INTERNATIONAL SOCIAL SECURITY ASSOCIATION

Social Policy Highlight 15

Pensions and demographic change

Currently, national pension systems are confronted with a number of major challenges. Among these, the multifaceted challenge of demographic change, involving falling fertility rates, increased longevity, changing migration patterns and evolving family structures, is pre-eminent. Most commonly, demographic change is viewed as threatening the financial sustainability of pension systems. In addition, the current global economic downturn has accentuated the financial pressures attributable to demographic change. This *Social Policy Highlight* examines the challenge of demographic change as it applies to pension systems and explains how they can adapt to address this challenge.

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The demographic context and its consequences for pension systems

Pension systems must adapt to demographic changes

Life expectancy at birth has increased in most countries, and globally has increased by more than 20 years since 1950. Life expectancy at age 60 has followed the same pattern, increasing by approximately 5 years. In turn, fertility rates have fallen globally, and in many countries are now close to the replacement rate level of 2.1 children per woman. Despite often large regional and national differences, the overall direction of these trends is similar.

These trends have direct consequences for pension systems. In many countries, the growth of the active population is negative or close to zero. At the same time, the number of pension beneficiaries is increasing significantly, which is posing major financial problems.

This issue

- Outlines the demographic context and explains its consequences for pension systems
- Examines the different reform options available to address the challenge of demographic change in more- and less-developed regions
- Highlights that sustainable pension systems must be socially as well as financially sustainable
- Underlines the role of the State in ensuring good governance and in creating an inclusive approach to reform

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Key statistics

- In 2010, there are 740 million people aged 60 or older; this will rise to 2 billion by 2050.
- In 2010, 64 per cent of those aged 60 or older live in the less-developed regions; this will rise to 79 per cent by 2050.
- In 2009, 55 per cent of those aged 60 or older were women.
- In 2010, there are 100 million people aged 80 or older; this will rise to 400 million by 2050.
- In 2009, life expectancy at age 60 for Japanese women was an additional 28 years.
- In 2009, life expectancy at age 60 for men in Costa Rica was an additional 22 years.
- In 2009, the fertility rate in 2009 in Niger was 7; in Germany it was 1.3.

The political and economic context

Pension systems represent long-term commitments, which call for a certain degree of stability. However, recent years have witnessed many pension system reforms and the current period of economic instability has brought further changes, which have sometimes been undertaken as a matter of urgency. Certain countries have thus reformed their pension system several times over a fairly short period. Other countries have not yet embarked on major reform, and the longer they wait the more difficult reform will become. Governments that have relied on increased productivity or on improvements in economic growth to restore the long-term stability of their pension systems have been confronted by the negative impacts of the crisis. For many, there is now recognition that economic growth alone will be insufficient to meet the financial challenge of demographic change.

Clearly, labour market conditions have a big impact on pensions and many pension systems would be in a healthier financial position if a larger proportion of the working-age population were working and contributing. However, many young people have trouble finding a first job, there are large numbers of unemployed who do not contribute and many men and women have left the labour market because of health problems, lack of qualifications, lack of mobility, etc. And older workers tend to claim their old-age pension as soon as they meet the minimum requirements for eligibility.

Gender equality, new family structures and migration

Pension systems were designed at a time when most families comprised a husband in paid employment and a mother who stayed at home to look after their children (i.e. the male breadwinner model). Many pension systems continue to reflect this composition providing, for example, a survivor's pension only for a female spouse. However, family structures have changed considerably. Urbanization has weakened family ties to a certain extent, with parents not necessarily following their children when they move in search of employment opportunities. At the same time, the presence of a fourth generation within families is increasingly common. In countries affected by HIV and AIDS, many orphans are being brought up by their grandparents.

With women living longer than men, it is important to study the impact of gender on pension systems. Many women have only a small survivor's pension to live on. And while an increasing number of women work and acquire their own pension rights, incomplete careers and, in many cases, lower salaries mean that their pensions are generally far less than those of men.

Migration has also increased in recent decades. Migrant workers, as new contributors, can enable a relative improvement of the dependency ratio of the systems to which they contribute in the medium term. In the long term, they will also receive benefits, which will have to be financed.

Different reform options to meet the demographic challenges

Ensuring sustainable defined benefit schemes

Defined benefit schemes have undergone many changes, a large number of which have been dictated by the demographic context. Parametric reforms have adjusted many factors that shape pay-as-you-go pension schemes: the value of contributions and benefits, the retirement age, etc. Contribution rates (where these have not yet reached what are deemed to be maximum levels) can be raised in order to cover increasing costs. However, countries often introduce measures to limit them. Benefits can be "reduced" in a more or less direct manner, for example by altering eligibility requirements (to make them more stringent) or by changing the rules governing the indexation of pensions (to make them less generous). There is a marked trend to tie the amount of benefits more closely to the amount of contributions.

Revisiting individual accounts

Demography also has an impact on defined contribution schemes. This is not, however, the main reason that has led a number of countries to reform their individual accounts system. More precisely, these schemes have not lived up to expectations. In particular, they have not led to higher rates of coverage, they have not proved less expensive in terms of administrative costs than the systems they replaced, and the benefits they provide are often very small. The amount of the benefit depends not only on interest on investments but also on contributions. The latter are often insufficient because the contribution rates have been fixed at a fairly low level. A first wave of reforms (sometimes known as "re-reforms") began a few years ago, as in Chile. However, the need to take demographic changes into account has led to certain changes; in particular, a reduction in benefits when annuity rates have been reduced to take into account increased longevity. Chile changed the mortality table for the calculation of pensions in 2004. Switzerland has revised its legislation pertaining to the occupational insurance fund several times and has reduced annuity rates.

