The Inverting Pyramid:
Demographic challenges to the Pension Systems in Europe and Central Asia

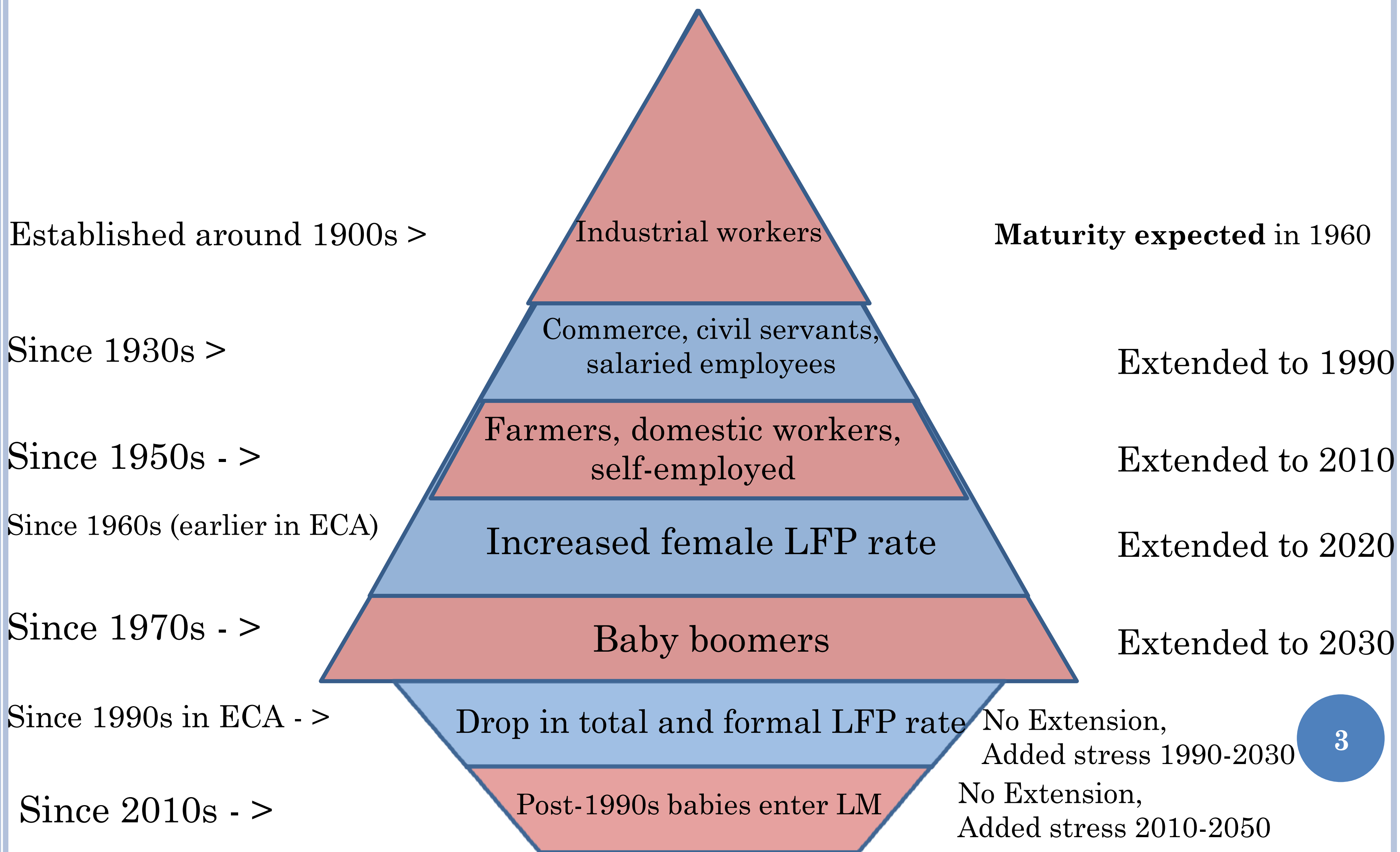
Anita M. Schwarz
Lead Economist
Human Development Department
Europe and Central Asia Region
World Bank

March 2014

Important Achievement of Providing Old Age Security

- Over last century, increasing number of workers insured against risks of old age, disability, and loss of a breadwinner
- Insured workers and their employers pay a percentage of wage as contribution
- When each new group of workers joins, contribution revenue goes up, but initially since no one from the new group is eligible for benefits, no additional expenditures occur
- Over time as the workers who have paid become eligible for benefits, expenditures increase

Maturation of Pension Schemes Throughout Europe



Policy choices changed

1900

Pensions Designed to Supplement Other Income

- Provided at 70
- Limited to those who had lost working capacity
- Relatively small amount

1950

Pensions Supply All of a Pensioner's Income

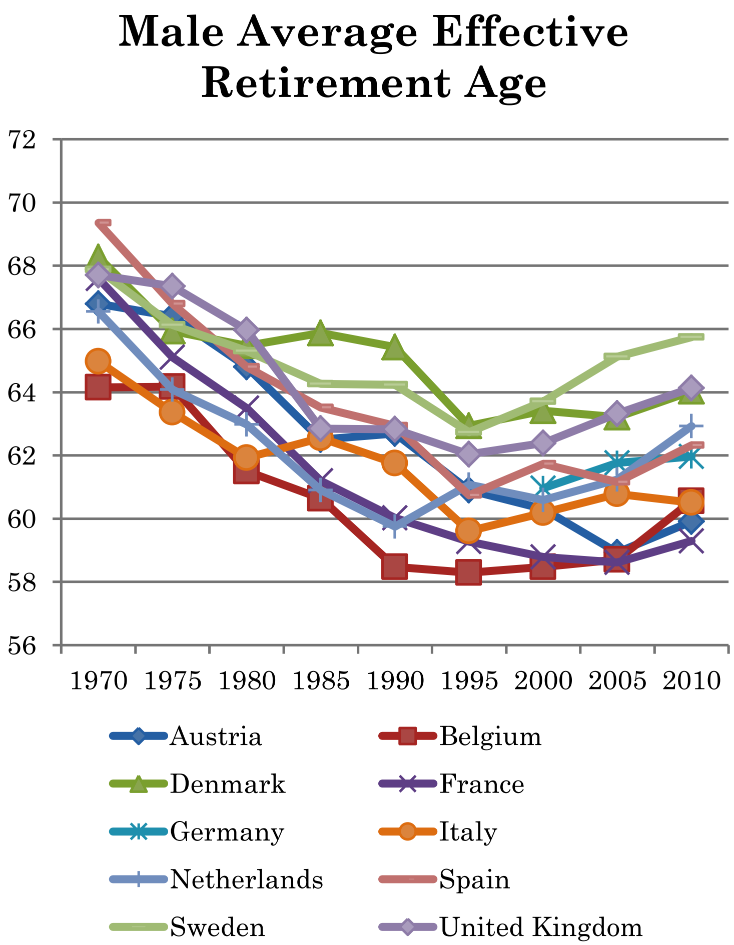
- Ages lowered
- Benefits increased
- Benefits extended to survivors

