Flash Economics

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How can the pension system be reformed?

First of all, it must be said that demographic ageing compromises the equilibrium of all pension systems:

- On a pay-as-you-go basis, because there are fewer and fewer contributors per pensioner;
- By capitalisation, because there are fewer and fewer young working people to buy the assets (financial or real estate) that retirees are selling.

To cope with ageing, one can:

- raise the legal retirement age;
- extend the minimum contribution period;
- if the return of capitalisation (the return on financial assets) is higher than the return of the pay-as-you-go basis (the growth of the economy), introduce a dose of capitalisation;
- reduce the replacement rate, which can be done by lowering pensions or by moving to a system where more employees contribute for shorter periods (points-based system), because experience shows that the points-based system reduces the contribution period;
- move from an essentially Bismarckian system (pensions are linked to earned income) to a more Beveridgian system (contributions are linked to income, pensions are the same for everyone).

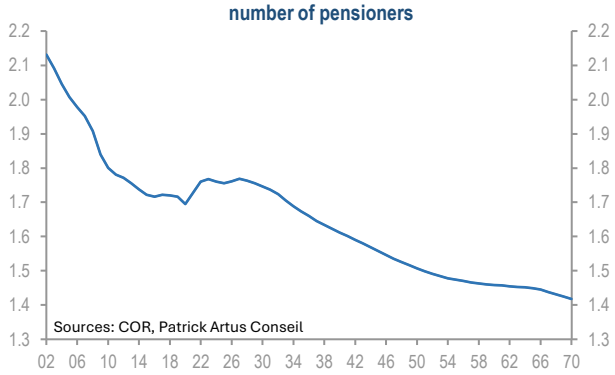
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Demographic ageing is putting both the pay-as-you-go and capitalisation pension systems in difficulty

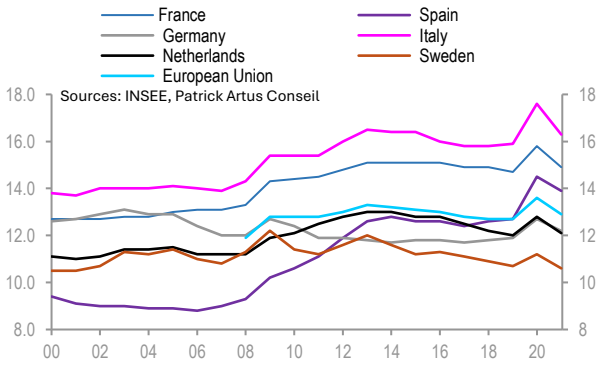
We will document the various points with **the example of the situation in France**.
Chart 1 shows the ratio of the number of contributors to the number of pensioners since 2002 and as it is forecast to evolve until 2070.

Chart 1
France : ratio between the number of contributors and the number of pensioners



One can see a significant decline in the number of contributors per pensioner. It is still 1.76 today and will decline to 1.42 by 2070. **The share of pensions in GDP (Chart 2)** is currently 14.9% in France (this includes all retirement and disability pensions, with pensions alone accounting for 13.5% of GDP). Without any change in the generosity of the pension system, the weight of pensions in GDP would reach 18.6% in 2070.

Chart 2
Pension expenditure (as % of nominal GDP)



Demographic ageing (in the sense of an increase in the number of pensioners per working person) is therefore obviously worsening the financial situation of pay-as-you-go pension systems. But demographic ageing is also affecting the financial equilibrium of capitalisation pension systems.

Indeed, if the pension system is managed on a capitalisation basis, retirees gradually sell their financial and real estate assets to younger working people. As there are fewer younger working people than retirees, **there is insufficient demand for financial and real estate assets, leading to a decline in the price of these assets**, and hence a decline in the return on capitalisation.

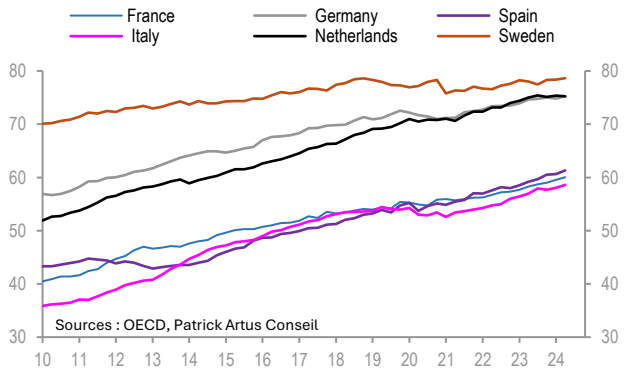
Six measures to ensure that the pension system can withstand demographic ageing

First solution: raise the legal retirement age

Raising the legal retirement age increases the employment rate of people over 60 and therefore increases the ratio of the number of contributors to the number of pensioners (for two reasons: a longer working life and a shorter duration of retirement).

Chart 3 shows that this increase in the statutory retirement age has already been used in all European countries.

