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Global ageing and innovative public pension reforms

The phenomenon of population ageing will have profound consequences for governments and societies all over the world, and not just for pension systems. Capital flows are likely to shift dramatically, as older societies sell their assets to younger ones to finance consumption in retirement. Worldwide immigration flows may accelerate, as older, developed nations become more dependent on workers from abroad to perform jobs that cannot be filled with domestic employees alone. The balance of geopolitical power may also shift over time, as emerging and younger powers become more dominant economically, allowing them to demand a greater say in world political affairs as well.

But it cannot be denied that the implications of population ageing are seen first and most clearly in the long-term projections of state-based pension systems. In a sense, actuarial projections of pension systems were, and are, canaries in the coal mine, providing advance warning of the coming demographic shift that will fundamentally alter the political and economic landscape.

In the 1950s and 1960s, population ageing was not even considered a possibility. With a post-war baby boom under way, in varying degrees, in most countries, political leaders were unconcerned that the new retirement promises made by their governments were dependent upon an ever-growing population and thriving economy. The widespread optimism about the future was captured succinctly by Konrad Adenauer, the post-war German Chancellor, who, in 1957, said 'people will always have children,' thus dismissing the population risks associated with a pay-as-you-go approach to pension financing.

But, of course, Adenauer was wrong. Birth rates fell dramatically, beginning in the mid-1960s. Germany's total fertility rate (TFR) – which measures the average number of births to women in a country during their lifetimes – fell from about 2.5 in the early 1960s to about 1.4 today. And people began to live longer – much longer. In the US, the average 65-year-old man could expect to get Social Security benefits for 12 years when the program first started. Today, he can expect to get benefits for 16 years.

By the 1980s, some countries began to take steps to prepare for the long-term challenges posed by an ageing population. In 1983, the US raised the Social Security normal retirement age – on a gradual basis – from 65 to 67 years old. The UK switched pension indexing from wages to prices, dramatically cutting the Government's long-term pension commitments. And Australia began the process of building a more universal system of retirement provision on employer-based savings accounts (these accounts became mandatory in the 1990s).

Continental Europe, however, largely did not act on pension reform in the 1980s, as the constituencies in favour of large state-based systems opposed strenuously any retrenchment of their hard-earned pension rights. At the same time, Japan's strong economic performance and overly optimistic population assumptions masked the need for prompt attention to its pension crisis.

By the early to mid-1990s, however, the momentum for reform began to build, largely due to the economic pressures associated with open global trade, economic integration in Europe, and Japan's long period of economic stagnation. Political leaders throughout the developed world began to see that state-based pension reform was an important component of economic reform in a competitive global marketplace. In particular, the crushingly high payroll tax rates for state-earned pensions – 20–30% in some countries – were seen as directly contributing to high unemployment and reduced opportunities for younger workers.

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And so, beginning in the early 1990s, many developed nations began to seriously pursue public pension reform. While there are notable examples of failed efforts, a surprising number of countries have successfully navigated the treacherous political terrain of pension reform and implemented significant changes in their state-based schemes. Along the way, a few innovative approaches to reform have emerged which are deserving of mention and study.

Notional defined contribution schemes

In 1991, with the country in a deep recession, the Social Democratic Government in Sweden was defeated and replaced by a multi-party, centre-right minority coalition that placed pension reform high on the agenda. The coalition Government established a small working group to negotiate the pension reform framework that was headed by the minister of social policy. The group included representatives from each of the five political parties supporting the reform process, including the Social Democrats, the Moderates, the Liberal Party, the Centre Party, and the Christian Democrats, as well as a few selected experts.

The group's sweeping pension reform proposal was adopted 'in principle' in 1994 by the Riksdag, the Swedish Parliament, shortly before elections returned the Social Democrats to power. The Parliament passed implementing legislation in June 1998, with the first benefit payments under the new rules beginning in 2001.

