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INTERNATIONAL SOCIAL SECURITY ASSOCIATION

ISSA Adequacy Project

User Manual for Retirement Adequacy Model

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The ISSA adequacy tool: User manual

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This manual sets out how the model works and the steps required to complete it.

Overview of project and tool

The definition of what is an adequate benefit has often been focused on one measure – the replacement ratio – but given the multiple aims of social security, this can be considered as too narrow. The International Social Security Association (ISSA) has developed a quantitative tool which defines and assesses a multi-variable measure of adequacy. By attempting to measure all aspects of benefit provision – such as labour market aims, security of benefits and interaction with other stakeholders and their benefit provision – the project seeks to broaden the debate and place a value on other elements of provision.

The tool described below has been developed by the ISSA Secretariat with input from the Swedish Institute of Social Research and the Technical Commission for Policy Analysis and Research at the ISSA. The pilot stage of the project seeks to ‘run’ the model by assessing the retirement benefit adequacy of a number of selected social security schemes. This phase also allows feedback from the participating pilot schemes on the model and to comment on its relevance and to suggest elements that can be refined or improved. We thank you for your participation. The results of this pilot phase will be presented in a report in late 2013.

Definition of retirement benefit adequacy and how the model works

The measurement chosen to assess retirement benefit adequacy under the ISSA project consists of seven parameters or criteria that attempt to capture the different aspects of adequacy and the objectives of a retirement benefit system. These criteria are:

1. Benefit levels
2. Exiting labour market at the correct age
3. Administrative adequacy
4. Interaction with other retirement provision
5. Intergenerational equity and the sustainability of adequacy
6. Security of adequacy
7. Coverage

Simon Brimblecombe

These seven parameters aim to represent some of the different aspects and objectives of adequacy, at both an individual and society level. They provide a tool to more fully consider the different aspects of retirement policy and how this policy is put in practice. However they should not be considered as neither definitive nor exhaustive measures. The parameters chosen are also driven by the availability and comparability of data. The aim of the ISSA project is to provoke debate and discussion surrounding the issue of adequacy.

For each **parameter**, a number of measures or **indicators** are adopted to assess adequacy under each criterion. By definition, these are proxy measures and their choice is driven by the availability of data, objectiveness and ease of comparison. For each indicator, possible sources are suggested in the accompanying spreadsheet. We invite you to use whichever source you judge as being the most appropriate (i.e. including national and other sources not cited in the spreadsheet) but please cite the source used when completing the spreadsheet.

The score for each parameter is determined by the total of the individual scores of each indicator multiplied by the **weighting** given to each indicator. An **example** score for a fictional retirement system is set out under each indicator described below. Although a default weighting placed on each of the four elements is included in the model, this weighting can also be adjusted to reflect an individual's country view on intergenerational equity and other influencing factors.

Please complete the spreadsheet with the scores for each indicator. The spreadsheet will calculate the total score for each parameter and automatically determine the spider graph overall score. Desired parameter scores can also be entered which allows gap analysis to be performed. More details of the parameters, indicators and scoring are now set out below.

Seven parameters defining adequacy and indicators to assess them

1. Benefit levels

Rationale for parameter and indicators used

This element is measured through replacement ratio calculations and the level of home ownership in a country. The replacement ratio used aims to reflect the level of benefit payment as a percentage of the last salary and in theory comparison across countries and across time is facilitated.¹ The scoring assumes that a replacement ratio of between 60 and 80 per cent is adequate. In reality, this will depend on income levels. For example, a person earning the national minimum wage will need a higher replacement ratio than someone earning three times the national average earnings. In addition, the use of replacement ratio is a proxy measure. In theory, the adequacy of cash payments should be assessed against the ability to use these to purchase a basket of goods and services. The parameter consists of three indicators measuring prospective adequacy (for those entering the workforce today), current adequacy (the adequacy of those retiring today) and recent adequacy (those having retired in the last ten years). Gross replacement ratios are used due to availability of data issues. The aim of including home ownership is to reflect that the ownership of accommodation in retirement reduces the need for pension. Again this is a general indicator (for example, it should in theory reflect ownership rates for pensioners as well as the amount of debt

¹ In reality, the situation is clearly more complex and should be compared across different income levels and also different situations (e.g. shorter working careers). The issue of inequality in adequacy will be the subject of a future research project.

outstanding but this data is not widely available so that overall home ownership rates can be included if ownership rates among retirees is not available).

