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The Economist

A special report on pensions

Falling short

People in rich countries are living longer. Without big reforms they will not be able to retire in comfort, says Philip Coggan

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WHEN GERTRUDE JANEWAY died in 2003, she was still getting a monthly cheque for $70 from the Veterans Administration—for a military pension earned by her late husband, John, on the Union side of the American civil war that ended in 1865. The pair had married in 1927, when he was 81 and she was 18. The amount may have been modest but the entitlement spanned three centuries, illustrating just how long pension commitments can last.

A pension promise can be easy to make but expensive to keep. The employers who promised higher pensions in the past knew they would not be in their posts when the bill became due. That made it tempting for them to offer higher pensions rather than better pay. Over the past 15 years the economics of the deal have become clear, initially in the private sector, where pensions (and health-care costs after retirement) were central to the bankruptcy of General Motors and many other firms.

There are big national differences, but in most developed countries the bulk of retirement income (around 60%, according to the OECD) comes from the state. Most countries offer some kind of basic safety net for those who have no other income. In addition to this, they may have a social-insurance scheme to which workers and employers contribute. Despite the insurance label, these are essentially pay-as-you-go (PAYG) systems in which benefits are paid out of current taxes.

In some countries workers also have pension rights that are linked to their employment, whether it is in the public or the private sector. Such schemes can be funded (as in America, Britain and the Netherlands) or unfunded (as in much of Europe). In some cases the state has required such schemes to cover all employees. Australia, for instance, has turned itself into the world's fourth-

largest market for fund management by setting up a compulsory national pension scheme for its 22m people. On top of that, people accumulate savings (sometimes called pensions and sometimes not) that they expect to draw on during their declining years.

The four challenges

Pension provision is higgledy-piggledy and often complex, but most rich countries are having to deal with four main underlying problems. This special report will analyse these in detail and suggest ways of tackling them. The first is that people are living longer, but they are retiring earlier than they were 40 years ago. A higher proportion of their lives is thus spent in retirement. Second, the large generation of baby-boomers (in America, those born between 1946 and 1964) is now retiring. But the following generations are smaller, leaving the children of the boomers with a huge cost burden.

Third, some employees have been promised pensions linked to their salaries, known as defined-benefit (DB) schemes. In the 1980s and 1990s the true cost of these promises was hidden by a long bull market in equities. But the past dismal decade for stockmarkets depleted those funds and left employers on the hook for the shortfall. Private-sector employers have largely stopped making such promises to new employees; the public sector is beginning to face the same issues, particularly in Britain and America.

Fourth, private-sector employers are now providing pensions in which the payouts are linked to the investment performance of the funds concerned. These defined-contribution (DC) schemes transfer nearly all the risk to the employees. In theory, they can provide an adequate retirement income as long as enough money is paid in, but employees and employers are contributing too little. Both sorts of funded schemes, DB and DC, essentially face the same problem. "The aggregate amount of pension savings is inadequate," says Roger Urwin of Towers Watson, a consultancy.

Estimating the cost of pension provision has proved enormously difficult. People have consistently lived longer than the actuaries have expected. In 1956 a 60-year-old woman retiring from a job in Britain's National Health Service had a life expectancy of just under 20 years; by 2010 she could expect to live for another 32 years.

Key terms

Support ratio: The number of people of working age compared with the number of people beyond retirement age.

Participation rate: The proportion of the population that is in the labour force.

