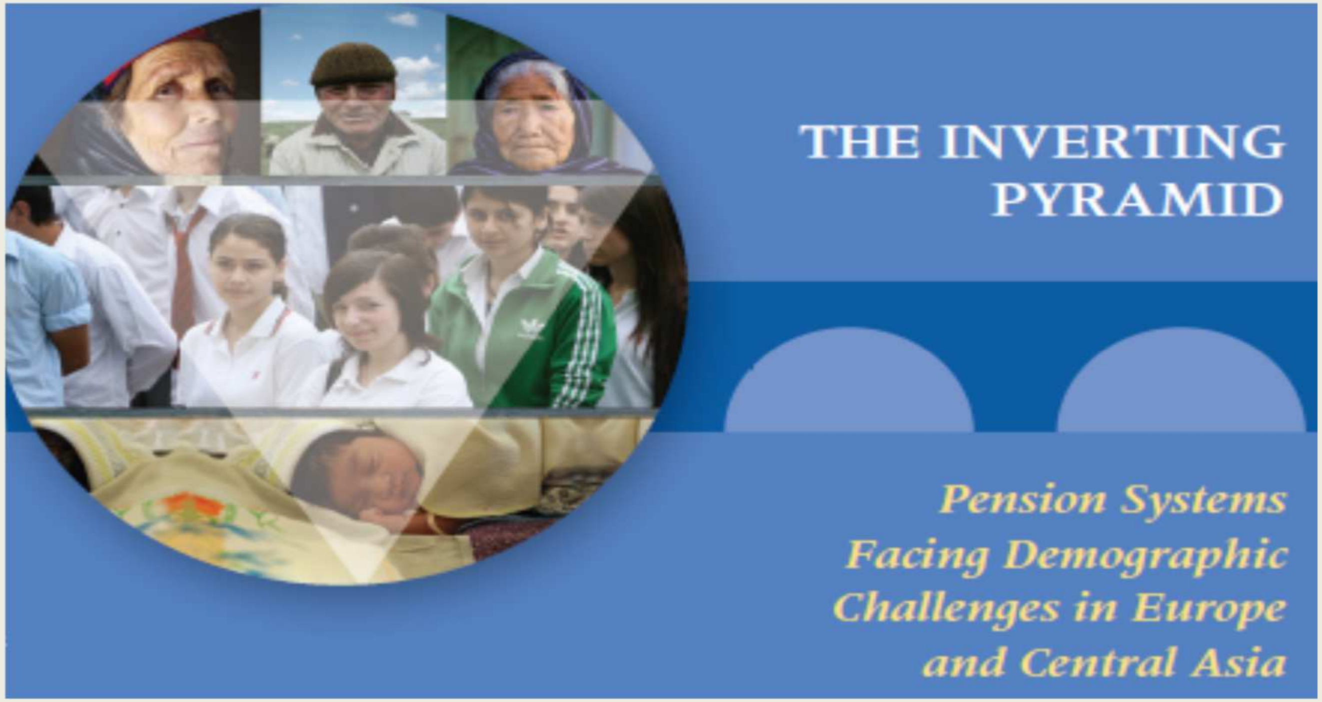


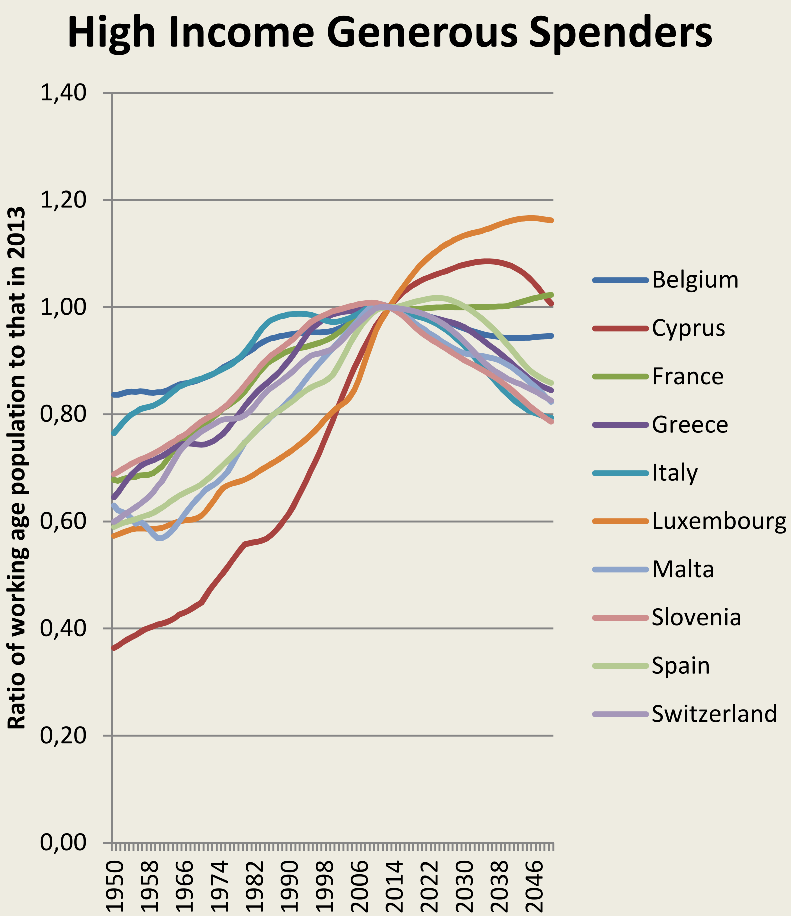
Demographic Challenges in Europe and Central Asia