Indicators

1.1. A prospective measure of adequacy

This should be calculated assuming current benefit rules (including future changes already agreed) for those who enter the workforce today and until they retire. This should be determined on a unisex basis (50:50 weighting).

Suggested weighting: 35

Scoring this indicator: Gross pension at normal retirement as percentage of gross median salary. A result of 60 – 80 per cent is scored at maximum (35) points with a score reduction of 1 for each 1 per cent below or above this.

Example: A man entering the workforce today is projected to receive a pension of 62 per cent of final salary and a woman 50 per cent at normal retirement. The unisex replacement ratio is thus 56 per cent and is scored at 31 (35 minus 4).

1.2. A current measure

A current measure is a calculation of gross replacement ratios for those retiring now as a percentage of salary.

Suggested weighting: 35

Scoring this indicator: Gross pension at normal retirement as a percentage of gross median salary at retirement. Scored at 35 points for a replacement ratio of 60 – 80 per cent with reduction of 1 for each 1 per cent below or above this.

Example: A male retiree in 2012 (latest data available) has a replacement ratio of 50 per cent and a female 44. The unisex replacement ratio is 47 per cent scoring 22 points (35-13).

1.3. Home ownership rates

Suggested weighting: 10.

Scoring this indicator: Calculated as the percentage home ownership rate amongst the adult population divided by 10.

Example: Home ownership rates are 61 per cent of the adult population scoring 6 points.

1.4. A backward-looking measure of adequacy

Determined as recent gross pension income (in last decade) as a percentage of gross salary for those close to or at retirement.

Suggested weighting: 20.

Scoring this indicator: Calculated as the gross median income of those aged 65 to 74 compared to gross median salaries of those aged 50-59 as a proxy of adequacy levels over the

last decade. If more accurate or relevant statistics are available (e.g. salaries for those aged between 55 and 64), then please use these. Scored at full points for 50-70 per cent + reducing by 1 point for each 1.5 per cent reduction.

Example: The gross median income of those aged 65 to 74 compared to 55 to 64 years is 55 per cent scoring 20 points.

Total score for Parameter 1 of 79.

2. Exiting labour market at the correct age

Rationale for parameter and indicators used

This parameter reflects the role of the retirement system in supporting objectives regarding labour market policies and in particular whether workers leave employment at the appropriate age. Whilst objectives will depend on the state of the labour market and also a value judgement regarding appropriate ages of retirement, the parameter is important as it attempts to assess how retirement systems interact with the behaviour of employees at and close to retirement.

Indicators

2.1. Supporting late retirement: Can a pensioner receive pension and continue to work?

Suggested weighting: 30.

Scoring this indicator: Simple yes / no response (scores 30 in the former case and 0 in the latter case).

Example: it is possible to receive pension and continue to work earning 30 points.

2.2. Are Early and Normal Retirement Age consistent with labour market exit age?

Suggested weighting: 20.

Scoring this indicator: Calculated by (Retirement age – Effective labour market exit age). Score determined according to difference on the following scale:

(0-1-> 20; 1-2->18; 2-3->16 etc.).

Example: Retirement age of 65 for men and women, average labour market exit age is 61.2 years scoring 14 points.

2.3. Retirement system supports late retirement: ability for a pensioner to defer pension and the terms on which this can be done

Suggested weighting: 20.

Scoring this indicator: Assessed by considering whether someone can defer retirement pension and whether the additional years of service are translated into a higher pension according to the benefit formula (i.e. part of pension linked to service). Scored by considering two elements:

1. Can defer pension awarded 7 points; partial deferral² additional 3 points (total 10).
2. Score of 10 for 1:1 (or better) correspondence between per cent additional service and per cent additional pension. If there is a maximum number of years of 40 years or more required for a full pension and if service is below this the pension is reduced pro-rata then this also counts as additional pension for additional service.

