Aging & Pensions in EU

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The aging of the population has been one of the main concerns of policymakers over the past two decades. In the European Union, all countries have implemented reforms that will substantially reduce the generosity of public pensions, paving the way for the privatization of pensions. The global financial crisis did not stop this trend. Indeed, it might well be that the rising issue of public debt will allow for further dramatic declines in pension and other social expenditure in the very near future. Besides its consequences on workers, this trend might threaten the social cohesion and may be analyzed, in more general terms, as a decline of democratic institutions.

Increased Longevity: Main Driver of "Aging Process"

The key factors behind demographic changes are the fertility rate, the rise in life expectancy and inward migration *(Table 1)*. The total fertility rate (TFR, i.e. the average number of births per woman) is expected to rise slowly in the EU from 1.52 in 2010 to 1.62 in 2050. This means the fertility rate should remain below the natural replacement rate of 2.1. Inward migration flows to the EU countries – which are already small – should decelerate and will remain concentrated on some countries (Spain, Italy, Germany and Britain). But the most important factor affecting the demographic structure will be the decline in mortality and, consequently, the rise in life expectancy. Life expectancy at the age of 65 should increase by 4.2 years for men and by 4.1 years for women over the period 2010-2050. The aging process can thus be characterized as aging "from the top" as it largely results from projected increases in longevity. The share of the elderly population (65 and over) in the total population should consequently increase from 17.4% to 28.8% between 2010 and 2050.

The aging process will be more rapid in the new member states (EU12), so much so that differences in population structures will become less pronounced in the future. In all countries, however, the aging of the population will follow a very similar long-term trend observed in the past. In fact, the aging of the population is not a new phenomenon. The demographic transition – i.e. the process by which a society shifts from a demographic regime with high mortality rates nearly equalling its high fertility rates to another regime where mortality and fertility rates are lower and still approximately equal – began two centuries ago and will probably come to a standstill in the next few decades, at least in most European countries. It will be amplified in the coming decade when baby-boomers reach the age of retirement.

Aging & Demographic Changes

The aging of the population will lead to a sharp increase in the old-age dependency ratio (defined here as the ratio of people aged 65 and over to the employed population). This ratio is expected to increase by 85% over the period 2010-2050 *(Table 2)*. This increase should be much larger in the EU12 than in the EU15. So the level of the old age dependency ratio should be very close in the two groups of states in 2050.

There is no doubt that the aging of the population would require an increase in public pension expenditure. However, this old-age dependency ratio largely overestimates the true burden that will fall on workers in the future. There are two reasons for this. First, the increasing proportion of old people in the population is caused in part by the decreasing proportion of children. Because, at any point of time, the employed population hands over part of their resources to the population not in the working age, whether young or old, the demographic dependency ratio, i.e. the ratio of the nonworking-age population to the employed population, gives a more accurate view of the economic consequences of future demographic changes. Second, part of the working-age population is not in employment. With the structural changes observed in the labor market over the past 30 years, employment has become a crucial issue for financing social expenditure. Therefore, from an economic point of view, we should be ultimately interested in the variations of the economic dependency ratio, i.e. the ratio of people out of work (whether inactive or unemployed) to people in work. It is this ratio that gives the best idea of the future economic burden that will fall on those in work because of future demographic and economic changes.

These various dependency ratios can be computed on the basis of figures released by the European Commission *("2009 Aging Report," European Economy, 2). Table 2* shows that there are very large discrepancies in the variations of these dependency ratios over the next decades. In all areas or countries, the increase in the economic dependency ratio will be at least four times less than the increase in the old-age dependency ratio. Moreover, the slight increase in the economic dependency ratio projected for the next 30 years follows a decline observed in the past 15 years. Consequently, it will take more than 30 years for this ratio to recover after 2040 its 1995 level in the EU15. From an economic point of view, the pressure of the population dependent on workers will not be higher in the next 30 years than in the near past.

Impact of Demographic Changes on Public Expenditure

The cost of these demographic changes may be expressed as the productivity gains that would be necessary to finance the aging of the population. *Table 3* shows the results of these calculations.

Annual productivity gains necessary to finance public transfers that go to the old-age population should be around 0.3% a year. When we take into account the whole economically dependent population, this cost is a little smaller. This figure may be compared with a projected increase in labor productivity of 1.9% a year over the period 2010-2050.