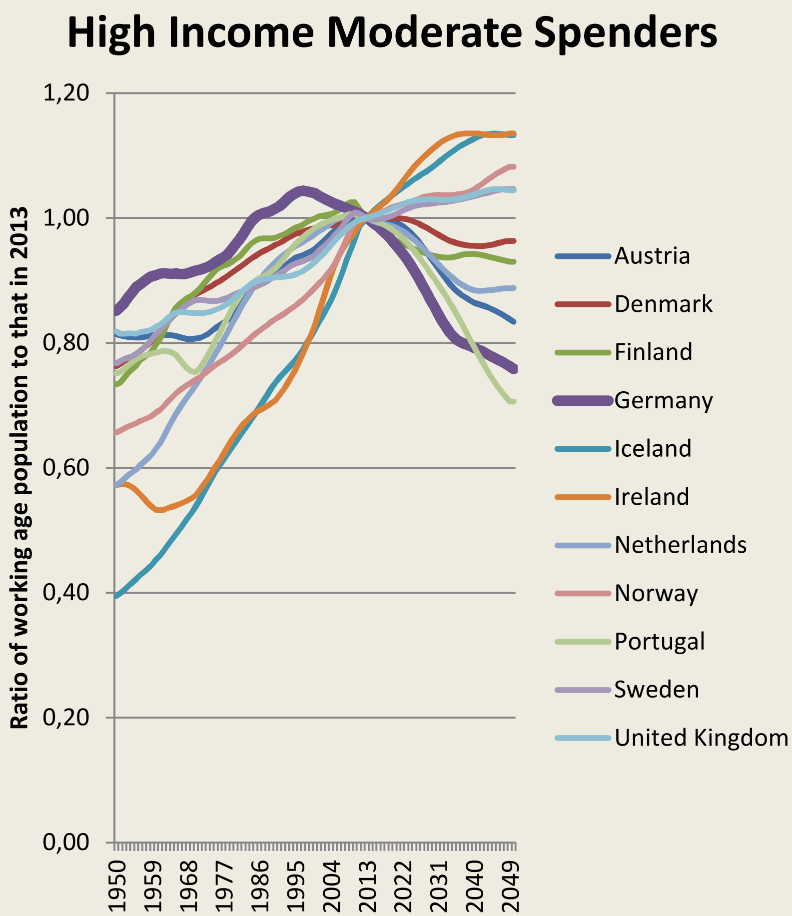
Anita M. Schwarz

Lead Economist

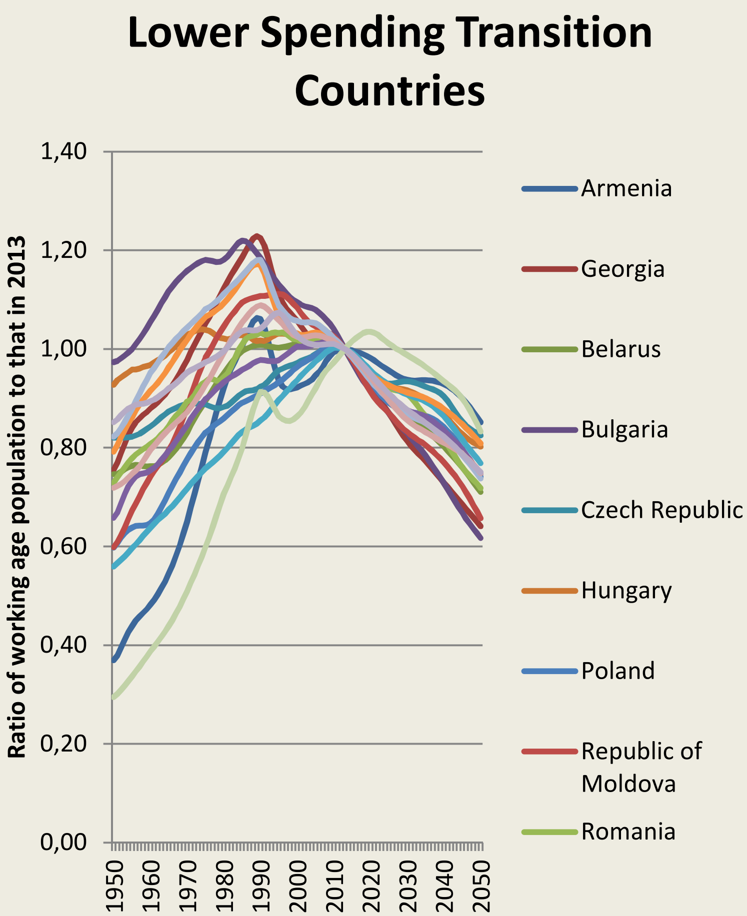
World Bank

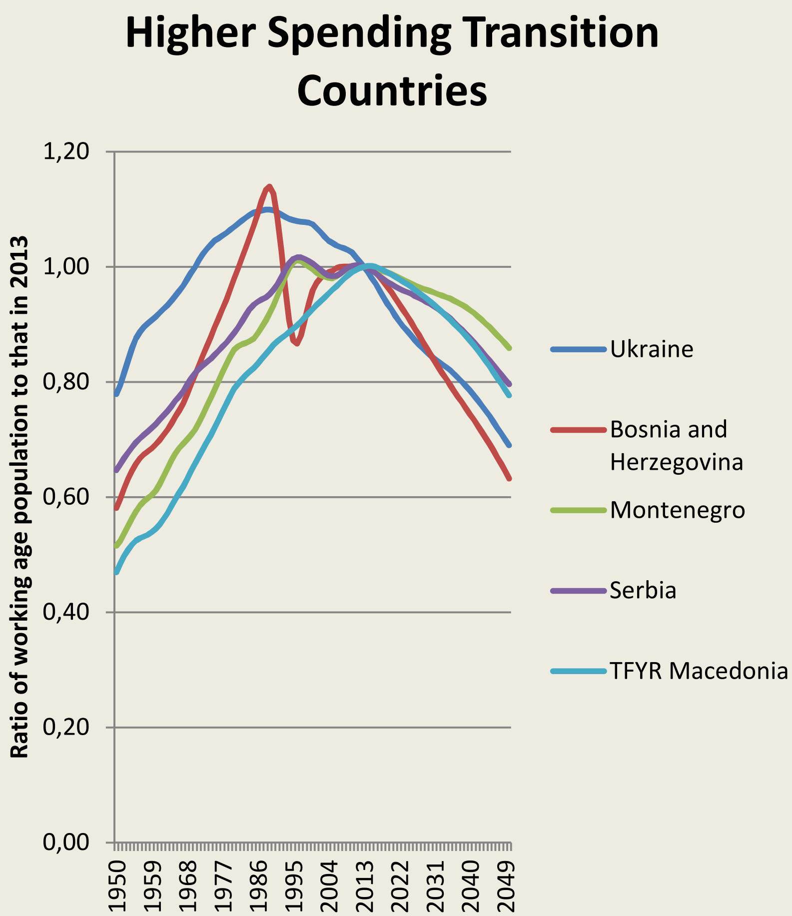
Structural Break in Growth of Working Age Population Around 2013