Example: 1. deferral of pension possible but not partial (i.e. have to take all or nothing), scores 7 points. 2. 45 years needed for full pension, with reduction for less years of service, scores 10 points. Total 17 points.

2.4. Retirement systems support retention of working population close to retirement age

Suggested weighting: 30.

Scoring this indicator: Pro rata of employment rates for those aged from 55 to 64 as a proportion of employment rates of those aged between 15 and 64. Scores maximum of 30 points for 1:1 or more; pro-rata for less than 1:1.

Example: Employment rate of 30 per cent of 55-64 year olds compared to 60 per cent for 15 to 64 year olds. Scores 15 points.

Total score for example for parameter 2:76.

3. Administrative adequacy

Rationale for parameter and indicators used

This element reflects the fact that if benefits are easy to access (e.g. a minimum of form filling) and provided in an efficient way, then this increases both the perception and the reality of an adequate benefit. This administrative adequacy is assessed using a number of criteria which aim to reflect how specific measures support adequacy.

Indicators

3.1. Benefits paid on a regular basis

Suggested weighting: 30.

Scoring this indicator: Two elements are used to assess points:

1. proportion of benefits paid on time (within 2 weeks) out of total (90 per cent scores 25 points then 1 point reduction for each percentage less);
2. existence of goals for average waiting time or deadline for benefit payments scores 5 points.

Example: Objectives regarding waiting times for payment of benefits exist (5 points) and 70 per cent of benefits are paid on time (5 points) scoring 10 points in total.

² Partial deferral refers to the situation when the individual can take part of the pension income now (eg 50 per cent) and defer the remaining part for payment at a future date

3.2. Can additional contributions be paid to increase benefit levels?

Suggested weighting: 10.

Scoring this indicator: Yes/No indicator only (10 points for yes; 0 points for No).

Example: It is not possible to pay additional contributions (0 points).

3.3. Information provided to individual to allow old age planning

Suggested weighting: 30.

Scoring this indicator: Five points are awarded for each time Yes answer to the following questions:

1. do you provide individual records to each participant?;
2. are records available via Internet?;
3. are individual records provided by regular mail at least once a year?;
4. do you provide a benefit statement to each beneficiary?;
5. are these available via internet?;
6. are they sent at least once a year by regular mail?

Example: 4 yes answers scoring 20 points.

3.4. Accessibility of benefit provision and contribution agencies

Suggested weighting: 20.

Scoring this indicator: Five points are awarded for each time Yes answer to the following questions:

1. can participants and beneficiaries be received at an office / client service centre?;
2. do you have goals for average waiting times?;
3. it is possible to be received by appointment?;
4. can beneficiaries contact the organisation by mail, phone and e-mail?

Example: organisation does not have average waiting time goals but allows beneficiaries to contact the organisation, make an appointment and be received at an office, scoring 15 points.

3.5. Number of documents required to claim pension

Suggested weighting: 10.

Scoring this indicator: Less than 8 documents scores 10 points reducing by 1 point for each additional document required from 8 and above.

Example: 12 documents required, scores 5 points.

Total score for parameter 3 is 50 points.

4. Interaction with other retirement provision

Rationale for parameter and indicators used

Beneficiaries do not necessarily distinguish between the different sources of benefit payments, but are instead interested by the total benefit received. Therefore this parameter seeks to assess how social security benefits are consistent with other retirement benefits provided. This is one of the hardest parameters to measure and the overall replacement ratio from first, second and third pillar is used (with the same caveats applying to the use of replacement ratio cited in parameter 1).

Indicators

4.1. Social security and supplementary pension provision (both compulsory and voluntary)

Suggested weighting: 70.

Scoring this indicator: Total prospective replacement ratio from both sources consistent with target benefit - scored maximum for benefit between 60 and 90 per cent. Lose one point for each per cent above or below this range. Note that second pillar includes both compulsory and average voluntary provision.

Example: Total pension received for an average earner entering the workforce now and retiring at normal retirement age is 40 per cent from social security and 15 per cent from voluntary supplementary provision making a total of 55 per cent and scoring 65 points.

