The Challenges of Population Aging: An International Perspective

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The framework: Population aging

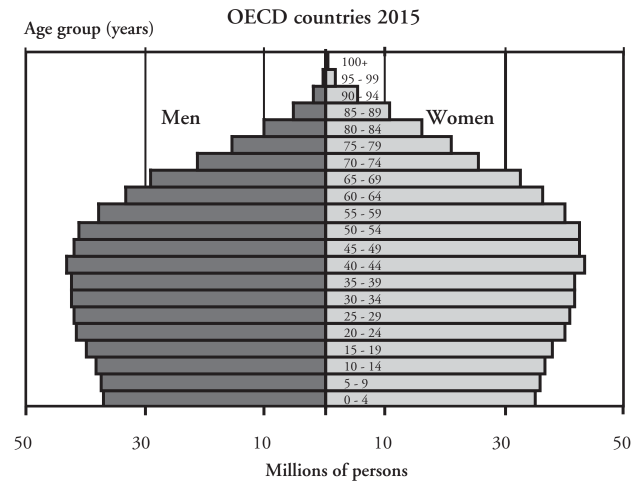
Population aging is set to affect all OECD countries, leading to higher elderly dependency ratios and ultimately smaller labor forces. Overall dependency will rise everywhere as the number of people outside the labor force outpace those within it. Increased longevity and better health are extremely good news, but they may become a nightmare if societies cannot find mechanisms for sustainable progress (for example, to provide resources that allow old people to benefit adequately from these developments). (Charts 1 and 2)

In OECD countries, where social protection and social security systems are extensive and generous, population aging presents huge fiscal challenges. At the same time, this unprecedented demographic transition calls for pension and social protection systems that are more responsive to demographic risks and more attentive to the needs of populations. (Chart 3)

Policy concerns: Growing and growing as time goes by

Already in 1998, the OECD ministers highlighted the importance of aging for our policymakers, the need for comprehensive reform,

Chart 1
The Demographic Profile Is Unfavorable for OECD Countries



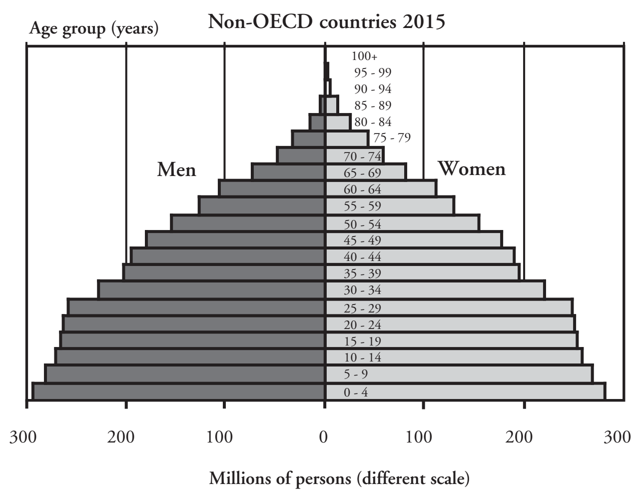


Chart 2
Populations Are Aging in the OECD

Projected overall dependency ratios
Total inactive population relative to total labor force (15 years and over)

