, social security, or, in the SNA 93, unfunded government employee schemes.

Faced with this situation, which is not specifically discussed in the SNA 93, European experts in national accounts and Japanese experts came to the same practical conclusion. They both chose to record the counterpart of the lump-sum received by the government as a capital transfer, thus improving the net lending/borrowing of the government and, thus, its net wealth on the year of the transaction.[3] This came after a first long (and painful) discussion in Europe in 1996[4], but was confirmed by Eurostat in February 2004.

This recording is seen by many as counter-intuitive, because a transfer is defined in the SNA as a provision without counterpart, while there is clearly a counterpart in a framework of accrual accounting such as the SNA: it is the pension obligation. On the other hand, the SNA did not give guidelines and an interpretation to the letter of the SNA did not seem to allow recording a liability for unfunded schemes. Overall, the decision of these experts appears to have been taken mainly because the SNA did not allow doing differently.

It is proposed here to avoid this very unsatisfactory situation in the new SNA by explicitly addressing this issue. Part of the problem may be avoided in the future with the extension of the borderline of the recognition of pension liabilities to *all* employer schemes. Indeed, when transactions similar as those explained above occur between two employer schemes, including the one of the general government for its own employees, the new SNA would treat it *mechanically* as a pure financial exchange, as pension obligations will now be recognised in the SNA for these two systems.

However, this may be insufficient. First, there may be transactions between employer schemes and social security schemes. Second, it is not yet assured that the main recommendation of the Task Force will be implemented in the new SNA and by all countries. It is therefore proposed that the AEG recommends including in the new SNA a specific recommendation to have these transactions as an exchange of a pension liability in all cases, based on the very existence of the explicit transaction itself. The rationale is that, because of the transaction itself, the pension obligation, which may not have had before the status of a full liability, becomes a full liability because its value has been recognised and calculated. In business accounting terms this would mean that the pension obligation would have moved from the status of "provision" or of an "off-balance-sheet

[3] It would be however wrong to think that the recording as a capital transfer is always "favorable" to the government. It is favorable on the year of the payment of the lump sum, but it is unfavorable in the next years as pension benefits are paid. On the long run, the net wealth is unaffected. In other words, the issue is limited to an accrual issue.

[4] This historically hot discussion, dubbed the "France-Télécom case", remains in the mind of many European national accountants. The challenge of the decision was very important as it was linked to the entry of France in the Euro-area.

item" to a status of liability. This recognition based on a transaction is not new in the SNA, which recognises goodwill as an asset because a transaction occurs where this goodwill can be valued. Some may still see that there is a contradiction in recognizing a pension liability for a unit for which one does not in principle recognise a pension liability. This can be resolved by several accounting means, such, for example, as creating a virtual unit, devoted to the support of this liability. But other solutions, such as to record a pre-payment of contributions, are possible. [5]

Overall, the proposed wording of the recommendation could be along the following lines:

It may happen that several pension schemes, whether employer or social security, private of government, openly exchange between them a pension obligation, with as counterpart, a cash lump-sum or other financial assets. If the exchange appears balanced, such a transaction should be treated an exchange of financial assets against a pension liability. If the SNA does not recognise pension liabilities for one or both units involved in the transaction, it is recommended to create a virtual pension scheme controlled by this unit and devoted to the recording of the explicit pension liability which has been exchanged. Other solutions such as treating the lump sum as a pre-payment of contributions may also be envisaged, as long as they have the same impact on the main balancing items of the units.

***Question 1 to the AEG**: does the AEG agree to add a specific recommendation in the SNA recognizing as pension liabilities those pension obligations that are exchanged in an explicit transaction between two units, even if the SNA does not record specifically pension liabilities for these units?*

* * *

[5] Some experts might prefer this presentation as pre-payment of contributions. This "technical" alternative solution had been proposed during the discussions in Europe. It has exactly the same recordings as the recognition of the pension liability, but using alternative titles and codes.

III Borderline between social security and employer pension schemes

This second issue is a clarification of the main recommendation of the Task Force on Pension Schemes which is to treat all *employer* pension schemes (including for government as an employer) as pure saving schemes[6] even if these schemes are Pay-as-you-go (or unfunded). This recommendation shifts the criterion to be used in the SNA to recognise a pension liability from the opposition "funded/unfunded" to the opposition "employer scheme/non-employer scheme". More precisely, the criterion proposed by the task force is *employer* versus *social security*.

