DEFUSING A PENSIONS TIMEBOMB

MATTHEW YOUNG THINKS THE OUTLOOK FOR PENSIONS IN EUROPE IS BLEAK WITHOUT IMMEDIATE ACTION, AND EXAMINES WHAT THE PROBLEMS ARE AND WHAT STEPS MAY BE NECESSARY TO OVERCOME THEM.

The Adam Smith Institute – a leading economic policy think tank – is a long-term contributor to the debate on pensions reform, maintaining close links with a range of specialist and senior researchers and policymakers in the financial services, industry, government and academe in the UK, Europe and the US. The notes below synthesize some of the important recent work touching the European pensions time bomb to provide a summary of the problem – its character, impact and importance – and the emerging direction for reform.

WHAT'S THE PROBLEM? Many of the major hazards facing the world right now – global warming, sustainable energy supplies, the War on Terror, AIDS and so on – are recognised although perhaps not well understood. The ageing of the developed world's population barely figures in media debate and yet its near-future economic impact may be the most far-reaching because it has the potential to bankrupt countries and impoverish citizens. This is a slow-moving catastrophe but we can already predict its damage. The working age population of Europe is set to decline by about 25% over the next 30 years. Without compensating gains in productivity we will spend much of the time after 2010 in recession, challenged by rising pensions and health program costs.

The central problem is that in Europe most public pensions programs are financed on a pay-as-you-go basis, where today's workers pay taxes to support today's retirees. This kind of social security system was created at a time when a large and growing labour force supported a small number of pensioners. Those pensioners were unable to fund their retirement, but they were also unlikely to survive for more than two years, hence the prominent role of the state as insurer for the unlikely catastrophe of a long retirement.

But the demographics of the world have changed dramatically. People have fewer children, working for shorter periods and living longer. The pinch point is the support ratio (the quotient of the number of people between ages 15 and 64 divided by those 65 and older). This quotient has fallen from seven in 1950 to a little more than three today. By 2025 it will be around two. If 60% of those aged between 15-65 are economically inactive working at that time (because of involuntary early retirement, unemployment or retraining) the ratio of workers to retirees will be alarmingly close to 1.1.

For Europe the pensions crisis will impose it's maximum strain somewhere between 2010 and 2025, when the largest European age group will be those who are retired or about to retire. With life expectancy at that point comfortably into the 80's and continuing to head north, we will be funding an average retirement period of 20-30 years and carrying with it truly staggering health care spending.

WHO IS WORST HIT? Taken together the forecast spending on state pensions and health benefits for the elderly in most European countries will see an increased tax take of 10% of GDP effectively crowding-out large slices of government spending programs.

A pay-as-you-go system for pensions would be inconceivable in such a situation since the payroll taxes would be enormous and the implied labour costs would mean fewer jobs. Of course this impending crisis is no secret, but few politicians dare to address its consequences. Illustratively the sort of tax increases required will be 18% for Austria, 15% for Spain, 11% for Italy, 10% for Germany and 8% for France. The UK will need less than 3%.

What these figures highlight is the differing degrees of reliance on paygo systems in the European countries. For example, in Germany 85% of pensions are provided by the pay-as-you-go system, in Britain it is about 60%, but in the Netherlands it is only 50%. In turn about 5% of German pensions are funded by occupational schemes, while in Britain about 25% are and in the Netherlands occupational schemes make up 40% of pensions. In each of these countries, individual provisions procure roughly 10% of pensions.

Those countries with the strongest reliance on paygo – Germany, France, Italy, Belgium – and with the most bloated benefits and healthcare systems, will be hardest hit by the looming demographic crisis.

WHAT ARE THE OPTIONS? When pension payments are found to be unaffordable, the options for action are limited: benefits must be cut, taxes or borrowings must be increased, or there must be stunning gains in productivity. Let's test these for realism.

- **Benefit cuts –** a reduction in paygo benefits means lowering the absolute level of pensions or increasing retirement age and any such reduction will be hard to deliver, especially where a large proportion of the voters is retired.
- **Tax increases –** the level of tax increases required to pay current benefit promises if applied to payrolls would be unthinkable – politically and economically.
- **Borrowing –** by 2020, if government borrowing were to finance rising pension and health benefit costs it would consume almost the total savings of the developed world, leaving nothing for private investment. Long before then global financial markets would act to bring the experiment to an unpleasant halt.
- **Productivity –** the problem here is that benefits are correlated with wages, which in turn are correlated with productivity. That is to say, as productivity goes up, benefits will also increase in these countries. Second, GDP growth is a function of the growth in workers and technical innovation. Forecasts already tell us that a continuing reduction in the numbers of workers will occur and the necessary offset by immigration to maintain support ratios would also be so large as to be politically unacceptable.