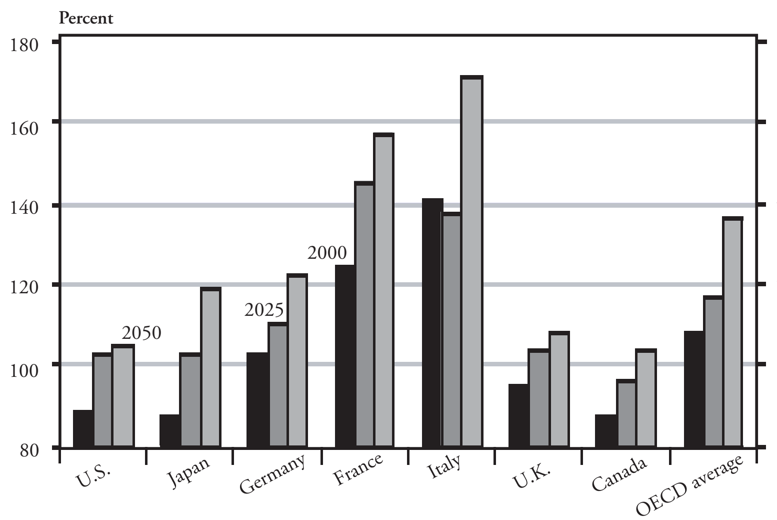
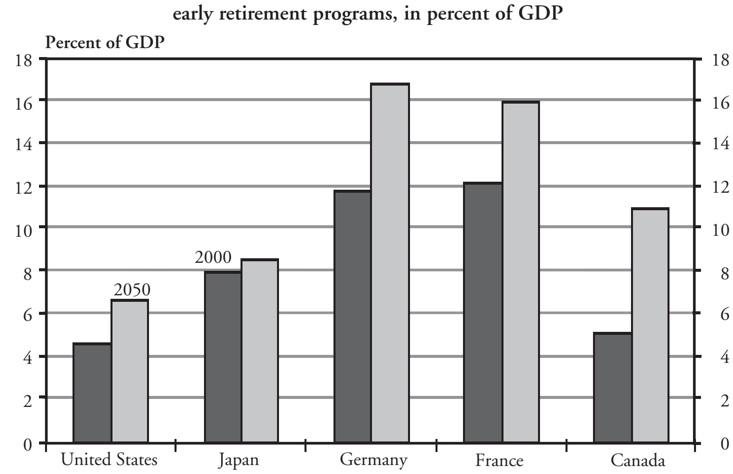


Chart 3
Aging Will Increase Financial Burden

Projected effects of aging on public spending: Old-age pension and early retirement programs, in percent of GDP



Note: In addition, OECD estimates that aging alone would add 3 percentage points of GDP to health spending by 2050.

encompassing all elements of the issue—financial, economic, social, fiscal—the urgency of far-reaching reform, and the obvious conclusion that the solutions will be much more difficult and painful if such reforms are postponed. All agreed that the responses to the aging challenges required *prompt* action on many fronts. And a clear consensus emerged that ways had to be found to contain spending on public pensions while the structure of retirement income should be reformed and incentives to early retirement eliminated.

Six years later, the issue is still very much with us. So, it is not surprising that the topic was again on the agenda of the OECD ministerial meeting held in May 2004. Clearly, there are reasons to be worried. The full impact of aging is now expected to hit our economies very soon, beginning the next decade in many countries. Still, it is not certain that our policymakers have taken the full measure of its consequences: We are talking here about the *sustainability of our future social and economic system.* If substantial and sustained action is not undertaken, we may face a major societal crisis.

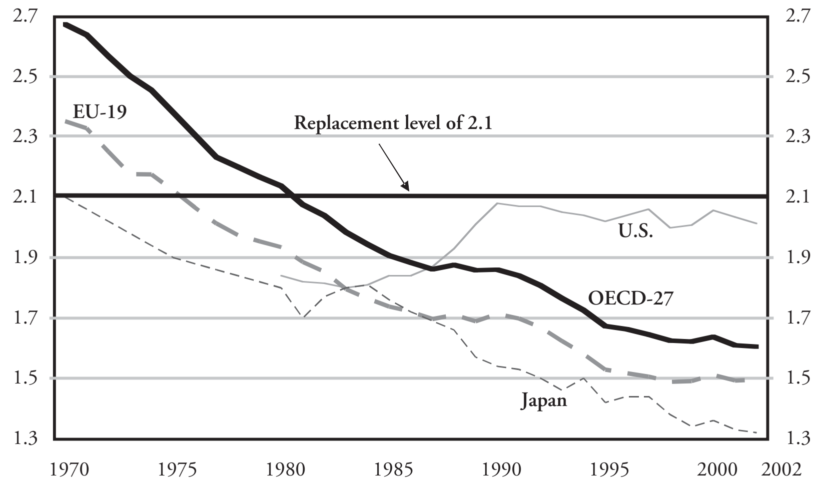
No escape from policy action

To avoid these dire consequences, governments around the world need to take action. Policy reforms will be required to achieve four key objectives: an increase in the working age population, an extension of the working life, a reduction of the pension promise, and a careful diversification of the sources of retirement income.

