Pension Systems Facing Demographic Challenges in Europe and Central Asia

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Main Messages

• Providing old age security will face challenges given the combination of demographics and system maturation

• Can be done iff:
  – Pensions are provided when people are too old to work
  – Benefit levels are kept modest
  – Labor markets welcome older workers and immigrants
  – Savings are developed to complement public benefits and make them more earnings-related
  – Public finances are consolidated to allow some pension spending to be financed from general revenue, potentially consumption taxes
Structural Break in Growth of Working Age Population Around 2013

High Income Generous Spenders

High Income Moderate Spenders

Ratio of working age population to that in 2013

- Belgium
- Cyprus
- France
- Greece
- Italy
- Luxembourg
- Malta
- Slovenia
- Spain
- Switzerland

- Austria
- Denmark
- Finland
- Germany
- Iceland
- Ireland
- Netherlands
- Norway
- Portugal
- Sweden
- United Kingdom
Structural Break in Growth of Working Age Population

Lower Spending Transition Countries

- Armenia
- Georgia
- Belarus
- Bulgaria
- Czech Republic
- Hungary
- Poland
- Republic of Moldova
- Romania

Ratio of working age population to that in 2013


Higher Spending Transition Countries

- Ukraine
- Bosnia and Herzegovina
- Montenegro
- Serbia
- TFYR Macedonia

Ratio of working age population to that in 2013

While contributors are falling, share of elderly in population is rising

Percentage of Population Above Age of 65 in 2010 and 2050
The Inverting Pyramid: Conjunction of System Maturation with Aging Results in Full Cohorts of Pensioners to Be Supported by Smaller Cohorts of Contributors
When contributors were growing, generosity of the systems grew

Expected Years in Retirement

Belgium: 63, 57, 59
Spain: 71, 64, 63
Sweden: 67, 63, 65

Effective Retirement Ages
- 1970
- 1990
- 2009

Average Pension Compared to Average Wage

Netherlands
- 1957
- 1961
- 1966
- 1971
- 1976
- 1981

Hungary
- 1950
- 1955
- 1960
- 1965
- 1970
- 1975
- 1980
- 1985
- 1990
Countries undertaking all kinds of reforms: Public pensions reforms

- Reforms focused partly on reducing spending
  - Restricted eligibility criteria
    - Raising retirement age
    - Tightening disability conditions
    - Raising years of service requirements
  - Reducing benefits in the long run
    - Basing benefits on full career salary
    - Indexing only to inflation
    - Lowering accrual rate
- Also focused on ensuring poverty prevention through generous indexation of minimum benefits
  - Some adopted by default or by choice for flat, universal benefits, sometimes complemented by savings pillar
- General emphasis on tightly linking contributions to benefits
  - Defined benefit systems based on average lifetime wages; point systems; notional accounts
  - Wanted pension differentiation to match newly differentiated wages
  - Wanted to use incentives to combat informality
Many countries added savings pillars

• 15 out of 30 transition countries adopted second pillar (fully funded defined contribution)
  – Linked benefits to contributions and reduced public pension in long run
  – Mandatory contributions were divided so that one part when to public system and the other to private system
  – Led to larger shortfalls in pension systems in the short and medium run
Retirement ages increased, but duration of retirement generally did not fall.

Source: Eurostat Statistics Database.
Duration of retirement still remains far above 15 years

![Bar chart showing years in retirement for different countries and spending categories](chart.png)
Early retirement is still prevalent

Old age pensioners below age 65, %

Total old age pensioners

Lower Spending Transition Countries

High Spending Transition Countries

Young Countries

Georgia
Lithuania
Armenia
Latvia
Bulgaria
Croatia
Albania
Slovakia
Romania
Belarus
Poland
Russia
Repulika Srpska
Bosnia Federation
Serbia
Kazakhstan
Kyrgyz Republic
Azerbaijan
Turkey

male
female
No clear trend-line of reduced spending per pensioner

Growth in Pension Spending per Elderly Person Relative to Growth in GDP Per Capita, 2001-09
Projected spending in 2060 compared to spending as share of GDP in 2010

Average Spending in 2010 – 9.5% of GDP
And this does not include all costs: The Number of Elderly Eligible for Pensions Are Expected to Fall Due to Informality Among Current Workers
Need more holistic approach

- Pension policy changes are not enough
  - Raising retirement ages without enabling workers to work longer cuts costs, but leaves some workers with an income gap, for example

- Encourage longer working lives through enabling policy environment

- Prioritize public pension spending
  - If there isn’t budget to provide earnings-related pensions for some and poverty relief for all elderly, priorities will have to be set
  - Implications for financing and pension policy design as well as interactions with safety nets

- Increase savings to maintain adequate benefits
  - Instead of focus on second pillar vs. third pillar, focus on savings using mechanisms like automatic enrollment

- Increase fiscal space if possible
Significant room for tapping on the potential for more “active aging”

Potential to increase Labor Force among 45-64 year olds

Data Source: ILO

Source: Based on ILO
Support policies for more Active Aging

Older workers do face barriers when looking for work and to remain productive at work, that can be addressed through:

• **Workplace adaptations** – Encouraging firms to adapt the workplace to fit older workers’ needs (BMW, CVS)

• **Smart tax/labor regulations and social benefits design** – Making them compatible with longer working lives by avoiding incentive “traps” (e.g, seniority wage premia), enabling flexible work, gradual retirement, and addressing barriers (e.g, childcare)

• **Training fit to labor market needs and to aging brains** – Engaging employers to provide more age-sensitive labor training and tap on benefits of age-diverse teams.
Given the demographic challenges, is pension spending efficient?

