Bickenbach, Frank; Gern, Klaus-Jürgen

Conference Paper
Financing old age

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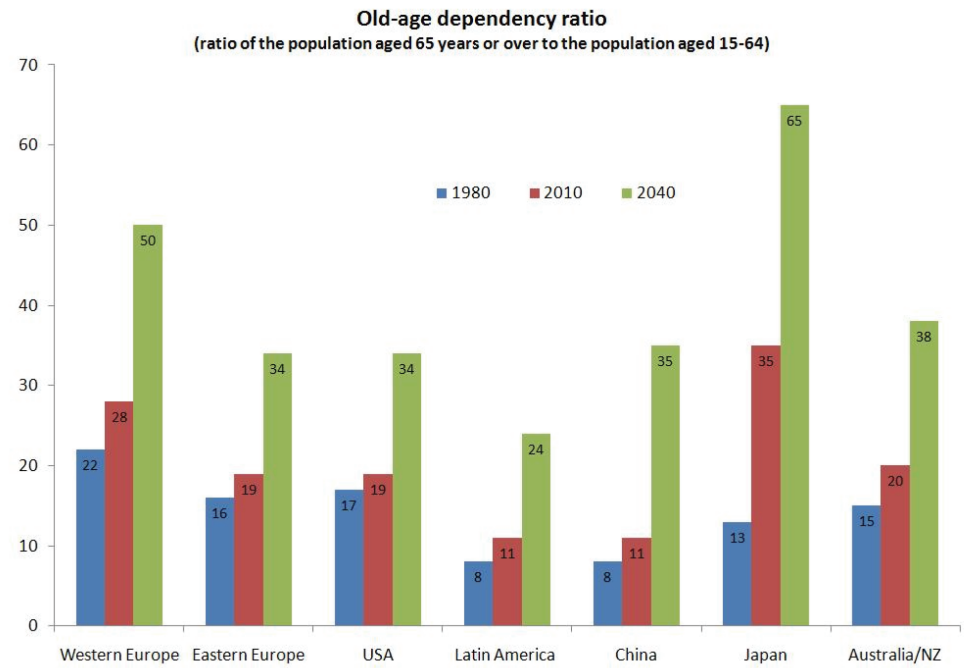
Financing Old Age

The Challenges

Populations are ageing in most developed countries, but increasingly also in emerging economies. Rising expenditures for pensions as well as health care and long-term care will claim an increasing share of governments' or families' incomes. Ensuring both adequate old-age incomes and the long-term financial sustainability of pension and health-care systems remains a huge challenge.

In a number of emerging economies, most notably in China, pension systems are still underdeveloped and cover only a small part of the population. In the developed world, many pension systems at current rules are not financially sustainable. In response to large implicit pension liabilities, various approaches to pension reform have been put forward, such as increasing the role of private and prefunded pension schemes, reducing public pension benefits, increasing pension age and reducing incentives to retire early.

The recent financial and economic crisis has highlighted further risks inherent in both public and private pension systems. While rising unemployment and sharply increasing government debt is putting additional stress on public finances and pay-as-you-go pension schemes, the substantial fall in asset prices has underlined the risks associated with pension funds invested in the financial markets. In the current environment there is the danger that immediate pressures on policy to act result in poorly designed short-term responses with negative long-term consequences for the capacity of pension systems to provide adequate levels of retirement income on a sustainable basis.



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision, http://esa.un.org/unpp, April 21, 2010

What are the lessons of the financial crisis for the appropriate balance of private and public schemes in the pension system? How can the resilience of pension systems to macroeconomic shocks be increased? What are the implications for the design, regulation and supervision of private pensions systems? Are there implications for the financing of health care and long-term care? What can government and the financial industry do to help people make informed choices when planning for their old age?

What can migration policies and policies raising fertility contribute to easing the demographic challenge? How could people be encouraged to prolong their working lives? What can government and business do to help elderly workers to acquire the skills and to preserve the physical and mental health needed to remain productive and competitive in today's work environments? Should there be specific pension arrangements for workers in particularly hazardous or arduous jobs? Is there a lesson from developed countries' experience for emerging economies which are still only developing old-age pension systems? How can politicians find support for successfully implementing the necessary reforms?

Proposed Solutions

Frank Bickenbach

Kiel Institute for the World Economy

Klaus-Jürgen Gern

Kiel Institute for the World Economy

1. **Policy makers should take the financial crisis as an opportunity to address the long-run challenges to the pension systems and avoid short-term responses to the crisis that exacerbate the long run challenges.**

The financial crisis provides a strong impetus for all countries to review the design and implementation of their pension systems. Policy makers should, however, be aware of the danger that immediate pressures to act may result in poorly designed short-term responses with negative long-term consequences for the capacity of pension systems to provide adequate levels of retirement income on a sustainable basis. Politicians should, for example, refrain from hiding unemployment through early retirement or from re-allocating contributions from the second to the first pillar without having properly assessed the consequences for the sustainability of the pension system in the longer term.

2. **Increase the resilience of pension systems to macroeconomic shocks and reduce the exposure of individuals to short term financial risks in funded systems.**

The crisis has not fundamentally altered the case for developing a multi pillar pension system, which is able to diversify demographic, economic, financial and political risks. With its consequence of substantial losses in pension fund assets around the world it has, however, highlighted the need to limit the exposure of individuals to the financial risks associated with funded arrangements. Pension fund risk management and supervision needs to be improved to reduce exposure to unduly risky investments. Measures that should be explored to limit the impact of financial volatility should include the introduction of life-cycle portfolios, which require workers to shift part of their balances to less risky assets as they get closer to retirement, as well as increasing flexibility in the timing of buying an annuity (phased or deferred annuitization). This would permit people near retirement to avoid locking in losses (liquidating their assets when markets are down and buying an annuity when interest rates are low). Policy should also consider promoting more flexible defined benefit plans that are customized to individual needs and circumstances but still provide the security that individuals need.

