



# Pension Systems Facing Demographic Challenges in Europe and Central Asia

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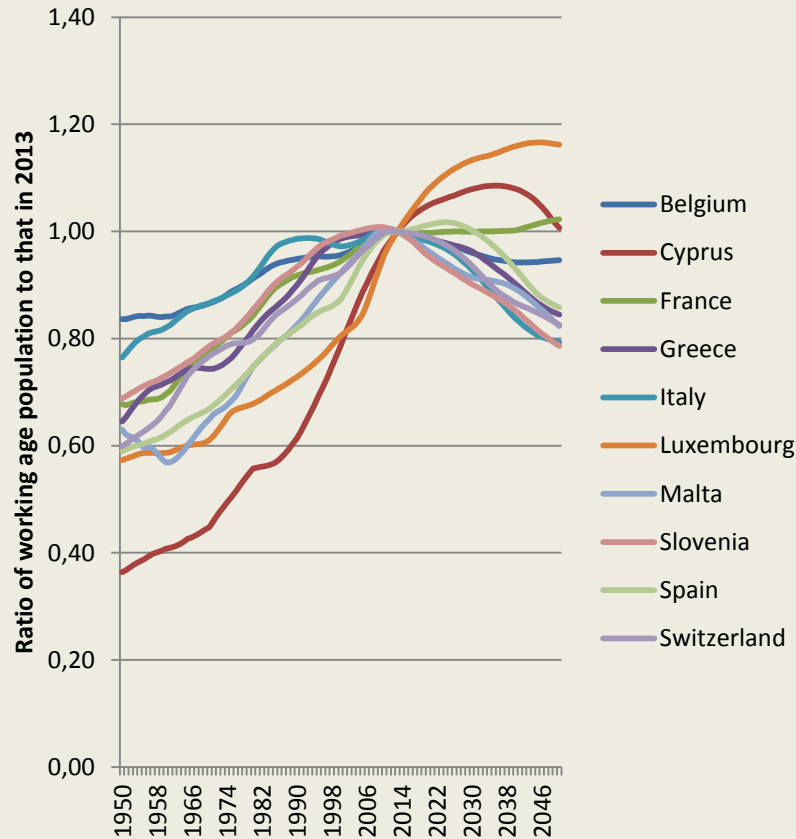


# Main Messages

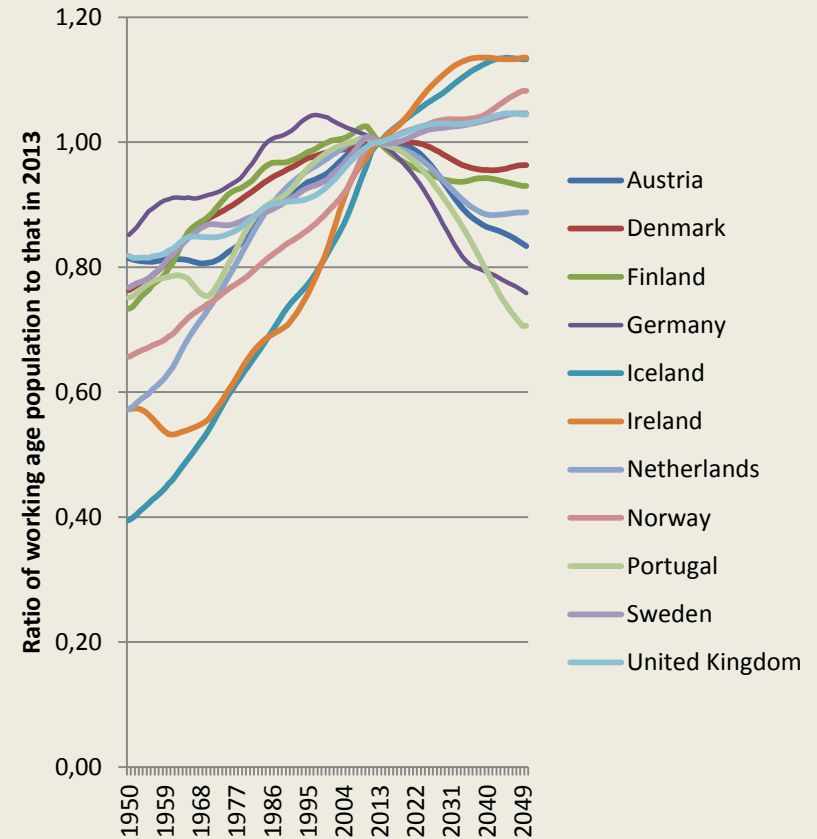
- Providing old age security will face challenges given the combination of demographics and system maturation
- Can be done if:
  - Pensions are provided when people are too old to work
  - Benefit levels are kept modest
  - Labor markets welcome older workers and immigrants
  - Savings are developed 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