In other words, future demographic and economic changes will not increase dramatically the economic burden on workers and one can reasonably assume that it is possible to share future productivity gains among all categories of the population, whether employed or not, without any dramatic consequence on the growth of the purchasing power of net wages. The increase in public transfers necessary to finance the whole dependent population (old and young inactive people, plus the unemployed) would still allow for a substantial increase in real net wages (1.6% to 1.7% a year). In most European countries, this is far more than what workers have experienced over the past 30 years.

These figures illustrate the fact that the main issue is not an economic one concerning the level of transfers from workers to "non-workers": it mainly concerns the organization of these transfers and, in particular, the respective shares of public and private transfers needed to support the whole economically dependent population. Transfers to pensioners normally take the form of compulsory contributions, whereas the overwhelming majority of transfers that go to young people occur within the family and take the form of private outlays. This is an essentially qualitative difference in the way economic resources are allocated and raises a political question.

The political dimension of this choice is also rather clear if we consider the consequences of the alternative scenario. If governments were to freeze public pension expenditure at its current level – as it is in fact the case with the ongoing reforms (see below) – it would imply a dramatic decline (more than 40%) in the benefit ratio, i.e. the ratio of the average pension to per capita GDP. Moreover, it is far from obvious that such a shift would reduce the cost of financing the dependent population and, in particular, the cost of pensions. As it has been documented by many studies such as the ones published by the International Monetary Fund or the World Bank (see for instance Orszag and Stiglitz, *"Rethinking Pension Reform: Ten Myths About Social Security Systems,"* 2001), the shift towards privatized pensions would not necessarily decrease the overall cost of pensions. On the contrary, it would imply transition costs, increased administrative costs and greater fiscal subsidies that would globally increase the cost of pensions for workers. There are thus hardly any economic reasons to shift from a publicly financed pension system to a privately managed one. That is indeed the choice that has been made in all member countries of the EU over the past two decades.

TABLE 1

Key demographic indicators

	Fertility rate		Life expectancy at 65 (male)		% of population aged 65 & over	
	2010	2050	2010	2050	2010	2050
EU27	1.52	1.62	16.73	20.91	17.4	28.8
EU15	1.65	1.71	17.10	21.08	18.0	28.4
EU12	1.37	1.51	14.45	19.51	14.8	30.9
5 largest EU countries						
Germany	1.35	1.49	17.04	21.11	20.6	31.7
Spain	1.39	1.52	17.30	21.24	16.7	32.1
France	1.98	1.94	17.93	21.68	16.7	25.6
Italy	1.39	1.52	17.70	21.52	20.3	32.6
Britain	1.84	1.84	17.09	21.22	16.4	23.0

Source: "2009 Aging Report," European Economy, 2, European Commission

TABLE 2

Increases in dependency ratios (% over 2010-2050)

	Old age	Demographic	Economic
EU27	85.7	46.3	22.0
EU15	74.1	40.5	18.8
EU12	149.1	76.3	40.1
5 largest EU countries			
Germany	72.2	44.2	22.5
Spain	120.0	63.6	26.6
France	66.9	32.1	15.2
Italy	79.0	45.9	18.9
Britain	47.9	23.9	10.4

Source: "2009 Aging Report," European Economy, 2, European Commission

TABLE 3

Public cost* of dependent population (2010-2050)

	Pensioners	Pensioners & other economically dependent	Expected labor productivity
EU27	0.34	0.31	1.90
EU15	0.30	0.27	1.79
EU12	0.50	0.50	2.22
5 largest EU countries			
Germany	0.33	0.29	1.76
Spain	0.44	0.38	1.94
France	0.26	0.23	1.72
Italy	0.37	0.32	1.68
Britain	0.18	0.15	1.80

*Note: *Annual productivity gains necessary to finance dependent population*
Source: "2009 Aging Report," European Economy, 2, European Commission

Previous Reforms Dramatically Reduce Financing Needs

Pension reforms have been implemented in all European countries over the past 20 years. The consequence is that the needs for financing future pensions have been considerably reduced. In the EU as a whole, the share of public pensions in GDP is still expected to slightly increase by 2.2 percentage points (p.p.) over the period 2007-2050 and by 2.3 p.p. for the EU15 *(Table 4)*. A report published by the European Commission *("2009 Aging Report")* has analyzed the contributions of various factors to this shift in the public pension-to-GDP ratio. This report shows that this slight increase in public pension expenditure is the consequence of two opposite forces.