Increase the working-age population

OECD countries have experienced spectacular declines of fertility rates over the last three decades. The average rate is now around 1.6 children per woman—well below the replacement level of 2.1. Our work suggests that some rebound in fertility rates is likely, but it will not be sufficient to reverse the trend. As long as women are not supported in their efforts to combine work and family responsibilities, and so feel obliged to choose between a career and their children, fertility rates will remain low. Family-unfriendly societies are not only

Chart 4
Increase Population: Reverse Declining Fertility

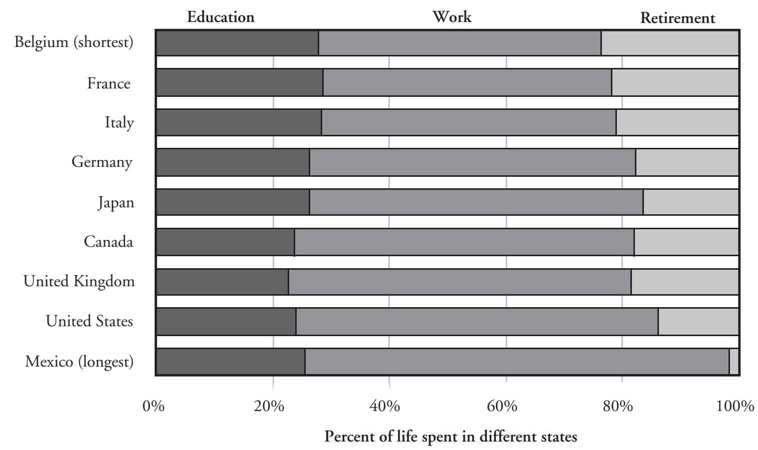


Note: OECD work suggests some rebound in fertility likely, but policy changes to reconcile work/family life are essential.

losing out in terms of fertility. They are also forsaking the valuable contribution that women in paid work can make to economic development and growth. (Chart 4)

Immigration is also sometimes seen as an answer to population aging. And, indeed, well-educated young migrants without dependents who immediately enter the workforce of the host country are likely to provide a net positive contribution to public finances and growth. But, in practice, it is difficult to select immigrants so tightly. And immigrants may seek re-unification with their families, which may impose a larger burden on public spending. In any case, both they and their families eventually grow old and acquire rights to pensions and health services. To have a significant effect, the scale of immigration would have to be substantial. Currently, net migration flows are fairly small in most OECD countries, with annual net inflows at around or above ½ percent of the population on a sustained basis in only Canada and Australia, while net outflows of that magnitude occur only in Mexico. These considerations suggest

Chart 5
Reduce Length of Pension Receipt:
Extend Length of Working Life



Note: OECD work suggests incentives to early retirement need to be ended; also labor demand and health issues to be addressed.

that immigration could be, at most, part of the response to the public finance implications of aging.

Simply put, having more people by itself is not a solution. Having a sustained increase of young people entering the workforce, whether immigrants or by increased fertility, is a solution, provided adjustments are made to working life and pensions.

Extend working life and increase the amount of time in paid work (Chart 5)

Extending the working life will be crucial for the sustainability of economic and social development in light of aging. With increasing life expectancy and young people entering working life late, the imbalance between the periods spent in and out of work has been growing dramatically. In Belgium, at the top of the chart, workers spend less than half of their lifetime in work. Education and retirement account for the rest of the time. Mexicans, on the other extreme, spend the largest part of their life in work and only a short period in retirement. (Chart 6)