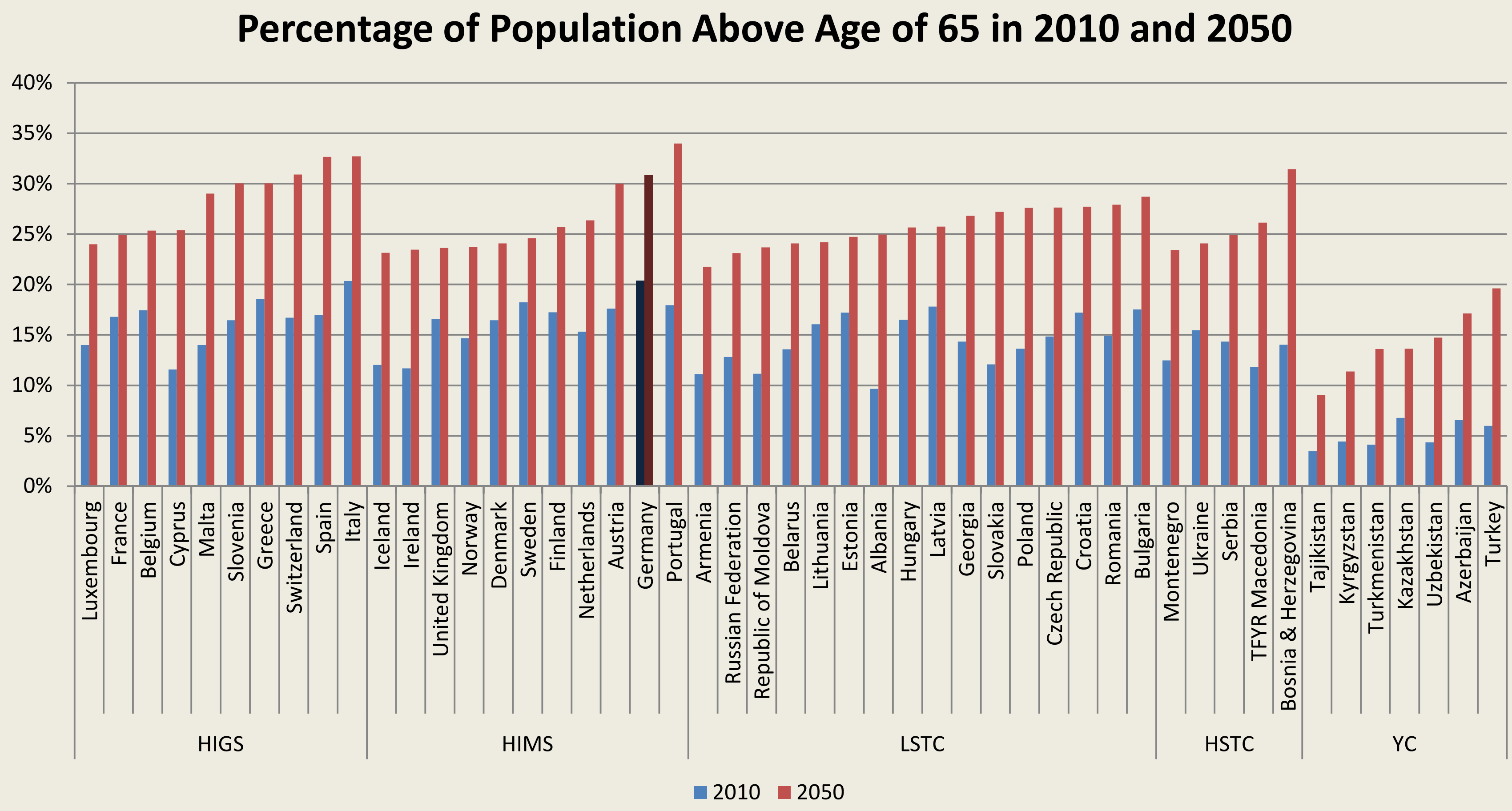


Structural Break in Transition Countries More Marked



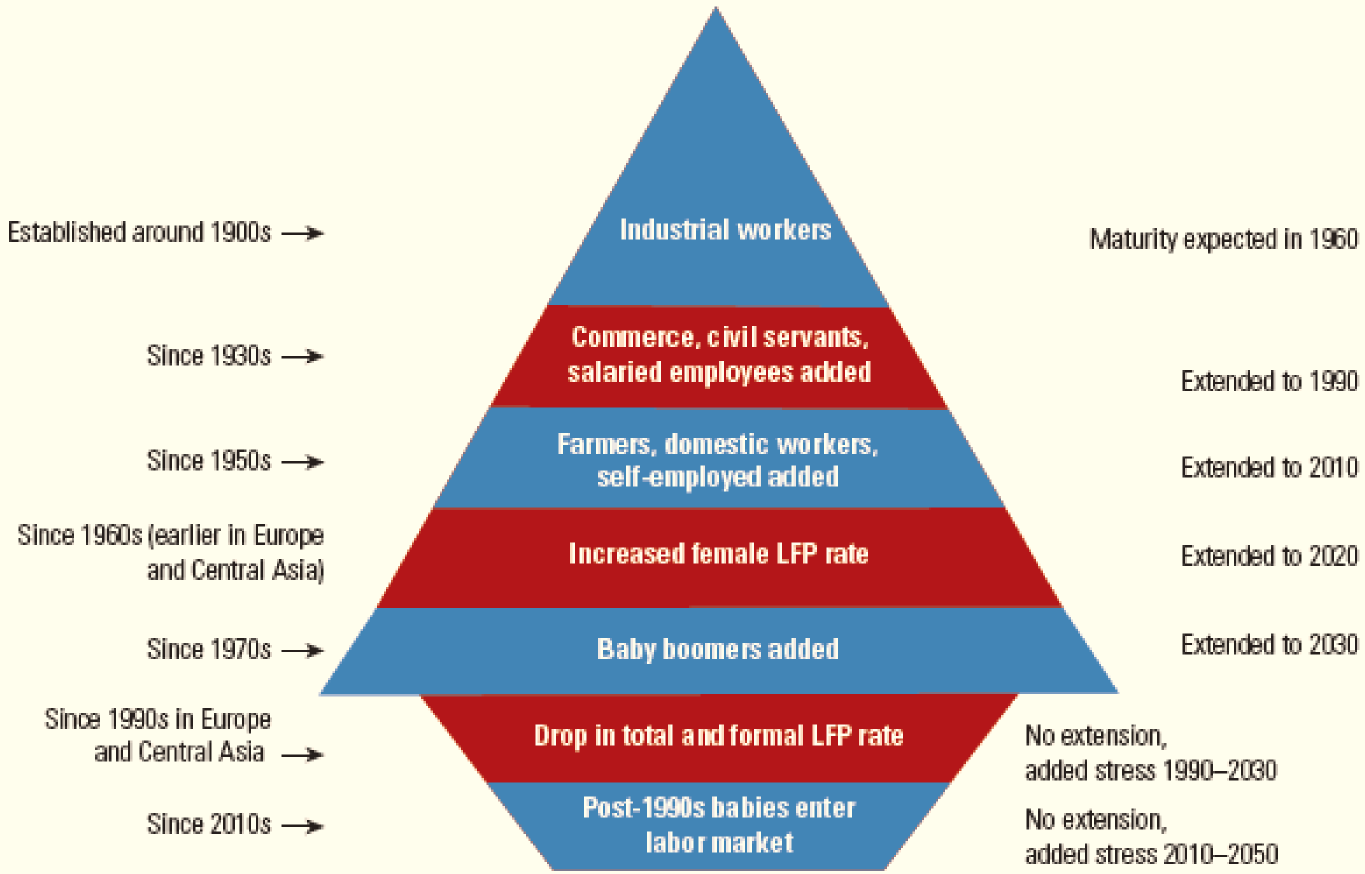


While contributors are falling, share of elderly in population is rising

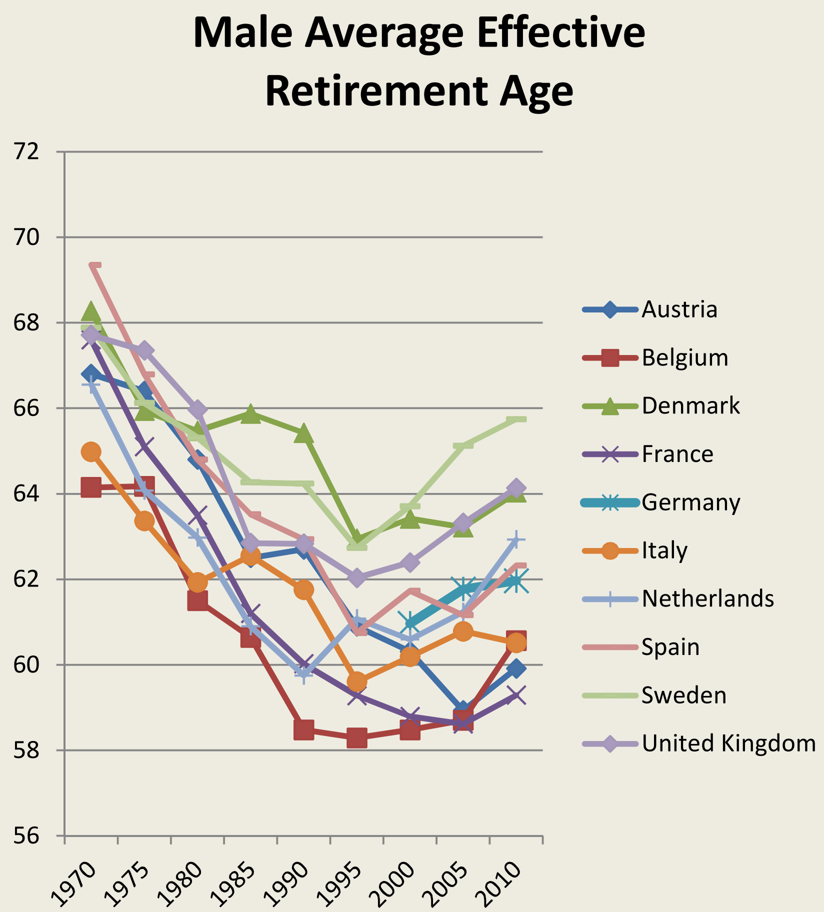


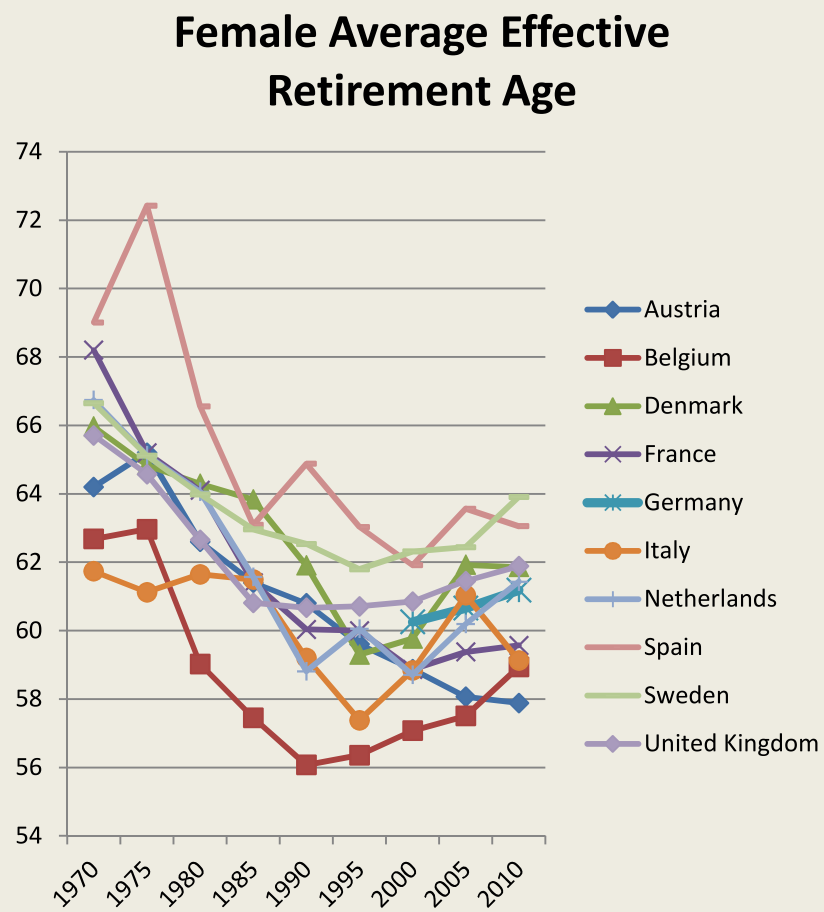
The Inverting Pyramid

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

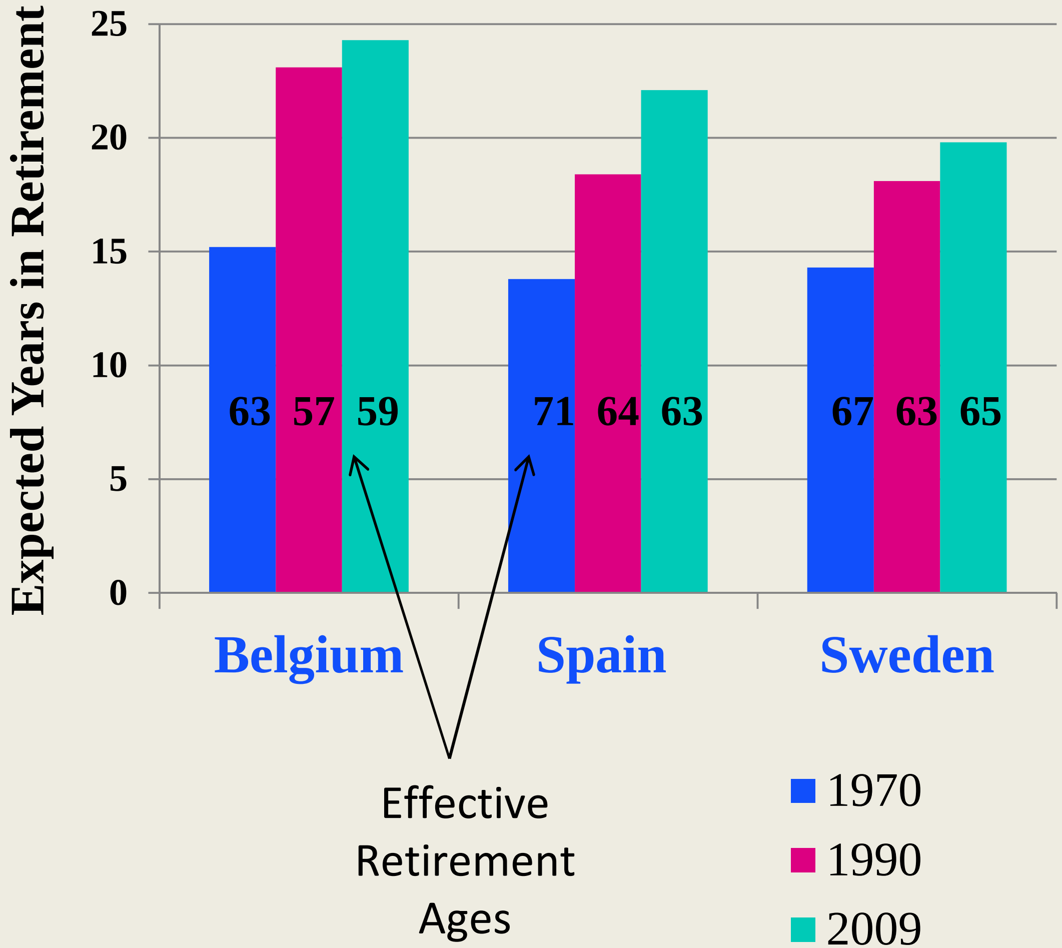


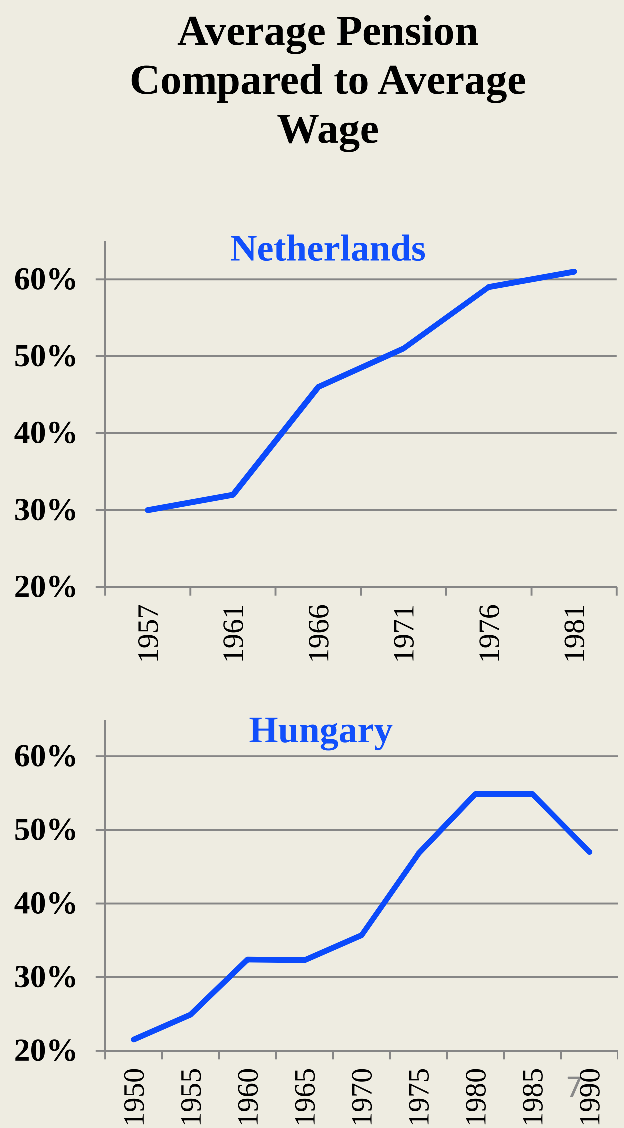
When contributors were growing, these countries increased generosity





Benefits were paid longer and at a higher rate





Concept of Retirement Changed

- Initially thought of as a supplement to income from part-time work
- Became full source of poverty-alleviating income
