PENSION SCHEMES : SOCIAL INSURANCE AND SOCIAL PROTECTION

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This note has been written in my personal capacity and the opinions in it do not represent the views of Eurostat.

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Annex : Eurostat’s paper “Coverage and border problems”

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1 I am grateful to Anne Harrison and Philippe de Rougemont for their comments on an earlier draft.
1. **Introduction.** This note is about the possibly different borderlines in two statistical systems which use the term “social” in regard to pension schemes. Current developments may be exacerbating differences which were previously minimal. First, in the national accounts, there is a border between pension schemes which are classified as **social insurance** and those which are classified as **individual life insurance**; secondly, in social protection statistics, at least in the European System (“ESSPROS”), there is a border between schemes which are classified as **social protection** and those which are outside the scope of social protection. In principle, the issues about borderlines should be considered in terms of schemes, which are not always the same as institutional units (IUs) in the national accounts.

2. This note is not about the further borderline, within both social insurance and social protection, between pension provision through social security and “other social” pension provision, which has been discussed recently by Eurostat’s Task Force on Pension Schemes. But some of the considerations are common to both this borderline and that between “social” and “individual”, especially in the case of schemes of a “defined contributions” nature.

3. A few preliminary remarks on the nature of **“Other social pension provision”** (meaning social pension provision other than through social security).

   a. **Scope**

   “Other social” provision includes schemes run by employers, those sponsored by trade unions and associations – and some schemes for individuals, whether self employed or employed, provided that they satisfy certain conditions (see below).

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2 In the old age and survivorship functions.
3 This further borderline is not the same as that between public sector schemes and private sector schemes. Here, “other social” pension provision includes pension provision by Government, central or local, for its own employees, as well as provision by private sector employees; in ESSPROS the former is likely to be classified in future as part of public pension schemes, in a new sub-category to be called “employer schemes of government”, which would bring the public sector/private sector distinction into line with that in the national accounts.
b. **Contributions.**

Employer schemes and those sponsored for employees by trade unions and associations usually provide for contributions to be made by both employer and employee, but occasionally they do not require the employee to make contributions (e.g., some employer schemes of Government).

c. **Funding**

Except in the case of some employer schemes of Government, “other social” pension provision is usually funded. The assets of the fund are usually segregated (an “autonomous pension fund”), but in Germany and (?) Austria the assets are not segregated within the employer’s balance sheet but a “book reserve” is set up on the liabilities side which shows the amount of the employer’s liability to pay future pensions (a “non-autonomous pension fund”); the risk of insufficiency of assets is reinsured. Individual pension policies are always funded, with segregated assets.

d. **Nature of benefits**

“**Defined contribution**” schemes: benefits from these schemes, which are always funded, depend on the performance of the invested fund and on the market for annuities.

“**Defined benefit**” schemes: the promised benefits are usually related to the length of the contribution period and to final or average salary. When the scheme is funded, the employer or sponsor carries the risk that the invested fund is insufficient. He may also pay pensions himself rather than purchase annuities, in which case he also carries the survivorship risk. The risk of early death or incapacity may be carried in house or insured externally (in both types of employer/sponsor scheme).

4. **“Social insurance” in the national accounts.** “Social insurance” includes social security. The criteria for inclusion in social insurance are well known\(^5\) and are only summarised here. To qualify, non-social security schemes must satisfy certain risks or needs.

Pension provision includes the risks or needs described as “old age” and “survivors”, in ESA\(^6\), and in ESSPROS. In addition, a policy must be a collective one or, if in the name of an individual, must satisfy at least one of three criteria :-

a. the scheme is a obligatory either by law or under the terms and conditions of employment

b. the scheme is collective one restricted to a specified group

c. an employer makes a contribution, actual or imputed.

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\(^6\) In SNA, they are described in more detail (8.56), but the meaning is the same.
5. **“Social protection” in ESSPROS.** The borderline was fully described in a paper for the February 2003 meeting of Eurostat’s Working Group on Social Protection entitled “Coverage and Border Problems”. Section B on pages 2-5, about “supplementary protection: personal provisions” is attached. I summarise the relevant parts of this section. A sub-section on “problems” states that individual insurance is becoming increasingly important alongside social security, and generally takes the form of taking out insurance or joining pension funds. This raises the question to what extent such provision should be included in ESSPROS as “supplementary social protection”.