Chart 6
Annual Hours Worked Per Employee, 2002

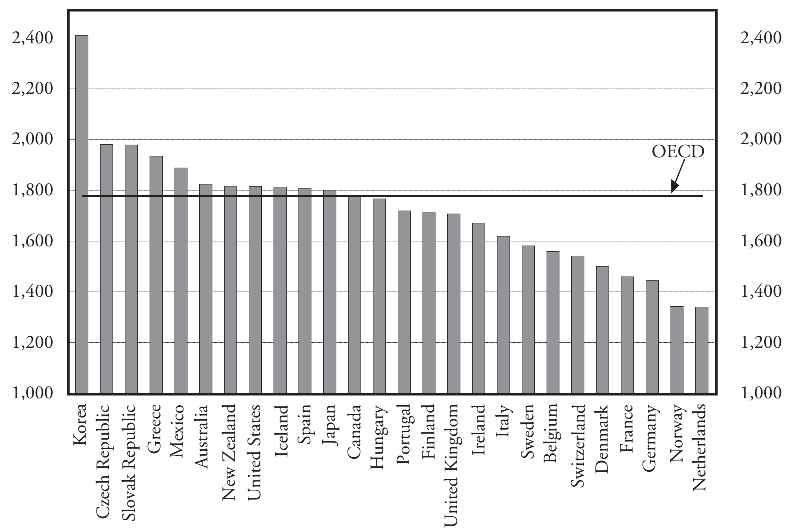


Chart 7
Employment Rate by Severity of Disability, Percentage of 20-54 Population, Late 1990s

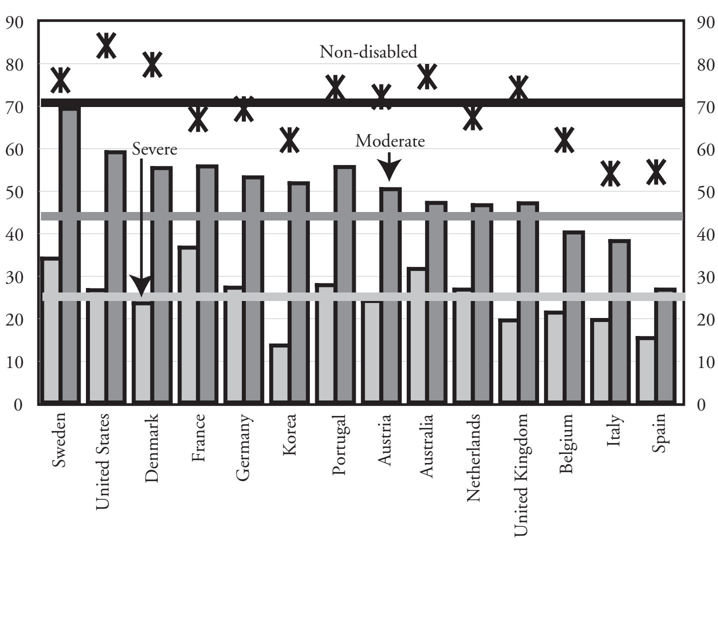
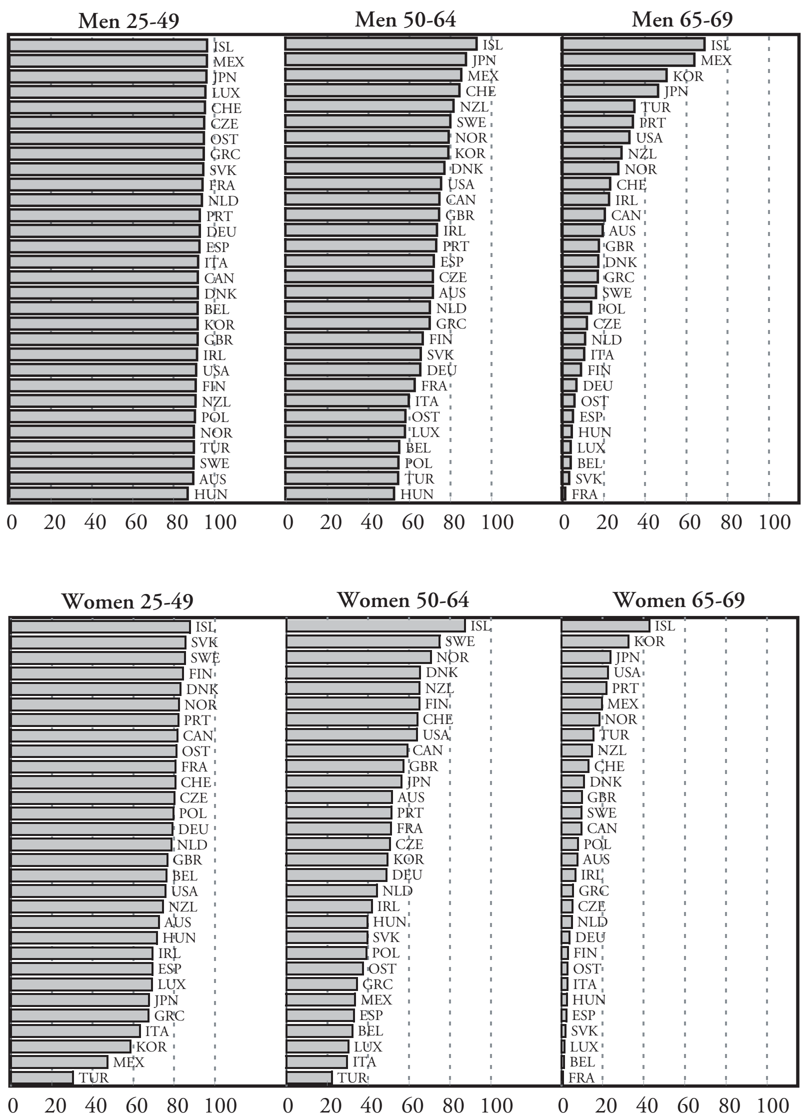