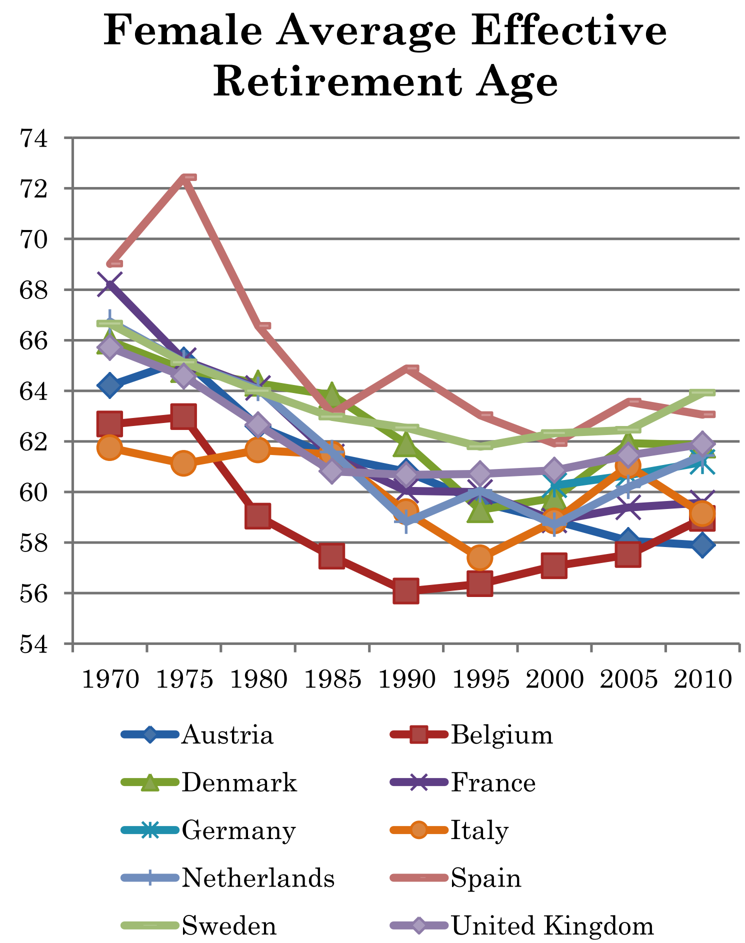
1970

Pensions Expected to Keep Up with Wage Growth of Working Age Population

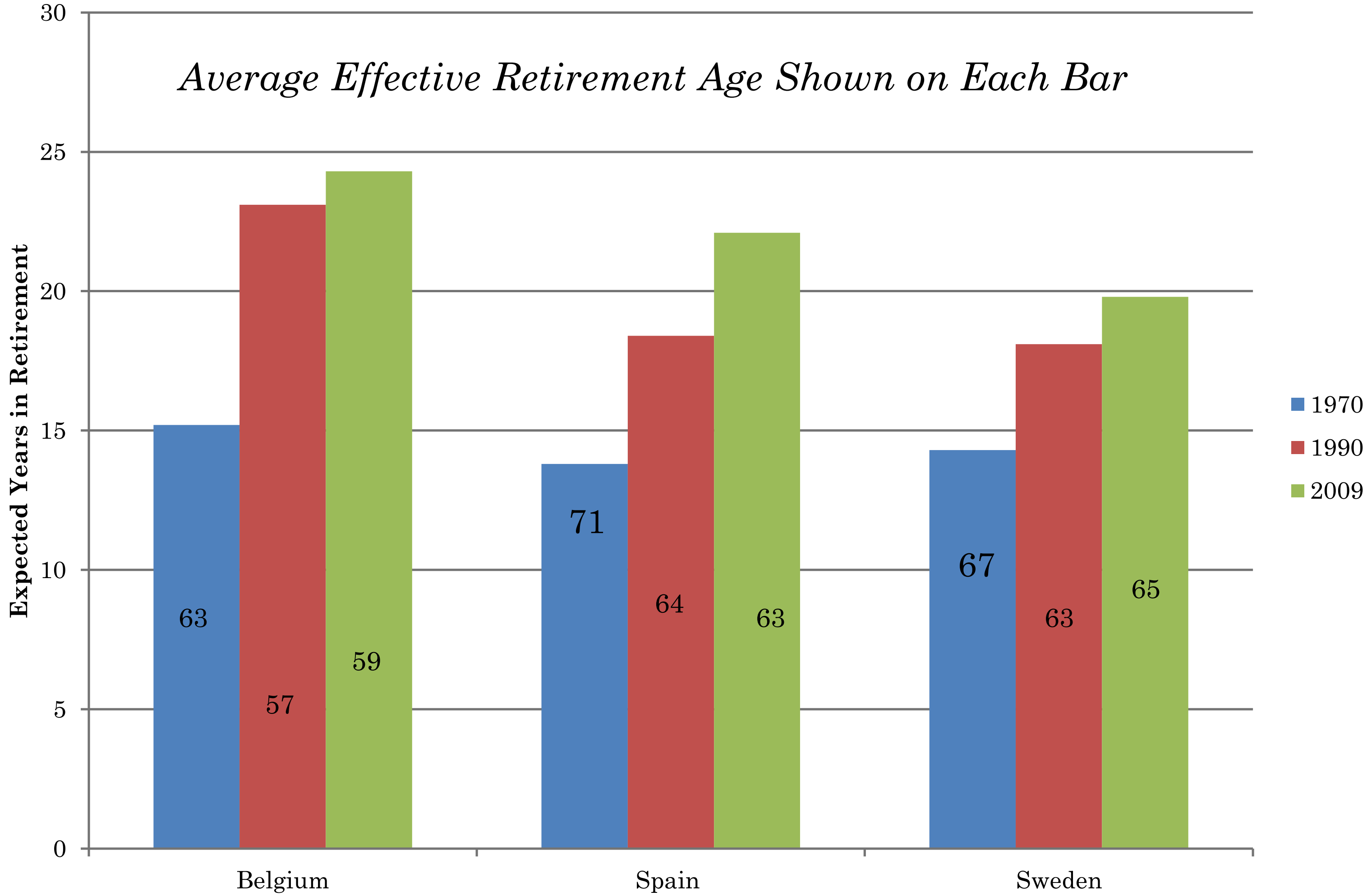
- Wage indexation or more

Policy choices when flush with contribution revenues



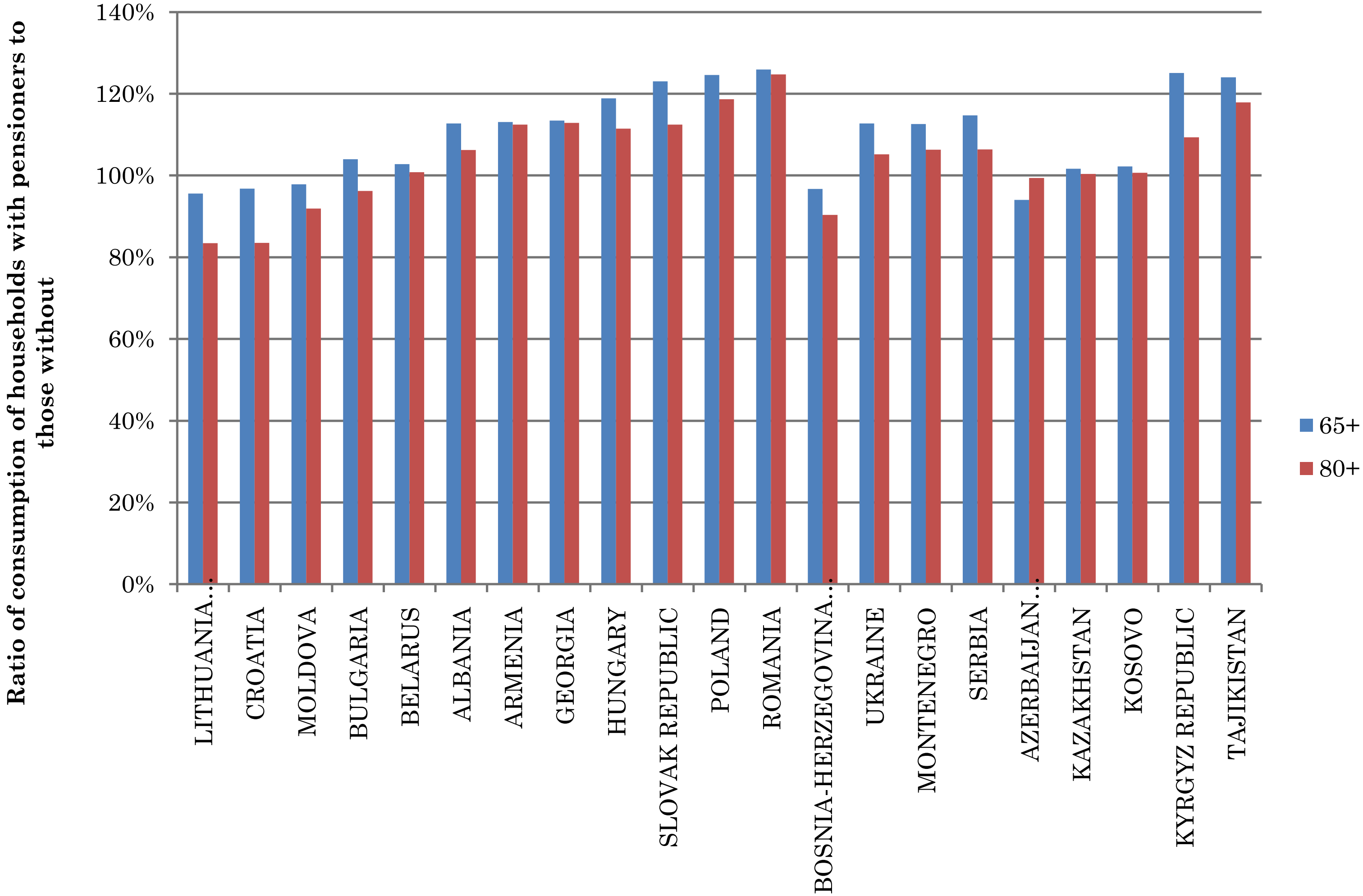


Duration of Retirement Increased from Increasing Life Expectancy *and* Falling Effective Retirement Age