- Became enough to guarantee a comfortable retirement
- Became enough to match working age income or even greater

Countries now undertaking all kinds of reforms: Public pensions reforms

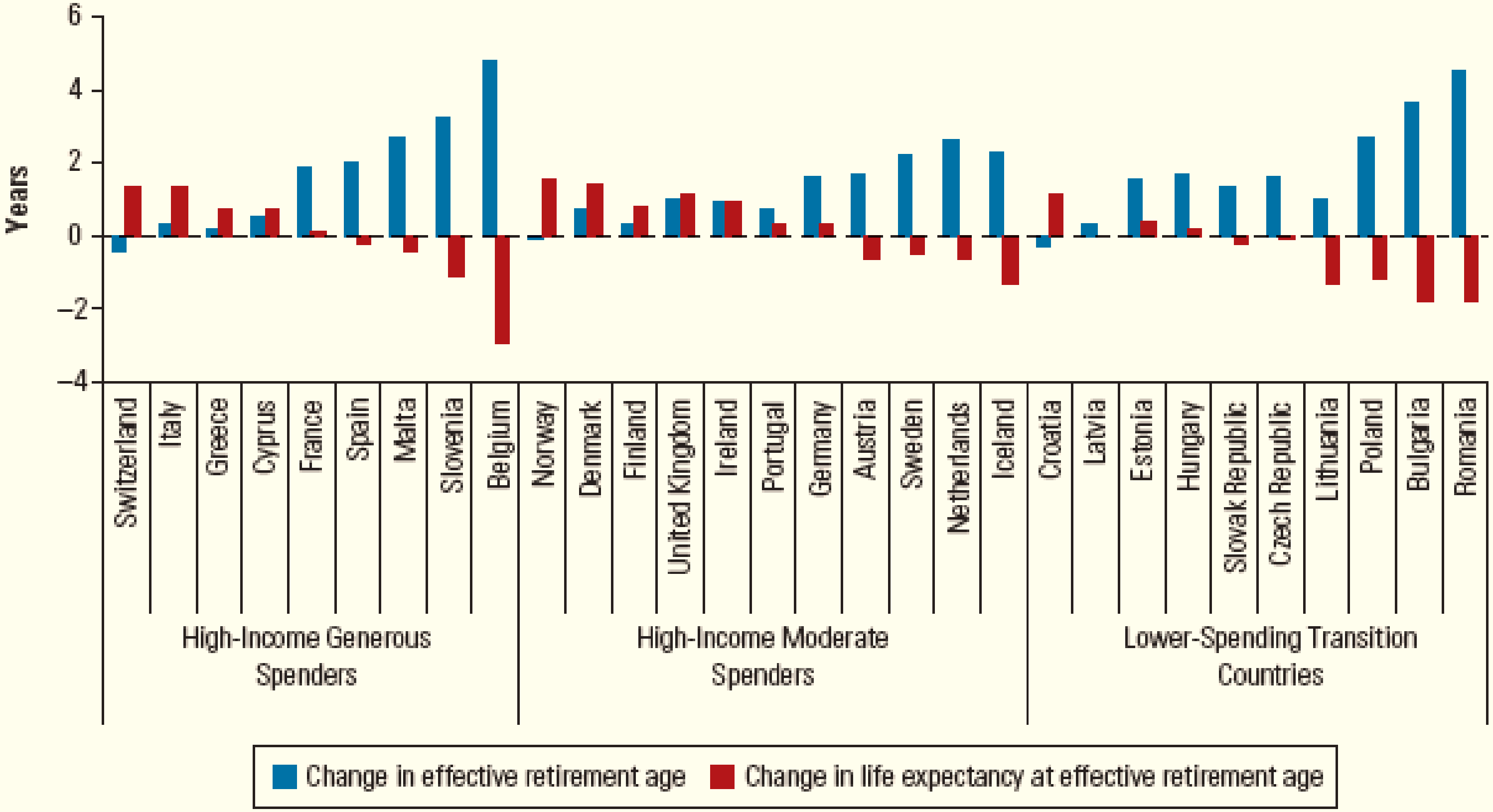
- Reforms focused partly on reducing spending
  - Restricted eligibility criteria
    - Raising retirement age
    - Tightening disability conditions
    - Raising years of service requirements
  - Reducing benefits in the long run
    - Basing benefits on full career salary
    - Indexing only to inflation
    - 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

Adding 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

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



Source: Eurostat Statistics Database.

