

Social security: Iceland

Abstract

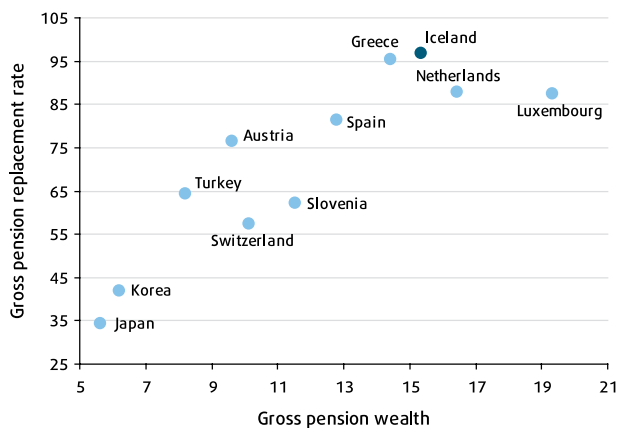
In attracting talented people from around the world, the United States and Canada are exceptional, but for somewhat different reasons. The U.S. economy is powered by immigration, and more than a million people immigrate there ever year. Canada also has one of the highest percentages of immigrants: one of five residents is foreign-born. The quality of immigration is high in North America. But immigration policy differs in many ways. The United States attracts migrants through its size, tradition as a country of immigrants, and its contestable labor markets and job opportunities. Off all the immigrants coming to the United States, more than a quarter have tertiary education. But the lack of a comprehensive policy can lead to undocumented migration and weak public institutions for integrating immigrants. Canada has a more comprehensive set of policies based on a “points” system to both meet labor market needs and reunite families.

Iceland’s pension system is good example of how to combine generous benefits with fiscal sustainability. The country has one of the most generous pension systems in the OECD while its public pension spending remains strikingly low. This note investigates how Iceland shaped its social security system.

More with less

Iceland’s population is relatively young, with 19.5 percent of the population over 65 (compared with the OECD average of 23.6 percent), a high fertility rate, and life expectancy of 81.7 years. For more than three decades, the pensionable age has been set at 67 years for both men and women. Icelanders work longer than most others in Europe: the average effective age of retirement is 69.7 years for men and 65.4 years for women. The pension system provides retirees with one of the highest replacement rates among the OECD countries, amounting to 96.9 percent for average earners (figure 65).¹ Somewhat surprisingly, such generous benefits come at a relatively low price of 1.9 percent of GDP, compared with the OECD average of 7 percent.

Figure 65: Gross pension replacement rates and gross pension wealth for median earners in selected OECD countries²



Source: OECD (2011).



The system and its origins

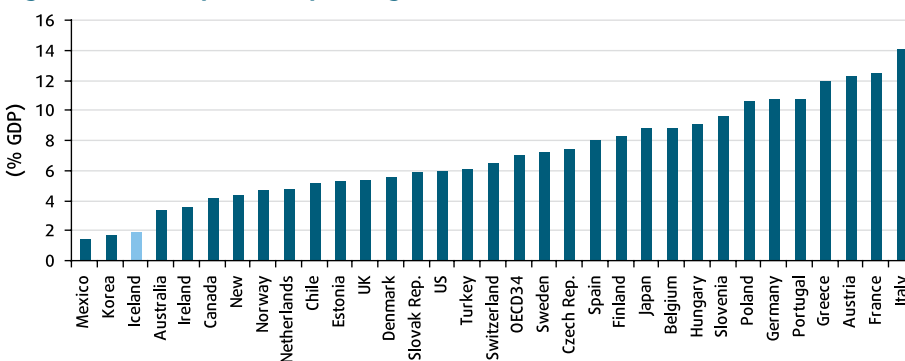
Iceland's social security system has its origins in the beginning of the 20th century and its design was partly based on New Zealand's pension system from 1938.³ The current scheme consists of three pillars:

- The first pillar is a tax financed public pension scheme that starts to be withdrawn once a certain level of earnings is achieved.⁴
- An important feature of the system is the mandatory character of the second pillar: the occupational or private (but publicly regulated) pension scheme. The mandatory occupational programs have their origins in 1969, when unions and employers' organizations signed an agreement on pension schemes.⁵ Currently, the occupational pension funds are legally obliged to secure a minimum benefit of 56 percent of previous pay, granted that a pensioner was contributing to the system for 40 years.⁶ Most of the funds follow a hybrid model of defined-contributions/defined-benefits schemes and provide pensioners with payments above the minimum level of 56 percent.
- The third pillar is a voluntary private pension fund involving, in most cases, defined-contributions schemes. Icelanders contributing to the third pillar are eligible for some tax exemptions.

The system also incorporates incentives for citizens to extend their employment beyond the official pensionable age and, at the same time, punishes early retirement with lower future benefits.⁷ The benefits of staying in the workforce are particularly strong for low and middle earners. Consequently, the participation rates of elderly are among the highest in the OECD.

The Icelandic pension system is surprisingly inexpensive, when compared with other OECD economies (figure 66). Low public expenditure on pensions stems from the means-tested character of the system and has its origins in the development of the social security system in the country. Even the first old-age support fund that was set up in 1909 included a means-testing component. And when in the postwar years the social benefits grew in most of the Nordic countries, the Icelandic system retained its lean and means-tested character.

Figure 66: Public pension spending in OECD34 countries in 2007⁸



Source: OECD (2011).