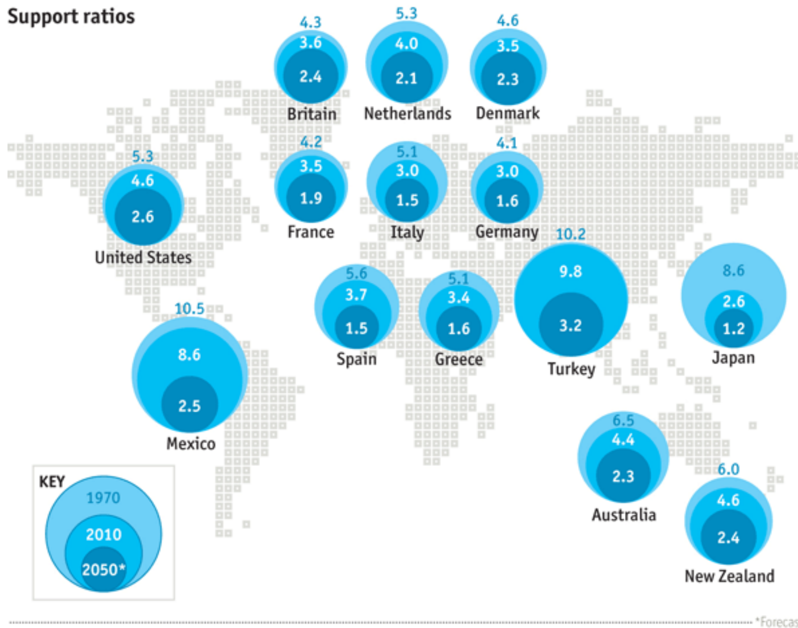
Defined benefit: A pension linked to the employee's salary where the risk falls on the employer.

Defined Contribution: A pension dependent on the amount contributed, and the investment performance, where the risk falls mainly on the employee

Paying a pension for longer is much more expensive, particularly if the payout is linked to inflation. *The Economist* asked MetLife, an insurance company, to calculate what a couple in America would have to spend on an annuity paying out the maximum level of Social Security benefit (the state pension) at age 66: $4,692 a month now and rising in line with inflation. The answer is almost $1.2m.

Politicians tend to underestimate the cost of financing PAYG systems. It is tempting to look simply at the ratio of cash benefits to contributions, rather than allowing for the value of the promises being made to future pensioners. But even on a cash basis, pension finances are deteriorating. In 2010 America's Social Security system ran a cash deficit for the first time since 1983 as more money was paid out in benefits than was collected in contributions. This happened about six years earlier than expected, thanks to unusually high unemployment.

The immediate cash cost is only part of the problem; the longer-term calculation also involves the value of future pension promises. In bearing that burden, the key figure is the ratio of workers to pensioners, known as the support (or dependency) ratio. This is deteriorating steadily in all rich countries (see chart). As a result, the tax burden is set to rise, at a time when many countries are still struggling to cope with the fiscal deficits left over from the financial crisis.



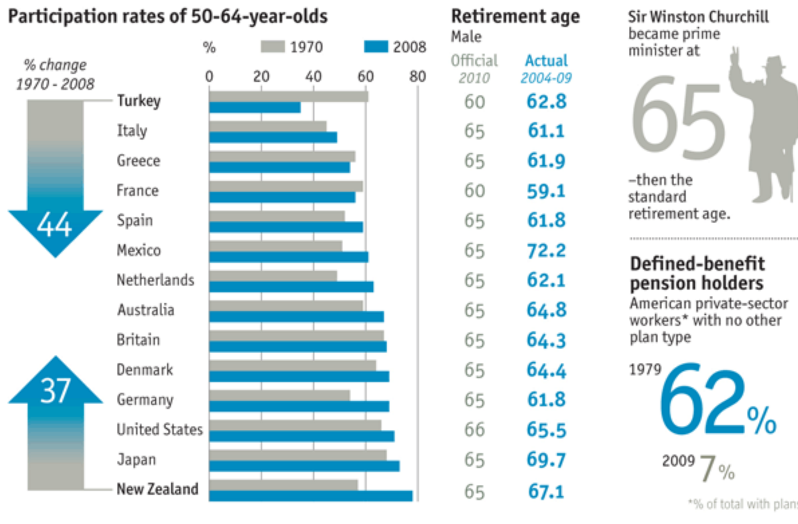
Pensions paid through a funded scheme do not necessarily work better. Many American states and cities have been underfunding the pension schemes for their employees for years, gambling on the stockmarkets to bail them out. That gamble has failed, and now taxpayers are expected to come to the rescue. Either taxes must rise or benefits must be cut.