The implementation of such a criterion immediately raises the issue of the borderline between an "employer scheme" and a "social security scheme". The Task Force's report notes that this issue should be reviewed as "a matter of urgency". The present paper proposes several clarifications on this point.

The words "social security" in the context of pension schemes have different meanings in different countries. In some countries (and for the majority of the members of the task force), "social security" is understood as a basic scheme, which is essentially redistributive, does not involve a contractual employer-employee relationship and where benefits are not directly linked to contributions. In other words, it is seen as a sort of minimal social benefit for the poor. Confronted with such systems, one has no difficulty to conclude that they do not imply any "saving" and thus any "pension liability". They are therefore purely "current transfer schemes". They should not be treated as saving schemes.

However, in some other countries, "social security" is similar to an unfunded multi-employer scheme organized by the government, involving a contractual employer-employee relationship and where pension benefits are linked to contributions. In one country, there even exists a (notional) defined contribution social security scheme, which is totally paradoxical for the SNA: as defined contribution, it should be treated as a saving scheme, as social security, it should be treated as a current transfer scheme! As we will see, it is even possible to imagine a funded social security scheme.

Unfortunately, the task force did not discuss specifically the case of multi-employer schemes, while a number of private schemes of that sort exist in OECD countries. My understanding is that it was assumed by the task force that private multi-employer schemes can only be funded and autonomous and thus the treatment of these schemes seemed to present no difficulties.[7] However, there is one case in which a PAYG (or, which is synonym, unfunded) multi employer scheme may exist: it is precisely when it is

[6] The task force presents its proposal in terms of "recognizing pension liabilities". The present paper prefers to qualify the treatment proposed for employer schemes as a "saving scheme". The two terminologies will be employed in a synonymous way in this paper. The qualification as "saving scheme" is, in my view, more adapted, as it immediately expresses that a whole new framework, partly imputed, is involved with the new treatment, and not only the recognition of a liability. Indeed, the saving of households is affected; there is an imputation of property income; etc…

[7] It is indeed difficult to imagine a private PAYG multi-employer scheme, because one of the employer may quit, putting the others in the difficult situation of having to pay for the retirees of the former…

organized by the general government. Indeed, then contributions can be made compulsory and the PAYG system can therefore function.

Thus, at this stage one should recommend that the SNA definition reflects this quite open picture of "social security".

What does the current SNA 93 say? The important paragraph in the current SNA 93 is the following[8]: Par 4.111 (underlined by me): *Social security schemes are social insurance schemes covering the community as a whole or large sections of the community that are imposed and controlled by government units. They generally involve compulsory contributions by employees or employers or both, and the terms on which benefits are paid to recipients are determined by government units. There is usually no direct link between the amount of the contribution paid by an individual and the risk to which that individual is exposed. Social security schemes have to be distinguished from pension schemes [..] which are determined by mutual agreement between individual employers and their employees, the benefits being linked to contributions.*

In my view, it is not necessary to change substantially this definition to allow for the large definition of social security that I mentioned earlier. The main characteristic of social security is that it is organized and controlled by the general government. The first two sentences are clear in this respect and should remain therefore unchanged.

The third sentence which discusses the link between contributions and benefits is more limitative. However it is also sufficiently prudent to cover different types of situations, as the term "usually" is introduced to avoid rejecting the qualification as social security schemes of those pension schemes in which there is indeed a link between the amount of contribution paid and the risk to which the individual is exposed. However, a better sentence for the third one could reflect more the possible different systems, and include in particular the terms "collective multi-employer scheme".

Now, nothing in this definition refers to any mode of financing of the scheme. It appears that there may be funded social security schemes, as recognised by the SNA which introduces the precision in its paragraph 13 of Annex IV: *Social security schemes may be either funded or unfunded.*[9]

It would therefore also be useful to introduce this precision in the definition of social security.

Overall the definition could thus become (new text in italics):

Social security schemes are social insurance schemes covering the community as a whole or large sections of the community that are imposed and controlled by government units.

[8] There are other paragraphs such as 8.63 and 8.64 (see annex of the present paper), but they are not essentially different from this one.

[9] As we will see below, this does not mean that the SNA 93 proposes to treat these schemes as saving schemes.