4.2. Spouse's benefits provided on death of pensioner or independent entitlements exist

Suggested weighting: 20.

Scoring this indicator: Existence of spouse's benefit on death of pensioner at a rate at least equal to 50 per cent of the level of the pension paid to the retiree at date of death), supplement to pension for dependant survivors or individual entitlement with credit for non-working time Score 20 if one element, 10 if two of the three elements and 0 if all elements are provided.

Example: Spouse's benefit of 60 per cent of pension payable (and no other elements), hence 20 points scored.

4.3. Existence of third pillar / individual pension savings vehicle

Suggested weighting: 10.

Scoring this indicator: Third pillar individual pension savings which effectively covers at least 10 per cent of the working population (ie actual contributing members considered not legal coverage).

Example: Although third pillar individual savings vehicles exist, only 5 per cent of the working population contribute. Therefore no points scored.

Total score for Parameter 4:85 points.

5. Intergenerational equity and sustainability of benefit adequacy

Rationale for parameter and indicators used

This measure seeks to address the issue of sustainability through the lens of intergenerational equity. The reason for this approach is twofold: firstly, because an assessment of whether current levels of adequacy are likely to be sustainable in the longer term is subjective and difficult to measure without an understanding of other public spending commitments and the overall size, growth and characteristics of the economy. For example, a pension expenditure of 12 per cent of gdp may be considered as sustainable if other government expenditure is lower or if society has a view that this is an appropriate spending level on pensions.

Secondly because sustainability is dynamic; what may not be sustainable today, may be in 30 years with appropriate reform measures implemented. For example, pension expenditure of 10 per cent of gdp may be more sustainable in one country which is ageing relatively slowly compared to a rapidly ageing country with current pension expenditure of 9 per cent. This measure of adequacy therefore does not seek to place a judgement on what a system is doing, but indicates simply any possible inconsistency between the cost of benefits and the financing mechanisms. Where this exists, it has implications for intergenerational equity.

Indicators

5.1. Increase in Dependency ratio from 2010 to 2050

Suggested weighting: 25.

Scoring this indicator: Dependency ratio is calculated as population over retirement age as a proportion of working age population. Indicator scored by comparing result in 2050 to that of 2010 : no change in ratio scores 15; reduction of +/- 2 per cent scores +/- 1 point.

Example: dependency ratio of 20 per cent in 2010 and 30 per cent in 2050 scoring 10 points ($15 - (10/2)$).

5.2. Increase in public pension spending 2010-2050

Suggested weighting: 25.

Scoring this indicator: Assessed by calculating change in public pension spending from 2010 to 2050 as a per cent of gdp. Scored as no change = 15; reduction of +/- 2 per cent relative scores +/- 1 point up to a maximum of 25 points for a reduction of 20 per cent and 0 points for an increase of 30 per cent of pension expenditure as a per cent of gdp from 2010 to 2050.

Example: public pension expenditure of 10 per cent of gdp in 2010 and 14 per cent in 2050. Increase of 40 per cent scoring 0 points ($15 - (40/2)$).

5.3. Normal retirement age correlated with life expectancy

Suggested weighting: 20.

Scoring this indicator: Life expectancy from retirement age (12-20: 10 points - maximum; from 20 upwards and 12 downwards: -1 for each additional year). Calculation performed for both 2010 and 2050.

Example: Normal retirement age of 65. Life expectancy of 22 (unisex) from age 65 in 2010 (8 points) and 25 projected in 2050 (5 points). Total 13 points.

5.4. Dependency ratio (absolute) at 2010 and 2050

Suggested weighting: 30.

Scoring this indicator: 10 per cent scored as 30 points; each 2 per cent above scores 1 point less down to 0 at 70 per cent. Calculated for 2010 and 2050 and weighted 50:50.

Example: Scores 23 points (see indicator 5.1 – 20 per cent dependency ratio in 2010 scores 25; 30 per cent dependency ratio in 2050 scores 20. Average scores of 22.5).

Total score for parameter 5 is 46 points.

