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The Center for Strategic and International Studies on why policy matters

*With the generational contract on the verge of breaking in many European countries, **Richard Jackson** looks at which countries are best prepared for the oncoming demographic change.*

Global ageing throws into question the ability of societies to provide a decent standard of living for the old without imposing a crushing burden on the young. Nowhere is this truer than in Europe, whose rapidly ageing populations threaten to overwhelm the welfare state. So which countries are the best prepared to meet the retirement challenge?

The Global Aging Preparedness Index (GAP index), which was developed by the Washington-based Center for Strategic and International Studies, provides a unique new quantitative assessment of the progress that countries worldwide are making in preparing for ageing societies, particularly the old-age dependency aspect of the challenge. The GAP index consists of two sub-indices – a fiscal sustainability index and an income adequacy index.

On the fiscal side, the GAP index looks at the projected growth in government old-age benefit spending, including both pensions and health care. It also takes into account the fiscal room that countries have to accommodate that growth, as well as the degree of elderly dependence on benefits, which may be a crucial factor in determining how politically difficult it will be to enact cost-cutting reforms – or indeed, to follow through on reforms that have already been enacted. On the adequacy side, the GAP index tracks the living standards of the old compared to the young based on household income projections that factor in the affects of changes in the generosity of state benefits, participation in private pension plans, and elderly labour-force participation rates.

The results for Europe are sobering. Besides Poland and Russia, which have partially privatised their state pension systems, only Sweden ranks among the top 10 GAP index countries on fiscal sustainability. Six of the seven lowest-ranking countries on fiscal sustainability are European: Switzerland, Germany, the UK, Italy, France, the Netherlands and Spain. Although several European countries earn high scores on income adequacy, this favourable result sometimes comes at the expense of unsustainably high growth in PAYG state benefit commitments – the case in Spain and, to some extent, the Netherlands. In Russia and Poland, the trade-off is precisely the reverse. They score well on fiscal sustainability, but badly on income adequacy.

Two countries score towards the bottom of both indices: France and Italy. Although the outlook in these countries is especially grim, it points to a dilemma facing many European countries. To rein in the rising costs of their PAYG old-age benefits, France and Italy enacted pension reforms that dramatically reduce the generosity of the public 'deal' that future retirees can expect to receive. According to the GAP index projections, the income of the middle-income elderly in both countries is due to fall by roughly 15% relative to the income of middle-income working-age adults over the next three decades. Yet France and Italy have such expensive old-age benefit systems that, even after the reforms, they remain on a fiscally unsustainable course. In short, both countries are moving towards retirement systems that are both inadequate and unaffordable.

However, some countries are moving in the right direction. Like France and Italy, Germany and Sweden have scheduled deep reductions in the future generosity of their state pension systems. But unlike France and Italy, they are on track to fill the resulting gap in elderly income by increasing funded pension savings and by extending work lives. Although their projected fiscal burdens remain high, they have been cut well beneath what they would otherwise have been without undermining future income adequacy.

This contrast points to a crucial lesson. Most of the world's developed economies – as well as a few emerging markets – will have to make large reductions in the generosity of state retirement provision to stave off fiscal Armageddon. But unless reforms also ensure income adequacy for the old, the reductions are unlikely to be socially and politically sustainable. This is especially true in Europe, where state benefits make up a huge share of total elderly income. In France, Germany, Italy, and Spain, over 70% of the income of the typical elderly person comes in the form of a government cheque.

The example of the UK should be heeded. In the 1980s, the UK switched the indexation of its basic state pension from wages to prices, flattening the projected growth in old-age benefits as a share of GDP. However, as price indexing caused benefits to decline steadily as a share of wages, concerns about the reform grew. In 2007, amid an emerging consensus that current policy would impoverish the elderly, the government re-indexed benefits to wages. The UK now scores much better on income adequacy than it would have 10 years ago, but it scores much worse on fiscal sustainability.

The experiences of other countries also provide some useful lessons. Those countries which score well in the GAP index on both dimensions of ageing preparedness generally have modest PAYG state benfits, large funded pension systems and high rates of elderly labour-force participation. Australia, which combines a low-cost, means-tested floor of public old-age income support with a large, mandatory, and fully-funded private pension system, ranks well into the top half of both indices. So does Chile, which has a similar mix of retirement policies. Canada and the US, with their robust private pension systems and large numbers of working elderly, also do a better job of balancing fiscal sustainability and income adequacy than most European countries.

One might object that these better prepared countries have more favourable demographics than most European countries do. This is true, though it is worth pointing out that the demographic outlook in Australia, Canada, and US gets a big boost from immigration, which is a matter of policy choice. Nor is demography necessarily destiny. The ageing trend in France, which has the highest birthrate in Europe, is no more severe than in Australia or Canada. Yet it ranks near the bottom of both indices. Japan, despite its massive age wave, ranks in the middle of both indices thanks to its relatively modest per capita public pension benefits, which help to minimise the fiscal burden, and its high rates of elderly labour-force participation and multigenerational living, which help to boost old-age income.

In short, policy matters. It may be too late for western European countries to adopt Australia's model of retirement provision, but they will have to do a more effective job in targeting limited fiscal resources to those elderly most in need.

Saving more for retirement and working longer must also be a crucial part of reform, since they provide the best means to maintain or improve the living standards of the old without imposing a new tax or family burden on the young.

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