- Pensions provided and withdrawal from the labor force well below the age of 65
  - Impact both on pension spending and contribution revenues, but also on economic growth
- Pension levels unsustainably high in some cases and too low to be adequate in others
- Survivor benefits sometimes encourage women not to participate in the labor market
  - Affects contribution revenues and economic growth
- Spending does not include spending on noncontributory benefits required to prevent all elderly from poverty
  - Fewer future elderly expected to be eligible to collect pensions
An Example Of Prioritizing Pension Spending and Costing It Out
If Effective Retirement Age Is 65 with Prime Age Labor Force Participation Until Age 64 - 2050
Same Priorities As Before But With Retirement Age Where Life Expectancy Equals 15 Years and Prime Age Labor Force Participation Until Then - 2050

Pension spending, percent GDP

- Basic to all old
- Disability
- Top-up to covered
- Survivor

Countries:
- France
- Slovenia
- Cyprus
- Greece
- Belgium
- Spain
- Italy
- Malta
- Portugal
- Ireland
- United Kingdom
- Norway
- Iceland
- Sweden
- Finland
- Denmark
- Germany
- Netherlands
- Austria
- Albania
- Russian Federation
- Slovakia
- Georgia
- Armenia
- Moldova
- Czech Rep.
- Estonia
- Lithuania
- Belarus
- Latvia
- Hungary
- Bulgaria
- Romania
- Poland
- Croatia
- Bosnia and Herzegovina
- Serbia
- Tajikistan
- Kosovo
- Kazakhstan
- Azerbaijan
- Kyrgyz Republic
- Turkey

FBIH: Republika Srpska

HIGS: HIMS: LSTC: HSTC: YC:
Some of the second pillar reforms were partially or fully undone due to fiscal constraints

- 7 of the 15 countries adopting second pillars temporarily or permanently reduced or eliminated contributions to the second pillar during the financial crisis, with only 3 more permanently moving away from the savings policy.
- Financial crisis reduced contribution revenues due to falling wages and rising unemployment, while pension payments remained the same or even rose:
  - Pension deficits rose.
  - Governments chose to divert contributions from second pillars back to public systems to reduce the deficits in the public systems.
- However, this means that the expected reduction in long-run public pension spending will now not take place.
Transition to a more efficient industrial organization of the pension fund management industry

- Centralize business areas with scale economies
- Create competition in the portfolio management industry along a common default pension portfolio using lifecycle strategies
- Design payout structures that ensure proper risk allocation of investments and longevity risks
- May even consider the introduction of guarantees on the value of the contributions
The role of voluntary pension schemes

• No substantial differences in coverage between auto-enrollment (opt out) and mandatory systems

• Opt out schemes can be instrumental for incentivizing additional retirement savings
  – Non discrimination test to ensure broad participation of workers
  – 2+2+2 (or so) to increase contribution (careful with the default option)
Overall tax burden is already high in most countries

Tax revenue structures, 2011

Percent of GDP

- social security contributions
- other taxes
- taxes on goods and services
- income taxes

Countries listed from left to right:
- Slovenia
- Armenia
- Albania
- Russia
- Georgia
- Lithuania
- Romania
- Estonia
- Latvia
- Slovakia
- Bulgaria
- Moldova
- Poland
- Croatia
- Czech Republic
- Belarus
- Hungary
- Macedonia
- Ukraine
- Montenegro
- Bosnia & Herzegovina
- Serbia
- Azerbaijan
- Tajikistan
- Kosovo
- Kyrgyz Republic
- Kazakhstan
- Turkey
Consolidation of pension finances within overall public finance framework

- Tax reform options mainly involve shifts from labor taxes to property and to a lesser extent consumption taxes, by
  - Strengthening incentives by cutting marginal rates especially for low wage earners
  - Strengthening administration and compliance
- Take decisions on components of pension policy that could be tax-financed rather than contribution-financed, rather than allowing deficits to spill over into general revenue
  - Social pension, minimum pension, disability benefits, for example
- Need for fiscal consolidation and prioritization
  - Pension expenditures will begin to squeeze out other fiscal spending
  - Look for savings where they can be found
Bottom Line: It Is Possible To Provide Old Age Security Even With Challenging Demographics!

• Will need some changes in expectations

• Future may be more like past in one of two ways:
  – Pensions given when people are too old to work
  – Pensions only guarantee poverty prevention

• In both cases, savings will play a central role, in the first to enhance benefits and in the second to provide earnings-related benefit

• Labor markets will also need to adapt to older workers
  – Allow more flexibility (part-time work, combine work and retirement, moving away from wages based strictly on seniority)
  – Workplace adaptations to accommodate older workers
  – Lifelong learning with training programs designed for older brains