As expected, demographic changes will lead to an increase in pension expenditure. The demographic factor is in fact the main driver of future pension expenditure. Over the period 2007-2050, the contribution of the aging process alone to the public pension-to-GDP ratio is expected to be 8.0 p.p. for the EU27 and 7.3 p.p. for the EU15. In other words, if the rules of governing public pension schemes were to remain unchanged, the public pension-to-GDP ratio would reach 18.2 % in 2050 instead of 10.2% in 2010 because of the aging of the population. However, other factors will counterbalance this effect to a large extent, reducing the financing needs of public pension systems by 70% (5.8/8.0, see *Table 4*).

These "negative" contributions to pension expenditure are mainly the consequence of a decline in the generosity of pension systems after the reforms that have been implemented in EU countries over the past two decades. There are, however, differences across countries. In Italy and to a lesser extent in France, for instance, reforms will quite completely offset the consequences of aging on pension expenditure. In Spain and Britain, the ongoing reforms will reduce the consequences of aging by a little less than 40%.

In order to reduce pension expenditure, reforms that have been carried out in the EU have used a variety of tools: incentives for working longer, promoting supplementary private pensions, and stronger links between contributions and benefits. More structural reforms have promoted pension systems that take account of increasing longevity when setting benefit levels and/or have introduced automatic or semiautomatic review mechanisms. The overall effect of these changes is to reduce the generosity of public pension systems.

Lower Coverage & Smaller Public Pensions

The downsizing of public pension schemes will be achieved in two major ways: a decline in the coverage of the old-age population and a sharp decrease in the level of benefits. With the ongoing reforms of pension systems, these two factors are expected to reduce pension expenditure in approximately the same proportions (-2.4 p.p. for the coverage effect and -2.1 p.p. for the benefit ratio; see *Table 5*).

Concerning the coverage, the legal retirement age has been postponed in many countries as is the case in France with the recent reform voted in November 2010. Early retirement schemes have also been abolished or reduced substantially in many countries and, more generally, eligibility criteria for receiving a pension have been tightened. Moreover, changes in the pension system may push some workers to postpone their retirement and exit the labor market after reaching the legal retirement age.

TABLE 4

Contributions to public pension spending-to-GDP ratio over 2007-2050 (% of GDP)

	Pensions/GDP	Aging	Other factors
EU27	2.2	8.0	-5.8
EU15	2.3	7.3	-5.0
EU12	2.8	8.5	-5.7
5 largest EU countries			
Germany	1.9	7.3	-5.4
Spain	7.0	10.6	-3.6
France	1.2	8.2	-7.0
Italy	0.7	10.4	-9.7
Britain	1.5	3.3	-1.8

Source: "2009 Aging Report," European Economy, 2, European Commission

TABLE 5

Contributions to public pension spending-to-GDP ratio over 2007-2050 (% of GDP)

	Coverage effect	Benefit ratio
EU27	-2.4	-2.1
EU15	-1.8	-2.0
EU12	-2.0	-2.4
5 largest EU countries		
Germany	-1.8	-2.2
Spain	-1.0	-1.0
France	-2.1	-3.8
Italy	-3.3	-4.2
Britain	-1.5	0.2

Source: "2009 Aging Report," European Economy, 2, European Commission

The overall impact of these measures is expected to translate into a decline of the coverage ratio (the number of benefit recipients as percentage of the pensionable population, i.e. the population at or above the legal retirement age). The coverage ratio at age 65 is expected to be reduced over the period 2007-2060 in all but one country (Luxembourg). This is the consequence of an expected increase in the average age of exit from the labor force and also, in some countries, of a lower number of pensioners below the legal retirement age, for instance workers getting disability pensions.

The generosity of the pension system will also be reduced with the expected decline in the benefit ratio, i.e. the ratio of average pension expenditure per pensioner to per capita GDP. This will be the case in all but five countries of the EU. Unlike the coverage effect, the decline in the benefit ratio will mostly take place in the long run and the largest contribution of the fall in benefit ratios is projected to show up over the period 2030-2040.

Financial Crisis & Need to Revisit Recent Pension Reforms

Most of these reforms were implemented before the global financial crisis that started in 2007. This crisis had major consequences on pension systems, but these effects vary according to the mode of financing pensions. PAYG pension schemes clearly suffered from a rise in unemployment and a subsequent fall in the number of contributors. However, fully-funded schemes suffered much more with a dramatic decline in the value of assets. In OECD countries, private pension funds lost 23% of their value in 2008 and most private schemes did not yet recover their losses. The financial crisis highlighted the vulnerability of these fully-funded schemes showing the need for reviewing past reforms.