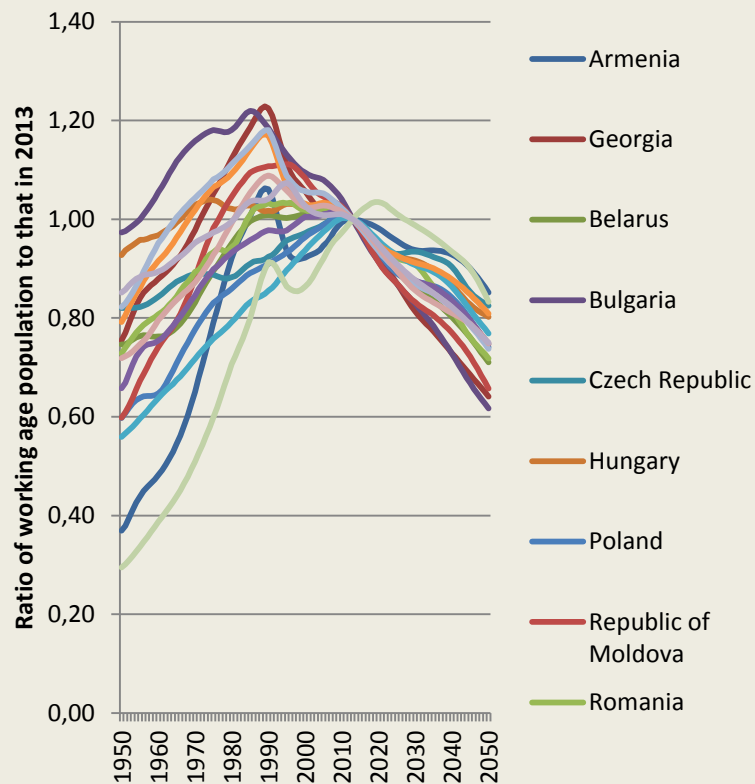
## High Income Moderate Spenders



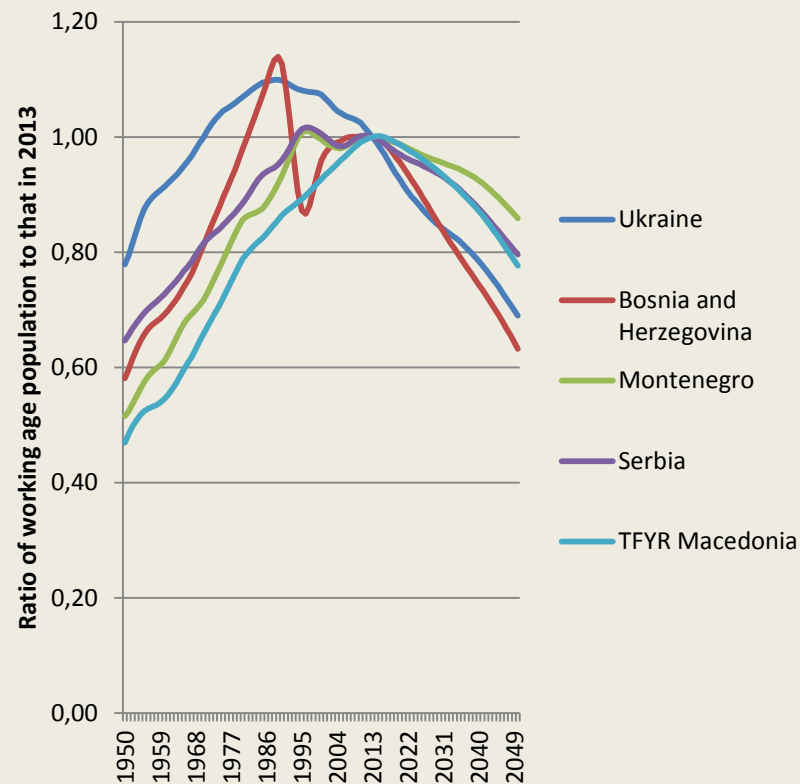


# Structural Break in Growth of Working Age Population

## Lower Spending Transition Countries



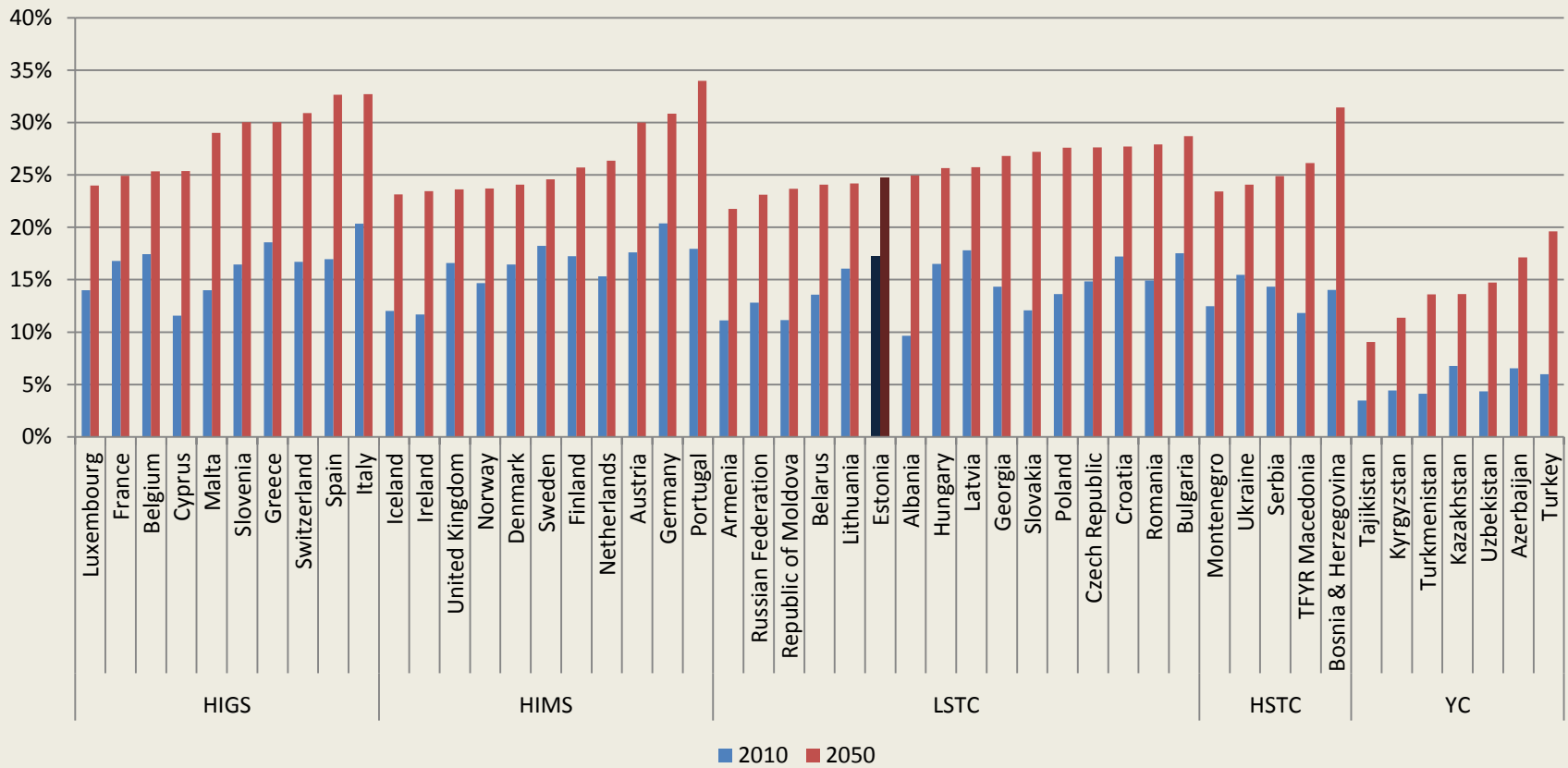
## Higher Spending Transition Countries





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

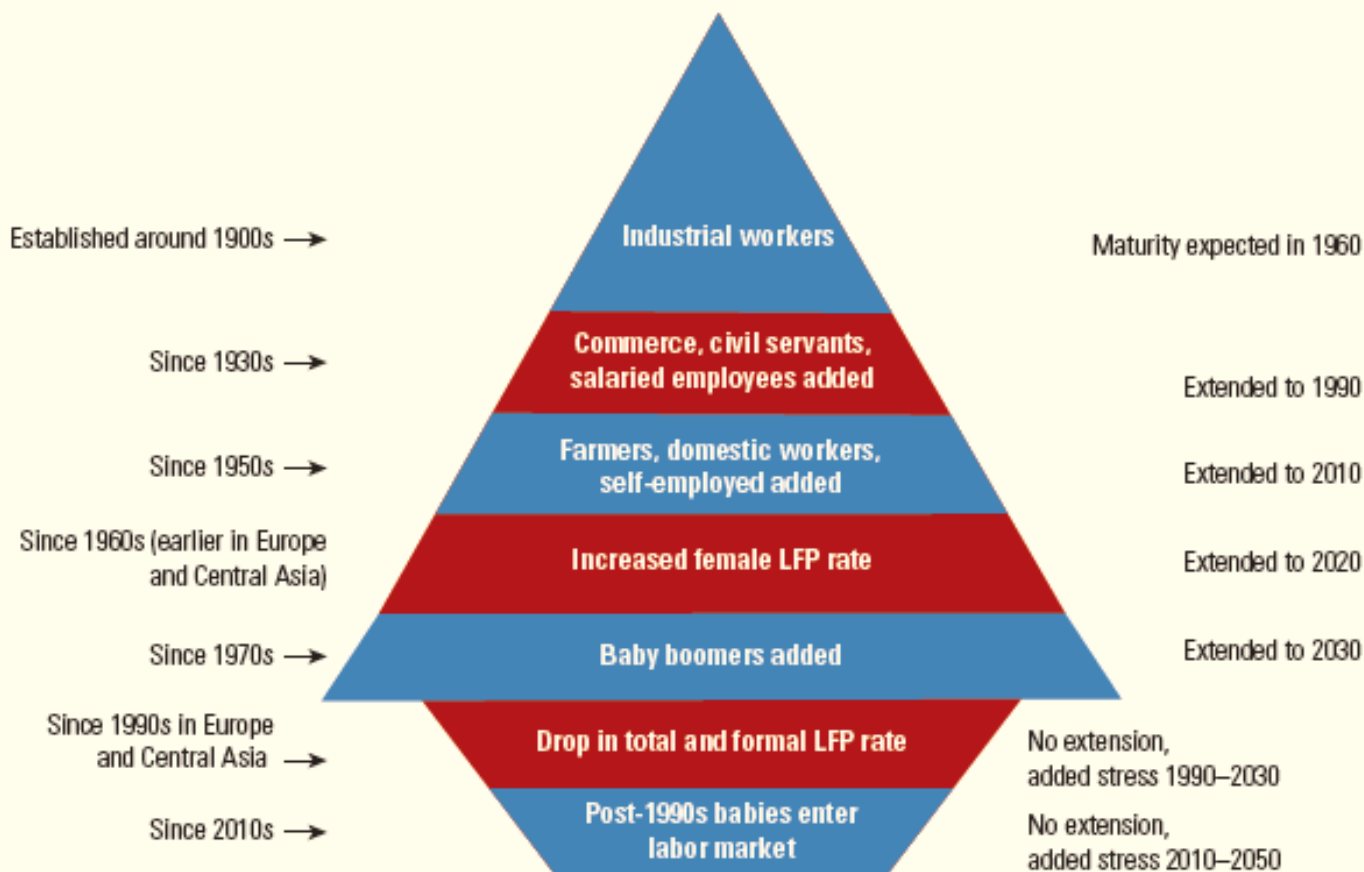
## Percentage of Population Above Age of 65 in 2010 and 2050