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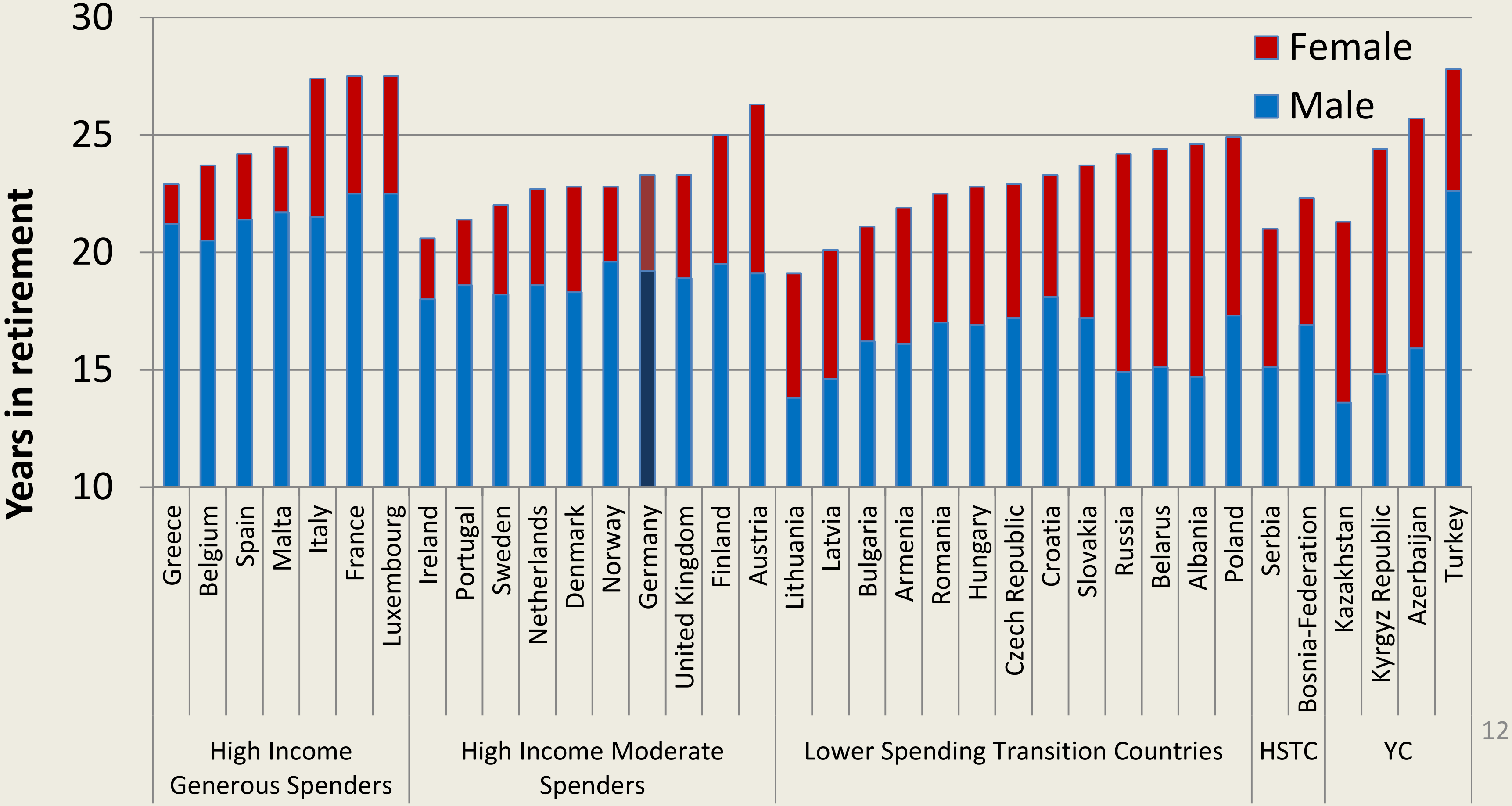
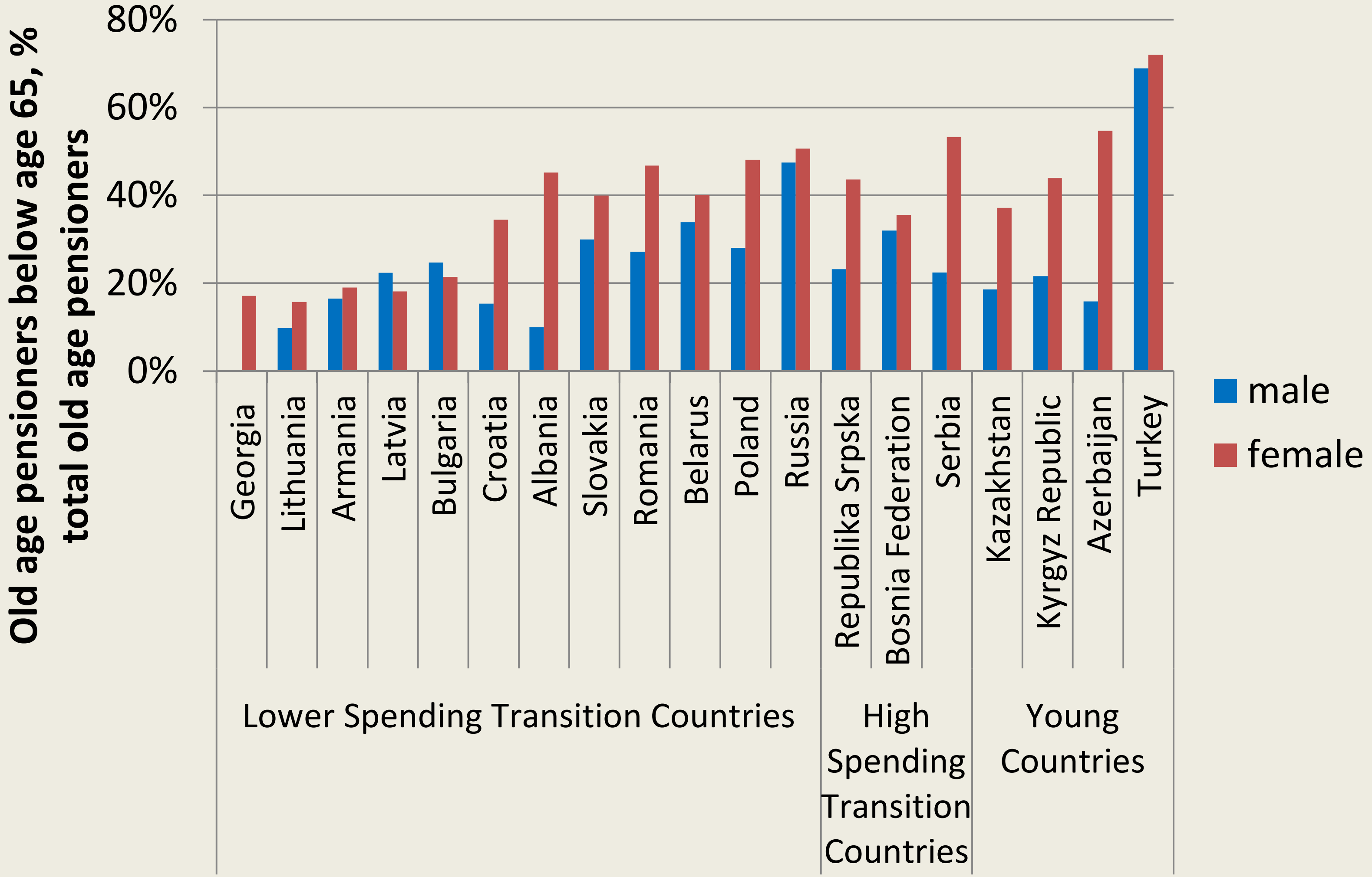
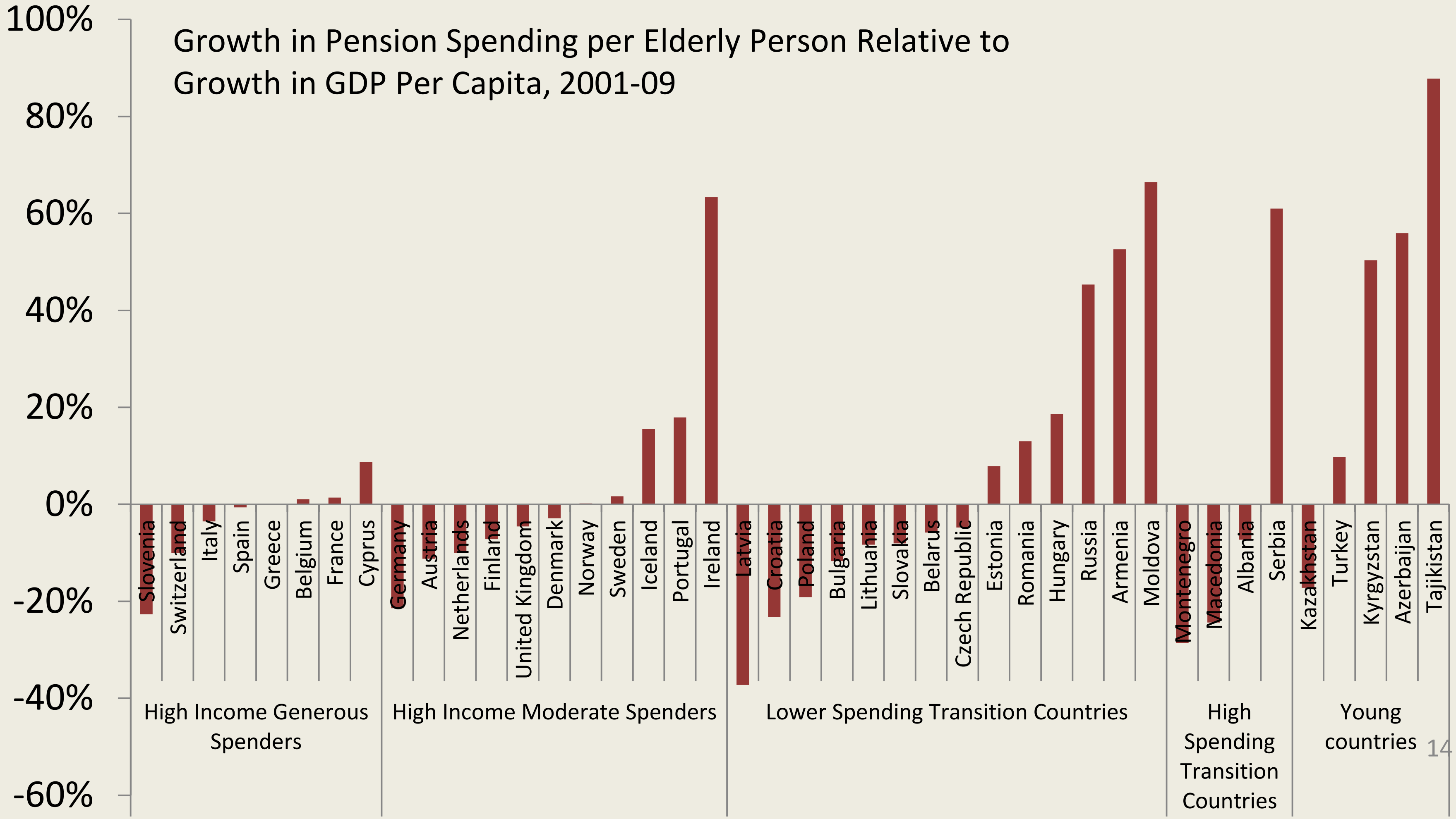
Duration of retirement still remains far above 15 years