Sweden's new pension system has several innovative features, including the conversion of the main pension entitlement from a defined benefit to a 'notional defined contribution' (NDC) system. Under the NDC, workers' payroll tax contributions are treated like contributions into an investment fund even though the actual tax payments are used to finance benefits for current retirees. The contributions are tracked separately and credited with a presumed rate of return equal to growth in average wages in the economy. Thus, Swedish workers build up a notional 'fund' from which they will draw an annuity at retirement.

The NDC approach to pension reform may have two important advantages over a traditional, defined benefit approach. First, the NDC system promotes benefit transparency, which may improve incentives for labour supply. Many defined benefit schemes inadvertently discourage work beyond a certain age, as workers who are already entitled to benefits gain little from additional pension contributions. With an NDC system, workers can see clearly that their wages translate directly into an increase in their NDC 'accounts,' and all wages are treated identically in the pension benefit formula. Thus, working beyond the age of 65 may become more attractive for workers.

Second, NDC systems appear to improve budgetary control. The pension entitlement is strictly tied to pension contributions; no benefit payment is made that is not financed by a worker's payroll tax payments. In the past, many countries made the mistake of expanding defined benefit promises without a clear means of financing the benefit expansion. Under an NDC system, the only way to provide more benefits is to increase the contribution rate into the NDC accounts, which may not be popular. In Sweden's case, the payroll tax – 16% of wages – is widely viewed as a ceiling that should not be breached.

Automatic benefit stabilisers

In the last decade, at least three countries – Sweden, Germany, and Japan – have adopted new, automatic adjustments in their pay-as-you-go pension schemes. These automatic adjustment mechanisms come in slightly different forms, but they generally serve the same purpose. Benefit payments to retirees are adjusted automatically – without further legislative intervention by government – to keep pension spending within available revenue.

In Sweden, the NDC system has two automatic stabilisers. At retirement, the NDC account balance must be converted into a monthly pension payment by way of an 'annuity divisor'. The divisor is updated for each annual cohort of retirees to reflect the most current estimates of life spans and mortality. Thus, as retirees are projected to live longer, the monthly annuity paid out from a fixed notional balance will automatically decline with successive cohorts unless the pensioners choose to begin taking their monthly annuities later than those who retired before them. The system, therefore, is protected against most of the cost of projected increases in life spans.

The other key variable in the Swedish system is the annual rate of return that is applied to the NDC account balances. The default assumption is that the account balances should grow with average wages. But, in a pay-as-you-go system, demographic factors, particularly fertility, population growth and labour force participation patterns, also play important roles in determining an affordable rate of return. Sweden tracks these demographic factors carefully and uses them to make an annual adjustment in the rate of return calculation. If, for instance, the birth rate falls below expectations, the workforce in the future will be smaller than current projections indicate, which means pension spending will also have to be constrained. Sweden's automatic stabiliser takes this information into account and immediately adjusts the rate of return that is applied to the NDC accounts to reflect the new demographic reality.

Unlike Sweden, Germany has opted to stay with a traditional defined benefit system, perhaps due to the country's long and generally favourable history with 'retirement insurances.' Over the last 15 years, however, the German system has been in a period of retrenchment, as costs have soared with longer life spans and revenue has stagnated with low fertility rates. Before the system was reformed in 2001 and 2004, projections indicated that the payroll tax rate needed to finance German pensions would increase substantially, from today's 19.5% to more than 28% of payroll in 2040.

Former chancellor Gerhard Schröder sought to stabilise the payroll contribution rate for pensions at no more than 20% before 2020 and 22% before 2030. A first effort, in 2001, made progress toward this goal but was based on overly optimistic economic and demographic assumptions. Soon after enactment, it quickly became clear that more reform was necessary.

In March 2004, the German Parliament adopted its own version of an automatic stabiliser. All German pensions – for new retirees and those who retired in earlier years – are tied to the same basic pension value

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component, which, in turn, is indexed to annual wage growth. The 2004 law amended the indexing rules to allow for an adjustment based on changes in the ratio of pensioners to workers supporting the system – the so-called 'sustainability factor'. As the ratio increases, the annual increase in pension value component decreases. Projections indicate that the sustainability factor will reduce the payroll tax necessary in 2040 from 28% to 24%. Clearly, even with the sustainability factor, the German system remains expensive, and perhaps unaffordable. But the sustainability factor has unquestionably improved the outlook and may serve as the basis for further reform in coming years. Japan passed two conventional pension reform measures – in 1994 and 2000 – that scaled back promises and made some progress toward sustainability. After each effort, however, new, more realistic demographic assumptions revealed a remaining financing shortfall.