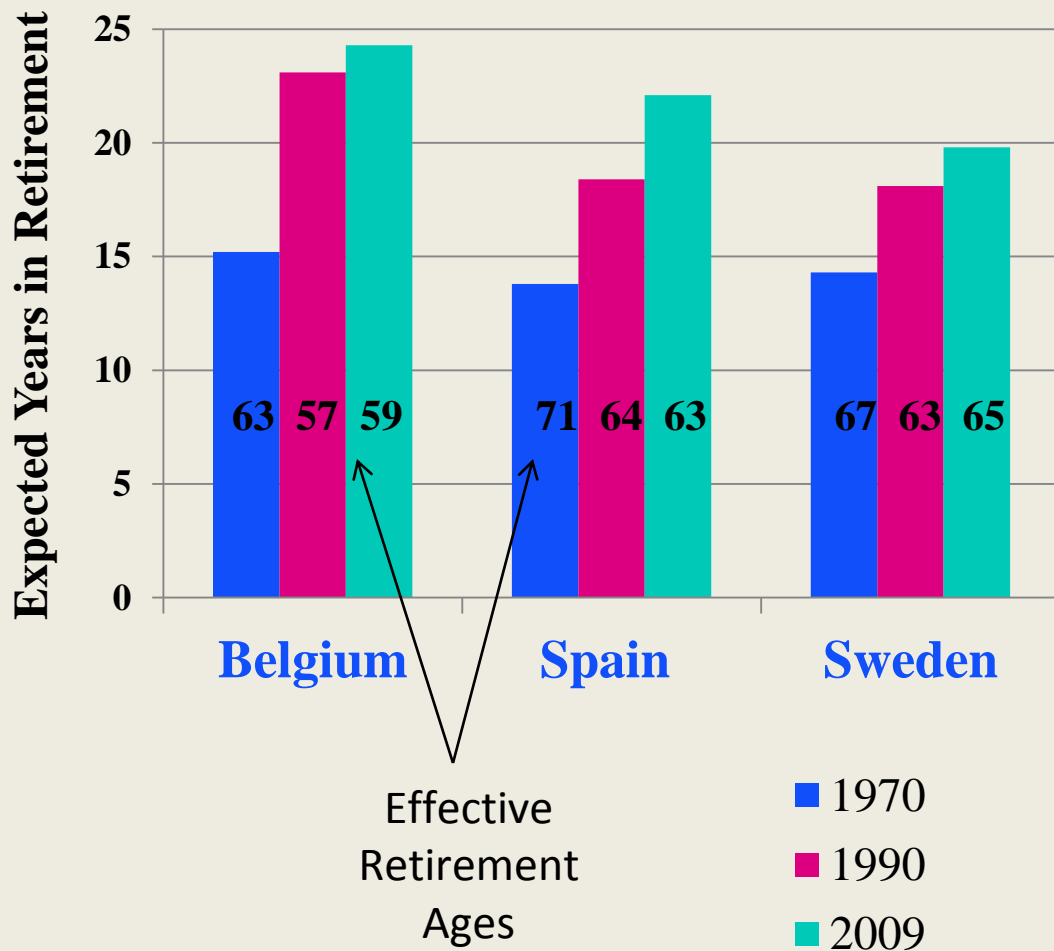
# The Inverting Pyramid: Conjunction of System Maturation with Aging Results in Full Cohorts of Pensioners to Be Supported by Smaller Cohorts of Contributors

## Extension of Coverage and Its Impact on Pension Systems in Europe and Central Asia, 1900s through 2050

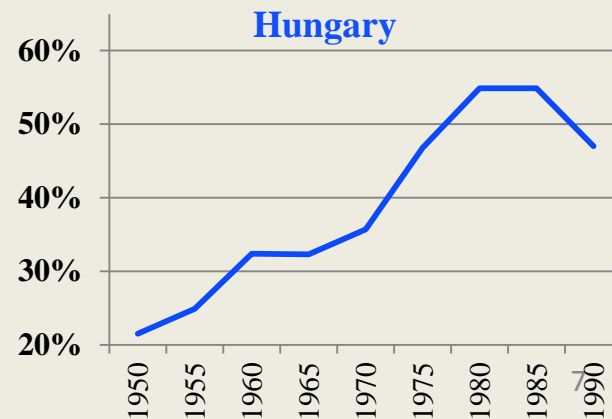
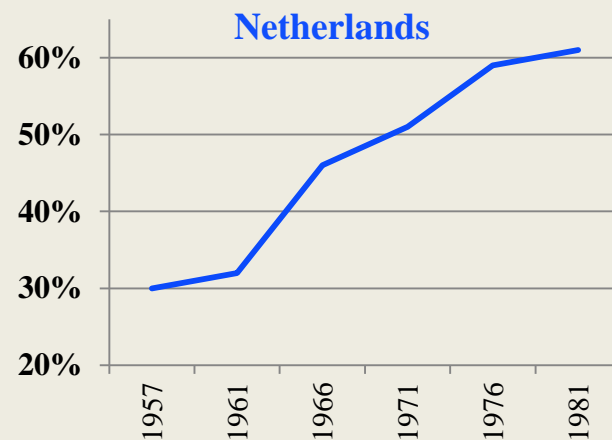