They generally involve compulsory contributions by employees or employers or both, and the terms on which benefits are paid to recipients are determined by government units. *Social security pension schemes cover a wide range of situations from minimal pension schemes to large collective multi-employer pension scheme, from generally unfunded schemes to, sometimes, funded schemes. A minimal pension scheme is a redistributive scheme, sometimes not even involving individual contributions, or where there is no link between the individual contributions and the pension benefit. Collective multi employer schemes are social security schemes that are based on an employment contract and that link contributions and benefits. However, this collective scheme is not sponsored directly by the employers but is organized through the government.*

***Question 2 to the AEG**: does the AEG support that the definition of social security pension schemes mentions the existence of "collective multi-employer schemes" and of some funded social security schemes?*

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It is possible to imagine that many readers are, at this stage of the paper, very concerned that such an extension might lead to the conclusion that one should treat some social security schemes as saving schemes. This is not my intention, as will appear in the next paragraphs. The definition is one thing, the treatment of social security schemes is something else.

What is the situation regarding the *treatment* of social security schemes?

The task force did not unfortunately have the time to discuss the situation of social security schemes. However, it seemed to me that most participants rejected by principle the treatment of unfunded social security schemes as saving schemes in the core national accounts. The European CMFB paper presented to the Task Force meeting does propose to record unfunded social security schemes as if they were saving schemes, but does not propose to include these recordings in the core accounts but rather in a supplementary set of accounts. The Task Force (and the author of the present paper) has concluded that this was an interesting proposal, and it is up to the AEG to take it up or not. However, in any case, nothing of that sort is expected to occur in the core accounts. Thus it would be useful, with the large definition of social security as seen before, that the AEG confirms this common stance.

Question 3 to the AEG: *does the AEG confirm that (1) only the unfunded schemes that are directly sponsored by an employer can be treated as saving schemes and, (2) any unfunded multi employer scheme, including collective multi employer scheme, are to be treated as current transfer schemes?*

Does this mean that <u>all</u> social security schemes should be treated as current transfer schemes? Well, remains the case of <u>funded</u> social security schemes. It has been mentioned above that the current SNA 93 had indeed envisaged that some social security schemes may be funded, however, the same paragraph that was quoted above continues

with saying (underlined by me): Par 13 of Annex IV: *Social security schemes may be either funded or unfunded. Even when separate funds are identified, they remain the property of the government and not of the beneficiary of the schemes.*

As can be seen, while recognizing the possibility of a social security scheme to be funded, the SNA 93 implicitly rejects the treatment of the scheme as a saving scheme by refusing to assign them to the beneficiary, as when the scheme is treated as a saving scheme. The reason of this is not clear. One possibility could be that the SNA drafters only considered situations where some limited "buffer funds" were put in place by some social security schemes in order to make the treasury of the fund more liquid.

However, everything can exist in the real world. Indeed, very recently, Eurostat was confronted in some countries to schemes that could be labelled as "social security" because they could be considered as imposed and controlled by the general government (which even guaranteed minimal benefits) but these schemes were funded, and these funds were not "buffer funds", and were even defined contribution schemes. Pension reforms are going indeed in the direction of building such mixed systems, having at the same time the characteristics of a collective scheme and the characteristics of a saving scheme. There is therefore a necessity for the new SNA to give some guidelines on such cases that could be more frequent in the future. The rationale is to treat all of it *or a part of it* as a saving scheme, if this characteristic is indeed dominant, despite the fact that it may be controlled, imposed or guaranteed by the general government, and thus having some of the characteristics of social security.

When confronted to such a case Eurostat took the decision (*Eurostat, New decision on deficit and debt, 2/3/2004*) to recommend classifying the system, or more precisely the branch which was a funded defined contribution sub-system, outside the government as an autonomous pension fund. In this case, Eurostat's decision applied to the classification of the scheme. An alternative conclusion, with similar impact on the accounts of the government, would have been to accept the idea that when a social security scheme is funded it should simply be treated as a saving scheme, even if remains classified inside the general government.

This would thus lead to the following recommendation.

