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Pension reform, from 1 January 2013 a reality in Luxembourg

Introduction

The need for a reform of the pension systems has been the subject of intense debate in the media for several years now, both in Luxembourg and in the surrounding countries.

In the Grand Duchy, this debate has been relatively muted. The principal reason for this restraint has been the current surplus in the private sector pension system arising from the increase in employment over the last thirty years, thus masking the need for reform. However, public opinion has now accepted the need to prepare for demographic changes, which will be felt as soon as the much increased active workforce will begin to draw their pensions.

Looking at the countries bordering the Grand Duchy, in Germany the pension system was reformed as at 1 January 2008 with a progressive increase of the legal retirement age from 65 to 67 years, which applies to all pensioners from 2031.

In France the reform process commenced with the law of 9 November 2010, which extended the minimum contribution period required for the state pension. Since then, a number of other measures contained in several laws and regulations progessively increased the retirement age.

In Luxembourg and in Belgium the reform of the state pension scheme takes effect as from 1 January 2013. In Belgium the law was approved in December 2011. In Luxembourg the pension reform legislation was voted in parliament on 5 December 2012. In principle, the reform affects both the pension system for the private sector and the pension systems for the public sector.

Generally speaking, all these reforms of the state pension system either increase contributions and/or encourage workers to extend their career to bring it into line with an increased life expectancy.

Key points of the pension reform in Luxembourg

1. ***At the moment, the global funding rate (24%) remains unchanged.***
2. ***Entry ages for retirement/ early retirement remain unchanged.***
3. ***Minimum pensions remain unchanged.***
4. ***Progressive reduction in the amount of state pension, phased in over 40 years.***
5. ***Abolition of the year-end pension supplement, if global pension funding is insufficient.***
6. ***Possibility to limit wage indexation of pensions in payment, if global pension funding is insufficient. However, price indexation will remain applicable.***
7. ***Monitoring period for the determination of the global funding rate.***
8. ***Anti-cumulation rules during early retirement have been relaxed.***

To appreciate the impact of legislative measures on pensions, we have set out below a summary of the elements of the system that remain unchanged and of the changes that have been implemented:

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No changes

1. Funding rate remains unchanged:

The private sector system for retirement pensions, survivor's pensions and disability pensions is funded on a pay-as-you-go basis with a funding reserve, based on the principle of inter-generational solidarity. The global funding rate is set at 24% of annual professional earnings, up to the upper earnings limit (€112,451.40 as at 1 January 2013); of this 8% are borne by the worker, 8% by the employer and 8% by the State.

2. Entry ages for retirement and early retirement remain unchanged

The state retirement age remains at 65 years. It is possible to claim the early state pension from age 57, if 40 years of contibutions have been paid or from age 60, if 40 years of contributions and deemed contribution periods have been reached; deemed contribution periods include, in particular, periods of study and of professional training between 18 and 27 years and military service in Luxembourg.

It is important to note that the status quo on the retirement age is certainly one of the weak points of the pension reform. The political intention is to reduce the level of state pensions progressively, but to leave workers the choice of obtaining the same pension by extending their career slightly. The law permits to obtain the same level of pensions in 2052 by working three more years.

Because state pensions are very high in Luxembourg, it would appear very optimistic to assume that workers will generally work those extra years to attain the level of pensions as before the reform.

3. Minimum pensions remain unchanged

The mechanism of the minimum pension remains in place and ensures a reasonable level of pension for those whose income has remained close to the minumum wage, even in case of early retirement at 57 after 40 years of contributions. In this way, the state pension system still provides access to a well-earned pension for those with a long career of physical labour.

Changes from 1 January 2013

4. Amount of retirement pension

a. Rate of the fixed part of the state pension

The rate used to calculate the fixed part of the state pension is progressively increased from 23,5% to 28% of the reference amount over the next 40 years, which equates to an average geometrical increase of 0,44% per annum.

The effect of this increase to 28% is relatively limited, as can be seen on current figures : In December 2012, the fixed part of the state pension after a career of 40 years amounted to €433.86, when calculated at the rate of 23,5% of the reference amount. The only noticeable effect will be on smaller pensions.

b. Rate of earnings-related part of the state pension

The earnings-related pension is today calculated at the rate of 1,85% of the sum of earnings subject to social security, which are restated at index level 100 on the basis of the applicable cost of living index and the wage index. This restated amount is then multiplied by the current index level and by the current wage index.