# When contributors were growing, generosity of the systems grew



## Average Pension Compared to Average Wage





# 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



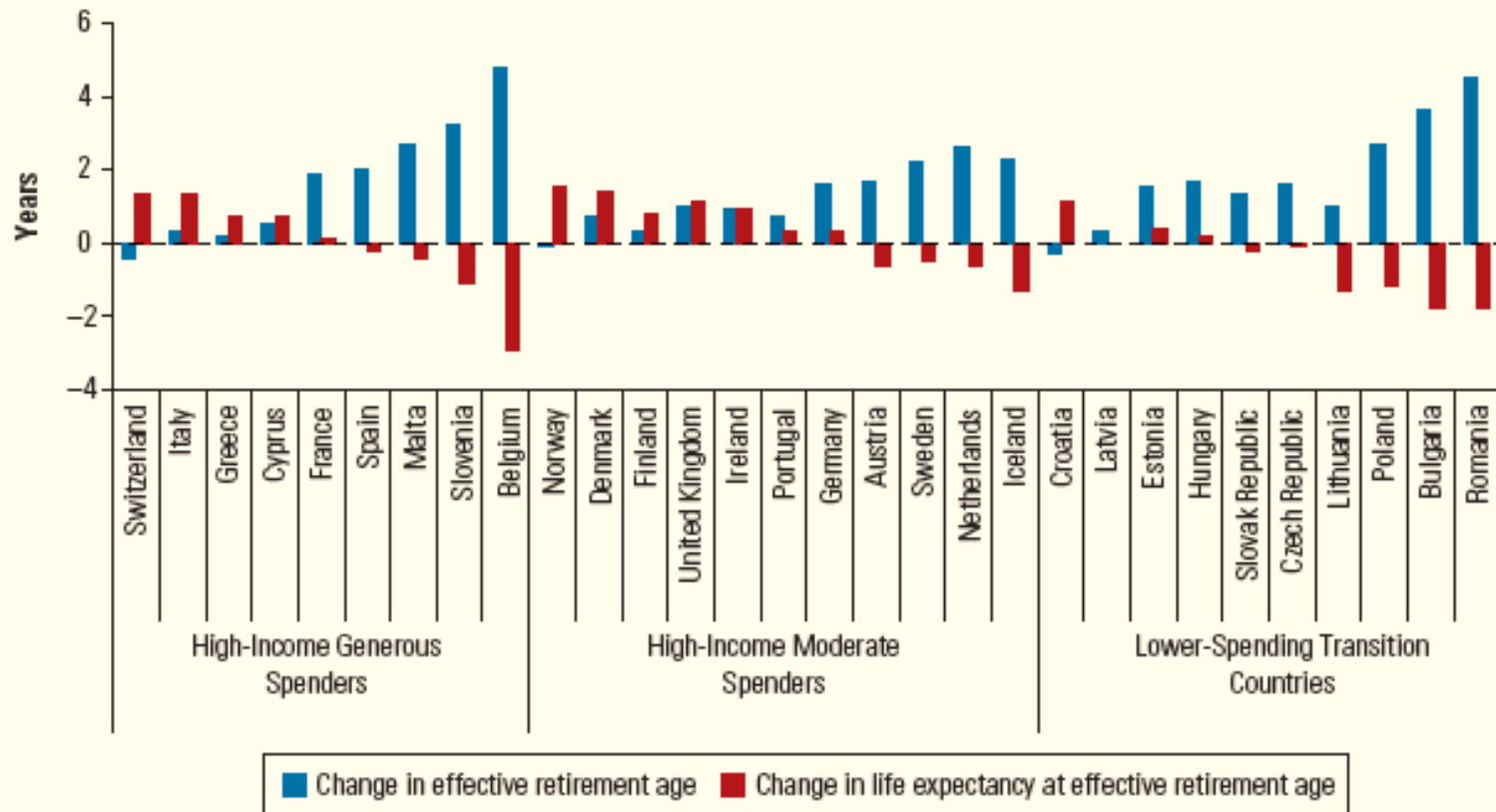
# Many countries added savings pillars

- 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 went 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

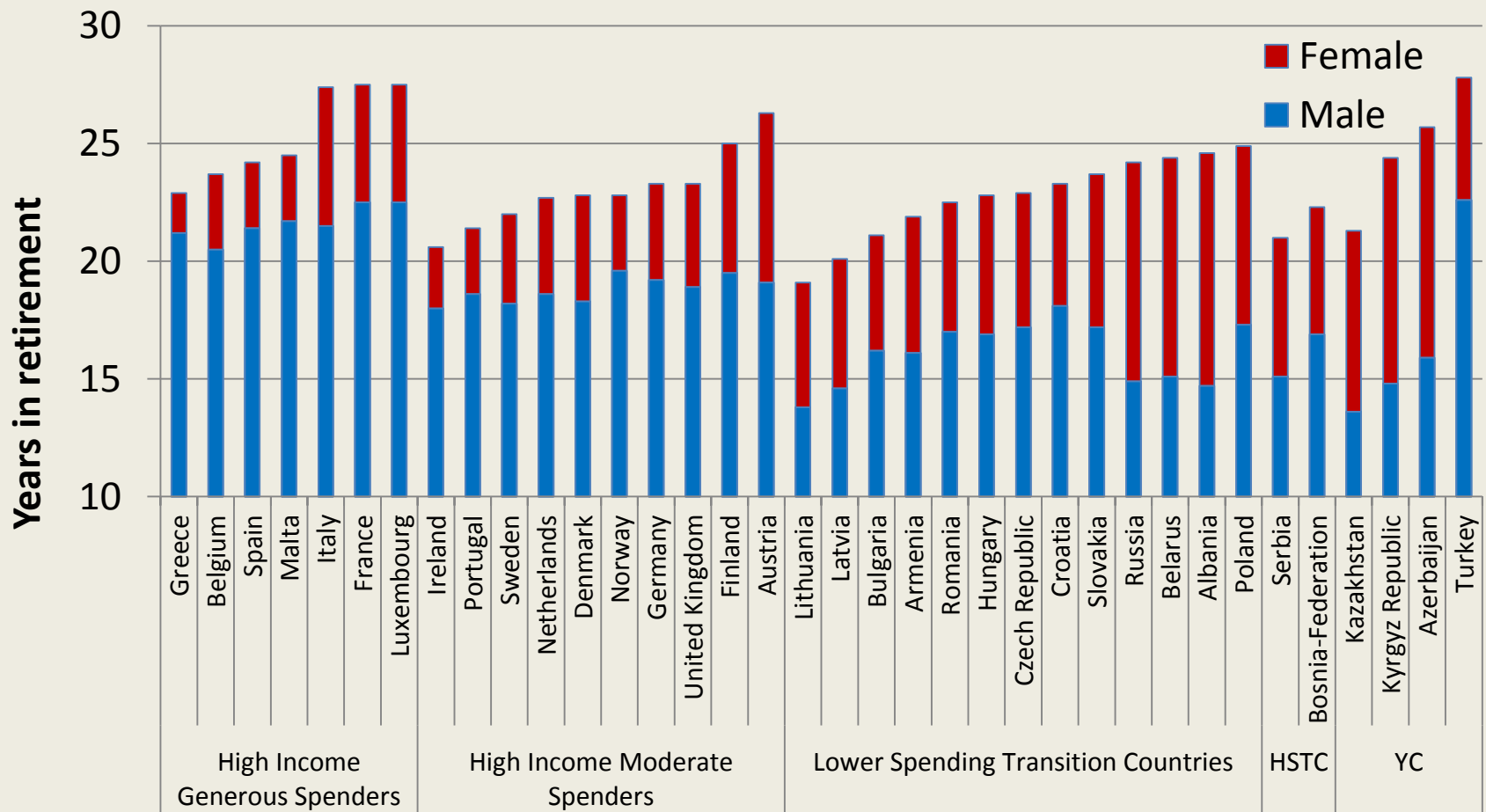
Change in Effective Retirement Age Compared to Change in Life Expectancy, Selected European Economies, 2001–2009



Source: Eurostat Statistics Database.