3. **Promote public awareness of pension issues to increase support for reforms and provide financial education and planning advice to improve citizens' understanding of the relevant financial instruments thus enabling them to make informed choices.**

Information campaigns and financial education are important to build public understanding of the need for reform and the need for individual savings to complement public pension benefits. The current crisis can provide the impetus for such an effort and creates an ideal opportunity for it to be effective as workers are more attentive to financial issues. With citizens' pensions coming from multiple sources, it is vital that they have access to unbiased information and financial education so that they can make informed decisions. At the same time, it should be acknowledged that financial education alone may not be sufficient to overcome behavioral biases such as a tendency to procrastinate about retirement savings decisions. Moreover, the complexity of investment decisions is such that complementary regulations on investments choices and default options are critical. In addition to improving the capability of individual to make appropriate savings decisions, informed discussions may help to combat widely held misconceptions about ageing, such as the myth that keeping older workers will squeeze out jobs for younger workers. Researchers have an important role to play in translating results and giving policy advice to the general public as well as to politicians.

4. **Promote the development of capital markets and financial instruments to productively support funded pension schemes by increasing the markets' capacities to accommodate larger inflows of capital and the financial industry's ability to manage long term risks, such as duration, inflation and longevity risks.**

The provision of a stable, functional and innovative financial system is a first-order public assignment to cope with challenges of population ageing. Governments and the pension fund industry should facilitate the deepening of capital markets and develop markets for undersupplied financial instruments that will be useful for retirement savings and the provision of pension benefits. For example, building a market for inflation-indexed bonds will allow insurance companies to offer inflation-indexed annuities. Other instruments which may be helpful in hedging risks include "longevity bonds" to better manage longevity risks at the macro level, life cycle products such as reverse mortgages, or micro pension schemes in low-income countries. With the introduction of complex products consumer protection issues should be given due consideration. In less developed countries, there is moreover often the more basic need for substantially deeper and more developed domestic capital markets in order to accommodate significant amounts of pension savings.

5. **Broaden coverage and ensure adequacy of formal pension systems to reduce the risk of old age poverty among the most vulnerable parts of the population. In addition, non-contributory safety nets should be introduced or strengthened where affordable and appropriate.**

Contribution (and payout) conditions of formal pension systems should be adjusted to make them more accessible and appropriate for temporary and low-income workers as well as the self-employed and those working in the informal sector. In Asia and Latin America coverage of formal pension systems is generally much lower than in OECD countries, and few countries have social pensions to provide safety-net retirement incomes for people who are not members of formal schemes. As networks of family support weaken and coverage of formal pension systems remain low, stronger systems of social pensions will be an important way of avoiding high and growing levels of old-age poverty. Even in a number of OECD countries low-paid people are at significant risk of very low incomes in their old age, particularly if periods of long-term unemployment are factored in. To decrease old age poverty, minimum pension guarantees can mitigate the effects of future economic volatility on the vulnerable elderly and lifetime poor. These systems need, however, to be carefully designed to ensure their affordability and that they do not have (excessive) negative incentive effects. Even in countries which offer basic universal pensions, micro pension schemes can provide a valuable opportunity for the poorest to supplement state income. In order to make contribution to formal pension systems more attractive for temporary and rural workers, they should be made more flexible allowing them to draw upon them in case of severe hardship such as severe illness.

6. **Encourage people to work at older ages by removing incentives to retire early, abolishing mandatory retirement and allowing retirees to work while drawing benefits.**

Lengthening working lives is an important element of the answer to the challenge posed by population aging. To encourage older citizens to remain in the labor market the incentives to retire early, that are built in public and private pension arrangements, should be removed as should be barriers and disincentives for older people who want to continue working. Mandatory retirement should be abolished and retirees should be allowed to work while drawing benefits. At least in some countries, raising the eligibility age in statutory pension systems will also be necessary as a response to increased longevity, and will be justifiable given the improved health of the elderly.

7. **To foster employment of the elderly, encourage job training and skill enhancement throughout the working life, promote health of the elderly and support a change in social attitudes away from ageism.**

The ability of the elderly to find or retain jobs is stifled by a number of barriers. Financial disincentives for employers to hire or retain older workers, such as systems of seniority remuneration or higher employment protection for older workers, should be removed. Elderly workers may need to accumulate new skills in order to remain productive and competitive in today's labor market. Efforts to promote on-the-job training and skill enhancement should therefore be strengthened. Other instruments available to sustain the productivity of older workers should also be increasingly used such as creating an appropriate working environment or using more flexible working conditions including part-time work, to react to potentially reduced physical or mental capacities. Other important measures to increase employability of older cohorts include the promotion of healthy behavior and of working practices and environments conducive to long-term health. Governments should also actively seek to change social attitudes in a way that ageism, the culture of valuing youth over experience, is rolled back.

8. **Expand the labor force and advance labor productivity to strengthen the funding base of the social security systems.**

The financial basis of social security systems should also be strengthened by increasing labor market participation of women and foreign-born parts of the population and by attracting more and more productive immigrants. To stimulate women's labor market participation improving institutions to reduce their burden of care for children and the very old will be important. Education and training as well as well-functioning and inclusive labor markets will be key in ensuring that immigrants are effectively integrated into the economy and society. Efficient education and labor market institutions will help increasing labor productivity in general thereby increasing the capacity of the economy to finance adequate old age incomes.