6. Security of adequacy

Rationale for parameter and indicators used

Social security systems provide benefits and services at a time when people are or become particularly risk averse. In addition, when payment is made, the risk appetite changes and, more importantly, the ability to manage risk reduces. This should be taken into consideration in the design and delivery of benefits and in the assessment of adequacy. Risk in life can be retained, reduced or / and transferred; but when sick or in retirement, a person's ability to reduce and transfer risk is significantly reduced. This means a greater proportion of risk must be retained. It is important therefore that social security systems provide benefits that take this into account.

This element of the ISSA adequacy measure therefore assesses the level of security in the benefits and services provided. Behind this is a recognition that, given the choice of:

- a guaranteed benefit of 100; or
- a benefit expectation of 110 with an outcome probability of 70 per cent and a benefit of 80 with a 30 per cent probability.

Many will prefer the former option even though the average expected benefit in the second case (101) is higher.

But this issue is important not only when benefits are paid. In order to properly plan for retirement (and other life events), a person benefits greatly from knowing the likely benefits that he or she will receive. For example, if from age 50 he or she knows to expect a benefit of 50 to 70 per cent of final salary, then other life decisions can already be made (e.g. preparation for part-time working, the need for voluntary savings, etc.). Risk transfer tools are also more accessible at earlier ages. This aspect is also reflected in the Administrative Adequacy measure.

Traditionally, this issue may not have been considered as important given the structure of benefits (typically, defined benefit) and relative importance (in many countries, the major source of benefit income) of social security benefits. However with a number of pension

reforms moving to a mix of financing sources for retirement benefits as well as a move to Notional Defined Contribution provision for social security and the use of automatic adjustment mechanisms, this element is becoming increasingly important. At the same time, even under traditional defined benefit systems, governments have changed rules (e.g. indexation of pensions in payment) leading to a reduction in the certainty of benefit payments. The assessment of “security” of adequacy therefore takes these factors into account.

Indicators

6.1. Whether there is defined benefit provision for all or part of benefit provision

Suggested weighting: 10.

Scoring this indicator: 10 points if all benefit is Defined Benefit; sliding scale down to 0 if all Defined Contribution or Notional Defined Contribution. Where both defined contribution and defined benefit elements are part of benefits, the score should reflect approximate weight of each element in total benefit provided.

Example: All defined benefit provision, scores 10 points.

6.2. Historic variability of average pension

Suggested weighting: 20.

Scoring this indicator: Determined by comparing pension increases with inflation over the last five years of which data available. Score of 20 if the ratio of increases to price inflation exceeds 1.1 then sliding scale losing 1 point for each 3 per cent reduction. Bonus of 5 points if automatic pension increases (i.e. set out in law or regulations that pensions increase automatically in line with a specified index).

Example: Cumulative pension increases of 15 per cent compared to cumulative inflation of 20 per cent scoring 9 points $(20 - (110-75)/3)$.

6.3. How benefit is affected if beneficiary misses 10 years of service

Suggested weighting: 20.

Scoring this indicator: Assessed by calculating the difference between replacement ratio on full career and replacement ratio on full career less 10 years. Score 20 if less than 10 per cent difference then sliding scale (each 1 per cent loses 1 point).

Example: Replacement ratio on full career of 70 per cent and on full career less 10 years of 50 per cent scores 10 points.

6.4. Pension amount payable on low income

Suggested weighting: 20.

Scoring this indicator: Assessed by determining unisex prospective replacement rate on half times average earnings. If result is below 60 per cent, score of 0 then score increasing by an additional one point for each 2 per cent above.

Example: replacement ratio of 75 per cent for a retiree on half times average earnings; score of 7.

6.5. Whether pension or lump sum paid

Suggested weighting: 10.

Scoring this indicator: 10 points for 100 per cent of benefit paid in pension; then sliding scale on a pro-rata basis. Note the proportion of lump sum is determined by the proportion of benefit that can be taken in that form even if a pensioner decides to take all benefit in pension form.

Example: 25 per cent of benefit can be taken in lump sum, score of 8 points (7.5 rounded up).

6.6. Can benefit be reduced depending on external factors (including automatic adjustment mechanisms)?

Suggested weighting: 10.