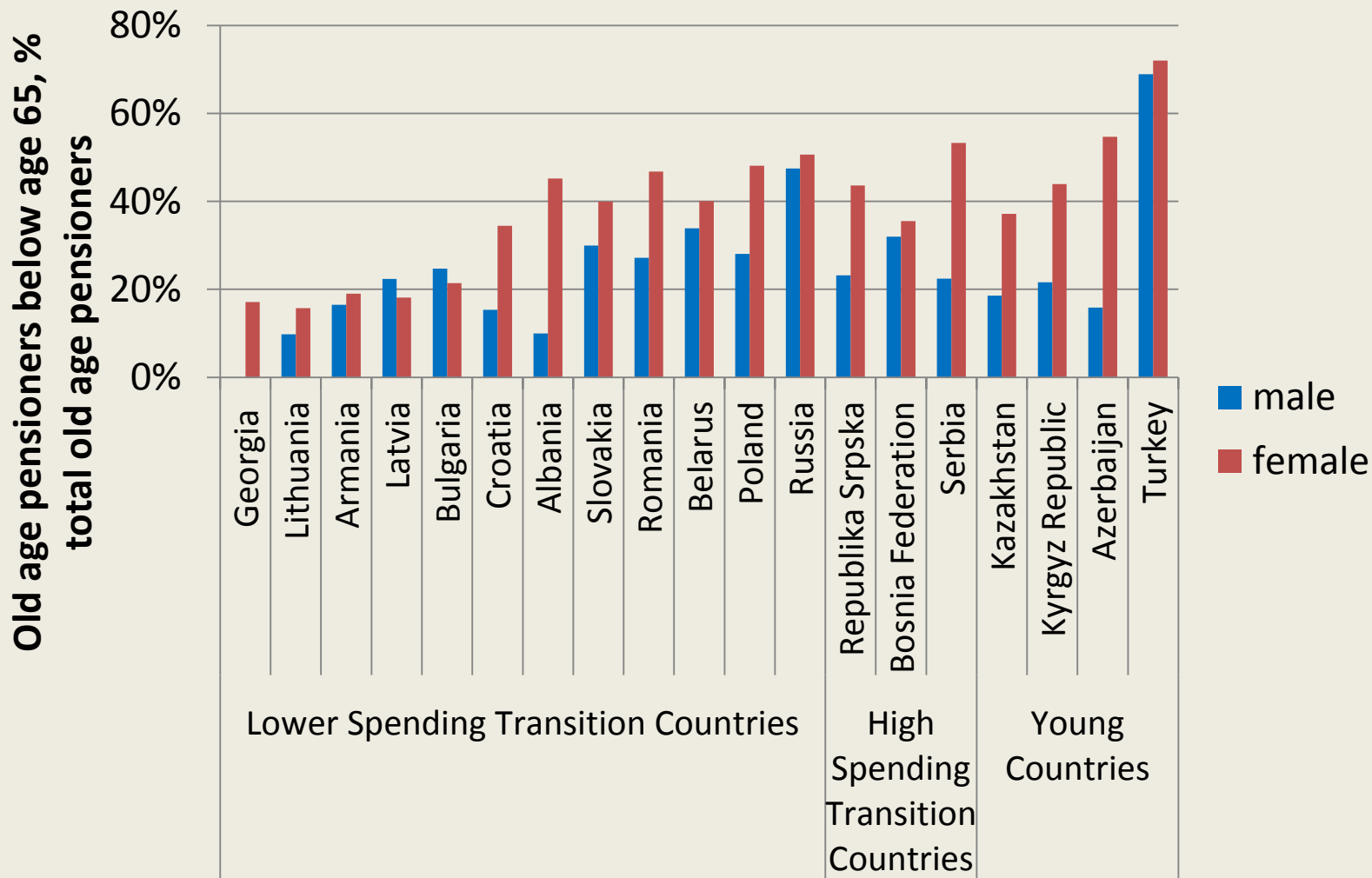


# Duration of retirement still remains far above 15 years



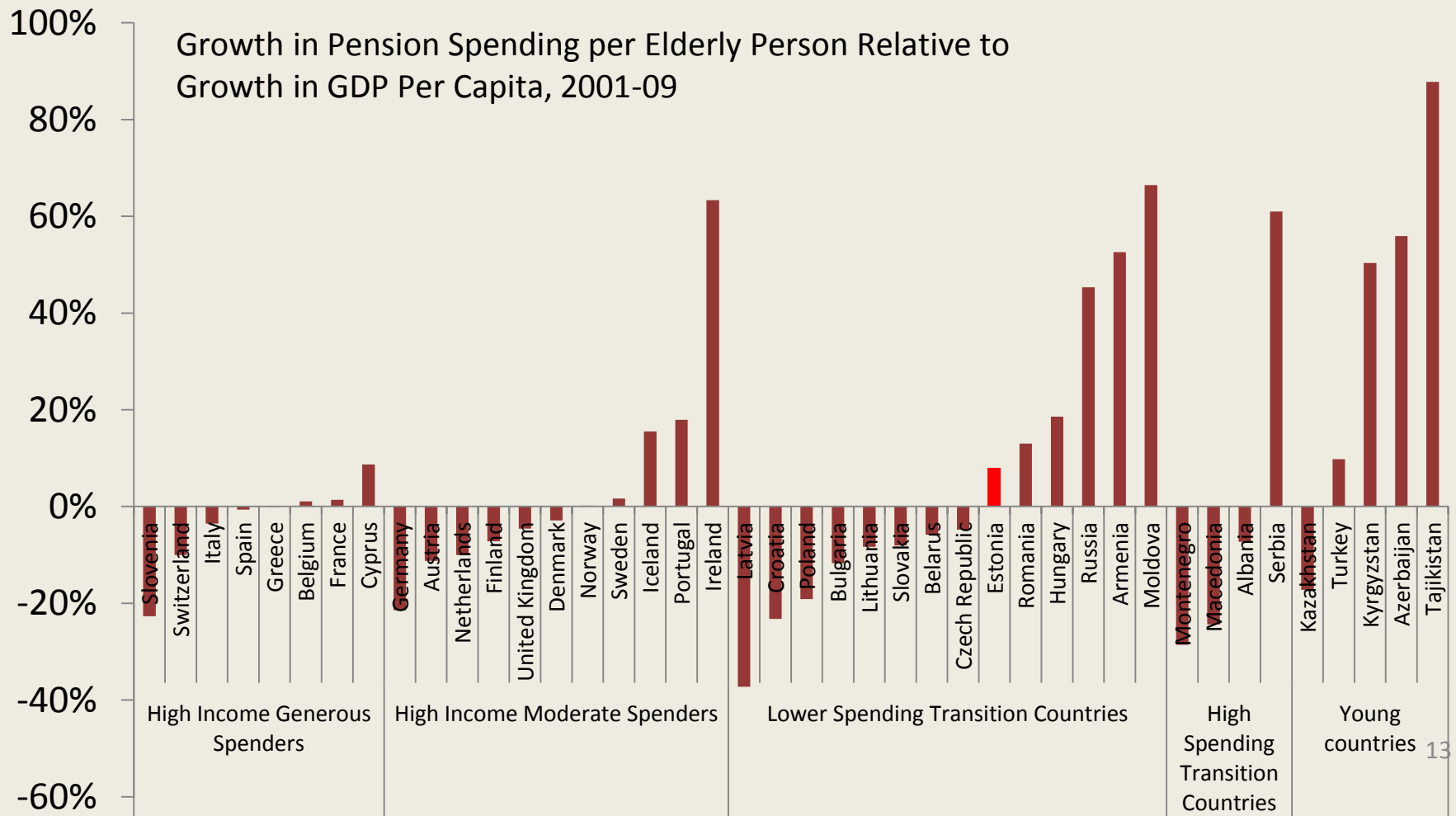


# Early retirement is still prevalent





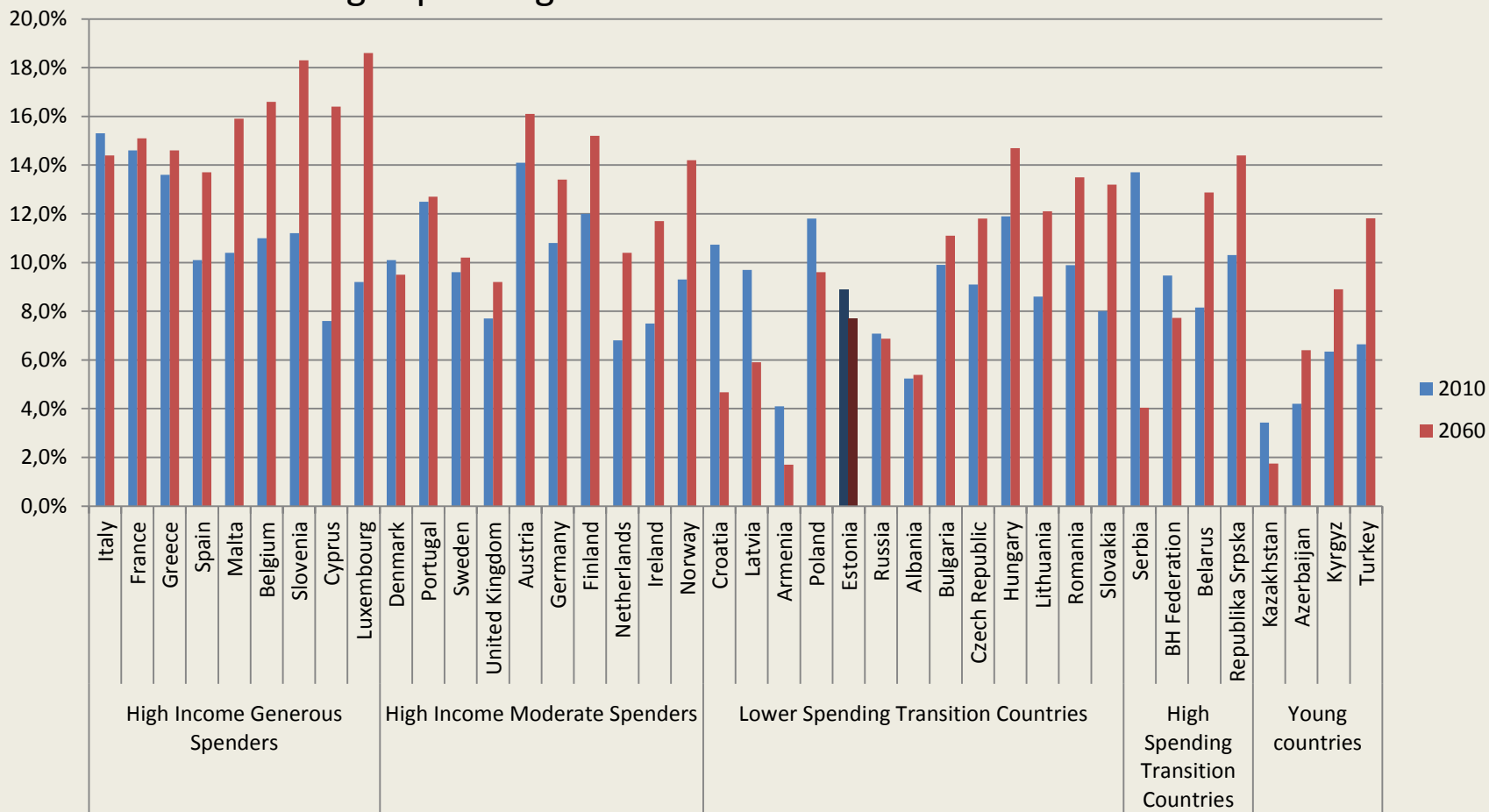