6. The next sub-section of Eurostat’s paper for the Working Group on Social Protection, about definitions, describes the existing borderline. According to this an insurance policy based on the principle of social solidarity will be within the scope of ESSPROS. This principle applies when, as a matter of policy, premiums or contributions are not proportional to the individual exposure to risks of the people protected. However, there is another overriding criterion: if by law or regulation certain groups of the population are obliged to participate in a designated insurance scheme, or employees are insured as a consequence of collective wage agreements, the schemes are social protection schemes regardless of whether or not premiums or contributions are proportional to risks.

7. Eurostat’s paper goes on to say that difficult borderline cases arise from *contracting out*, where the law allows people to leave the general scheme managed by the social security fund and acquire protection by other means. There is a suggestion that such replacement schemes would not be social protection, unless the criterion of social solidarity (premiums not proportional to risks) applies. The next sub-section of the paper, on difficulties, points out that certain individual pension schemes may be eligible for State guarantees, guarantees from employers, or fiscal benefits, and that this raises questions about their status in ESSPROS.

8. **Borderlines in both systems.** It seems to me that these points raise questions about the status of such arrangements in the national accounts; leaving aside these new developments, the criteria have been similar though not identical. The criterion of an obligatory scheme for a designated group is common to both systems. Where these do not apply, ESSPROS relies on social solidarity (premiums not proportional to risks);

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7 This definition relates to insurance schemes. The principle of social solidarity applies elsewhere, for instance being a feature of social security and social assistance schemes.
but the national accounts say that where an employer makes a contribution, actual or imputed, to a scheme in an individual name, it can be classified as social insurance.

9. My personal comment, on the points made by Eurostat and summarised in paragraphs 5-7, is that guarantees in various forms could well mean that premiums or contributions are not proportional to the individual exposure to risk. This is less likely, however in the case of fiscal benefits, depending on their precise form. The ordinary principle of ‘deferred income’ – premiums or contributions and possibly investment income being tax deductible, but benefits being only available wholly or mainly in the form of an annuity (a pension) which is liable to income tax – applies to both collective and individual schemes; and such schemes, being fiscally neutral, on the deferred income principle, appear to have premiums or contributions which are proportional to the individual exposure to risk, so that the existence of fiscal benefits of this kind should not, of itself, qualify the arrangements as social protection.

10. If there is no obligation, however, to take benefits mainly in the form of a taxable annuity, there may be a question of a special advantage – the (tax deductible) premiums or contributions being not wholly proportional to those encountered by members of fiscally neutral pension schemes.

11. Case by case study will be needed but, subject to this, I make a suggestion, below at paragraph 19(e), about a possible modification of the existing criteria in the national accounts.

12. Defined contribution schemes. Just as with linked life insurance, “the investment risk is borne by the policy-holder”, in the words of the European Accounting Directive on insurance. There may be discounts on premiums or contributions when arrangements are made by employers or trade associations for groups – economies of scale – but these do not mean that the premiums or contributions are no longer proportional to risks. Unless there are some other features which embody an element of defined benefit, such as guarantees in some form or other, defined contribution schemes would only qualify as part of social protection, it seems, if the overriding criterion applies that the scheme is both obligatory and for a group. This could raise difficulties in countries where employers or trade unions are prevented by law from making membership of a pension
scheme of the defined contributions type compulsory, as part of the conditions of employment (e.g., the United Kingdom, see footnote 8 below).

13. In the **national accounts** it is different; the criterion of proportionality to risks does not apply and the scheme must satisfy only one of the three criteria summarised in paragraph 4. Thus a scheme operated by an employer for a specified group of employees\(^8\), which is of a defined contributions nature without any guarantee – which is becoming increasingly common – would score as part of “social insurance” in the national accounts even if membership was voluntary; similarly a scheme in the names of individuals would score if the employer made actual or imputed contributions. Neither of these schemes would score as “social protection”, it seems.