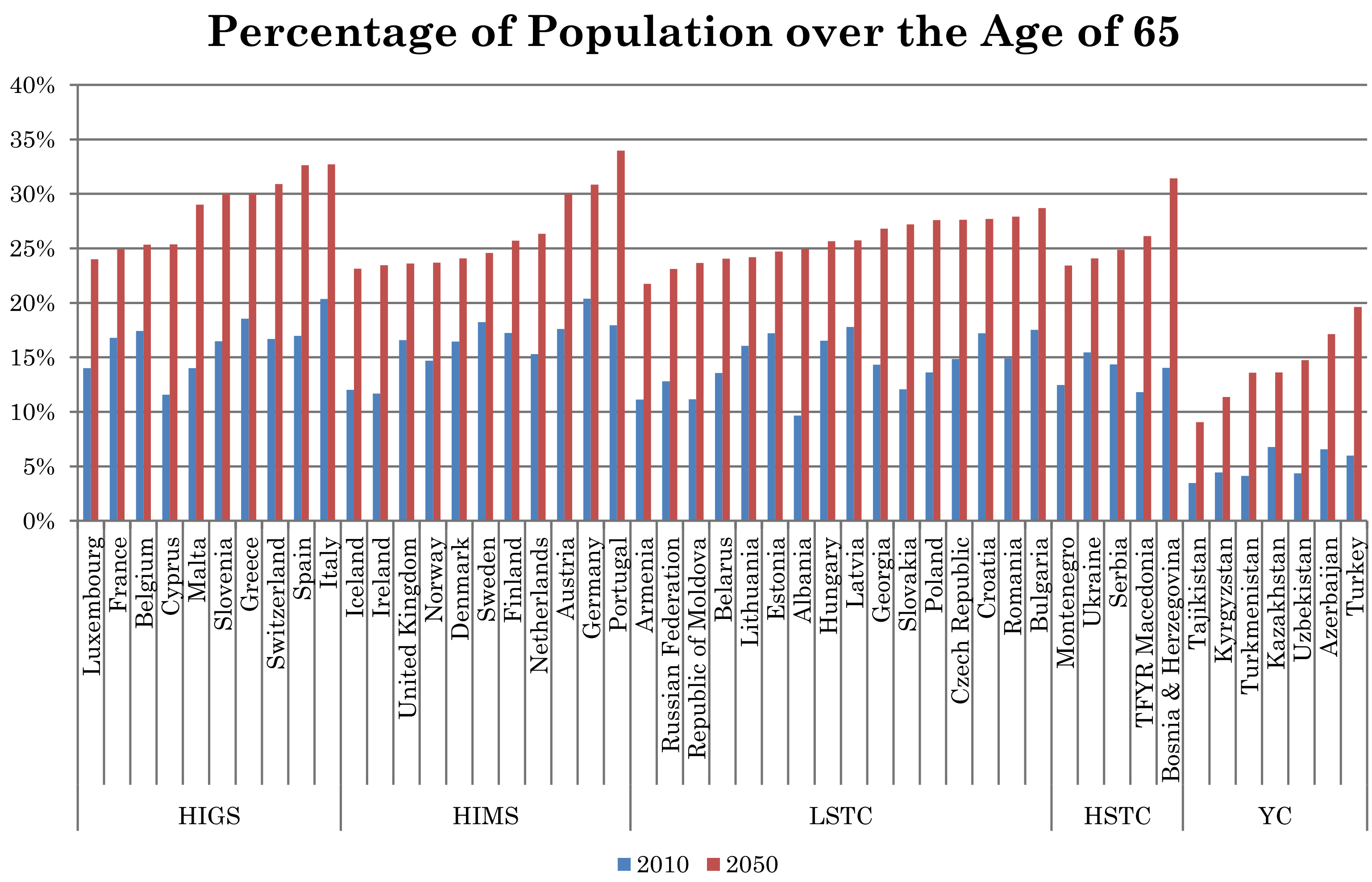


Data Sources: OECD, Eurostat

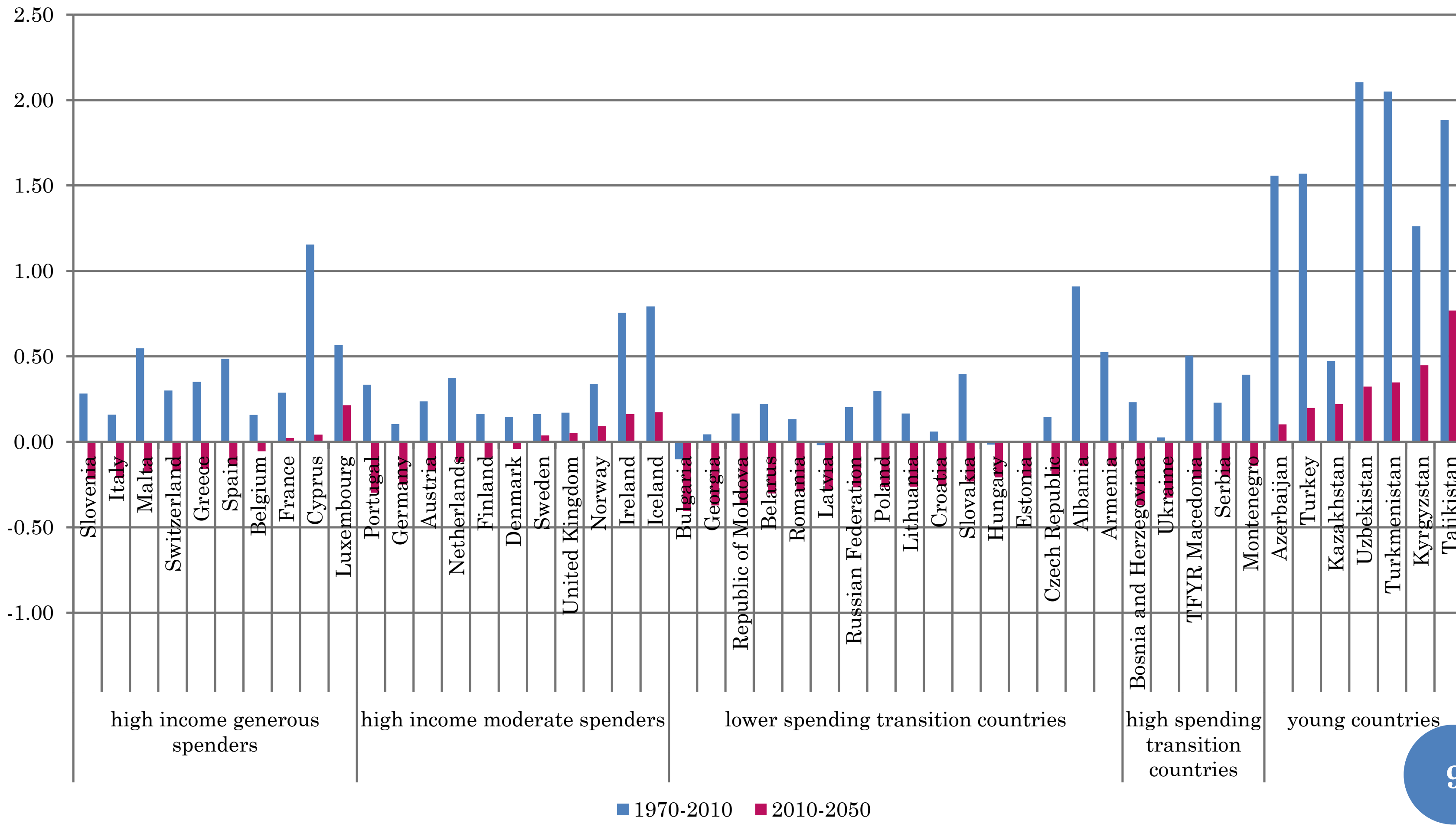
Elderly are Not In General More Poor Than Younger Cohorts



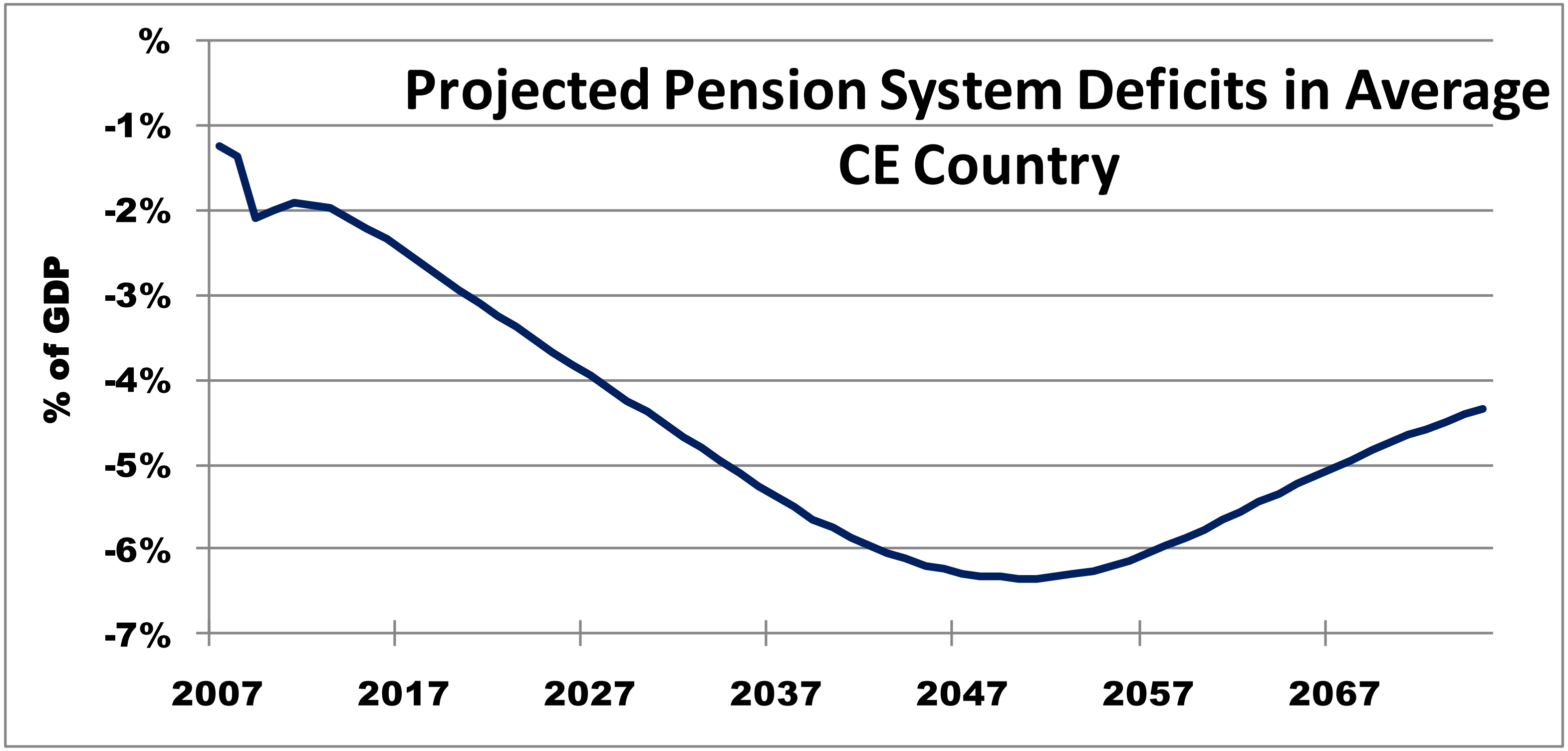
Now Europe Is Aging



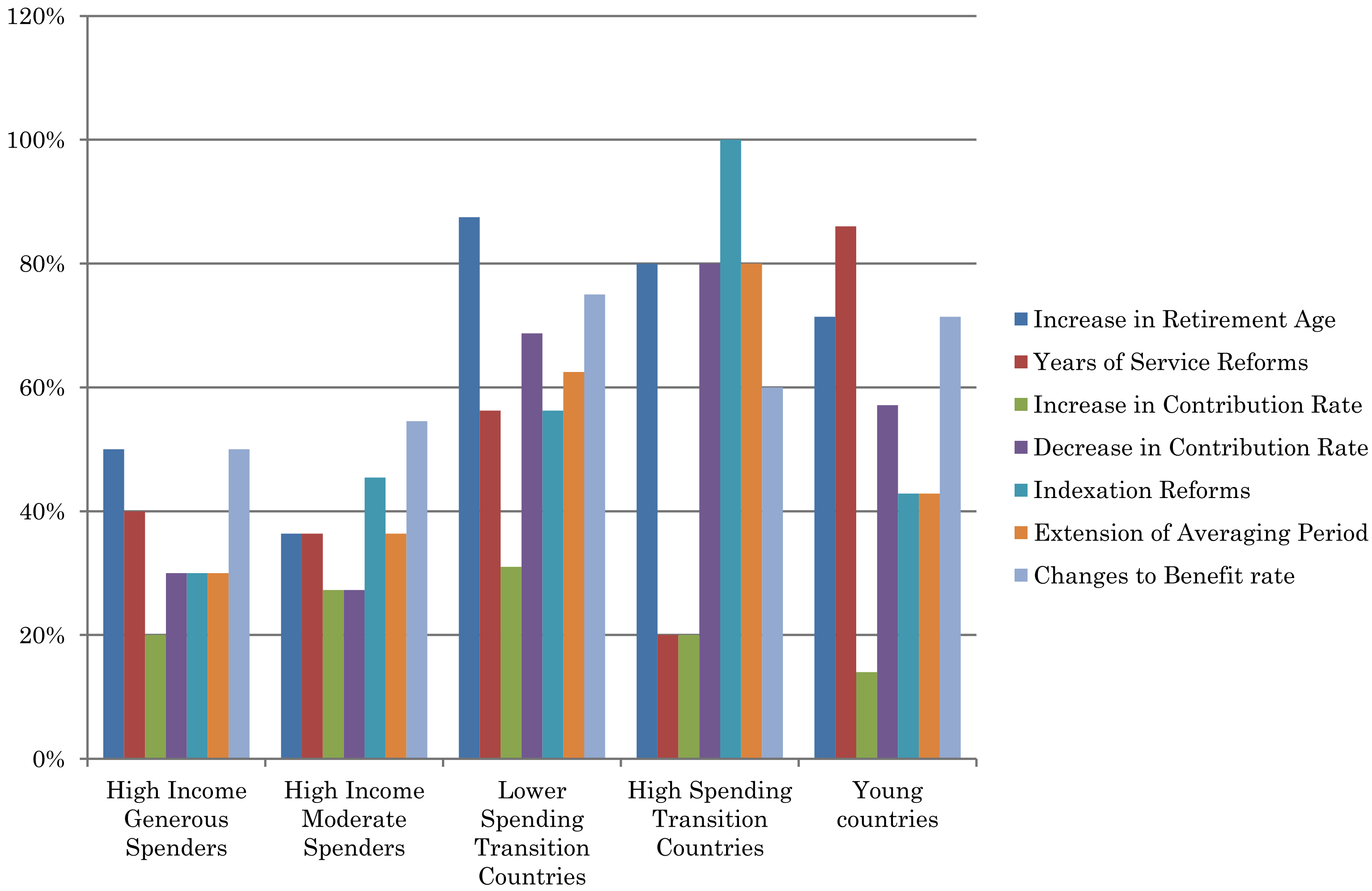
But more troubling is the projected decline in working age population