Chart 8
There Is Great Scope to Increase the Participation Rates of Older Men, Women, and Disabled People

Participation rates by age and gender in OECD countries, 2003



In many countries, one of the key challenges is to increase participation in the labor market. *About 35 percent on average of the OECD population of working age are not employed—the majority of them being statistically classified as "inactive," although they can and often would like to work.*

In terms of economic performance and living standards, what counts is the amount of labor input going into the productive process. This requires looking at both employment rates and the number of hours worked. In 2002, the number of annual hours worked per worker ranged from a low of 1,340 hours in the Netherlands to a high of about 2,400 hours in Korea. (Chart 7)

Countries differ only slightly in the labor force participation rates of men aged 25-50. However, there is potential for increasing the amount of work by women, particularly mothers, through initiatives to better reconcile work and family life, and disabled people with moderate disabilities. Societies need to change the way they think about disability and the term "disabled" should no longer be equated to "unable to work." OECD work shows that the probability of re-entering the labor market, once having been declared disabled, is almost zero in virtually all countries.

But the really big differences across countries are in the amount of work at the end of people's working lives. (Chart 8)

Many countries' pension systems still function in a way that encourages workers to retire at the earliest moment possible. This has to change. The parameters of public pension systems need to be adjusted by, for example, increasing the retirement age, linking benefits to life expectancy, and providing appropriate actuarial adjustments to benefits for early and late retirement. Our pension monitoring activities, however, show that most countries are now moving in this direction. They are closing down pathways into early retirement embodied in pension systems and changing the calculation of pensions in a way that ensures working longer actually pays.

However, in many countries there are still many publicly supported pathways to early withdrawal from the labor market. For example, in Austria every second man aged 50 and over retires on grounds of disability, and Sweden is facing a considerable rise in the number of older workers on long-term sickness. As a result, the effective age of retirement is often well below the official age. (Chart 9)

But policies also need to address health and disability issues concerning older workers as well as the role of employers in extending working life. Experience suggests that there could well be barriers that would make it difficult for an added supply of older workers to find jobs. Thus, overly strict job protection and rigid wage structures may make firms hesitant to hire older workers. Emphasis also needs to be given to active labor market policies and training throughout careers. In addition, late retirement will not be an option for all workers, and this should be recognized by policymakers. Equity considerations, especially regarding low-income workers who also tend to have a shorter life expectancy, should be an integral part of these reforms.