14. **New developments : “contracting out”**. The last criterion in the national accounts, that the employer makes a contribution, actual or imputed, impinges on the difficulties when there is “contracting out” from a State scheme. In the United Kingdom, for example, there has been the following history of employer schemes. First, larger employers set up company schemes, usually of the defined benefits type, and usually made membership of the scheme compulsory as part of the terms of employment. These are “pillar 2” schemes. Later, the Government set up an compulsory umbrella scheme for employees who were not members of company schemes, called the State Earnings Related Pension Scheme (“SERPS”) – which is part of social security but within “pillar” 2, and also offers defined benefits. Then, in the 1980’s, there were two changes – employers could no longer oblige their employees to participate in the company scheme, and employees covered by SERPS could opt out if they took out a “personal pension”, being a funded scheme run by a financial institution not offering defined benefits and in their individual names.

15. A UK employer with a company scheme has a strong incentive to “contract out” of SERPS in respect of the members of the company scheme, which means that, in view of the employer contribution to the company scheme, he pays a lower rate of social security contribution. An individual opting out of SERPS and joining a Personal Pension Scheme was entitled to be credited with the difference between the two rates of employer’s contribution; but the employer did not pay this directly. He continued to pay to the Government at the higher “not contracted out” rate, and the Government paid the

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\(^8\) The scheme may be collective or may permit eligible participants to take out policies in their own names.
difference between the two rates of contribution directly into the individual’s personal pension plan. Arguably, this would be an imputed employer contribution qualifying personal pension plans as part of “social insurance” in the national accounts for the UK. The way they are treated in ESSPROS is not entirely clear.

16. **Other new developments: EU Member States.** After discussion by Eurostat’s Working Group on Social Protection of the paper “Coverage and Border Problems”, it was concluded, on the section of the paper about “supplementary protection: personal provisions”, that further study of the problems would be needed, between by bilateral contacts between Eurostat and the countries concerned. There will be an opportunity, therefore, to consider the national accounts aspects at the same time.

17. **Other new developments: EU Accession States.**
   a. Accession States participated as Observers at the meeting; many do not have “pillar 2” pension schemes. But two countries have them; the following is based on my reports to Eurostat of visits to all Accession States in 1999-2000, in regard to their national accounts, including S.125 “Insurance and Pension Funding”. The descriptions therein may need updating.
   b. **Czech Republic**
   Under an amendment to a law of 1994, pension provision supplementary to “pillar 1” is available. Anyone is eligible to join; it is not necessary to be employed. Contributions are tax deductible, up to a (fairly low) limit. Employers may also contribute. As an incentive the Government also makes a contribution, of 30% of the member’s contribution up to an (even lower) limit. Benefits may be taken as a lump sum, and usually are taken in this form. It appeared that the scheme was nearer to individual life insurance than to social insurance, but the Government contribution created uncertainty, in view of ESA 4.88, which says:-
   "social insurance schemes are schemes in which workers are obliged, or encouraged, by their employers or by general government to take out insurance against certain eventualities or that may adversely affect their welfare or that of their dependants."

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9 Employees had also been given the right to opt out of group employer schemes but if so would forgo the difference between the employer contribution to the company scheme and the difference between the two rates of social security contribution, which usually is much lower.

10 The replacement scheme, known as “stakeholder pensions”, does not benefit from indirect employer contributions and so no longer offers the same incentive to opt out of SERPS. Beyond the usual fiscally neutral relief on contributions up to a threshold, the only advantage over ordinary long-term saving with life insurance companies is possibly lower charges by insurance companies.
c. **Poland**