Chart 3
Employment rate of population aged 55 to 64 (as %)



There is, however, a limit to the use of raising the statutory retirement age: people's unwillingness to work beyond a certain age. The average effective retirement age is 64.2 in Germany and 65.5 in Italy (62.3 in France), whereas the statutory retirement age is 67 in Germany and Italy.

Table 1: Legal Retirement Age (in Years)

Country	Current Legal Retirement Age	Legal Retirement Age (After Ongoing Reforms)
France	62	64 (for people born after 1968)
Finland	64	65 (2027)
Belgium	65	67 (2030)
Spain	65 or 66.5*	67 (2027)
Germany	66	67 (2031)
Denmark	67	69 (for people born after 1967)
Italy	67	
Netherlands	67	Starting in 2027, the retirement age will increase by eight months per additional year of life expectancy

* depending on contribution period
Source: CLEISS

There is therefore a ceiling to the employment rate of 55–64-year-olds, which is around 75% (Chart 3), which means that raising the statutory retirement age is no longer effective in rebalancing the pension system when it is already high.

Second solution: increase the minimum contribution period

The minimum contribution period to obtain a full-rate pension is 172 quarters (43 years) in France (from 2035).

In France (provided the pension reform is maintained), there will therefore be a double condition for a full-rate pension: being at least 64 and having contributed for at least 43 years. Table 2 shows the situation in various European countries.

Table 2: Contribution Period Required for a Full Pension (in Years)

Country	Period
Germany	45
Belgium	45
France	43
Spain	37

Source : CLEISS

Moving from a system where there is a statutory retirement age to one where there is a minimum contribution period avoids having to set specific rules for people who entered the labour market early (in France, the statutory retirement age, after the reform, is 58 for people who started working before the age of 16, 60 for people who started working between the ages of 16 and 18, and 62 for people who started working at the age of 20 or 21).
In addition, if the rule is based on the number of quarters contributed, it is easier to introduce bonuses (for children, for example).

Third solution: reduce the replacement rate

Today, the replacement rate (ratio of retirement pension to last salary received) in the private sector in France is 55.5% for a manager and 75.6% for a non-manager; in the public sector, the replacement rate is 68.5%. Table 3 shows that the replacement rate in France (for non-executives) is comparable to that in countries where it is high.

Table 3: Replacement Rate in 2016 and 2019 (in %)

	Italy	Spain	France	Sweden	Netherlands	Belgium	Germany
2016	69	66	68	57	50	48	46
2019	73	70	65	55	51	46	44

Source : COR

The average replacement rate falls:

- if pensions are not indexed to nominal wages;
- if the calculation of the reference salary becomes less favourable.

The disappearance of productivity gains from 2019 means that indexing pensions to wages maintains the purchasing power of retirees after they retire. Table 4 shows that in France, the standard of living for senior citizens is higher than in the countries of Northern Europe.

Table 4: Standard of Living of Seniors Relative to that of the Overall Population in 2021 (in %)

	Over 65 Years	66 to 75 Years	Over 75 Years
Belgium	78	85	69
Netherlands	79	85	70
Sweden	86	98	72
Germany (2020)	90	91	87
Spain	95	104	85
France	96	99	92
Italy	98	108	88

Source: COR

The problem with lowering the replacement rate is the high level of inequality between the incomes of private sector pensioners, which means that lowering the replacement rate greatly increases the number of people receiving the lowest pension (the minimum contributory pension).

Fourth solution: switch to a points-based pension system (notional accounts, à la carte pensions)

Italy and Sweden have switched to a points-based pension system.

The advantage of this system is that it is automatically balanced, if the value of the point is defined in such a way as to ensure the balance of the pension system.

In addition, it allows **individual freedom in the choice of retirement age**. The disadvantage is that in countries where this system has been introduced, experience shows that people retire too early if they are free to choose their retirement age, and therefore only receive a small pension.

Fifth solution: a dose of capitalisation

As we have seen, funded pension systems also suffer from demographic ageing. However, the return on capitalisation (the return on financial assets) is higher, in the long term, than the return on distribution (the growth of the economy). **This implies that the weight of pensions in GDP can be reduced if the pension scheme is partially managed on a capitalisation basis,** since a same contribution would result in a higher pension.

Sixth solution: Moving from an essentially Bismarckian to a more Beveridgian system

A Bismarckian pension system is one in which the amount of pension received is linked to the amount of contribution paid, which depends on income.

A Beveridgian pension system is one where contributions are linked to income, and the pension received is the same for everyone, independent of income.

Introducing a larger dose of the Beveridgian system into the current French system, which is essentially Bismarckian, would reduce pension system expenditure.

Summary: what is the solution to controlling the size of pension expenditure?

It is not possible for the size of pension expenditure to grow from 14% to 18.6% of GDP by 2070, which would be the case if demographic ageing were not corrected. More than likely, all possible solutions will be used to stabilise the weight of pension expenditure:

- extending the minimum contribution period rather than postponing the legal retirement age, with the possibility of switching to a points-based system;
- reducing the replacement rate ;
- introducing an increased dose of the 'Beveridgian' system (equal retirement for all, with contributions linked to income);
- introducing a dose of funded pensions.

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