Leads To Fiscal Deficits in Pension Systems Far Greater Than During Recent Financial Crisis



Faced with The Demographic Onslaught, Europe Has Undertaken Lots of Parametric Pension Reform



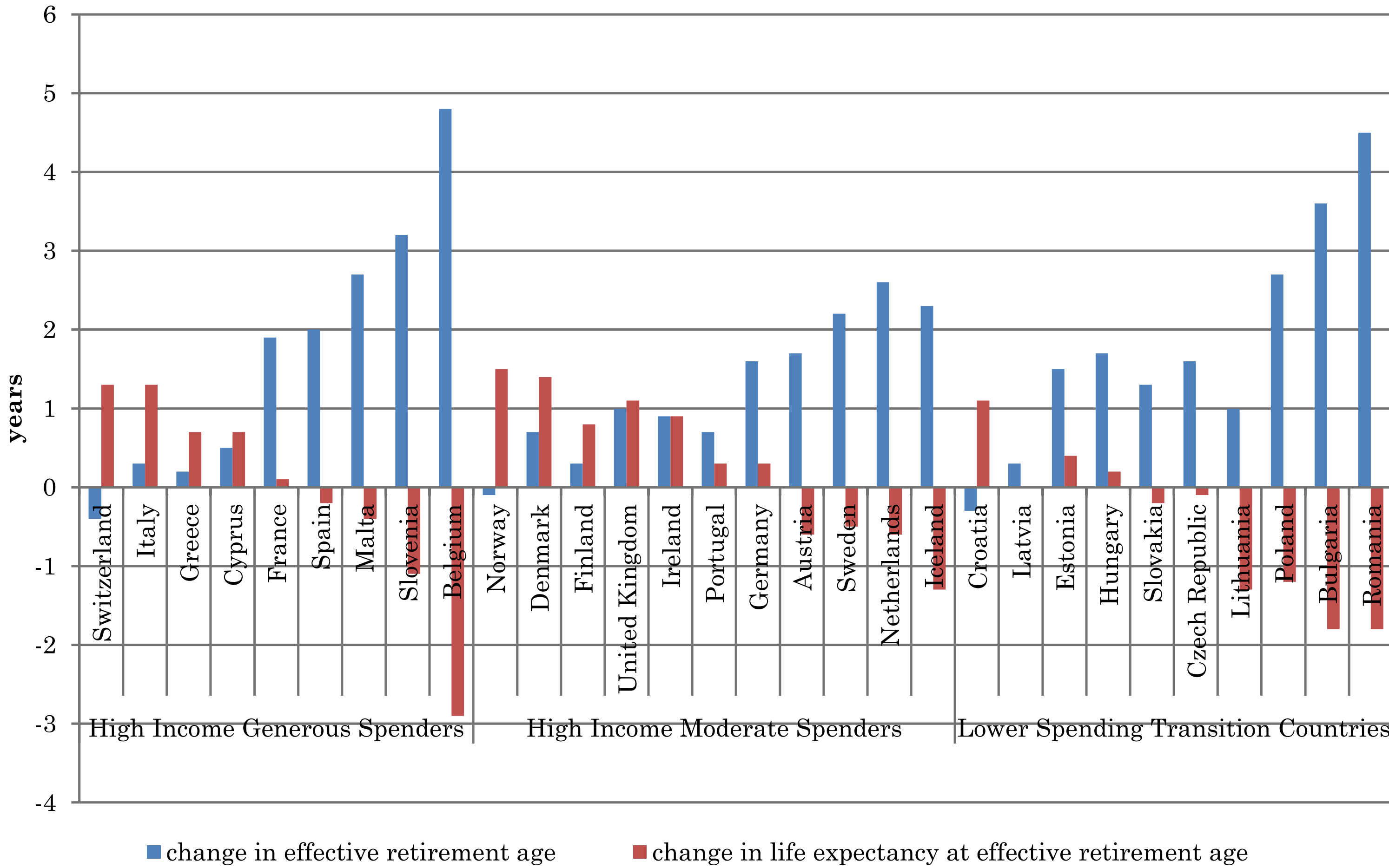
Adopted a smorgasbord of structural reforms

Point System	Notional Accounts	Funded Defined Contribution	Universal Pension
Germany France (pvt sector) Romania Slovak Republic Estonia Bosnia, RS Croatia Montenegro Serbia	Sweden Italy Latvia Poland Azerbaijan Kyrgyz Rep Russian Fed Turkmenistan	Sweden Denmark Poland Hungary Slovak Rep Lithuania Latvia Estonia Bulgaria Romania Croatia FYR Macedonia Kazakhstan Kosovo Kyrgyz Rep Russian Fed	Ireland UK Netherlands Denmark Czech Republic Georgia Kazakhstan Kosovo

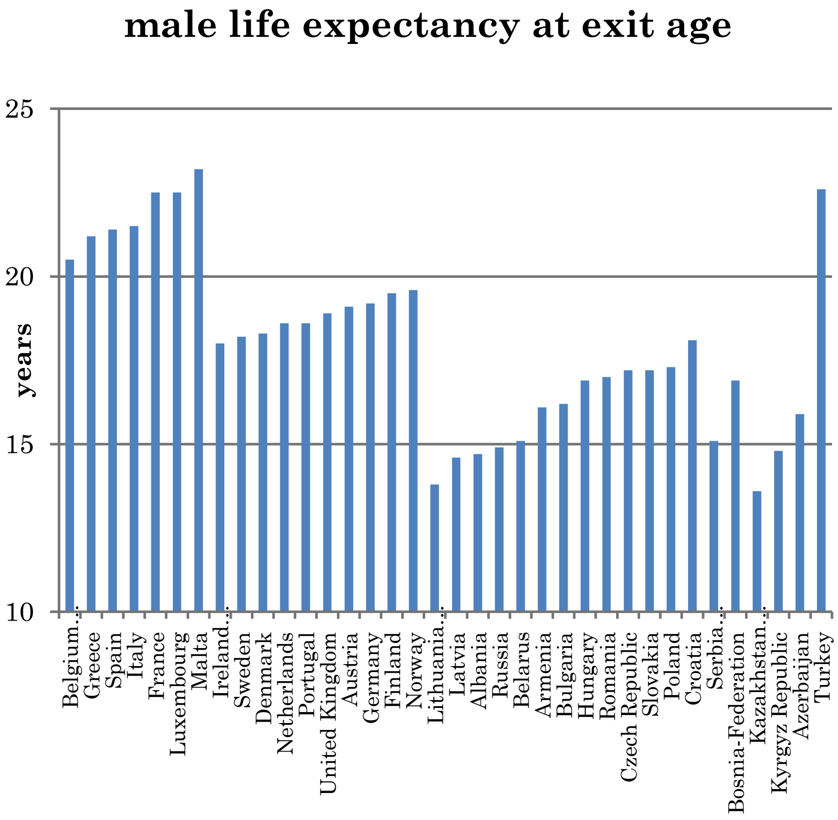
No Single Dominant Paradigm Has Emerged

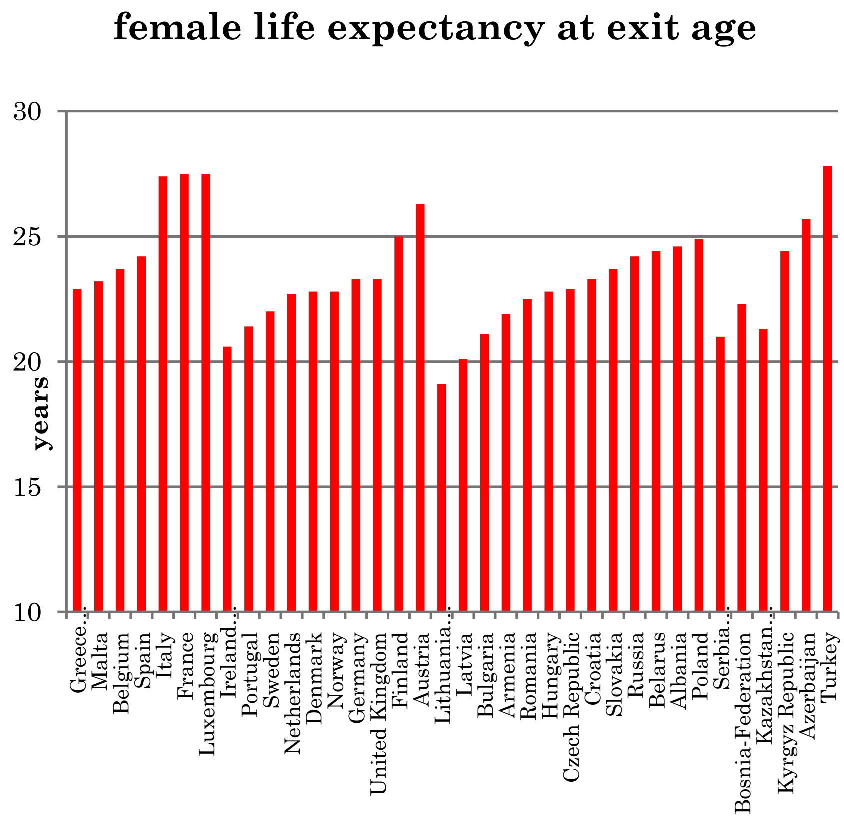
- Pension systems have two main objectives:
  - Poverty alleviation among the elderly
  - Replacing the income retirees used to earn so that they don't face a sharp drop in consumption ability
- So far, pension systems in the region have more or less done both – not so in other regions
- Country interest in ECA has been toward income replacement
  - Strengthening links between contributions and benefits
- Will this be affordable in the future?