The crisis has accelerated the pace of reforms

The current crisis, the outcome of which remains uncertain, has accelerated the pace of reforms. Pay-as-you-go pension schemes have acted as a social buffer, however, this has often been at the expense of their finances, thus creating a need for

more urgent and also more extensive reform than that envisaged prior to the crisis. This has been the case, for example, in France and Greece and also in Spain and the United Kingdom. Recapitalization plans have been introduced in certain private fully-funded schemes based on increased contributions as well as reduced benefits. In several European countries, contributions to second pillar individual accounts schemes have been temporarily reduced and allocated to pay-as-you-go first pillars in order to compensate for the cyclical deficits of the latter. Generally, the aim is to compensate for these reduced contributions by increased contributions in future years.

Self-adjustment mechanisms: A solution?

Although there is no precise definition of an automatic adjustment mechanism, a certain number of countries have introduced such mechanisms to maintain (or re-establish) the sustainability of their system, particularly in order to adjust to demographic change.

Self-adjustment mechanisms

In the framework of work undertaken by the ISSA Technical Commission on Statistical, Actuarial and Financial Studies, the Office of the Chief Actuary of Canada carried out a survey on self-adjustment mechanisms in social security schemes: 26 countries responded and 17 countries indicated that their retirement system included an automatic adjustment mechanism. Most of these consist of mechanisms that respond to the demographic (but also economic) situation, because the projected challenge to sustainability is often the result of demography. As a result, adjustment measures often involve the adjustment of demography-based criteria such as retirement age. Such measures often affect both contributors and beneficiaries. For example, increased contributions and reduced benefits would both occur if the mechanism that exists in Canada were ever to be activated. Several countries have complex mechanisms. In particular, in Sweden, where in 2010 the automatic mechanisms was triggered and led to a decrease in pensions for the first time since the introduction of the notional accounts scheme. Nevertheless, many countries keep the financial sustainability of their pension systems under constant surveillance, whether or not they include automatic adjustment mechanisms.

Retirement age and the employment of older workers

The activity rate of older workers is unquestionably the key factor. Everywhere, raising the retirement age seems to be the best solution – or, in any case, the best among difficult choices. Countless countries have raised the pension age, are in the act of raising it or will soon do so. The change is usually introduced progressively to enable those workers implicated to adapt and to reduce its impact on those close to retirement. This is seen to be the key factor because raising the retirement age affects income as well as expenditure, enabling a system both to collect contributions over a longer period and to pay benefits for a shorter period. At the same time, members who contribute longer accrue better pensions (provided the legislation remains unchanged). In practice, an employment policy adapted to older workers is indispensable; otherwise, many of the insured may risk being "too old to work, too young to retire". A change in attitude is the first step towards responding to demographic challenges.

The adequacy and coverage of pensions

In developing countries in general and in Africa in particular, decision-makers can no longer ignore the fact that the vast majority of their old people have not contributed to a retirement scheme and therefore do not receive pensions. Tax-financed pension systems may provide an answer, given the changes in family structure and the limited financial resources of many poor families. Such systems may vary in their structure; they may be means-tested or universal, provide the same benefit for everybody or provide an amount based on income or family composition. Both their impact on poverty and their indirect impact on the economy appear to be highly positive. In Latin America, the addition of a basic pillar (zero pillar) financed from taxation and aimed at providing a universal guaranteed minimum benefit is good news for all those who receive these benefits, many of whom are excluded from the contributory scheme.

In the developed regions, another important issue is the adequacy of the benefits provided. Few systems have a specific objective in terms of the replacement rate to be provided. Increasingly complex regulations for the calculation of pensions make it difficult to provide estimates and many reforms have tended to reduce the level of benefits in response to demographic changes. Well-targeted minimum benefits are thus a necessity and many recent reforms have in fact reinforced their role particularly, but not only, as a result of the crisis.

Conclusions

Examination of the current demographic situation and its probable evolution indicates that pension systems are likely to remain in the limelight and subject to discussion. Their future is fraught with challenges; in some cases, minor adjustments, for others, major reforms. However, the upheaval caused by population ageing is far from over. In the wealthiest countries, systems designed initially to meet the income replacement needs of those who are no longer directly economically productive now play a different economic and societal role. In those countries where coverage is low, it is becoming increasingly urgent to extend coverage quickly, not least because it will be even more difficult to do so as the cohorts of older people increase in size. An active employment policy adapted to older workers is also indispensable.

Although an aim of many recent reforms is to restore the long-term financial equilibrium of pension schemes, this is often being pursued through reducing benefits. Yet, in a manner that is often overlooked, the sustainability of a pension scheme is more than a question of financial sustainability – it is also a question of its social sustainability. There is a pressing need for these two different but vital aspects to be more readily assimilated by all social actors involved in the reform process. This naturally implies a need to find an acceptable balance between the generosity of benefits and what the system can actually afford to provide. In this regard, political will and trust are paramount.

Current policy priorities associated with addressing the challenges of the global downturn should not overshadow the longer-term objectives of pension systems to provide income protection. Ultimately it is the role of the State, by ensuring the pursuit of good governance and working in an inclusive manner with all legitimate social actors, to ensure that this is so.

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