When taking up a third reform effort in 2004, Japanese political leaders decided to take a different approach from the previous efforts. To avoid the need for additional *ad hoc* adjustments to benefits, the 2004 reform introduced an automatic stabiliser, or 'macroeconomic slide', that automatically adjusts benefits to compensate for changing demographics. The automatic stabiliser is modelled on the German approach. It adjusts the normal indexing formula applied to both new and current benefits by two factors – one designed to offset the decline in the number of contributing workers, the other to offset the increase in the life expectancy of beneficiaries. It is expected that the stabiliser, which is scheduled to remain in effect for 20 years, will cut annual indexation adjustments by an average of 0.9 percentage points each year between 2004 and 2023, at which point the replacement rate for an average wage earner is projected to be 50%, down from 59% today.

Government-owned and invested pension reserve

While other countries made substantial cuts in future benefits to offset the projected cost of population ageing, Canada chose to pursue a different strategy. In 1997, the Government passed a large increase in the payroll tax rate. Between 1998 and 2003, the rate was raised in stages from 6% to 9.9%, well above the system's current cost rate, to create a Government-owned investment fund to offset the costs of higher pension spending in the future.

To help ensure that the 'partial advance funding' resulted in genuine savings, the Government created a firewall between the general budget and the pension fund. Investments are managed by the Canadian Pension Plan Investment Board (CPPIB), an independent agency whose 12 members are appointed by the finance minister. The CPPIB has a legislated mandate to invest assets solely in the interest of the beneficiaries. Prior to the 1997 reform, Canada's public pension reserves were invested primarily in low-interest loans to the provincial governments, much like US Social Security trust fund surpluses are invested in special interest US Treasury bonds. Since the reform, pension assets have been invested primarily in marketable securities. As of 30 September 2006, the fund totalled C$103bn, nearly two thirds of which was invested in equities.

The Canadian pension reserve fund is projected to grow rapidly over the next few decades, accumulating assets of roughly C$600bn by 2030, or the equivalent of six years of benefits. Current contributions are expected to exceed annual benefit payments until 2022, after which investment income will be needed to finance a growing portion of costs.

Over the years, many countries, including the US, have tried to put in place reforms similar to the Canadian approach. Few, if any, of these efforts have met the most basic litmus test of success – raising national savings. Typically, the pension reserves are invested poorly, and the Government increases other spending in proportion to the pension surplus.

Canada may well prove to be an exception. The firewall separating the operations of Canada's reserve funds from the general budget seems to be functioning effectively so far. Investment decisions appear to be made by the investment board with minimal if any political interference. The Federal Government, moreover, has run uninterrupted budget surpluses since the late 1990s, not counting the surpluses generated by the pension system. It also helps that Canada's political culture is accommodating of a large government stake in the ownership of private sector companies, something which would not sit well in other countries, including the United States. Over the long run, even Canada is likely to find it difficult to sustain the discipline necessary to ensure the fund truly is 'saved' for the future, particularly when an economic crisis hits. Even so, it must be admitted that the Canadian approach shows much more promise than previous efforts at government-owned pension reserves.

Conclusion

The challenge of population ageing can be overwhelming. For many developed countries, the ratio of pensioners to the working age population is set to double over the next half century. Such a dramatic shift toward an older population will not occur without difficulty. Among the many challenges will be maintaining a political and economic balance between adequate retirement provision and an affordable pension contribution rate. Two decades ago, the political prospects for addressing the pension challenge looked bleak. But in the last 15 years, many countries have put in place reforms that have improved the long-term outlook, even if modestly. While much more reform undoubtedly lies ahead, the successful implementation of innovative approaches to state-run pensions in several countries should increase our optimism about the political prospects of addressing the remaining challenge.

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