Scoring this indicator: Simple Yes (score 0) or No (10 points) possibility.

Example: Such mechanisms do not exist: scores 10 points.

6.7. Sharing of financing burden

Suggested weighting: 10.

Scoring this indicator: Score maximum if employee and employer contribute at least 50 per cent of estimated cost.

Example: Employee and employer pay a contribution rate of 12 per cent of salary each. Score 10 points.

Total score for parameter 6:64 points.

7 Coverage levels

Rationale for parameter and indicators used

Given that an assessment of the adequacy of a retirement system should be considered also at a society level, then coverage levels are an essential measure of whether a system meets its objectives. This should be considered not only for those in the formal sector but for those in the informal sector and for specific groups (the self-employed, those on career breaks, etc.). Eligibility conditions can also be judged as a coverage criterion. In the ISSA adequacy project, this variable is measured through both the legal coverage of active workers as well as the effective coverage (assessed as active contributors as a percentage of the economically active population and the share of those over pension age receiving benefits).

Indicators

7.1. Legal coverage of active workers

Suggested weighting: 30.

Scoring this indicator: Estimate of the number of persons covered by law for an old age pension under social security as a percentage of the working age population.

Example: 60 per cent of the working age population covered by law scores 18 points.

7.2. Active contributors to a social security old age benefit (Effective coverage)

Suggested weighting: 30.

Scoring this indicator: Active contributors as a percentage of economically active population. Scores maximum for more than 90 per cent effective coverage then on a sliding scale of -1 point for each 2 per cent below.

Example: effective coverage of 60 per cent scores 15 points (30 – 15).

7.3. Effective coverage of pensioner population

Suggested weighting: 20.

Scoring this indicator: Share of population above the statutory pensionable age benefiting from an old-age pension. Scores maximum points for more than 90 per cent then on a sliding scale of -1 point for each 3 per cent below.

Example: effective coverage of 70 per cent scores 14 points (20 – 6).

7.4. Coverage of self-employed and migrant workers

Suggested weighting: 10.

Scoring this indicator: Legal coverage of migrant workers and the self-employed. Scored as 5 points if self-employed can join and 5 points if migrant workers are covered (after a vesting period of no more than 2 years).

Example: Voluntary coverage for the self-employed (5 points) and migrant workers covered (5 points) scoring a total of 10 points.

7.5. Other conditions for eligibility

Suggested weighting: 10.

Scoring this indicator: Minimum vesting / service requirement of 1 year or less scores 10 points then reducing on a sliding scale on a 1:1 basis down to 0 for 10 years required.

Example: 5 years required scores 5 points.

Total score for parameter 7:62.

Summary of model

Table 1 below summarises the indicators used for the different parameters representing adequacy in the ISSA adequacy model as well as the example scores.