Impact of Reforms - Retirement Ages Went Up, But So Did Life Expectancy – Duration of Retirement Did Not Change Much

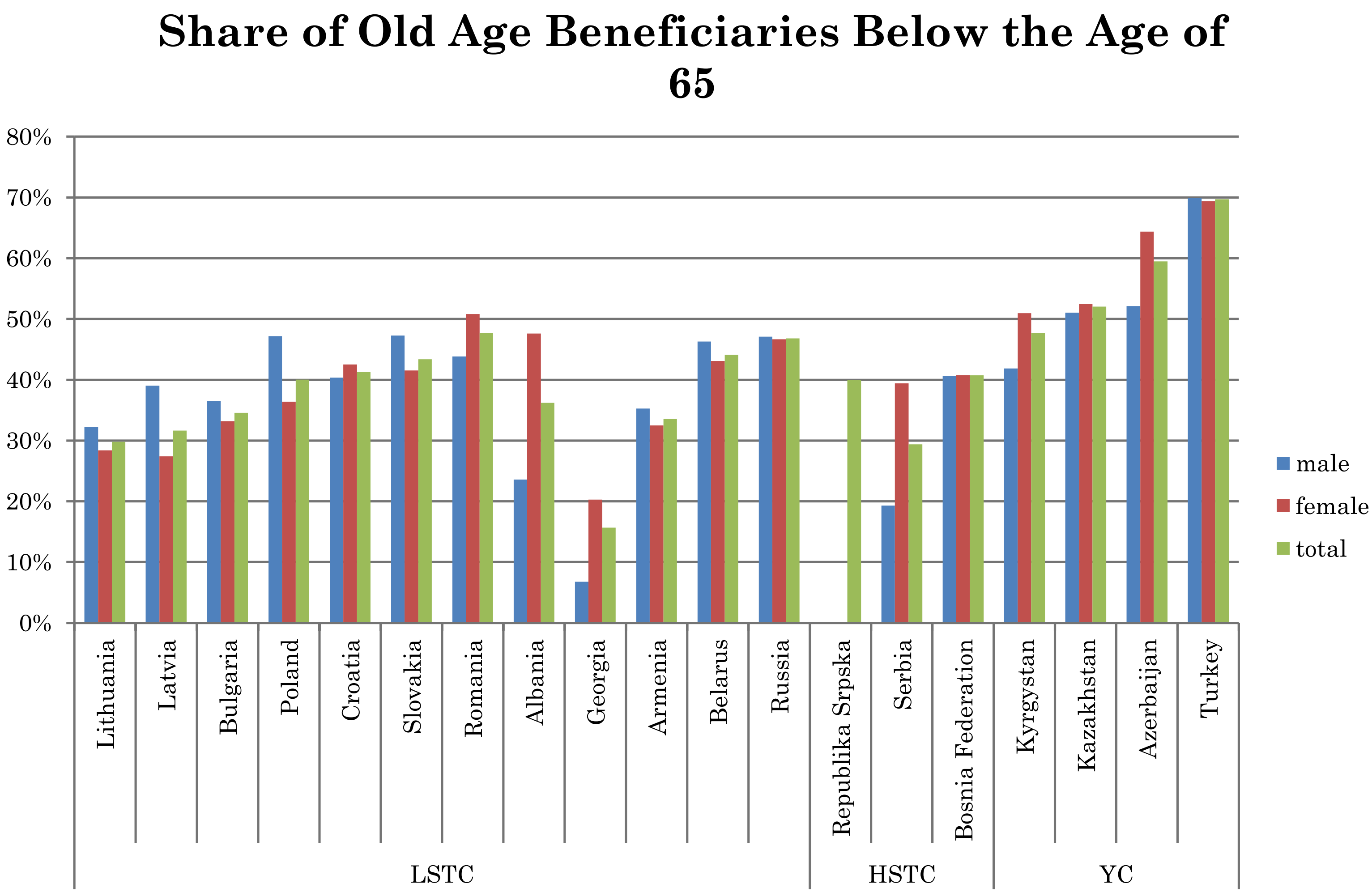


Life Expectancy At Retirement Remains Well Over 15 Years

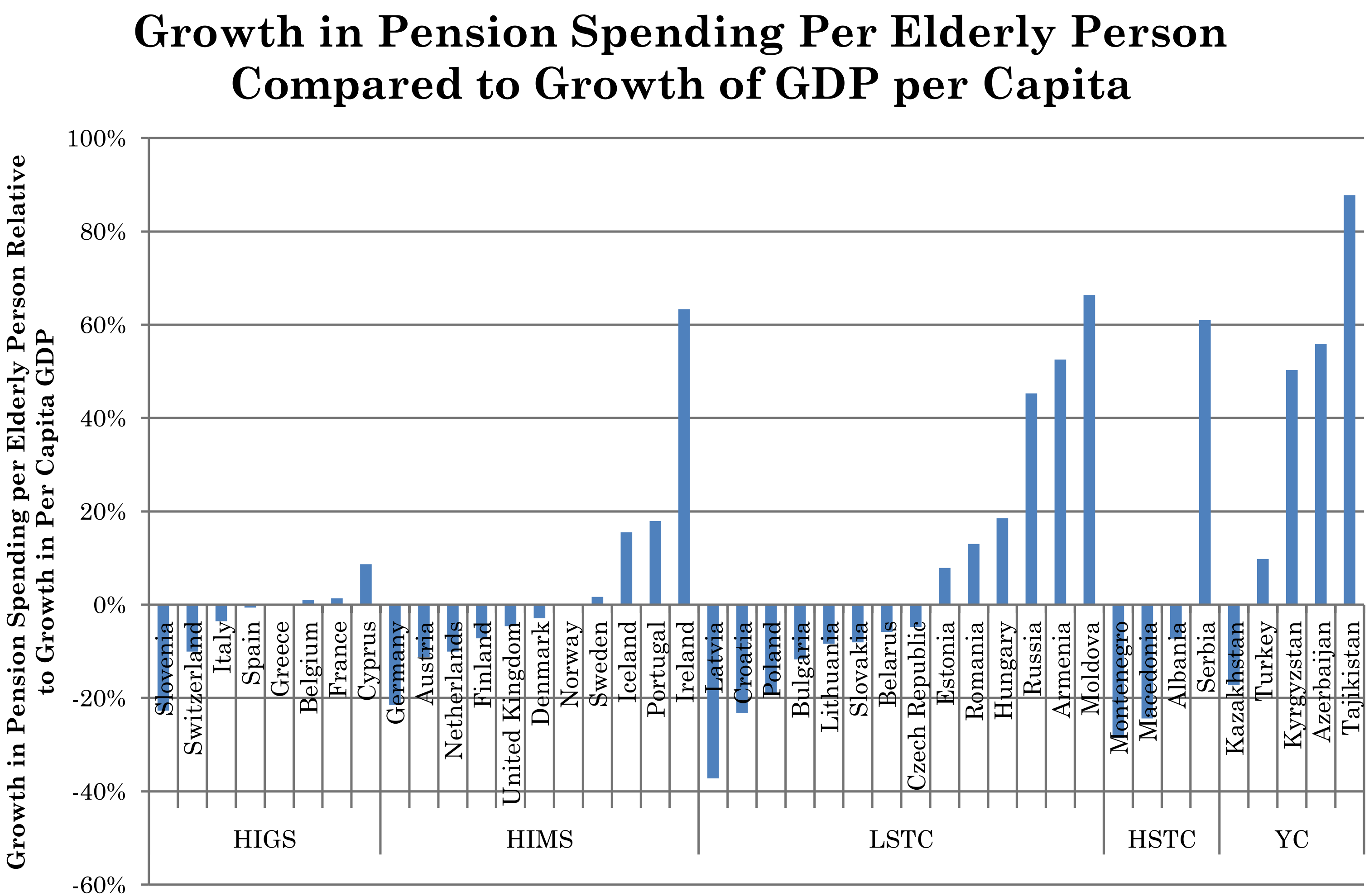




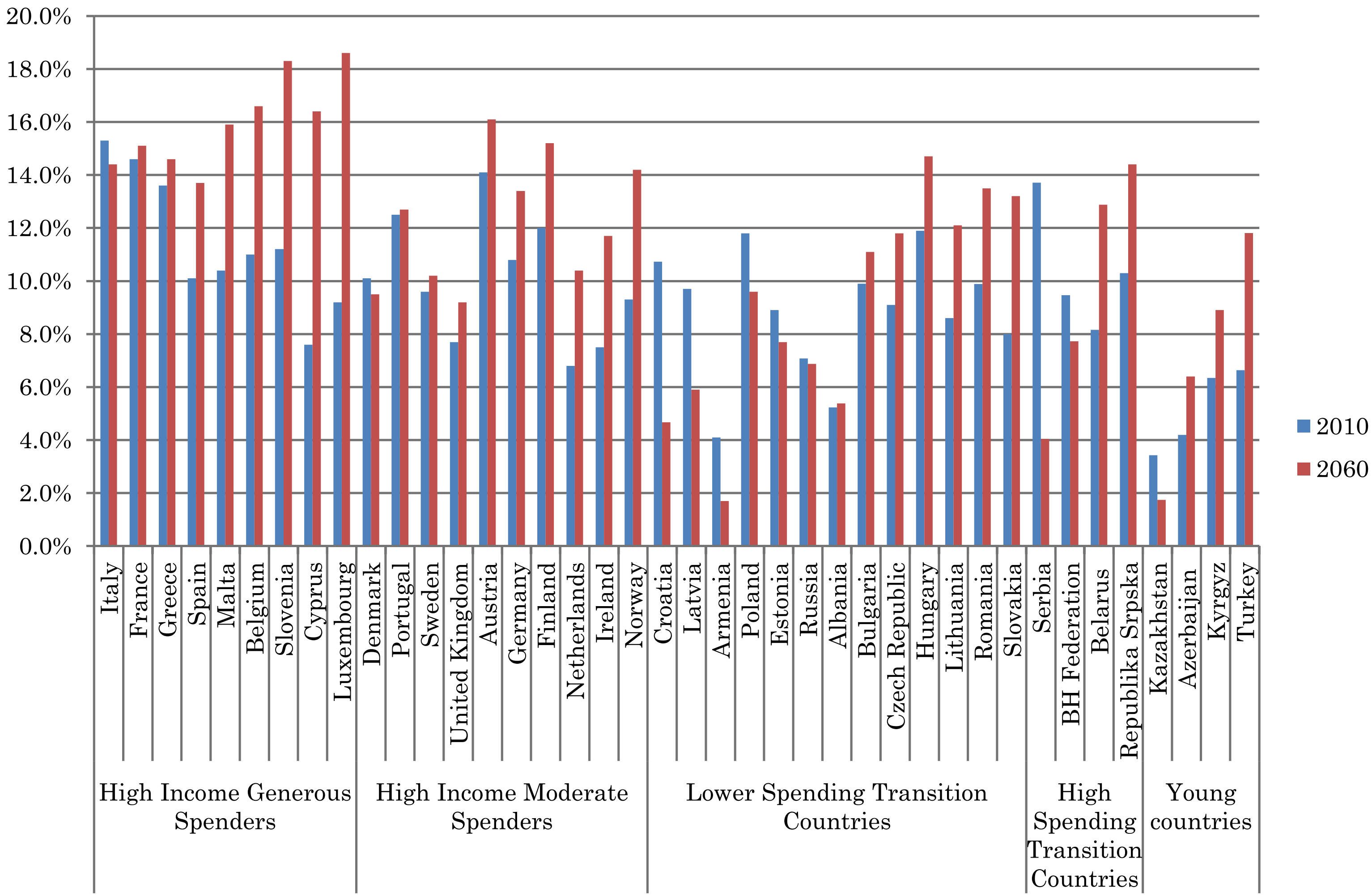
Persistence Of Early Retirement



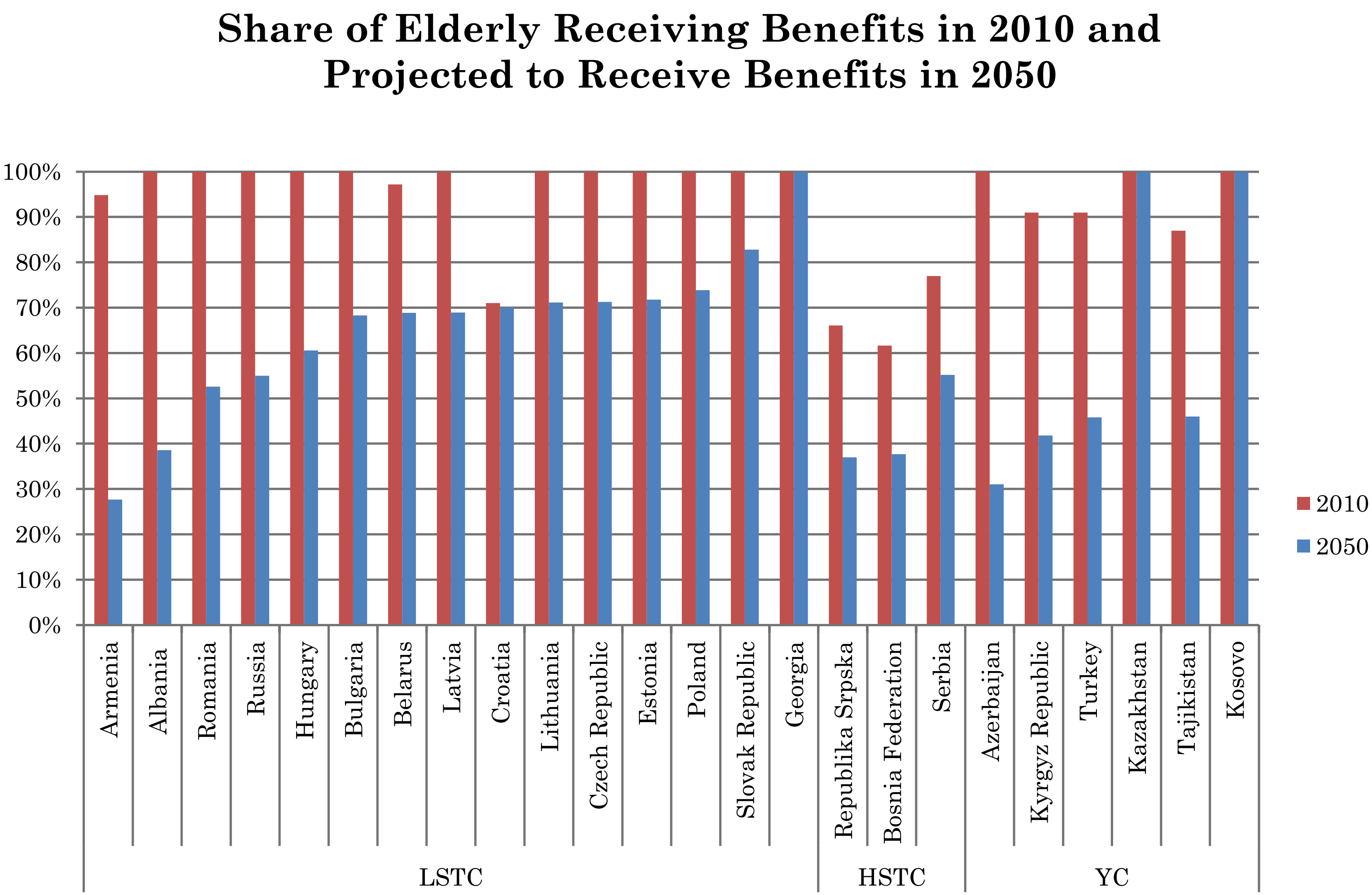