# No clear trend-line of reduced spending per pensioner





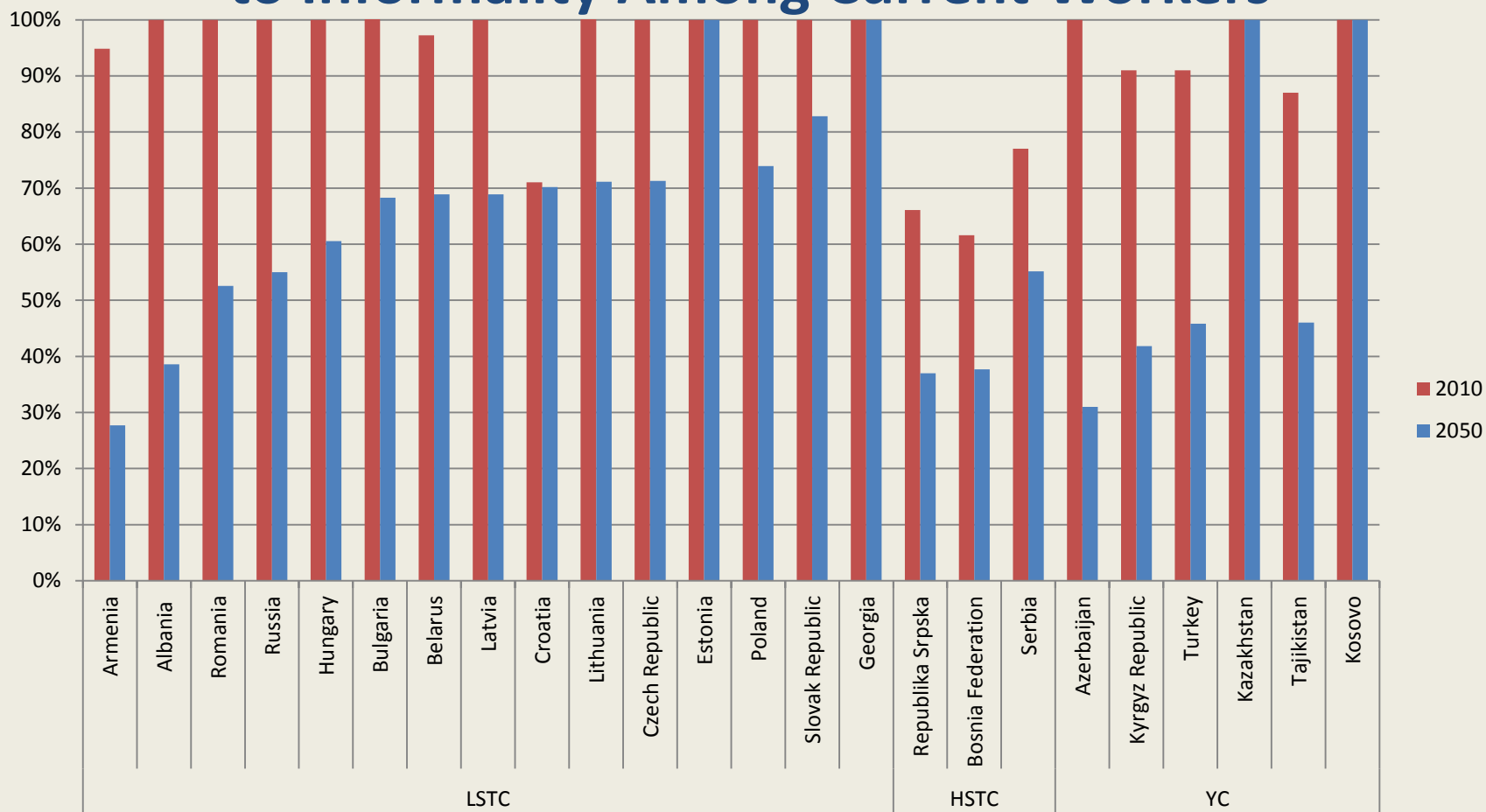
# Projected spending in 2060 compared to spending as share of GDP in 2010