A higher rate may be used for workers who have attained the age of 55 years and who have paid contributions for at least 38 years. However, the rate applied to the earnings-related pension may not exceed 2,05%.

From 2013, the rate of the earnings-related pension reduces from 1,844% in 2013 to 1,600% in 2052 in accordance with the new law. This rate can be increased to a maximum of 2,05% as a result of new rules relating to age, career and certain limits applicable at retirement.

The implications of these changes are illustrated by the following examples :

At retirement		Scenario 1	Scenario 2	Scenario 3
		you are aged 58 years with 40 years of contributions	you are aged 63 years with 40 years of insurance, of which 35 years are contributions	you are aged 68 years with 40 years of contributions
Start of pension	Fixed rate (as % of reference amount)	Rate of earnings-related part of pension		
Before 2013	23,50%	1,900%	1,850%	1,980%
In 2013	23,61%	1,899%	1,899%	2,009%
In 2020	24,40%	1,852%	1,852%	1,982%
In 2030	25,53%	1,772%	1,772%	1,942%
In 2040	26,65%	1,696%	1,696%	1,906%
In 2052	28%	1,600%	1,600%	1,800%

These examples show a progressive, but not catastrophic reduction of the rates applied to the earnings-related part of the state pension.

Those who continue working to 68 years in future in order to accumulate the maximum number of contribution years (scenario 3) reach almost the same earnings-related rate as those to take early retirement today at age 58 and after 40 years of contribution.

5. Year-end pension allowance

All pensioners who receive a state pension on the 1 December of the current year also receive a year-end pension supplement of (currently) €709.80 for a full career of 40 years. This year-end supplement will be abolished, if the total annual cost of pensions (as percentage of total salary) exceeds the global funding rate.

6. Review of the double indexation mechanism

All state pensions in payment are and will remain linked to the price index. In addition, pensions are linked to the evolution of the average wage level. The wage indexation of pensions in payment will be affected by the introduction of a moderating factor, which is set at one upon implementation of the new law. If the total cost of pensions is higher than total contributions, the moderating process is triggered and the wage indexation of pensions in payment is limited to no more than half of the increase of the average wage level. This is a key element of the reform. The mechanism is relatively subtle, but it may be applied as soon as the pension system becomes too expensive (when pension cost exceeds global funding) and it applies to a considerable volume (all pensions).

It should be noted that the increase of the wage index due to be applied at the start of 2013 (in respect of the two previous years) has not been enacted and this slice of the wage indexation is not expected to be recovered later.

7. Monitoring period for the determination of the global funding rate

The monitoring period for the determination of the funding rate is currently set at seven years. This monitoring period is increased to ten years for the period from 2013 to 2022 (inclusive) onwards. If the technical balance sheet of the pension system and the actuarial forecasts of the IGSS (Inspection Générale de la Sécurité Sociale) in five years show that the funding rate is insufficent to meet future pension costs, it will be reviewed at that point.

8. Anti-cumulation rules for pensioners in early retirement are relaxed

The are no anti-cumulation rules for normal retirement pensions from age 65.

On the other hand, in case of early retirement (from age 60 or even from age 57), the following rules now apply:

- ⇨ Those claiming an early retirement pension may only receive revenue from self-employment up to a limit of 1/3 of the minimum wage for social security. If the income from self-employment exceeds this limit, the early retirement pension may be significantly reduced or even entirely refused.
- ⇨ They may continue to receive a salary. The sum of state pension and salary may not exceed the average of the five highest salaries of the contribution period.

Conclusions

The existing rules as to the right to a pension remain unchanged under the new law. Therefore the option to take early retirement of the age of 57 or 60 remains in place, but the worker will receive a progressively smaller pension. Those close to retirement are only affeced to a very limited extent by the new rules.

Younger workers will see their pensions reduce further, but still only to a limited extent. The overall aim of the reform is to reduce pensions by about 15%. Pension levels will therefore remain significantly higher than in the neighbouring countries and the sustainability of the system, which depends on significant levels of economic growth, is still in question after this reform.