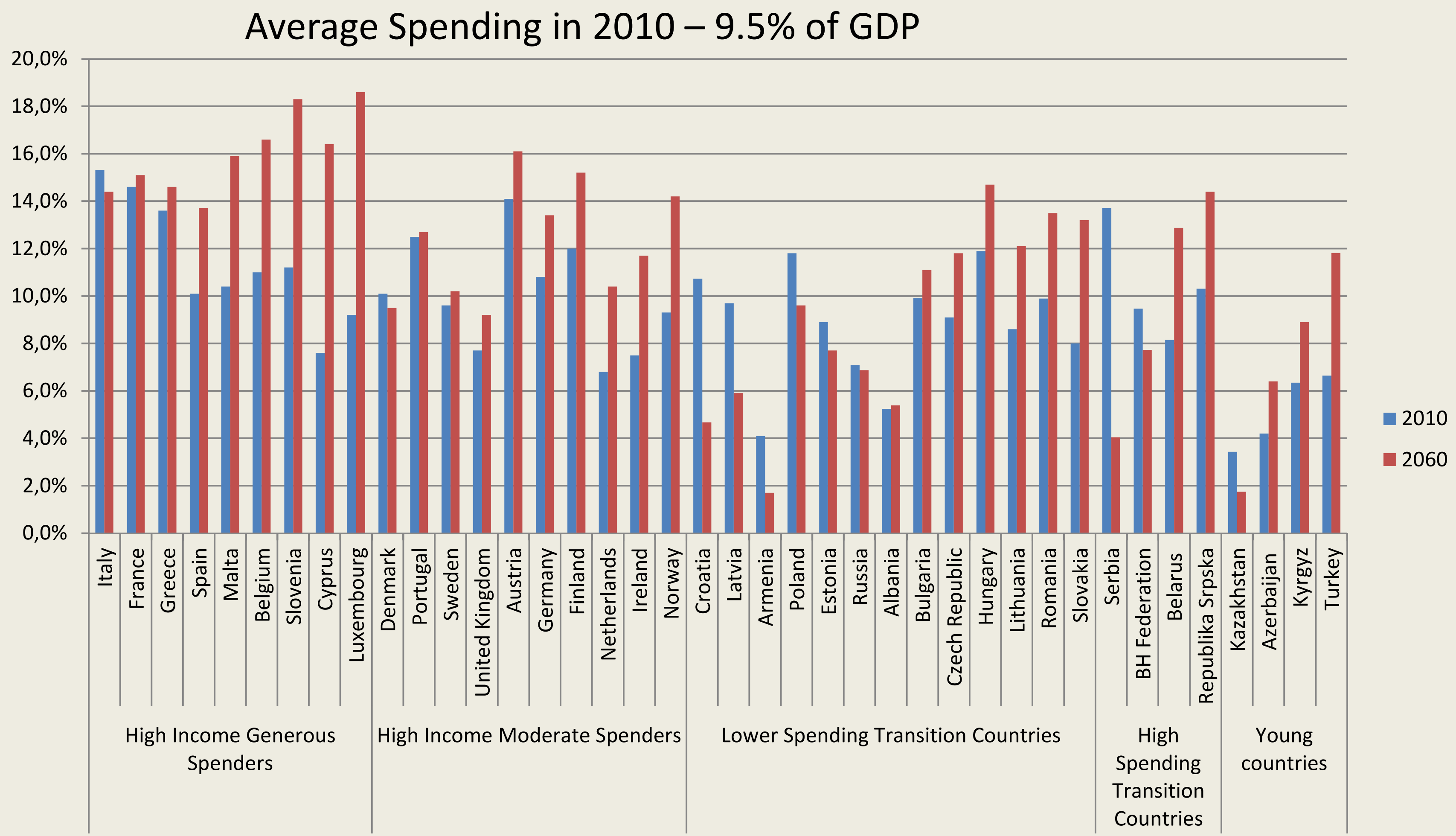
Early retirement is still prevalent



No clear trend-line of reduced spending per pensioner



Projected spending compared to spending as share of GDP in 2010



Policy Recommendations

- Increase savings to maintain adequate benefits
- Increase fiscal space if possible
- Encourage longer working lives
- Prioritize public pension spending

Some of the second pillar reforms were partially or fully undone due to fiscal constraints

- 7 of the 15 countries adopting second pillars reduced or eliminated contributions to the second pillar during the financial crisis, with 1 having now fully restored second pillar
- 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

Mitigate incentives to unwind funded pension schemes

- Rely more heavily on tax financing of transition deficit
  - Earmarking revenues (i.e. VAT increases) with transition expenses might help
- Define reliable methodologies for calculating the implicit pension debt, and make these figures available to public
  - Increase awareness of government commitments that are not reported in the main variables of the Stability and Growth Pact
- In the absence of fiscal responsibility no pension system will be sustainable

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
  - » Use “optimal” portfolio as common default portfolio
  - » Consider lifecycle strategies (governance of the default)
  - » Consider how current generation benefits from the pension fund investments
- Collective schemes versus individual schemes

Transition to a more efficient industrial organization of the pension fund management industry (2)

- Design payout structures that ensure proper risk allocation of investments and longevity risks
  - While variable income annuities are attractive instruments for benefit payments, they might be difficult to supervise and regulate.
- Risk averse policymakers may consider the introduction of guarantees on the value of the contributions,
  - Guarantees need to be properly priced
  - Guarantees need to be written by an independent party and not by the pension fund management companies