Currently, higher benefits from the second and third pillars substantially decreased the taxed financed benefits. The OECD estimates that Icelandic private funds accounted for more than 60

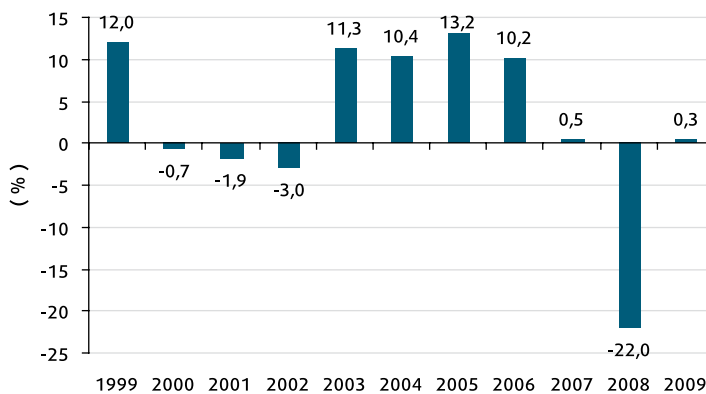
percent of mandatory components of the pension system. However, a low expenditure ratio could also be a result of the county's relatively young population, low unemployment rate, and high labor participation rate among men and women. Finally, the lean character of the pension system is strongly related to the Icelandic preference toward private and self-help solutions.

The system during the crisis

The system came under stress during the recent financial crisis. Private pension funds incurred significant losses in their stock and bond portfolios as well as in currency markets. For example, the currency protection contracts cost the funds up to ISK 73 billion in 2010.⁹ The funds came under even more stress when the government considered writing off mortgages of insolvent households amounting to US\$2 billion (around 17 percent of GDP in 2009). Before and during the crisis, pension funds were involved in the mortgage market by granting fund members loans against residential housing and purchase of securities financing the state housing loan system.¹⁰ General write-offs of the mortgage would increase the existing losses and, therefore, decrease benefits for future pensioners.¹¹

As a result of the crisis, the net real return of the funds amounted to -22 percent, according to the Financial Supervisory Authority of Iceland (figure 67). This was partly the result of high inflation, corporate bond write-offs, and currency restrictions. However, only some pension funds cut the benefits due to the crisis, on average by 5 percent. In order to partially offset the impact of the crisis, the government temporarily allowed for the early repayments from the third pillar. These payments amounted to 2.5 percent of annual GDP between 2009 and April 2010. The pension system recouped most of crisis-related losses in 2009, with pension funds assets reaching the level of 118.3 percent of GDP.

Figure 67: Net real return of pension funds in Iceland, 1999-2009



Source: Iceland Financial Supervisory Authority.

Sustainability concerns

The Icelandic model manages to provide Icelanders with sufficient income and at the same time keeps the state's fiscal burden in check. The growth of pension funds contributed also to the development of Icelandic financial market and, in some cases, started to become too predominant. The performance of the pension funds is linked to the fluctuations in equity markets. As pension funds increase their holdings of equities, they become more volatile. Although, the



10-year average of net real returns in years 1999–2009 amounted to 1.8 percent, the variance was substantial (figure 67). High returns in 2003–06 contrast with periods of negative rates caused by the global downturns in equity prices in 2001 and 2008, amounting to -22.0 percent in 2008. The exceptionally good performance of the funds before the crisis derived partly from high returns on domestic stocks due to privatization of Icelandic banks as well as returns on domestic bonds (thanks to high interest rates). The risk of these fluctuations is mostly borne by the fund's participants.¹² Consequently, the choice of the fund, if possible, may determine future benefits. Due to nature of pension system, allowing customers to switch between funds according to their current performance could pose a threat to the long-term stability of the system.¹³ Finally, it also needs to be underscored that Icelandic model is a hybrid of a defined-contributions/defined benefits-model, thus the risk of falling contributions due to market fluctuations is smaller than in purely defined-contributions model.

In any case, sustainability is a common challenge for most of pension systems across the globe. The Melbourne Mercer Global Pension Index, which rates pension systems according to their adequacy, integrity, and sustainability, did not grant the best "A" grade to any country.¹⁴ Iceland switched to the funded model before issues connected to ageing societies became predominant. The implementation of the funded pension scheme in 1970s happened early enough to avoid substantial decreases in benefits.

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Notes

- 1 According to the OECD methodology, it measures the relationship between incomes in and out of work.
- 2 In line with the OECD definition, pension wealth denotes the present value of the lifetime flow of pension benefits.
- 3 In terms of the means-testing component.
- 4 The public pension scheme incorporates a basic and supplementary pension, both means tested. Earnings include pensions from other sources. However, the level at which the supplementary pension is reduced, is substantially higher than for other income sources.
- 5 The mandatory character of the schemes was introduced in 1974 for wage earners and in 1980 for the self-employed.
- 6 Minimum contribution to the occupation schemes is set at 12 percent of earnings (employer – 8 percent, employee – 4 percent).
- 7 There is a high change in wealth from working between 60 and 65. On the other hand, future benefits decrease by 7 percent for each year of early retirement.
- 8 OECD34 consists of Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherland, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.
- 9 Around US\$0.6495 billion (according to the exchange rate quoted by Bloomberg, April 11, 2011).
- 10 From 1986 it is obligatory for the pension funds to buy some share of bonds issued by the Housing Financing Fund (formerly the State Housing Fund). In 2004 pension funds held 41 percent of all housing bonds issued by the HFF.
- 11 The compromise was reached between the government and pension funds, allowing a debt reduction for worst positioned households of up to 70 percent of the property value.
- 12 The character of the risk bearing depends on the type of the funds. In case of the employer-guaranteed funds, it is the employer who bears the investment risks, while the participants of the private funds share the investment risk collectively.
- 13 Due to differences in benefit rules across the funds (e.g., linear benefit formula versus age-related formula).
- 14 Iceland is not taken into account in the Mercer ranking.