Social security schemes are generally unfunded. However, some may possess funds. In general, these funds are "buffer" funds, allocated to the scheme to smooth its treasury problems. These buffer funds are not considered by the SNA as the property of the beneficiaries, and these schemes should remain treated as current transfer schemes and not saving schemes. However, there may also be mixed schemes, where part of the social security scheme functions in fact as a funded pension scheme. In this case, it is recommended to separate the part functioning as a saving scheme and either classify it as a pension fund, outside the general government, or keep it inside the government but treat it as a saving scheme.

***Question 4 to the AEG**: does the AEG support to treat as a saving scheme all funded pension scheme, even if it is organized under the label of a social security scheme?*

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Last but not least of the needed clarifications of the borderline between social security and employer scheme is the very important case of schemes set up by government in respect of their own employees. The current SNA 93 is very clear (Par 8.63) on the classification of these schemes: *Schemes set up by government in respect of their employees only are not included in social security schemes but are treated in the same way as other employers' social insurance schemes.*

While not discussed specifically, this recommendation would have certainly been confirmed by the Task Force. However, what appeared purely as a classification recommendation between sub-sectors of the general government will take another meaning under the proposals of the Task Force, because it then means that these schemes are to be treated as saving schemes even if they are not funded.

These schemes are at the center of the discussion of the Task Force's main recommendation, because they are large and a change of their treatment has a significant impact on the general government accounts. The sensitivity is compounded by the fact that in some countries, the scheme organized by the general government for its own employees, even if independent and not labeled "social security", is similar in its organization (contribution, system of benefit) to the social security scheme organized by the same government for the private sector employees. [10] Thus in the view of experts of these countries, the scheme organized by the general government for its own employees is in fact a quasi "social security scheme" and thus should not be treated as an employer scheme (i.e. a saving scheme) but as a social security scheme (i.e. a current transfer scheme).

This is partly why, in practice, the discussion focuses on this case of government schemes for their own employees. Some (the majority of the task force) insists that, being employer schemes, they should be treated as private employer schemes, some (the opposition) insists that, being unfunded, they are close to social security schemes and should be therefore treated, as current transfer schemes.

The present paper supports the position of the majority of the Task Force to treat all employer schemes, including general government employee schemes, as saving schemes. However, the discussion above shows that one specific clarification is to be added: what happens if the government organizes its pension scheme for its own employees under the label of a larger "social security scheme"? The current SNA seems to consider that in that case it is no more an employer scheme, as the paragraph shown above is limited to "s*chemes set up by government in respect of their employees only"* (underlined by me).

As explained earlier, in some countries social security can include government employees. In some other countries, the schemes might be different units, but it may be the (official

[10] In some countries it may even be a unique scheme, covering private sector and public sector employees.

or unofficial) aim of the government to have the two schemes organized in exactly the same way. Thus, in such a case, the scheme organized by the government for its own employees could be quite easily assimilated to the general social security scheme. In practice, a government could easily label its specific scheme for its own employees as part of the larger social security system. This would mean that the SNA's recording of a pension liability would depend on a thin institutional difference, which might be changed quite easily. In this case, a government will wipe out its "SNA pension liability" simply by labeling its own scheme as part of social security.

The new SNA should avoid such an absurd situation. It should therefore request that a pension scheme for the general government for its own employees should be treated as an employer scheme *in all situations*, even if it is linked or embedded in a larger social security scheme. This possibly means *extracting* a virtual scheme from the general scheme. This leads to the last question to the AEG:

***Question 5 to the AEG**: Does the AEG support that government pension schemes for their own employees should always be shown as an employer scheme and thus as a saving scheme, even if the scheme is labeled or organized under a more general social security scheme?*

ANNEX

Other SNA 93 paragraphs on social security

Par 8.63: Social insurance schemes organized by government units for their own employees, as opposed to the working population at large, are classified as private funded schemes or unfunded schemes as appropriate and are not classified as social security schemes.

Par 8.64: Social security schemes are schemes imposed and controlled by government units for the purpose of providing social benefits to members of the community as a whole, or to particular section of the community. Their receipts consist mainly of contributions paid by individuals and by employers on behalf of their employees, but they may also include transfers from other government funds. The payment of social security contributions by [..] employees may be compulsory by law, but some other individuals may choose to pay voluntarily in order to qualify for the receipts of social security benefits. The benefits paid to individuals [..] are not necessarily determined by the amounts previously paid in contributions, while the levels of the benefits paid out to the community as a whole may be varied in accordance with the requirements of the government's overall economic policy.