As the ILO writes in a recent report *("World Social Security Report 2010/11")*, "In view of the recent experience, a fundamental review is needed of social security pension systems; some of the pension reforms undertaken during the last two decades need to be revisited." In particular, corrections are needed to reduce the degree of vulnerability of pension levels to the performance of capital markets, a vulnerability that has been introduced and enhanced in pension systems over the past three decades.

The crisis has also cast doubt on some mechanisms that were introduced to automatically stabilize pension expenditure. In Sweden, for instance, past reforms introduced an "automatic balancing mechanism" in the pension system. With the crisis, this mechanism would have led to a decrease in pension levels for several years. Such a prospect opened public debate, the conclusion of this debate being that discretionary government intervention should be allowed to suspend the existing rule and reduce the scale of the decrease in pensions.

One might thus expect that past reforms could be revisited in a way that would increase the adequacy as well as the security of future pensions. These necessary guarantees would only cost a fraction of the cost of the recent bailout of the financial system. One can hardly see, however, such a trend emerging today in the EU. After the collapse of financial markets in 2008, many governments have welcomed the positive countercyclical impact of social security programs as a short-term response to the crisis.

Two years later, however, a majority of European governments are turning to austerity plans that would have a dramatic impact on welfare programs and public pension schemes. The main reason is that the global financial crisis has also exacerbated the issue of public debt. There is nevertheless little relationship between public debt and social public spending. Figures released by Eurostat *("Structure of Government Debt in Europe," Statistics in Focus, 110,* 2008) show that in most countries, the sector holding the largest proportion of public debt is the central government. By contrast, debt in the social security funds sector is only seen in a few countries and, in all of these cases, it is relatively limited. In other words, one should not confuse the public debt and the debt of social security funds as it is often the case in the political discourse.

Despite this fact, austerity plans that have been implemented or are about to be carried out in most European countries in the near future will mostly consist of cuts in social expenditure, including of course public pensions. Indeed, the question of the public debt and its necessary reduction has been one of the main arguments behind recent pension reforms in France and Spain for increasing the legal retirement age. Increased pressures on public pensions will help reduce social contributions that finance pensions in most European countries and this might well reinforce pressures to reduce wages and labor costs. In such a situation, it would be easier for employers to capture most of productivity gains at it has been the case over the past decades with the dramatic fall in labor share that has been, as stressed by many commentators, at the core of the global financial crisis.

Policy Issues

In such a context, the future of pensions encapsulates issues that go far beyond the sustainability of public finances. And this can explain the strong resistance of European populations to current reforms. To understand this phenomenon, it is thus useful to put it in a broader historical perspective.

The process of reforming pension systems started in the EU about two decades ago. In the first half of the 1990s, most European governments reached a compromise with trade unions to set up the design of pension reforms and that is one of the reasons why these reforms have been successfully implemented and quite well accepted by the populations (*"Social dialogue and pension reform,"* ILO, 2000).

The situation changed over time when European governments wanted to further reduce pension benefits, a process that has been clearly supported by the European Commission. The former compromises started to break out. That is one of the reasons why 2003 witnessed such large protests against pension reforms in Europe. It was the case not only in France but also in Germany, Italy and Austria where the first general strike since 1945 took place to protest against the attacks on the pension system, including the one planned by the rightwing Austrian government of Chancellor Wolfgang Schüssel. European populations increasingly feel that there is a kind of never-ending process of "reforming" pensions and that the meaning of these "reforms" would always be to reduce the generosity of pensions. The massive demonstrations of French people last autumn to protest against an overhaul of France's pension system as well as demonstrations in Spain last December against the pension reform of Prime Minister Jose Luis Rodríguez Zapatero are the latest signs of this disappointment. The process of reforming pensions moved from dialogue and consultation to open confrontation between the political elite and the populations.

In the context of the global financial crisis, European populations feel that pension reforms as well as other attacks against the welfare state are only a way to make people pay for a crisis which they are not responsible for. The bailouts of banks and financial stimulus packages that governments used to "solve" the crisis merely turned banks' debt into public debt. After the threat of an aging population, public debt seems to be the latest alibi to further privatize pension systems.

As Karl Polanyi clearly demonstrated in his influential book (*The Great Transformation,* 1943), the development of social protection schemes may be analyzed as a response of society to unbearable pressures put by market forces on the populations. The move towards larger market-driven private funds is a reverse trend that could well threaten social cohesion and endanger one of the most fundamental democratic institutions of European countries. JS

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