No Effective Decline in Generosity (2001-2008)



In Almost Every Country Pension Spending Is Projected to Grow as Share of GDP



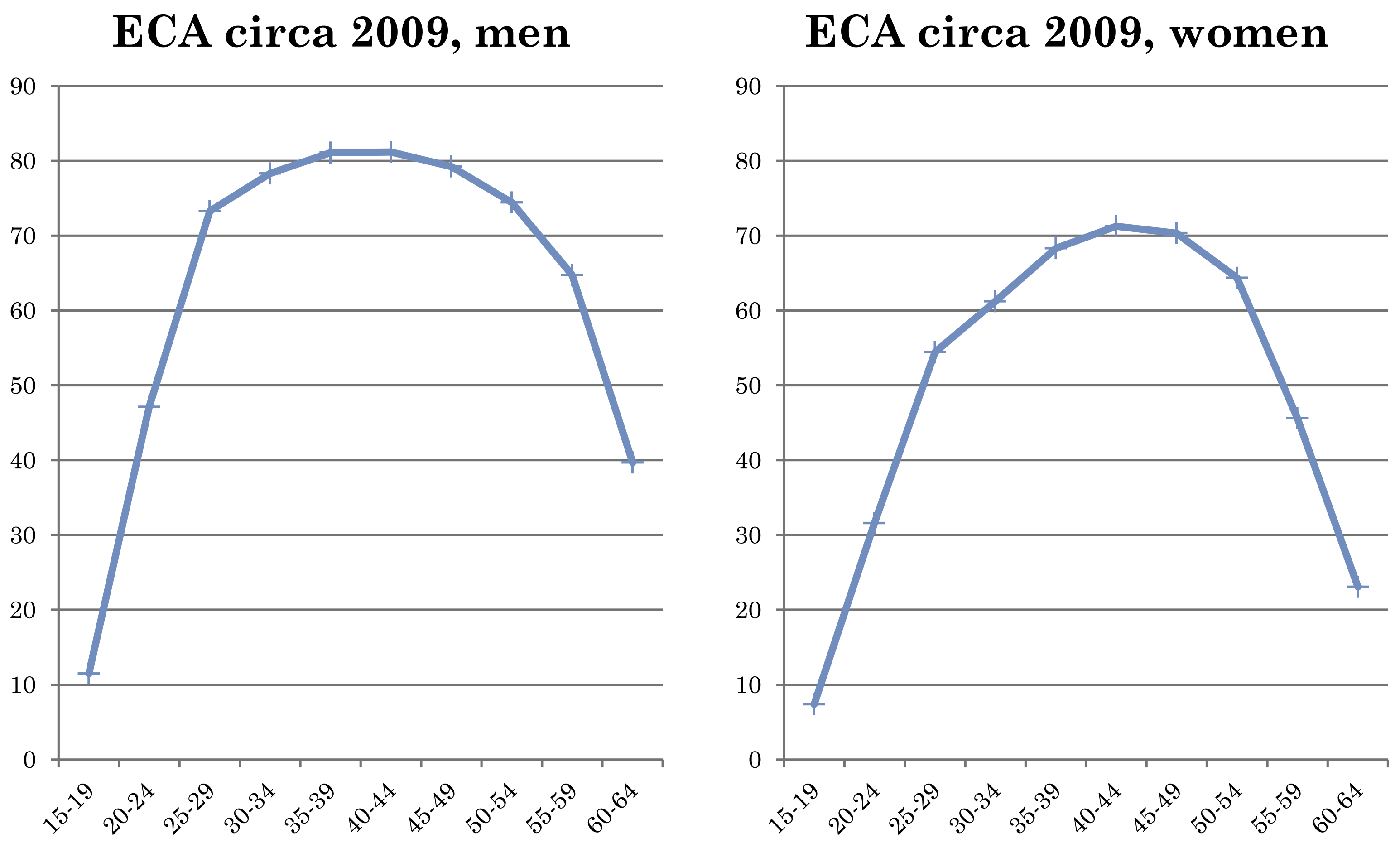
And Coverage Of The Elderly Is Expected To Fall – More Spending Needed To Prevent Old Age Poverty



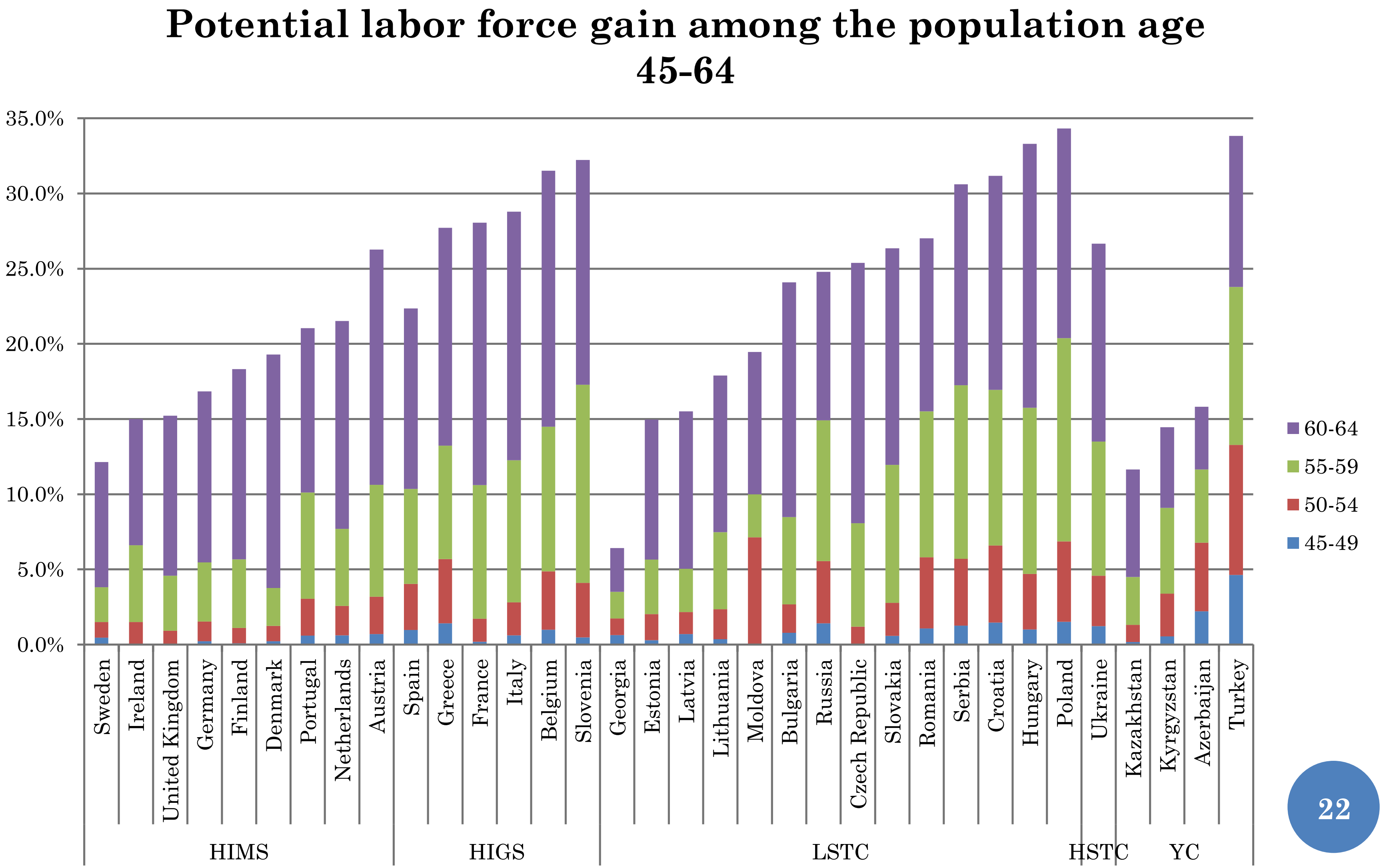
What Are Possible Solutions?