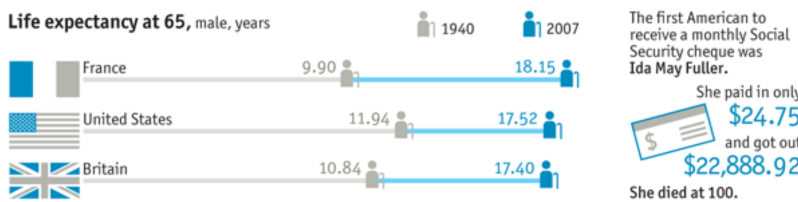
A cut by another name

The most obvious "cut" is for people to work longer so that pensions are paid over a smaller proportion of their lifetime. In many countries reform attempts have accordingly concentrated on raising the minimum retirement age or increasing the number of years for which an employee has to contribute before qualifying for full benefits. In France a move to raise the minimum retirement age to 62 was accompanied by a phased increase in the minimum level of contributions from 40.5 to 41.5 years, a change that was duly attacked by left-wing commentators as being unfair to unemployed workers, part-timers and students entering the job market late. Italy has gone one stage further: from 2015 on, future changes in the retirement age will be indexed to the rise in life expectancy.

Sweden, Germany and Japan already have an automatic balancing system to deal with deteriorating pension finances, largely by making the inflation-linking of benefits less generous.

The Netherlands, which has the best-funded (and widely admired) DB pension system in the world, also limits inflation-linking, but delivers pensions that are very close to average earnings. Research by Towers Watson shows that it has a higher ratio of pension assets to GDP than any other country—and it benefits from economies of scale, with pension provision dominated by the giant ABP and PGGM funds. However, contributions are high and the rules on solvency are extremely strict, requiring liabilities to be more than 100% funded.





Pension promises involve a transfer from one generation to another, even when one of those generations is too young to vote. That is true even when schemes are funded, and the money invested in equities and bonds; future workers will have to generate the income needed to pay the dividends on those shares and the interest on that debt.

That is turning pensions into a battleground, pitting young against old and taxpayers against pensioners. The fiscal crisis has exacerbated the fight. Pension promises made by the government (either to all citizens or to public-sector workers) do not show up in the debt-to-GDP ratios that are used to analyse state finances. Adding them in makes the position look even more alarming. On conservative accounting assumptions, the combined pension deficits of the American states are equal to a quarter of the gross federal debt.

The problem is particularly acute at the level of America's states because so many of them have balanced-budget amendments. When pension shortfalls require higher contributions, the money must be found from somewhere: higher taxes, less spending on other services or higher contributions from workers (amounting to a pay cut). A further difficulty is that pension rights have been deemed to be legally (and in some cases constitutionally) protected—though some Republican governors have tried to cut unions' bargaining rights.

Private-sector workers may be aggrieved at having to fund the generous pensions of their public-sector counterparts through their taxes. But unions are strongest in the public sector and will fight hard. Nobody seriously disputes that employees should keep the pension rights they have accrued so far, although they may receive the benefits later; the

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as the support ratio. This is deteriorating steadily in all rich countries

battle is over whether employees should be allowed to keep accruing the same perks in the future.

Britain's coalition government is desperately trying to cut its deficit, so a rise in pension costs is particularly inopportune; as it is, the gap between public-sector pension benefits paid and contributions received is expected to widen from £4 billion in 2010-11 to £10.3 billion by 2015-16. A recent government-commissioned report into the cost of public-sector schemes by Lord Hutton, a former Labour minister, proposed a number of changes, including a later retirement age, higher employee contributions and a pension based on the employee's career-average, rather than final, salary.