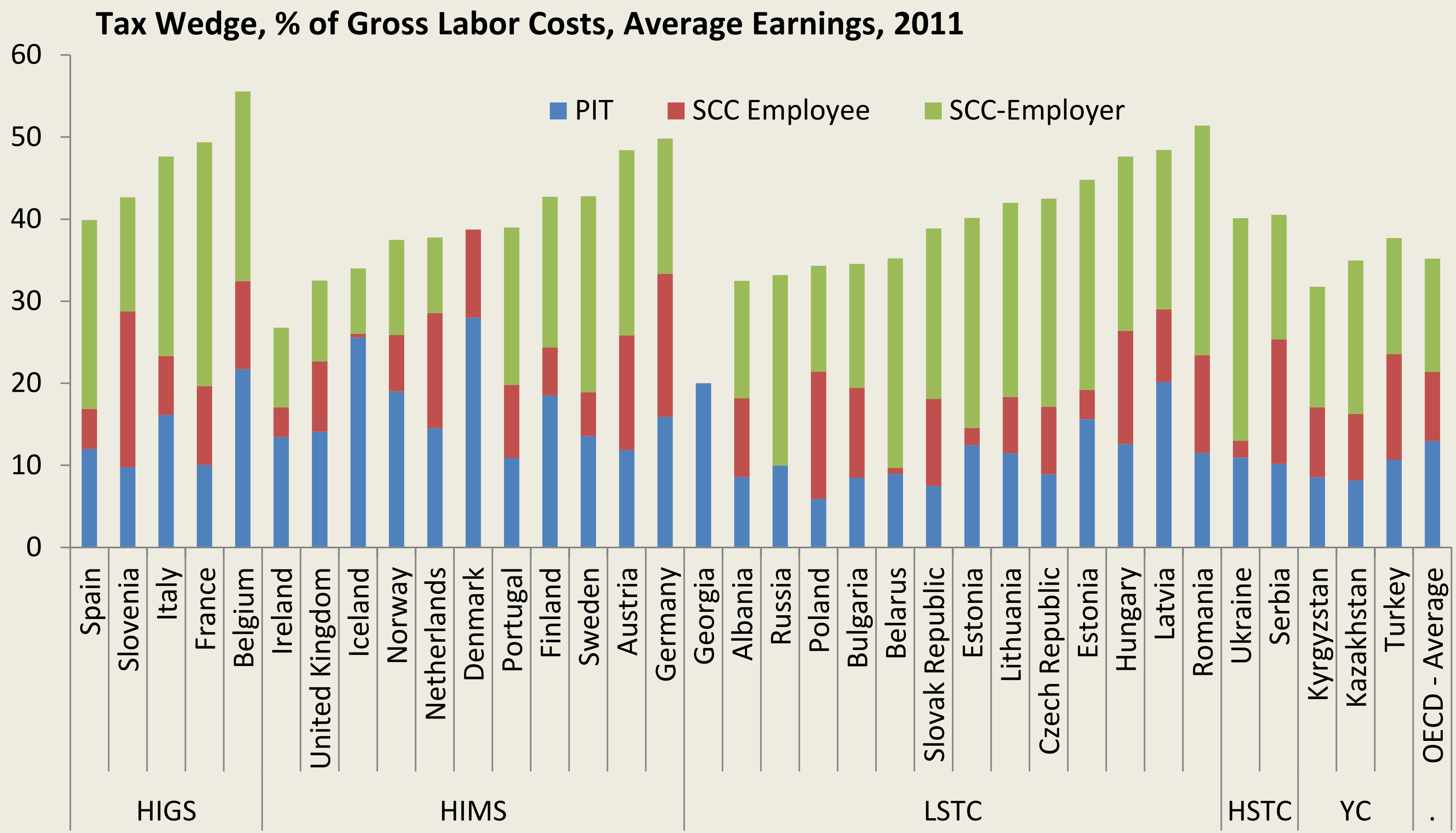
The role of voluntary pension schemes

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

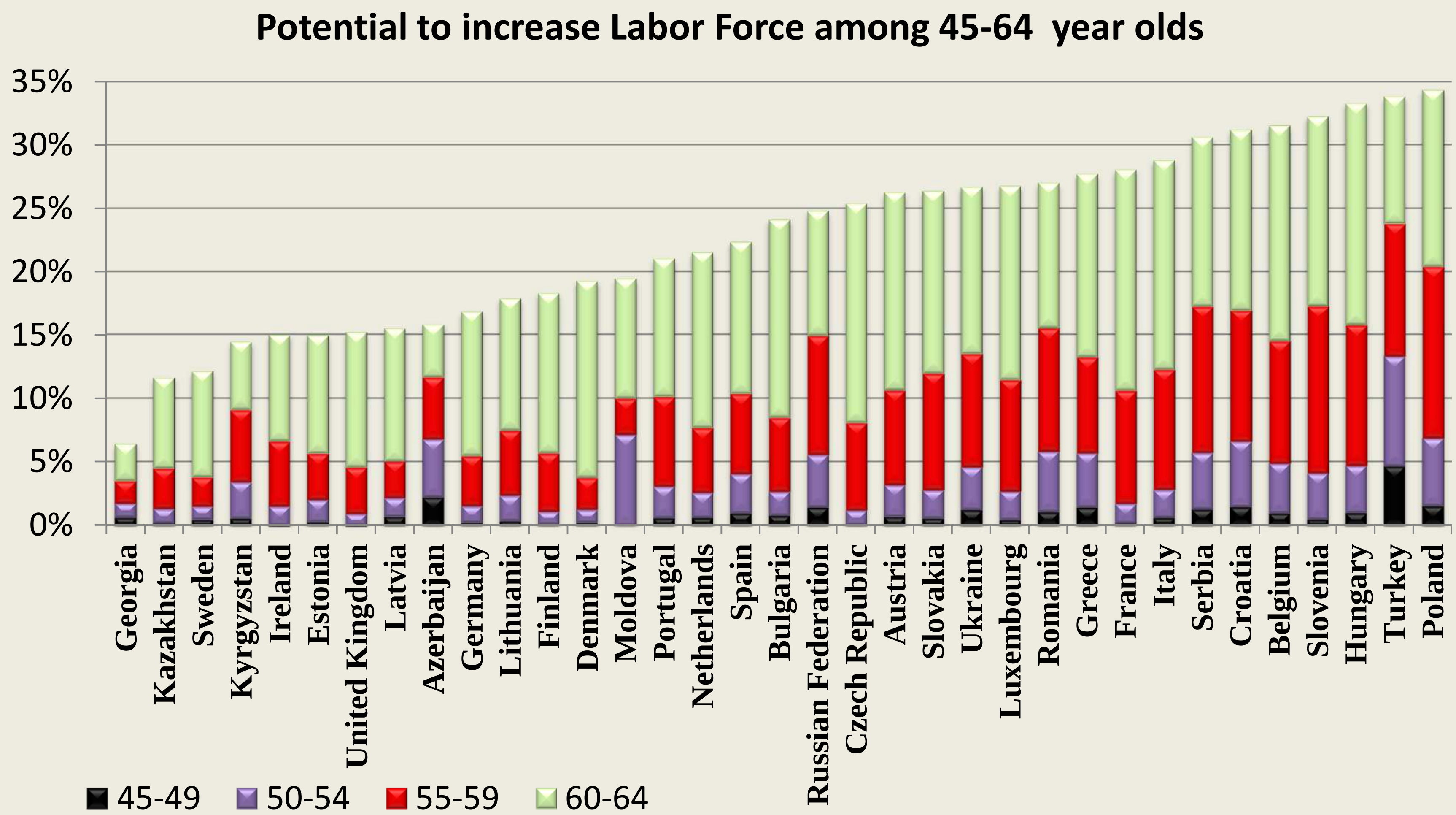
- Opt out schemes can be instrumental for incentivizing additional retirement savings
  - » Non discrimination test to ensure broad participation of workers
  - » 2+2+2 (or so) to increase contribution (careful with the default option)

Most countries already have a high tax burden on labor

- Labor taxes (SSC+Personal income tax) account for about 30 percent of Labor Costs => **Further increase constrained by pressures of international competitiveness**



Significant room for tapping on the potential for more "active aging"



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.

Workplace Adaptations: BMW 2017 production line pilot in Bavaria

Helping Older Workers be as Productive as Younger Staff

Initial condition: Aging assembly line workforce

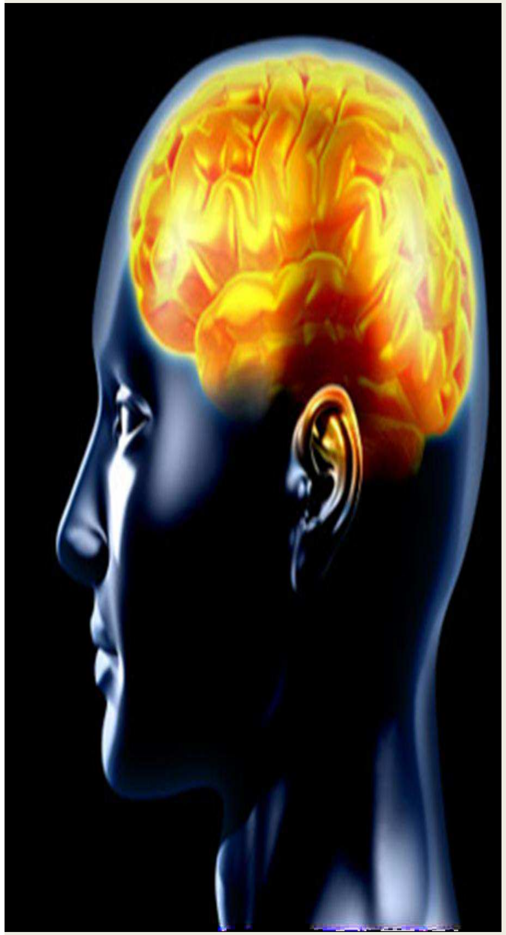
Result 7% productivity improvement in one year, equaling the productivity of lines staffed by younger workers