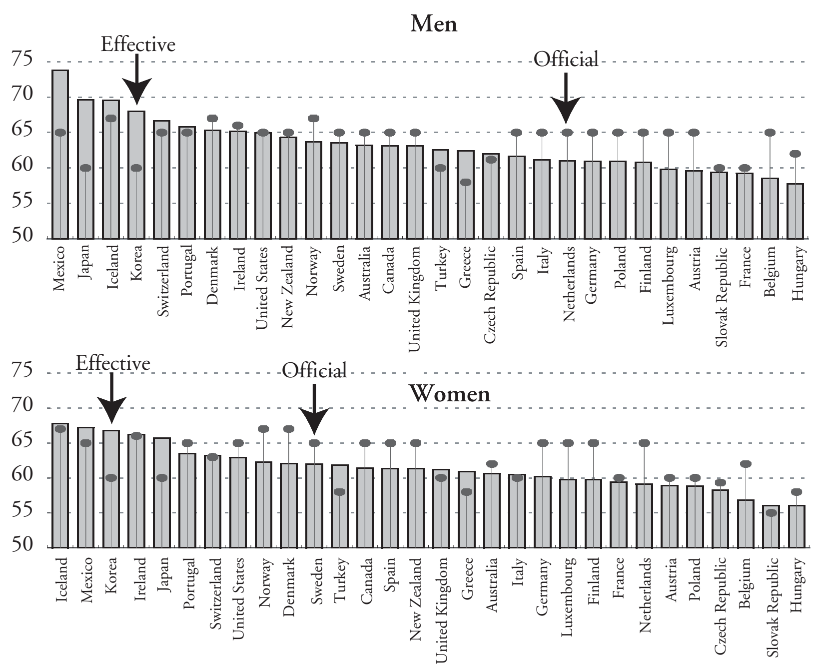
Reduce the pension promise

Countries need to give a realistic pension promise: one that is affordable yet pays a sufficient amount to prevent poverty. Most countries have been cutting down on their pension promises, in some cases quite substantially. Nevertheless, as Chart 10 shows, some countries are still offering pensions to those who are starting their working life which are over 90 percent of previous earnings. Such pension levels are not realistic—nor are the very low public pension guarantees in some other countries, which may need to strengthen their old-age safety nets in order to avoid a resurgence of pensioner poverty. Already, the most recent OECD data show that a 20-year decline in the poverty rates of elderly people stopped in the mid-1990s in many countries.

Focusing on the long term is not enough, however. In the medium term, pressures on public budgets will still be strong in many of the countries that have successfully reduced the pension promise given to

Chart 9
Much Remains to Be Done: The Average Effective Age of Retirement Is Often Well below the Official Age

Effective and official retirement age in OECD countries, 1997-2002



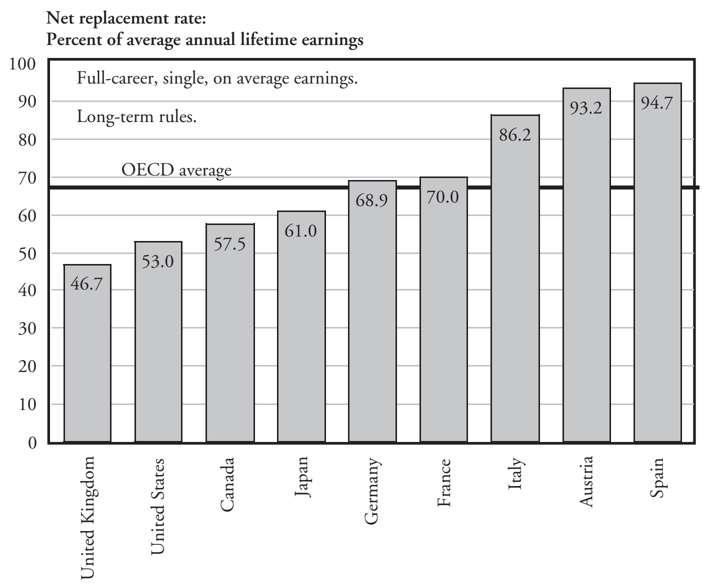
those just starting their working lives, because the new, less generous regulations are usually phased in gradually.

That being said, the pension promise can be generous if the years of retirement are markedly reduced.

