CONSEIL D'ORIENTATION DES RETRAITES
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Pay-as-you-go system, reserves and capitalisation: what are the challenges for pensions?

Brief

Prepared by the Council's General Secretariat, under the direction of the President of the COR

Rationale: In principle, a pay-as-you-go pension scheme is not designed to accumulate reserves: contributions from working people finance the pensions of retirees each year. However, in the face of certain demographic or economic uncertainties, several schemes have chosen to build up reserves in order to smooth out the necessary adjustments to the pension system over time. As at 31 December 2024, assets recognised as representing reserves built up within pay-as-you-go pension schemes amounted to €213.8 billion (market value), or 7.3% of GDP. The file analyses the calibration of these reserves and the management strategies operated by the schemes. It also examines the advisability of moving the French pension system towards an increased share of capitalisation.

1. Overview and calibration of pension system reserves

- ***Why do some pension schemes build up reserves?*** The decision to build up reserves in a pay-as-you-go pension scheme is primarily a response to the need to guarantee pension payments in the face of various uncertainties. For example, the timing of contributions from active workers and pension payments does not always coincide. This can result in temporary cash flow imbalances, which can be offset by building up reserves. Reserves also make it possible to cover financing needs linked to unfavourable economic conditions or unexpected retirement behaviour. In this regard, several schemes drew on their reserves during the health crisis, revealing their stabilising role in the face of economic shocks (**document no. 4**). In the longer term, the pay-as-you-go pension system is closely dependent on demographics, whose developments partly determine its financial equilibrium. Building up reserves during favourable periods makes it possible to smooth out the need for future adjustments to contributions or pensions (**document no. 2**).
- ***What is the optimal level of reserves?*** In absolute terms, borrowing can also be used to meet financing needs, but it does not have the same consequences in terms of intergenerational equity: reserves are financed immediately by the generations contributing to them, while debt shifts part of the financing to future generations. The constitution of reserves must therefore obey a principle of fair measure: sufficient to provide the capacity to absorb shocks and guarantee the financial sustainability of the system, but limited so as not to place an excessive burden on current generations. This is why consideration of the constitution of reserves is inseparable from an analysis in terms of intergenerational equity. Simulations carried out by the technical department of Agirc-Arrco illustrate the high sensitivity of the scheme's reserves to the main management parameters (**document no. 3**).
- ***Do all schemes have reserves?*** There are significant disparities between pension schemes: some schemes have financial reserves enabling them to guarantee, at least in part, the payment of pensions in the future. However, the main basic schemes, such as those for private sector employees and agricultural workers, as well as the integrated scheme (basic and supplementary) for local government employees, do not have reserves and yet face the same difficulties as schemes that do (**document no. 5**).

2. Should the pension system move towards greater capitalisation?

- ***Pay-as-you-go vs. capitalisation: what are the differences in returns?*** Pay-as-you-go offers an average return equal to economic growth, while capitalisation depends on financial market returns, which cannot be summarised by the average returns on certain financial assets. Indeed, no pension fund or saver invests solely in equities: diversification is essential to control risk. Upon retirement, capital must be converted into pension income, requiring liquid and low-volatility assets. Stock market indices therefore do not reflect the actual trade-offs or constraints of funded schemes. Furthermore, even if the return on capital often exceeds long-term growth, the insured remains exposed to market fluctuations, intermediation costs and the risk of heavy losses in the event of a crisis (**documents no. 7 and 8**).

- ***Are the two financing systems exposed to the same risks?*** Pay-as-you-go schemes are sensitive to demographic, economic and political shocks, while funded schemes are vulnerable to financial volatility and the potential decline in capital returns linked to population ageing. In terms of ***financial sustainability***, pay-as-you-go schemes must constantly balance contributions and pensions, while funded schemes rely on the system's ability to accumulate sufficient assets to cover its future commitments (**document no. 6**).
- ***How do the issues of fairness and solidarity differ?*** Pay-as-you-go schemes are based on intergenerational solidarity, unlike funded schemes, which naturally do not rely on such a principle. From an intragenerational perspective, pay-as-you-go schemes allow for numerous redistributions between population groups. In funded schemes, redistributive mechanisms can be incorporated when they are collective.
- And ***what are their impacts on the economy?*** Capitalisation can contribute to the financing of the productive economy by directing savings towards long-term investments, even if this objective may conflict with the pursuit of financial performance. Pay-as-you-go system, by immediately mobilising contributions to pay pensions, leaves less room for financial savings.
- ***And what are the challenges in terms of social acceptability?*** In both cases, social acceptability depends on the system's ability to guarantee a sustainable level of contributions for the working population and a satisfactory standard of living for pensioners (**document no. 6**).
- ***What would be the difficulties of transitioning to a funded system?*** Replacing a pay-as-you-go system with a funded system, even partially, is complex to envisage and involves either one or both of the following: 1/ double contributions for workers in order to guarantee the financing of pensions currently paid under the pay-as-you-go system while providing for the acquisition of new rights under the funded system; 2/ a contribution from current pensioners, for example by permanently under-indexing pensions, which also presents recessionary risks for the economy; 3/ coverage by the State, which represents an additional burden on public finances (**documents no. 6 and 9**).