How? Pilot assembly line with design and equipment changes and changes in work practices

- 70 changes to workplace equipment reduced physical strain and the chances of error
- Job rotation across workstations during a shift in order to balance the load on workers' bodies
- Physiotherapist developed strength and stretching exercises for workers to do every day

Cost-effective: US$40,000

Training aging brains: Workforce training can work for adults

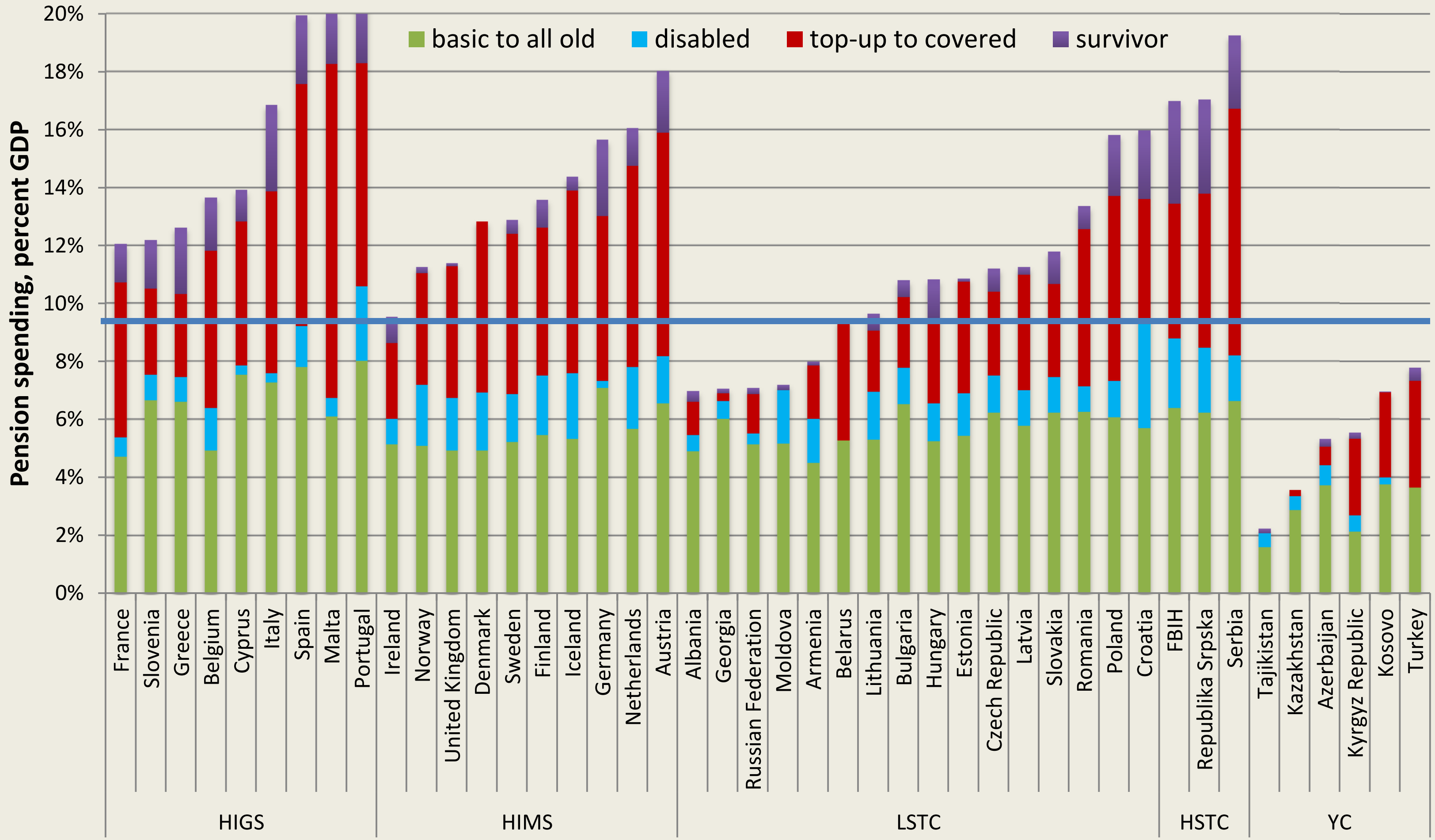


- Recent rigorous evaluations in the US: Wide range of public and private training strategies produce significant returns to investments
  - Estimated returns up to 10-26% (vs. 6-10% average rate of return on stocks)
- Growing number of studies show training impacts typically turn positive in 2nd or 3rd years
  - "Lock-in effects" in first year generate initial negative impacts
- Most promising programs are fit to how adults learn - integrate basic skills instruction into a specific occupation or set of occupations, use modular approach with recognition of prior learning

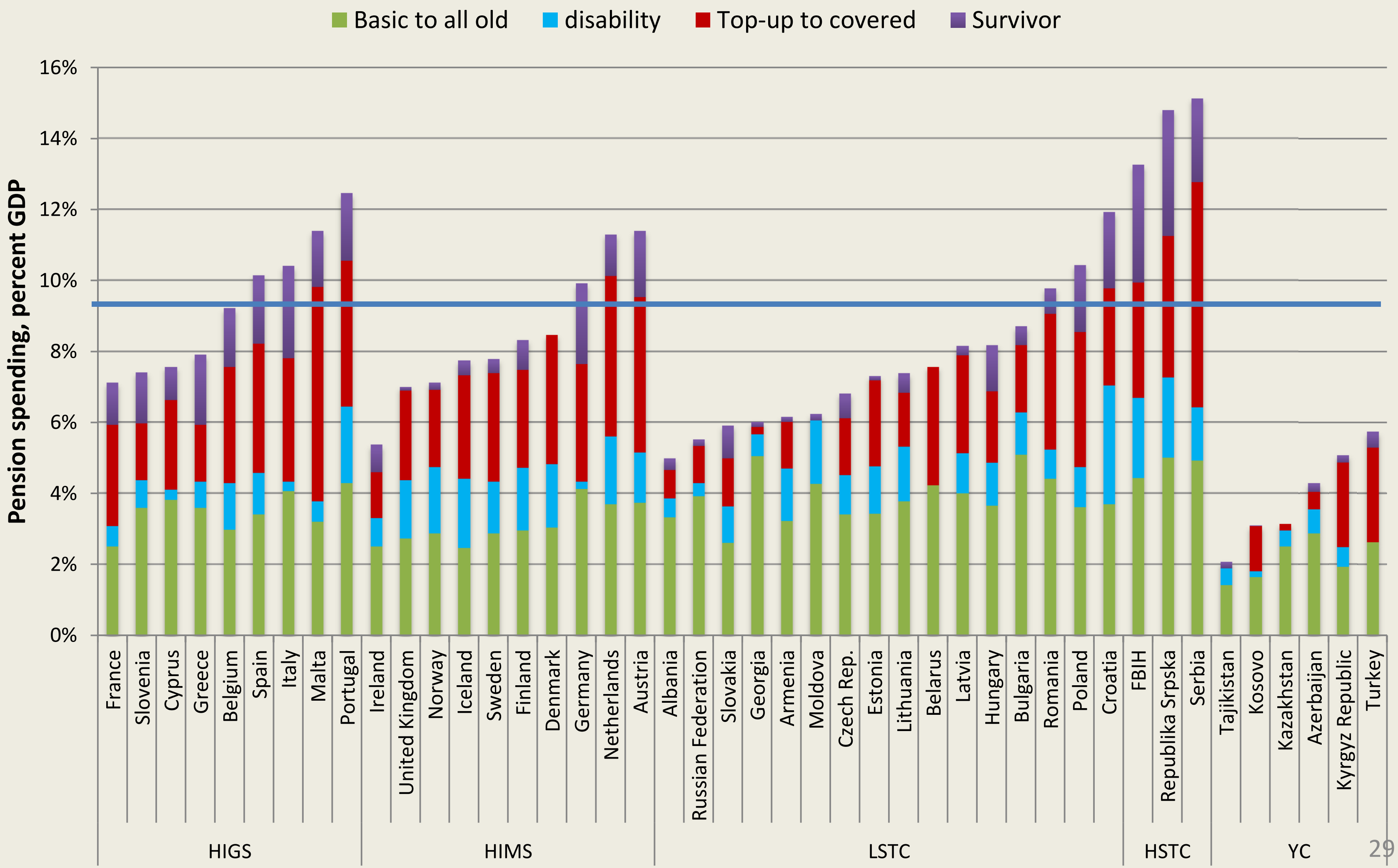
Given the demographic challenges, is pension spending efficient?

- 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 other
- 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



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