Since pensions are a form of deferred pay, workers view such reforms as a pay cut, albeit to pension rights they have not yet accrued. There is room for debate about whether such cuts are fair. But in some countries the raid on pensioners' assets has been rather more brazen. Hungary, for instance, set up a mandatory pension system in 1998 to supplement the state scheme, with contributions deducted from wages and invested in a private fund. By 2010 the fund had amassed nearly $14 billion of assets, but the cash-strapped government has in effect nationalised it by imposing stiff financial penalties on workers who want to remain in the private sector. Argentina, for its part, seized private-sector pension assets in 2008.

The most siblings to reach pension age, 7 sons and 12 daughters born to Eugene and Alice Theriault in Canada between **1920** and **1941**. They were all claiming a government pension in **2007**, with their ages ranging from **66** to **87**.

If all the burden is not to fall on the state, workers need to save more during their lifetimes. That may require a change in attitude. The old system was distinctly paternalist: either the employer or the government would provide. In America and Britain the switch from DB to DC schemes in the private sector has left the responsibility with the individual worker, but employees have yet to rise to the challenge. They are not putting enough money in, and inevitably will not get enough out. British pensioners with DC plans have accumulated an average pension pot of only £27,000, according to Aviva, an insurance company—enough to buy a pension of just £2,000 a year, with no inflation protection. That will not go far to supplement Britain's meagre state pension.

Whether or not people can expect a comfortable retirement depends on the replacement ratio—the proportion of their lifetime average earnings that their pension will pay out. This does not have to be close to 100% because generally pensioners need less to live on than full-time workers. They avoid the expenses associated with work and dependent children, have mostly paid off the mortgage on their house and no longer need to save for their retirement.

But the ratio often falls short of expectations. The OECD reckons that the average worker in its member countries currently gets a state pension of around 42% of his average earnings. If state benefits are cut, more of the burden will fall on private provision. A recent survey by Aviva suggested that European workers are hoping for a replacement ratio in the region of 70% but are likely to get only 35-55%, depending on the country.

The replacement ratio needs to be higher than average for the least well paid, who spend proportionately more on essentials such as food, fuel and shelter. The OECD reckons that the net replacement ratio (allowing for the effect of taxes) for the poorest workers, on half mean earnings, averages just under 83%, but there are big national differences; in Denmark, Greece and the Netherlands it is more than 100%, but in Germany, Mexico and Japan it is under 60%.

In 2009 California fire chief Pete Nowicki retired on a pension of **$241,000** a year, an improvement on his final salary of **$186,000**. He then returned to work for the department, earning a consultancy fee of **$176,000**.

So despite the need for cutting costs, governments need to ensure that their elderly citizens have enough money to maintain a decent standard of living. In the majority of countries poverty rates among the elderly are higher than those in the general

population. Women are in a worse position than men: they live longer, typically earn less and spend a shorter time in the workforce. If they are married, their pension entitlements often depend on their husbands' earnings.

Japan, which started greying earlier than other developed economies, can be viewed as an ominous precedent. Its only advantage in the pensions battle has been that its workers tend to retire later than those in other countries—around a decade after those in France. Nevertheless, the ageing of its population over the past 20 years has been accompanied by deflationary pressures, sluggish economic growth and moribund asset markets. Public spending on pensions has risen by more than 80%. In the corporate sector lax accounting standards disguised the true cost of providing pensions. When the standards were changed, the true horror was revealed: in 2003 the average plan was just 42% funded, so the government had to take over the liabilities of many companies. Even after this rescue, Japan Airlines had to slash pensions by 30% as part of a restructuring plan—a huge blow to pensioners' standard of living.

Where Japan has led, other ageing economies may follow. This special report will focus on rich countries, where most of the problems arise. The details may differ but the impact of the baby-boomers shows up everywhere; their pensions will be a huge burden on coming generations.

Infographic sources: J.P. Morgan; Guinness World Records; Human Mortality Database; OECD; US Social Security Administration; Towers Watson; *Wall Street Journal*

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