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An optimistic perspective on population aging

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Population aging is typically associated with economic challenges for productivity and innovation of an economy, financial threats for the pension system, and fears of increasing impoverishment of the elderly. This is substantiated in endless studies over recent years and sometime decades through projected population aging – measured through the rising share of elderly in population or the ratio elderly to active population-, and is leading to the conclusion that future generations will not only have to work longer but also will risk receiving less when old. While the situation for advance economies seems dire as ageing has already progressed, the situation for emerging economies may be even worse. While the rich countries got rich before getting slowly old, the poor countries risk getting old very fast before getting rich.

Yet, it is time to move away from this gloomy perspective and take a much more optimistic policy position on population ageing. After all, living longer has been the dream of mankind for thousands of years. This policy note argues that the traditional definition of ageing and how it is measured needs to be rethought and redefined. In addition, there is strong hope that an ageing society can be as productive and innovative as a younger one, and that ageing can be a joyful personal experience. But the salvation does not come automatically – one has to have the required policies in place and to this end one has to change the mind-set of policy makers and the society at large.

To change the mind-set it needs to be understood that population aging and the increasing life expectancy without boundaries are quite likely the biggest challenge to mankind in recorded history. For thousands of generations life expectancy at birth was constant and around 30 years of age, and has not changed since the times of hunters and gathers till around 1800 in the most advanced countries. The more than tripling of the life expectancy as an adult over the last 200 years is a revolution to economy and society which is not yet understood or even less internalized. And population ageing does not show any signs to stop in the near or distant future, if at all. Hence population aging will stay with us, perhaps forever, and we will need to address this heads-on. This calls for a review and full-blown revision of, perhaps, all societal institutions, from the likely oldest one – marriage – to one of the youngest – public retirement income schemes. Mere tinkering at the margin of existing retirement income programs will be neither sufficient nor helpful; on the contrary.

To facilitate such fundamental review for all public programs in general and retirement income in particular it is suggested to proceed in three steps: (a) to rethink the traditional definition of individual age and population ageing and replace the traditional retrospective by a prospective view; (b) to ask what it would require to make population aging a pleasant individual experience while addressing the broader economic implications and put the appropriate policies in place to make it happen; and the latter includes (c) to outline the implications of population ageing for the selection of the pension system. Many policy answers to the raised questions and issues are not yet known. But the approach to first ask what needs to be done to make population ageing a pleasant experience and then to identify promising policy interventions to make it happen is conjectured not only to be superior to angst and gloom but also workable.

The populations of all countries are aging by at least one measure, and the traditional measures include the number of elderly, the share of elderly in the population, the ratio older to active population, the medium age (i.e. the age when half of the population is younger, half older). Each of these measures hinges critically on one definition: who is old? As life expectancy at birth and at higher ages is increasing we need to move from the traditional, chronologic and retrospective definition of aging to a dynamic and forward-looking definition that takes account of the increasing number of years left at any age.

Adjusting our view on population aging with a prospective view on years of life left does not only dramatically change the measurement of aging in numerical terms, it is also justified as our individual behavior is or should not be determined by how many years we have already spent on earth but how many we have left. And health, cognitive capabilities manual skills, etc. should not be an obstacle as it may be feared or is at times maintained. The spell of bad health at life end need not to increase with life expectancy, it may actually shrink; the cognitive and manual skills will decrease with age within a cohort but can increase dramatically for a given age between cohorts; and productivity of an older worker can be as high as that of a younger one if the appropriate policies are in place.

The list of issues to look at and policies to identify to make it happen is quite likely long and only imperfectly known. At the center of any policy selection should be the welfare of the individual and the question: What is required to age happily? My take from the empirical literature across many different fields of aging research suggests 4 key ingredients: (i) have a purpose in life that is on your mind when you get-up and ready for the day. This can be a paid or unpaid job, a hobby, or another occupation that makes life worthwhile; (ii) do physical exercise, preferably every day and as best as you can, and enjoy it; (iii) stay socially embedded through family, friends, or other forms of social interaction, as these established psychological mirrors are critical for wellbeing; and (iv) take care of the "birds and the bees," as this is a major part of one's humanity throughout life.

These results are consistent with the economic analyses as it suggest an easy way to address population aging and its economic implications: (a) handling the impact of population aging on the distribution of the economic pie requires an adjustment in the activity span through longer work/later retirement; and (b) handling the impact of population aging on the growth of the pie requires assuring that the productivity of an older workforce continues to also increase. The key necessary conditions for this are proposed to be threefold and require keeping individuals healthy, skilled, and motivated to work longer. Yet, while these conditions are easily pronounced, the relevant knowledge and quite likely the policy interventions to make this happen are currently largely missing.

What needs to be done for all policy areas is to sit back and think deeply about the key issues and come forward with out-of-the-box proposals; at times, this knowledge is lacking, but issues and processes to this end need to be identified. And the policy areas that will quit likely need major reviews and reformulations include labor markets, financial markets, health care, education, and social insurance, and in particular for health care, long-term care and retirement income.

For the selection of the most appropriate retirement income system of an ever aging population what are the criteria that matter most? Five criteria are suggested to be in the forefront: (i) incentives to stay in the labor market; no bias for retirement at the earliest possible date; incentives to remain formal and skilled, healthy and motivated, etc.; (ii) the capability to adjust automatically to a change (increase) in a cohort's life expectancy; (iii) an adjustment mechanism to demographic and economic shocks to keep the system financially afloat; (iv) a structure that offers high intra- and inter-generational equity; i.e., a low rate of variation in the rate of return within and across age cohorts; (v) easy and least distortive integration of redistributive objectives into scheme design/coordination with other redistributive programs.

Reviewing the options for the main earnings-related pension scheme combination by benefit type (DB or DC) and by funding type (unfunded or funding) suggests a clear dominance of DC over DC schemes for most or all of the above criteria, but more ambivalence of funded vs. unfunded schemes. The ambivalence is linked to the expected rates of return of funded vs. unfunded schemes, but also to their dispersion under de-centralized vs. centralized modes of accumulation and decumulation. Hence more analytical work is needed to guide policy. Yet what is clear is that the main (national) scheme needs to be supplemented by a basic pillar to address poverty issues in old age, and a voluntary pillar for income needs in retirement above mandated levels to form a comprehensive pension system to address population aging best. But more analytical work is required to avoid new distortions creeping into the system, in particular from the side of minimum income/pension guarantees, and more policy work is required to make sure that the financial sector is encouraged to and able to deliver. Let's the quest finally begin.

For more information on the challenges of population aging, read Robert's IZA Discussion Paper "A Provocative Perspective on Population Aging and Old-Age Financial Protection".

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