Diversify sources of pensioner income

Another key axis of policy reform relates to diversification and monitoring of pension promises.

Chart 10
Public Pension Entitlement: Values Reduced in Many Cases



Note: OECD work shows that while some countries have been cutting down on their pension promises, in others replacement rates are still over 90 percent of previous earnings.

The OECD has long urged diversification of the sources for retirement income and the development of private pensions as a complement to public schemes. Taking account of the need to reflect national social and economic features, the OECD does not recommend any specific type of private schemes. But, whatever form they take, private schemes must, from a public policy viewpoint, be well-regulated and underpinned by efficient financial markets.

Regrettably, private pension systems today face a number of major challenges that remind our policymakers of the need for good regulation and to rebuild trust in the system. Let me just mention some of these challenges.

Coverage of private pension arrangements

Private pension coverage is still low in many OECD countries, often less than 5 to 10 percent of the labor force, though the trend in coverage is clearly heading upward. Still, even in countries with medium levels of coverage, richer households are most likely to participate in private arrangements, while poorer households are often unable to benefit from the tax incentives offered to private pension plans.

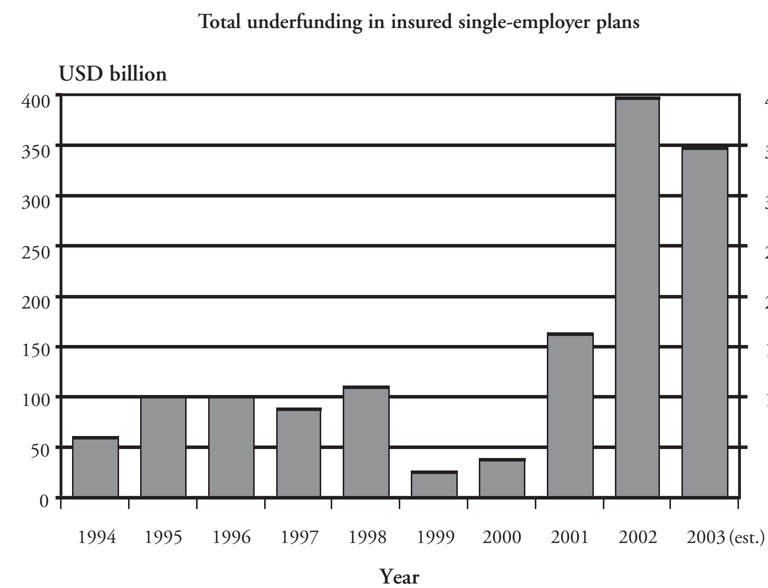
A major tenet of public policy should be that the increasing role of private pensions should not take place to the detriment of the objective of reducing old-age poverty. Expanding coverage will therefore have to rely on appropriate incentives for poorer households. The OECD has just released a study estimating the long-term budgetary implications and coverage effects of tax incentives for retirement savings in OECD countries. The analysis shows that the design of these measures needs to be improved in order to be more cost effective. Various options are available in this regard. Some countries have chosen the route of mandating private pension schemes or at least requiring automatic enrollment into such arrangements. In any event, the more private pensions develop, the more their performance will have to be assessed against general social objectives.

Corporate pension liabilities

The emergence of astonishingly large pension funding gaps has been a source of major concerns for financial policymakers in 2003. The size of funding shortfalls speaks for itself: On a worldwide basis, it has been estimated that the shortfall was close to $1,000 billion at the end of last year. Although some analysts believe that many companies will not have insurmountable difficulties in meeting their pension obligations, it is generally recognized that these obligations could represent a serious drain on resources that would otherwise be available for investment in coming years. And it is of little comfort to know that the largest adverse effects of funding shortfalls are expected to be on firms operating in mature or sunset industries in manufacturing and transport. (Chart 11)

The OECD is extremely concerned by the potential impact of this "time bomb:" The funding gaps may just be an advanced flavor of an

Chart 11
Monitoring of Private Pensions: Funding Gaps Have Increased



Source: U.S. Pension Benefit Guaranty Corporation (PBGC), Annual Report 2003

unprecedented societal crisis if future pension liabilities—which will be exacerbated by the arrival of baby boom cohorts on the retirement market—are not matched due to inappropriate funding. The "early warning" provided by the gaps issues that have emerged in the past three years need to be taken into consideration very seriously.