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





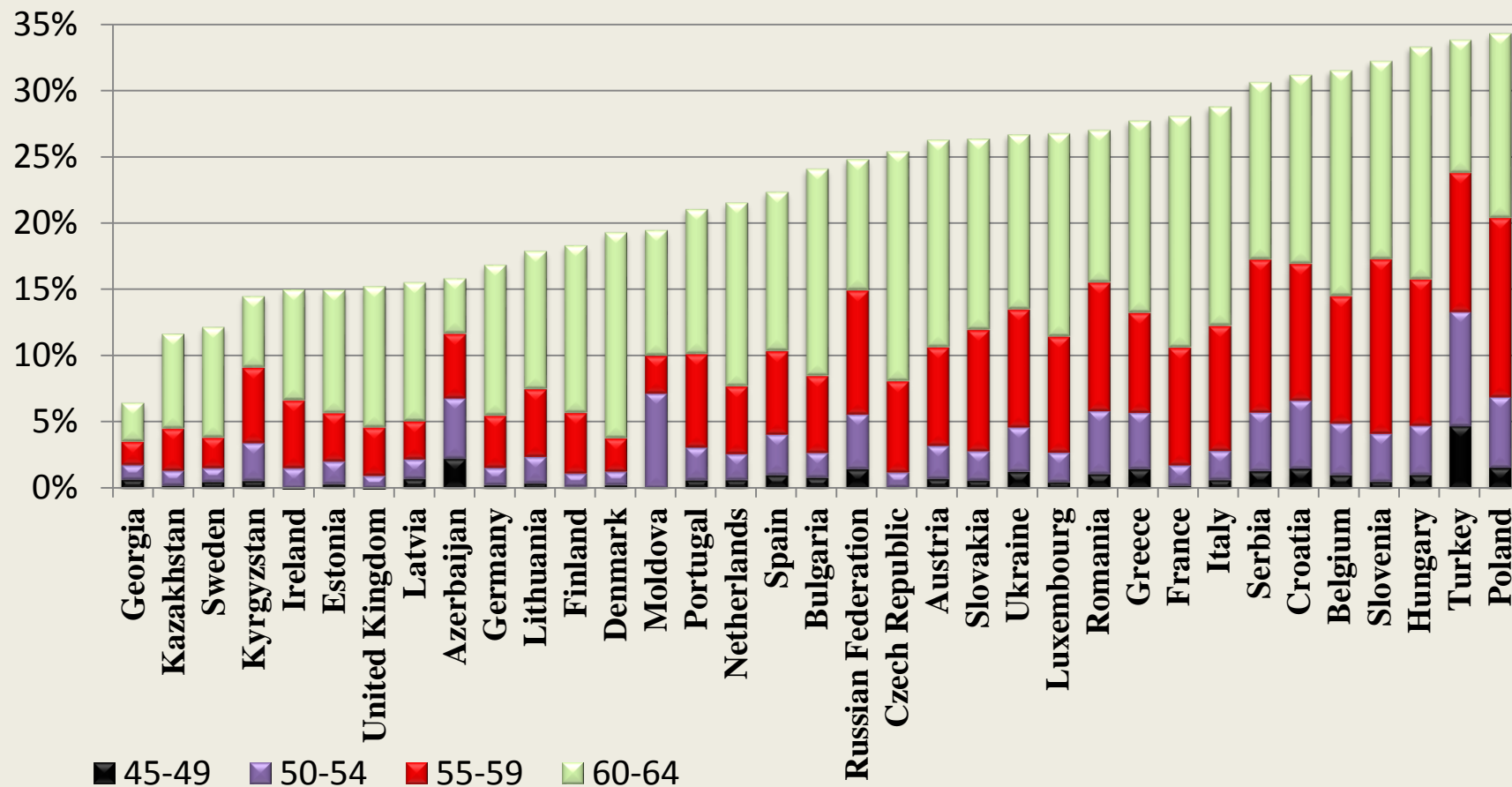
# Need more holistic approach

- 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 life 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





