Asia: Ready or Not

Peter S. Heller

Finance and Development, a quarterly magazine of the IMF. September, 2006.

The world's most populous continent must prepare now for an aging population

The challenges faced by industrial countries in the West and Japan with the prospective retirement of the "baby-boom" generation are well recognized. Governments face a growing financial burden from pension costs, medical care, and possibly long-term care, implying either sharp increases in taxes or a reneging on the promised level of benefits. But less appreciated is the fact that many Asian countries also face their own demographic "time bomb." Although they lag two decades or so behind the industrial countries, the sharp decline in fertility rates and rising longevity will result in a growing proportion of elderly people, relative to both the overall population and the number of working-age people, by 2020–30.

Asian countries sit astride the "demographic transition" at various points (see chart). Some, such as Korea and Singapore, are much more advanced in the process, with the elderly dependency rate (EDR)—the ratio of elderly to the working-age population—converging to industrial country levels by 2030 and with further dramatic increases forecast in subsequent years. Korea, for example, is said to have the fastest rate of aging in the world. China and Thailand follow, with the so-called demographic dividend period (when there is a large share of working-age population) lasting through about 2035–40, but with the proportion of elderly rising quickly thereafter. Malaysia is close behind, with its demographic dividend period lasting through 2045. India, Indonesia, and the Philippines will see a high EDR beginning to emerge only sometime after 2050. [Click here to see an old-age dependency chart for Asian nations.]

Getting rich before becoming old

The boom in Asia's economies has positioned it to take advantage of the demographic dividend and tap the region's high levels of savings (the focus here is on Asia's more developed economies outside of Japan: China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand). The opportunities afforded by high savings and investment rates relate both to achieving a higher per capita income (PCI) by the time the population becomes aged and to building up a stock of assets, both real and financial (and both internal and external), that can be drawn upon to help finance the consumption needs of an elderly population.

Several Asian countries (for example, Hong Kong SAR, Korea, Malaysia, and Singapore) have successfully pursued a development strategy built on exploiting their demographic dividend. China, coming from much further behind in economic terms and despite its extraordinarily rapid growth and high savings and investment rates, is still challenged to create productive jobs for its large labor pool in coming years.

Looking ahead, Asian countries face a "double imperative" in considering their appropriate macroeconomic policy stance. Policies should continue to support rapid economic growth, given that growth rates will fall with a slowing, if not declining, labor force in the later stages of the demographic transition. Labor market pressures, reflected in higher real wages, will require new strategies to maintain external competitiveness. Policies should also be framed by the recognition that governments will eventually have to address the pension, medical treatment, and long-term care challenges associated with a substantial increase in the EDR. This underscores the importance of having a sound fiscal position, with low public debt levels, at the time the potential demands of an elderly population become particularly acute. The relative importance of each of these imperatives depends both on how close a country is to the time when its EDR rises and on the extent of its convergence to industrial PCI levels.

But there is also a microeconomic dimension to the aging problem. When a society ages, how will it meet the financial needs of its elderly? Will the elderly be dependent on their own accumulated savings, on the support of individual family members, on the general taxpayer, or on payroll contributions from the workforce through government social insurance schemes (as in the industrial countries)? Or will they be forced to work longer? How will the needs of the very elderly be met, since they frequently require either long-term care or substantial medical or social support?

Virtually all the Asian countries under discussion have wrestled with the issues involved in developing social insurance systems to manage the risks associated with retirement income and medical care. The variety in the observed strategies principally reflects differences in national perspective. Only three—Korea, Singapore, and perhaps Malaysia—can be said to have social insurance systems whose coverage is broad enough that their design features can be evaluated in terms of their robustness or adequacy in addressing the needs of a future aged population.

Two approaches to pensions

Starting with pensions, across Asia, two approaches stand out. The first is that of the Central Provident Funds (CPF) of Singapore and Malaysia (and, to a limited extent, Thailand), as well as the recently established (in 2000) Mandatory Provident Fund of Hong Kong SAR. Each is essentially a defined-contribution (DC) approach. These contrast with the various civil service and private employer–based defined-benefit (DB) schemes of India, Korea, the Philippines, and Thailand.

For the DB schemes, the coverage of the labor force ranges from very low (India), to 30 percent (Thailand), to largely universal (Korea). Replacement rates for covered workers—the ratio of average pension benefits to wages—range from 30 percent in Thailand to 50–60 percent in the Philippines and Korea. Because most of the DB systems are pay-as-you-go (PAYG)—with pension benefits financed from current contributions—they rely heavily on their capacity to raise workers' contribution rates in the event of future operational deficits. They may thus be prone to the same financial pressures as industrial countries once the EDR rises.

The CPF approach essentially pre-funds certain large expenditure obligations before retirement (for housing, education, and, in some cases, medical care), as well as income needs during retirement, with commensurately higher national saving rates implied. High mandatory saving rates in the CPF schemes (in the mid-30 percent range up to a wage ceiling), coupled with investment strategies for the accumulated assets, provide for a lump-sum payment at retirement (where the eligible age ranges from 55 to 62). However, the income stream that can be realized by purchasing an annuity with this lump sum is not generous, ranging from 20 to 40 percent of average wages. Such systems entail the potential risk for households of using funds too soon after retirement.

Most Asian countries are still far from establishing a financially sustainable pension system that will provide a basic level of retirement income for the bulk of the elderly when the EDR rises. The three-pillar system remains the most viable approach for framing a strategy for retirement income. For most Asian countries, what will be critical is to ensure that the system is realistic in terms of the promises that can be financed. This underscores the importance of a first pillar to address the needs of the elderly destitute and a third pillar to promote individual and household savings. It also points to the importance of strengthening the functioning of the financial system both to absorb an increasing volume of household saving and to channel it effectively to high-quality investments and loans.

