# The Challenge of Public Pension System Reforms

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# PRESS RELEASE

## The challenge of public pension system reforms

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**In the paper entitled The Challenge of Public Pension Reform in Advanced and Emerging Economies[1], International Monetary Fund (IMF) experts emphasize that public sector reform will be one of the key challenges for public policy makers, both in advanced and emerging economies. According to their projections, the share of public pension expenditure in GDP between 2010 and 2030 will grow by 1 percentage point and between 2010 and 2050 by 2.5 percentage points on average. Although the appropriate reform measures depend on country circumstances and preferences, the IMF team gives particular prominence to the numerous advantages of increasing retirement ages.**

At the end of 2011, IMF's Fiscal Affairs Department published a paper dealing with an analysis of public pension systems. As many economies will have to undergo fiscal consolidation, and given the already high levels of taxation, the focus will be on expenditure rationalisation, i.e. on public pension spending which accounts for a large share in total public consumption and has been on a constant increase. Consequently, the IMF experts: (a) analyse the causes of public pension spending growth; (b) provide forecasts/projections of public pension spending for the following twenty and forty years; (c) assess the sensitivity of the projections to demographic and macroeconomic factors and the risks of reform reversal; and (d) give recommendations for curbing the growth of expenditures on public pension systems. Although the sample of countries does not include Croatia, this review sets out the main findings of the paper, because it deals with an issue, which is very topical in Croatia as well.

### Public pension spending

Public pension expenditures account for about one fifth of total public expenditures in both advanced and emerging economies. Over the period 1970-2010, the share of public pension spending in GDP rose by 3.5 percentage points in the former group of economies (from 5% to 8.5%), and over the 1990-2010 period by 1.5 percentage points in the latter group of economies (i.e. from 7.5% to 9% in European countries and from 2% to 3% in other countries)[2]. There are four drivers underlying the change in public pension spending as a share of GDP in advanced economies: population ageing, eligibility rates, replacement rates (the share of average pension in average wage) and labour force participation rates.

[1] IMF, 2011. *The Challenge of Public Pension Reform in Advanced and Emerging Economies*, 28 December 2011.

[2] *Advanced economies include*: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Great Britain and USA. *Emerging economies include*: Argentina, Brazil, Bulgaria, China, Chile, Egypt, Estonia, Hungary, India, Indonesia, Jordan, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Philippines, Poland, Romania, Russia, Saudi Arabia, South Africa, Thailand, Turkey and Ukraine.

From 1970 to 1990, population grew older, replacement rates increased and the statutory retirement age declined by 1 year, which all together resulted in an increase in public spending. This increase was partly offset by a rise in female labour participation, and from 1990 to 2010, it was contained by tighter pension eligibility conditions and a further increase in labour force participation rate. In emerging economies, the growth of public pension spending was mainly the result of higher replacement rates and population ageing.

**Public pension spending projections**

According to the IMF team projections, public pension spending will grow substantially in many advanced and emerging economies. The following two decades are expected to see an increase in its share in GDP by one percentage point, but the situation differs markedly across countries. Among advanced economies, increases in pension spending in excess of 2 percentage points of GDP are projected in Belgium, Finland, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Slovenia and Switzerland, while decreases in spending are projected in Denmark, Italy, Japan and Sweden. As to emerging economies, spending growth in excess of 3 percentage points of GDP is projected in China, Egypt, Jordan, Russia and Turkey, whereas its fall is projected in Bulgaria, Chile, Estonia, Hungary and Poland.

**Risks to projection accuracy**

These projections are relatively uncertain, as they depend on numerous factors. More specifically, the 20-year projections made so far have overestimated the fertility rates and underestimated life expectancy, which means that in both cases, the public pension spending projections were lower than the outturns. Macroeconomic assumptions also affect public pension spending projections. For example, lower-than-expected productivity implies lower wages, which can result in higher-than-expected replacement rates. Projections are further influenced by policy makers' commitment to fully implement the pension system reforms aimed at achieving reductions in public pension spending. For example, raising the statutory retirement age can result in an increase in claims for disability pensions. Problems within the private pension schemes can also become a public fiscal problem. Replacement rates in the private pension system may be too low, and, although the government is not legally obliged to „step in“ and solve the problem, there is an implicit social obligation of the public pension system to ensure adequate income in retirement, especially for low-income groups.

**Public pension reforms**

Public pension system reforms affect the welfare of elderly citizens, labour force participation rate and private savings, and thus long-term growth, and the success of fiscal consolidation. Although it may be difficult to reduce public pension spending as a share of GDP, it is at least possible to stabilize it in order to avoid the need for cuts in other public spending. Governments should also resist temptation to spend potential pension system savings on other budget items.

The authors of this study believe that increasing retirement ages has many advantages. First, it promotes higher employment levels, while longer working periods boost aggregate demand by strengthening personal consumption. Second, raising retirement ages helps avoid even larger cuts in replacement rates, thus affecting poverty/wealth of elderly population. Third, public acceptance of increased retirement ages could be higher in light of increasing life expectancies. It is often believed that such a measure would increase unemployment, but there is very little evidence that increased labour force participation of the elderly would increase the aggregate unemployment rate in the long run. It is essential that increases in retirement ages are accompanied by measures protecting those who cannot continue to work. For example, in the USA, one fourth of all workers in their sixties have difficulties in continuing to work due to disability or impaired health. This is especially the case for low-income earners. At the same time, incentives for early retirement should be reduced.

### A comparison with Croatia

Pension spending participated with 10.6% in Croatia's 2010 GDP. A comparison between Croatia and 52 countries from the IMF sample suggests that only 7 countries had higher pension expenditures, i.e. Austria (13.9%), France (13.3%), Greece (12.1%), Italy (14.7%), Portugal (12.7%), Poland (11.3%) and Ukraine (17.7%). This confirms the urgency of pension system reforms in Croatia, and all the more so because the country also needs fiscal consolidation. However, as underlined by the IMF experts, country-specific characteristic have to be taken into account, which applies to Croatia as well.

With respect to retirement ages, Croatia, with its statutory full retirement age of 65 for men and the equalisation of retirement ages of men and women by 2030, does not deviate from the advanced economies' average. However, the problem lies in the difference between the statutory and the actual retirement age. Last year, the numbers of old-age and early retirement pension beneficiaries in Croatia totalled 16,330 and 13,384[3] respectively. The average retirement age for the former category (both men and women) was 64 years, and for the latter category 59 years (61.5 for men and 56 for women). Last year, old-age pension beneficiaries totalled 513,031, and early retirement pensioners 119,741.

The Institute of Public Finance and the Banka magazine jointly organised a series of round tables last year, on the issue of the Croatian pension system[4]. Among the topics discussed was the increase in elderly employment. The resulting recommendations were as follows[5]:

- changing the retirement practice, by making the staying in employment financially more favourable for both employees and employers;
- improving access to jobs for the elderly;
- introducing public incentives for lifelong learning;
- improving the efficiency of public health care and safety at work; and
- developing social care services for the elderly and children (given that women often retire in order to look after their parents or grandchildren).

[3] Croatian Pension Insurance Agency, 2011. *Statistical Information*. February 2011. Zagreb.

[4] A Collection of papers presented at the round tables is available at the Institute of Public Finance's website at: [http://www.ijf.hr/upload/files/file/AMS/zbornik.pdf].

[5] The recommendations were published in a special issue of the Banka magazine - Analiza mirovinskog sustava (Pension System Analysis), October 2011, p. 57.