- Increase labor force
  - Fertility increases – too little, too late
  - Increase labor force participation rates in prime ages
  - Increase coverage – increases fiscal problem in future
  - Increase productivity – typically reflected in wages, which affect benefits
  - Immigration
  - Longer work life
- Use other fiscal resources
- Use savings to complement public benefits during retirement

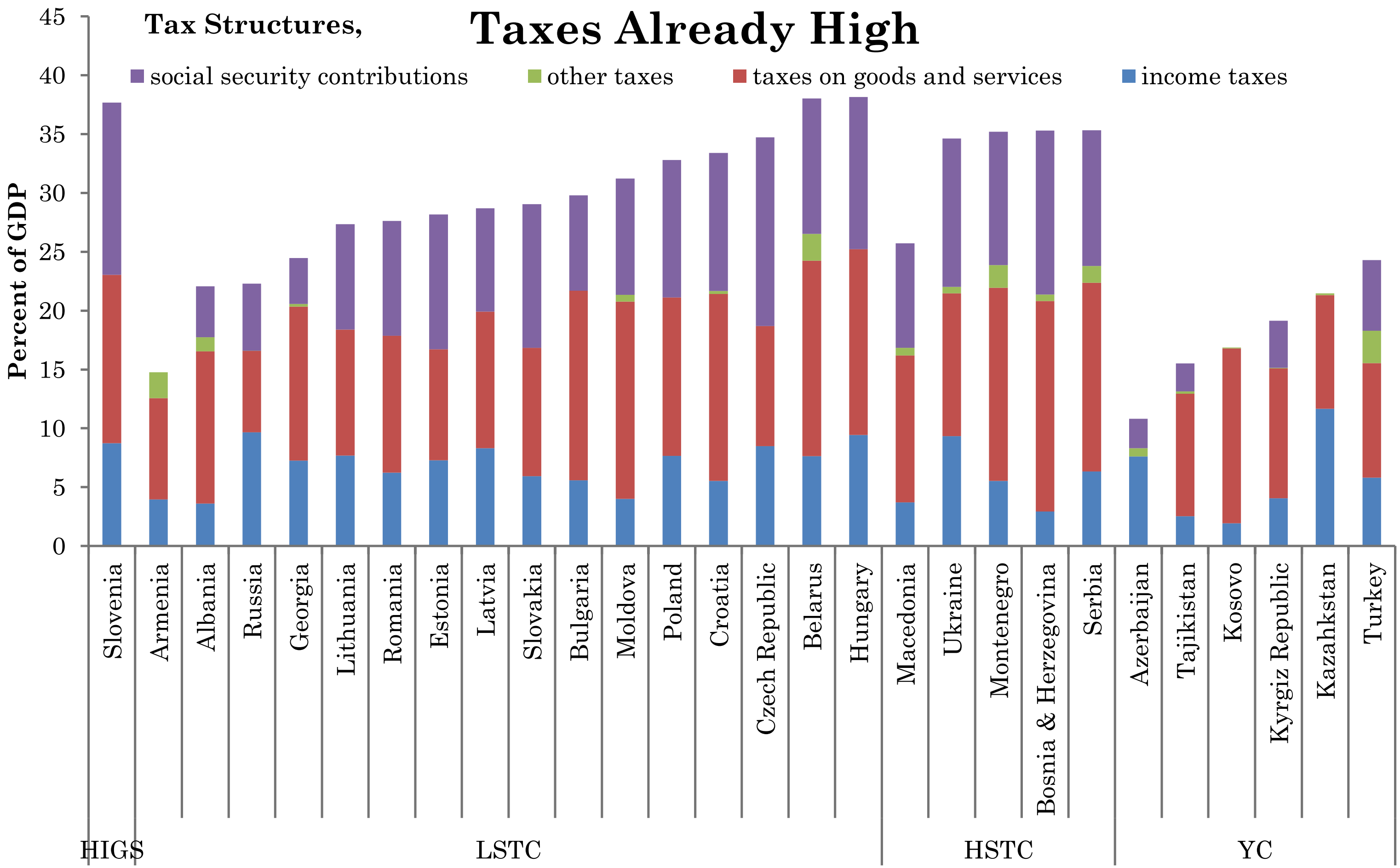
Increase Labor Force Participation – Not Much Room In Prime Working Ages



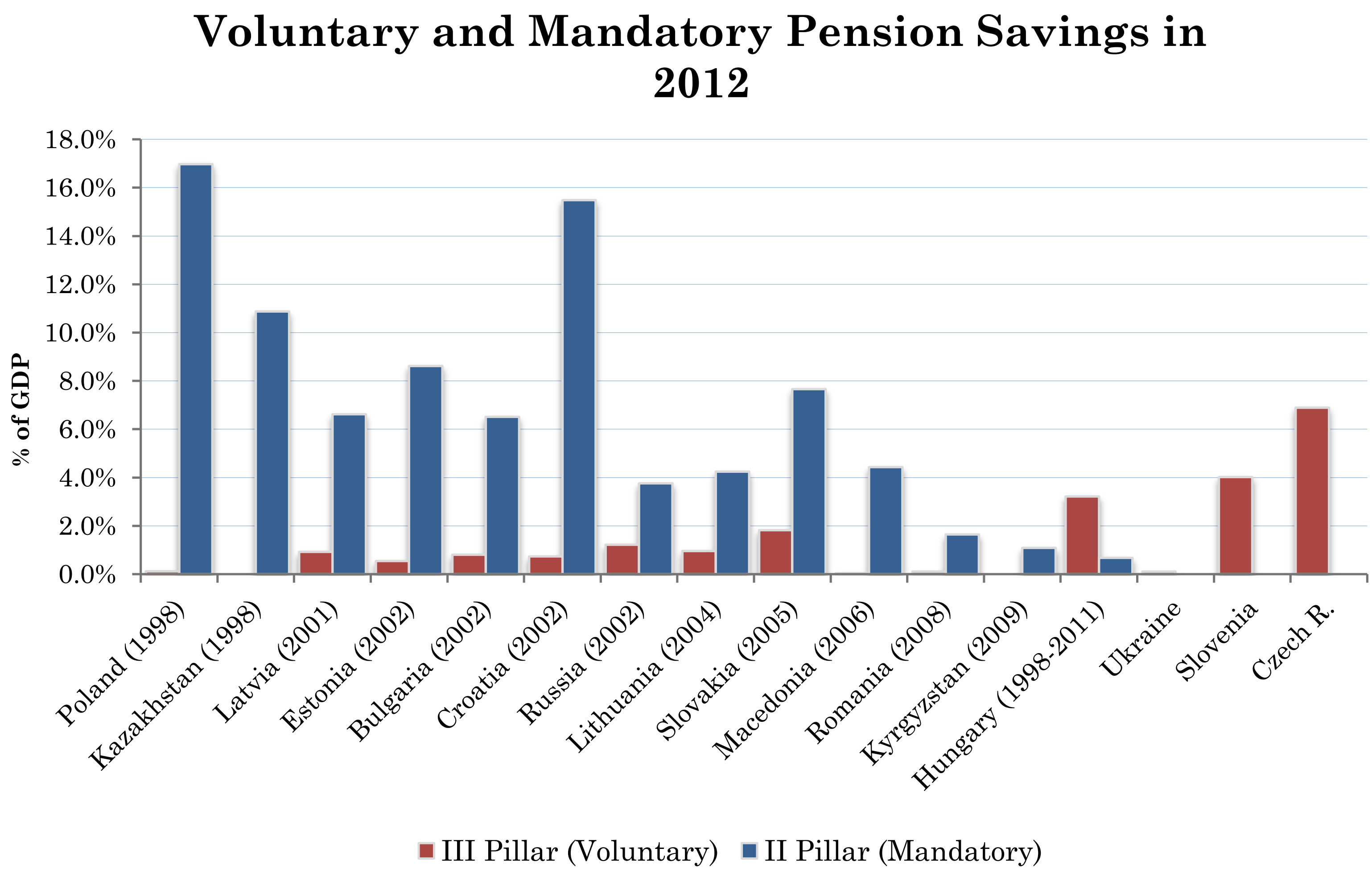
Potential for "active aging" is huge in ECA region



ROOM FOR USING OTHER FISCAL RESOURCES IS LIMITED



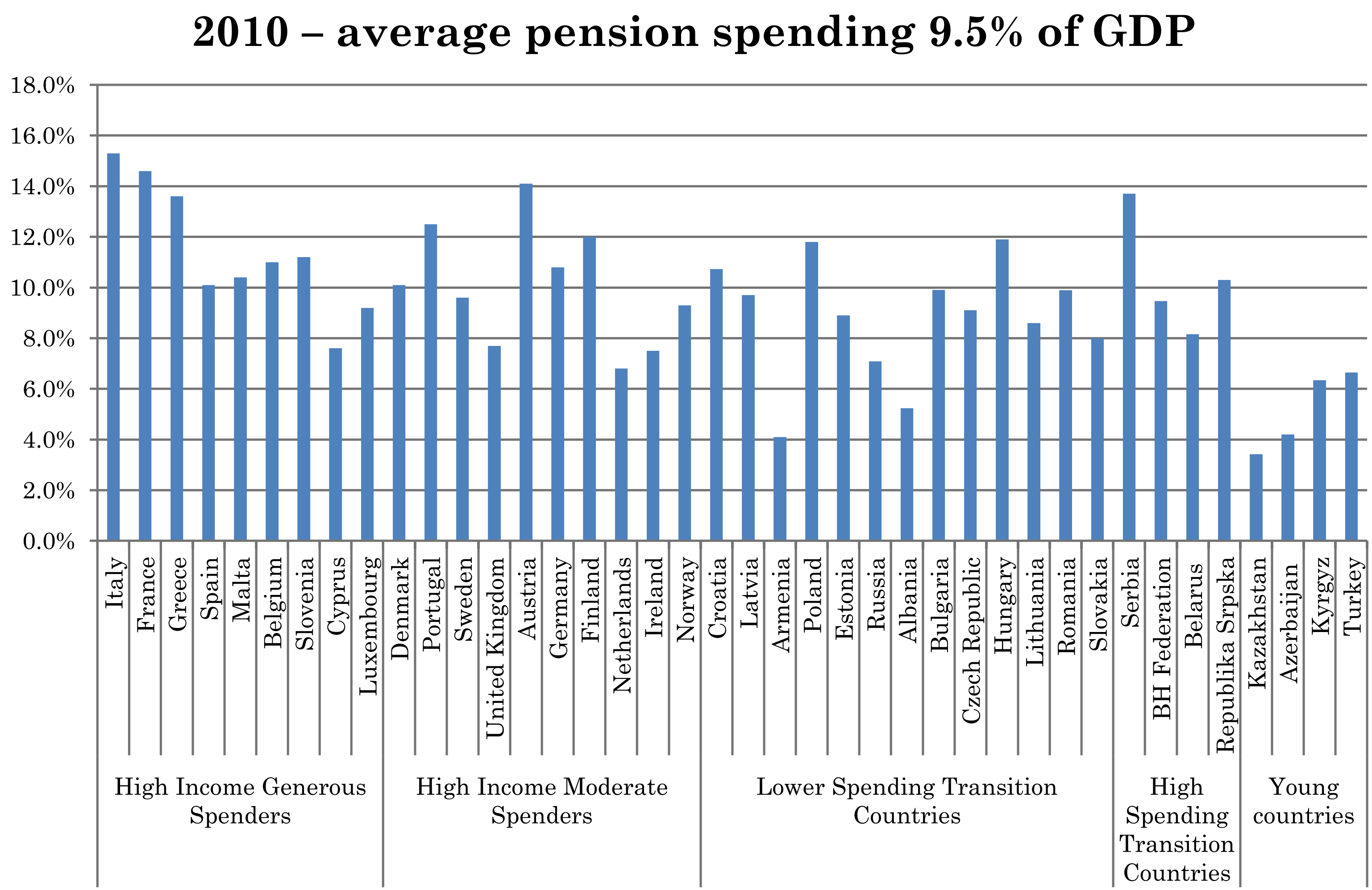
SAVINGS COULD HELP SUPPLEMENT PUBLIC BENEFITS, BUT LIMITED SAVING ACTUALLY TAKING PLACE