Pressures on Asian health costs

Across Asia, the aging of the population will progressively put added strains on health care systems. Already, with rising incomes and urbanization, these countries are experiencing a rise in such chronic diseases as cancers, diabetes, and cardiovascular diseases. The financial burden of treating and managing these illnesses will become heavier as the population age structure shifts and as globalization intensifies the demand for costly modern technologies and drugs.

Health care systems are particularly difficult to categorize. Some countries are heavily reliant on public systems (Hong Kong SAR, Indonesia, and Malaysia), with universal access to care in principle, but with the quality of effectively available services varying widely according to a household's income and place of residence. Even where care may be formally available in terms of public facilities, in some cases, the fact that most costs must be borne out of pocket effectively limits access. China's once-vaunted universal medical care system collapsed in the 1980s with the introduction of the market economy and, as with pensions, the cost, availability, and system of financing differ dramatically between and within urban and rural areas.

In some countries, the private sector may also be a key provider—this might reflect the inadequacies of the public health care system (India), or it might be an intrinsic element in the design of the medical care system (Thailand). In other cases, the private sector caters largely to a narrow segment of the population. Korea is currently debating the prospective role of the private sector in medical care.

Can Korea be used as a model?

In principle, Korea's largely PAYG pension and social health insurance system with universal coverage might appear the most responsive to the challenges of an aged population. Korea has even introduced a scheme for long-term care as of 2008. Yet like many industrial countries, its pension promises, in terms of replacement rate at the current age of eligibility for retirement, are too generous. Some estimates suggest that Korea's pension fund will be exhausted by 2041, forcing painful choices about higher contribution rates, lower benefits, or delayed retirement. Moreover, for many of Korea's working population, their lack of participation in the National Pension System, combined with the absence of any additional minimum benefits scheme for the poor, means that many elderly will fall into destitution in the absence of any family support.

For medical care, Korea's system does not overpromise the benefits generally available. The operative question is more whether it can respond to the intensified financial pressures that may arise as the population

ages. A higher proportion of elderly will give rise to demands for more care (in part because of the higher costs of dealing with chronic conditions), as will the pressures of demand for available productive and sophisticated medical technologies. Yielding to these demands will strain the finances of Korea's social health insurance system, increasing the burden on taxpayers and forcing higher contribution rates.

Mixed outlook

Overall, Asia's report card on its preparedness for an aging population is decidedly mixed. Most countries have pursued, and are pursuing, policies supportive of rapid income growth that will enlarge the size of the income pie available to finance higher living standards at the time the populations become increasingly aged. Most have also pursued a policy of fiscal consolidation, reducing public debts and providing flexibility for governments to absorb some of the potentially higher burdens of public spending in connection with an aging population. This also provides fiscal space to deal with the inevitable uncertainties as to the pace of aging and its prospective fiscal consequences. With the exception of China and perhaps Korea, most face only a limited level of implicit debt associated with existing social insurance obligations.

It is in the sphere of social insurance and welfare schemes that much effort is still needed to lay down a policy framework that can accommodate the challenges of an aging population. Since most of the social insurance systems that have emerged in Asia have not been designed with the anticipation of a relatively aged population, there is a need not only to extend coverage, over time, to existing social insurance systems but, more important, to ensure that the expanded systems are affordable. This argues for an emphasis on reforming the key policy provisions of existing systems, with affordability as a key concern.

Pension reforms should include a gradual deferral in the age of eligibility for retirement benefits, lower replacement rates, actuarial neutrality in linking benefit levels to the length of the prospective retirement period, a move to payout methods that provide for income rather than lump-sum payments, and restrictions on the use of funds before retirement. Some minimal social safety net scheme is needed to address the potential problem of the indigent elderly.

In the medical sphere, the challenge will be to facilitate provision and access to a basic level of care for all elderly at reasonable co-payment rates while avoiding the potential cost pressures and significant inequalities that can arise in a medical care system that lacks the regulatory or budgetary capacity to impose a global budget ceiling.

In closing, it is also worth remarking on two final strategic policy options for confronting an aging population. One option being adopted by some industrial countries is seeking a more pronatalist policy framework in their labor market policies, facilitating earnings replacement for mothers after childbirth, and subsequent child care arrangements. Singapore, Malaysia, and Korea are notable among the Asian countries for introducing some incentives to promote marriage and a larger family size.

Another option, in industrial countries, is to recognize that the fiscal sustainability of social insurance systems will require a longer working life commensurate with increased longevity. With the exception of Singapore, there is little evidence in Asia of policies to create incentives for a longer participation in the labor force. (Singapore is seeking to provide incentives to employers to hire the elderly, including policies to reduce wages for workers above age 60.) Indeed, in China, the overwhelming priority to address unemployment pressures has led to pressures for workers to retire early (with the retirement at age 55 for women and 60 for men). Asian countries cannot be faulted too seriously for this neglect since Western industrial countries themselves are only slowly removing the disincentives for working longer. But Asian countries should now be moving early to ensure that social insurance systems, the labor market policy framework, and the health care delivery system support incentives for workers who choose to work longer and for enterprises to take advantage of the skills of elderly workers. Increasing female labor force participation or encouraging immigration are additional policies to be encouraged.

Peter Heller is Deputy Director of the IMF's Fiscal Affairs Department.