Where will it all end? The goal is to ensure over time that successive generations pay roughly the same in tax as we do – the generational balance. Kotlikoff and Ferguson examined this specifically in the eurozone and in the context of social security and pensions. Their conclusion was that the tax hikes or government spending cuts required to fund these commitments would be unprecedented in peacetime (at 10% and more) and they would have a centrifugal effect on the euro. One or more countries will exit and this will lead very probably to the collapse of the euro within the decade. Curiously the foreign exchange markets seem not to have factored-in this eventuality.

WHAT MUST BE DONE? As the American humorist and economist Herb Stein said: "If something is unsustainable, it tends to stop." What we have to do is find a counterweight to the demographic shift and to recognise that inaction can have even more dramatic consequences than taking the risks involved in change and reform.

For the UK the position is under control, although by common consent the state pension is inadequate. The impenetrable complexities of the government's combination of Stakeholder, State second pension and the Minimum Income Guarantee are the attempt to address that. Most of continental Europe however remains saddled with promises it cannot keep and the ECB meantime has urged governments to reduce commitments before they wreck public finances or cause tax raising or borrowing at levels that will cripple economic progress.

Europe has a window of opportunity to make the necessary reforms and the sooner started the easier it will be. The options for reform will include a mix of the following:

- **Working Longer –** it needs to be made easier for older people to remain employed. Retirement should be flexible and graduated and the financial disincentive of withdrawing pension entitlement should be abolished. The maximum state pension provision should be targeted to those probably aged 70 and over.
- **Encourage self-provision –** a reduced state pension risks swapping one problem for another – pensioner poverty. What is needed is a set of incentives to encourage private saving. Tax relief fails to target those on low to middle incomes but pound-for-pound matching to a pre-set level looks convincing.
- **Towards a fully funded system –** a political consensus may emerge that will allow a very gradual transition over a long period of time. The starting point will be funded supplement as a partial substitute for a minor portion of pay-as-you-go system. There will be of course a period of double funding – the old and the new systems – achieved by government borrowing and spread over several generations.

Among countries leading pension reform a clear three-step structure has emerged:

- a mandatory, publicly-managed , tax-financed first step for poverty prevention (a re-distributive defined benefit);
- a mandatory privately-managed second step (personal accounts, defined contribution); and
- an optional privately-managed step for people who want more protection for old age.

The second step is the newest and most controversial aspect of reform, adopted by Britain and more than 20 countries including the Netherlands, Switzerland and Sweden and others as far afield as Australia, Hong Kong and Chile.

This is likely to increase substantially as the movement toward reform spread throughout Eastern and Central Europe and the former Soviet Union over the next few years.

Why Mandatory? To address the risks of myopia and moral hazard, whereby people who don't save enough for their old age on a voluntary basis become a burden on society when they grow old.

Why fully funded? To make the costs and ownership clear up front so that governments will not be tempted to make promises today that they will be unable to keep tomorrow.

Why Privately Managed? To ensure the best allocation of capital and the highest return on savings.

A MORE IMMEDIATE PROBLEM? This year's fall in equity prices and the resulting defined benefit pensions scheme deficits highlighted by the FRS 17 accounting measure, present a profound danger for companies and shareholders. The cost of defined benefit (DB) schemes remains high, even where these schemes are closed. The essence of the problem is the heavy exposure to equities and the requirement for many companies to make substantial top ups, meanwhile dumping equities in favour of bonds.

As Graham Bishop at Schroder Salomon Smith Barney has pointed out in a recent paper, this will erode profits and threaten dividends, lead to redundancies (to protect a the pensions of the people dismissed) and for some companies threaten their survival. Low interest rates create a double whammy here because that is what is driving down gilts yields, thus further increasing DB deficits. Companies with a 31 December 2002 year end will need to see a 25% market rise by then or they will be reporting serious deficits in March 2003.

Meantime, this slow motion crisis threatens to continue to take it's toll on equities with every recovery hit by sellers probably through to and beyond the next election.

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