NOT THE SAME ALL OVER

Population ageing is a worldwide issue – but how to prepare for it differs between developed countries and emerging markets

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Population ageing poses a growing challenge to retirement security in both developed countries and emerging markets. The nature of the challenge, however, is different in Italy, Germany or Japan from China, India or Mexico. For developed countries, it's how to maintain the current high living standard of the old without imposing a crushing burden on the young. For emerging markets, it's how to provide a modicum of income security for the old when large numbers currently have none at all.

It may help to start with a little history. In the decades following the Second World War, most developed countries greatly expanded the generosity of their state pension systems. Although the designs differed, almost all were financed on a pay-as-you-go (PAYGO) basis, meaning that current workers paid for current retirees. With both workforces and wages growing rapidly, this arrangement seemed perfectly affordable. Given the low income and high poverty rate of the elderly, subsidising retirement also seemed like enlightened social policy.

No sooner had these systems been put in place than falling birthrates and slowing economic growth began to undermine their foundations. At the same time, dramatic improvements in the economic circumstances of the elderly – whose income now approaches, equals or exceeds the national average in most developed countries – rendered the rationale for subsidising retirement less compelling. Faced with alarming projections of rising old-age benefit costs, by the 1980s and 1990s governments had shifted from expanding the generosity of state pension systems to attempting to control the mounting costs.

The situation in developed countries

There is no question that much progress has been made on this front. Gone are the no-penalty early-retirement programmes that in many European countries virtually bribed older workers to retire. Most developed countries have already raised or are in the process of raising their full-benefit retirement ages. Many have also reduced initial benefit formulae and/or modified the indexation of benefits in current payment status.

Some countries have gone further and built automatic stabilisers into their state pension systems. Ten countries in the EU have indexed their full-benefit retirement ages to life expectancy. Some countries, including Italy, Norway and Sweden, have transformed their traditional defined benefit pension systems into notional defined contribution systems, in which benefits are not only indexed to life expectancy but also to the growth rate in taxable payroll. Others, notably Germany and Japan, have added automatic stabilisers to their state pension systems while leaving their basic structures unchanged.

What is less clear is whether these reforms are socially and politically sustainable. In many of the countries that are making the deepest cuts to state pension benefits, the elderly are highly dependent on them. In Germany, 68% of elderly income is from a government pay-out. In Italy, it's 76% and in France it's 78%. Given this dependence, scheduled benefit cuts could result in large reductions in the living standard of the elderly relative to that of working-age adults.

To forestall this, governments almost everywhere are promoting funded retirement savings. Countries like Germany and Italy, which until recently relied almost exclusively on PAYGO pension systems, have jump-started new supplemental funded systems. Meanwhile, from Super in Australia to KiwiSaver in New Zealand and Nest in the UK, countries that have long had supplemental funded systems are trying to expand them.

A lot hinges on the success of these initiatives, since retirement reforms that achieve fiscal sustainability at the expense of income adequacy are unlikely to prove lasting. The UK learned this the hard way. In 1980, it reindexed its state pension from wages to prices, greatly improving its fiscal sustainability. But as the relative living

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standard of the elderly declined, worries shifted from how to control costs to how to prevent impoverishment. In 2010, with the introduction of the triple lock, the reform was effectively repealed.

Challenges in emerging markets

While today’s developed countries became affluent societies before they became ageing societies, many emerging markets are growing old while they are still in the midst of development. Informal sectors are typically large, which means that much of the workforce – sometimes the majority of it – fails to contribute to the state pension system. In India, the effective coverage rate is just 20%.

Until recently, governments could count on the extended family to step in and provide for workers who reached old age without a pension. Traditional family support networks, however, are under stress from the forces of modernisation, including urbanisation and industrialisation, and will soon come under intense demographic pressure from shrinking family size. In a survey by the Global Aging Institute of 10 Asian countries, no more than 13% of respondents in any country thought that grown children should be primarily responsible for providing income to retirees.

Over the past few decades, many emerging markets have tried to address the low coverage problem by introducing non-contributory social pensions. While these are a near-term necessity, they have the drawback of encouraging the very labour informality that makes them necessary. They also threaten to become prohibitively expensive as societies age.

More recently, some emerging markets, such as China and India, have begun to experiment with a promising alternative: voluntary retirement savings schemes with flexible contribution and withdrawal rules that suit the needs of informal-sector workers.

Much is at stake. In the developed world, failure to adequately address the challenge posed by population ageing could force painful trade-offs between tax hikes and benefit cuts. In the emerging world, it could result in a humanitarian ageing crisis of immense proportions.