Take A Simpler Approach To Pension Design and Explain It Well

- What can we afford to spend on pensions as a percentage of GDP?
  - What do we spend now?
  - Do we see room realistically for increasing revenues?
- What are our expected future needs to cover old age and disability support?
  - How much is spending we have to do and how much is spending we would like to do, but can painfully reduce if absolutely necessary?
- How do we reconcile the two?

What Do We Spend Now?



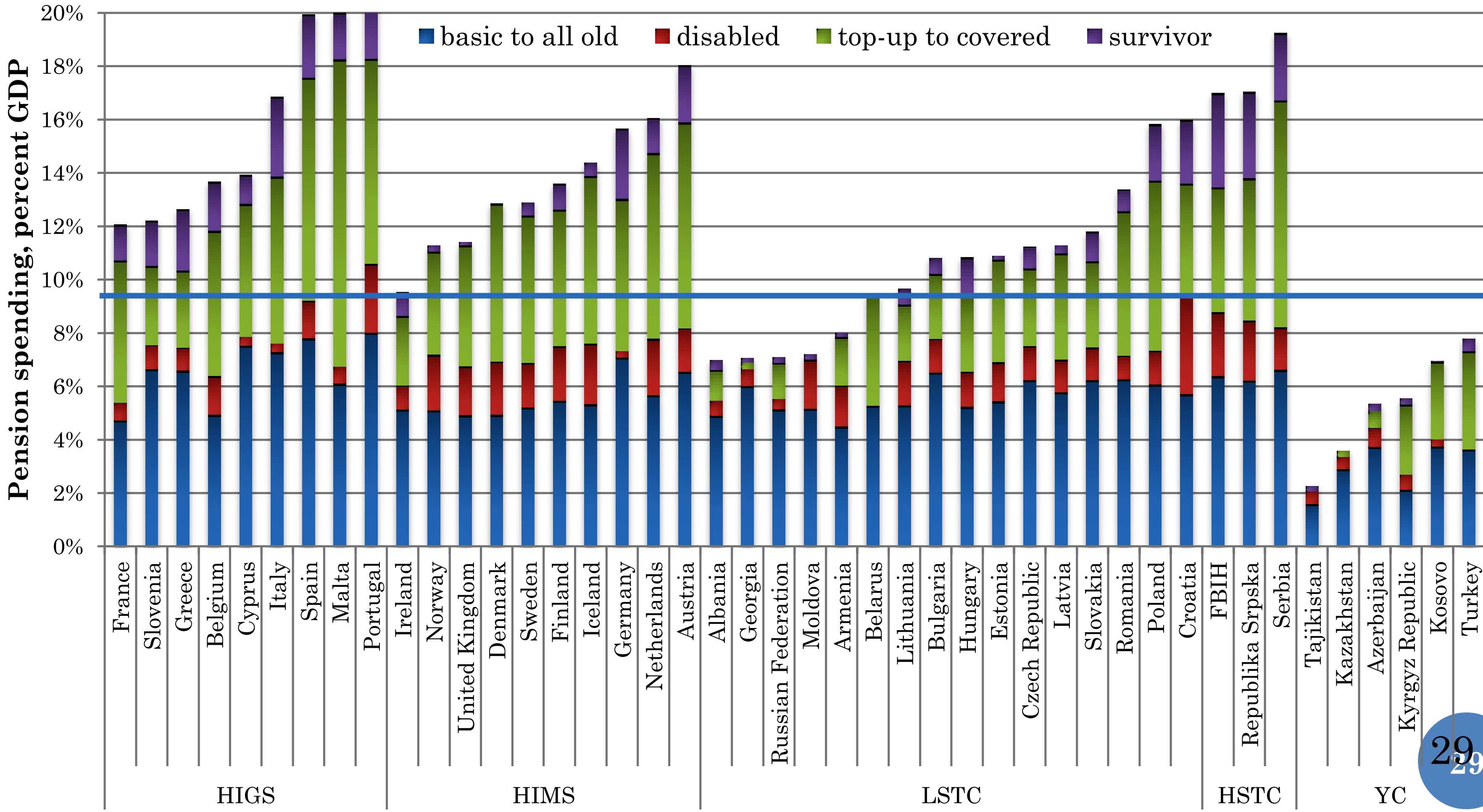
But This Spending Is Not Necessarily Well Prioritized

- 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
- 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

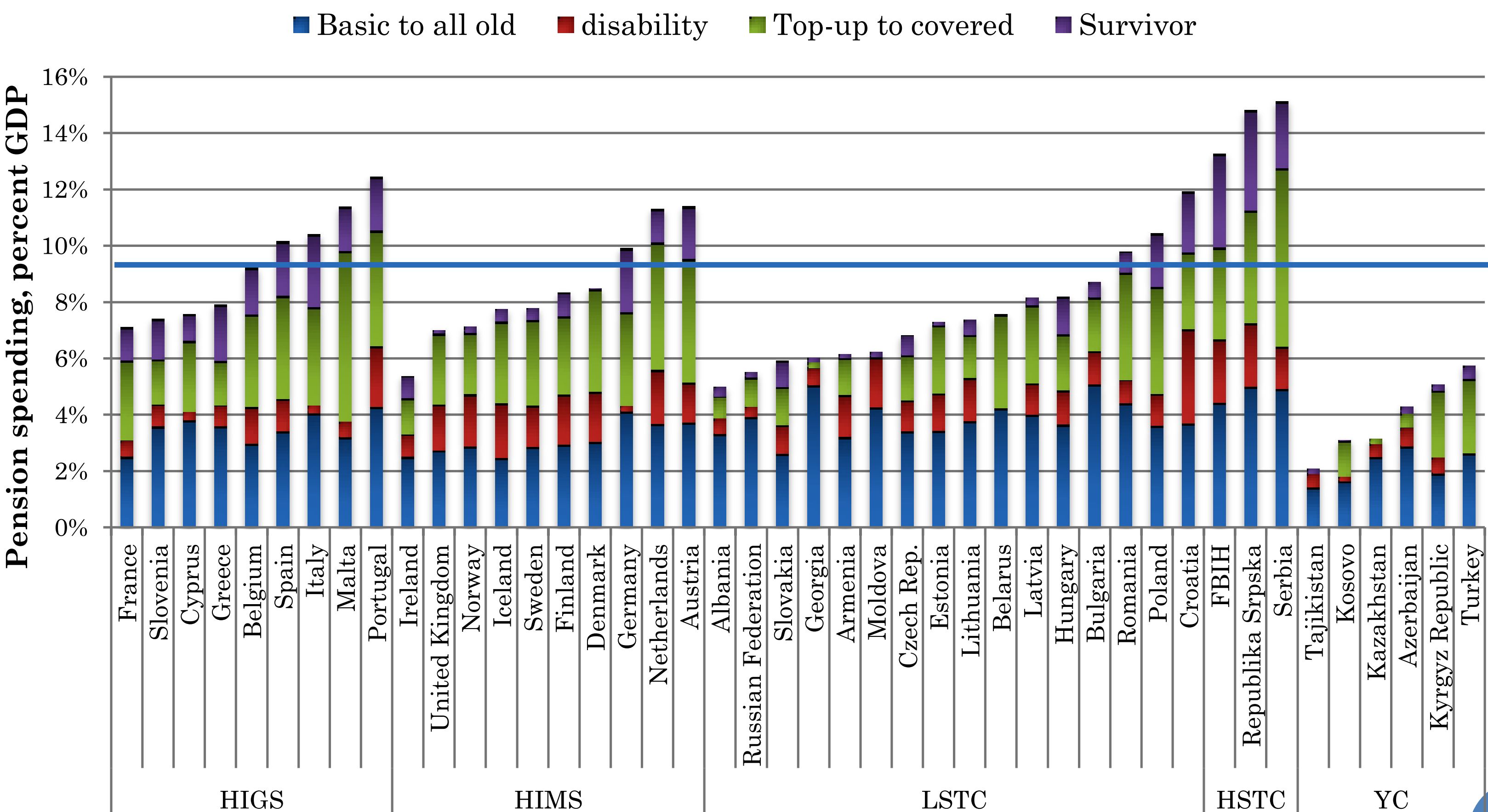
What Kind of Priorities Could Societies Set?

1. No person over the retirement age (65) should fall below the poverty line (20% of GDP per capita)
2. Disabled individuals – those unable to provide for themselves - should be protected, regardless of age
3. Those who contribute to the pension system should receive a higher pension than the basic poverty alleviating one
4. Spouses and families of those who contributed should receive some additional supplement upon the death of the contributor to help support the family

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



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



How To Get From Here To There

- How do we equitably divide the change across generations?
- What do these decisions imply for pension system design?
- What do these decisions imply for the financing of old age security?
- Accompanying changes:
  - Changes in labor markets that encourage full labor force participation until retirement and discourage earlier withdrawal from labor force
  - Encouraging retirement savings to provide more generous benefits than publicly provided

Bottom Line: It Is Possible To Provide Old Age Security Even With Challenging Demographics!

- Will need some major changes in expectations
- Future may be more like past
  - Pensions given when people are too old to work
  - Pensions guarantee poverty prevention
  - May provide limited earnings replacement
  - Savings required for enhanced benefits