From 1999, a new scheme for “pillar 2” was introduced, which will be obligatory for all people born after 1969, whether employees or not, and will be funded on a contributory basis by 21 autonomous pension funds. The fund is chosen by the insured but its members are ‘reinsured’ against the risk of under-performance by separate “pension societies”. The risk of under-performance is further covered by a special Guarantee fund funded by all the pension societies, and only as a last resort by Government. In the future, separate pension insurance companies are likely to be set up, which will annuitise the pension rights accumulated and pay the pensions. It seems that both the pension funds and pension societies would be appropriate to S.125 and that the whole system would be part of “social insurance” in the national accounts, on grounds of being obligatory, even though there are no employer schemes and (apparently) no employer contributions. The reinsurance and the ultimate guarantee by the State is also interesting and suggests that these are a kind of hybrid between “defined contributions” and “defined benefits” schemes. In Poland there is also a third “pillar” which would clearly be classified as individual life insurance in the national accounts.

18. The treatment of such schemes in ESSPROS will be considered. The obligatory nature of the Polish “pillar 2” scheme indicates that it is part of social protection just as it is part of social insurance in the national accounts. With the Czech scheme, however, the Government contribution appears to mean that the benefits are not proportional to risks so that the scheme would be part of social protection even though it is voluntary. Its status in the national accounts is open to considerable doubt and, on current criteria, classification as individual life insurance seems likely.

**Tentative conclusions**

19. a. The existing criteria for classification as social protection under “ESSPROS” and as social insurance in the national accounts are different whenever a pension scheme is not compulsory either by law or as part of the conditions of employment.
b. In theory, social protection under “ESSPROS” is narrower than social insurance in the national accounts when defined contribution schemes organised by employers or trade unions are voluntary, because the criteria for “social solidarity”, that premiums are not proportional to risks, does not apply (unlike with voluntary defined benefit schemes): paragraphs 8 and 13. This is not a new feature. However, it seems unlikely that, in practice, such schemes are classified by EU Member States in different ways in the two systems.

c. Amongst new features, the right of individuals to opt out of a compulsory scheme creates borderline problems in both systems (paragraphs 14 and 15). In the national accounts, there is a question whether indirect employer contributions qualify a scheme to remain within social insurance. In ESSPROS the criterion that premiums are not proportional to risks is affected by the question whether the indirect contribution should regarded as a subsidy by Government or as an employer contribution (part of normal remuneration).

d. Pension schemes in the names of individuals which remain in place upon a change of job, on criteria settled by the Government, may create classification problems, though if they are compulsory they would appear to be “social” in both systems.

e. Guarantees and contributions by Government, not related to employment, could mean that such schemes in the names of individuals, if voluntary, would score as social protection, on the criterion that premiums are not proportional to risks (paragraph 18); but they would not be part of social insurance in the national accounts, because none of the criteria in paragraph 4 apply. This particular difference would be removed, if criterion 4 (c) of the national accounts were altered to read:-

“an employer or Government makes a contribution, actual or imputed, or offers a guarantee”.
Addendum: a more radical approach to the national accounts.

20. A possible alternative way of looking at marginal cases would be look at the question whether the whole amount of benefit may be taken as a lump sum, or the whole or major part must be taken as an annuity (and not before a specified age, except in the case of disability). If there is some obligation to take an annuity, it could be said that the scheme is social in nature even if in individual names and even if the other criteria do not apply. This would accord with the ‘lay’ person’s understanding of what is a pension scheme and what is not, but it would considerably widen the scope of “social insurance”. For instance, pension schemes for the self-employed, where contributions benefit from tax relief would score as social on the grounds that an annuity must be purchased. In consequence, the existing difference between the treatment of pensions of the previously employed – consumption is financed by disposable income, including the pension – and of the pensions of the previously self employed – consumption is financed by dissaving – would be avoided.

21. This, however, would introduce a difference of principle between social insurance and social protection; in the national accounts, social insurance for the risks and needs of old age would then be defined as all forms of organised and contractual provision for deferred income, but social protection would be confined to compulsory schemes or schemes where there is some element of guarantee or subsidy. Since the purposes of the activities covered by the two systems are different, it might be no bad thing to recognise this explicitly; and this might bring into question the overriding criterion in ESSPROS that if an insurance scheme is compulsory it is social protection regardless of its other features, which looks as if it was intended to limit differences between the two systems.

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