Shift toward defined benefit schemes

The recent moves toward defined contributions plans that are being experienced in a growing number of countries will ease pressures on defined benefit schemes. But let us be clear: This move will not be a panacea since they may just reallocate the risks away from companies (fund sponsors) and transfer them to the "ordinary people" in our societies.

Asset meltdown hypothesis

Another concern, which so far appears to have been the domain of a few specialists, is related to the fact that over the next decades, changes in the age structure of populations will affect the economy's *saving behavior*, including the level of saving and the choices of saving vehicles. When baby boomers start entering retirement, they will become net sellers of financial assets to finance retirement consumption. As subsequent generations are smaller in numbers, other things being equal, this would put downward pressure on financial asset prices ("asset meltdown hypothesis"). We may expect that this will impact not only on growth and investment but also on the adequacy of retirement income. In any case, even if there were no generalized financial asset sell-off, there might be a switch from equity to fixed-income instruments, reflecting life-cycle considerations—which will have difficult-to-foresee consequences on the functioning of our financial markets.

How is OECD responding to these challenges?

I am aware that the picture I have painted is far from rosy. But both governments and the public at large need to face these risks squarely and take the courageous and unavoidable steps needed to prevent the time bomb from exploding. As I noted earlier, many countries have already undertaken reforms and set mechanisms in place that will, over time, alleviate some of the most dangerous problems. But, clearly, complacency must be completely out of order here and vigorous political leadership is indispensable.

My organization (OECD) considers that aging is a top policy priority and will continue to be so in the years ahead. Policymakers and experts are discussing on an ongoing basis the complex and varied aspects of aging in our specialized committees (economics, financial, social) where they can benefit from each other's experience. This is the fundamental role of the OECD: to enable our members to learn from the successes and failures of their peers.

Monitoring of the fiscal and social sustainability of pension promises is a key activity in our work on aging. We are currently updating our projections on age-related public expenditure jointly with the European Union. These calculations run up to 2050 and include spending on pensions, health, and long-term care.

We are also projecting future replacement rates of the 30 OECD pension systems for a wide range of income levels. The calculations use a single set of economic and financial assumptions and are thus strictly comparable across countries. We plan to repeat this exercise every two years, which will enable us to assess the impact and social sustainability of pension reform. The first edition of our new series, “Pension Policies at a Glance,” will be published soon. Our pension models will be available to all interested parties and we are hoping that policymakers and academics will make ample use of this new tool.

Increasing the labor market participation of older workers is a huge challenge for the majority of our member countries. Everyone agrees on the need to work longer, yet little is happening. Adjusting the incentives in pension systems is an important measure, but it is far from sufficient. We need to understand better why companies are reluctant to employ older workers, and we also have to find ways to change the early retirement culture that is so strong in many of our member countries. This is why we are conducting reviews in more than 20 countries which analyze the factors determining the supply and demand for older workers. We are also conducting similar country reviews focusing on the labor market situation of women and disabled people.

Private pensions are prominent in our work. The organization had the foresight several years ago to establish a special group to deal with the regulatory aspects of private pension schemes. We have taken a three-pronged approach to this end: data collection, benchmarking of best practices, and development of principles and standards. Just recently, the OECD council approved a new recommendation on core principles for occupational pension regulation. This recommendation provides a comprehensive set of principles addressing areas such as the establishment of pension plans and funds, the funding of pension liabilities, and the regulation of pension fund investment, the supervision of pension funds, as well as the rights of beneficiaries.

We regard all of these activities as crucial in our objective to assist member countries in the difficult but essential task of making sustainable the financing of retirement for our future generations. The stakes are very high and, because of our responsibility vis-à-vis our children, the aging challenge is one that we cannot afford to fail. Because the OECD has this capacity to compare countries' performances, it is well placed to help decision-makers arrive at the best policy choice.