Table 1: Summary of ISSA Adequacy Measure for Retirement Benefits

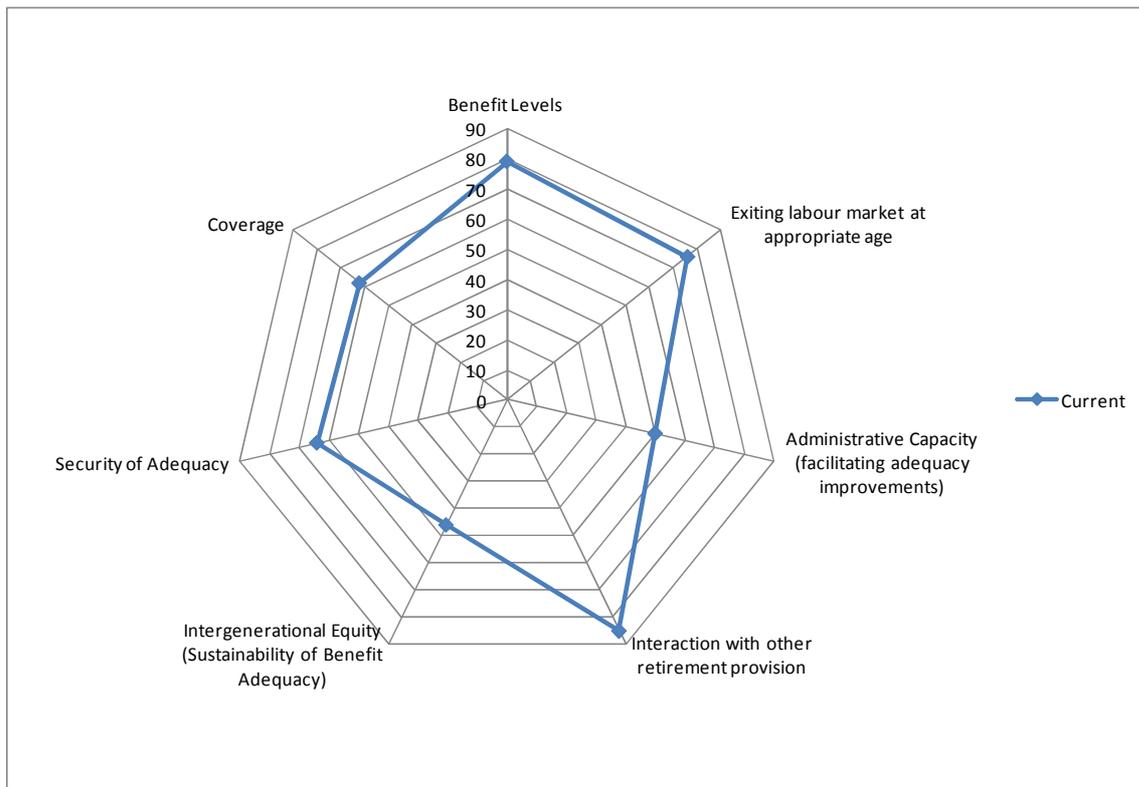
Parameter	Indicators used	Example Score
1. Benefit Levels	1.1. Prospective replacement rate 1.2. Current replacement rate 1.3. Home ownership rates 1.4. Historic replacement rate	79
2. Exiting labour market at correct age	2.1. Supporting late retirement: Can a pensioner receive pension and continue to work? 2.2. Are Early and Normal Retirement Age consistent with labour market exit age? 2.3. Retirement system supports late retirement: ability for a pensioner to defer pension and the terms on which this can be done 2.4. Retirement systems supports retention of working population close to retirement age	76
3. Administrative Adequacy	3.1. Benefits paid on a regular basis 3.2. Can additional contributions be paid to increase benefit levels 3.3. Information provided to individual to allow old age planning 3.4. Accessibility of benefit provision and contribution agencies 3.5. Number of documents required to claim pension	50
4. Interaction with other retirement provision	4.1. Social security and supplementary pension provision 4.2. Spouse's benefits provided or independent entitlements exist 4.3. Existence of third pillar / individual pension savings vehicle	85
5. Intergenerational Equity (Sustainability of Benefit Adequacy)	5.1. Increase in Dependency ratio 2010 – 2050 5.2. Increase in public pension spending 2010-2050 5.3. Normal retirement age correlated with life expectancy 5.4. Dependency ratio (absolute) at 2010 and 2050	46
6. Security of Adequacy	6.1. Defined Benefit provision for all or part of benefit 6.2. Historic variability of average pension 6.3. How benefit is affected if beneficiary misses 10 years' service 6.4. Pension amount payable on low income 6.5. Pension or lump sum paid 6.6. Benefit can be reduced depending on external factors (including automatic adjustment mechanisms)? 6.7. Sharing of financing burden	64
7. Coverage	7.1. Legal coverage of active workers 7.2. Active contributors to a social security old age benefit (Effective coverage) 7.3. Effective coverage of pensioner population 7.4. Coverage of self-employed and migrant workers 7.5. Other conditions for eligibility	62

Specimen project output

As part of the pilot project, an assessment of adequacy using the tool will be carried out for a number of different countries' systems. In the manual above, a hypothetical case has been detailed with example calculations. The summary of these results is set out in Table 1 above.

The results can then be expressed in the form of a multi-dimensional spider graph set out below in Figure 1.

Figure 1: Adequacy measure for example case cited above



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