# 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.

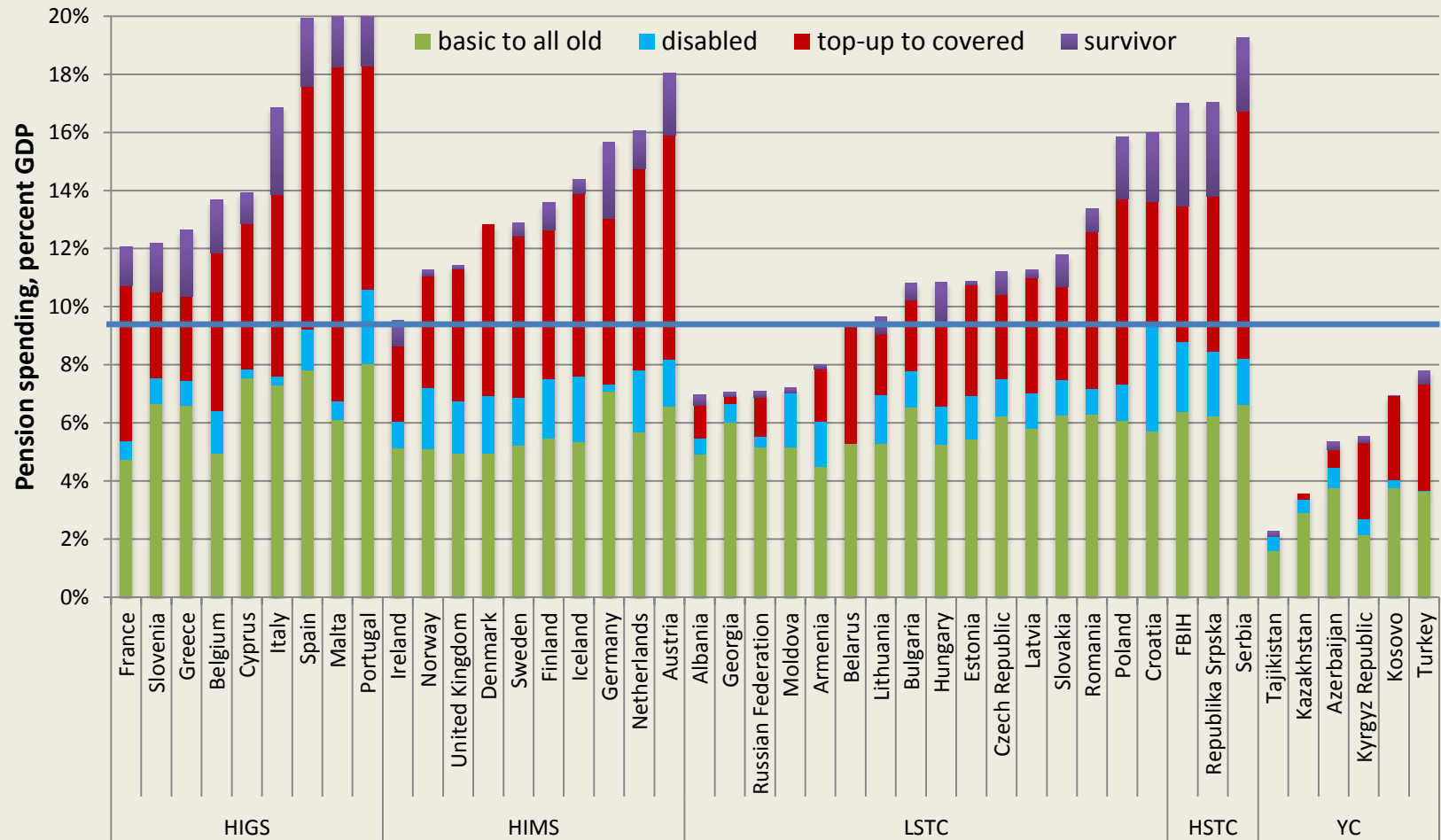


# Given the demographic challenges, is pension spending efficient?

- 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

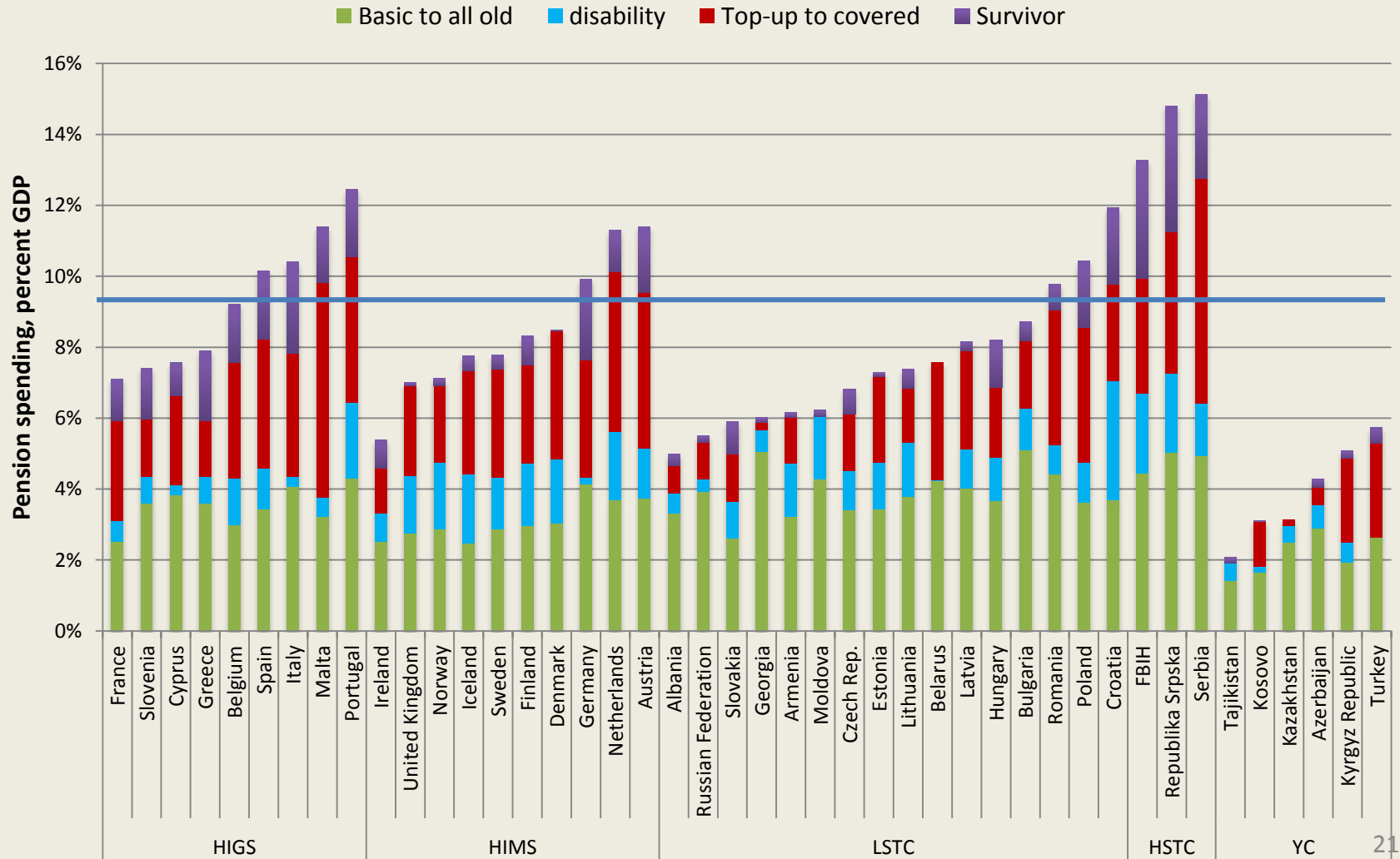


# An Example Of Prioritizing Pension Spending and Costing It Out If Effective Retirement Age Is 65 with Prime Age Labor Force Participation Until Age 64 - 2050





# Same Priorities As Before But With Retirement Age Where Life Expectancy Equals 15 Years and Prime Age Labor Force Participation Until Then - 2050





## 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



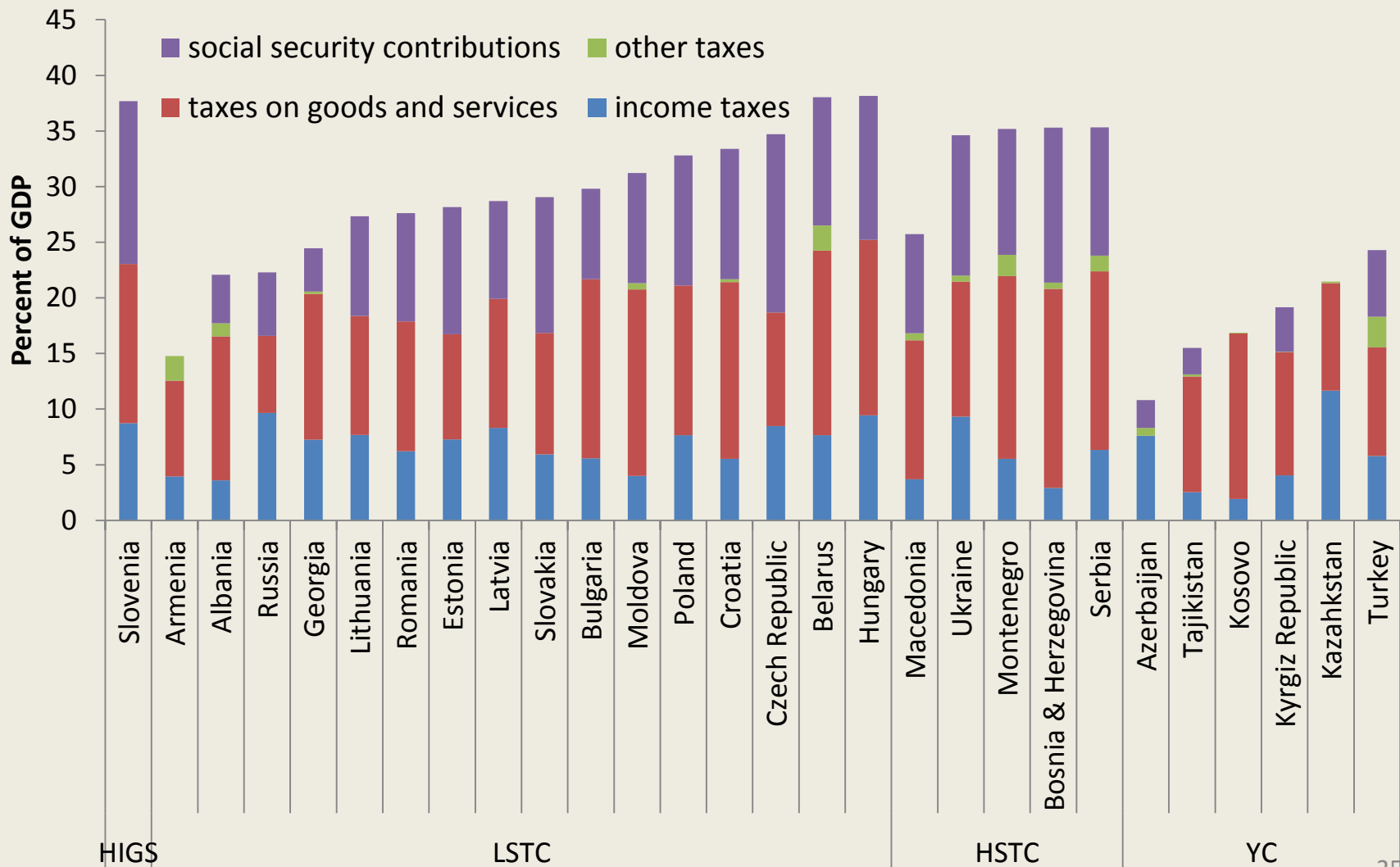
# The role of voluntary pension schemes

- 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





# 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